EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS, AND JOB CREATION

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

JANUARY 18, 2012

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WEDNESDAY, JANUARY 18, 2012

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS, AND JOB CREATION

Wednesday, January 18, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT, AND
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to notice, at 9:33 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the Subcommittee on Financial Institutions and Consumer Credit] presiding.

Members present from the Subcommittee on Financial Institutions and Consumer Credit: Representatives Capito, Renacci, Royce, Manzullo, McHenry, Pearce, Westmoreland, Luetkemeyer, Huizenga, Duffy, Canseco, Fincher; Maloney, Gutierrez, Watt, Hinojosa, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, and Carney.

Members present from the Subcommittee on Capital Markets and Government Sponsored Enterprises: Representatives Garrett, Schweikert, Royce, Manzullo, Biggert, Neugebauer, Pearce, Posey, Hayworth, Hurt, Dold, Grimm, Stivers; Maloney, Waters, Sherman, Hinojosa, Lynch, Miller of North Carolina, Green, Ellison, Perlmutter, Donnelly, Carson, Himes, and Peters.

Ex officio present: Representatives Bachus and Frank.

Chairwoman CAPITO. This hearing will come to order.

I would like to welcome everybody back from the Christmas and New Year's holiday. We want to start with a good hearing, and I think that's what we have in front of us today.

I would like to thank both panels of witnesses for coming this morning. The participation in this morning's hearing will help our members of the Capital Markets and the Financial Institutions Subcommittees better understand the complexities and the far-reaching nature of the proposed Volcker Rule.

Members and our witnesses should note that the first panel will be excused at noon; and, as we do expect Floor votes around 1 p.m., we will see what happens from there. Given the size of the second panel, we will likely recess and then come back at the call of the Chair.

Today's hearing will examine implementation of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the Volcker Rule, after former Federal Reserve Chairman Paul Volcker. This rule will prohibit U.S. bank holding companies and their affiliates from engaging in proprietary trading. We are going to learn a lot about the definitional boundaries of proprietary trading today.

Proponents of Section 619 have made assertions that proprietary trading, the practice of banks buying and holding securities for their own accounts, was a key contributor to the financial crisis. On the contrary, Chairman Volcker himself has admitted that proprietary trading in commercial banks "was not central to the crisis." I think this raises questions about the size and scope of the problems that Section 619 is seeking to resolve.

The Federal financial regulators have been tasked with writing rules to carry out the objectives of Section 619. The result of their efforts is a proposed rule that is nearly 300 pages long and asks more than 1,300 questions for comment from market participants. This has led to significant confusion—I will put myself in that vote—and many unanswered questions over the consequences of implementing Section 619.

This morning's hearing will give members of the Capital Markets and Financial Institutions Subcommittees the opportunity to better understand the decision-making process of the Federal agencies. Our second panel of witnesses will testify to the potential effects the proposed rules will have not only on financial institutions but also institutional investors, pension funds, shareholders, and the American public in general.

I would like to really thank our witnesses for joining us here today. This is a very serious issue, and the participation of the principals from the financial regulators is greatly appreciated by this chairman and the entire committee.

At this point, I would like to yield to the ranking member of the Financial Institutions Subcommittee, Mrs. Maloney from New York, for the purpose of making an opening statement.

Mrs. MALONEY. I want to thank the chairwoman for calling this very important hearing, and to welcome all of our distinguished guests, particularly two who were former residents of the great City of New York: Mary Schapiro and Gary Gensler. We look forward to your testimony.

We are here today because of the financial crisis and recession which cost American families over $17 trillion in household wealth and business wealth, and over 5.5 million jobs. We are still recovering from this crisis, and a very important part of that recovery and the Dodd-Frank reform legislation was the Volcker Rule which we are discussing today, which some believe is the most important part of Dodd-Frank in terms of preventing another crisis. And I might add that as recently as September, building on the crisis we already had, the Swiss bank UBS lost $2.3 billion, thanks to a rogue unregulated trader; and MF Global, although not a depository institution, still cannot find over $1.3 billion. So, we clearly have a challenge.

This past crisis, like most, was caused primarily by unregulated areas of the market through loan defaults, unconventional banking

activities such as mortgages, loans, and commercial real estate, which led to no market liquidity, no capital, and dried-up credit markets. The risky proprietary trading activities of some financial institutions, including some of the largest broker-dealers—Bear Stearns, Merrill Lynch, and Lehman Brothers—contributed to these conditions. Other losses at financial institutions would have brought them to bankruptcy had there not been extraordinary government intervention taken.

Chairman Volcker proposed a ban on proprietary trading because he believed financial firms should be serving their clients, rather than taking risky bets for their own book of business, which in some cases would have put depositors at risk. Bonuses were tied to excessive risk-taking, unlike the Volcker Rule. Now, bonuses are rightly tied to fees and bid-ask spreads. The regulators have taken his simple, clear goal and made it overly complex, in my opinion, with over 298 pages of rules that are accompanied by over 1,000 questions.

I agree with the testimony last month by Sheila Bair—the former Chairman of the FDIC—before the Senate Banking Committee, where she stressed that the rule is too complex, particularly in seeing the bright line between proprietary trading and market making. Some financial institutions have already ended proprietary trading and have literally set up separate financial institutions for this purpose.

Chairman Volcker has said that recognizing proprietary trading activity should be simple: You know it when you see it. But I do not see how you can see it unless you have access to the data.

I am hearing some concerns from some of my constituents that the burden of providing this data is overwhelming. I would like to know from the panelists today to what extent the new compliance requirements are different from what financial institutions have had to provide in the past, and how are they different or are they the same as what the new Office of Financial Research will be collecting.

While there were many causes that helped create the financial crisis, an inability of regulators and interested parties to see financial transactions was certainly one of them. Regulation did not cause the financial crisis, but we are discussing today ways to prevent another one in the future, and the Volcker Rule is an important part of that discussion and an important part of that prevention. It is important that we get it right.

I look forward to your testimony today, and to seeing your final rule.

Thank you.

Chairwoman CAPITO. Thank you.

I would like to recognized the chairman of the full Financial Services Committee, Chairman Bachus, for 3 minutes.

Chairman BACHUS. Thank you, Chairwoman Capito, for holding this hearing, along with Chairman Garrett.

To the regulators, I know that what you are doing is trying to carry out Section 619. That is what the Congress asked you to do, to prohibit proprietary trading, and I think that was a mistake. I think Section 619 was a mistake, and I think that is where the problem lies, that our request to you was a mistake.

None of us want to go through what we did in 2008 and 2009; we want to avoid the mistakes of 2008 and 2009. But proprietary trading was not one of those mistakes. Secretary Geithner has said that it did not cause the financial crisis. I am not sure that it contributed to the financial crisis. There were companies engaged in proprietary trading that did other dangerous activities, undercapitalized, overleveraged, and we certainly want to avoid that. And with Basel 3, I think the entire global community is going towards greater capital standards and we are addressing liquidity—leverage. You are addressing that.

But what we are hearing from not only companies but consumers is that this rule will threaten the United States and its financial markets, its capital markets. They are the deepest and the most liquid in the world. And proprietary trading actually contributes to that liquidity. It contributes to that availability of capital. If we had not had liquid assets during the financial crisis, many of the loans to companies that otherwise would have failed would not have been made.

These rules, I will admit are a responsible request from this Congress, from Dodd-Frank, but Section 619, in my opinion, will be a self-inflicted wound on this country, its economy, and its financial markets, because a country will not have a strong economy if its financial markets are not stable. They have to be safe, but they also have to be liquid. There has to be capital for investment. I believe this will restrict capital, I believe it will drive up the cost of loans, and I believe it will make our financial markets and, thus, our economy and our country less safe.

So thank you—and let me end by saying that it will also cost jobs. I think that is becoming evident to all of us. It will cost hundreds of thousands of jobs.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I would like to recognize the ranking member of the Capital Markets Subcommittee, Ms. Waters from California, for 3 minutes.

Ms. WATERS. Thank you very much, Chairwoman Capito and Chairman Garrett, for holding this joint hearing on the Volcker Rule.

Three years ago, this country experienced the worst financial crisis since the Great Depression; and families continue to struggle with the resultant unemployment, foreclosures, and loss of equity in their homes. And while observers will disagree about the central cause of the crisis, I think there is wide agreement that a number of factors played a role in what we experienced in 2008.

One of these factors certainly was proprietary trading or when banks make speculative investments in financial instruments from their own accounts rather than on behalf of the clients. This type of trading, while profitable during good times, proved to be tremendously harmful when bets on real estate and other assets started to soar. The GAO reports that in the 5 quarters during the financial crisis, the 6 largest U.S. holding companies lost a combined $15.8 billion from stand-alone proprietary trading desks.

The Dodd-Frank Act, under the provision commonly known as the Volcker Rule, attempts to grapple with this particular cause of the financial crisis not by prohibiting proprietary trading alto-

gether, but by stating that banks which have access to the Federal safety net cannot use that advantage to make speculative bets in the market.

The Volcker Rule likewise prohibits commercial banks from investing in hedge funds and private equity funds with certain small exemptions. The rationale behind this provision is that, while there is a justification for government support for commercial banks whose presence ensures a stable and continued flow of credit to small businesses and individuals, there is no public policy rationale for taxpayer subsidies for banks trading.

However, even with clear prohibitions under the Volcker Rule, Congress recognized that commercial banks should still be able to serve clients through underwriting and market making or acting as an intermediary between buyers and sellers in a securities market and gave regulators significant flexibility to implement this provision. So I think the approach that Congress adopted under the Volcker provision was very measured and attempted to surgically excise only those elements of trading that posed the greatest risk.

As one of our witnesses will testify to today, of course, the devil is in the details; and I am curious to hear from the witnesses here today on how they think this rule is being implemented by the interagency group of regulators on the first panel. In particular, I want to make sure that market making is not impeded and that the rule is not bogged down in complexity that will hinder compliance.

So as I have said during on previous hearings on the implementation of Wall Street reform, I hope that the regulators are being responsive to legitimate industry concerns while they also uphold the intent of what we did in Dodd-Frank.

I look forward to the witnesses' testimony today, and I yield back the balance of my time.

Chairwoman CAPITO. Thank you.

I recognize Mr. Royce for 2 minutes.

Mr. ROYCE. Thank you, Madam Chairwoman.

On the topic of international cooperation, 2 years ago we had the Deputy Treasury Secretary Wolin say we are working closely with our G-20 partners to make sure that we get a regime that works worldwide so that we don't have new opportunities for arbitrage. That was the view then.

Then, about 6 months ago, Michel Barnier, the European Union's top financial regulator, came back and said that European regulators won't seek a measure similar to Volcker. "We don't have the same approach," is what he said.

So what has become clear in the months since passage is that neither Asia nor Europe are on board, and we are nowhere near a regime that works worldwide. And, instead, we go along with the hope that this approach will protect our markets here from another crisis.

Unfortunately, better protecting our capital markets doesn't come from micromanaging financial institutions. It comes from ensuring that no institution is too-big-to-fail, and enforcing higher capital requirements and liquidity standards. So if Volcker is going to be a priority for the Administration, it needs to be clear and concise,

something that Paul Volcker noted, and there needs to be international buy-in.

And unfortunately, the proposed rule is anything but clear or concise. Ironically, we seem to get intra-national coordination. Among the five regulators responsible for this, we can't seem to get them on board, let alone the implementation of the larger international cooperation we are seeking here. We have a problem internally getting concurrence on this.

So until our capital markets operate effectively and allow for failure, the best policy response is to make the rules so simple that everyone can understand and enforce them, thus preventing carveouts and special favors. Volcker takes us in the opposite direction here.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Scott is recognized for 2 minutes for the purpose of an opening statement.

Mr. SCOTT. Thank you very much, Chairwoman Capito.

This is indeed an important hearing, examining the impact of the Volcker Rule on markets, businesses, investors, and job creation.

In October, our Federal regulators issued a joint proposal on implementation of the rule, and it totaled 300 pages, over 1,300 questions, and 400 topics. Originally, the comment period established by Federal regulators had been scheduled to end last Friday, January 13th. However, to me and to many of my House colleagues, this timeline seemed much too brief in order to effectively capture the impact of this extensive and lengthy proposal.

Therefore, I joined with 120 Members of Congress in cosigning a letter to our regulators requesting that the comment period for the rule be extended, and I expressed in the letter that there remained several unanswered questions about the Volcker Rule that must be carefully examined before its adoption. The rule will affect capital formation for United States' businesses and, thus, the national economy in general at a time when a recovery is needed more than ever.

I was and I remain a very strong supporter of the Dodd-Frank financial legislation from which the Volcker Rule's provisions originated. However, this is my concern. We must be sure that the implementation of such a far-reaching rule will not have negative effects on overall market liquidity, thereby limiting economic growth. Our national economic health has an opportunity to improve, and it is improving greatly as we speak, and any action must be made deliberatively to warrant a healthy and lasting economic recovery. That is paramount.

I look forward to the questions. Thank you very much, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I recognize Mr. Neugebauer for 1½ minutes for an opening statement.

Mr. NEUGEBAUER. I thank the chairwoman and I thank Mr. Scott for being one of the 121 Members who signed that letter, and I appreciate the regulators' response to that.

I would remind you there were three parts of that letter. One was to extend the comment period, and the second part of that was

to re-propose a rule after you had all of these comments. We have a piece of a rule here that has over 300 pages, and asks 1,300 questions. And so, you have to believe that after you hear back from all on those questions that obviously re-proposing the rule is the only right solution to make sure that after you have heard the answers to those questions obviously, hopefully, it makes the rule more effective.

And then the third part of that is, because of this process, to move the deadline for implementation, because while you kept the comment period open, you did not extend the effective date.

But I think interwoven into that, which is extremely important, is to have a comprehensive cost-benefit analysis. Because what we are hearing from both industries, from other countries, that this has far-reaching effects on the financial markets moving forward. Studies out there are saying this is going to cost investors billions of dollars, going to cost borrowers billions of dollars, and really basically change the landscape on transactions that we have been doing for a very long period of time.

So I hope as we move forward today that we can have more discussion about what kind of cost-benefit analysis is actually going on and has been developed through this process, and I thank the chairwoman.

Chairwoman CAPITO. Thank you.

I would like to recognize the ranking member of the full Financial Services Committee, Mr. Frank, for 3 minutes.

Mr. FRANK. For how much time?

Chairwoman CAPITO. I was informed it would be 3 minutes.

Mr. FRANK. Thank you.

I speak as one of the 315 Members of the House who hasn't asked to you delay this. I must say that it does seem to me the delay here was a stalking horse for opposition in the case of most people, and I am particularly struck in general by people who don't like regulation, and who think things are actually running pretty well from the legal standpoint during the time when all the troubles were accumulating, they have said they really are concerned about uncertainty and they blame a lot on uncertainty. So what are they asking for now? More uncertainty. They are asking for a delay in this rule. It is in the statute. It is coming. I don't understand how you reconcile an argument that uncertainty is our major problem with a plea for more uncertainty by delaying the rule.

We are also told that this is going to be putting us in international disadvantages by some. My understanding—and I hope this will be elaborated on in the testimony—is that in England, our major competitor in the financial area, they have a proposal called "ring-fencing." I don't know what that means in England, but, whatever it is, as I read it, it seems to be more restrictive on the deposit-taking institutions than what we are proposing.

And I think we do sometimes have financial institutions, when they talk about international regulation, they follow the motto of the teenage child of divorced parents playing mommy off against daddy, claiming that, "He will let me do it," or "She will let me do it." I do think, as I said, England has gone even further here.

Then, we are told we shouldn't do anything about it because it wasn't the cause of the crisis. I agree this particular thing was not

the cause of the crisis. But the notion that in adopting regulation, we should deal only with things that have already proven to be problematic and not try to anticipate and not try to make other improvements, I think is a grave error. I do think that there is a reason to do this in a very comprehensive way.

Finally, there is a complexity argument. As I understand the complexity argument, you are guilty, you regulators, of trying to accommodate some of the concerns that the financial institutions had. There are people who have Glass-Steagall nostalgia. They talk about how it was six pages. A very simple rule could have been formulated, but it would not have accommodated the concerns that you heard from the financial institutions. So, to some extent, they are complaining about your having accommodated them.

The final thing—I said final, but there is one last point.

Chairwoman CAPITO. If I may interrupt the ranking member for just a moment, I was informed incorrectly. You are to have 5 minutes. So, you don't have to talk so fast, or you don't need to wrap up so quickly. You have an additional 2 minutes.

Mr. FRANK. There is the option of repeating myself, but we all take advantage of that. That comes with the territory.

I will talk about—and I appreciate that, Madam Chairwoman.

I was talking about complexity. One of the legitimate concerns we have heard is that market making is important because of liquidity. Although I was impressed with a chapter I just read in a compilation put out by the London School of Economics by Adair Turner, the head of the Financial Services Authority, in which he makes the argument, I think persuasively, that doing anything that increases liquidity, even by a very small amount, regardless of what it might mean in terms of instability, is not a good idea. There is a cost-benefit analysis that has to be applied for people who say anything that gives us more liquidity—I have bonds, and I would like them to be able to sell, but I don't think they would have to be sold in 8 seconds for me to be satisfied.

Market making is, however, a legitimate concern here. And what I am told by some is, well, yes, we understand that the regulators say they will allow market making by institutions regardless—that the Volcker Rule will allow them to engage in market making, but we are afraid that they will overregulate, that they will be too tough; and, therefore, institutions fearful of excessive rigidity and harshness, fearful of vindictive regulatory action if they come to close to the line will pull back too far.

My question there is, in what universe have people been living in which the problem has been that financial regulators have been too tough, too harsh, too vindictive, have extracted too great a penalty for errors of misunderstanding? In fact, I think the record is very clear that our regulators over time, both parties have—if anything, we have underregulated and underapplied the rules.

But one of the things I will ask our witnesses is, and I think this is important, my understanding is that the regulators do appreciate the importance of market making because of the legitimate contribution it makes to liquidity. And I would think a very good thing to do to not have uncertainty would be to get the rule put in place in a reasonable time period, not further delaying it and having the regulators demonstrate in fact what I hope they will

demonstrate today rhetorically that they appreciate the importance of market making and do not intend to enforce this rule in any way that will impinge on legitimate market-making activities.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I now recognize Mr. Grimm.

Mr. GRIMM. Thank you, Madam Chairwoman.

First, let me state that I disagree with my colleague on the other side of the aisle, the ranking member. I think the Volcker Rule is a terrible idea, and I think it should be repealed.

Proprietary trading, as we just heard, was not a driving cause in the financial crisis, and this rule I think will do little more than add needless costs and complexity to an untold number of financial transactions. So, with that being said, it is my opinion that the regulators have also been a bit overzealous in proposing the rule and somehow found a way to make—through incredibly creative ways, actually—a terrible rule even worse.

You take the exemptions of municipal securities, for example. Dodd-Frank is silent on the distinction between general obligation bonds and limited obligation bonds. Yet, the regulators saw fit to insert into the rulemaking language that explicitly subjects limited obligation bonds to the Volcker Rule. This decision will limit liquidity in these securities and raise the borrowing costs of municipalities for cities like New York City.

With that, I will yield back.

Chairwoman CAPITO. Thank you.

And, finally, I would like to recognize Mr. Canseco for 1 minute for the purpose of making an opening statement.

Mr. CANSECO. Chairwoman Capito, I would like to thank you and Chairman Garrett for having this hearing.

When Dodd-Frank was passed a year-and-a-half ago, we were promised that there would be international coordination to ensure that the U.S. financial industry would not be left at a competitive disadvantage. Yet in the case of the Volcker Rule, the United States finds itself charging ahead while competing markets wait to find out just how big of an advantage they may have.

In the international context, Volcker was supposed to be one of our field of dreams regulations: If we build it, they will come. Yet, no other country has adopted anything similar to the Volcker Rule, and as we will hear from our second panel today, the proposed rule would have a negative impact not just on U.S. competitiveness but on the individual investors, pensioners, and small businesses that rely on our capital markets for economic security. These types of outcomes have indeed become a disturbing trend in the wake of Dodd-Frank, and I am eager to hear from our witness today on this very important matter.

Thank you.

Chairwoman CAPITO. Thank you.

That concludes our opening statements. I would now like to introduce our witnesses for the purpose of giving a 5-minute opening statement.

I will begin with the Honorable Daniel Tarullo, Governor, Board of Governors of the Federal Reserve System.

Welcome.

STATEMENT OF THE HONORABLE DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Chairwoman Capito, Chairman Bachus, Ranking Member Waters, Ranking Member Frank, and other members of the committee.

I should begin by saying that I think our goal—certainly at the Federal Reserve but really of all the regulators—is to implement the Volcker Rule in a manner that is faithful to the language of the statute but in a manner that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth. That is, we begin with the statutory language and we work from there.

I found that the biggest drafting challenge in implementing the Volcker Rule is to distinguish between prohibited proprietary trading on the one hand and underwriting, market making, and hedging on the other. In my prepared remarks, I used market making to make this point and I will try to do so briefly in this oral presentation.

While there are relatively obvious examples of pure proprietary trading, and at least a textbook version of pure market making, in the broad middle between these two clear cases falls a good bit of what we actually see in firms. The difficulty is that a proprietary trade and a trade pursuant to market making can be indistinguishable based solely on the features of the trade itself. In both activities, the banking entity is acting as principal, holds the position for a relatively short time, and gains a profit or suffers a loss based upon any price variation in the security during the time it is held.

The statute recognizes this difficulty and uses an intent test to distinguish between the two types of trade. Thus, the definition of trading account refers to the purpose of near-term resale and the intent to profit from short-term price movements.

Obviously, it will be difficult for regulators to monitor purpose and intentionality directly. So, the agency proposal sets forth a framework that includes the factors that the agencies see differentiating prohibited and permitted trades, includes a requirement that firms establish a compliance program in accordance with those factors, and includes data collection and reporting requirements to facilitate monitoring of firm compliance and the potential development of more precise guidance over time.

There is no question that this is not a simple test. Staffs and principals from the agencies considered various possible alternative approaches. And while some alternatives may seem simple when described in a sentence, they proved to promise considerable complexity or deviation from the statutory standards in practice. That is, as we thought through what they would mean in practice. So that is why the proposed rule takes the approach that it does.

But we are clearly open to a better idea if there is one out there. I would only ask that anyone making such a proposal first remember that we have to follow the statute and, second, to give us enough detail so we can make a comparison of the relative efficiency and efficacy of that idea relative to the proposed agency rule.

Thank you very much.

[The prepared statement of Governor Tarullo can be found on page 211 of the appendix.]

Chairwoman CAPITO. Thank you.

Next, I would like to recognize the Honorable Mary Schapiro, Chairman, U.S. Securities and Exchange Commission, welcome.

STATEMENT OF THE HONORABLE MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Ms. SCHAPIRO. Thank you.

Chairwoman Capito, Chairman Bachus, Ranking Members Waters and Maloney, and members of the subcommittees, thank you for the opportunity to testify regarding the Commission's joint proposal with the Federal banking agencies to implement Section 619 of the Dodd-Frank Act, commonly referred as to the Volcker Rule.

The proposal reflects a collective and extensive effort by the agencies to design a reasonable and balanced rule implementing the required prohibitions and restrictions on proprietary trading and investing in covered funds in a way that is consistent with the language and purpose of the statute.

As you know, the statute defined a number of key terms, including banking entities subject to the rule, proprietary trading, and trading accounts. Under the law, any position that is in a banking entity's trading account is subject to the statutory provisions.

The proposed rule captures all SEC-registered dealers and security-based swap dealers accounts as trading accounts. The proposal also recognizes the need for these entities to be able to provide critical liquidity to our markets, capital for issuers, and intermediation services to customers. Therefore, while the proposal, consistent with the statute generally, prohibits proprietary trading, it does allow market making, underwriting, and risk mitigating hedging.

In drafting the proposed rule, the Commission and its staff focused on these three activities because they are absolutely integral to the effective operations of the securities markets.

In particular, underwriting activity is important to capital formation and economic growth. The proposal, like the statute, continues to permit trading activities that serve an important role in support of effective underwriting.

Much like underwriting, the proposal recognizes the very important benefits of market making, including customer intermediation and market liquidity. Permitting legitimate market making in its different forms should facilitate market liquidity and efficiency by allowing covered banking entities to continue to provide customer intermediation and liquidity services in both liquid and illiquid instruments.

As acknowledged in the proposal, effective market making also involves hedging of market making positions and anticipatory market making related trading activity.

The proposal also recognizes that an overly broad interpretation of underwriting market making or risk mitigating hedging could result in these exemptions being used for evasive purposes. In addition, where exemptions are permitted, an exemption is not available if the transaction or activity involves a material conflict of interest, higher risk assets or trading strategies, or a threat to a cov-

ered banking entity's safety and soundness or to U.S. financial stability.

Further, a key component of the proposed rule is the requirement for a tiered compliance program reasonably designed to monitor a banking entity's permitted activities including, again, underwriting, market making and hedging, and investing in covered funds and to ensure compliance with the specific requirements of the statute and the proposal.

As an additional means of monitoring market-making activities and preventing evasion of the prohibition on proprietary trading, the proposal sets forth specific quantitative measurements that certain covered banking entities would be required to calculate, report, and record for their trading units engaged in market-making activities.

The statute also specifies that a banking entity may not invest in or sponsor a hedge fund or a private equity fund, which are defined in the proposed rules as "covered funds." The Commission recognizes that it is critical to define covered fund in a manner that would implement the purposes of the statute; and, thus, the proposal seeks extensive comment on the proposed approach as well as alternative ideas. We expect that commenter input will help inform our understanding of the potential scope and impact of the proposed definition.

Finally, the proposal includes a joint request for comment on the potential impacts of the proposed implementation of the statute, including the potential compliance costs, competitive effects, and impacts on market liquidity and efficiency. In addition, the proposal seeks commenters' views on the costs and benefits of all aspects of the proposal, as well as comment on whether alternative approaches to implementing the Volcker Rule would provide greater benefits or involve fewer costs. We encourage commenters to provide quantitative data to the extent possible in support of comments regarding the potential economic impact of this proposal.

In conclusion, we are committed to working closely with our fellow regulators to carefully review the comments and to further refine the rule prior to adoption.

I will be happy to answer your questions.

[The prepared statement of Chairman Schapiro can be found on page 187 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is the Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission.

Welcome.

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. GENSLER. Good morning, and thank you, Chairwoman Capito, Chairman Garrett, and Ranking Members Maloney and Waters. It is also good to see Chairman Bachus and Ranking Member Frank of the full committee. Thank you for inviting me to speak today on the Volcker Rule. I also am glad to join my fellow regulators in testifying today.

Following Congress' mandate last week, the CFTC-proposed Volcker Rule is consistent with the joint rule proposed in October by Federal regulators.

The Commission's proposal also included additional questions. I know there were 1,300, but we added a few additional questions seeking public comment on whether certain provisions of the common rules are even applicable to CFTC registrants which are part of a banking entity.

The Dodd-Frank Act, as we have all just been talking about, amended the Bank Holding Company Act to prohibit banking entities from engaging in proprietary trading, yet also permitted certain activities. The one that has gotten the most talk here is about market making and risk mitigating hedging. So the law requires the banking entities with significant trading activities to have policies and procedures in place to identify and prevent violations of this statutory provision on proprietary trading.

The Dodd-Frank Act directs the CFTC to write rules implementing the Volcker requirement for just those parts of the banking entity for which the agency is a primary regulator. So what does that mean in real terms? The CFTC's role with regard to the Volcker Rule is significant, but it is a supporting member along with the bank regulators who have the lead on bank holding companies.

The Dodd-Frank Act requires that the various regulators consult and coordinate, and that is what we have done, though we were a bit later than others, just sheer capacity issues at the CFTC. But the proposed rule would apply to the activities that we register at the CFTC. What is that? Futures Commission merchants and swap dealers.

For a swap dealer that is part of a larger bank, the CFTC rule applies just to the activities of the swap dealer, not the broader activities of the bank. Or for a Futures Commission merchant that is also registered as a broker-dealer, our rule would be about their futures activities. For their brokerage activity, that would be over at Chairman Schapiro's Commission.

In adopting the Volcker Rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk. But, at the same time, Congress permitted banking activities to engage in market-making activities, something that is vital to the liquidity of the capital markets. So one of the challenges that we as regulators are all faced with is finalizing the rule in achieving these twin goals that Congress laid out for us.

I think it will be critical to hear from the public on how best to achieve Congress' twin mandates, as I would call them here. The public has been invited to comment on this for 60 days, in our case, which hopefully brings us in line with the other regulators. I think there will be substantial public input, and we look forward to it.

As with other rules, the CFTC is working to implement this rule in a thoughtful, balanced way, not against the clock; and the Commission specifically requests comments from the public regarding the cost, benefits, and economic effects of the proposed rule.

In Chairmen Capito and Garrett's letter to us inviting us to speak here today, you solicited and asked us questions about the economic effect, which I believe are included in the CFTC's release.

But further in conversations with Chairman Bachus and a number of the chairs of the subcommittees, you have stressed the importance as we move forward to finalize the rule in taking into consideration the economic effects of the rule; and I think consistent with these conversations, we will do just that—carefully consider all of the incoming public comments, importantly including those on the economic effects.

I thank you and look forward to your questions.

[The prepared statement of Chairman Gensler can be found on page 139 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is the Honorable Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation.

Welcome.

STATEMENT OF THE HONORABLE MARTIN J. GRUENBERG, ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. GRUENBERG. Thank you very much, Chairwoman Capito, Chairman Garrett, Chairman Bachus, Ranking Members Frank, Waters, and Maloney, and members of the subcommittees. Thank you for the opportunity to testify today on behalf of the FDIC on the proposed regulations to implement the so-called Volcker Rule.

Section 619 of the Dodd-Frank Act is intended to strengthen the financial system and constrain the level of risk undertaken by firms that benefit from the safety net provided by Federal deposit insurance and access to the Federal Reserve's discount window.

While Section 619 broadly prohibits proprietary trading, it provides several permitted activities that allow banking entities to continue to offer important financial intermediation services and to ensure robust and liquid capital markets. Most notably, Section 619 allows banking entities to take principal risk to the extent necessary to engage in bona fide market-making and underwriting activities, risk mitigating hedging, and trading activities on behalf of customers.

The statute also prohibits acquiring and retaining an ownership interest in or having certain relationships with a hedge fund or private equity fund subject to certain exemptions. The challenge to the regulators—and I really think this has been articulated by all of us this morning—in implementing the Volcker Rule is to prohibit the types of proprietary trading and investment activity that the statute intended to limit while allowing banking organizations to provide legitimate intermediation in the capital markets.

Consistent with the requirements of Section 619 of the Dodd-Frank Act, the FDIC participated in a coordinated interagency rulemaking effort with the Federal Reserve, the OCC, the SEC, and the CFTC. In drafting the proposed rule, the agencies also benefited from the required FSOC study on implementing the Volcker Rule and the many comments received from interested stakeholders.

As drafted, the proposed rule is intended to carry out the statutory requirements to prohibit proprietary trading and establish prudent limitations on interest in the relationships with hedge funds and private equity funds consistent with Section 619. It is in-

tended to allow banking entities to continue to engage in permitted activities including bona fide market-making and underwriting activities, risk mitigating hedging, trading on behalf of customers, and investments in covered funds consistent with the statutory mandates. The goal is to allow banking organizations to continue to provide important financial intermediation services.

While most proprietary trading has been conducted by the largest bank holding companies, the FDIC and other agencies have carefully considered and limited the potential impact of the proposed rule on small banking entities and banking entities that engage in little or no covered trading activities. Accordingly, the agencies have proposed to limit the application of certain requirements such as reporting and recordkeeping requirements and compliance program requirements for those banking entities that engage in less than $1 billion of covered trading activities or covered fund activities and investments.

Further, the FDIC and its fellow agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation; and, therefore, we specifically requested public comment and information on this issue. As has been noted, we extended the comment period until February 13th to allow interested persons more time to analyze the issues and prepare their comments. The agencies will analyze the potential impacts of the rule based on the comments received and work to minimize the burden on the industry and the public while meeting the statutory requirements set by the law.

Thank you very much, and I will be glad to respond to your questions.

[The prepared statement of Acting Chairman Gruenberg can be found on page 143 of the appendix.]

Chairwoman CAPITO. Thank you.

Our final witness is Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency.

Welcome.

STATEMENT OF THE HONORABLE JOHN WALSH, ACTING COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

Mr. WALSH. Thank you, Chairmen Garrett and Capito, Ranking Members Waters and Maloney, members of the subcommittees, and Chairman Bachus and Ranking Member Frank. I appreciate the opportunity to appear today to provide an update on the work of the Office of the Comptroller of the Currency in connection with the Volcker Rule.

As you have heard the OCC, the Fed, the FDIC, and the SEC published our implementing regulation on November 7, 2011. The legislation itself is complex, and its impact and the impact of its implementing rules will have significant consequences for the operations of our Nation's banking firms and the financial system as a whole.

Recognizing these considerations and to enable commenters to react to the CFTC's subsequently proposed rule to implement Section 619, the OCC, the Federal Reserve, the FDIC, and the SEC recently extended the deadline for submitting comments on our

proposal by 1 month, to February 13th. We are hopeful that this extension will give the public more time to evaluate the proposal and provide robust comments.

As described in my written statement, the agency's proposal implements the prohibitions, restrictions, permitted activity exceptions, backstops, and rules of construction of Section 619. This combination of statutory provisions alone is quite complex.

The proposed rule also establishes requirements for statutorily permitted activities and interprets many of the permissible activity provisions conservatively, including in particular the provisions for underwriting, market-making related activities, and risk mitigating hedging. Admittedly, the proposal's approach for implementing the statutorily permitted activities introduces a number of operational complexities in an effort to be precise in drawing distinctions between permissible and prohibited activities.

The proposed rule also requires banking entities engaged in any permitted activity to develop and implement a compliance program that addresses internal policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping. The extent of these requirements escalates depending upon the volume of activity.

It has been noted by many that the proposal contains an unusually large number of questions. While the number of questions may seem daunting, they were driven by our desire to understand what may be quite complicated and significant consequences of elements of the proposal and to provide a sound legal basis for adjusting key areas of the rule where the agencies deem that necessary.

As the regulator of many of the banks that will be most affected by the Volcker Rule, the OCC is particularly concerned with how to strike the right balance in identifying and preventing impermissible activities without undermining activities that are safe, sound, and profitable; that help reduce a bank's overall risk profile; and that contribute to healthy and liquid markets.

We also recognize the compliance burdens on banking entities of all sizes arising from the proposal and therefore will be keenly interested in whether comparably effective compliance results could be achieved through less burdensome approaches.

We appreciate the concerns raised about the potential burden of the proposed regulation in addition to the Volcker Rule statutory provisions. To date, the OCC has completed an assessment of the impact of the proposal on OCC-regulated entities under the Unfunded Mandates Reform Act and the Regulatory Flexibility Act. We are also soliciting extensive comments on the full economic impact of the proposal, including its impact on market making and liquidity, cost of borrowing by businesses and consumers, and the price of financial assets. We have strongly encouraged comments on these issues and hope that the extended comment period will facilitate thoughtful and robust responses.

The letter of invitation also solicits views on whether the proposal places U.S. banking entities at a competitive disadvantage.

Competitive consequences here have various sources. There are competitive consequences that follow from provisions of the statute that reflect legislative choices made by Congress that may differ from approaches adopted in other jurisdictions. These differences

are based on policy as well as risk management grounds, and it is not unique for the United States and other jurisdictions to have differences on such issues.

Second, the manner in which the provisions of the statute are implemented by regulation can affect its competitive impact. This is why we welcome comments on the impact of the proposed rulemaking on the competitiveness of U.S. banking entities as well as comments on the flexibilities that may exist in the statutory requirements.

I appreciate the opportunity to update the committee on our work. This is very much a work in process. We appreciate your concerns and will certainly keep the committee advised of the status of the rulemaking effort.

I am happy to answer your questions.

[The prepared statement of Acting Comptroller Walsh can be found on page 232 of the appendix.]

Chairwoman CAPITO. Thank you.

I want to thank all the witnesses, and I would like to begin the questioning.

Governor Tarullo, you mentioned—I think one of the most telling parts of your statement was when you said you are clearly open to new ideas. And I think all of you have expressed a real eagerness to see the comments and the comment period, but you have asked for backup data and details to legitimize that. I am concerned—and I think many of us have expressed this—in this time of economic slowdown, what kind of effect this would have on the man on the street here in West Virginia or other various States in terms of obtaining credit, in terms of our community banks being able to supply funds for small businesses, home mortgages, etc. Is this one of the effects that you are going to be looking at in more detail as you move through this comment period?

Mr. TARULLO. Certainly, as I said, Madam Chairwoman, the task for us is to figure out the most effective and efficient way to implement the statutory language. To my mind, that includes considering the effects of the various alternatives that are available. The impact on credit and credit availability which would presumably come through the liquidity channel that several of your colleagues have mentioned would be one of those.

Chairwoman CAPITO. Thank you.

Chairman Schapiro, we were talking in the back room, and somebody mentioned that Mr. Volcker had said of proprietary trading, "You will know it when you see it." And then you and I discussed whether proprietary trading desks were still going forward, and you had mentioned that some of them have already closed their solitary proprietary trading desks but that some proprietary trading would be embedded in other areas of an investment bank.

How are the differentiations—it seems so very complicated. I have the flow chart here. That certainly put me to sleep last night when I got to about page 3 trying to flow through the flow chart. How are you going to make these distinctions when you get into the guts—or how are they, I guess—it is going to be incumbent upon them to be distinguishing, people sitting side by side, basically on appearance moving in the same direction but by definition

or definitionally maybe engaging in market making or maybe engaging in proprietary trading.

Ms. SCHAPIRO. That's a great question, Madam Chairwoman. I think the easy part maybe has been answered, that the bright line proprietary trading desks are easy to identify. Many firms have in fact, as you and I talked about, already moved ahead and disbanded those.

The proposal tries to help regulated entities think about how to distinguish proprietary trading from market making. In fact, it lays out a series of principles around risk management, source of revenues, revenues relative to risk, customer facing activities, payment of fees, commissions, and spreads, and in thinking through each of those areas helps to determine what might be market making and what might be proprietary trading. So, for example, market makers generally earn fees, commissions, and spreads. Proprietary traders routinely pay fees, commissions, and spreads.

Source of revenues are different—not entirely, not perfectly, not with a bright line between them—but they tend to be different for market makers versus proprietary traders. Customer facing activity is obviously different for market makers than it is for proprietary traders. So the rule tries to give guidance on how to think about distinguishing market making from proprietary trading.

I want to say in addition that we recognize as a capital markets regulator in particular the absolute criticality of market making to successful capital markets. For issuers, investors, and traders, market making is a critical function. So we have asked a lot of questions about whether we have gotten this exemption for market making right in the proposal and how might we change it if that's what is necessary to ensure that critical function continues for trading purposes and in support of underwriting and hedging.

Chairwoman CAPITO. Thank you. Mr. Walsh, I would like to ask you, you mentioned this in your statement, but I think this is a source of concern, and it has been voiced by some of our U.S. allies—Japan, the United Kingdom—that the Volcker Rule could cause some operational and transactional cost of trading in their bonds and that they are concerned about that. Do you have a comment to make about that?

Mr. WALSH. I didn't speak directly to that, but obviously—

Chairwoman CAPITO. You talked about competitive advantages around the world, so—

Mr. WALSH. Right. It is certainly something to which we will want to pay careful attention. The Canadians, the Japanese, the U.K., have expressed some concerns about trading in their sovereign bonds, and so we want to certainly take a look at that as we consider the final—

Chairwoman CAPITO. Is that contained in the rule as it is created right now?

Mr. WALSH. I think their concern is that there is preferential treatment of U.S. Treasuries while other instruments are caught by the rule, and that it will create a distinction that may affect them adversely. So, we will want to take a look at that.

Chairwoman CAPITO. Thank you. I would like to recognize Mr. Frank for questioning for 5 minutes.

Mr. FRANK. Thank you. Let me begin on the market-making issue, and again, I want to stress one of the things I think we should be looking at is the extent to which liquidity is a goal, and as I believe the erroneous notion that—liquidity is almost like the magic word; if it increases liquidity, it trumps other considerations. But market making is truly a very important, legitimate liquidity function, and the concern is that, I have heard voiced, even though you collectively say you respect market making and that it is going to be important, because of the ambiguity, because it depends on motive, that people will stop short of what you might allow because of fear of excessive regulation.

So let me ask all of you, do you believe that if the rule were to be adopted substantially, as proposed, you could administer it in a way that would allow market making, legitimate market-making activity to go forward and, as that happened, give the institutions the confidence that they could continue engaging in it?

Let's start with Mr. Tarullo.

Mr. TARULLO. I believe we can. I think—

Chairwoman CAPITO. If I could interrupt for just a moment. Some of the Members are having trouble hearing, so if you could pull the microphone close and sort of speak up, it would be to our benefit.

Mr. TARULLO. Is that better?

Chairwoman CAPITO. That is better.

Mr. TARULLO. Okay. I think we can. The rule, the proposed rule, as you can tell, is informed by an expectation that there is going to be an iterative quality to its implementation. That is why we are asking each of the firms to develop a compliance plan that is consonant with the principles and factors that we lay out in the proposed rule. It is also why we are going to be requiring reporting, so that we can monitor how different kinds of market making are in fact proceeding, and give us the opportunity to monitor whether this is or is not market making.

Mr. FRANK. Let me go—

Mr. TARULLO. I think the combination of the conformance period and the firm-specific compliance will allow us to, over time, develop the application of the rule in such a way that legitimate market making should be—

Mr. FRANK. And it is your intention to protect legitimate market making?

Mr. TARULLO. Oh, of course, absolutely.

Mr. FRANK. Chairman Schapiro?

Ms. SCHAPIRO. I really don't have anything to add. I agree completely with Governor Tarullo. I think we can administer it in a very rational way. We are not intending, in any sense, to be doing trade-by-trade analysis, to look at every transaction to see if it is proprietary trading or market making but, rather, to collect data that will allow us to see over time what the—

Mr. FRANK. Let me just ask, as SEC enforcement has come up, people have been saying you have to be tougher. If some bank in the process engages in activities which it turns out weren't market making, what are you going to do to them?

Ms. SCHAPIRO. I think it would depend a lot on what their intent was. Was their intent to violate the Volcker Rule or was their intent to—

Mr. FRANK. So if it is inadvertent—

Ms. SCHAPIRO. —engage in market making and they just get it wrong sometimes? We have no interest in pursuing activity where people are intending to provide market-making services but get it wrong.

Mr. FRANK. Chairman Gensler?

Mr. GENSLER. As the CFTC has done in other rules, we hope that when we finalize this, it will be a policies and procedures approach, that these banking entities have to have policies and procedures to ensure something, but that they actually are the ones ensuring that they can do market making—I believe that is critical—but they are not doing proprietary trading. But I would say we are going to be informed by the comments as well. This is really important, as we say, to get balance, to get it right. So if people point out that we don't have it right, that we make adjustments.

Mr. FRANK. But also in practice, I guess part of it is what is the mindset that you approach? That is, I think it is important to affirm that you all agree that market making is legitimate and that you understand there is an ambiguity there, so people should not worry about getting too close to the line because an inadvertent crossing of the line, especially in the early phases, isn't going to bring forward some terrible punishment.

Mr. GENSLER. I think that is correct. I think even Congress addressed that because there is a conformance period that the Federal Reserve will oversee, but that conformance period is not one with a lot of teeth.

Mr. FRANK. Thank you, Mr. Gensler. I am not sure about the implications of "even Congress," but that is okay.

Mr. Gruenberg.

Mr. GRUENBERG. Congressman Frank, I think it is important to underline that there is a 2-year compliance period provided by the statute for these companies to implement the rule, so in some sense there will be an extended period of engagement between the regulators and the companies.

Another point to make is we have a tiered approach for reporting trading activity. At the end of the day, it is going to be a relatively small number of large companies that are going to be impacted by this, so we are going to have an opportunity to work through this process. At the extremes, it is clear when it gets close—

Mr. FRANK. Let me just, if I could just for a few seconds, I don't want to exclude Mr. Dugan.

Mr. WALSH. He was my predecessor—

Mr. FRANK. Mr. Dugan, I am sorry. We did exclude Mr. Dugan.

Mr. Walsh—you would think since I am from Massachusetts, I could get those names straight.

Mr. WALSH. In any case, I agree with all that has been said.

Mr. FRANK. Let me just summarize, if I could have 10 seconds, Madam Chairwoman. I think it is very clear. If people don't like the rule, they don't like the rule. But if you look at the implementation, if you look at the way our regulators have worked, I think the notion that people are going to be scared away from doing mar-

ket making because of an excessive rigidity has no real foundation. And I am encouraged to know that these five regulators all are committed to making sure that market making goes forward and understand the importance of a regulatory framework in which people are encouraged to do that. Thank you.

Chairwoman CAPITO. Thank you. I would like to recognize the chairman of the full Financial Services Committee, Chairman Bachus, for 5 minutes for questions.

Chairman BACHUS. Thank you. I would say to Ranking Member Frank, famous last words, if you don't think some individual regulator or examiner will not misinterpret. You are asking, and I think every witness has said you are asking regulators to determine motive and intent, and that is a tremendously difficult, problematic—

Mr. FRANK. Will the gentleman yield? We ask 6 processors to do that all the time.

Chairman BACHUS. I will if I have additional time. Now, Ranking Member Frank, you will recall that we looked at this in the House and decided against the Volcker Rule. It was only sort of at the last hour that Senator Carl Levin and Senator Shelley Berkley and some others urged us to go forward with the Volcker Rule. That was my understanding. It certainly didn't pass out of the House.

Mr. FRANK. If I could get 15 seconds, the gentleman is right; it wasn't in the House, but there was a press conference in the White House that I attended long before it got to the end. But it was not in the House bill, I agree.

Chairman BACHUS. Yes. And you will recall around that same time, Paul Volcker—let me tell you, we all have tremendous respect for him, and I think that is how we got here, is we all respected him, and when he said this is something you need to do, no one wanted to cross him, at least some people didn't. But he said you can't draw a bright line between these activities, yet, we have asked these five agencies to do just that.

Now, Chairman Schapiro, you have said that you are not going to look at individual trades. I don't know how you don't end up on some occasion in the future looking at an individual trade. I know you probably will assure me that you won't, but I can't imagine how you can enforce a rule if you don't look at trades.

Ms. SCHAPIRO. If I could respond to that, the statute, the rule is done largely under the Bank Holding Company Act.

Chairman BACHUS. I agree, bank holding companies are prohibited from doing this.

Ms. SCHAPIRO. With respect to our narrow part of it, which is really broker-dealers and security-based swap dealers, and for those provisions that are done under the Bank Holding Company Act, although there are several that are also done jointly under the Exchange Act, but for those under the Bank Holding Company Act, our only mechanism, after notice and opportunity for hearing, would be to direct a company to terminate an activity or divest an investment. It is only with respect to the compliance program and the reporting and recordkeeping requirements that the SEC's Enforcement Division would have its full panoply of enforcement powers.

Chairman BACHUS. Of course. But let's say that it is almost impossible to distinguish. Paul Volcker said it is going to be impos-

sible to draw a bright line. So, companies are going to legitimate hedging, underwriting, market making, which can all be beneficial, which all create jobs in the United States, and which did not contribute to the last financial crisis. Those jobs will go someplace else. We talked about our relationships with Canada, with England, with Japan. We were assured—in the Conference, we had a discussion where Mr. Kanjorski assured us that most of the G20 nations would go along with this, and I offered an amendment that we wouldn't—it took a majority of the G20, and it was rejected. But we were told that they would, we are sure our allies will all go along with this. None of them have. And these jobs are going to go overseas. They are going to go to Canada. Plus, I have relatives in Canada who come to Arizona for the winter. Well, they do. We have snow birds, and they all come down to Florida. This tourist trade in Florida depends on the Canadians.

In our second panel, Mark Standish will testify that they will move those jobs that are presently in the United States to Canada because their ability to meet their customers' orders or investments—they are not going to be able to do so.

To the regulators—they said to us, "We are following your orders;" all five of them said, "We are doing what you asked us to do." I am not blaming them. They have been given an impossible order.

I am over my time. I am just going to close with what Jamie Dimon said, and Governor Tarullo, I think you referred to this in a different manner. This is psychology. He talked about how—and I don't think it is an exaggeration—every trader is going to need a psychiatrist and a lawyer sitting next to him. We have all done things that later on we were accused of doing something terrible when it was legitimately hedging, when it was—yes, but we are—we have all been there. When we have to interpret people's motives, we are on thin ice. Thank you.

Chairwoman CAPITO. Thank you. I would like to recognize the ranking member of the Capital Markets Subcommittee, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you. I will yield—

Chairwoman CAPITO. I am going to stick to 5 minutes now. I gave them both an extra minute there.

Ms. WATERS. I would like to yield 10 seconds to the ranking member of the full Financial Services Committee, Mr. Frank.

Mr. FRANK. I won't be substantive about this, but I disagree with the chairman's summation of the history. It is true that the Volcker Rule per se, in those words, was not in the House bill. There were things in the House bill that the gentleman from North Carolina, the gentleman from Colorado, Mr. Kanjorski himself, all had versions of things that approached it. And in fact, there was a press conference early in 2010, long before the Senate began to take up the bill, in which several of us endorsed the Volcker Rule. So he is right, it wasn't in the House bill, but it was not a last-minute addition.

Chairman BACHUS. Will the gentleman yield for 15 seconds to me?

Mr. FRANK. It is not my time. If we could—could we give another 15 seconds—not from the gentlewoman's time? I would hope we can do that.

Ms. WATERS. The gentlewoman will yield another 10 seconds.

Chairman BACHUS. I am just saying in the Senate and in the conference, it grew into something else.

Mr. FRANK. No, I—the gentleman has—

Chairman BACHUS. And the gentleman from Colorado will tell you that.

Mr. FRANK. This is what we said in a press conference earlier in the year. It was not something that just came out of—

Chairwoman CAPITO. I am going to ask the gentlemen to cease and let the gentlewoman continue with her questions.

Mr. FRANK. I would ask unanimous consent that the gentlewoman have an additional 30 seconds.

Chairwoman CAPITO. Without objection, it is so ordered.

Ms. WATERS. Thank you very much. I would like to continue on the discussion about market making that was initiated by Ranking Member Frank. One of the concerns that has been expressed by financial institutions is a requirement that regulators distinguish between market-making activities and proprietary trading activities. Members of Congress who supported the Volcker Rule during Dodd-Frank consideration felt that, done properly, market making is not speculative and could be compensated from spreads and fees rather than from changes in the prices of the financial instrument.

When you first gave your testimony, Mr. Tarullo, you indicated that you believed that you could distinguish between proprietary trading and market making, and you also offered that if anybody has a better mousetrap, you certainly would like to hear it, and that we have this extended period of time where you will be entertaining some ideas.

Now, as I understand it, all of this coordination has been going on between all of the agencies. And I guess, Mr. Gensler, you have had some responsibility, even though you say it is not significant, with this coordination, with the Treasury having the lead role.

Does everyone agree that given the law, Dodd-Frank, as it is, that you have to move forward in describing how you can distinguish between market making and proprietary trading and that you are all committed to doing that? I will start with you, Mr. Gensler. What is your role?

Mr. GENSLER. The CFTC has a significant role.

Ms. WATERS. I can't hear you.

Mr. GENSLER. The CFTC has a significant role with regard to swap dealers that are part of bank entities and also the Futures Commission merchants. And yes, to your question, I think that we are to move forward to achieve these twin goals of prohibiting proprietary trading, permitting market making, and making sure that this can be fostered, and comments are going to help inform us tremendously.

Ms. WATERS. So in the coordination that has been going on, is everyone on board for moving forward in the way that Mr. Tarullo explained at this time? Each person, yes or no?

Mr. GENSLER. Yes.

Ms. SCHAPIRO. We are very open to additional—

Ms. WATERS. I can't hear you.

Ms. SCHAPIRO. We are very open to additional ideas and approaches, yes.

Mr. GRUENBERG. Yes.

Ms. WATERS. Yes?

Mr. WALSH. Yes.

Ms. WATERS. All right. So, no one at the table this morning is here to talk about repeal of the Volcker Rule, but rather, how you are working to try and be consistent with the law as it is described in Dodd-Frank; is that correct?

Does anyone at this point in time have new ideas or better ideas or more information about market making that would make it easier to distinguish between market making and proprietary trading activities at this time? Any more information we should know about?

Ms. SCHAPIRO. There is a long history at the SEC of regulating market making in the equity and fixed-income markets, and much of that thinking has been incorporated into the proposal that the agencies have generated together. A lot of it hinges on the ability and the willingness to hold yourself out as being willing to make markets and provide two-sided quotes on a continuous or a regular basis, and to be a buyer to sellers.

We recognize that is not perfect, that historical basis upon which market-making exemptions have been based, but it is a starting point, and we have asked commenters lots of questions to give us better information or different ideas about how to make the market-making exemption effective going forward.

Ms. WATERS. We have a few more seconds. Would anyone like to add anything to that? Mr. Gruenberg?

Mr. GRUENBERG. Just to say that I think it is important to acknowledge that we are still in the midst of the comment period, the extended comment period. And I think the proposed rule went to great effort to solicit a broad public comment on a range of issues, and in particular the ones that you raised, and I think Chairman Schapiro pointed this out. I think the feedback we get will be very important in terms of formulating the final rule.

Ms. WATERS. I think that your presence here this morning is extremely important, and maybe one of the most important things that will come out of your presence here this morning is that you are all working together, the coordination is taking place, you are committed to making the Volcker Rule work, you want to make sure that you get additional input, and that period has been extended, regulatory period has been extended in order to do that. And so, I think that clears up in my mind that you are not working to advise us that the Volcker Rule should be repealed at all but, rather, it can be worked with. I yield back the balance of my time.

Chairman GARRETT [presiding]. The gentlelady yields back the balance of her time. And just coming into the committee, I appreciate the opportunity to see the panel today and for your statements and for the questions. I will now recognize myself for 5 minutes and, without objection, I will put my opening statement in the record.

Despite what the ranking member just said, we are obviously dealing with an extremely complicated issue here—a rule, with

over 1,300 individual questions, and obviously, there are a number of issues that are still out there. So I would like, for the first question, to just quickly run down through the panel. Do you believe individually, as your agencies, that you have the authority to waive the implementation date for the rule?

Mr. TARULLO. The Federal Reserve, Mr. Chairman, has authority under Dodd-Frank to extend the conformance period.

Chairman GARRETT. Okay. Yes.

Mr. TARULLO. That was—

Mr. GENSLER. I believe under the Bank Company Holding Act, it is the Federal Reserve.

Mr. GRUENBERG. I agree with that.

Chairman GARRETT. Everyone agrees. So then, the next question is easy. Will you agree, in light of the questions that have already come up and in light of the questions I presume that are going to come up afterwards, that it is necessary to do so and to not put a burden on the businesses? Because we have heard about the extraordinarily astronomical billions of dollars that it will cost to comply with this in following this hearing to put a—within 30 days to waive the statutory deadline so we can have a longer period of time.

Mr. TARULLO. I am sorry; we may be conflating two things here, Mr. Chairman.

Chairman GARRETT. Okay.

Mr. TARULLO. One is the final date for the final rule, and then the other is the period within which the rule has to be implemented. The latter is committed by Dodd-Frank to the Fed alone. The former would be a joint decision of all the agencies.

Chairman GARRETT. Exactly. And so, I will restate the question quickly. Would we agree here today that we should extend that period of time?

Mr. TARULLO. If you are talking about the first point, which is when there should be a final rule in place, I think it depends on the kind of comments that we are getting and the extent of the changes that we think we would need to make. I think we extended it for 30 days.

What normally happens in a rulemaking is you look at all the comments you get in, and then you make an assessment as to how much you are going to have to modify your proposed rule. Sometimes, it is around the edges.

Chairman GARRETT. I take it the answer is "no." The point here is, at this point in time, as you know, industry is—stakeholders are already trying to answer the questions that are out there and also are already trying to change their businesses in light of what the proposed rules are taking or proposal to take. So, it would help if we actually had that extension now so that they would actually know that in light of all the complexity of this issue, because it is unlike almost any other issue, but I understand the question.

Commissioner Gensler, many people have said that you move too quickly on some of your proposed rules and regulations, myself included. On this one, of course, you came out a little bit after the fact. Commissioner Sommers raised the question at the last hearing, and so let me ask this question to you now. Assuming for the sake of argument that each of the regulators sitting next to you on

the panel decides to repropose their rules in light of information that comes out, what would be your intention at that point? To issue a reproposed rule as well so that there is one final joint rule coming out at the same time? How would that work?

Mr. GENSLER. At the CFTC, we are committed to getting the rules right and balanced and not against a clock, and we have reproposed some other rules. We are actually looking forward to reproposing a very important rule for the markets called the block rule for swaps as well. That would probably be the third or fourth time we have reproposed something. So if the other regulators came to that conclusion, I assume that we would come to that conclusion jointly and do the same with them.

Chairman GARRETT. I appreciate that, thank you.

Mr. Tarullo, the language of Section 619(g)(2) expressly says this, and I will read it: "Nothing in this Section shall be construed to limit or restrict the ability of a banking entity or a nonbank financial company supervised by the board to sell or securitize loans in a manner permitted by law."

So, given this language, can you clarify how the risk retention Section of 941 and the restrictions on banks owning funds in the proposed rules will impact upon the issuers of asset-backed securities?

Mr. TARULLO. Obviously, the risk retention rules, I think—are you asking a question about how the two would—

Chairman GARRETT. Yes, jibe, which is—

Mr. TARULLO. —intersect?

Chairman GARRETT. Right.

Mr. TARULLO. Our presumption would be that the Volcker Rule enforcement would take as given whatever the requirements of the final rules on risk retention would be, and would try to ensure that there not be any further constraint on securitization beyond what those rules or other exogenous rules would require.

Chairman GARRETT. So you would see to it that there would not—your goal would be to see to it that there is not a cumulative effect, I guess is what I am thinking of?

Mr. TARULLO. I think the aim is to make sure that you don't have some incremental inhibition upon securitization beyond what rules are, by their own nature, intended to do with respect to regulating securities.

Chairman GARRETT. All right. And then a final question, along that line. Do you believe, in general, that the proposed rules, as many people suggested, will negatively impact upon liquidity in the markets, in the corporate bond markets, corporate markets such as for the—especially for the mid-cap companies and such?

Mr. TARULLO. Will there be some incremental effect on liquidity in some markets at the margin? I think the answer is probably "yes."

Chairman GARRETT. It is only going to be at the margin, though?

Mr. TARULLO. Well, no; I said would there be some. Beyond that, I think the answer to the question depends upon two things. First, how well we do at implementing the intention everybody here has stated, which is to try to make sure that market making is preserved.

Chairman GARRETT. And if you don't do it, will it go past the margins then?

Mr. TARULLO. It could, sure. And second, the degree to which nonregulated firms pick up, particularly proprietary trading, and I think at least one firm has already stated publicly that they see enormous opportunities here.

Chairman GARRETT. I appreciate that. My time has expired. I yield to the gentlelady from New York, Mrs. Maloney, and recognize her for 5 minutes.

Mrs. MALONEY. I thank the gentleman for yielding. And all of the panelists, one of our other colleagues on the other side of the aisle, or several, have said that if we enact the Volcker Rule, that our banks will move overseas. I would venture that the model overseas is very different from the efficient model we have in America that has made us the strongest capital market in the world. In Europe, large banks can invest in industrial companies, so if you bail out the bank, you get to bail out the bank and the industrial companies in which they have invested. The model is very different in America, and it is one that has traditionally been stronger and more efficient.

My colleague, Chairman Bachus, expressed some concern that the regulators are going to have difficulty determining the motive and intent and the difference between proprietary trading and market making. And I would venture to say that the CEOs and executives in the American financial systems have the same concern. They want to make sure that their organization is market making and not doing illegal proprietary trading, so they will be partners in helping to place a window on what is happening in these areas.

The author of the amendment, Paul Volcker, has said, "Proprietary trading is easy; you know it when you see it." But I would venture to say it is difficult to see it if you don't have the data to analyze it and understand what is taking place.

I therefore would like to ask, and I am going to ask Governor Tarullo to comment on it, but also to get in writing back from the panelists—because I think this is an important point—to what extent would the new compliance requirements involve the collection and reporting of data that banking entities have not been required to report in the past? I would venture that a lot of what they are reporting is what they have had to do in the past. And how do the metrics that you have created in the proposed rule ensure that you will be able to know it when you see it, and what metrics would be different, really, and information different between market making and proprietary trading?

We are also moving, as you know, for a research center that would have information on the content, and how important do you think is this information in preventing crises and problems in the future, Governor Tarullo?

Mr. TARULLO. Ranking Member Maloney, I think that the first point is that there are some firms which currently collect information in a way that would allow distinctions to be drawn, or at least give insight into market making or hedging versus proprietary trading. Others do not. So, the interagency proposal would move towards some standardization of both the management information systems of the firms and, consequently, their reporting to us.

Second, I think that when we start getting that information, we will be substantially better positioned to draw the kinds of distinctions that all of you are asking about, because I think it is important to note that what market making consists of in one kind of market, say for corporate bonds of Fortune 500 companies, is different from what market making may be in the case of a less traded instrument,, and we are going to need data that distinguishes among those different markets in order to oversee this rule effectively.

Mrs. MALONEY. Thank you. The Volcker Rule is basically five words: market making, underwriting, risk mitigation. Yet, when you look at this rule, it is roughly 300 words, 25 pages, if not more. And I would like to ask the panelists what is in this 295 pages? How much of it is exceptions and how much of it is truly defining the real Volcker Rule? I will start with Mr. Gensler.

Mr. GENSLER. A lot of it is questions, 1,300, as people have noted. I don't know what page count that takes, but it could be half of the document. But a lot of it is really trying to get at achieving these twin goals—market making or, of course, underwriting and hedging, which are so critical to the capital markets.

Mrs. MALONEY. How much is exceptions?

Mr. GENSLER. I think Congress actually laid out seven key permitted activities or, if you wish, exceptions. And underwriting, market making, and hedging are three critical ones, but there are others as well, and we want to fully comply with the intent of Congress.

Mrs. MALONEY. Chairman Schapiro?

Ms. SCHAPIRO. It is largely—a lot of it is the exceptions, the permitted activities, the criteria for determining the permitted activities, and then a discussion about the compliance program and the kind of metrics, records, and reporting that would need to be done so that financial institutions and regulators are in a position to understand if those exemptions are being appropriately applied.

Mrs. MALONEY. And I noticed there was no enforcement in these 200-some, almost 300 pages, no enforcement if there is a violation. Would anyone like to comment on that?

Mr. TARULLO. Towards the end of the regulation, there is a sub-Section on what can be done in the event of noncompliant activities. But because this is part of the Bank Holding Company Act, our full panoply of supervisory, regulatory, and enforcement tools would be available to us in appropriate circumstances.

Mrs. MALONEY. My time has expired. Thank you.

Mr. SCHWEIKERT [presiding]. Thank you, Mrs. Maloney. I yield myself 5 minutes—great timing. And this is for anyone on the panel, but we will start with—and I always mispronounce your name; is it "Tarullo?"

Mr. TARULLO. "Tarullo."

Mr. SCHWEIKERT. In an environment where we are stepping into Basel 3 and the level of reserves and the definitions of Tier 1 and Tier 2 and what can be held there, how does that all mesh when we now head into the proprietary trading rules in Volcker and what can be moved and what can't? Am I causing damage? Are the rules combined, this new regulatory scheme? How much damage to liquidity, to where capital is, are we going to have certain amounts

of idle capital? Explain to me how they mesh together and how they don't.

Mr. TARULLO. That is an important question because the Basel 3 exercise, actually it was Basel 2.5, the part of the Basel 3 exercise that was concluded a couple of years ago addressed specifically the trading book, and thus we are in the same universe that we are talking about with the Volcker Rule. There was a widespread view, a correct one I think, that capital regulation of trading activities had been seriously inadequate in the years running up to the crisis, and so a good bit of what Basel 2.5 did was to adjust the risk weights for traded assets.

There is an intention to take another look at the trading book more generally, because those were some quick changes that were obviously related to the sources of the crisis. And in taking that look, I think obviously when one looks at the amount of risk associated with a particular pattern of trading, you are going to want to have higher capital associated with higher risk, which is open position, so in that sense the two do merge.

Mr. SCHWEIKERT. Okay. Does anyone else want to touch on that point? Madam Chairman?

Ms. SCHAPIRO. I would just note that, and I have not had a chance to read this carefully yet, but a study was released earlier this week by Darrell Duffie at Stanford University that suggests that in lieu of trying to define market making and put limitations on market making, that much more rigorous capital and liquidity requirements might be another way to approach the kinds of issues that we are seeking to address through Volcker. But I haven't read it carefully, so I can't tell you whether I agree with it or not.

Mr. SCHWEIKERT. But in some ways, that is ultimately what at least the Basel 3 is heading towards; am I correct?

Mr. TARULLO. It may in the next iteration of the trading book review, although, again, Congressman, to the degree that an activity is not being pursued within a firm, then the higher capital requirements that would otherwise be associated with it would obviously not be applicable to that firm.

Mr. SCHWEIKERT. I made the mistake of leaving some of my notes over there, but I will try to do part of this off the top of my head.

Has anyone—and I know you are working through thousands of comments out there, trying to build a velocity model, a model that basically says if we did a far-reaching version of the Volcker Rule through definition, what happens to the banking system, particularly the large banks, how much less velocity, how much is now sitting in reserves, how much idle capital? Is anyone out there building an economic model for the regulation to do the tests?

Mr. TARULLO. I think it would be premature to try to work through that kind of analysis since, as several of my colleagues have noted, we are in the process now of gathering comments and then eventually refining the rule. And I think as we keep saying in response to many of your questions and comments, we want to ensure that to the degree possible, the kinds of market-making operations that are going on now that are entirely legitimate continue as such.

The other issue, of course, is going to be something I mentioned before, which is the degree to which straight proprietary trading is going to be picked up by other firms, hedge funds or others who see new market opportunities.

Mr. SCHWEIKERT. Mr. Gruenberg—and I don't have it in front of me, but the letter that came out from the Canadian banking regulator—explain to me their concerns and why—first explain their concerns, and we will go on to the second part of that.

Mr. GRUENBERG. I think under the Volcker Rule, there is an exception for companies to trade in U.S. securities, U.S. Government securities, but that benefit is not extended to the government securities of other countries. And I think the focus of the letter from the Canadians was on that issue, that they would want the ability, at a minimum, to have the exception for trading in their own government securities that U.S. firms have in regard to U.S. Government securities.

I would note that in the preamble to the rule, we raise a question specifically on this issue, whether we should consider some flexibility in that area, and I think we will be getting comments, and this will be one of the issues we will be looking at.

Mr. SCHWEIKERT. All right. I have so many questions, but I am out of time. I believe now it is 5 minutes to Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much. It seems like we are discussing—sometimes we just forget how we all got here or why we are here. I kind of remember back in 2008 the cardiac arrest our economy went into, and now we are discussing whether or not we should lower our fat intake or exercise or maybe stop smoking; maybe it is okay, let's light up once again. That is what it really seems like to me, instead of taking into consideration how it is we don't need to go see the doctor again.

So I want to ask Chairman Schapiro, there has been a lot of—and maybe you don't have this, someone else might have this information or an idea. There is this continuing questioning on the basis of the cost of the implementation, not of Frank-Dodd, but today of the Volcker Rule. And on more than one occasion, I have heard this morning, it is going to cost the industry billions of dollars in order to implement the Volcker Rule. What is your assessment, Chairman Schapiro?

Ms. SCHAPIRO. We have asked for extensive comment in the joint release about the costs of implementation as well as the costs and impacts on competitiveness of the Volcker Rule. Separately in the Sections that the SEC promulgated under our statutory authority, we have asked for specific comment on the costs of the compliance program and the reporting metrics, but we have also asked about the effect on competition of broker-dealers, for example, that have to comply with the reporting requirements of the compliance program and those that don't, the disincentives to engage in market making or underwriting. So there is a very, very broad request for comment on costs and a request for data from the industry, which is where the data would reside to help us be more informed about the costs overall.

Benefits, as you know, are much harder to quantify. Every rule has that challenge for us. The benefits to the public tend to be general and diffuse, and costs are much more easy to identify at least,

if not necessarily to quantify. So as we go forward, we have to try to balance exactly those things.

Mr. GUTIERREZ. How does someone arrive at billions of dollars?

Ms. SCHAPIRO. There are a number of studies that have been done recently that seek to quantify the costs. I believe SIFMA commissioned Oliver Wyman to do a study that looked at the market liquidity impacts of the Volcker Rule and suggested that the range could be from $90 billion to $315 billion in loss of value for investors as a result of higher interest rates to compensate for liquidity risk, higher transaction costs, and mark-to-market loss of value. So, that is a pretty wide range.

It is not clear to me how well-grounded that study is. I just don't know. But it is clearly information that we will be looking at. I think, again, benefits are always hard to quantify. Costs can be easy to identify but then hard to quantify.

Mr. GUTIERREZ. Mr. Tarullo, do you have any idea, or would you care to share with us your thoughts on the cost?

Mr. TARULLO. As I said earlier, Congressman, I think it depends on two things: first, it is going to depend on how effective we are in this iterative process of ensuring that market making and underwriting and hedging can be done; and second, the degree to which straight proprietary trading is picked up by other firms.

One comment, though, on the Oliver Wyman study; it is actually a more general comment. I think we all need to be a little bit wary of the false precision that sometimes is associated with analytic advocacy. If you are asked to do something that produces a number, you have to start making assumptions. So, they made a bunch of assumptions about how liquidity would be affected, a set of assumptions that really weren't grounded in any particular explanation. They didn't include the possibility that other firms would pick up such business as may be lost, and they used as their base period the height of the crisis as opposed to a more normal period. So, if you relaxed those assumptions or used other assumptions, I think you would probably get very different numbers, and that is going to be true from any perspective. Whenever anybody does analytic advocacy—

Mr. GUTIERREZ. So when do you think we—

Mr. TARULLO. The assumptions you make at the beginning—

Mr. GUTIERREZ. When do you think we will know with some degree of certainty? One year into it, 2 years?

Mr. TARULLO. I think when we are a year into the conformance period, we are going to have a much better sense of how this process is working out, and we will be happy to talk with you during that period.

Mr. GUTIERREZ. Let me ask you and the chairman, so the rulemaking process that we are in, will it be completed and the rule in place by January of 2013?

Ms. SCHAPIRO. It depends very much on the process going forward. We have extended the comment period until the middle of February. CFTC's comment period goes somewhat beyond that. Depending upon what the comments suggest, the extent to which we might modify the rule—

Mr. GUTIERREZ. Let me just ask one last question.

Ms. SCHAPIRO. Sure.

Mr. GUTIERREZ. Because I enjoy listening to your answers.

I just want to ask the last question, and that is to Mr. Gruenberg. At the FDIC, in the last 2 years, what has been the cost to the Federal Deposit Insurance? How much have you paid out?

Mr. GRUENBERG. In 2010, we had 157 institutions fail. This past year, in 2011, we had 92 institutions. I would have to go back and check the exact dollar loss, but it was—

Mr. GUTIERREZ. And hundreds failed in 2009?

Mr. GRUENBERG. No, in 2009, 25 failed. So the big failures really occurred in—

Mr. GUTIERREZ. And what was the cost to the Federal Deposit Insurance?

Mr. GRUENBERG. Approximately a $30 billion cost over the past 2 years.

Mr. GUTIERREZ. Thank you.

Chairman GARRETT [presiding]. And I thank the gentleman. Mr. Renacci is recognized for 5 minutes.

Mr. RENACCI. Thank you, Mr. Chairman. And thank you to all the witnesses for being here today.

Chairman Gensler, you stated earlier, in your verbal testimony, that the Volcker Rule gives you, you have a twin mandate, and risk mitigation but assuring that there is still market-making availability. And then later on, you talked about a twin goal of making sure there is still market-making availability but prohibiting proprietary trading.

Isn't there a little conflict in that as to how you can make sure that there is still market-making availability with mitigating risk; and don't you, at some point in time, have to determine how much tolerance you can take?

Mr. GENSLER. I think that is correct. I think Congress said, let's prohibit proprietary trading in banking entities, banking entities that might have availability to the discount window or other backing of the taxpayers. To lower risk to the taxpayers might bail out these banking entities once again, and at the same time, importantly, keep the vital function of market making, and that is the challenge that we are all addressing in this rulemaking. So, I agree it is a challenge, but I think with the help of the public comment period, we will get it balanced and get it finalized.

Mr. RENACCI. Okay. And when Ranking Member Frank asked all of you, do you believe we can still get market-making, it can still occur, Governor Tarullo, you said, "I think we can, based on firm-specific compliance." Chairman Schapiro, you said, "I think we can." Chairman Gensler, you said, "We hope so." And the other two of you didn't get to finish your answers, but I assume you are on that same track.

It leads me to believe that based on everything we know today, we are not really sure if we can. Is that correct? I would ask for just a "yes" or "no" from each one of you. Based on what you have today—and I know you are bringing in all these—the information, you are requesting information, but today, as we stand, you would not be able to implement that and be affirmative that we can make this happen; is that a correct statement?

Mr. TARULLO. If it were in effect today, without the kind of information that Ranking Member Maloney was talking about earlier, no, we couldn't do it. But that is exactly why we are asking for this kind of information, so that we are able to draw appropriate distinctions.

Ms. SCHAPIRO. I would agree with that. We can do it, but we just have to be able to draw the contours correctly, and that is why the comment process is so important.

Mr. GENSLER. I would say that it is just a proposal. We have been generous, maybe overly generous with 1,300 questions, but I think we will greatly benefit from input from participants in the markets.

Mr. GRUENBERG. I agree with the points that have been made.

Mr. WALSH. I think market making will continue. The question is, will you restrict legitimate activity if you draw the rule too tightly? And that is why we have asked the questions, to try to get that right. So, that is where we are.

Mr. RENACCI. Again, and I appreciate what you are doing, and I think that is why rushing into something without having all the information could be a worse situation than making sure that we evaluate this before we do it.

Chairman Garrett asked a question, and I am just going to try and get some more specifics. In regard to joint examinations, how are you going to develop a single coordinated view of the firm's activities if you have joint examinations going? What in advance are you planning to do in regards to joint examinations?

Mr. TARULLO. I can start, but others can chime in. I don't think, Congressman, this will be fundamentally different from other important regulatory issues when we do joint examinations, either the banking agencies among themselves, or with our colleagues at the market regulators for broker-dealers and commodities dealers; which is to say, you do begin from the base of the same regulations, and you understand who has primary responsibility, and who has backup authority. But I think, more importantly, you try to keep a common understanding of the expectations you have for the firms in question. As I said, I think that is something that the agencies all learned a lot about in the run-up to, during, and after the crisis—and I would say, I think, across-the-board that kind of coordination, particularly at the largest institutions is substantially better than it was a few years ago.

Mr. RENACCI. But you would all agree that, from the standpoint of the individual entity, it is going to be almost impossible to try and determine which way all of you are going if in advance, you don't come up with similar—

Mr. TARULLO. Absolutely. I think that is why we are—we have the contemplation of a compliance plan on a firm-specific basis, that any of the—any regulators who have relevant jurisdiction can take a look at.

And just one other thing I would add. On this issue, as on some others, because it really disproportionately affects the very largest firms, I think we at the Fed are going to make sure that we have a pretty centralized way of looking at what is going on at all of the major firms, so this won't be something that can just go off the rails at individual firms around the country. We are going to make

sure that our risk people here are seeing all the plans and are being able to evaluate how it is being implemented everywhere.

Mr. RENACCI. Thank you. I yield back.

Chairman GARRETT. The gentleman yields back. Mr. Watt is recognized for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. I actually have several questions. I will get through as many of them as I can.

First, Ms. Schapiro, you referred to a paper that had been written by a Stanford University professor in which he suggested that higher capital requirements would be a better way or a way of dealing with this. If you concluded that were the case, would you have the authority under the current legislation to accommodate that approach as opposed to dealing with this in the way that, under our proposed rule, has been proposed? Let me just get all of the questions out, and then maybe I will get the answers in the order that I ask them.

Second, a number of my insurance company constituents have raised questions about whether you intentionally exempted or whether you intended for an ownership interest in a covered fund to be exempted under the exemption for general accounts. And to the extent that you can answer that, I would appreciate it, Mr. Tarullo, and Mr. Gensler.

And third, Mr. Walsh, a number of people have raised questions about the extent to which businesses or jobs are going—would be driven offshore by this set of proposals. And perhaps Mr. Walsh, since he hasn't had much to say, could address that issue if we have time. So in that order, though, I would like to have the responses.

Ms. SCHAPIRO. I am happy to. First, I want to make it clear that I don't agree with Darrell Duffie necessarily. I was just trying to respond that there was this alternative that had been proposed, but I don't think that we could go that route under the statute. I think we are on a path—

Mr. WATT. So that would require us doing something legislatively to—

Ms. SCHAPIRO. I believe so, and maybe Governor Tarullo may have a view about that as well.

On insurance companies, the statute does exempt from the proprietary trading ban trading by an insurance company for its general account. But it does not do that for insurance company investments in covered funds. In order for us to create that exemption, we would have to meet a very high threshold to show that it would promote the safety and soundness of the banking institution or the financial stability of the United States.

That said, we have asked questions about it in the release, and we have met with a number of insurance companies, I believe, and we would welcome their comments and suggestions on that, but—

Mr. WATT. And you intend to clarify that further into the process?

Ms. SCHAPIRO. We will, but we hope to get comment on it, because it is quite clear on proprietary trading that insurance companies can engage in trading, but not investing in covered funds.

Mr. WATT. Do you agree with that, Mr. Tarullo?

Mr. TARULLO. I do, Congressman.

Mr. WATT. And Mr. Walsh, on the driving of business and jobs offshore, give me your general assessment of the arguments that are being made.

Mr. WALSH. As Governor Tarullo alluded to, there is a question, if certain activities are prohibited in banks, the question is, where will that activity go? Some of it may go to unregulated entities in the United States, hedge funds and others may take up that business. Some of it may go to foreign firms in the case of activities that are limited. It is not unusual to have prohibitions, limitations, capital charges, and other features of the regulatory framework, so we are creating some such limitations, and that business will presumably migrate elsewhere.

Mr. WATT. But I assume the extent to which that migration will take place will depend on the extent to which you all get this rule right or adjusted?

Mr. WALSH. It will, but to the extent that there are certain things that are clearly prohibited, that activity will no longer be in banks; it will move elsewhere.

Mr. WATT. All right. I think I got all three of my questions asked and answered in my 5 minutes, so I will yield back.

Chairman GARRETT. That is always a good record if you can do that. Very good. The gentleman from New York is recognized for 5 minutes.

Mr. GRIMM. Thank you, Mr. Chairman.

I will ask Chairman Schapiro first. If the rule as proposed does not limit liquidity, does not increase the spreads, does not increase the cost of doing business, why would we need an exemption for treasuries and municipalities for their municipal securities?

Ms. SCHAPIRO. I believe the exemption is really premised on the idea on the municipal side that it doesn't raise the same kinds of concerns about short-term trading that other proprietary trading does, and so the statute exempted government obligations generally from the proprietary trading ban. But I understood in your opening comments a concern to be that we have construed that too narrowly, to only include the obligations directly of the State or State agency and not, for example, the Turnpike Authority or other political subdivisions. And we have flagged that in the proposal and sought comment directly on whether we should use a broader definition of government obligations, like the definition of municipal securities under the 1934 Act to provide a broader exemption.

Mr. GRIMM. Okay, thank you. If we have a small or mid-sized company that needs access to liquidity, short-term cash flow, and they want to float $25 million of commercial paper and they go to a brokerage firm to do this, and the firm says, well, we can place $20 million right away, we have that, but the other $5 million we are going to have to hold it and work it over the next week or so, would that transaction be considered a proprietary trade for that broker-dealer, Mr. Tarullo?

Mr. TARULLO. I think you are touching here on the underwriting exception, and the specifics would obviously depend on the kinds of practices that are necessary to underwrite. As you know, when an investment bank underwrites an issue, it does often take some risk if it pulls into its own inventory the uncommitted securities.

Mr. GRIMM. And that is the scenario I am giving you. They place 20, they can't place the other 5, they are going to work it. This happens every day. So, it is not some—

Mr. TARULLO. Yes. So I don't want to—one always is hesitant to address any specific hypothetical because others will take it. But I will say the whole point here is to look at the kinds of practices in underwriting that are conventional so that conventional underwriting can continue to be performed, and that, again, will be part of the process of the firm-based compliance and the kind of metrics that we get. And if you are talking about a situation that is similar to what we see every day, presumably that would fall within the exception, and we will give that clarity to the firms going forward.

Mr. GRIMM. Okay. My understanding, though, is that we are leaning towards looking at if—to try to decide whether something is proprietary or not, it is my understanding—and I could be dead wrong, please correct me—that if the firm is making most of their money on fees, on spreads, but not on the value increasing over time, then it is not proprietary trading. But in this case scenario, if they are working a position, they very well may make more money because the value could go up in that week.

Ms. SCHAPIRO. If I could just elaborate. I think when a broker-dealer purchases securities from the issuer with the purpose of reselling them, if not immediately, in a reasonable period of time, to the public, that is clearly in furtherance of underwriting and would be permissible under the rule.

Mr. TARULLO. Yes. It is important to make the point here, Congressman, with respect to underwriting or market making, the fact that a firm will in some instances make money because of a short-term price movement does not in and of itself make it a prohibited trade.

Mr. GRIMM. That is what I want to make sure of.

Mr. TARULLO. Right. The point is, is it market making, is it underwriting? And of course, the underwriter takes a risk that the market likes the issue less 2 weeks after issuance than beforehand.

Mr. GRIMM. Exactly. Okay, very good. If a non-U.S. firm ultimately sells a security to a U.S. institution, a proprietary, the non-U.S. entity definitely did a proprietary trade and ultimately sells that security to a U.S. institution, does that fall under the purview of U.S. regulators? Is that subject to the Volcker Rule?

Chairman GARRETT. And we will make this the final question.

Mr. GRIMM. Final question. Chairman Schapiro?

Mr. TARULLO. Can you give us the facts again?

Mr. GRIMM. Okay, sure. We have a non-U.S. entity with non-U.S. subsidiaries doing proprietary trades. Let's just say they bought whatever security, they have held it, it has appreciated, and they now sell that appreciated security that they have a proprietary profit on to a U.S. entity. Does that fall under the Volcker Rule? Are we going to try to enforce these rules—

Mr. TARULLO. And they have been doing that overseas, Congressman? Sorry.

Mr. GRIMM. Right.

Ms. SCHAPIRO. I believe, and I would like to confirm this for you, that if the foreign banking entity sells to a U.S. customer, they lose the exemption from the Volcker Rule.

Mr. GRIMM. Right. And so, that begs the question, how do you plan on enforcing Volcker on non-U.S. entities, and would that not drive business to non-U.S. entities if they are not—you are saying they are not subject to the exemption.

Chairman GARRETT. The gentleman's time—

Mr. GRIMM. Okay.

Chairman GARRETT. And I say that because it was a great question and a good point, but I understand now that the panel is leaving at noon, so we are going to try to get as many people in as we can, so we will try to adhere to the 5-minute rule.

The gentleman from Texas, Mr. Hinojosa, is recognized for 5 minutes.

Mr. HINOJOSA. Thank you, Mr. Chairman.

I ask unanimous consent that my opening statement be included in today's—

Chairman GARRETT. Without objection, it is so ordered.

Mr. HINOJOSA. I want to make reference to an article that appeared in today's—January 18th—Bloomberg News saying that the attack by lobbyists for U.S. banks is seen as exaggerating the cost of disruption to the bond markets.

We have been discussing this morning the proposal championed by former Federal Reserve Chairman Paul Volcker. According to the article, it says that the lobbyists are saying that it will constrain the largest banks from betting on—sorry—anyway, this article says that their fears are greatly exaggerated. The industry's claim ignores the fact that when the largest banks stop doing this kind of trading—and I'm reading from that article—that somebody else will step in to do it, and we have to weigh those costs against the risk of banks blowing up.

This discussion has been very interesting; and I want to ask a question as it refers to the smaller institutions, community banks and credit unions in particular, because they didn't cause the recent economic decline. Some fear that additional regulations will harm the smaller financial institutions that arguably serve currently as the foundation of our Nation's economy.

It is my understanding that Section 619's prohibitions on proprietary trading do not apply to small business investment companies known as SBICs, allowing for banks to invest in them. So I ask my first question, which is, does the Dodd-Frank Act and proposed rulemaking provide other exemptions that benefit small business resulting in job growth?

That first question is for Governor Tarullo of the Federal Reserve System.

Mr. TARULLO. Thank you, Congressman.

I think probably from the standpoint of a small business or medium-sized business, somebody who has access—would normally have access to public capital markets, probably the most important thing is the line of questioning that we were engaged in a few minutes ago, which is to say making sure that the underwriting exception is interpreted and applied in such a fashion that they are able to get underwriting services. Because sometimes the issue of a smaller firm will be less liquid than that of a larger firm and they are going to want to know that the underwriter can in fact hold the inventory as appropriate and then sell it later.

I think that is probably the most important thing in addition to the SBIC exception that you referred to a moment ago.

Mr. HINOJOSA. I will ask the same question of Chairman Gruenberg of the FDIC.

Mr. GRUENBERG. I agree with the point Governor Tarullo made, and I also think it is worth noting that in terms of small banks, community banks, they by and large don't engage in this activity and should not be impacted directly by the Volcker Rule. The activity is really principally by our largest financial companies.

Mr. HINOJOSA. Thank you.

The Comptroller of the Currency, John Walsh, what is your answer?

Mr. WALSH. I agree with what has been said. It is also the case that public welfare investments that banks make in community projects are also exempted.

Mr. HINOJOSA. Very good.

The U.S. Chamber of Commerce will testify in the second panel, and they contend that the Volcker Rule as currently constructed will not reduce systemic risk nor will it improve economic well-being, but will in fact increase systemic risk. Governor Tarullo, what concerns address the possibility that if the Volcker Rule were implemented, banks would be unable or unwilling to underwrite public and private bonds for corporations, municipalities, health care providers, and our universities?

Chairman GARRETT. We will have that be the last question. The gentleman can answer.

Mr. TARULLO. Again, going back to what I said a moment ago, Congressman, that the intentions with respect to the underwriting exception are quite clear to make sure that underwriting can continue to be pursued as appropriate.

Chairman GARRETT. I thank the gentleman. The gentleman yields back.

Mr. Luetkemeyer is now recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Gruenberg, in our work papers here and briefing papers there is a statement that says that Chairman Volcker has argued that activities such as proprietary trading and sponsoring hedge funds and private equity funds should not be conducted by firms that benefit from a Federal safety net such as deposit insurance or access to the Federal Reserve System discount window. Proponents of the rule have argued that by moving certain risky non-core activities out of institutions that benefit from deposit insurance and access to the window, restrictions would better protect taxpayers and help create a more resilient U.S. banking system. What is your reaction to that statement?

Mr. GRUENBERG. I think the underlying premise to the proponents is that the activity here is speculative short-term trading—

Mr. LUETKEMEYER. Right.

Mr. GRUENBERG. —relying on funds that are generated as a result of the public safety net of deposit insurance and access to the discount window. I think that is, for the proponents, the key issue, and that is why they want to constrain that activity, that it is inappropriate to, in effect, engage in speculative trading activity utilizing funds derived from the public safety net.

Mr. LUETKEMEYER. A while ago, I think Mr. Gutierrez asked you a question about the costs to the FDIC insurance fund over the last several years. You gave a $30 billion cost to the failures. What proportion of that would you say would be as a result of the kind of activities that we are talking about this morning, that the Volcker Rule would affect?

Mr. GRUENBERG. I don't know that you can discern from the failed institutions that there is a relationship to proprietary trading activities.

Mr. LUETKEMEYER. Out of the banks, the 200 banks that failed in the last couple of years, I am sure a lot of those were community banks, which you just testified weren't part of the problem. Of the bigger folks that have caused some difficulties for the other banks—obviously, the big banks were consolidated and a lot of them didn't fail as a result of the too-big-to-fail doctrine, but there are a lot of folks who were inadvertently affected by this. No figures on that? No guess?

Mr. GRUENBERG. In terms of tying it to the proprietary trading activity, I think it has—

Mr. LUETKEMEYER. I think there are hedge funds and private equity funds, too. This is what the Volcker Rule was addressing here. That is why I read the whole question.

Mr. GRUENBERG. I think the proponents—and that includes Mr. Volcker—have indicated that they view the proprietary trading restriction essentially as a forward-looking—

Mr. LUETKEMEYER. How much risk do you think is appropriate for the banks to take on utilizing these instruments? Do you think there should be a different weighting of this when you start looking at adequate capital with regards to the size of the institution, the amount of activity they have? Are there certain criteria that you think would be necessary there?

Mr. GRUENBERG. The Volcker Rule is focused on the question of what mechanism you want to use to try to address the risk identified here.

One approach would be capital requirements relating to these activities. Another, which is really the statutory provision in Section 619, goes to constraints on the activity itself. There are two alternative approaches. I think the statute chose the latter.

Mr. LUETKEMEYER. I am running out of time here. I have two more questions I want to get to.

One is—Ms. Schapiro, you and I have discussed this before. It is a little bit off the topic here. But it is with regard to activities with regulatory stuff coming from different departments. The Department of Labor issued a proposed ruling on the definition of fiduciary. Have you been working with the Department at all on this issue and can you give us a quick update in about 15 seconds?

Ms. SCHAPIRO. We have had a number of conversations and discussions with them. As you know, they are interpreting their rules under ERISA.

Mr. LUETKEMEYER. Are you working with them and making sure that your point of view and your oversight over this is not impacted?

Ms. SCHAPIRO. Yes, we have had a number of conversations.

Mr. LUETKEMEYER. Mr. Tarullo, you were trying to address with Congressman Grimm here a minute ago with regards to the question he had on enforcement of these foreign entities who are dealing with proprietary trading activities. I thought it was a great question, and we didn't get an answer. Would any of you like to jump in here, how is enforcement mechanism going to work on folks who are offshore who are doing business here? Can you explain the oversight on that?

Mr. TARULLO. If they have a subsidiary or branch or an agency here in the United States—

Mr. LUETKEMEYER. In order to sell here, they have to have a branch or subsidiary?

Mr. TARULLO. Well, no, that wouldn't necessarily be the case, Congressman. It could be they had a branch which was unrelated directly to the proprietary trading but that is still an avenue in for enforcement because you have jurisdiction over the entity. If it is purely an entity overseas, there could be a jurisdictional question of what kind of—

Mr. LUETKEMEYER. In other words, if an entity overseas is doing business with an individual or a company here and selling these types of—or doing these activities back and forth, is there a question of jurisdiction, who would be able to enforce?

Chairman GARRETT. That will be the last question.

Mr. TARULLO. Well, remember, the firms we are going to primarily be concerned with are those that are operating in the United States and they would have one of the subsidiaries or agencies or branches that I referred to a moment ago.

Mr. LUETKEMEYER. Thank you very much.

Thank you very much, Mr. Chairman.

Chairman GARRETT. The gentleman's time has expired.

Obviously, we will have some other questions that we will probably want to submit to the panel in writing.

The gentlelady, Mrs. McCarthy, is now recognized for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman, and I thank the witnesses for their patience.

When you start thinking about these committee hearings, you think about what questions you want to ask, and of course when it gets down to you, most of the questions you wanted to ask have already been asked. But I would like to talk about the aspect of the implementation that is equally important, part of the whole process that we are on right now, and that is making sure that the agencies have the staff but also who have the knowledge. I know we had a hearing several years ago, and one of the things we found out is that a lot of your agencies didn't actually have the expertise of having someone who worked in compliance on Wall Street and knew what to look for and things like that. I am wondering if that has changed?

And what additional resources might you see a need for in the future as far as staff, and do you anticipate that you are going to need to perform the duties—are you going to be able to have the staff that you need to perform the duties that you are talking about? Because with all of you sitting here, we know that there will be a heck of a lot of staff behind you also doing that work.

As far as the money—the market making, when you conduct your warranted exams, what happens when each and every one of you come together? How are you going to analyze the data if you have different opinions? Who takes the lead on coming down with the final decisions?

Mr. GENSLER. I am going to take the opportunity to say at the CFTC, no, we do not have enough staff. We have been asked to take on a market 7 times the size of the futures market, a $3 trillion swaps market. So I am hopeful as it relates to the Volcker Rule that we can leverage off of this to some of the agencies at this table who are, frankly, self-funded.

I think that is why I am being pragmatic about this. If it is a swap dealer or Futures Commission merchant that is part of a broader banking entity, at the CFTC, we are going to look to be efficient by leveraging off of some of the examination authority at the banking authorities.

Mr. TARULLO. I would say, we may be self-funded, but we don't regard ourselves as having a blank check. I think the entire government is aware of the need to conserve resources. What the needs will be over time, I think we will have to wait and see.

One thing I will say, though, is that right now there is an awful lot, obviously, of staff time being devoted to drafting a lot of regulations, Dodd-Frank regulations, Basel-Committee-derived regulations, and the like. And I would anticipate that once that process—doesn't come to an end, exactly, but once it slows down and the peak levels of activity have diminished some, we will be able to redeploy people.

But you made a critical point, I think, in the premise of your question, which is having the right kind of people to implement and administer not just the Volcker Rule—

Mrs. MCCARTHY OF NEW YORK. All of the rules.

Mr. TARULLO. —but the kind of supervision we do know.

This is not just an advanced form of making sure that loans are underwritten properly. It requires a set of skills and expertise that are different.

And a point on coordination—as I said earlier, I think we are actually coordinating in general quite well both with respect to rule writing and with respect to individual supervision. Every agency does have to fulfill its statutory mandate. We have primary responsibility for the institutions that are assigned us by the Congress.

But, for example, if we are doing a holding company with a big national bank, the supervisors from the Fed and the OCC routinely—and by routinely, I mean daily—consult with one another, and if there are differences of views on policy matters, they are both expected to push those up the line where, if necessary, eventually, John and I will discuss them.

Mrs. MCCARTHY OF NEW YORK. Thank you.

Ms. SCHAPIRO. For the SEC, we will obviously be responsible for broker-dealers and security-based swap dealers that are affiliated with depository institutions; and so, I would imagine that we will rely heavily, as the CFTC will, on the Fed and the bank regulators to take the lead. But, we obviously have a key role to play with respect to the broker-dealers. I do think the standardization of the metrics and the data will enable all of us to see the same informa-

tion and work together very closely on our different components of the banking entities.

Chairman GARRETT. The gentlelady's time has expired.

The gentleman from Texas has a letter from the Small Business Investor Alliance (SBIA) which is to be entered into the record.

Mr. HINOJOSA. Yes, I ask unanimous consent that the SBIA letter—

Chairman GARRETT. Without objection, it is so ordered.

The other gentleman from Texas is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

As I said in my opening statement, we sent you a letter from 121 Members of Congress, and that was a bipartisan letter. A number of committee chairmen signed that letter.

And you know when you look at—I pulled up a copy of Dodd-Frank a while ago. It was 11 pages for this Section in Dodd-Frank, and it has turned into 300 pages of regulation and 1,300 questions that you put out for part of your rule. When somebody starts asking a lot of questions, it leads me to believe that there are some conclusions that were not drawn prior to the rule coming out.

And when you look at—the current estimate is 6.2 million manhours to comply with this piece of legislation. We have other countries saying that they are not going to go in the same direction as Dodd-Frank. So, it obviously creates some bifurcation in the marketplace.

Back to the letter we sent you, as I mentioned, we mentioned three things, one was to extend the comment period. But, more importantly, after asking all of those questions and receiving answers to 1,300 questions and 400 issues, there appears to be at least one conclusion, and that is that you are going have to go back and rethink and re-look at those different issues after you have had those questions answered and send the proposal back out and see if everybody then is on the same page. Is there disagreement that is not a good strategy, Mr. Tarullo?

Mr. TARULLO. I think it depends, Congressman, on the answers that we get to the questions that have been asked.

And, as I said earlier, as is the case I think in all administrative rulemakings, the pattern is you look at the responses that have come in and you make an assessment as to whether you need to adjust your proposed rule at the margin or whether you need to make some significant changes that don't fundamentally affect the structure of it or whether you need to change the structure of it. And I think that what will happen is, once the comment period has ended, we are all looking at the staffs and we are all looking at the comments, and we will need to make an assessment as to which of those three categories we are in.

I would say if we were in a category in which we thought we had to change the basic approach, then one would expect that a re-proposal would probably be what you do. But if, on the other hand, you are making adjustments to the basic approach that you have made, we may well not feel the need to re-propose the regulation as opposed to making changes but then go final and, as I said earlier, have the opportunity for further refinement during the conformance period.

Mr. NEUGEBAUER. Ms. Schapiro, have you ever seen a rule that had 1,300 questions in it?

Ms. SCHAPIRO. I can't say that I have. I have seen rules and we have done rules at the SEC where we have asked hundreds of questions to inform our process. The goal of the questions was not to give everybody out there who is commenting lots of work to do, but to really help inform us about how to draft this rule, and these exemptions in particular, correctly. So, it was really our effort to make sure we covered all the bases.

Mr. NEUGEBAUER. Mr. Gensler, have you ever seen a rule with 1,300 questions?

Mr. GENSLER. I don't know that I have. As I say, while we may have been overly generous, it really is to solicit public input on a challenge here of how to achieve these twin goals of prohibiting one thing, permitting another thing, the two overlap, and so how to deal with that overlapping, fulfill congressional intent to lower risk to taxpayers.

But to the chairman and subcommittee question earlier, and your chairman as well, to the two chairmen, we have been willing at the CFTC to re-propose on a number of occasions when it is not a logical outgrowth, and if that is the collective view at some point this spring or summer when we are getting to that point we would—

Mr. NEUGEBAUER. Isn't the goal here to do this right?

Mr. GENSLER. Absolutely. Do it right, in a balanced way to fulfill congressional mandates.

Mr. NEUGEBAUER. And so with something as important as this, it seems to me that we should make sure we get it right. I think the question that a lot of people are asking is, what in this new rulemaking process, this 300-page rule, would have prevented the financial crisis from transpiring?

Mr. Tarullo, can you point to a Section?

Mr. TARULLO. There are a couple of things, and some people alluded to this earlier. First, yes, there was some proprietary trading. Would I identify it as at the core of what led to this financial crisis? No. But one is always enjoined not to fight the last war as one goes forward, and so I assume that the motivation was to address other issues. And if you don't have a balanced book, obviously, you have more risk in one other than you otherwise would.

I want to say one more thing on the questions, and the questions are in the 300 pages. There are a lot of questions. But part of what the questions do actually is to reveal to the public how we have been thinking about the rulemaking. They don't have to answer—you can send in a one-page comment or you can send in a 100-page comment. It is not like one of my old law exams where the kids had to answer everything whether they wanted to or not. This is one where you pick the questions you want to answer.

But I do think they actually serve a transparency function as well by giving an insight into the way in which we are debating within the agencies.

Chairman GARRETT. That will be the last question that this gentleman asks.

Mr. Miller is recognized now for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

There has been some question in this committee about whether propriety trading played a role in the financial crisis, but one thing that obviously did play a role was the repo market, the repurchase market. The repurchase market is largely still unregulated, it is opaque, dimly understood certainly by Congress and by the public, and huge. At the time of the crisis or just before, it was the equal of all deposits and lent itself to great instability by matching up short-term borrowing with longer-term lending.

Before the crisis, Bear Stearns was borrowing $40 billion overnight in the repo market and using those funds to purchase mortgages. So, that obviously creates a great deal of instability. Yes, it creates liquidity, but it also creates a great deal of instability.

I understand that there is an exception in the proprietary trading rule designed to get at repo lending, the repurchase. That if you take a security as collateral, even though it is characterized as a purchase, if it is in fact a loan with collateral, that is not treated as proprietary trading. I want to find some ways to get at the repo market and the instability that it creates, but I think that rule probably makes sense.

Sheila Bair and others have suggested that the way the rule is written, it will also exempt purchase of assets financed through the repo market. MF Global—you are shaking your head; I am glad to see that—was using a financing technique called "repo-to-maturity." They were buying European sovereign debt with the European sovereign debt as the security, as the collateral for the purchase. It was basically 100 percent financing.

Sheila Bair and others have suggested that the rule would in fact allow that and not treat that—if done by an institution subject to the proprietary trading rule, it would have exempted that.

Mr. Tarullo, you have already shaken your head "no." Do you not read the rule that way?

And I would like to hear from the others as well.

Mr. TARULLO. I think you have it exactly right on all three counts, Congressman.

One, the repo exception is meant to recognize the fact that it is essentially a borrowing relationship. It is not a trading relationship, even if title passes back and forth.

Two, if the repo is the financing, what you do with the financing, whether you get the financing from deposits or from long-term bond issuance or from repo, what you do with it is what the Volcker Rule addresses. So, short-term trading for proprietary purposes, whether you financed it through deposits or through repo or through a long-term bond, it will still be prohibited.

The third thing you got right is MF Global would not have been subject to this because they don't have a depository institution.

Ms. SCHAPIRO. I was going to add that I agree with all of that completely, that had they been associated with a depository institution, the fact that they were engaged in repo would not change the character of the underlying purchases of the sovereign bonds. And assuming those were not done pursuant to market making or underwriting, they would likely have been proprietary trading and prohibited.

Mr. MILLER OF NORTH CAROLINA. Does anyone disagree?

Do any of you think there should be some limitation on the repo market? We had a hearing in the Oversight Subcommittee of this committee on MF Global—of course, there have been a lot of hearings in Congress—and certainly one of the lessons I took from that hearing was that the repo market, although we have heard testimony in this committee that it is now vastly changed from what it was before the crisis, is still a remarkable source for instability. I think the assumption in Europe is that things will get really chancy for the financial system when there is a fault. I suspect things will get really chancy when the repo market starts requiring a lot more collateral for sovereign debt when sovereign debt is used as collateral.

Mr. Tarullo, is there any regulation in the works?

Mr. TARULLO. We certainly have been looking at the repo market in the context of wholesale funding and what is sometimes referred to as the shadow banking system more generally. If you think about it, there are really two big goals that I think regulatory reform post-crisis needed to have. One was the too-big-to-fail issue where we have made some progress. We are not there yet, but I think we have the tools in place to do it.

The second is in wholesale funding more generally in the areas in which there is a potential for runs under circumstances in which the value of collateral all of a sudden becomes a question to those who have been taking it.

Chairman GARRETT. The gentleman's time has expired.

Mr. TARULLO. With respect to all of these, you will need more attention. Sorry.

Chairman GARRETT. The gentleman's time has expired.

The gentlelady from New York is recognized.

Dr. HAYWORTH. Thank you, Mr. Chairman, and I thank all of the panelists. With great respect for the little time remaining, during this hearing it has been most impressive that all of you take a very thoughtful and thorough approach to this almost seemingly impossible task, and I give you great credit for that.

But clearly, as Chairman Neugebauer has indicated, it seems as though it would be very reasonable to consider that this rule, this proposal is not what, as a scientist, being a physician—it is not the most elegant solution to the problem that we face, which is that we have certainly put taxpayer dollars at great risk and we have expended an enormous amount of taxpayer money to rescue financial institutions that have acted unwisely. The causes for that or the conditions that have been conducive to that kind of action of course are at the crux of this problem. I think those of us who feel Federal intervention in the markets has augmented the moral hazard would automatically take a different approach.

Would any of you be willing to say that statutorily, it would be appropriate for us to give very serious consideration to legislation that removes this particular burden, and perhaps we should direct our legislative efforts toward again a more elegant solution such as really strictly limiting the circumstances under which we will indemnify institutions for losses?

Mr. TARULLO. I can start. I think too-big-to-fail is an agenda, and the moral hazard that comes from it is an agenda that we should

all share and we should all pursue, regardless of what happens in other areas.

Having said that, there are going to be major consequences to the financial system if a major financial institution fails, even if it does fail and is resolved by Chairman Gruenberg and the FDIC in a way that does not involve the expenditure of taxpayer funds. So financial instability and harm to the system can result even if you are not in a position of bailing out a firm.

And I think with respect to capital and other rules, that is part of the motivation of thinking as to how we are going to both move towards a situation of more market discipline, avoiding too-big-to-fail, and to in an anticipatory fashion mitigate the consequences that would ensue even from the resolution as opposed to bailout of a major financial institution.

We are moving forward now on implementation. We are waiting for the comments to see whether there is a better approach. Although, as I said in my prepared remarks, I haven't seen it yet. I welcome it if it does come, but someone has to elaborate it.

The only thing I would say to you is, as we go through—assuming we go through with this framework and this approach, as we go through the conformance process, if there are things that we think would need legislative attention, we will certainly come back to you.

Dr. HAYWORTH. But it seems clear, especially from Representative Grimm's question, that we are—and we can't deny the fact that we are in a competitive global marketplace, and that certainly creates great challenges for our financial services sector as we try to compete, as we have U.S.-based companies competing with those that are based overseas. That has to be a concern for all of you as you—

Mr. TARULLO. Sure, absolutely. That is why we paid as much attention as we did in the capital area which I think is critical to making sure not only do other countries adopt Basel 3 but that they actually implement them in their firms in a rigorous fashion so their risk weighting is done like ours. So I agree with that proposition.

It is a little different, though, to ask the question, does every country need to have exactly the same regulations for all of its firms. And some other countries don't have—they put constraints on their firms in ways that we don't. So, we have to make a judgment I think collectively as to whether this is something that goes to the heart of the ability of a big international financial firm to compete.

Chairman GARRETT. The gentlelady's time has expired.

I understand this panel was told that they would be out of here by noon. With the panel's permission, I would like to have an even number from both sides of the aisle to be able to question the panel. Mr. Scott has just come in, and I recognize him for questions.

Mr. SCOTT. Thank you, Mr. Chairman, for that time.

I want to share with the committee my major concern with the implementation of the Volcker Rule. This is not whether or not we should do it, but it is to make sure we do it right.

I am very concerned. We are moving forward in a very, very strong economic recovery period. The unemployment level has come down to 8.5 percent. We have increased jobs just last month in the private sector of 200,000 jobs that have come on. Auto sales are up. We have General Motors moving from the doorsteps of bankruptcy now to we have them pivoted right back up to the top as being the number one automobile manufacturer in the world, passing Toyota. Great signs, which means consumer confidence is going up and business confidence is going up.

This Volcker Rule goes at the central nervous system of our entire financial system and could really have a devastating impact, in my opinion, if it is not done right, because the general thrust of this Volcker Rule is in capital formation, which clearly impacts the whole question of liquidity. So as we move forward with this interpretation of this rule, let us keep in mind that we do not want to do anything that would get us off course from the great upward movement we are making in our economic recovery.

I have two central questions. First of all, Ms. Schapiro, one area—it touches every area, but one of the areas that we talked about is in the swaps and in the hedging. And I want to commend you, first of all, for meeting with and the work that you have done with the IntercontinentalExchange. That is particularly within the portfolio margining requirement for clearing members. I commend you for that, and I hope you will proceed in extending that margining of portfolios for customers as well, because I would think it would help.

But I understand there is a pending request before your Commission for an exemption to permit the commingling of security-based swaps with index-based CDS's in an account overseen by the CFTC. Here is how this little wrinkle works, for example. Has your staff made any progress on this request or identified any policy issues that stand as an impediment to granting this request, which I understand is critical to ensuring the buy side utilize central clearing for these same products? And this is particularly in fact because the CFTC has an impact on this as well. How does that work between the two of you?

Ms. SCHAPIRO. Congressman, I am going to have to get back to you—I am sorry—for status from my staff on exactly where those conversations are, but Chairman Gensler may have more information.

Mr. GENSLER. If I could take it, the two agencies are working together on swaps and securities-based swaps regulation. In this one area that you mentioned, credit default swaps, where narrow based and individual swaps are the jurisdiction of the SEC and the index steps are over at the CFTC, I share the goal that you mention, that market participants can get the benefit of central clearing and the benefit of portfolio margining. And, of course, the devil is in the detail because of the two statutory regimes. But I know staffs have been working together with market participants on how to achieve that, and the CFTC, I believe, is committed to do that. I haven't heard of a concern from the SEC, but, given the capacity of all that we are doing, your highlighting helps just to remind us to keep attention on it.

Mr. SCOTT. Thank you so much.

My time is getting short, but back to my general concern about the overall health of this economy, making sure that we get this rule right so it doesn't interfere with the great progress we are making in the economic recovery, there are some studies that have shown there could be a significant impact on U.S. companies, particularly our financial companies, in increased borrowing costs if the Volcker Rule is not implemented the right way. Now, given the complexity of this task, the significant downside of getting it wrong and the fact that the CFTC just released its rule, what is the downside of taking comments and re-proposing with greater clarity based on these comments?

Mr. TARULLO. As I said earlier, Congressman, I think whether we do that or not will depend on the assessment we make of the comments we have received. If there is not a fundamentally different track down which to head, then I think it would actually be in everyone's interest, including the firms, to have a sense sooner rather than later what the rule will look like.

If, on the other hand, we do think that we need to change fundamentally—I haven't seen it yet, but—

Mr. SCOTT. Do any of you believe that in the process of interpreting this rule and putting it in place, there is a downside to it, having a negative impact on the great advances we are making with our economic recovery, especially in the job creation?

Mr. TARULLO. I think if, as you say, the rule is implemented properly—and that is probably most importantly focused on making sure that the underwriting and market-making functions are able to proceed in a productive fashion—then, we shouldn't see that kind of impact.

Might we see some shifts from one firm to another in, for example, being able to run a proprietary desk? Yes, I think we may see some of that. But that was the congressional judgment that that kind of proprietary trading in a firm with a depository institution was not necessary for the firm itself and raised certain financial stability risks. If we do underwriting and market making right, I think that the capital flows with which you are most concerned are going to be preserved.

Mr. SCOTT. Thank you very much.

Chairwoman CAPITO [presiding]. I am going to conclude the first panel. I want to thank the witnesses. I think you answered some great questions and have been very forthright, and I appreciate it. Thank you.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

I will call the second panel up as soon as they are able to switch places.

If I could ask everyone to take their seats, and we will proceed.

At this time, we have the second panel of witness before us, and I will introduce them individually. I understand Congresswoman Hayworth will make an introduction, which I will save until we get to your constituent.

Our first witness is Mr. Anthony J. Carfang, partner, Treasury Strategies, Inc., on behalf of the U.S. Chamber of Commerce.

STATEMENT OF ANTHONY J. CARFANG, FOUNDING PARTNER, TREASURY STRATEGIES, INC., ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. CARFANG. Thank you, Madam Chairwoman, and members of the committee. We are pleased to speak to the committee today on an issue of such profound importance to the stability of the financial system.

My name is Tony Carfang, and I am a partner at Treasury Strategies. We are the world's leading consultancy in the areas of treasury management. For 30 years—in fact, today is our 30th anniversary—we have been working with corporate treasurers and CFOs, helping them manage their daily cash flows and growing their businesses.

We also consult to the financial institutions who provide treasury and liquidity services to those corporations.

We are speaking today on behalf of the U.S. Chamber of Commerce, its 3 million members, and the 3 million treasurers of those companies who will have to deal with these regulations. And what I would like to do today is share with you the untold story of how these regulations will impact the daily management of America's businesses. As a matter of fact, there are five points I would like to make here, five chapters to this story.

Number one, American businesses are the most capital-efficient in the world, and the Volcker Rule will change that.

Number two, as every treasurer knows, risk can neither be created nor destroyed, only transformed. And while the Volcker Rule may remove this risk from the banking system, it puts it right in the lap of every U.S. corporation.

Number three, the rulemaking process that you were discussing earlier is so unaligned in terms of the comment periods and in terms of the implementation, that it further adds to the uncertainty and increases the possibility that all except the largest banks will either scale back or reduce the number of services they offer altogether.

Number four, this is one of four major pieces of regulation impacting corporate treasurers along with Basel, along with proposed additional money market fund regulations, and along with derivatives regulations, all four of these designed to impact financial institutions, but frankly landing right on the desk of every corporate treasurer in America.

Number five, there are no do-overs here. Corporate treasurers will be realigning their balance sheets, reprogramming their ERP systems as they change banks and change the way they manage risk and raise capital. Those are long-term changes. Now, it may take 12 to 18 months for even a mid-sized company to make these changes, and once made, they are not going to be easily reversed.

I would like to dwell on the first point of capital efficiency, because at Treasury Strategies, we are with our corporate treasurers day in and day out helping them manage their cash. U.S. corporations keep cash balances of about $2 trillion here in the United States, which is 14 percent of U.S. GDP. In Europe, the comparable

ratio is 21 percent, about 50 percent higher. Should banks exit some of the capital raising and risk management businesses, companies will need to increase their cash buffers, and essentially, we will see the cash deficiency decline.

Should that 14 percent rise to the European level of 21 percent, that would mean an extra $1 trillion. Corporations would have to raise and, frankly, idle, sideline $1 trillion if capital efficiency decreases to European levels, which could well happen under the Volcker Rule. That $1 trillion is more than the entire TARP bailout. That $1 trillion is more than the stimulus. That $1 trillion is more than the recent Federal Reserve's quantitative easing. And to take that money out of the system and sideline it would have huge economic impacts. That can only be done through downsizing or deferring growth and expansion plans, postponing maintenance and capital investment, not a good outcome. We encourage you to think very carefully about how all of this plays out.

There are four major regulations designed to impact national institutions that will impact the way corporate treasurers manage their cash day in and day out: the Volcker Rule; potential money market fund regulations; derivatives regulations; and Basel 3 capital requirements. All of these are untested, yet are going to hit the markets simultaneously.

Ladies and gentlemen, this has not been thought through. We would encourage you to take the time necessary to think this through.

Finally, the ultimate question is, when a U.S. corporate treasurer calls his or her bank in order to raise capital or manage risk, will there be anybody there to answer the phone?

Thank you very much.

[The prepared statement of Mr. Carfang can be found on page 83 of the appendix.]

Chairwoman CAPITO. Thank you.

Mr. CARFANG. I am happy to answer any questions.

Chairwoman CAPITO. Thank you.

I now recognize Ms. Hayworth for an introduction.

Dr. HAYWORTH. I have the pleasure of introducing Mr. Scott Evans, who happens to be a constituent of mine. I am privileged to be his Representative in Congress in the 19th Congressional District of New York. He is the executive vice president and president of asset management of TIAA–CREF. He is the chief executive officer of the company's investment advisory subsidiaries, so he has oversight of nearly $441 billion in combined assets under management.

He previously served as chief investment officer and, prior to that, he was head of CREF Investments. His BA is from Tufts University, his MM from Northwestern University's Kellogg School of Management, and he is a chartered financial analyst and a member of the New York Society of Security Analysts.

I am privileged to welcome you, Mr. Evans, and I thank you for your testimony.

Thank you, Madam Chairwoman. I yield back.

Chairwoman CAPITO. Thank you.

Mr. Evans?

STATEMENT OF SCOTT EVANS, EXECUTIVE VICE PRESIDENT, PRESIDENT OF ASSET MANAGEMENT, TIAA–CREF

Mr. EVANS. Thank you, Congresswoman Hayworth, for that kind introduction.

Chairwoman Capito, Chairman Garrett, Ranking Members Maloney and Waters, my name is Scott Evans. I am the executive vice president with TIAA–CREF and president of our Asset Management Division. I appreciate the opportunity to speak with you about some of the effects of the Volcker Rule on the insurance industry, specifically as it relates to our ability to invest in certain financial vehicles.

Please allow me to tell you just a little bit about TIAA–CREF. We are the Nation's largest provider of retirement benefits. We have a not-for-profit heritage, serving 3.7 million Americans in the academic, research, medical, and cultural fields. We are an insurance company managing $464 billion in assets, providing over $10 billion a year in retirement income to teachers, nurses, campus service personal, and others in the not-for-profit sector.

In order to provide our participants, our clients with a comprehensive set of financial solutions, we also own a thrift institution. Many of our participants have a lifetime relationship with TIAA–CREF and trust us to provide for their long-term financial success. Our thrift further enables us to meet our participants' lifetime financial needs by providing them with a banking partner as they live to and through retirement.

Now, our thrift currently compromises less than a tenth of a percent of our total assets. However, it still qualifies as an insured depository institution under the proposed rule and thus subjects our entire enterprise to the investment and sponsorship restrictions of the Volcker Rule.

While the proposed regulations provide an exemption from proprietary trading restrictions for insurance companies, this exemption does not expressly extend to allowing insurers to hold an ownership interest in covered funds defined to encompass private equity funds. This is a concern for TIAA–CREF and, quite frankly, others in the insurance industry, since private equity investments are an integral part of our long-term investment strategy. These investments are widely used by insurers to diversify our portfolios and enable us to deliver on long-term commitments that we have to our participants.

Our insurance portfolio primarily compromises core investments with stable return characteristics. Private equity investments allow us to diversify our portfolio while also seeking higher yields over extended investment horizons. This investment blend enables us to meet the long-term financial goals of our participants, providing them a steady stream of income in retirement built on a variety of asset classes.

Additionally, many private equity investments provide essential long-term capital to important sectors of the economy, including infrastructure, projects to build roads, airports, water treatment facilities, desalination plants, and energy distribution facilities.

We believe that the intent of Congress with respect to the Volcker Rule as stated in the Dodd-Frank Act was to appropriately accommodate the business of insurance. We do not believe the pro-

posed rule follows this intent as it subjects our entire enterprise to limitations designed to regulate the investment activities of the thrift.

TIAA–CREF appreciates that Congress is conducting responsible oversight of the regulations to implement the Volcker Rule, and it is our hope that final regulations will not result in any significant disruption for insurers or the individuals depending on us for their long-term financial security.

Thank you again for the opportunity to testify before you today, and I look forward to taking your questions.

[The prepared statement of Mr. Evans can be found on page 97 of the appendix.]

Mr. SCHWEIKERT [presiding]. Thank you.

Professor Johnson?

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you very much.

I would like to make three points, if I may.

The first is with regard to the cost of financial crisis, including the cost of the last crisis and the cost of any future crisis. I have listened to the hearing so far this morning, and I have heard little discussion of what we lost and what we could stand to lose in the future.

You can measure it in different ways. You could talk about more than 8 million jobs lost. You can talk about the loss of growth that we will not get back. I will stress the fiscal cost. According to the Congressional Budget Office, the change in medium-term debt of the United States, the Federal Government debt held by the private sector is roughly 50 percent of GDP, $8.5 trillion. That is a huge cost.

What is the mechanism through which we encountered the previous financial crisis? What are the risks we face going forward? This is my second point. A lot of these risks come from the behavior of very large banks; and, despite the best intentions and attempts by Congress to deal with this problem of so-called too-big-to-fail banks, I am afraid these structures are still with us. There is a distorted set of incentives that these banks have. They get the upside when things go well. They get the profits, the compensation for executives. When things go badly, the risks, the costs get shoved on to, ultimately, the American taxpayer. That is the point of the $8.5 trillion in losses.

And the way that you blow up a bank, the way that Lehman was destroyed, the way that Bear Stearns was destroyed, the way that Merrill Lynch incurred such large losses was precisely and exactly through proprietary trading, properly defined, as defined by the statute, as defined by Mr. Tarullo in his remarks this morning. It was exactly the intent of those institutions to buy and to hold securities, hoping to benefit from short-term price movements, that led them into what were regarded as very highly rated investments. Triple A securities were in fact where they suffered the most damaging losses.

Mr. Tarullo said this morning we shouldn't always be fighting the last war; and, of course, he is right. And the advantage of the Volcker Rule, as written and as attempted now to be implemented, is precisely on a forward-looking basis to prevent the big banks from again putting their hand into the pocket of the American taxpayer.

My third point is, I understand that the industry is concerned about this, and I have read carefully the documents that SIFMA has sponsored, put out through various organizations and individuals. And I am deeply skeptical, for the reasons expressed in my written testimony, of the estimates of the so-called liquidity costs or reduction in liquidity. I think these are massively overstated. I think the methodology that is used, for example, in the Oliver Wyman report, is deeply flawed. I have explained that in my testimony. I am happy to take that up with you further.

However, let's say there are small liquidity costs. Let's say we should be evaluating and thinking about potential costs, and you all have done that very carefully this morning. We must weigh those costs surely against the benefits. Surely the question is not, can you find this or that small nickel and dime cost in various parts of the economy, but what are you doing to the risks that this society will face another massive, devastating financial crisis because we have banks that are so big that when they threaten to fail they can bring down the entire economy?

We can talk about alternative approaches. We can argue there should be more capital in the financial system. I argue this day in, and day out with regulators both here and around the world. But you won't get it. Basel 3 will not give you enough capital. There is nothing else on the table that will make meaningful progress in this area.

I would close by reinforcing and reiterating the point made by Barney Frank in this morning's panel, which was, if uncertainty is an issue and you want to get past the process of resolving what happened before and what is the basis for the rules going forward, then you shouldn't have more delay. You need to have rules now. And the rules are available. The rules can be put into place. And I would urge you not to encourage the regulators to delay any further.

Thank you very much.

[The prepared statement of Professor Johnson can be found on page 161 of the appendix.]

Mr. SCHWEIKERT. Thank you, Professor Johnson.

Mr. Elliott?

STATEMENT OF DOUGLAS J. ELLIOTT, FELLOW, THE BROOKINGS INSTITUTION

Mr. ELLIOTT. Thank you all for the opportunity to testify today on the Volcker Rule. I should note that, while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf.

I believe that the Volcker Rule is fundamentally flawed and will do considerably more harm than good for the economy. I base this on 2 decades on Wall Street, as well as on the years I have spent at think tanks since them.

Despite being a former banker, I should note that my views on the Volcker Rule do not stem from opposition to the Dodd-Frank reforms. Indeed, I am on record as a strong supporter of the overall approach of the legislation.

My core problem with the Volcker Rule is that it tries to eliminate excessive investment risk at our major financial institutions but without measuring either of the two key attributes: the level of investment risk; and the capacity of the institution to bear the risk. Instead, the rule focuses on the intent of the investment.

I believe that the globally agreed-upon Basel rules on bank capital take a more intelligent approach by explicitly measuring both investment risk and the adequacy of capital to absorb those risks. One can validly argue about the techniques used to do this, but it makes a lot more sense to fix any flaws in that approach than to act as if we have no ability to measure risk or capital.

Focusing on intent instead creates multiple fundamental problems. For starters, the concept of proprietary investments is highly subjective. I surmise that the underlying rationale is to try to separate out activities that are integral to banking from those that are not. By focusing on investments alone, the Volcker Rule implicitly assumes that lending is good. In addition, some investment activities are recognized as integral to banking, as we have discussed this morning. Others are not.

This raises several concerns for me. Most fundamentally, finance has evolved over the last few decades to the point where corporate borrowers switch easily between borrowing via loans and via securities. This means that securities activities are now integral to modern corporate banking just as lending has always been. Further, it is extremely hard to draw the line between acceptable and unacceptable activities under the Volcker Rule.

Operationalizing the arbitrary and subjective distinctions will force regulators to peer into the hearts of bankers, which will be extremely difficult. We are in danger of forcing regulators to micromanage banks in one of their core activities, the ownership and trading of securities.

In addition, the rule misses investments that are taken on with an acceptable intent but which still represent excessive risk. For example, we want banks to hold safe and highly liquid securities to meet sudden demands for cash without having to make a fire sale of their loans or other assets. Therefore, the proposed rules provide an exemption for liquidity activities, but a large portion of the investment losses at commercial banks in the crisis were on their holdings of securities purchased for liquidity purposes. They bought AAA mortgage-backed securities, as Professor Johnson noted, which were quite liquid at the time of purchase; thus, the intent would have been considered acceptable, but banks still lost a lot of money.

These critical flaws mean that the Volcker Rule will do a poor job of identifying or eliminating excessive investment risk, will be costly even when it correctly identifies risk, and will be even more costly when it discourages risk-taking that is incorrectly treated as if it were excessive. Thus, the rule will raise the cost of credit to our suffering economy. Securities markets will be harmed by a substantial reduction in the liquidity provided by banks. This will

widen bid-ask spreads and make new issuances of securities more expensive.

Meanwhile, banks themselves will have a reduced role in profitable lines of business that are integral to modern banking, forcing them to recoup the lost revenues through other ways of charging more to their customers. As a result of all this, businesses will pay more for funds to invest in new plants or R&D or to hire additional workers.

The decreased efficiency of markets will also spur investors to demand higher risk premiums, reducing the price of existing stocks, bonds, and other assets, potentially including housing. U.S. banks will also lose market share to global competitors. This will further reduce their profits, leading to the pass-through to customers of more costs and destroying some high-paid U.S. jobs.

Ideally I would like to see Congress repeal the Volcker Rule. Failing that, Congress should send a clear signal that regulators are to implement the rule in a modest and relatively simple fashion that focuses on only stopping those activities that very clearly violate the rule.

Thank you again for the opportunity to testify. I look forward to your questions.

[The prepared statement of Mr. Elliott can be found on page 94 of the appendix.]

Mr. SCHWEIKERT. Thank you, Mr. Elliott.

Our next speaker is Alexander Marx, head of global bond trading, Fidelity Investments.

STATEMENT OF ALEXANDER MARX, HEAD OF GLOBAL BOND TRADING, FIDELITY INVESTMENTS

Mr. MARX. Thank you. Chairmen Capito and Garrett, Ranking Members Maloney and Waters, and members of the subcommittees, thank you for your opportunity to testify today. My name is Alex Marx, and I am the head of global bond trading for Fidelity Investments. In this role, I am responsible for the bond trading that supports the investment products for which Fidelity serves as investment adviser, including Fidelity's mutual funds.

Fidelity is one of the world's leading providers of financial services, with assets under administration of $3.4 trillion, including managed assets of more than $1.5 trillion. Fidelity provides investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing, and other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms. We manage over 400 mutual funds across a wide range of disciplines, including equity, investment-grade bonds, high-income bonds, asset allocation, and money market funds. The assets we manage belong not to Fidelity but, rather, to the funds and the shareholders and customers who have entrusted us with their savings.

In this role, Fidelity has a fiduciary duty to serve in the best interests of these clients, who are mostly small investors, such as retirees, parents saving for college, and other individual investors, as well as pension plan participants and institutional investors such as governments, universities, nonprofits, and other businesses.

It is in this fiduciary capacity that I appear before you today to make you aware that the implementation of the Volcker Rule, as proposed, would have significant negative impacts on Fidelity's customers. Fidelity is not here to represent the interests of Wall Street, but is a buy-side capital markets participant who is interested in ensuring the U.S. capital markets remain the most liquid and efficient in the world.

We have two primary concerns with the regulations that have been proposed to implement the Volcker Rule. First, the rules as proposed will have significant burdens on banks when they engage in principal trading. The result of this is that the funds will need more cash available to accommodate shareholder redemptions, causing a loss of investment opportunities and higher transaction costs, which in turn will lead to reduced return investors across the fund industry.

Second, the proposed rule could slow growth in the economy by raising the cost of capital issuance for U.S. companies and municipalities, which would come at a particularly unfortunate time as the economy continues to strive for recovery. As an investment adviser, Fidelity is not a bank that would be directly regulated by the proposed rules. Indeed, we recognize that the Volcker Rule, as passed by Congress, regulates banks and seeks to reduce the likelihood that proprietary trading conducted by those banks could put the U.S. economy at risk. The banks provide liquidity in the capital markets through their ability to commit capital to trade securities with our funds at any point in time.

This customer-facing principal trading with the dealer as the principal on one side of the trade and Fidelity's funds as the principal on the other is significantly different from the speculative proprietary trading that the Volcker Rule sought to limit, yet this distinction is not adequately addressed in the proposed rules. We are concerned that the proposed market-making exemption will be so burdensome for the dealers that they will either have to charge market participants more for trades or, in some cases, dealers will choose to exit market making in certain businesses altogether, resulting in less liquidity, increased volatility, and higher transaction costs for investors.

Additionally, banks regulated by the Volcker Rule serve critical roles as underwriters in the capital markets. As underwriters, the banks purchase securities from corporate and municipal issuers and sell these securities to investors such as Fidelity's funds. The proposed rules will likely affect the manner in which banks conduct underwriting services, potentially resulting in higher costs of capital issuance for borrowers. Higher borrowing costs for small- to mid-cap issuers could potentially cause downstream effects on the health of U.S. businesses and their ability to hire workers and invest in new markets. The resulting higher capital costs and less efficient markets may also compromise the competitiveness of U.S. businesses globally.

Lastly, due to the narrow definition of municipal securities in the proposal, there will be higher debt costs for many municipal issuers, impairing their ability to fund critical projects.

The impact of the Volcker Rule proposal would have significant impact on equity markets as well as fixed-income markets. For ex-

ample, the proposal would jeopardize the abilities of dealers to engage in block or program risk trading with large institutional investors like Fidelity's funds. My written statement includes additional details on the effect on equity markets.

In conclusion, we look forward to working with Congress and the regulators to ensure that any final rulemaking is appropriately tailored and will not create negative, unintended consequences for investors, capital formation, and economic growth. I would like to thank the subcommittees and their staffs for their work on issues important to investors in the financial markets and for holding this hearing to consider the implications of the proposed regulations related to the Volcker Rule, and I would be happy to answer any questions.

[The prepared statement of Mr. Marx can be found on page 165 of the appendix.]

Mr. SCHWEIKERT. Thank you, Mr. Marx.

Our next witness is Wallace Turbeville, on behalf of Americans for Financial Reform.

STATEMENT OF WALLACE C. TURBEVILLE, ON BEHALF OF AMERICANS FOR FINANCIAL REFORM

Mr. TURBEVILLE. Thank you. Today, I speak on behalf of Americans for Financial Reform, a coalition of more than 250 organizations who have come together to advocate for reform of the financial sector. I am reminded today of a time 33 years ago when as a young attorney I was commissioned to write testimony for a partner of Goldman Sachs to be delivered to a committee of Congress on behalf of the Securities Industry Association. That is the predecessor organization of SIFMA that represented investment banks. The goal of the testimony was to resist repeal of Glass-Steagall, so to protect investment banks from competing with commercial banks and the cheap and plentiful capital that they would have. Those issues are really sort of still central to what we are talking about today.

Now, there has been discussion of the Volcker Rule as based on intent or based on looking into the hearts of people or using psychiatrists and what not. In reality, in looking at the rules, the Volcker Rule is all about prohibiting a line of business which has a purpose, so you have to define what the purpose is of the business. That is a direct threat in terms of a run on the financial system.

In other words, proprietary trading large positions where margin calls are required, regardless of what the crisis is, regardless of what the causes are, the vehicle that is most threatening to the financial system has historically in this country been a run on it, and that is what it does. Proprietary trading is not made illegal. Trading demand can, and, under the rule, will be met by other institutions in the system.

The Act surgically excises only those trading practices which cause the greatest risks and tries to leave as permissible client-oriented trading. However, what has happened over the years is client-oriented trading, the fever of proprietary trading has sort of infiltrated client-oriented trading, so it is hard to tease out what is client-oriented and what is not. That is why the rules are so long and complex.

Ninety percent of the 300 pages is about discussion, and of those 300, that 90 percent, most of it is about trying to tease out what is client-oriented and what is not. Having prevailed with the insertion of numerous exceptions and permissions in the Volcker Rule, it is ironic that banks now complain that the rules are complex. That was somewhat inevitable.

The industry sets forth a number of objections, but the centerpiece is that liquidity in the traded markets will dry up, imposing large costs on society, and studies are put forth to support that, but these studies don't withstand scrutiny.

For example, an explicit assumption of the Oliver Wyman study that SIFMA commissioned is that reduced bank activity will not be replaced. That assumption is transparently false. Proprietary trading that is profitable and useful and makes sense will migrate out of banks and into other organizations, and the capital behind that will follow it. It is really remarkable that all of the industry comments assume that this will not be replaced. They pound the drums about the business moving off to Dusseldorf, but they ignore the possibility, when they do their numbers and come up with their costs, that the business might actually just move across the street.

The claim about the cost of lost liquidity is a complex one. In fact, a lot of the trading that is going to be prohibited isn't actually about liquidity, it is about—it is trading of other types.

There is an interesting study done by Professor Thomas Philippon of NYU Stern School that found that the overall financing costs in the entire real economy have actually increased over time, despite greater IT efficiencies. In his words, the finance industry that sustained the expansion of railroads, steel, and chemical industries, and the electricity and automobile revolutions was more efficient than the current financing industry.

This reduction of liquidity asserted by the commenters is based on all these misleading assumptions using market data from stress situations and the rest; but worse, the commenters ignore the costs and risks arising from subsidized, too-big-to-fail trading. And finally, in all of the cost benefits, the value to the public of avoiding bailouts is not even considered.

Thank you for the opportunity to speak, and I am happy to answer questions.

[The prepared statement of Mr. Turbeville can be found on page 220 of the appendix.]

Mr. SCHWEIKERT. Thank you.

Our next witness is Douglas Peebles, chief investment officer and head of fixed-income, AllianceBernstein, on behalf of the Securities Industry and Financial Markets Association Management Corp.

STATEMENT OF DOUGLAS J. PEEBLES, CHIEF INVESTMENT OFFICER AND HEAD OF FIXED INCOME, ALLIANCEBERNSTEIN, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION'S ASSET MANAGEMENT GROUP

Mr. PEEBLES. Good afternoon, Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the subcommittees. 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 $400 billion in assets under management. AllianceBernstein is a major mutual fund and institutional money manager, and our clients include, among others, State and local pension funds, universities, 401(k) plans, and similar types of retirement funds and private funds.

Today, I will focus on provisions of particular concern to AllianceBernstein and SIFMA's Asset Management Group. We believe significant changes must be made to the implementing regulations, particularly with respect to the market-making exemption. Market making is a core function of banking entities and provides liquidity 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, market buyers and sellers are much less likely to wish to trade at the same moments 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 the risks in purchasing the securities 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.

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 markets.

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.

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 net asset value. 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 retirements.

Rather than establishing applicable standards to government-permitted market-making activities, however, the proposal creates a presumption that any covered financial position held for a period of 60 days or less is a prohibited proprietary transaction, essentially prohibiting market makers from holding inventory. 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 several 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.

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 a market maker's willingness to commit capital to facilitate orderly trading. 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 the corporate issuers to raise capital in the United States 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 prepared statement of Mr. Peebles can be found on page 180 of the appendix.]

Mr. SCHWEIKERT. Thank you, Mr. Peebles.

Our next witness is Mark Standish, president and CEO, RBC Capital Markets, on behalf of the Institute for International Bankers.

STATEMENT OF MARK STANDISH, PRESIDENT AND CO-CEO, RBC CAPITAL MARKETS, ON BEHALF OF THE INSTITUTE OF INTERNATIONAL BANKERS (IIB)

Mr. STANDISH. Thank you, Chairmen Capito and Garrett, Ranking Members Maloney and Waters, and members of the subcommittees. My name is Mark Standish, and I am president and co-CEO of RBC Capital Markets, the corporate and investment banking platform for the Royal Bank of Canada. Now, as someone who is British by birth and American by choice, it is an honor to testify before you on behalf of the Institute of International Bankers.

The IIB's members consist principally of foreign banks that have substantial banking, securities, and other financial operations in

the United States. Our members contribute significantly to the depth and liquidity of U.S. financial markets and to the overall U.S. economy. IIB members' U.S. operations have approximately $5 trillion in assets, generate a quarter of the commercial and industrial bank loans made in this country, employ tens of thousands of Americans, and directly contribute to the U.S. economy more than $50 billion in annual expenditures. Our U.S. operations are subject to U.S. regulation and supervision, our activities outside the United States are subject to regulation by authorities in the countries in which we operate, and our home country regulators supervise our global activities.

Like U.S. banks, we have concerns regarding how the proposal impacts our U.S. operations. However, today my remarks will focus on the cross-border implications of the proposed regulations.

The IIB supports the goal of financial reform. We acknowledge the agencies' hard work and the challenges in developing regulation to implement the Volcker Rule. However, we submit, the proposal as currently formed is inconsistent with Congress' intent and will not advance reform goals. Congress was clear that foreign banks trading or funds activities conducted outside of the United States are not subject to the rule, recognizing that these activities are regulated under foreign law by home country supervisors. The proposed regulations, however, fail to adhere to this long-standing U.S. policy.

For example, the proposal would restrict a foreign bank's trading desk in London, Toronto, or Tokyo from buying or selling for its own account any securities traded on a U.S. trading platform, including the New York Stock Exchange, or under the proposal, our employees in Houston would not be able to market a non-U.S. fund to clients in South America. A Canadian bank could not sell interests in Canadian mutual funds to the 1.2 million Canadian snowbirds who regularly visit the United States. Foreign banks would be restricted from transacting in liquid securities of home-market issuers necessary to fulfill our roles in supporting our domestic trading markets. And finally, the proposal would frustrate our ability at the parent-bank level to actively and dynamically manage our balance sheets in currencies outside of our home countries.

In short, the extraterritorial reach of the proposed regulations restricts activities that would pose no threat to the United States but, rather, directly and indirectly support U.S. jobs and the U.S. economy.

The proposal exempts trading in U.S. Government securities but fails to allow principal trading in non-U.S. Government securities. Regulators in Canada and Japan have written to the agencies explaining that such an uneven playing field could undermine the liquidity of government debt markets outside of the United States as well as impede the ability of foreign banks to manage their liquidity and funding needs. IIB strongly urges the agencies to adopt an exemption for trading foreign government securities.

Lastly, I would be remiss not to comment on the extremely complex compliance requirements. They impose extensive quantitative reporting requirements on banks that engage in permitted activities, such as market making and risk-mitigating hedging. Apart from the questionable usefulness of the approach, such require-

ments should not apply to the non-U.S. operations of foreign banks without regard as to whether the U.S. taxpayer is put at risk.

In conclusion, we are very concerned that the burdens of the proposed regulation will far outweigh the alleged benefits. It will encroach on the autonomy of foreign banks and regulators, and it will harm the competitiveness of U.S. markets, and the global markets that U.S. counterparts transact in.

We urge the agencies to take their time in developing regulations to implement the rule to make sure they get it right, and we would submit that the Basel 3 requirements very well may achieve the objectives sought to be addressed by the Volcker Rule. Thank you and I look forward to your questions.

[The prepared statement of Mr. Standish can be found on page 198 of the appendix.]

Mr. SCHWEIKERT. Thank you, Mr. Standish.

I recognize Mrs. Biggert for 5 minutes for questions.

Mrs. BIGGERT. Thank you, Mr. Chairman, and my questions are for Mr. Evans to start out with, and I am glad you are here. I did not have the opportunity to ask the regulators about the insurance issue, but I am going to submit several questions that I had for them also, so I think that your testimony has been very helpful.

You stated in your testimony that the Dodd-Frank Act provides an exemption from the Volcker Rule for insurance companies, but there seems to be part exemption and a question about private equity. If you could give some examples of the private equity investments that are attractive to insurers that invest for long term, and could you explain how that will—do those investments differ from private equity firms like Carlyle or Bain, but is there a clarification in the Volcker Rule that these are acceptable as exemptions or not?

Mr. EVANS. Thank you, Congresswoman, for the question. The Dodd-Frank Act says that the regulators should appropriately accommodate the business of insurance, and the accommodations could take the form of giving an exemption for proprietary trading or giving an exemption for covered funds, private equity funds, hedge funds, etc.

The interpretation of the rulemaking seems to be that it exempts only proprietary trading, which makes no sense when you think about it, because proprietary trading is a short-term activity. Insurance companies invest for the long term to provide, in our case, lifetime income for 3.7 million people in the academic, medical, and cultural fields, and so for us, it is extraordinarily important that we maintain an ability to make these type of investments.

Now, we do all kinds of investing that would be considered covered-fund investing, but to give you some examples of long-term investing that helps us allow our 3.7 million participants to have large and stable lifetime income, we are invested in a power plant in the Northeast, a toll road in the Southeast, an electricity transmission business in the Southwest, and a clean coal gasification plant in the Midwest. These are long-lived investments, 20, 30, 40 years in duration. They are designed to provide steady streams of income that can support average working people's lifetime income after their working years.

Mrs. BIGGERT. Okay. Then, obviously, we have been working on making sure that insurance companies, which are regulated by

States—and so this bothers me that they are really bringing this into the Volcker Rule on this. How do State insurance investment laws add a layer of protection from equities speculation by insurance companies affiliated with banks?

Mr. EVANS. State regulators have regulated insurance companies like TIAA–CREF for many, many years, and they have a number of restrictions. It is no accident that insurance companies are structured in a conservative manner and made it through the recent downturn in relatively good shape, because we are under strict regulations. In our case, the State of New York is the primary State regulator. We have restrictions on the type and amount of covered-fund type investing that we do. There are very strict regulations on that. Those regulations work well, and we are working with the new Federal insurance overseer to make sure there is consistency and not duplication of regulations as we transfer to Federal regulation.

Mrs. BIGGERT. Do you think that Congress intended to allow insurance companies just to be able to engage in proprietary trading and also to invest in the private equity and hedge funds?

Mr. EVANS. It is our belief that Congress intended, when it said that the rulemakers should appropriately accommodate the business of insurance, that they were speaking of both proprietary trading and covered funds, particularly since insurance companies don't engage in proprietary trading, so in our minds, they must have meant covered funds. And we think it is very important that the rules, as they become finalized, specifically exempt covered funds' activities for the reasons that I mentioned.

Mrs. BIGGERT. Thank you very much.

Mr. EVANS. Thank you.

Mrs. BIGGERT. Mr. Carfang, do you think that the Volcker Rule has the potential to raise the cost of capital for both large non-financial companies and small to mid-sized American businesses?

Mr. CARFANG. Thank you for the question, Congresswoman. Absolutely. Because of the Volcker Rule's eliminating or restricting the activities of market participants, the costs will go up. There are fewer bidders to bid down the price. But I think an even greater concern is the crowding out of small businesses. As we continue to have concentration in the larger banks—and the Volcker Rule exacerbates that—the largest companies will still have access to—the largest and highest credit rated companies will still have access to capital, albeit at a higher cost. There is a real question of whether there is enough capital to avoid the crowding out of smaller businesses at any cost.

Mrs. BIGGERT. We have been working to try and increase jobs and take down the barriers for small businesses to be able to do that. The only jobs that the Dodd-Frank bill seems to have increased is compliance jobs, and so is this one of the costs that would be increased?

Mr. CARFANG. Exactly. Costs will go up in terms of, first of all—

Mr. SCHWEIKERT. And I hope you will forgive me, Mrs. Biggert—

Mr. CARFANG. —the cost of the services, the rates, the operating services across-the-board.

Mrs. BIGGERT. Thank you. I yield back.

Mr. SCHWEIKERT. Thank you, Chairwoman Biggert.

Ranking Member Maloney has asked us to make sure we work through Members on her side who did not get a chance to ask a question before. Mr. Ellison, I think you are next.

Mr. ELLISON. Thank you, Mr. Chairman, and also thank you, Congresswoman Maloney. And also, thank you to the panel. I appreciate all of the help that you have given us to understand these issues, but I just want to ask kind of a basic question first.

Do you all agree with the basic premise that trading operations of banks shouldn't be subsidized with deposit insurance access to the discount window and other Federal subsidies? Do you agree with that basic idea? How about you, Mr. Carfang?

Mr. CARFANG. I generally agree with that statement. However, like everything else in this bill, it is subject to—

Mr. ELLISON. Thanks a lot. I only have limited time. Does everybody basically agree with that or is there anybody who disagrees? Professor Johnson?

Mr. JOHNSON. If I understood the question correctly, you are asking whether we agree with the subsidies, with the existing structure of subsidies?

Mr. ELLISON. No, no. What I am asking is, do you basically agree with the goal and intent of the Volcker Rule? Do you agree with the premise that trading operations of banks should not be subsidized?

Mr. JOHNSON. Absolutely, Congressman.

Mr. ELLISON. Oh, I know you agree. I know you agree, and I know Mr. Turbeville agrees, but I am kind of curious—

Mr. ELLIOTT. It is a more complex question than it might appear on the surface.

Mr. ELLISON. I hear you, Mr. Elliott, and I want to ask you about that. So if you agree on the basic idea that banks should not be subsidized by deposit insurance or, basically, the taxpayer, if they want to engage in investment which could lose or gain money—

Mr. ELLIOTT. I don't believe they should be subsidized in any of their activities based on things like deposit insurance. However, if you subsidize them at all, the money is fungible. You end up effectively subsidizing any of the things that they choose to do. That is why I view it as a more—

Mr. ELLISON. Okay, now, thank you for asking that because before I came to Congress, I was a public defender. This stuff is complicated. But I am aware that between the establishment of Glass-Steagall and Gramm-Leach-Bliley, for a long time banks couldn't—the core functions of banks and insurance companies and investment banks were separated, and they couldn't do this kind of stuff, and the system seemed to be pretty stable. And now that they can do it, things seem kind of unstable, and what everybody except for Mr. Johnson and Mr. Turbeville seem to be saying is that we absolutely have to allow banks trading operations to use subsidized deposit insurance and discount window access and the monies and the accounts associated. We have to do that because if we don't, we won't have access to capital, overseas investors will outcompete us, we will lose jobs. That seems to be the—tell me why the system was stable for so long when we couldn't do this and how it is so essential that we have to do it now. Mr. Turbeville, maybe you can—

Mr. TURBEVILLE. I actually remember the old system.

Mr. ELLISON. Okay. Me, too.

Mr. TURBEVILLE. I think you have hit on the real issue, which is not that this business is going to, poof, go away, but we are really talking about moving the business from being capitalized by subsidized capital to being subsidized by free market properly priced capital. I think it is absolutely correct, and I think that what one of the things that was part of the genius of the New Deal was they figured out, yes, you put in the safety net for the banks, but you also separate out this trading activity so that one doesn't overlap the other. I think Mr. Elliott is absolutely right, even though deposit insurance, for instance, doesn't directly subsidize the capital, it indirectly does because you can't let those institutions go.

Mr. ELLISON. It seems to me, in the absence of something like the Volcker Rule, we have a "heads-I-win, tails-you-lose" system in which, if I am a bank, I can go out and buy mortgage-backed securities, AAA rated, and if they make a bunch of money, I keep that. I don't give that to depositors whose money I use. But if I lose a bunch of money, then I am coming to the taxpayer to save me, and it just seems so unfair.

And as we go through this debate, a lot of you guys who are so smart, you know so much, and I am so impressed, but it seems like what you are doing is saying, "There are 10 exceptions, no, 20, no 30, no 50. You know what, it is too complicated, let's just keep it how it was since 1999." And it just doesn't seem right. It seems like if we can't fix and have everything perfect that we can't do anything, which of course is a good deal because if I said, "Look, I am going to use somebody else's money, invest it, maybe put it in mortgage-backed securities, if I make a bunch of money, I keep that; if I lose a bunch of money, somebody else pays." And of course, why would anybody want to stop that, if they are on the plus side of it?

And I guess what everybody except for Mr. Johnson and Mr. Turbeville is saying is, right, we don't want to stop it, we like it. So tell me why I am wrong.

Mr. ELLIOTT. If I could just briefly say, as I mentioned in my testimony, I have been a strong supporter of Dodd-Frank, which contains many things that are far from perfect but move us in a safer direction. So I want to be clear about that.

Mr. ELLISON. Okay.

Mr. ELLIOTT. The thing is, the premise of your question and the explicit comments of Professor Johnson are that the Volcker Rule would actually increase safety in some appreciable way. That I do not actually believe. For instance, holding the mortgage-backed securities. The holding of mortgage-backed securities, most of them would have been perfectly okay under the Volcker Rule. You can lose money on these investments without being in danger from the Volcker Rule.

Mr. ELLISON. Does anybody—well, let me—

Mr. JOHNSON. Congressman, you are exactly right. The Volcker Rule proposes to remove the subsidies from some very powerful people in our society. Not surprisingly, they would like to keep those subsidies, and they are telling you that today.

And with regard to access to capital and the cost of capital, this is not just unfair, Congressman, this is incredibly inefficient. What has destroyed access to capital, what has destroyed access to jobs in this country over the past 4 years, was the behavior of the biggest firms in the financial sector, the way they used those subsidies in a reckless and excessive manner, and they will do it again.

Mr. SCHWEIKERT. Mr. Ellison?

Mr. ELLISON. I am out of time?

Mr. SCHWEIKERT. Yes. It was getting interesting, but we are out of time.

Mr. ELLISON. Sorry about that.

Mr. SCHWEIKERT. Thank you, Mr. Ellison.

Without objection, the following statements will be made a part of the record: the American Bankers Association; BlackRock, Inc.; the Bond Dealers of America; the Business Roundtable; CMS Energy; ICI Global; SIFMA; Silicon Valley Bank; and Stanford Professor Darrell Duffie's comment letter.

Mr. SCHWEIKERT. I am going to yield myself 5 minutes and see if I can actually do a little continuing on parts of this discussion.

Professor, I actually heard a couple members of the panel, at least one but maybe two, touch on Basel 3 and Basel 2.5 that are already out there. Basel 3 is also creating a capital safety net. Can you comment on that?

Mr. JOHNSON. Yes, Congressman. Basel 3 is very unlikely to provide enough capital for the financial system. Remember, this is a least common denominator negotiation across leading countries, industrialized countries. It includes the Europeans, and as I am sure you are fully aware—

Mr. SCHWEIKERT. Are you picking on the Europeans?

Mr. JOHNSON. They brought it on themselves.

Mr. SCHWEIKERT. I should share, I think, that in Germany, the first stage of downgrade may have happened today.

Mr. JOHNSON. I missed that.

Mr. SCHWEIKERT. Germany.

Mr. JOHNSON. What about Germany today?

Mr. SCHWEIKERT. Downgrade.

Mr. JOHNSON. I am sorry, I didn't hear that, I didn't hear the point.

The Europeans don't want capital in their banks, so Deutsche Bank, for example, is a very lightly capitalized bank. They have consistently resisted, from all accounts within the Basel Committee, attempts to raise capital standards, even to the levels proposed by the Federal Reserve, even to the levels that Mr. Tarullo was recommending. So the idea that Basel 3—from an American perspective, does Basel 3 do enough to make our system safer? Absolutely not. Capital requirements should be increased way beyond what you will get in that framework.

Mr. SCHWEIKERT. Okay. To that point, Mr. Standish, you actually touched on Basel 3. Help me understand where the professor is right, or half right, or wrong.

Mr. STANDISH. Thank you, Congressman. We have actually adopted in Canada large parts of Basel 3, and by the 1st of January 2013, we will have also adopted Basel 3 in our trading books. The effect of that from pre-crisis levels has probably been to in-

crease the amount of capital supporting our trading activities by 2 to 3 times.

In order for Members to understand Basel a little better, on the key characteristics of Basel 3, banks will need to hold substantially more capital than is required today, and again I just mention that additional capital is heavily in linked to trading books.

Bank capital will be comprised predominantly of common equity, and that is versus Tier 2/Tier 3 types of paper capital. Banks will need to hold substantially more unencumbered liquid assets to enhance their liquidity positions and reduce dependency on short-term financing, and that also includes increased term funding of their businesses. Banks will be required to establish loan loss reserves that consider full economic cycles, and here we are talking about countercyclical capital. When things are great, everyone thinks it is going to continue, so you don't think you need to hold much capital against those exposures. That will be reversed. Banks will be subject to global leverage ratios that will govern balance sheet leverage, and that includes bringing onto balance sheets the impact of off-balance sheet vehicles that were the cause of a lot of the problems with the shadow banking system.

So I feel that Basel 3 actually does a tremendous job and actually does, I think, a better job than Volcker of addressing the shortfalls in the financial system. Obviously, Basel 3 is then applied globally differently by jurisdiction, depending on the risks in individual jurisdictions.

Mr. SCHWEIKERT. And Professor, maybe you could quickly respond, because there are a couple other areas I want to touch on?

Mr. JOHNSON. Just to counter on the point of whether there is enough capital, Deutsche Bank, which is, as far as I am aware, almost Basel 3-compliant at this point, has total assets of around 1.9 trillion euros, it has bank capital compliant with Basel 3 of about 60 billion euros. It faces potential losses on, of course, its sovereign lending and exposure to other banks within the European context. This is a very thinly capitalized major bank around which the Germans and the Europeans are negotiating.

They also own Talus Corporation in the United States, that is more than 50-to-1 leveraged according to the official Federal Reserve statistics, and that is okay also, apparently, under the way we operate.

Mr. SCHWEIKERT. Only because I am down to a minute left, but I would love to have a side conversation with you on this. I actually have some real interest in the ECB issues.

Mr. Evans, your book of business is somewhat unique with what you do and the population you serve. How would we exempt you? How would the hedging practices, particularly the number of folks who—and I must admit, I think actually I even have some resources with you also, the annuities and the other products. Tell me what the Volcker Rule does to you and mechanically how you see yourself either needing to be exempt, or the costs we just pushed on to your members.

Mr. EVANS. Thank you, Congressman. I think it is actually pretty straightforward. If the rulemakers adjust their interpretation of your intent to include, your intent to appropriately accommodate the business of insurance to include an exemption for covered-funds

activity, I think that does the trick, because that will enable us to make these investments in what are loosely defined as private equity securities, but what we recognize as very long-term investments in infrastructure and other assets. So, I think it is actually pretty straightforward in terms of what needs to be done to correct this.

Mr. SCHWEIKERT. You win the award for the simplest answer of the day. My time has expired.

I now recognize Mr. Perlmutter.

Mr. PERLMUTTER. Thanks, Mr. Chairman, and to the panel, excellent testimony. I think all of you make legitimate points. I draw some different conclusions than some of you do.

And Mr. Carfang, you really had a cogent—you laid it out nicely to begin with, and then you sort of countered by the professor, and sitting here as kind of the political guy, the decision-maker, we want to have robust, efficient markets, yet we don't want to stick the taxpayer with a ton of responsibility if those efficient markets somehow fail. And so, the more efficient they are going up, the more efficient they are going down. And in America, we try to sort of limit that a little bit, and that started with the New Deal, with the Glass-Steagall separating investment banking from commercial banking, and over time, that eroded; unitary banking went, the investment banking piece went, we still have the FDIC, which I think is the third piece of Glass-Steagall that is left.

So when this all came to us, we started out, and Mr. Miller and I had a one-page amendment that was more or less not the Volcker Rule but sort of the precursor to the Volcker Rule that said—I first said if you are a systemically significant organization, it could have been an insurance company, it could have been a bank, whatever, and your trading places the economy at risk, then you can be ordered to divest it. So, there was a danger piece to it.

Mr. Miller said, we ought to have that for banks generally. So we added banks, but there was a danger piece to it. We did some carveouts for the insurance industry for their hedging and their covering and all of that stuff, went to the Senate. They said, no, we are just—we don't like it, but we will do a few exceptions. And then, it went to the Conference Committee who said, you can't do this except—and they go through all of the market making, insurance kinds of issues, foreign banks, holding companies. And now, we have placed the regulators with the responsibility to take what I think—Section 619 is a pretty prescriptive Section. We ask them to make rules from this to try to deal with who can trade and who can't, and when can they and when they can't. So, from my point of view, I think we did a pretty good job.

I appreciate some of the comments Mr. Peebles and you, Mr. Standish—and do we have two Englishmen on the panel today?

Mr. JOHNSON. I am also an American, Congressman.

Mr. PERLMUTTER. I know, but—

Mr. JOHNSON. The accent, yes, does originate elsewhere.

Mr. PERLMUTTER. Okay. All right. Americans, but English by birth? Okay. It is nice to have you guys on the panel.

Mr. STANDISH. We came over on separate boats.

Mr. PERLMUTTER. Okay. So, let's go back. We are where we are, we had a tremendous fall, and it may be a trillion dollars in costs

and inefficiency to the capital market, but by my calculation, just the drop in the stock market between the summer of 2008 and the end of 2008 was 6,000 points. That is $1.3 billion per point or $7.8 trillion. That is $26,000 for every man, woman, and child in America. And so, we have to deal with that. I have to deal with that.

I don't think we can delay this any further. We are not going to go back to Glass-Steagall, that is the bright-line test.

Mr. Carfang, do you disagree with what I have said? Don't we have to have some restrictions in there?

Mr. CARFANG. I absolutely agree that unbridled risk-taking should not be supported by taxpayers, by deposit insurance. The issue is the gray area and the lack of clarity around the regulations and the lack of a precise definition of proprietary trading. Much of what could be falling into this gray area has become standard risk-taking practices that every company uses, and even individuals use. And without that lack of clarity, the fear on the part of corporate treasurers is banks will err on the side of conservatism and withdraw from businesses, making medium-sized to small businesses totally without access to capital raising and risk management tools. We absolutely agree that—

Mr. PERLMUTTER. So my question to you then is, I am not sure it is the rulemaking as it is getting rid of—from your position—getting rid of Section 619.

Mr. CARFANG. We already have a robust system of capital requirements that Basel 2 is making even stronger with the additional capital requirements for systemically important institutions. In addition to that, regulators have substantial latitude in terms of the risk weighting of assets on bank balance sheets, and I think that is where you manage the problem, not simply coming up with hundreds of pages of prescriptions on how 3 million U.S. treasurers should do their job every day. That is not doable.

Mr. PERLMUTTER. Thank you.

Mr. RENACCI [presiding]. Thank you. I yield 5 minutes to myself.

Mr. Elliott, in the book, you write that we will survive the implementation of the Volcker Rule, but that it is an unnecessary, self-inflicted wound. You also write that you would like to see Congress repeal the rule.

Is it possible for the regulators to adopt a Volcker Rule that does not have the negative consequences you describe, or has Congress given the regulators a mandate that simply cannot be fulfilled in a way that the benefits will outweigh the costs?

Mr. ELLIOTT. Frankly, I think it is the latter. I think there is such a lack of clarity as to what proprietary trading is, an inherent lack of clarity that there isn't some platonic answer that if we just searched for it, we would find it. It is inherently subjective and an arbitrary choice. It creates all these other issues.

I would rather have seen, as I mentioned, an approach similar to the Basel approach. If you end up feeling that isn't nearly conservative enough, then quadruple the levels or something, but at least it would say, we are going to measure risk and we are going to measure the capital to take the risk, and we will make sure there is enough.

Mr. RENACCI. It is interesting because one thing I seem to have learned today from both panels is there is still a lot of uncertainty in the implementation.

Mr. Marx, you testified that the Volcker Rule will reduce liquidity, which will have a negative effect on Fidelity's customers. Can you expand on that? Who are your customers? Why do they invest with Fidelity? What does reduced liquidity mean for them? Will the Volcker Rule mean that your customers may have to work longer to retire or won't be able to save as much for their children's education, for example, or things like that?

Mr. MARX. Sure. As I mentioned in my statement, the customers that we have are retail investors, parents saving for college for their children, 401(k) pension plan participants, institutional investors as well. When I talk about the fact that it is going to cost more, I talk mostly in the markets arena where the transaction costs are going to be precipitously higher, depending upon the asset class that you are referring to. So, the ability for investors to get in and out of funds with regards to redemptions, the ability for issuers where they are trying to come into the market, it is going to give us a moment of pause as far as investments on behalf of our shareholders, and therefore ask for more from issuance. All around it is going to cost more people, it is going to cost the issuers whether they are corporations or municipalities, in order to give us the protection that we need for our investors. And that is just the buffer, that is not that they are getting something incremental in a new issue. It is just to give them the buffer to get out from the liquidity perspective.

Mr. RENACCI. Do you have some modifications that you think would work, that would make the Volcker Rule work as far as liquidity in bringing some of those issues to the table?

Mr. MARX. I think at a high level, the most important thing—there are two or three important things. One is really, truly identifying the difference between principal risk-taking and proprietary speculative risk-taking. I think if you can take the time to figure out how to separate the two, you are going to be in a lot better space, and it will allow dealers to feel more comfortable that they are not going to get in trouble with the regulators. I think that is the biggest thing.

The second issue for me is when you think about this legislation and other legislation that is trying to be enacted right now, it is too granular. You are trying to solve for all of the answers at once. And I think if you take it up—we use the term "take it up"—to 50,000 feet as opposed to try to get it all done at 10,000 feet, and you give it time to sort of focus through, you are going to realize what the unintended consequences are as opposed to all of a sudden them being right there for you.

Mr. RENACCI. And again, I think your response relates back to a lot of things I have heard today about just trying to figure out the differences, and we need to take that time.

Professor Johnson, if market making becomes the purview of nonbanks because it is difficult to distinguish from proprietary trading, won't the risks to the financial markets be even greater given that nonbank firms like MF Global would not be subject to the same strict oversight that bank holding companies are?

Mr. JOHNSON. No. No, Congressman, not at all. Under Dodd-Frank, you have the ability, the regulators have the ability to designate any institution, any financial institution as systemically important and therefore to regulate them.

I am well aware of the arguments put forward by Professor Darrell Duffie, for example, in the paper he submitted and you put into the record, but it doesn't make any sense. If there is anybody who is a significant player becoming a significant market maker who you think is generating potential damage to the financial system, they can absolutely be covered under the systemically important provisions of the Dodd-Frank Act.

Mr. RENACCI. Thank you. My time has expired. I now recognize Representative Carney for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you to the panel for coming. I must apologize; I wasn't here for your opening statements, so I am probably going to ask some of you to repeat some of what you said.

But in the first panel, I know some of you were here, Governor Tarullo said that if there is—kind of an astounding comment—a better idea out there, we are open to it. Does anybody have a better idea? I have heard some specifics, but does anybody have a better idea of an approach?

That is one question, and part of that question is, I have heard some of you say that you don't think it is possible to make the distinction clearly enough, I think Mr. Elliott, between market making and proprietary trading. And so, I guess I would be interested in what everybody thought about that. So, start off with those two quick questions, and I only have 5 minutes. Please.

Mr. CARFANG. Sir, you know, it is our sense that among the better ideas are many of the regulations that are already in place, as I mentioned earlier, on capital requirements and on risk weightings. There are four major pieces of regulation that are impacting corporate treasurers, none of which have been tested: the capital requirements of Basel 2; the Volcker Rule; money fund regulations; and derivatives regulations. We think a better idea is to not do all four of them at the same time.

Mr. CARNEY. Okay. He mentioned Basel 2. How about Basel 3? Are you saying that the Volcker Rule and Basel 3 are unnecessary, they are—in some ways, Basel 3 accomplishes what the Volcker Rule is attempting to accomplish?

Mr. STANDISH. Yes, Congressman, I do. I think the issue currently with Basel 3 is the current overall implementation plan is 2019 globally. I would contend that should be accelerated and sped up, and it will, I believe, meet certainly all of the checks and balances on the financial system.

Mr. CARNEY. I don't know the details, but don't Basel 2 and 3 essentially deal with capital requirements?

Mr. STANDISH. They do, but it take it to another level. They focus not just on increasing trading book capital. One of the negatives, I will admit, is that it penalizes or applies more capital to support market-making trading activities in lower-rated securities. So where I do have an issue with someone else stepping up and supporting markets is in smaller, lower-rated companies. I think that

will end up being a bit of a black hole in the market that should concern the Members.

Mr. CARNEY. Unless there is somebody else who has a better idea—quickly, please.

Mr. JOHNSON. In my written testimony, Congressman, I suggested that putting the firms in charge of compliance, which is what—

Mr. CARNEY. I read that.

Mr. JOHNSON. That strikes me as not a good idea, and that is a relatively easy thing for Mr. Tarullo and his colleagues to address.

Mr. CARNEY. Right. So I would like to go to this fixed-income market question. So what dynamic are you saying will create the effects that you just mentioned in response to Mr. Renacci's question? What does the Volcker Rule limitations do to the fixed-income? I have talked to some of the folks from Fidelity and Vanguard, and I have heard some of those arguments. I would like you to state them for the record.

Mr. MARX. I think if you take a very basic example, if you take a look at the high-income market versus the investment-grade corporate market, the investment-grade corporate market is probably 3 times the size from a new issue perspective on an annual basis over the last couple of years. So if you think that there is any sort of fear that liquidity will dry up, which it will, based upon people's inability to take risks or for fear of dealers to take risks because they don't want to be at odds with the regulators and the rules that are being implemented, you are going to see a market that is 3 times the size of the high-income market approach spreads that are in liquidity that are in the high-income market, and that is a significant change as far as the liquidity that is going to be provided.

Mr. CARNEY. So people have their hands up; would you like to add to that?

Mr. PEEBLES. I completely agree with what Mr. Marx just said. To give you a very simple example, so Fidelity or AllianceBernstein manages a mutual fund, but let's say we own all corporate bonds in that mutual fund. Today, there is a trading notion that takes place in those bonds, and tonight we receive redemption orders from our clients, right? And those redemption orders we process at today's closing price. We wake up tomorrow, we see collectively that we have redemptions, we have to go in the marketplace to sell the securities to fund those redemptions. The price that we expected to be there as of close of last night is very far away. So the 65-year-old woman from Iowa who wanted to raise $1,000 now has $750 in terms of her redemption. That is a big problem.

Mr. CARNEY. I have 10 seconds left. How do you fix it? I had another part of that, but I only have 10 seconds. Is there a fix?

Mr. MARX. To me, the fix truly is identifying the difference between principal risk-taking and proprietary risk-taking. We need prudent risk-takers in the market and not speculative risk-takers.

Mr. CARNEY. Mr. Johnson, I would love to hear from you, if my colleague from Ohio would allow it.

Mr. JOHNSON. Congressman, it strikes me that we should have more confidence in the market. The assumption here is that the liquidity will only be provided by the existing big banks that are

highly subsidized, and if you withdraw those subsidies, that somehow the liquidity provision will go away. Why? If it only exits because of subsidies, that may be true. But if there is genuine opportunity there, if there is really profit to be made in these markets, making the markets, that business will shift. That is the problem with the Oliver Wyman study, very extreme assumptions, but the logic should be that the market will adapt, that is the basic principle of how the deep financial markets work.

Mr. CARNEY. Thank you.

Mr. RENACCI. I want to recognize Ranking Member Maloney for 5 minutes.

Mrs. MALONEY. First, Mr. Turbeville, you had your hand up, you wanted to comment?

Mr. TURBEVILLE. Yes, there is another way to look at this, is that when someone goes out and places a block, and they are going have a liquidation or they need to buy some securities, they go to a bank and they put the block with the bank. And what is happening there is that institution is renting the bank's balance sheet because they are saying, we are going to move these securities at a price over to your balance sheet.

So the question is this, and Professor Johnson is right: Do you want the balance sheet that is rented to be a subsidized balance sheet supported by too-big-to-fail, or do you want it to be an unsubsidized balance sheet with an institution that is not subject to the safety net and subject to too-big-to-fail guarantees?

Mrs. MALONEY. Thank you. Mr. Peebles—and I know that many people have questions on it and we can follow up with written questions on it—are you familiar with the global legal entity identifier?

Mr. PEEBLES. No, I am not.

Mrs. MALONEY. Anybody on the panel? You are?

Mr. TURBEVILLE. Yes.

Mrs. MALONEY. Do think that this identifier will enable financial regulators and the public sector to have a better review of the benefits and to better control what is happening? Do you think that this is important to manage finance and prevent failures and risk the identifier?

Mr. TURBEVILLE. Aside from the issues we are talking about today, perhaps actually to be able to monitor the markets and understand what is going on, having data is absolutely the most important thing.

The first threshold issue is the legal entity identifier, which is to sort out what the legal entities are that are involved in all these transactions. I believe the fact is that Lehman Brothers had 2,500 or more separate entities inside it when it went under and caused a massive systemic problem. So the legal entity identifier is the linchpin, the first of getting a handle on what is actually going on in the financing markets.

Mrs. MALONEY. Who do you believe should bear the cost of implementing the legal identifier?

Mr. TURBEVILLE. I believe the cost—if I were in charge of everything, the industry would bear the cost.

Mrs. MALONEY. And going on to the implementation of the Volcker Rule, do you believe that we will see an increase in trading

firms? People are saying people will be moving overseas. There is a likelihood they might move across the street and open a trading firm. Can you comment on whether or not you think this will have an impact on increasing trading firms or not?

Mr. TURBEVILLE. I that is right. I think it will increase trading firms and trading will change in the different firms. Even Professor Duffie in his paper talks about that. Nobody really believes this business. If it is a sound business, if it is profitable, if it makes sense, if the trading business makes sense, that people will find a place to do it and the capital will find its way to those institutions.

Mrs. MALONEY. But won't that increase liquidity?

Mr. TURBEVILLE. I think it not affect liquidity, because I think what will happen is it will find its own surface. I think what will happen, though, is that if you don't have capital devoted to trading that is too-big-to-fail kind of capital, subsidized, that some kind of trading that probably doesn't—I am sure it doesn't add anything to liquidity, but probably is a drag on the economy—some of the layers of intermediation and some of the trading that has nothing do with liquidity and nothing to do with the things that have been talked about on this panel will dry up. That kind of trading will cease.

Mrs. MALONEY. Will too-big-to-fail banks' revenues increase or decrease in your opinion?

Mr. TURBEVILLE. I think too-big-to-fail banks' revenues will decrease, except for the years in which they blow themselves to smithereens and create massive financial problems for the economy. But I think also their capital will shrink and their businesses will change.

Mrs. MALONEY. In your opinion, what will be the impact on the financial industry? And more importantly, how will market hedge funds, public and banks react to increased trading volumes? What effect will this increased trading volume have on the whole system?

Mr. TURBEVILLE. The overall volume may or may not go up. The liquidity will survive and that liquidity purpose will be fulfilled. It is entirely possible—and I meant to suggest that in my oral statement—it is possible that the system itself now, the financing system and the trading system is efficient from the bank's perspective but is not efficient from corporate America's perspective. So that the actual cost of financing and raising capital is higher now than it was 50 years ago. There is some research that suggests that. So it is entirely possible that in the post-Volcker world, if indeed moving proprietary trading out of banks causes some of this not productive trading except for financial institutions to go away, that it will actually be beneficial.

Mr. RENACCI. I want to thank—did you want additional time?

Mrs. MALONEY. I would like Mr. Johnson to comment if he could briefly, there were many causes out there for the financial crisis, but would you say that one of them was the inability of regulators and interested parties to see financial transactions and track what is happening and see what is happening? One of our goals is that we created an Office of Financial Research that would be capable of providing risk assessment and stress tests based on realtime data, and would that have an impact that could prevent loss and prevent crises. Some CEOs who testified before us said that this

central system could be very effective in preventing crisis in the future. What is your opinion?

Mr. JOHNSON. Congresswoman, I was the chief economist of the International Monetary Fund in 2007 through August 2008. I was involved in discussing the details of the financial crisis as it developed, including at the highest levels of government, both in this country and around the world. And the lack of data was a very big problem.

But my concern is that even now, even after the creation of the Office of Financial Research, with derivatives markets in particular remaining so completely opaque in many regards and with cross-border transactions continuing to be extremely complex, are now under massive pressure because of what is happening in Europe, I am afraid the sensible steps taken to collect better data and to provide better analysis are not enough. You also need to supplement that with many other measures, including the Volcker Rule.

Mrs. MALONEY. Thank you.

Mr. RENACCI. Mr. Perlmutter?

Mr. PERLMUTTER. In keeping with the theme dealing with England, I would like to offer and place in the record an excerpt from a chapter by Adair Turner, a professor at the London School of Economics, on the future of banking.

Mr. RENACCI. Without objection, it is so ordered.

Again, I want to thank the panel members for their testimony today. The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

With that, the hearing is adjourned.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

A P P E N D I X

January 18, 2012

Chairman Garrett Opening Statement
Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012

As I have said before, it appears that the so-called Volcker Rule in a lot of ways is a solution in search of a problem. It is not clear to me that the "disease" that it seeks to cure – proprietary trading and investment in private equity and hedge funds by depository institutions – was a significant driver of the 2008 financial crisis.

But even for the rule's defenders, the form it has taken as jointly proposed by the regulators is not constructive and will almost surely do more harm than good.

For instance, when the rule was first proposed, Paul Volcker, himself, reportedly commented, "I don't like it, but there it is."

Much of the concern about the rule has been around the difficulty of figuring out the difference between proprietary trading and market making, and the very burdensome and costly compliance regime that the rule suggests.

I also have concerns that the restrictions proposed in the rule on fund investments go beyond the scope of Congressional intent.

The end result, I fear, is that market liquidity will be restricted, which ultimately kills jobs, and investment options for depository institutions will be constrained,

leading to a concentration of risk on bank balance sheets that at the end of the day could make them actually less stable than they would be without this rule.

Furthermore, while the current administration likes to point to its efforts at international cooperation, several foreign governments have weighed in with their concerns about this proposal's extraterritorial overreach, as well as with their fears that it will unnecessarily increase the cost of trading foreign sovereign debt.

One thing I hope not to hear from today's first panel is that their hands are tied because the statute requires such an unwieldy and unworkable rule. While I have concerns about the statutory language, I do believe it leaves regulators with the flexibility to do better than what has been proposed to date.

Finally, I feel very strongly that this rule must be re-proposed, with another round of comments, before it goes final. The current proposal contains more than 1,300 questions that commenters must consider and respond to, but in no way resembles an implementable rule. A more complete and settled draft proposal is necessary for market participants and others to comment on before completing this rulemaking process.

In addition, more evidence is needed that a robust cost-benefit analysis has been undertaken on such an important rule that will have far-reaching impacts on our financial institutions, our markets, and, indeed, the broader economy.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
CAPITAL MARKETS AND FINANCIAL INSTITUTIONS
JANUARY 18, 2012

CHAIRMEN GARRETT AND CAPITO, RANKING MEMBERS WATERS AND MALONEY,

GLASS-STEAGALL WAS ENACTED TO ADDRESS THE CAUSES OF THE GREAT DEPRESSION. SLOWLY BUT SURELY THE LEGISLATION WAS WHITTLED AWAY AS THE PRIVATE SECTOR WATERED DOWN SECTION 23A AND SECTION 23B OF THE BANK HOLDING COMPANY ACT. FINALLY IN 1999 WHEN CITIGROUP ACQUIRED TRAVELERS INSURANCE, GLASS-STEAGALL WAS FOR ALL INTENTS AND PURPOSES REPEALED.

WE KNOW WHAT HAPPENED FROM 1999 TO PRESENT DAY: OUR CONSTITUENTS HAD TO BAILOUT LARGE INSTITUTIONS; THE STOCK MARKETS DROPPED PRECIPITOUSLY; AND OUR ECONOMY ALMOST COLLAPSED. THE GLOBAL ECONOMY COMES CLOSER EACH DAY TO THE BRINK OF ECONOMIC DISASTER, WHICH UNFORTUNATELY IS NOT AN EXAGGERATION.

SMALLER INSTITUTIONS, COMMUNITY BANKS AND CREDIT UNIONS IN PARTICULAR, DID NOT CAUSE THE RECENT ECONOMIC DECLINE. THEY PLAYED AN ABSOLUTELY CRITICAL ROLE PROVIDING LIQUIDITY TO THE MARKETS AT A TIME WHEN NO OTHER INSTITUTIONS WOULD OR COULD.

THEY ENSURED THAT CAPITAL CONTINUED TO FLOW TO SMALL BUSINESSES ENABLING THEM TO CONTINUE TO OPERATE AND EVEN TO GROW, THEREBY BENEFITTING THE LOCAL COMMUNITY AND ECONOMY.

A SMALL BUSINESS ADMINISTRATION STUDY SHOWS THAT THE EXPENSE FOR SMALL FIRMS TO COMPLY WITH FEDERAL RULES IS 45 PERCENT GREATER THAN IT IS FOR LARGER BUSINESS COMPETITORS, AND ALMOST 90 PERCENT OF THE COUNTRY'S 26 MILLION SMALL BUSINESSES USE SOME FORM OF CREDIT.

THE DODD-FRANK ACT MAKES EXPLICIT PROTECTIONS TO PROTECT SMALL BUSINESSES FROM UNINTENDED CONSEQUENCES. SECTION 619 PROHIBITIONS ON PROPRIETARY TRADING DO NOT APPLY TO SMALL BUSINESS INVESTMENT CORPORATIONS (SBICS), ALLOWING FOR BANKS TO INVEST IN SMALL BUSINESS INVESTMENT COMPANIES SBICS. THREE DIFFERENT SECTIONS—1099, 1424, AND 1474—ALL REQUIRE STUDIES TO ENSURE THAT CREDIT COSTS ARE NOT INCREASED FOR SMALL BUSINESSES THROUGH THIS REGULATION.

THE VOLCKER RULE WILL HELP IMPROVE THE SAFETY OF OUR NATION'S BANKING SYSTEM BY PROHIBITING PROPRIETARY TRADING ACTIVITIES AND CERTAIN PRIVATE

FUND INVESTMENTS AND ALLOW COMMUNITY BANKS AND CREDIT UNIONS TO TAKE CARE OF THEIR CONSTITUENCIES.

WE ARE STILL IN THE EARLY DAYS OF THE IMPLEMENTATION OF THE DODD FRANK ACT, AND THERE WILL STILL BE SOME UNCERTAINTY ABOUT HOW THE RULES WILL AFFECT FINANCIAL INSTITUTIONS GOING FORWARD.

I WOULD LIKE TO KNOW MORE ABOUT THE PROVISIONS ALLOWING FOREIGN BANKS TO CONDUCT PROPRIETARY TRADES OUTSIDE THE UNITED STATES, WHICH I WILL ADDRESS DURING THE QUESTION AND ANSWER PERIOD.

THIS IS TRULY A CRITICAL MOMENT FOR OUR COUNTRY, AND IT IS MY HOPE THAT WE CAN COME TOGETHER TO HELP THIS COUNTRY TURN AROUND, SO ONCE AGAIN OUR CHILDREN AND RESIDENTS MAY HAVE THE FULL OPPORTUNITIES PROMISED TO THEM AND THE ABILITY TO ACHIEVE THE AMERICAN DREAM.

I YIELD BACK THE REMAINDER OF MY TIME.

Statement
of the
U.S. Chamber
of Commerce

ON: "Examining the Impact of the Volcker Rule on Markets, Business, Investors and Job Creation"

TO: The Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit

DATE: January 18, 2012

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Good morning Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the subcommittees. It is an honor to be invited to testify at today's hearing: "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation". This is a timely hearing that goes to the heart of the stability of the financial system and I am pleased to be able to contribute to the discussion.

I am Anthony J. Carfang, a founding partner of Treasury Strategies, Inc. Treasury Strategies is the world's leading consultancy in the area of treasury management, payments and liquidity. Our clients include the CFOs and treasurers of large and medium sized corporations as well as state and local governments, hospitals and universities. We also consult with the major global and regional banks that provide treasury and transaction services to these corporations. In thirty years of practice, we have consulted to many of the world's largest and most complex corporations and financial institutions.

I am here today, on behalf of the U.S. Chamber of Commerce to discuss the impact of the Volcker Rule on non-financial businesses.

In my mind the question that has not been asked and that needs to be answered by both the regulators and Congress is simply this: how does the Volcker Rule impact the ability of non-financial companies to raise capital and mitigate risk and are we willing to live with the adverse impacts of the Volcker Rule that will affect the competitiveness and the overall efficiency of the U.S. economy.

Let me first state that Treasury Strategies and our clients fully support well thought out efforts to improve economic efficiency and to reduce the likelihood of another systemic failure. The U.S. Chamber's position is the same and has advocated for stronger capital rules, rather than a unilateral ban on proprietary trading, as a pro-growth means of stabilizing the financial system and avoiding systemic failure.

However, we feel strongly that the Volcker Rule, as currently constructed, will not succeed in this effort. We believe that it will make U.S. capital markets less robust, U.S. business less competitive and ultimately reduce underlying economic activity. We believe that the lack of clarity in many of the proposed regulatory provisions and the lack of a precise definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide.

Simply put, after the Volcker Rule goes into effect, when a business' treasurer calls a bank to raise the cash needed to pay the bills, will someone answer that phone call?

Besides reduced financing for American businesses the Volcker Rule could actually INCREASE systemic risk by consolidating assets into the banking system, exacerbating too-big-to-fail.

Process Issues

Before I discuss the impacts of the Volcker Rule upon non-financial companies please let me take a minute to discuss regulatory process issues that make it extremely difficult if not impossible for businesses to understand how the Volcker Rule will impact their ability to raise capital.

The Federal Reserve ("Fed"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC") and Securities and Exchange Commission ("SEC") proposed their portion of the Volcker Rule implementing regulations in October and these were published in the Federal Register on November 7, 2011. The Commodities and Futures Trading Commission ("CFTC") voted on its proposal last week and to my knowledge has not published its proposal in the Federal Register.

Each of these regulators looks at a separate portion of the markets so it is only possible to understand the full scope and impacts of the proposed regulations when one can see how each of the proposed rules interact with one another and the markets themselves. While the CFTC is expected to close its comment period 60 days after publication in the Federal Register, the other regulators' comment period will close on February 13, 2012.

With competing comment periods, tt is impossible to conduct a thoughtful analysis and provide regulators with informed answers to the over 1,000 questions they have asked.

Accordingly, in terms of fundamental fairness the comment periods should be reconciled and extended for all of the regulators.

Summary

Businesses operating in the U.S. are the most capital efficient and productive in the world. Thanks to our financial institutions and existing banking frameworks, businesses and the U.S. economy benefit greatly from:

- The broadest, deepest, and most resilient capital markets,
- The best risk management products and tools,
- The most robust liquidity markets,
- The technologically advanced cash management services, and
- The most efficient and transparent payment systems.

As a result, U.S. businesses are extremely efficient. Consider the following Treasury Strategies analysis. Companies doing business in the U.S. operate with approximately $2 trillion of cash reserves. That represents only 14% of U.S. gross domestic product. In contrast, corporate cash in the Eurozone is 21% of Eurozone GDP. In the UK, the ratio is even higher.

Highly liquid means of raising capital allow treasurers to keep less cash on hand and use a just-in-time financing system that allows companies to pay the bills and raise the capital needed to expand and create jobs.

Should the Volcker Rule be enacted in its present form, capital efficiency will decline, resulting in increased corporate cash buffers. Were cash to rise to the Eurozone level of 21% of GDP, that new level would be $3 trillion.

Stated differently, CFOs and treasurers would need to set aside and idle an additional $1 trillion of cash:

- That $1 trillion is greater than the entire TARP program.
- It's more than the Stimulus program.
- It is even greater than the Federal Reserve's quantitative easing program, QE II.

This would seriously slow the economy to the detriment of businesses and consumers alike. To raise this extra $1 trillion cash buffer, companies may have to

downsize and lay off workers, reduce inventories, postpone expansion and defer capital investment. Obviously, the economic consequences would be huge.

Why would treasurers have to idle so much more cash?

The Volcker Rule, as currently proposed, will increase administrative expenses for banks, create a subjective regulatory scrutiny of trades thereby making a company's ability to raise capital more expensive and time consuming. This will raise costs for all companies; make foreign capital markets more attractive for some, while shutting other companies out of debt markets entirely.

This is also not happening in a vacuum.

Corporate treasurers must also contend with looming money market regulations that may imperil 40% of the commercial paper market, Basel III lending requirements and expected derivatives regulations.

All of these efforts are converging in one place—the corporate treasury and their combined impact upon a business's ability to raise capital and mitigate risk have not been vetted or thought through.

I would like to add a statement about managing financial risk. A common understanding among our clients is that, like energy, risk can neither be created nor destroyed but only transformed. So when you consider ways to reduce banking system risk, do not be tricked into thinking that risk disappears. It simply moves elsewhere.

To truly minimize the probability of future financial crises, we must understand how this risk transforms and where it will show up next. Risk is managed most efficiently when it is transparent, properly understood and the market responds with robust, efficient and liquid hedging solutions.

Specific Unintended Consequences of the Volcker Rule

Ambiguity surrounding provisions of the Volcker Rule is likely to have a chilling effect on precisely those banking services that account for U.S. competitiveness, capital efficiency and financial stability. This is an issue for U.S. businesses, large and small.

Some of the unintended consequences, in addition to a general slowdown in economic activity, include:

- Impaired market liquidity and reduced access to credit
- Higher costs and less certainty for borrowers
- Restricted trading in proper and allowable businesses
- Competitive disadvantage for U.S. businesses and financial institutions
- Increased compliance costs for **non-financial** businesses
- Higher bank fees for consumers and businesses
- Less access to capital for small businesses and start-ups
- Shifting of risks to other sectors of the economy
- Capital flows into offshore markets

Let's take these one by one.

1.) Impaired market liquidity and reduced access to credit

The Volcker Rule will impair the ability of banks to function as market makers. Banks act as significant buyers and sellers of securities to ensure that borrowers can find investors and investors can find investments.

As market makers, banks hold inventory. This could be inventory in various investment instruments, treasury debt, customer securities and foreign currencies. However, the Volcker Rule significantly constrains their ability by dictating how banks should manage their inventory. This will reduce the depth and liquidity of our capital markets.

For example, corporations, municipalities, healthcare providers, and universities rely upon the "market making" activities of banks in order to secure affordable funding in the bond market. Without these "market making" activities, banks would be unable or unwilling to underwrite these public and private bonds. Thus, if banks can no longer hold inventory, it will be much more difficult for businesses, municipalities and schools to raise capital.

Bank trading activities are what create market liquidity and enable the market to provide an efficient clearing price. Without these activities, markets take a giant step backward to bilateral 'deals' and, in effect, a barter or auction system.

2.) Higher costs and less certainty for borrowers

The Volcker Rule will increase the cost of capital for all companies. With reduced market liquidity, transaction spreads widen, risks increase and price changes become more volatile. To compensate for these new risks, investors will demand higher rates.

Because banks can currently underwrite a bond issue for a customer and hold any unsold bonds in inventory, credit worthy borrowers can be reasonably assured of timely access to credit. However, under the Volcker Rule in its current form, banks may not be able to hold that inventory. They therefore, may decide to defer or delay underwriting those bonds for their customers until buyers are found in advance.

Imagine a municipality or a hospital facing a critical funding need. Under the Volcker rule, they would go bankrupt waiting for a bank to line up the funding. Or, they end up paying a crippling rate.

3.) Restricted trading in proper and allowable businesses

The Proposed Rule is inherently complicated and forces regulators to define the intent of a trade. Worse, they require banks to "prove" the intent of each trade. This cannot be done in any reliable and consistent way. One entity's proprietary trade is another entity's market making activity. 'Proprietary trading' defies a symmetrical definition.

The complexity and vagueness of the Volcker Rule will force banks to adopt the most conservative interpretation of the rule and the least favorable "intent" of any trade. With the burden of proof on the banks, the compliance costs become prohibitive. The net result will likely be the elimination of perfectly acceptable "market making' activities. This could result in banks exiting or scaling back such routine activities as commercial paper issuance, cash management sweep accounts and multi-currency trade finance. These are services which all of Treasury Strategies clients view as critical solutions to execute sound financial management.

4.) Competitive disadvantage for U.S. businesses and financial institutions

The United States' major trading partners have rejected the Obama Administration's request to follow the Volcker rule. This puts American businesses and financial institutions at a disadvantage. By eliminating a core revenue stream from U.S. banks, the Volcker Rule would effectively reduce the ability for U.S. banks to compete and grow. Additionally, in order to avoid the territorial jurisdiction of the Volcker Rule, foreign financial firms may retreat from the U.S., further depriving American businesses of capital and degrading the ability of U.S. regulators to oversee and regulate financial activity.

Finally, most companies will still have financial risks that need to be managed. U.S. businesses will increasingly turn to foreign banks in overseas markets. Perversely, this will simultaneously weaken U.S. banks while strengthening foreign banks.

5.) Increased compliance costs for **non-financial** businesses

The reach of the Volcker Rule can extend to non-financial businesses, although they present no systemic risk whatsoever. Many businesses offer financing services to their customers. They may own a bank, have a commercial or consumer finance subsidiary or have a credit card company. These businesses will incur increased costs and higher compliance burden. Some will pass these costs on to their customers. Others will simply discontinue the financial or card services. In any event, the result is higher cost credit for those willing to pay and less credit for most small businesses and consumers.

6.) Higher bank fees for consumers and businesses

The cumulative effect of regulatory changes such as the Volcker Rule and Basel III will reduce or eliminate core banking revenue. At the same time, the Volcker rule will materially increase the costs of regulatory compliance. In order to continue providing high quality, technologically advanced banking services, U.S. banks will need to increase banking fees on a wide range of services. They may also need to become more selective in the customer segments they choose to serve, thereby reducing the general availability of banking services.

7.) Less access to capital for small businesses and start-ups

As banks restrict the availability of their services and increase the price, an inevitable "crowding out" will occur. The very highest rated corporations and those who transact in the highest denominations will still have access to credit and risk management products. However, the less credit worthy customers and start-ups will

be left out. Many traditional services will be no longer cost effective. Some may not be available to those segments at all.

8.) Shifting of risks to other sectors of the economy

As we stated, risk is neither created nor destroyed. It can only be transformed. A corporate CFO whose company imports a raw material from the Far East, for example, must manage currency risk, commodity price risk, interest rate risk, and operational shipping risks. Simply precluding a bank from helping the company hedge those risks, the Volcker Rule does not make those risks go away. Indeed, the risk becomes less transparent and thus more potent.

CFOs and treasurers will undoubtedly conclude that some risk management techniques and some heretofore efficient transactions will no longer be cost effectively. They will decide to "go naked" and retain that risk internally. The upshot of this is that they will hold even more precautionary cash on their balance sheets as a buffer. This will take money out of the real economy.

9.) Capital flows into offshore markets

Corporate treasury is the financial nerve center of the firm, daily facing, and managing the complexities of the global markets. Most treasurers select a lead bank as their primary source of capital, information, and advice. That bank must be one that both give the company global visibility, and can seamlessly operate in markets far and wide. The Volcker Rule would virtually eliminate U.S. banks from contention for that important 'lead' role.

Many companies have recently engaged Treasury Strategies to assist in upgrading their treasury technology. Their intent is to get a real time view of their cash and implement automated tools to easily move that cash around the globe. In this frictionless environment, cash can easily move to the most favorable jurisdictions.

Many U.S. multinational companies are already selecting lead banks for each region of the globe, eroding the dominance of the U.S. banks. Many companies are establishing regional treasury centers for functions traditionally housed in the U.S. All of this leads to capital flowing out of the U.S. and competitiveness declining.

Conclusion

I appreciate the opportunity to appear before you today on behalf of the U.S. Chamber of Commerce.

We feel strongly that the Volcker Rule, as currently constructed, will not reduce systemic risk nor improve economic well-being. We believe that it will make U.S. capital markets less robust, U.S. business less competitive and ultimately reduce underlying economic activity. We believe that the lack of clarity in many of the bill's provisions and the lack of a precise definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide. Finally, we are deeply concerned that the Volcker Rule will increase concentration of assets into the banking system and actually increase systemic risk.

I am delighted to discuss these issues further and answer any questions you may have.

Douglas J. Elliott

Thank you for the opportunity to testify today on the Volcker Rule. I should note that while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf, as Brookings does not normally take policy positions as an institution.

As I will explain, I believe that the Volcker Rule is fundamentally flawed and will do considerably more harm than good for the economy. I base this on two decades on Wall Street as well as on the years I have spent examining federal policy towards financial institutions at Brookings and earlier at another think tank. Despite being a former banker, my views on the Volcker Rule do not stem from opposition to the Dodd-Frank reforms. Indeed, I am on record as a strong supporter of the overall approach of that legislation, although there are certainly things I would have preferred to see done differently.

My core problem with the Volcker Rule is that it seems to me to be trying to eliminate excessive investment risk at our core financial institutions without measuring either the level of investment risk or the capacity of the institutions to handle the risk, which would tell us whether the risk was excessive. Instead, the rule focuses on the intent of the investment rather than its risk characteristics.

This approach creates at least four conceptual problems. First, there is the question of relevance. It is unclear to me why I care very much what the intent of the bank was. It's the level of risk relative to the capacity to bear that risk which is of prime interest. The globally-agreed Basel rules on bank capital take a more intelligent approach, by explicitly measuring both investment risk and the adequacy of capital to absorb those risks. One can validly argue about the techniques used to do this, but it makes a lot more sense to fix any flaws in that approach than to act as if we have no ability to measure risk or capital. If you are dubious about the technical measurements, then add further safety margins, but retain the focus on the key attributes of *risk* and the *ability to bear risk*.

Second, the concept of "proprietary investments" is a very subjective and arbitrary one. Many supporters of the rule seem to be particularly concerned about investments made by banks which are funded with depositor money and on which the shareholders collect any gain. However, this set of criteria captures essentially any investment made by a bank, since depositor funds are basically interchangeable with all the other funds gathered by a bank and the shareholders always benefit from any gains on investments. I surmise that the underlying rationale for the rule is to try to separate out activities that are integral to banking from those that are not. By focusing on investments alone, the Volcker Rule implicitly assumes that lending is good. In addition, some investment activities are recognized as integral to banking, while others are not.

This raises several concerns for me. First, I do not always agree with the arbitrary choices about what is integral and what is not. For example, I believe that the Volcker Rule is much too onerous in its restrictions on the roles that banks are allowed to play with hedge funds and private equity funds, which are now core parts of the investment management business, which has long been a key banking function. Second, it is often extremely hard to draw the line between acceptable and unacceptable

activities. For instance, securities dealing requires the holding of securities to meet potential customer demand in a timely manner. At what point does the inventory shift from being an appropriate size to being at a level which indicates speculation of a type the Volcker Rule is trying to stop?

Perhaps more fundamentally, finance has evolved over the last few decades to the point where corporate borrowers switch easily between borrowing via loans and via securities. This means that securities activities are now integral to modern banking, just as lending has always been. Even the distinction between a loan and a security is far less clear than it was originally. Advances in information technology and communications mean that it is relatively simple to take a transaction which involves extending credit and to structure it as a loan, if that is advantageous, or as a security, if that would be better for the lender. Large loans are not only syndicated among many banks, but are actively traded among banks and sold to non-bank buyers as well. Thus, the implicit assumption of the Volcker Rule that investments are substantially less integral to banking than lending is misplaced.

Third, operationalizing the arbitrary and subjective distinctions created by the Volcker Rule forces regulators to peer into the hearts of bankers, which will prove to be extremely difficult, if not impossible. This explains why the proposed rules are inevitably so complex, as regulators make an honest effort to obtain enough information to guess the intent behind investment actions. We are in danger of forcing regulators to micromanage the actions banks take in one of their core activities, the ownership and trading of securities. There is no reason to believe that regulators will be better at this than bankers, even recognizing the mistakes made by bankers in the run-up to the financial crisis.

Fourth, by focusing on intent, we are almost certain to miss large swathes of investments that are taken on with an acceptable intent, but still represent excessive risk. This is not a purely theoretical argument, as I can show with an example. As a public policy matter, we want banks, even small ones, to hold substantial portfolios of safe and highly liquid securities so that they can meet sudden demands for cash without having to make a fire sale of their loans or other assets. Much, if not all, of this portfolio will be funded with depositor money and the gains and losses will accrue to shareholders, so it is difficult to distinguish from other "proprietary" investments. Therefore, we clearly have to provide an exemption in order to ensure banks are allowed to hold enough securities for this purpose and the proposed rules do provide such an exemption. But, this brings its own major problem. A large portion of the investment losses at commercial banks in the crisis were on their holdings of securities purchased for liquidity purposes. They bought mortgage-backed and asset-backed securities that were rated "AAA" and which were quite liquid until the financial crisis struck and rendered them illiquid. Thus, the intent would have been considered acceptable, but it did not prevent bankers from weakening their institutions by losing large sums of money.

These four sets of flaws lead me to believe that the Volcker Rule will do a poor job of identifying or eliminating excessive investment risk, will be costly even when it correctly identifies risk, and will be even more costly when it discourages risk that is incorrectly treated as if it were excessive.

The Volcker Rule will raise the cost of credit to our suffering economy by harming our securities markets and by increasing the costs for banks and decreasing their revenues, which will push them to find other ways to pass costs along to their customers. Securities markets will be harmed by a substantial reduction in the liquidity that is currently provided by banks. This will force a widening of bid/ask spreads, equivalent to increasing commissions charged to investors, and will also make new issuances of securities more expensive. Meanwhile, banks will have a reduced role in profitable lines of business that are integral to modern banking, forcing them to find other ways to increase their revenues or reduce their costs. In the end, customers bear the brunt of such efforts.

All of this will translate into a higher cost of funds for companies wishing to invest in new plants or R&D or to hire additional workers. The decreased efficiency of markets would also spur investors to demand higher risk premiums, which should reduce the value of existing stocks, bonds, and other assets, potentially including housing.

There will also be an effect on the international competitiveness of our banks, since they will be more burdened by these restrictions than their global competitors. Globally mobile finance activities will be more likely to take place outside the US than would be the case without this rule. This would further reduce US bank profits, leading to the pass-through to customers of more costs, and would destroy some high-paid US jobs.

I do not wish to exaggerate the effects of the Volcker Rule. We will survive its implementation, but I view it as an unnecessary, self-inflicted wound. Ideally, I would like to see Congress repeal the rule. Failing that, it would be helpful for Congress to send a clear signal that regulators are to implement the rule in a modest fashion that focuses on stopping only those activities that very clearly violate the Volcker Rule without halting activities where the intent of the transactions is unclear. Along with this, regulators should be encouraged to implement the rule in the least burdensome manner possible. That said, the arbitrariness of this rule and the ambiguity of definitions means that there will necessarily be excessive complexity in the regulations.

Thank you again for the opportunity to testify today. I look forward to your questions.

Hearing before the Committee on House Financial Services
Subcommittees on Capital Markets and Government Sponsored Entities and Financial Institutions and Consumer Credit

Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation

January 18, 2012

Statement of
Scott Evans, Executive Vice President
President of Asset Management
TIAA-CREF

I. Introduction

Chairman Capito, Chairman Garrett, Ranking Member Maloney, Ranking Member Waters, members of the subcommittees, TIAA-CREF thanks you for the opportunity to testify on the "Volcker Rule" before the Subcommittees on Capital Markets and Government Sponsored Entities, and Financial Institutions and Consumer Credit.

Specifically, we appreciate the chance to address the Proposed Rulemaking on the Volcker Rule published in the Federal Register on November 7, 2011, by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the Federal Deposit Insurance Corporation ("FDIC"), and the U.S. Securities and Exchange Commission ("SEC"), referred to collectively throughout this testimony as the "Agencies." The Proposed Rulemaking outlines the implementation of new Section 13 of the Bank Holding Company Act ("BHC Act"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), commonly referred to as the "Volcker Rule."

Attached as an Appendix to this testimony are a number of relevant supplementary documents regarding the Volcker Rule including excerpts from the Congressional Record, language pertaining to the Volcker Rule included in recent legislation, an excerpt from the Financial Stability Oversight Council's ("FSOC") study on the Volcker Rule, and previous comment letters submitted by TIAA-CREF to Federal Agencies.

II. TIAA-CREF Background

TIAA-CREF is the leading provider of retirement services in the academic, research, medical, and cultural fields. We manage over $464 billion in retirement assets (as of December 31, 2011) on behalf of 3.7 million participants and serve more than 15,000 institutions.

Teachers Insurance and Annuity Association of America ("TIAA") was incorporated as a stock life insurance company in the State of New York in 1918 and is a licensed insurer in all 50 states, the District of Columbia and Puerto Rico. The College Retirement Equities Fund ("CREF") is registered as an investment company with the SEC under the Investment Company Act of 1940, as amended (the "Investment Company Act"). CREF is supervised by the New York State Department of Financial Services ("NYS DFS") and is registered as an insurance company in several states.

At the core of TIAA-CREF's not-for-profit heritage is our mission "to aid and strengthen" the financial future of the clients we serve by providing financial products that best meet their special needs. Our retirement plan annuities and mutual funds offer a range of options to help individuals and institutions achieve financial well-being and meet their retirement plan administration and savings goals, as well as income and wealth protection needs. In addition to our core retirement business, we have a number of other products and services available to ensure we are meeting our participants' goals of lifelong financial well-being.

III. TIAA-CREF and the Volcker Rule

In order to provide our participants with the financial solutions they are seeking, TIAA owns a thrift institution. Our participants trust us as a partner in their long-term financial success and because of this trust and confidence, they have asked us to provide options for post-retirement money management solutions. The thrift further enables us to meet the broader financial needs of our participant base throughout their lifetimes.

Our thrift institution currently comprises less than 0.2% of TIAA's $222 billion in admitted assets (as of September 30, 2011).[1] However, it still qualifies as an "insured depository institution" under Section 2(p) of Subpart A of the Proposed Rulemaking. Further, under the Proposed Rulemaking, TIAA's ownership of this thrift triggers the investment restrictions of the Volcker Rule. This in turn subjects many aspects of TIAA's business, including ordinary course investing activities of the parent insurance company, to the investment and sponsorship restrictions of the Volcker Rule.

TIAA-CREF's primary concern with the Proposed Rulemaking has to do with the manner in which it addresses the provisions in Section 619(d)(1)(F) of the Dodd-Frank Act. The language in this section includes investing by an insurance company's general account as a "permitted activity" and, by its terms, exempts permitted activities from both the "proprietary trading" and "covered fund" restrictions of the Volcker Rule.

While the Proposed Rulemaking does provide an exemption from the proprietary trading restrictions for insurer general accounts, this exemption does not expressly extend to allowing the general account to hold an ownership interest in a covered fund. In addition, the proposal defines covered funds in a way that essentially designates all private equity funds as covered funds. This is an area of concern not only to TIAA-CREF, but to many in the insurance industry since private equity investments are widely utilized by insurers' to diversify investment portfolios, both for the benefit of their general accounts and on behalf of customers. Private equity investments generally offer a long-term investment horizon and are an integral tool for ensuring adequate returns and higher yields for policyholders and customers, which is particularly important in the current low interest rate environment. In addition, many private equity investments provide necessary long-term capital to important sectors of the economy, including infrastructure projects to build roads, airports, wind farms, and other renewable energy projects, fueling jobs and growth.

The following sections provide a more detailed analysis of the Proposed Rulemaking, in addition to our arguments for why it is important to exempt insurers from both the proprietary trading and covered fund restrictions of the Volcker Rule, as we believe was the intention of Congress in drafting the Dodd-Frank Act.

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[1] Admitted assets are those assets of an insurance company that may be included under applicable insurance laws and regulations as assets for purposes of determining the statutory surplus of such insurance company.

IV. Dodd-Frank Act and Proposed Rulemaking Analysis

Section 13(a) of the BHC Act contains the general prohibitions on a banking entity engaging in proprietary trading or sponsoring or acquiring and retaining an ownership interest in a private equity fund or hedge fund. Section 10(b)(1)(i) of Subpart C of the Proposed Rulemaking uses the term "covered fund" in lieu of the statutory references to "private equity fund" and "hedge fund," defining that term to include, among other things, any entity that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. This definition designates not only most privately offered pooled investment funds structured as limited partnerships or limited liability companies, but many other structures not traditionally considered "hedge funds" or "private equity funds," as covered funds.

Section 13(d)(1)(F) of the BHC Act was enacted specifically to ensure that insurers affiliated with insured depository institutions could continue to conduct existing regulated investment activities without regard to the Volcker Rule's restrictions. By its very nature, this permitted activity contemplates the ability of insurance companies to continue to invest in a wide range of securities, including interests in private funds, within the limits set by insurance investment laws.

We note that Section 13(d)(1)(G) of the BHC Act and Section 11 of Subpart C of the Proposed Rulemaking permit banking entities to sponsor and invest in covered funds, subject to de minimis ownership limits and other requirements. Although insurance companies affiliated with a depository institution are covered by the broad definition of "banking entities" under the Volcker Rule, in light of clear Congressional intent to accommodate the activities of insurance companies (discussed further below), we believe that Section 13(d)(1)(F) of the BHC Act was intended to provide insurance companies greater latitude in their ability to sponsor and invest in covered funds than other banking entities. Insurance companies affiliated with a depository institution should be governed by Section 13(d)(1)(F) (or Section 13(d)(1)(D), if activity is being conducted on behalf of customers), so as to allow insurance companies to sponsor and invest in private funds without regard to the investment limits imposed on other banking entities engaged in similar activities, subject to regulation in accordance with applicable insurance company investment laws (as specifically contemplated in Section 13(d)(1)(F)(i)). However, the Proposed Rulemaking does not expressly extend Sections 13(d)(1)(F) or Section 13(d)(1)(D) to so apply.

We therefore believe that the Agencies should amend the Proposed Rulemaking to extend to the covered fund prohibition the exemption contained in Section 13(d)(1)(F) of the BHC Act as relates to investing for the general account of an insurance company. Providing insurance exemptions only for proprietary trading (as such term is defined in the Volcker Rule) would in fact have little meaning for an insurance company, because insurance companies generally do not engage in proprietary trading "principally for the purpose of selling in the near term" (as defined in Section 13(h)(6) and as the term "proprietary trading" is further defined in Section 3(b) of Subpart A of the Proposed Rulemaking).

The fundamental business model of an insurance company does not involve engaging in high risk or short-term profit seeking. The primary mission of an insurance company is to invest its policyholders' contributions with a long-term horizon in mind, in order to provide products that help policyholders meet longer-term goals (e.g., wealth protection and income in retirement). This requires investing the insurance company's own assets in a prudent manner in order to ensure a healthy portfolio that can continue paying benefits to its policyholders over the long term and investments in private funds are traditional tools for accomplishing this goal.

V. The Importance of Investing in and Sponsoring Private Funds for Insurers

We believe Congress provided the broad exemption for insurance companies under Section 13(d)(1)(F) because it recognized that permitting insurance companies to continue to invest in a manner that aligns its conservative long-term objectives with its long-term obligations benefits both insurers and their policyholders. Investing in and sponsoring private funds without regard to the conditions imposed on other banking entities engaged in similar activities as part of the ordinary course provides access to companies, markets, and investment strategies that might not otherwise be available, specifically with respect to diversification.

Investments in private equity funds historically have had a low correlation to other insurance company investments and represent a good portfolio fit for long-term liability products and insurance company surplus accounts. The importance of investing in the private equity fund asset class is further underscored by the current low interest rate environment, which is projected to continue for a number of years. Newly issued fixed income investments issued by highly creditworthy borrowers are currently paying institutional lenders, such as insurance companies, extremely low interest rates, and, as many insurance companies have issued contracts guaranteeing their policyholders specified rates of return on their contributions, a low interest rate environment is a quite challenging investment environment. Investments in private equity funds (most typically as a limited partner or limited liability company member), which have a low correlation to other principally fixed income assets, are a critical component of an insurance company's diversified investment program.

In addition, investments in hedge funds (again, most typically as a limited partner or limited liability company member) have served as a diversification tool for institutional investors such as insurance companies, diversifying sources of risk away from traditional equity and fixed income asset instruments, which still remain the hallmark of most insurance companies' investment profiles. In addition, hedge funds often offer access, on an indirect basis, to asset classes that provide even further diversification for a primarily long-term investor, including commodities, precious metals and other direct asset investments.

Together, the longer-term asset/liability profile of insurers' investments, the quantitative investment limits imposed by state law (discussed further below), and the fact that insurers' covered fund investments are almost always in a limited liability vehicle ameliorates the risks of owning these investments compared to depository institutions.

Further, allowing insurance companies to sponsor private funds without regard to the conditions imposed on other banking entities engaged in similar activities appropriately accommodates the business of insurance in a number of ways. Specifically, it enables insurance companies to (1) build scale in multiple investment classes; (2) obtain important diversification by owning a smaller percentage of a larger number of assets; (3) build and develop better investment staff to perform research and invest on behalf of the insurance company; and (4) control investment timing and allocations to suit long-term investment objectives, rather than relying exclusively on third-party managers who may have different objectives than the insurance company.

Furthermore, insurance companies have historically achieved diversification in their investments by including co-investors. Establishing a relationship with co-investors and structuring a transaction to include participation by co-investors are costly and time consuming endeavors and doing so for multiple transactions is significantly inefficient compared to establishing a pool of capital to make multiple investments – i.e., forming a private fund to make such investments. In light of an insurance company's expertise in making such investments, it is only natural that the insurance company would sponsor such funds and be permitted to make a meaningful co-investment in that fund, one that indicates an alignment of interests between the sponsoring insurance company and the unaffiliated co-investors.

VI. Congressional Intent

Both the statutory language of the Volcker Rule and the legislative history behind it clearly establish Congress' intent to "appropriately accommodate the business of insurance." Members of Congress explicitly recognized the potential unintended affects of the Volcker Rule on insurers with small banking operations and noted in the debate surrounding the enactment of the Dodd-Frank Act that the Act should not affect ordinary investment activities of insurers.[2] In addition, Congress recognized that an effectively regulated insurance company provides a safe and sound corporate structure within which to engage in such banking activities along with the unique nature of insurance company operations and, in particular, the comprehensive state regulatory infrastructure that governs investment activity of insurance companies and their affiliated entities.

Unfortunately, the Proposed Rulemaking does not appropriately accommodate the business of insurance in a number of ways that, if not addressed in the final rules implementing

[2] In addition to statements in the Congressional Record throughout the Spring of 2010 by Senators Hutchison, Hagan and Merkley, the Financial Services Appropriations Committee of the U.S. House of Representatives noted in its Report language for the 2012 fiscal year appropriation that, with respect to the Volcker Rule, "[t]he Committee believes that the traditional investment activities of State-regulated insurance companies for their general accounts, including investing in both sponsored and third-party funds, are preserved by the law without constraint." (See Appendices A through D for the relevant documents.)

the Volcker Rule, will cause the investment activity of insurers "central to the overall insurance business model" to be "unduly disrupted" in contravention of clear Congressional intent.[3]

VII. Efficacy of State Regulation

The primary mission of an insurance company is to invest its policyholders' contributions with a long-term horizon in mind, in order to provide products that help policyholders meet longer-term goals (e.g., wealth protection and income in retirement). The system of state insurance regulation is tailored with this mission in mind.

As mentioned previously, insurance companies invest in and sponsor private funds. Such activities are subject to regulation in accordance with the relevant insurance company investment laws. Perhaps most germane to ensuring the safety and soundness of insurance company operations in respect of investment activity is the fact that state insurance laws provide ceilings on the proportion of an insurer's investments that may be invested in a particular asset and asset class, such as equity securities (and by extension, "covered funds"). In effect, these laws require wide diversification of an insurer's investments.

Further regulated insurance companies such as TIAA are required to file reports, generally including detailed annual financial statements with state insurance regulators in each of the jurisdictions in which it does business, and its operations and accounts are subject to periodic examination by such authorities. Insurance companies also are subject to risk-based capital ("RBC") requirements, which take into account the inherent differences associated with investments in equity and investments in fixed income and will generally assess a higher capital charge to equity investments. Within equity investments, including investments in pooled vehicles such as private equity and hedge funds, the RBC calculations often further differentiate to approximate the relative risk to the insurer's capital and solvency associated with such investments. Insurance laws provide state insurance regulators the authority to require various actions by, or take various actions against, insurance companies whose RBC ratio does not meet or exceed certain levels.

Given this existing regulatory framework, we believe that the Proposed Rulemaking should be modified to confirm expressly that insurance companies affiliated with insured depository institutions (to the extent those insurance companies are "banking entities" under the Volcker Rule) continue to be able to invest in and sponsor private funds consistent with traditional practice and without regard to the conditions applicable to other banking entities engaged in similar activities, subject to regulation in accordance with the relevant insurance company investment laws at the state level.

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[3] Financial Stability Oversight Council Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 2011), p. 71. (See Appendix E)

VII. Conclusion

In summary, the statutory language of the Dodd-Frank Act clearly establishes that the business of insurance should not be subject to the Volcker Rule and statements made by Members of Congress strongly support the intent of this language. Second, the Volcker Rule is designed to address specific risks to individuals, institutions and the safety and soundness of the financial system as a whole that the business of insurance, as properly regulated through a comprehensive system of state insurance regulators, simply does not present. Accordingly, we believe that ordinary rules of statutory construction combined with sound policy analysis require a broad recognition that the business of insurance (as described in Section 13 of the BHC Act), should not be subject to either the proprietary trading restrictions or the restrictions on investing in and sponsoring covered funds.

APPENDIX A

Statement of Senator Jeff Merkley regarding the Volcker Rule
From the July 15, 2010 Congressional Record

Through Oversight of Proprietary, PROP, Trading Act of 2010, and the subsequently filed Merkley-Levin Amendment, No. 4101, to the Dodd-Lincoln substitute, which was the basis of the provision adopted by the Conference Committee.

I yield the floor to my colleague, Senator MERKLEY.

Mr. MERKLEY. I thank Senator LEVIN and will be setting forth here our joint explanation of the Merkley-Levin provisions of the Dodd-Frank Act. Sections 619, 620 and 621 do three things: prohibit high-risk proprietary trading at banks, limit the systemic risk of such activities at systemically significant nonbank financial companies, and prohibit material conflicts of interest in asset-backed securitizations.

Sections 619 and 620 amend the Bank Holding Company Act of 1956 to broadly prohibit proprietary trading, while nevertheless permitting certain activities that may technically fall within the definition of proprietary trading but which are, in fact, safer, client-oriented financial services. To account for the additional risk of proprietary trading among systemically critical financial firms that are not banks, bank holding companies, or the like, the sections require nonbank financial companies supervised by the Federal Reserve Board, the "Board", to keep additional capital for their proprietary trading activities and subject them to quantitative limits on those activities. In addition, given the unique control that firms who package and sell asset-backed securities (including synthetic asset-backed securities) have over transactions involving those securities, section 621 protects purchasers by prohibiting those firms from engaging in transactions that involve or result in material conflicts of interest.

First, it is important to remind our colleagues how the financial crisis of the past several years came to pass. Beginning in the 1980's, new financial products and significant amounts of deregulation undermined the Glass-Steagall Act's separation of commercial banking from securities brokerage or "investment banking" that had kept our banking system relatively safe since 1933.

Over time, commercial and investment banks increasingly relied on precarious short term funding sources, while at the same time significantly increasing their leverage. It was as if our banks and securities firms, in competing against one another, were race car drivers taking the curves ever more tightly and at ever faster speeds. Meanwhile, to match their short-term funding sources, commercial and investment banks drove into increasingly risky, short-term, and sometimes theoretically hedged, proprietary trading. When markets took unexpected turns, such as when Russia defaulted on its debt and when the U.S. mortgage-backed securities market collapsed, liquidity evaporated, and financial firms became insolvent very rapidly. No amount of capital could provide a sufficient buffer in such situations.

In the face of the worst financial crisis in 60 years, the January 2009 report by the Group of 30, an international group of financial experts, placed blame squarely on proprietary trading. This report, largely authored by former Federal Reserve System Chairman Paul Volcker, recommended prohibiting systemically critical banking institutions from trading in securities and other products for their own accounts. In January 2010, President Barack Obama gave his full support to common-sense restrictions on proprietary trading and fund investing, which he coined the "Volcker Rule."

The "Volcker Rule," which Senator LEVIN and I drafted and have championed in the Senate, and which is embodied in section 619, embraces the spirit of the Glass-Steagall Act's separation of "commercial" from "investment" banking by restoring a protective barrier around our critical financial infrastructure. It covers not simply securities, but also derivatives and other financial products. It applies not only to banks, but also to nonbank financial firms whose size and function render them systemically significant.

While the intent of section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world and permit a broad array of low-risk, client-oriented financial services. As a result, the barrier constructed in section 619 will not restrict most financial firms.

Section 619 is intended to limit proprietary trading by banking entities and systemically significant nonbank financial companies. Properly implemented, section 619's limits will tamp down on the risk to the system arising from firms competing to obtain greater and greater returns by increasing the size, leverage, and riskiness of their trades. This is a critical part of ending too big to fail financial firms. In addition, section 619 seeks to reorient the U.S. banking system away from leveraged, short-term speculation and instead towards the safe and sound provision of long-term credit to families and business enterprises.

We recognize that regulators are essential partners in the legislative process. Because regulatory interpretation is so critical to the success of the rule, we will now set forth, as the principal authors of Sections 619 to 621, our explanations of how these provisions work.

Section 619's prohibitions and restrictions on proprietary trading are set forth in a new section 13 to the Bank Holding Company Act of 1956, and subsection (a), paragraph (1) establishes the basic principle clearly: a banking entity shall not "engage in proprietary trading" or "acquire or retain . . . ownership interest[s] in or sponsor a hedge fund or private equity fund", unless otherwise provided in the section. Paragraph (2) establishes the principle for nonbank financial companies supervised by the Board by subjecting their proprietary trading activities to quantitative restrictions and additional capital charges. Such quantitative limits and capital charges are to be set by the regulators to address risks similar to those which lead to the flat prohibition for banking entities.

Subsection (h), paragraph (1) defines "banking entity" to be any insured depository institution (as otherwise defined under the Bank Holding Company Act), any entity that controls an insured depository institution, any entity that is treated as a bank holding company under section 8 of the International Banking Act of 1978, and any affiliates or subsidiaries of such entities. We and the Congress specifically rejected proposals to exclude the affiliates and subsidiaries of bank holding companies and insured depository institutions, because it was obvious that restricting a bank, but not its affiliates and subsidiaries, would ultimately be ineffective in restraining the type of high-risk proprietary trading that can undermine an insured depository institution.

The provision recognizes the modern reality that it is difficult to separate the fate of a bank and its bank holding company, and that for the bank holding company to be a source of strength to the bank, its activities, and those of its other subsidiaries and affiliates, cannot be at such great risk as to imperil the bank. We also note that not all banks pose the same risks. Accordingly, the paragraph provides a narrow exception for insured depository institutions that function principally for trust purposes and do not hold public depositor money, make loans, or access Federal Reserve lending or payment services. These specialized entities that offer very limited trust services are elsewhere carved out of the definition of "bank," so we do not treat them as banks for the purposes of the restriction on proprietary trading. However, such institutions are covered by the restriction if they qualify under the provisions covering systemically important nonbank financial companies.

Subsection (h), paragraph (3) defines nonbank financial companies supervised by the Board to be those financial companies whose size, interconnectedness, or core functions are of sufficiently systemic significance as to warrant additional supervision, as directed by the Financial Stability Oversight Council pursuant to Title I of the Dodd-Frank Act. Given the varied nature of such nonbank financial companies, for some of which proprietary trading is effectively their business, an outright statutory prohibition on such trading was not warranted. Instead, the risks posed by their proprietary trading is addressed through robust capital charges and quantitative limits that increase with the size, interconnectedness, and systemic importance of the

business functions of the nonbank financial firm. These restrictions should become stricter as size, leverage, and other factors increase. As with banking entities, these restrictions should also help reduce the size and risk of these financial firms.

Naturally, the definition of "proprietary trading" is critical to the provision. For the purposes of section 13, proprietary trading means "engaging as a principal for the trading account" in transactions to "purchase or sell, or otherwise acquire or dispose of" a wide range of traded financial products, including securities, derivatives, futures, and options. There are essentially three key elements to the definition: (1) the firm must be acting "as a principal," (2) the trading must be in its "trading account" or another similar account, and (3) the restrictions apply to the full range of its financial instruments.

Purchasing or selling "as a principal" refers to when the firm purchases or sells the relevant financial instrument for its own account. The prohibition on proprietary trading does not cover trading engaged with exclusively client funds.

The term "trading account" is intended to cover an account used by a firm to make profits from relatively short-term trading positions, as opposed to long-term, multi-year investments. The administration's proposed Volcker Rule focused on short-term trading, using the phrase "trading book" to capture that concept. That phrase, which is currently used by some bank regulators was rejected, however, and the ultimate conference report language uses the term "trading account" rather than "trading book" to ensure that all types of accounts used for proprietary trading are covered by the section.

To ensure broad coverage of the prohibition on proprietary trading, paragraph (3) of subsection (h) defines "trading account" as any account used "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)" and such other accounts as the regulators determine are properly covered by the provision to fulfill the purposes of the section. In designing this definition, we were aware of bank regulatory capital rules that distinguish between short-term trading and long-term investments, and our overall focus was to restrict high-risk proprietary trading. For banking entity subsidiaries that do not maintain a distinction between a trading account and an investment account, all accounts should be presumed to be trading accounts and covered by the restriction.

Linking the prohibition on proprietary trading to trading accounts permits banking entities to hold debt securities and other financial instruments in long-term investment portfolios. Such investments should be maintained with the appropriate capital charges and held for longer periods.

The definition of proprietary trading in paragraph (4) covers a wide range of financial instruments, including securities, commodities, futures, options, derivatives, and any similar financial instruments. Pursuant to the rule of construction in subsection (g), paragraph (2), the definition should not generally include loans sold in the process of securitizing; however, it could include such loans if such loans become financial instruments traded to capture the change in their market value.

Limiting the definition of proprietary trading to near-term holdings has the advantage of permitting banking entities to continue to deploy credit via long-term capital market debt instruments. However, it has the disadvantage of failing to prevent the problems created by longer-term holdings in riskier financial instruments, for example, highly complex collateralized debt obligations and other opaque instruments that are not readily marketable. To address the risks to the banking system arising from those longer-term instruments and related trading, section 620 directs Federal banking regulators to sift through the assets, trading strategies, and other investments of banking entities to identify assets or activities that pose unacceptable risks to banks, even when held in longer-term accounts. Regulators are expected to apply the lessons of that analysis to tighten the range of investments and activities permissible for banking entities, whether they are at the insured depository institution or at an affiliate or subsidiary, and whether they are short or long term in nature.

The new Bank Holding Company Act section 13 also restricts investing in or sponsoring hedge funds and private equity funds. Clearly, if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue. A financial institution that sponsors or manages a hedge fund or private equity fund also incurs significant risk even when it does not invest in the fund it manages or sponsors. Although piercing the corporate veil between a fund and its sponsoring entity may be difficult, recent history demonstrates that a financial firm will often feel compelled by reputational demands and relationship preservation concerns to bail out clients in a failed fund that it managed or sponsored, rather than risk litigation or lost business. Knowledge of such concerns creates a moral hazard among clients, attracting investment into managed or sponsored funds on the assumption that the sponsoring bank or systemically significant firm will rescue them if markets turn south, as was done by a number of firms during the 2008 crisis. That is why setting limits on involvement in hedge funds and private equity funds is critical to protecting against risks arising from asset management services.

Subsection (h), paragraph (2) sets forth a broad definition of hedge fund and private equity fund, not distinguishing between the two. The definition includes any company that would be an investment company under the Investment Company Act of 1940, but is excluded from such coverage by the provisions of sections 3(c)(1) or 3(c)(7). Although market practice in many cases distinguishes between hedge funds, which tend to be trading vehicles, and private equity funds, which tend to own entire companies, both types of funds can engage in high risk activities and it is exceedingly difficult to limit those risks by focusing on only one type of entity.

Despite the broad prohibition on proprietary trading set forth in subsection (a), the legislation recognizes that there are a number of low-risk proprietary activities that do not pose unreasonable risks and explicitly permits those activities to occur. Those low-risk proprietary trading activities are identified in subsection (d), paragraph (1), subject to certain limitations set forth in paragraph (2), and additional capital charges required in paragraph (3).

While paragraph (1) authorizes several permitted activities, it simultaneously grants regulators broad authority to set further restrictions on any of those activities and to supplement the additional capital charges provided for by paragraph (3).

Subparagraph (d)(1)(A) authorizes the purchase or sale of government obligations, including government-sponsored enterprise, GSE, obligations, on the grounds that such products are used as low-risk, short-term liquidity positions and as low-risk collateral in a wide range of transactions, and so are appropriately retained in a trading account. Allowing trading in a broad range of GSE obligations is also meant to recognize a market reality that removing the use of these securities as liquidity and collateral positions would have significant market implications, including negative implications for the housing and farm credit markets. By authorizing trading in GSE obligations, the language is not meant to imply a view as to GSE operations or structure over the long-term, and permits regulators to add restrictions on this permitted activity as necessary to prevent high-risk proprietary trading activities under paragraph (2). When GSE reform occurs, we expect these provisions to be adjusted accordingly. Moreover, as is the case with all permitted activities under paragraph (1), regulators are expected to apply additional capital restrictions under paragraph (3) as necessary to account for the risks of the trading activities.

Subparagraph (d)(1)(B) permits underwriting and market-making-related

transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services. Market-making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments. Done properly, it is not a speculative enterprise, and revenues for the firm should largely arise from the provision of credit provided, and not from the capital gain earned on the change in the price of instruments held in the firm's accounts. Academic literature sets out the distinctions between making markets for customers and holding speculative positions in assets, but in general, the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open, and the volatility of profits and losses, among other factors. Regulations implementing this permitted activity should focus on these types of factors to assist regulators in distinguishing between financial firms assisting their clients versus those engaged in proprietary trading. Vigorous and robust regulatory oversight of this issue will be essential to the prevent ''market-making'' from being used as a loophole in the ban on proprietary trading.

The administration's draft language, the original section 619 contemplated by the Senate Banking Committee, and amendment 4101 each included the term ''in facilitation of customer relations'' as a permitted activity. The term was removed in the final version of the Dodd-Frank Act out of concern that this phrase was too subjective, ambiguous, and susceptible to abuse. At the same time, we recognize that the term was previously included to permit certain legitimate client-oriented services, such pre-market-making accumulation of small positions that might not rise to the level of fully ''market-making'' in a security or financial instrument, but are intended to nonetheless meet expected near-term client liquidity needs. Accordingly, while previous versions of the legislation referenced ''market-making'', the final version references ''market-making-related'' to provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs, without unduly warping the common understanding of market-making.

We note, however, that ''market-making-related'' is not a term whose definition is without limits. It does not implicitly cover every time a firm buys an existing financial instrument with the intent to later sell it, nor does it cover situations in which a firm creates or underwrites a new security with the intent to market it to a client. Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that any time the firm created a new mortgage related security and began soliciting clients to buy it, the firm was ''making a market'' for the security. But one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling existing securities. The reality was that Goldman Sachs was creating new securities for sale to clients and building large speculative positions in high-risk instruments, including credit default swaps. Such speculative activities are the essence of proprietary trading and cannot be properly considered within the coverage of the terms ''market-making'' or ''market-making-related.''

The subparagraph also specifically limits such underwriting and market-making-related activities to ''reasonably expected near term demands of clients, customers, and counterparties.'' Essentially, the subparagraph creates two restrictions, one on the expected holding period and one on the intent of the holding. These two restrictions greatly limit the types of risks and returns for market-makers. Generally, the revenues for market-making by the covered firms should be made from the fees charged for providing a ready, two-sided market for financial instruments, and not from the changes in prices acquired and sold by the financial institution. The ''near term'' requirement connects to the provision in the definition of trading account whereby the account is defined as trading assets that are acquired ''principally for the purpose of selling in the near term.'' The intent is to focus firms on genuinely making markets for clients, and not taking speculative positions with the firm's capital. Put simply, a firm will not satisfy this requirement by acquiring a position on the hope that the position will be able to be sold at some unknown future date for a trading profit.

Subparagraph (d)(1)(C) permits a banking entity to engage in ''risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.'' This activity is permitted because its sole purpose is to lower risk.

While this subparagraph is intended to permit banking entities to utilize their trading accounts to hedge, the phrase ''in connection with and related to individual or aggregated positions . . .'' was added between amendment 4101 and the final version in the conference report in order to ensure that the hedge applied to specific, identifiable assets, whether it be on an individual or aggregate basis. Moreover, hedges must be to reduce ''specific risks'' to the banking entity arising from these positions. This formulation is meant to focus banking entities on traditional hedges and prevent proprietary speculation under the guise of general ''hedging.'' For example, for a bank with a significant set of loans to a foreign country, a foreign exchange swap may be an appropriate hedging strategy. On the other hand, purchasing commodity futures to ''hedge'' inflation risks that may generally impact the banking entity may be nothing more than proprietary trading under another name. Distinguishing between true hedges and covert proprietary trades may be one of the more challenging areas for regulators, and will require clear identification by financial firms of the specific assets and risks being hedged, research and analysis of market best practices, and reasonable regulatory judgment calls. Vigorous and robust regulatory oversight of this issue will be essential to the prevent ''hedging'' from being used as a loophole in the ban on proprietary trading.

Subparagraph (d)(1)(D) permits the acquisition of the securities and other affected financial instruments ''on behalf of customers.'' This permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves. This subparagraph is intended, in particular, to provide reassurance that trading in ''street name'' for customers or in trust for customers is permitted.

In general, subparagraph (d)(1)(E) provides exceptions to the prohibition on investing in hedge funds or private equity funds, if such investments advance a ''public welfare'' purpose. It permits investments in small business investment companies, which are a form of regulated venture capital fund in which banks have a long history of successful participation. The subparagraph also permits investments ''of the type'' permitted under the paragraph of the National Bank Act enabling banks to invest in a range of low-income community development and other projects. The subparagraph also specifically mentions tax credits for historical building rehabilitation administered by the National Park Service, but is flexible enough to permit the regulators to include other similar low-risk investments with a public welfare purpose.

Subparagraph (d)(1)(F) is meant to accommodate the normal business of insurance at regulated insurance companies that are affiliated with banks. The Volcker Rule was never meant to affect the ordinary business of insurance: the collection and investment of premiums, which are then used to satisfy claims of the insured. These activities, while definitionally proprietary trading, are heavily regulated by State insurance regulators, and in most cases do not pose the same level of risk as other proprietary trading.

However, to prevent abuse, firms seeking to rely on this insurance-related exception must meet two essential qualifications. First, only trading for the general account of the insurance firm would qualify. Second, the

trading must be subject to adequate State-level insurance regulation. Trading by insurance companies or their affiliates that is not subject to insurance company investment regulations will not qualify for protection here.

Further, where State laws and regulations do not exist or otherwise fail to appropriately connect the insurance company investments to the actual business of insurance or are found to inadequately protect the firm, the subparagraph's conditions will not be met.

Subparagraph (d)(1)(G) permits firms to organize and offer hedge funds or private equity funds as an asset management service to clients. It is important to remember that nothing in section 619 otherwise prohibits a bank from serving as an investment adviser to an independent hedge fund or private equity fund. Yet, to serve in that capacity, a number of criteria must be met.

First, the firm must be doing so pursuant to its provision of bona fide trust, fiduciary, or investment advisory services to customers. Given the fiduciary obligations that come with such services, these requirements ensure that banking entities are properly engaged in responsible forms of asset management, which should tamp down on the risks taken by the relevant fund.

Second, subparagraph (d)(1)(G) provides strong protections against a firm bailing out its funds. Clause (iv) prohibits banking entities, as provided under paragraph (1) and (2) of subsection (f), from entering into lending or similar transactions with related funds, and clause (v) prohibits banking entities from "directly or indirectly, guarantee[ing], assum[ing], or otherwise insur[ing] the obligations or performance of the hedge fund or private equity fund." To prevent banking entities from engaging in backdoor bailouts of their invested funds, clause (v) extends to the hedge funds and private equity funds in which such subparagraph (G) hedge funds and private equity funds invest.

Third, to prevent a banking entity from having an incentive to bailout its funds and also to limit conflicts of interest, clause (vii) of subparagraph (G) restricts directors and employees of a banking entity from being invested in hedge funds and private equity funds organized and offered by the banking entity, except for directors or employees "directly engaged" in offering investment advisory or other services to the hedge fund or private equity fund. Fund managers can have "skin in the game" for the hedge fund or private equity fund they run, but to prevent the bank from running its general employee compensation through the hedge fund or private equity fund, other management and employees may not.

Fourth, by stating that a firm may not organize and offer a hedge fund or private equity fund with the firm's name on it, clause (vi) of subparagraph (G) further restores market discipline and supports the restriction on firms bailing out funds on the grounds of reputational risk. Similarly, clause (viii) ensures that investors recognize that the funds are subject to market discipline by requiring that funds provide prominent disclosure that any losses of a hedge fund or private equity fund are borne by investors and not by the firm, and the firm must also comply with any other restrictions to ensure that investors do not rely on the firm, including any of its affiliates or subsidiaries, for a bailout.

Fifth, the firm or its affiliates cannot make or maintain an investment interest in the fund, except in compliance with the limited fund seeding and alignment of interest provisions provided in paragraph (4) of subsection (d). This paragraph allows a firm, for the limited purpose of maintaining an investment management business, to seed a new fund or make and maintain a "de minimis" co-investment in a hedge fund or private equity fund to align the interests of the fund managers and the clients, subject to several conditions. As a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be $5 to $10 million or less. Large funds or funds that are not effectively marketed to investors would be evasions of the restrictions of this section. Similarly, co-investments designed to align the firm with its clients must not be excessive, and should not allow for firms to evade the intent of the restrictions of this section.

These "de minimis" investments are to be greatly disfavored, and subject to several significant restrictions. First, a firm may only have, in the aggregate, an immaterial amount of capital in such funds, but in no circumstance may such positions aggregate to more than 3 percent of the firm's Tier 1 capital. Second, by one year after the date of establishment for any fund, the firm must have not more than a 3 percent ownership interest. Third, investments in hedge funds and private equity funds shall be deducted on, at a minimum, a one-to-one basis from capital. As the leverage of a fund increases, the capital charges shall be increased to reflect the greater risk of loss. This is specifically intended to discourage these high-risk investments, and should be used to limit these investments to the size only necessary to facilitate asset management businesses for clients.

Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs seek to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.

Subparagraph (J) permits the regulators to add additional exceptions as necessary to "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." This general exception power is intended to ensure that some unforeseen, low-risk activity is not inadvertently swept in by the prohibition on proprietary trading. However, the subparagraph sets an extremely high bar: the activity must be necessary to promote and protect the safety and soundness of the banking entity and the financial stability of the United States, and not simply pose a competitive disadvantage or a threat to firms' profitability.

Paragraph (2) of section (d) adds explicit statutory limits to the permitted activities under paragraph (1). Specifically, it prevents an activity from qualifying as a permitted activity if it would "involve or result in a material conflict of interest," "result directly or indirectly in a material exposure . . . to high-risk assets or high-risk trading strategies" or otherwise pose a threat to the safety and soundness of the firm or the financial stability of the United States. Regulators are directed to define the key terms in the paragraph and implement the restrictions as part of the rulemaking process. Regulators should pay particular attention to the hedge funds and private equity funds organized and offered under subparagraph (G) to ensure that such activities have sufficient distance from other parts of the firm, especially those with windows into the trading flow of other clients. Hedging activities should also be particularly scrutinized to ensure that information about client trading is not improperly utilized.

The limitation on proprietary trading activities that "involve or result in a material conflict of interest" is a companion to the conflicts of interest prohibition in section 621, but applies to all types of activities rather than just asset-backed securitizations.

With respect to the definition of high-risk assets and high-risk trading strategies, regulators should pay close attention to the characteristics of assets and trading strategies that have contributed to substantial financial loss, bank failures, bankruptcies, or the collapse of financial firms or financial markets in the past, including but not limited to the crisis of 2008 and the financial crisis of 1998. In assessing high-risk assets and high-risk trading strategies, particular attention should be paid to the transparency of the markets, the availability of consistent pricing information, the depth of the markets, and the risk characteristics

of the assets and strategies themselves, including any embedded leverage. Further, these characteristics should be evaluated in times of extreme market stress, such as those experienced recently. With respect to trading strategies, attention should be paid to the role that certain types of trading strategies play in times of relative market calm, as well as times of extreme market stress. While investment advisors may freely deploy high-risk strategies for their clients, attention should be paid to ensure that firms do not utilize them for their own proprietary activities. Barring high risk strategies may be particularly critical when policing market-making-related and hedging activities, as well as trading otherwise permitted under subparagraph (d)(1)(A). In this context, however, it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.

Subsection (d), paragraph (3) directs the regulators to set appropriate additional capital charges and quantitative limits for permitted activities. These restrictions apply to both banking entities and nonbank financial companies supervised by the Board. It is left to regulators to determine if those restrictions should apply equally to both, or whether there may appropriately be a distinction between banking entities and non-bank financial companies supervised by the Board. The paragraph also mandates diversification requirements where appropriate, for example, to ensure that banking entities do not deploy their entire permitted amount of de minimis investments into a small number of hedge funds or private equity funds, or that they dangerously over-concentrate in specific products or types of financial products.

Subsection (e) provides vigorous anti-evasion authority, including record-keeping requirements. This authority is designed to allow regulators to appropriately assess the trading of firms, and aggressively enforce the text and intent of section 619.

The restrictions on proprietary trading and relationships with private funds seek to break the internal connection between a bank's balance sheet and taking risk in the markets, with a view towards reestablishing market discipline and refocusing the bank on its credit extension function and client services. In the recent financial crisis, when funds advised by banks suffered significant losses, those off-balance sheet funds came back onto the banks' balance sheets. At times, the banks bailed out the funds because the investors in the funds had other important business with the banks. In some cases, the investors were also key personnel at the banks. Regardless of the motivations, in far too many cases, the banks that bailed out their funds ultimately relied on taxpayers to bail them out. It is precisely for this reason that the permitted activities under subparagraph (d)(1)(G) are so narrowly defined.

Indeed, a large part of protecting firms from bailing out their affiliated funds is by limiting the lending, asset purchases and sales, derivatives trading, and other relationships that a banking entity or nonbank financial company supervised by the Board may maintain with the hedge funds and private equity funds it advises. The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition, or through writing a derivative. Further, providing advisory services to a hedge fund or private equity fund creates a conflict of interest and risk because when a banking entity is itself determining the investment strategy of a fund, it no longer can make a fully independent credit evaluation of the hedge fund or private equity fund borrower. These bailout protections will significantly benefit independent hedge funds and private equity funds, and also improve U.S. financial stability.

Accordingly, subsection (f), paragraph (1) sets forth the broad prohibition on a banking entity entering into any "covered transactions" as such term is defined in the Federal Reserve Act's section 23A, as if such banking entity were a member bank and the fund were an affiliate thereof. "Covered transactions" under section 23A includes loans, asset purchases, and, following the Dodd-Frank bill adoption, derivatives between the member bank and the affiliate. In general, section 23A sets limits on the extension of credit between such entities, but paragraph (1) of subsection (f) prohibits all such transactions. It also prohibits transactions with funds that are controlled by the advised or sponsored fund. In short, if a banking entity organizes and offers a hedge fund or private equity fund or serves as investment advisor, manager, or sponsor of a fund, the fund must seek credit, including from asset purchases and derivatives, from an independent third party.

Subsection (f), paragraph (2) applies section 23B of the Federal Reserve Act to a banking entity and its advised or sponsored hedge fund or private equity fund. This provides, inter alia, that transactions between a banking entity and its fund be conducted at arms length. The fact that section 23B also includes the provision of covered transactions under section 23A as part of its arms-length requirement should not be interpreted to undermine the strict prohibition on such transactions in paragraph (1).

Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of "prime brokerage" between the banking entity and a third-party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest. Essentially, it was argued that a banking entity should not be prohibited, under proper restrictions, from providing limited services to unaffiliated funds, but in which its own advised fund may invest. Accordingly, paragraph (3) is intended to only cover third-party funds, and should not be used as a means of evading the general prohibition provided in paragraph (1). Put simply, a firm may not create tiered structures and rely upon paragraph (3) to provide these types of services to funds for which it serves as investment advisor.

Further, in recognition of the risks that are created by allowing for these services to unaffiliated funds, several additional criteria must also be met for the banking entity to take advantage of this exception. Most notably, on top of the flat prohibitions on bailouts, the statute requires the chief executive officer of firms taking advantage of this paragraph to also certify that these services are not used directly or indirectly to bail out a fund advised by the firm.

Subsection (f), paragraph (4) requires the regulatory agencies to apply additional capital charges and other restrictions to systemically significant nonbank financial institutions to account for the risks and conflicts of interest that are addressed by the prohibitions for banking entities. Such capital charges and other restrictions should be sufficiently rigorous to account for the significant amount of risks associated with these activities.

To give markets and firms an opportunity to adjust, implementation of section 620 will proceed over a period of several years. First, pursuant to subsection (b), paragraph (1), the Financial Stability Oversight Council will conduct a study to examine the most effective means of implementing the rule. Then, under paragraph (b)(2), the Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall each engage in rulemakings for their regulated entities, with the rulemaking coordinated for consistency through the Financial Stability Oversight Council. In coordinating the rulemaking, the Council should strive to avoid a "lowest common denominator" framework, and instead apply the best, most rigorous practice from each regulatory agency.

Pursuant to subsection (c), paragraph (1), most provisions of section 619 become effective 12 months after the issuance of final rules pursuant to subsection (b), but in no case later than 2 years after the enactment of the Dodd-Frank Act. Paragraph (c)(2) provides a 2-year period following effective date of the provision during which entities must bring their activities into conformity with the law, which may be extended for up to 3 more years. Special illiquid funds may, if necessary, receive one 5-year extension and may

also continue to honor certain contractual commitments during the transition period. The purpose of this extended wind-down period is to minimize market disruption while still steadily moving firms away from the risks of the restricted activities.

The definition of "illiquid funds" set forth in subsection (h) paragraph (7) is meant to cover, in general, very illiquid private equity funds that have deployed capital to illiquid assets such as portfolio companies and real estate with a projected investment holding period of several years. The Board, in consultation with the SEC, should therefore adopt rules to define the contours of an illiquid fund as appropriate to capture the intent of the provision. To facilitate certainty in the market with respect to divestiture, the Board is to conduct a special expedited rulemaking regarding these conformance and wind-down periods. The Board is also to set capital rules and any additional restrictions to protect the banking entities and the U.S. financial system during this wind-down period.

We noted above that the purpose of section 620 is to review the long-term investments and other activities of banks. The concerns reflected in this section arise out of losses that have appeared in the long-term investment portfolios in traditional depository institutions.

Over time, various banking regulators have displayed expansive views and conflicting judgments about permissible investments for banking entities. Some of these activities, including particular trading strategies and investment assets, pose significant risks. While section 619 provides numerous restrictions to proprietary trading and relationships to hedge funds and private equity funds, it does not seek to significantly alter the traditional business of banking.

Section 620 is an attempt to reevaluate banking assets and strategies and see what types of restrictions are most appropriate. The Federal banking agencies should closely review the risks contained in the types of assets retained in the investment portfolio of depository institutions, as well as risks in affiliates' activities such as merchant banking. The review should dovetail with the determination of what constitutes "high-risk assets" and "high risk trading strategies" under paragraph (d)(2).

At this point, I yield to Senator LEVIN to discuss an issue that is of particular interest to him involving section 621's conflict of interest provisions.

Mr. LEVIN. I thank my colleague for the detailed explanation he has provided of sections 619 and 620, and fully concur in it. I would like to add our joint explanation of section 621, which addresses the blatant conflicts of interest in the underwriting of asset-backed securities highlighted in a hearing with Goldman Sachs before the Permanent Subcommittee on Investigations, which I chair.

The intent of section 621 is to prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures. This practice has been likened to selling someone a car with no brakes and then taking out a life insurance policy on the purchaser. In the asset-backed securities context, the sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. They, like the mechanic servicing a car, would know if the vehicle has been designed to fail. And so they must be prevented from securing handsome rewards for designing and selling malfunctioning vehicles that undermine the asset-backed securities markets. It is for that reason that we prohibit those entities from engaging in transactions that would involve or result in material conflicts of interest with the purchasers of their products.

Section 621 is not intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it. Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position. But a firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.

We believe that the Securities and Exchange Commission has sufficient authority to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets.

In conclusion, we would like to acknowledge all our supporters, co-sponsors, and advisers who assisted us greatly in bringing this legislation to fruition. From the time President Obama announced his support for the Volcker Rule, a diverse and collaborative effort has emerged, uniting community bankers to old school financiers to reformers. Senator MERKLEY and I further extend special thanks to the original cosponsors of the PROP Trading Act, Senators TED KAUFMAN, SHERROD BROWN, and JEANNE SHAHEEN, who have been with us since the beginning.

Senator JACK REED and his staff did yeoman's work in advancing this cause. We further tip our hat to our tireless and vocal colleague, Senator BYRON DORGAN, who opposed the repeal of Glass-Steagall and has been speaking about the risks from proprietary trading for a number of years. Above all, we pay tribute to the tremendous labors of Chairman CHRIS DODD and his entire team and staff on the Senate Banking Committee, as well as the support of Chairman BARNEY FRANK and Representative PAUL KANJORSKI. We extend our deep gratitude to our staffs, including the entire team and staff at the Permanent Subcommittee on Investigations, for their outstanding work. And last but not least, we highlight the visionary leadership of Paul Volcker and his staff. Without the support of all of them and many others, the Merkley-Levin language would not have been included in the Conference Report.

We believe this provision will stand the test of time. We hope that our regulators have learned with Congress that tearing down regulatory walls without erecting new ones undermines our financial stability and threatens economic growth. We have legislated to the best of our ability. It is now up to our regulators to fully and faithfully implement these strong provisions.

I yield the floor to Senator MERKLEY.

Mr. MERKLEY. I thank my colleague for his remarks and concur in all respects.

Mr. DODD. Mr. President, I said so yesterday, and I will say it again: I thank Senator MERKLEY. I guess there are four new Members of the Senate serving on the Banking Committee. Senator MERKLEY, Senator WARNER, Senator TESTER, and Senator BENNET are all new Members of the Senate from their respective States of Oregon, Virginia, Montana, and Colorado. To be thrown into what has been the largest undertaking of the Banking Committee, certainly in my three decades here—and many have argued going back almost 100 years—was certainly an awful lot to ask.

I have already pointed out the contribution Senator WARNER has made to this bill. But I must say as well that Senator BENNET of Colorado has been invaluable in his contributions. I just mentioned Senator TESTER a moment ago for his contribution on talking about rural America and the importance of those issues. And Senator MERKLEY, as a member of the committee, on matters we included here dealing particularly with the mortgage reforms, the underwriting standards, the protections people have to go through, and credit cards as well—we passed the credit card bill—again, it was Senator JEFF MERKLEY of Oregon who played a critical role in that whole debate not to mention, of course, working with CARL LEVIN, one of the more senior Members here, having served for many years in the Senate. But the Merkley-Levin, Levin-Merkley provisions in this bill have added substantial contributions to this effort. So I thank him for his contribution.

I see my colleague from North Dakota is here. I suggest the absence of a

APPENDIX B

Senators Hutchison-Hagan Motion to Instruct
From the May 24, 2010 Congressional Record

will be covered by the Consumer Financial Protection Bureau. It is going to be at an upstream location, but it is covered. One hundred percent of them are covered. Why would we put this extra cost and expense on the retail operation that is not loaning the money? They are not doing this.

If my colleagues are concerned about this area, do this. If they are concerned about having overregulation and overreach by Washington, support my motion. The loan is still covered, and we are not having this double coverage of belts and suspenders on auto loans that is going to hurt the ability of people to get loans, and it is going to drive up the cost of auto financing. It is going to hurt Main Street businesses that we lost 1,700 of last year and that lost us 88,000 jobs. I thought this bill was targeted at Wall Street, not at Main Street where we didn't have this problem going on. We haven't had this problem within auto loans as far as causing the financial meltdown. The regulation is already there. The regulation will be there. This extra regulation is not needed.

I ask my colleagues to support Main Street on this one. Support the local auto dealers out there, those who are working with the community, trying to help the community thrive and survive, instead of putting a double dose of regulation on top of them that is going to hurt the business, hurt auto sales, hurt financing opportunities.

I urge support for the Brownback motion.

The PRESIDING OFFICER. The Senator from Texas.

Mr. DODD. All time has expired on BROWNBACK?

The PRESIDING OFFICER. All time has expired.

MOTION TO INSTRUCT CONFEREES

Mrs. HUTCHISON. I call up the Hutchison-Hagan motion to instruct conferees.

The PRESIDING OFFICER. The clerk will report the motion.

The assistant legislative clerk read as follows:

MOTION TO INSTRUCT CONFEREES

The Senator from Texas (Mrs. HUTCHISON) moves that the managers on the part of the Senate at the conference on the disagreeing votes of the two Houses on H.R. 4173 (the Restoring American Financial Stability Act) be instructed to insist that the final conference report ensure that proprietary trading restrictions do not prevent insurance company affiliates of depository institutions from engaging in such trading as part of the ordinary business of insurance, especially insurance company affiliates serving military service members and their families, as such restrictions would result in higher costs and significant inconveniences to those sacrificing in service to our country.

The PRESIDING OFFICER. The Senator is recognized for 10 minutes.

Mrs. HUTCHISON. I ask to be notified at the end of 5 minutes so I may yield the floor to Senator HAGAN for the rest of the time.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mrs. HUTCHISON. Mr. President, the Hutchison-Hagan motion to instruct is trying to narrow the definition that falls under the Volcker rule and the underlying bill. I believe our amendment would have passed overwhelmingly if we had been able to get it up before cloture was invoked. I appreciate there was a lot going on last week, but this is the way we hope to be able to assure that our amendment is a part of the final bill. The Volcker rule contained in the measure before us seeks to restrict or ban risky proprietary trading at depository institutions. As currently written, the rule brings about some unintended consequences that could be disastrous for our financial system and to a special class of customers—American service men and women. The major problem with the current language is that its reach extends beyond the bounds of the depository institution to a bank's affiliates and subsidiaries, including insurance companies. For diversified financial institutions that serve as one-stop shops of banking and insurance products, especially those serving our military service men and women and their families, the extension of the Volcker rule's proprietary trading restrictions to a depository institution's insurance company affiliates threatens their ability to address the special financial needs of the U.S. military community. The Hutchison-Hagan motion to instruct conferees seeks to ensure that the Volcker rule's proprietary trading restrictions do not extend to the normal operations of insurance affiliates of insured depository institutions so that we can preserve convenient access to the full spectrum of financial services for the U.S. military community.

It is important to note that the proprietary trading that insurance entities engage in is significantly different from the proprietary trading that is the target of the Volcker rule.

First, insurance companies use premiums to fund trades, not customer deposits. Thus, insurers are trading their own funds, not those of depositors. Insurance company trades are generally low risk, focus on long-term payment of claims and profitability, and are already heavily regulated by State insurance regulators. Simply put: Proprietary trading is essential to the life insurance and property and casualty insurance business. Proprietary trading is what allows insurers to offer annuities and other insurance products that can protect consumers in the long term.

The motion to instruct is narrowly drafted. We have worked with the majority staff as well as the minority staff of the Banking Committee to assure that the drafting is in line with what we all intend to do. It doesn't speak to the Volcker rule's impact on depository institutions at all. It merely seeks to allow regulated insurance entities to continue to operate as they currently do in a manner that ensures payment of claims and annuities for years to come.

I urge my colleagues to support the Hutchison-Hagan motion. We have worked on this for several weeks together. I believe this bipartisan motion to instruct will be overwhelmingly approved because so many people have heard from their constituents.

I ask unanimous consent to have printed in the RECORD a letter from the Non Commissioned Officers Association of the United States of America, the Air Force Sergeants Association, the Naval Enlisted Reserve Association, and the TIAA CREF, a national financial services organization dedicated to serving the financial needs of those who work in the academic, medical, and cultural fields, all in support of our amendment and our motion to instruct.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

NON COMMISSIONED OFFICERS ASSOCIATION OF THE UNITED STATES OF AMERICA,

Selma, TX, May 3, 2010.

Hon. CHRISTOPHER DODD,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

Hon. RICHARD C. SHELBY,
Ranking Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

DEAR CHAIRMAN DODD AND RANKING MEMBER SHELBY: I write on behalf of the Non Commissioned Officers Association of the United States of America (NCOA), representing active duty, enlisted service members of all military services, the United States Coast Guard, associated Guard and Reserve Forces, retirees and veterans of all components. NCOA has strong concerns regarding the impact of the Restoring American Financial Stability Act of 2010's (S. 3217) "Volcker Rule" provisions on NCOA members and for that matter, the entire U.S. military community.

NCOA is dedicated to providing for service members and their families through every stage of their military career from enlistment to eventual separation, retirement and continuing to provide services to veterans' surviving family members. We understand and respect the achievements and sacrifices made by all service members and their families and are committed to ensuring that the military community has access to the "one stop shop" providers of financial services necessary to address their unique banking and insurance needs. This ease of access to essential financial resources is crucial to minimize the financial stresses and other burdens accompanying military life.

S. 3217's Volcker Rule, as currently proposed, threatens this essential access to one stop shop providers of financial services for NCOA members and their families. Limiting the provision's proprietary trading restrictions by excluding the insurance affiliates of insured depository institutions is necessary to maintain access to financial products and services that meet the unique needs of the military community. Making this small change to the Volcker Rule language will ensure that the financial stability of enlisted service members and their families is not put in jeopardy. Thank you for your thoughtful consideration of this issue and its

impact on NCOA members and the entire U.S. military community.

Sincerely,

H. GENE OVERSTREET,
12th Sergeant Major of the United States Marine Corps (Ret.), President.

AIR FORCE SERGEANTS ASSOCIATION,
Temple Hills, MD, April 29, 2010.

Hon. CHRISTOPHER DODD,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

Hon. RICHARD C. SHELBY,
Ranking Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

DEAR CHAIRMAN DODD AND RANKING MEMBER SHELBY: I am writing on behalf of the Air Force Sergeants Association (AFSA), the global, 120,000 member strong organization dedicated to all enlisted grades of Air Force Active Duty, Air National Guard, and Air Force Reserve Command, retired, veteran and family members. AFSA has strong concerns regarding the impact of the so called "Volcker Rule" provisions in the American Financial Stability Act of 2010, S. 3217, on AFSA members and the entire enlisted military community.

AFSA members and their families have made many sacrifices in order to invest their lives in the cause of freedom. They require access to "one stop shop" providers of financial services to address their unique banking and insurance needs. Ease of access to essential financial resources is particularly crucial today as our American military community faces the financial stresses and other burdens accompanying multiple deployments and frequent and costly relocations during times of active conflict. S. 3217's Volcker Rule provisions, as currently drafted, will prevent financial services providers from offering both banking and insurance products to AFSA members and their families tailored to their specific financial needs.

Making a small change to the bill's current language to ensure the Volcker Rule's proprietary trading restrictions are not extended to the insurance affiliates of insured depository institutions would allow one stop shop providers of financial products and services to continue meeting the unique needs of the military community. If the language is not corrected, this ease of access to important financial resources by American servicemen, women and their families will be in jeopardy. Thank you for your thoughtful consideration of this issue and its impact on AFSA's membership and the entire U.S. military community.

Sincerely,

JOHN R. "DOC" MCCAUSLIN,
CMSgt, USAF, Retired, Chief Executive Officer.

NAVAL ENLISTED RESERVE ASSOCIATION,
Falls Church, VA, May 5, 2010.

Hon. CHRISTOPHER DODD,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

Hon. RICHARD C. SHELBY,
Ranking Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

DEAR CHAIRMAN DODD AND RANKING MEMBER SHELBY: I am writing on behalf of the Naval Enlisted Reserve Association (NERA), a voluntary, nonprofit organization of active duty and retired enlisted reservists and other dedicated persons committed to promoting and maintaining the Navy Reserve, United States Marine Corps Reserve, and United States Coast Guard Reserve. NERA has strong concerns regarding the impact of the Restoring American Financial Stability Act of 2010's (S. 3217) "Volcker Rule" provisions on NERA members and the entire U.S. military community.

NERA is dedicated to protecting the individual rights, benefits, and privileges our American servicemen and women have earned through their commitment to military service and their access to "one stop shop" providers of financial services that understand their unique banking and insurance needs. Ease of access to essential financial resources for active duty and retired enlisted reservists and their families is crucial to minimizing the financial stresses and other burdens accompanying military life.

S. 3217's Volcker Rule provisions, as currently drafted, threaten this essential access to comprehensive financial services for NERA members and the entire enlisted community. Making a small change to the Volcker Rule language to ensure that the proprietary trading restrictions are not extended to the insurance affiliates of insured depository, institutions would allow one stop shop providers of financial products and services to continue meeting the financial needs of NERA members and their families.

If the Volcker Rule language is not corrected, the entire military community's access to essential financial resources will be in jeopardy. Thank you for your thoughtful consideration of this issue.

Sincerely,

SENIOR CHIEF NICK MARINE,
U.S. Navy (Ret.)
National President.

TIAA-CREF,
Washington, DC, May 24, 2010.

Hon. KAY BAILEY HUTCHISON,
U.S. Senate,
Washington DC.

DEAR SENATOR HUTCHISON: On behalf of TIAA-CREF, a national financial services organization dedicated to serving the financial needs of those who work in the academic, medical, and cultural fields, I write to express our support for your amendment (SA 4055) to the financial services regulatory reform legislation, which is likely to be offered as a motion to instruct conferees on Monday, May 24th.

TIAA-CREF is pleased to serve 3.7 million individual participants, and we endeavor to assist them to and through retirement. Passage of your amendment will send a strong message that insurers should continue to be able to make appropriate investments on behalf of their participants to adequately provide for their retirement savings.

Thank you for proposing this significant improvement to the legislation. If our company can be of additional assistance to you or your staff in this endeavor, please do not hesitate to contact me or Langston Emerson, Director of Federal Government Relations.

Sincerely,

DANIEL J. KENIRY,
Senior Vice President, Government Relations.

The PRESIDING OFFICER. The Senator from North Carolina.

Mrs. HAGAN. Mr. President, I rise in support of the motion to instruct offered by my colleague from Texas, Senator HUTCHISON. I thank the Senator from Texas for her leadership on this issue of importance to members of the military in our States and across the country. Section 619 of the Restoring American Financial Stability Act of 2010 bans certain activities not only at depository institutions but also at bank affiliates, including insurance affiliates. In doing so, section 619 inadvertently jeopardizes access to the important financial resources offered by diversified financial institutions to service men and women and their families. Section 619 bans proprietary trading, but proprietary trading by insurance entities is significantly different than the risk that comes with banks' proprietary trading. Insurance companies use premiums to trade funds, not the consumer deposits that this provision targets. Insurance trades are generally low risk and focus on long-term payment of claims and are already heavily regulated by State insurance regulators.

Servicemembers and their families rely on the ability of diversified financial service firms to provide both insurance and banking services under one roof. I am concerned that section 619 may force military members to change their current financial service providers and possibly subject the service men and women to unnecessary cost and burdens. That is why Senator HUTCHISON and I have worked for several weeks to correct this oversight, and why I introduced amendment 3799 with Senators HUTCHISON, CARPER, CORNYN, BEGICH, WEBB, BURR, and ISAKSON. Amendment 3799 was a narrow change that addressed the issue. To my knowledge, it was not opposed by anyone. While amendment 3799 was not voted on, Senator HUTCHISON's motion to instruct provides clear guidance to the conferees to ensure that proprietary trading restrictions do not prevent insurance company affiliates of depository institutions from engaging in such trading as part of the ordinary business of insurance.

It is critical that we adopt this motion so that diversified financial institutions may continue to provide low-cost and convenient access to diversified financial services for those sacrificing in service to our country. I urge my colleagues to vote yes on this motion.

I yield the floor.

The PRESIDING OFFICER. The Senator from Connecticut.

Mr. DODD. Mr. President, I commend both of my colleagues, Senator HUTCHISON and Senator HAGAN, my good friends from Texas and North Carolina. They have done a great job and deserve our thanks for the work they have put into this proposal. I am supportive of the motion to instruct. As a conferee, I will have something to say about this, I presume, in the conference. I thank them for their efforts. They have laid this out pretty well. I don't need to take a lot of time. I have some further remarks that lay out why I think this is a good proposal. I appreciate very much their efforts in this regard.

I am prepared to yield back time on this matter and urge colleagues to support the Hutchison-Hagan motion to the financial reform package. It is a good proposal, one that deserves all of our support.

The PRESIDING OFFICER. The Senator from Texas.

Mrs. HUTCHISON. Mr. President, I thank the distinguished chairman of the committee. He has been supportive of this amendment from the beginning. Senator HAGAN and I can say that we have regularly communicated with the chairman, and maybe he would even consider that we have hounded him to death. But nevertheless, I know he was helping us all along. We worked on the drafting to assure that the language met both the minority and majority requirements. I am pleased he has worked with us on this amendment. I thank Senator HAGAN as well for being such a staunch cosponsor of this amendment.

I yield back my time and ask for the yeas and nays.

The PRESIDING OFFICER. Is there a sufficient second?

Mr. DODD. Have the yeas and nays been ordered on both motions?

The PRESIDING OFFICER. They have not.

Mr. DODD. I don't see my colleague from Kansas but I know he wants the yeas and nays.

I ask for the yeas and nays on the Brownback motion.

The PRESIDING OFFICER. Is there a sufficient second?

There appears to be a sufficient second.

The yeas and nays were ordered.

Mr. DODD. I ask for the yeas and nays on the Hutchison-Hagan motion.

The PRESIDING OFFICER. Is there a sufficient second? There appears to be a sufficient second.

The yeas and nays were ordered.

Mrs. HUTCHISON. Mr. President, I ask the distinguished chairman, when we start the vote at 5:30, it will be the Brownback motion first and then Hutchison-Hagan.

Mr. DODD. BROWNBACK would come first and then the Hutchison-Hagan motion.

I suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The assistant legislative clerk proceeded to call the roll.

Mr. DODD. Mr. President, I ask unanimous consent that the order for the quorum call be rescinded.

The PRESIDING OFFICER. Without objection, it is so ordered.

The question is on agreeing to the Brownback motion to instruct conferees.

The yeas and nays have been ordered.

The clerk will call the roll.

The assistant legislative clerk called the roll.

Mr. DURBIN. I announce that the Senator from West Virginia (Mr. BYRD), the Senator from Arkansas (Mrs. LINCOLN), the Senator from Missouri (Mrs. MCCASKILL), the Senator from Oregon (Mr. MERKLEY), the Senator from New York (Mr. SCHUMER), and the Senator from Virginia (Mr. WARNER) are necessarily absent.

Mr. KYL. The following Senators are necessarily absent: the Senator from Georgia (Mr. CHAMBLISS), the Senator from Oklahoma (Mr. COBURN), the Senator from Georgia (Mr. ISAKSON) and the Senator from Mississippi (Mr. WICKER).

The PRESIDING OFFICER (Mrs. SHAHEEN). Are there any other Senators in the Chamber desiring to vote?

The result was announced—yeas 60, nays 30, as follows:

[Rollcall Vote No. 163 Leg.]

YEAS—60

Alexander	Enzi	Menendez
Barrasso	Graham	Mikulski
Bayh	Grassley	Murkowski
Begich	Gregg	Murray
Bennett	Hagan	Nelson (NE)
Bond	Hatch	Nelson (FL)
Boxer	Hutchison	Pryor
Brown (MA)	Inhofe	Reid
Brownback	Johanns	Risch
Bunning	Kerry	Roberts
Burr	Klobuchar	Rockefeller
Cardin	Kohl	Sessions
Cochran	Kyl	Shaheen
Collins	Landrieu	Shelby
Conrad	Lautenberg	Snowe
Corker	LeMieux	Specter
Cornyn	Lieberman	Thune
Crapo	Lugar	Vitter
DeMint	McCain	Voinovich
Ensign	McConnell	Wyden

NAYS—30

Akaka	Dorgan	Leahy
Baucus	Durbin	Levin
Bennet	Feingold	Reed
Bingaman	Feinstein	Sanders
Brown (OH)	Franken	Stabenow
Burris	Gillibrand	Tester
Cantwell	Harkin	Udall (CO)
Carper	Inouye	Udall (NM)
Casey	Johnson	Webb
Dodd	Kaufman	Whitehouse

NOT VOTING—10

Byrd	Lincoln	Warner
Chambliss	McCaskill	Wicker
Coburn	Merkley	
Isakson	Schumer	

The motion was agreed to.

Mr. BROWNBACK. Madam President, I move to reconsider the vote, and I move to lay that motion on the table.

The motion to lay on the table was agreed to.

VOTE ON HUTCHISON MOTION TO INSTRUCT

The PRESIDING OFFICER. The question is on agreeing to the motion to instruct, offered by the Senator from Texas. The yeas and nays have been ordered.

The clerk will call the roll.

The bill clerk called the roll.

Mr. DURBIN. I announce that the Senator from West Virginia (Mr. BYRD), the Senator from Arkansas (Mrs. LINCOLN), the Senator from Missouri (Mrs. MCCASKILL), the Senator from New York (Mr. SCHUMER), and the Senator from Virginia (Mr. WARNER) are necessarily absent.

Mr. KYL. The following Senators are necessarily absent: the Senator from Georgia (Mr. CHAMBLISS), the Senator from Oklahoma (Mr. COBURN), the Senator from Georgia (Mr. ISAKSON), and the Senator from Mississippi (Mr. WICKER).

The PRESIDING OFFICER. Are there any other Senators in the Chamber desiring to vote?

The result was announced—yeas 87, nays 4, as follows:

[Rollcall Vote No. 164 Leg.]

YEAS—87

Akaka	Ensign	McConnell
Alexander	Enzi	Menendez
Barrasso	Feinstein	Merkley
Baucus	Franken	Mikulski
Bayh	Gillibrand	Murkowski
Begich	Graham	Murray
Bennet	Grassley	Nelson (NE)
Bennett	Gregg	Nelson (FL)
Bingaman	Hagan	Pryor
Bond	Harkin	Reed
Boxer	Hatch	Reid
Brown (MA)	Hutchison	Risch
Brown (OH)	Inhofe	Roberts
Brownback	Inouye	Rockefeller
Burr	Johanns	Sessions
Burris	Johnson	Shaheen
Cardin	Kaufman	Shelby
Carper	Kerry	Snowe
Casey	Klobuchar	Specter
Cochran	Kohl	Stabenow
Collins	Kyl	Tester
Conrad	Landrieu	Thune
Corker	Lautenberg	Udall (CO)
Cornyn	Leahy	Udall (NM)
Crapo	LeMieux	Vitter
DeMint	Levin	Voinovich
Dodd	Lieberman	Webb
Dorgan	Lugar	Whitehouse
Durbin	McCain	Wyden

NAYS—4

Bunning	Feingold
Cantwell	Sanders

NOT VOTING—9

Byrd	Isakson	Schumer
Chambliss	Lincoln	Warner
Coburn	McCaskill	Wicker

The motion was agreed to.

Mr. DODD. Mr. President, I move to reconsider the vote and to lay that motion on the table.

The motion to lay on the table was agreed to.

Mr. FEINGOLD. Madam President, while I opposed the motion to instruct offered by the Senator from Kansas, Mr. BROWNBACK, I did so with reluctance. The vast majority of auto dealers in Wisconsin do not engage in the kinds of behavior that have been held up as a reason to oppose the Senator's motion, or the amendment he had previously offered to the financial regulatory reform bill. Our dealers are wonderful corporate citizens, who have contributed significantly to our communities and our State.

Some of that excellent track record stems from Wisconsin's tough consumer protection laws that not only safeguard consumers, but also protect those firms that treat their customers fairly from the fly-by-night operators who seek to gain a competitive advantage over honest dealers at the expense of the consumer. Had Wisconsin's consumer laws and history of vigorous enforcement been reflected in other States across the Nation, there would have been a stronger argument for carving out an exception in the bill for a specific set of firms, as is proposed by the motion to instruct.

Even though I opposed the motion to instruct, supporters of the motion are right when they note that auto dealers, who are almost uniformly small businesses, should not be treated the same as the large financial institutions that are the focus of much of this bill. That is why I supported the amendment offered by the Senator from Maine, Ms.

APPENDIX C

Excerpt from the Report to Accompany the
Financial Services and General Government Appropriations Bill, 2012

112TH CONGRESS, 1st Session } HOUSE OF REPRESENTATIVES { REPORT 112–136

FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS BILL, 2012

JULY 7, 2011.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mrs. EMERSON, from the Committee on Appropriations, submitted the following

R E P O R T

together with

MINORITY VIEWS

[To accompany H.R. 2434]

The Committee on Appropriations submits the following report in explanation of the accompanying bill making appropriations for financial services and general government for the fiscal year ending September 30, 2012.

INDEX TO BILL AND REPORT

67–238

Judgment Fund Transparency.—The Secretary of the Treasury shall submit to the Committee and make available to the public on its website an annual report about payments made under 31 U.S.C. 1304 for the fiscal year. Unless the disclosure of such information is otherwise prohibited by law or court order, the report shall consist of: (1) the name of the plaintiff or claimant, (2) the name of the counsel for the plaintiff or claimant; (3) the name of the agency that submitted the claim; (4) a brief description of the facts that gave rise to the claim; and (5) the amount paid representing principal, attorney fees, and interest, if applicable. The first report is due within 60 days of enactment of this Act.

Volcker Rule.—In Public Law 111–203, subsequent to a study issued by the Financial Stability Oversight Council (FSOC), Congress directed FSOC to coordinate the efforts of the appropriate Federal banking regulators, the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission to promulgate regulations, known as the "Volcker Rule," that "appropriately accommodate the business of insurance." The Committee believes that the traditional investment activities of State-regulated insurance companies for their general accounts, including investing in both sponsored and third-party funds, are preserved by the law without constraint.

The Committee is concerned the rule-making process is moving forward without a Senate-confirmed, voting member of the FSOC who can represent the views of the insurance industry. The Committee looks forward to reviewing the proposed regulations to ensure that Congressional intent is fulfilled.

Economic Warfare and Financial Terrorism.—Not later than 150 days after the enactment of this Act, the Committee directs the Secretary to submit a report to the House and Senate Appropriations Committees, the House Financial Services Committee, the Senate Banking Committee and other Committees the Department deems necessary regarding the potential risks to U.S. financial markets and economy posed by economic warfare and financial terrorism. The Secretary shall consider what vulnerabilities currently exist and potentially may arise in the future. In preparing the report, the Secretary shall consult with appropriate agencies, departments, bureaus, and commissions that have expertise in terrorism and complex financial instruments. The report may be submitted in classified and unclassified forms.

OFFICE OF TERRORISM AND FINANCIAL INTELLIGENCE

SALARIES AND EXPENSES

Appropriation, fiscal year 2011	$– – –
Budget request, fiscal year 2012	– – –
Recommended in the bill	100,000,000
Bill compared with:.	
Appropriation, fiscal year 2011	+100,000,000
Budget request, fiscal year 2012	+100,000,000

When the Administration was preparing its 2011 budget request during the summer and fall of 2010, it could never have imagined that a desperately discouraged vegetable vendor in Tunisia would give rise to the protests in Tunisia and elsewhere such as Libya, Egypt, Syria, and Yemen. The resulting uncertainty and instability

APPENDIX D

Excerpt from the Military Construction and Veterans Affairs and Related Agencies Appropriations Act, 2012 Conference Report

112TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPORT
112–331

MILITARY CONSTRUCTION AND VETERANS AFFAIRS AND RELATED AGENCIES APPROPRIATIONS ACT, 2012

CONFERENCE REPORT

TO ACCOMPANY

H.R. 2055

DECEMBER 15, 2011.—Ordered to be printed

DIVISION C—FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS ACT, 2012

References in this statement to the Senate bill are to the bill (S. 1573) as reported to the Senate by the Committee on Appropriations on September 15, 2011 (S. Rept. 112–79). References to the House bill are to the bill (H.R. 2434) as reported to the House by the Committee on Appropriations on July 7, 2011 (H. Rept. 112–136).

Language included in House Report 112–136 or Senate Report 112–79 that is not changed by this joint explanatory statement is approved by the committee of conference. This explanatory statement, while repeating some report language for emphasis, is not intended to negate the language in the referenced House and Senate committee reports unless expressly provided herein.

Where the House or Senate has directed submission of a report, that report is to be submitted to the Committees on Appropriations of both the House of Representatives and the Senate.

TITLE I

DEPARTMENT OF THE TREASURY

DEPARTMENTAL OFFICES

SALARIES AND EXPENSES

The conference agreement provides $308,388,000 for departmental offices salaries and expenses, instead of $185,749,000 as proposed by the House and $306,388,000 as proposed by the Senate.

Within the amount provided under this heading, the conference agreement provides $100,000,000 for the Office of Terrorism and Financial Intelligence and within that amount no more than $26,608,000 for administrative expenses. The conference agreement also provides full funding for the Secretary's security and travel, both domestic and international (including civilian and military).

Judgment Fund.—The conferees adopt the House report language regarding the Judgment Fund, except that the first report is due within 180 days of enactment of this Act and annually thereafter.

Volcker Rule.—The conferees note that consistent with Public Law 111–203, the appropriate Federal banking regulators and the U.S. Securities and Exchange Commission proposed regulations implementing the "Volcker Rule," and the U.S. Commodity Futures Trading Commission is expected to propose a similar rule, that appropriately accommodates the business of insurance by permitting trading by a regulated insurance company for its general account. These accommodations are subject to subsections (d)(1)(F) and (d)(2)(A) of section 13 (or "sections 13(d)(1)(F) and 13(d)(2)(A)") of the Bank Holding Company Act of 1956.

Economic Sanctions and Divestments.—The conferees direct the Department to fully implement the sanctions and divestment measures applicable to North Korea, Burma, Belarus, Iran, Sudan, and Zimbabwe. The Department is further directed to promptly no-

APPENDIX E

Study & Recommendations on Prohibitions on Proprietary Trading &
Certain Relationships with Hedge Funds & Private Equity Funds

Financial Stability Oversight Council, January 2011

STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

January 2011

THE ACCOMMODATION OF THE BUSINESS OF INSURANCE

The statute requires the Council to put forth recommendations to "... appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system." As discussed above, under the Volcker Rule, certain investments made by insurance companies for their general account are permitted activities, and thus generally exempt from the prohibitions of the Volcker Rule. Those activities, however, remain subject to the statutory backstop described above.

Insurance companies assume risk and collect premiums and, in turn, invest those premiums. Investment return contributes to the company's net worth (i.e., policyholder surplus), which in turn supports underwriting and the payment of future claims to policyholders and claimants.[60] The investment activity of insurers is central to the overall insurance business model and could be unduly disrupted if certain provisions of the Volcker Rule applied. As such, Section 619 of the Dodd-Frank Act amends the BHC Act by adding Section 13(d)(1)(F), which provides specific permission for this investment activity:

> "(F) The purchase, sale, acquisition, or disposition of securities and other specified instruments described in subsection (h)(4) by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company, provided that such activities by any affiliate are solely for the general account of the regulated insurance company, if–
>
> > (i) the purchase, sale, acquisition, or disposition is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which each such insurance company is domiciled; and
> >
> > (ii) the appropriate Federal banking Agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and territories of the United States, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in clause (i) is insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States."[61]

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[60] Insurance companies also retain assets and earnings, and in the case of stock companies, may issue dividends to shareholders, or in the case of mutual companies, may provide dividends or other benefits to members.

[61] 12 U.S.C. § 1851(d)(1)(F).

APPENDIX F

TIAA-CREF Comment Letter on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds

FINANCIAL SERVICES
FOR THE GREATER GOOD®

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College Retirement Equities Fund
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Brandon Becker
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November 5, 2010

The Honorable Timothy F. Geithner
Chairman, Financial Stability Oversight Council
Secretary, U.S. Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Docket No. FSOC-2010-0002)

Dear Secretary Geithner:

TIAA-CREF appreciates the opportunity to respond to the Financial Stability Oversight Council's ("FSOC") request for input on the study regarding implementation of certain aspects of Section 619 of the Dodd-Frank Act ("DFA"), commonly referred to as the Merkley-Levin amendment or the "Volcker Rule."

TIAA-CREF is the leading provider of retirement services in the academic, research, medical, and cultural fields managing over $430 billion of retirement assets on behalf of 3.7 million participants at more than 15,000 institutions nationwide.[1] TIAA was incorporated as a stock life insurance company in the State of New York in 1918. CREF is registered as an investment company with the Securities and Exchange Commission under the Investment Company Act of 1940. At the core of our not-for-profit heritage is TIAA-CREF's mission "to aid and strengthen" the financial future of the clients we serve by providing financial products that best meet their special needs. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals, as well as income and wealth protection needs.

To help decrease costs for our participants and increase efficiencies in the services we provide to our core retirement clients, TIAA owns an ancillary thrift institution that comprises a very small portion of our overall assets. Even though the thrift represents a minor part of our business, we are concerned about provisions in the Volcker Rule that could potentially result in all affiliates of our thrift, including our insurance business, becoming subject to the restrictions on investing in or sponsoring hedge funds and private equity funds. These types of investments allow insurers to provide valuable investment services and assist institutional clients with diversification of assets.

[1] As of 9/30/2010.

In adopting the Volcker Rule, policymakers specifically concluded insurers were not an intended target of such restrictions and therefore merit different treatment under the Rule than other financial institutions. Consistent with both the statutory language and intent of the DFA, the FSOC as part of its study should recommend that the regulators implementing the Volcker Rule ensure their efforts do not directly or indirectly reverse or restrict the accommodations provided in the statutory language that allow insurers to continue to conduct their normal business operations as long as those operations do not introduce undue risk to the economy as a whole. Moreover, consistent with that Congressional conclusion, regulators should provide additional accommodations for the conduct of the insurance business based on the data gathered pursuant to the required study. Because the statutory language allows insurers affiliated with banking entities to continue their existing regulated investment activities, including those involving separate accounts and private equity and hedge funds, the FSOC's study and recommendations should reflect that directive.

While the enclosed appendix provides specific responses to some of the questions raised in the FSOC's request for comment, there are two overarching and fundamental arguments we would like to highlight. First, the statutory language in the DFA clearly establishes that the business of insurance is not subject to the Volcker Rule and we believe statements made by Members of Congress strongly back the intent of this language. Second, the Volcker Rule is designed to address specific risks to individuals, institutions, and the financial system as a whole that the business of insurance simply does not present. The business of insurance is a highly regulated, minimally leveraged, and low risk industry. Accordingly, we believe that ordinary rules of statutory construction combined with sound policy analysis require a broad recognition that the business of insurance is not subject to the Volcker Rule.

We look forward to working with you and the FSOC as this issue progresses. Please feel free to contact me at 212.916.4750 with questions or concerns.

Very truly yours,

Brandon Becker

Brandon Becker
Executive Vice President and Chief Legal Officer

cc: Alastair Fitzpayne, Deputy Chief of Staff and Executive Secretary, Department of Treasury
Ben Bernanke, Chairman of the Federal Reserve System
John Walsh, Acting Comptroller of the Currency
Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission
Sheila Bair, Chairman of the Federal Deposit Insurance Corporation
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Edward J. DeMarco, Acting Director of the Federal Housing Finance Agency
Debbie Matz, Chairman of the National Credit Union Administration

Responses

1. Submit views on ways in which implementation of the Volcker Rule can best serve to:

(vi) Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system.

Congress did not intend to place the business of insurance under the purview of Section 619 of the DFA. Members of Congress explicitly recognized the unintended affects of the Volcker Rule on insurers with small banking operations and noted in the debate that the DFA should not affect ordinary investment activities of insurers (see statements in the Congressional Record from Senators Kay Bailey Hutchison (R-TX),[2] Kay Hagan (D-NC),[3] and Jeff Merkley (D-OR)[4]). The existing insurance regulatory investment regime ensures life insurance companies are undertaking the sophisticated yet prudent investment steps necessary to ensure the health and growth of their portfolios in order to meet their current and future policyholder obligations. The safety and soundness of a banking entity affiliated with a life insurer is established when the life insurer itself is effectively regulated and provides a corporate structure designed to appropriately support such banking activities. To accomplish this, life insurers must be able to continue to invest conservatively as allowed under insurance investment laws. We urge the FSOC to find in its study that the business of insurance does not pose the types of risks to an affiliated bank that are being targeted by Section 619 and therefore should be exempted from the provisions of this section.

The business of insurance differs fundamentally from other areas of the financial services sector. Insurance products allow consumers to transfer risk through products such as life insurance (the risk of dying too soon) and annuities (the risk of living too long), as opposed to taking on greater risk, as is often the case with other financial products such as stocks (market risk) and bonds (interest rate risk). Since insurance products generally require policyholders pay premiums in exchange for a legal promise that is often years in the future, insurers are compelled to manage assets in a way that reflects the long-term nature of their obligations. This results in insurers being less leveraged than other sectors of the financial services industry. In addition, insurer liabilities tend to operate independent of the business cycle in that they are predetermined (e.g. annuities, term life) or randomly dispersed (natural disasters) so that the payout schedule is not a function of economic conditions. Insurers have the freedom to choose when to sell assets to meet obligations rather than being forced to liquidate assets to satisfy short-term obligations.

Insurance is regulated on a state-by-state basis and solvency is the fundamental form of consumer protection in the insurance industry. State regulators impose strict rules on the quality and type of capital insurers must hold to guarantee their solvency. A state regulator's primary tool for ensuring insurers meet their obligations to policyholders is the examination process. State regulators examine insurers licensed in their jurisdictions on a regular basis. In turn, to ensure

[2] Vol. 156, No. 79. Congressional Record. S4136-S4138, May 24, 2010.
[3] Vol. 156, No. 79. Congressional Record. S4136-S4138, May 24, 2010.
[4] Vol. 156, No. 105. Congressional Record. S5896. July 15, 2010.

each state regulatory body's exam process is adequate, regulators are overseen by their peers via the National Association of Insurance Commissioners (NAIC) and via other interstate cooperative mechanisms. State regulators face further scrutiny by their state peers in NAIC forums such as the Financial Analysis Working Group, in which teams of representatives from multiple states assess nationally significant insurers. Furthermore, the NAIC accredits state insurance departments through its own examinations process, which requires each state to have statutory accounting, investment, capital, and surplus requirements embedded in state law. These laws increase regulators' ability to identify when an insurer's financial strength has weakened and empowers the regulators to intervene when needed.

Another tool that assists in the regulation and solvency of insurance companies is the system of state-sponsored guaranty associations. Each state operates a guaranty fund for resolving policyholder claims (up to specified limits) or to assume or transfer policies if an insurer has insufficient assets to pay out customer claims. Insurers must join state guaranty associations in every state in which they are licensed and must pay into these funds relative to their size. This system of guaranty associations prevents the failure of an insurance company, regardless of its size, from posing a systemic threat to the financial system as a whole. State-based guaranty funds would substantially cover payouts to consumers even in the failure of a major insurer. In addition, history demonstrates that due to the vibrant competition within the U.S. insurance market additional insurance providers are available to fill any market voids created by the failure of an insurer.

State insurance laws also provide ceilings on the proportion of an insurer's investments that may be invested in a particular asset and asset class. These laws compel insurers to hold their investments in a diversified portfolio but they do not straitjacket insurers into any specific portfolio structure. For instance, Section 1405 of the New York Insurance Law prohibits an insurer from carrying more than 20% of admitted assets in real property and no more than 2% in any individual property.[5] Similarly, New York constrains the amount of investments an insurer can make in foreign property, obligations, securities, etc. It should be noted that this law does not set a floor that forces insurers to invest in any particular asset or asset class. States may also limit or prohibit derivatives transactions. For instance, NY law does not restrict currency hedging but it does limit other types of derivatives transactions. These state statutory limitations constrain insurers from taking excessive investment risks while simultaneously allowing insurers a great deal of leeway in determining the most profitable mix of investments at an acceptable level of risk for the individual insurer's business.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

The recommendations made by the FSOC in its study should ensure regulators keep the exemption for insurance companies as provided in Section 619(d)(1)(F) of the DFA and as

[5] Similar statues in other states include Florida - Fla. Stat. § 625.305; Illinois - 215 ILCS 5/126 et seq.; Ohio - ORC Ann. 3907.14; Pennsylvania - 40 P.S. § 504.2; Texas - Tex. Ins. Code §§ 425.108-23; Washington - Rev. Code Wash. §§ 48.13 et seq.

intended by Members of Congress. The exemption should permit the full scope of investment activity engaged in by insurance companies in accordance with insurance investment laws and regulations to continue, including investing in and sponsoring private equity funds.

Section 619(d)(1)(F) was enacted specifically to allow insurers that are affiliated with banking entities to continue to conduct their current regulated investment activities after the Volcker Rule is implemented. By its very nature, this permitted activity includes the ability of insurance companies to continue to invest in a wide range of securities, including private equity funds, within the limits allowed under insurance investment laws. Section 619(a)(1) begins with the phrase, "Unless otherwise provided in this section…" before stating the prohibitions on proprietary trading and investing in and sponsoring private equity funds. Moreover, Section 619(d)(1) begins with the phrase "Notwithstanding the restrictions under subsection (a)…the following activities…are permitted." Section 619(d)(1)(F) then expressly permits regulated insurance companies to continue their general account investment activities as provided for and regulated under state insurance investment laws. This is clear recognition by Congress that insurers must be allowed to carry out their fundamental business model, which requires them to invest the company's own money in order to ensure a healthy investment portfolio for paying customer benefits and prudently managing the company.

There is a possible interpretation that, because Section 619(d)(1)(F) uses the description of securities contained in the definition of "proprietary trading," Congress intended the permissible activities of insurance companies under Section 619(d)(1)(F) to be limited to proprietary trading, as defined in the Volcker Rule. We believe this is an erroneous interpretation. If Congress had intended to restrict Section 619(d)(1)(F) to only permit proprietary trading, the language in Section 619(d)(1)(F) would have simply said as much. Instead, Section 619(d)(1)(F) says, "Notwithstanding the restrictions under subsection (a), …the following activities are permitted: …The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) by a regulated insurance company…" Note that the term "proprietary trading" is not in Section 619(d)(1)(F). "Proprietary trading" is a defined term under Section 619(h)(4) of the Volcker Rule and Congress used the term "proprietary trading" when it intended to focus on proprietary trading. The text of Section 619(d)(1)(F) makes plain Congress was cross-referencing Section 619(h)(4) solely to define "securities and other instruments" and not to further restrict the permitted activities of 619(d)(1)(F).

A letter submitted to the FSOC and signed by numerous senators, including the co-sponsors of the amendment that ultimately became Section 619, Senators Jeff Merkley (D-OR) and Carl Levin (D-MI), specifically states that the intention of legislators was to, "set forth a clear mandate to end high-risk, conflict-ridden financial activities."[6] In addition, in his testimony before the Senate Banking Committee earlier this year, Paul Volcker noted specifically that the intent of his proposal was to address the "strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity."[7]

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[6] Letter submitted to the FSOC by 16 senators in response to its request for comments on implementation of Section 619.

[7] Statement of Paul A. Volcker before the Committee on Banking, Housing, and Urban Affairs of the United States Senate. Washington, DC. February 2, 2010.

The intent of the Volcker Rule is to insulate federally insured banking activities from the risk that highly leveraged, principal trading by a parent or affiliate will place the federally insured bank at risk. The specific concern is that losses associated with such risky trading will lead to a "run-on-the-bank," creating financial instability and threatening the FDIC by virtue of the applicable deposit guarantee. The long-term investments undertaken by insurance companies, due to their dramatically different business model and highly regulated nature, do not present such risks to their affiliated banking institutions. Accordingly, we believe it is appropriate for the FSOC to interpret the Volcker Rule, as applied to insurance companies, in a manner consistent with the statutory language. In other words, most regulated insurance company activity, even if undertaken on a principal basis, should not be subject to the Volcker Rule.

Insurance companies invest with long-term horizons in prudent investments consistent with strict insurance investment laws, rather than engaging in the short-term, high-risk trading activities that Congress and Mr. Volcker were targeting with this legislation. In addition, an exemption for proprietary trading as defined in the Volcker Rule would have little meaning for an insurance company, because insurance companies do not engage in proprietary trading "principally for the purpose of selling in the near term," as defined in Section 619(h)(6). The fundamental business model of an insurance company does not involve engaging in high risk or short-term profit seeking. Rather, it requires investing the company's own money in a prudent manner that ensures a healthy portfolio that can continue paying customer benefits over the long term.

We believe Congress provided the broad exemption for insurance companies under Section 619(d)(1)(F) because it recognized that there are benefits to insurance companies and their customers if insurance companies are permitted to continue to invest in a manner that aligns its conservative long-term objectives with its long-term obligations. Investing in private equity funds as part of the ordinary, regulated investment activity of an insurance company provides access to companies, markets, and investment strategies that might not otherwise be available to the insurance company. Private equity funds also enable the insurance company to diversify in a manner that would not otherwise be available. Investments in private equity funds have historically had a low correlation to other insurance company investments and represent a good portfolio fit for long-term liability products and company surplus accounts. In addition, private equity funds have historically generated higher rates of return as compared to the returns of the public equity markets for periods of over 10 years, with lower volatility. For all of these reasons, Congress recognized that insurance companies must be exempt from the investment restrictions of Section 619(a) of the Volcker Rule and, therefore, adopted Section 619(d)(1)(F) to provide a broad exemption.

It is also important to ensure any rulemaking under Section 619 exclude insurance company separate accounts and the variable insurance and annuities they support. A separate account is a traditional device established on the books of an insurance company pursuant to state insurance law in order to fund certain types of variable insurance contracts. Under insurance law, the assets of a separate account are considered assets of the insurance company. As a provider of retirement plans, we understand the importance of separate accounts. The variable investments we offer under our separate accounts include equities, fixed income, and money market accounts. These investments work in conjunction with, not in addition to, our general account and are an

important component to clients' retirement plans, allowing them to build a fully diversified portfolio.

Separate accounts should be included in any formal definition of investment activities "on behalf of customers" so that separate accounts are brought in under the exemption. Again, it is important to note that during the legislative process, numerous policymakers made clear that it was not the intent of Section 619 to prohibit or interfere with an insurer's ability to offer, maintain, or administer insurance contracts that are supported by separate accounts (see statements in the Congressional Record from Senators Kay Bailey Hutchison (R-TX),[8] Kay Hagan (D-NC),[9] and Jeff Merkley (D-OR)[10]).

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

As set forth in detail in the response to item 2 above, Congress included Section 619(d)(1)(F) of the Volcker Rule to provide insurance companies with a broad exemption from the investment restrictions of Section 619(a), both for the proprietary trading restrictions in Section 619(a)(1)(A) and the restrictions on investing in private equity funds in Section 619(a)(1)(B). By the clear language of Section 619(d)(1)(F), Congress intended insurance companies to continue their general account investment activities as provided for and regulated under state insurance investment law. This intent is supported by another provision in the Volcker Rule – Section 619(b)(1)(F), which directs the FSOC to make recommendations that appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of the U.S. financial system any banking entity with which such insurance company is affiliated. Thus, it was the intent of Congress that all regulated investment activity of the general account of insurance companies including, without limitation, investing in private equity funds, be permitted to continue after implementation of the Volcker Rule.

In addition to preserving the ability of insurance companies to continue to invest in the full range of securities for its general account including, without limitation, in private equity funds, we also believe that to the extent the Volcker Rule prohibits insurance companies from sponsoring private equity funds, such result would be an unintended consequence of the Volcker Rule. The text of the Volcker Rule and the legislative history suggest such unintended consequences should be addressed when making recommendations on implementing the provisions of the Volcker Rule.

Congress intended that the business of insurance within an insurance company be appropriately accommodated, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with

[8] Vol. 156, No. 79. Congressional Record. S4136-S4138, May 24, 2010.
[9] Vol. 156, No. 79. Congressional Record. S4136-S4138, May 24, 2010.
[10] Vol. 156, No. 105. Congressional Record. S5896. July 15, 2010.

which such insurance company is affiliated and the U.S. financial system [Section 619(b)(1)(F)]. Insurance companies have in the past and currently continue to sponsor private equity funds. Such activities are subject to regulation in accordance with the relevant insurance company investment laws. TIAA, for example, is highly regulated by the New York State Insurance Department ("NYSID") and by the insurance regulators in all 50 states of the U.S., as well as the District of Columbia, Puerto Rico and the U.S. Virgin Islands. State insurance regulators allow insurance companies to sponsor private equity funds up to state limits on equity investments. NYSID, for example, has strict regulations on investment limits and capital requirements to protect the financial strength and solvency of regulated insurance companies. In light of such regulation and the language of Section 619(b)(1)(F), we suggest that the FSOC recommend that implementation of the Volcker Rule confirm that insurance companies affiliated with depository institutions continue to be able to sponsor private equity funds, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system.

We note that Section 619(d)(1)(G) permits banking entities to sponsor private equity funds, subject to de minimis ownership limits and other requirements. Although insurance companies affiliated with a depository institution are covered by the broad definition of "banking entities" under the Volcker Rule, in light of the clear Congressional intent to accommodate the activities of insurance companies, we believe that Section 619(d)(1)(G) is intended to apply to banking entities, generally, but that Sections 619(d)(1)(F) and Section 619(b)(1)(F) are intended to provide insurance companies, specifically, greater latitude in their permissible activities. We believe that implementing the Volcker Rule in this manner relieves a tension between such provisions. To be clear, we think that any depository institution, whether or not affiliated with an insurance company, must comply with Section 619(d)(1)(G) when sponsoring a private equity fund. Insurance companies affiliated with a depository institution, however, should be governed by Section 619(d)(1)(F), and Section 619(d)(1)(F) should be implemented in a manner that confirms that such insurance companies may continue to sponsor private equity funds, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system.

It is our view that allowing insurance companies to sponsor private equity funds benefits insurance companies by enabling them to (1) build scale in multiple investment classes, (2) obtain investment diversification by owning a smaller percentage of a larger number of assets, (3) build and develop better investment staff to perform research and invest on behalf of the insurance company, and (4) control investment timing and allocations to suit long-term objectives, rather than relying on third-party managers who may have different objectives than the insurance company. Furthermore, insurance companies historically have achieved diversification in their investments by including co-investors. Establishing a relationship with co-investors and structuring a transaction to include participation by co-investors are costly and time consuming endeavors. Doing so for multiple transactions is significantly inefficient compared to establishing a pool of capital to make multiple investments – i.e., forming a private equity fund to make such investments. In light of an insurance company's expertise in making such investments, it is only natural that the insurance company would sponsor such fund.

The issues discussed above could be clarified by (1) confirming in the definition of "a permitted activity by an insurance company" [Section 619(d)(1)(F)] that insurance companies that are affiliated with depository institutions are permitted to continue to invest in private equity funds and (2) expanding the definition of "a permitted activity by an insurance company" so that such insurance companies are permitted to continue to sponsor private equity funds, in each case subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system. In doing so, it may be appropriate to confirm that such affiliated depository institutions must comply with Section 619(d)(1)(G) if they sponsor a private equity fund. We note that Senate Report 111-176 provides, in part, that: "It is not the intent of the [Volcker Rule] to interfere inadvertently with longstanding, traditional banking activities that do not produce high levels of risk or significant conflicts of interest. For that reason, the [FSOC] is given some latitude to make needed modifications to definitions and provisions in order to prevent undesired outcomes."[11] We submit that this is such an instance where an undesired outcome may be prevented.

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

(iv) "Such similar fund" [§619(h)(2)];

It is our view that the phrase "such similar fund" was included by Congress to prevent depository institutions from circumventing the Volcker Rule. For example, a depository institution could create private equity funds or hedge funds offshore, which entities may not need to rely on either Section 3(c)(1) or 3(c)(7) to be excluded from the Investment Company Act of 1940. Another example would be synthetic fund structures, where the result of coordinated activities with third party co-investors mimics the risk/return profile of private equity funds and hedge funds. For example, a depository institution might engage in a transaction or a series of related transactions in concert with others that creates the same risks for the financial soundness of the depository institution as investing in a hedge fund or a private equity fund – e.g., by investing in leveraged, high risk, short term instruments as hedge funds do, or acquiring operating companies as private equity funds do. We note, however, that direct investment activity was not the focus of the phrase "such similar fund," and thus in our view the activity must be coordinated with co-investors in a manner that mimics a fund in order to be captured by the phrase "such similar fund."

Congress clearly did not intend to pick up any category of exclusion under Section 3(c) of the Investment Company Act other than subsections (1) and (7), as set forth in the Volcker Rule.

(xiv) A permitted activity by an insurance company [§619(d)(1)(F)]

As discussed in the responses to numbers 2 and 3, above, the definition of "a permitted activity by an insurance company" [Section 619(d)(1)(F)] should be clarified so that (1) investments in private equity funds by insurance companies that are affiliated with depository institutions are permitted to continue and (2) such insurance companies are permitted to continue

[11] Senate Report No. 111-176. 111th Congress. 1st Session. p. 91. (2010)

to sponsor private equity funds without being required to comply with Section 619(d)(1)(G), while confirming that the depository institutions must comply with Section 619(d)(1)(G) if they sponsor a private equity fund.

APPENDIX G

TIAA-CREF Comment Letter on Conformance Period for Entities Engaged
in Prohibited Proprietary Trading or
Private Equity Fund or Hedge Fund Activities

FINANCIAL SERVICES
FOR THE GREATER GOOD®

Teachers Insurance and Annuity Association of America
College Retirement Equities Fund
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January 7, 2011

The Honorable Ben S. Bernanke
Chairman, Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington D.C. 20551

Re: Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities (Docket No. R-1397; RIN No. AD 7100-58.)

Dear Chairman Bernanke:

TIAA-CREF appreciates the opportunity to provide input on the implementation of Section 619 of the Dodd-Frank Act ("DFA"), commonly referred to as the "Volcker Rule." As the leading provider of retirement services in the academic, research, medical and cultural fields, TIAA-CREF manages over $450 billion of retirement assets on behalf of 3.7 million participants at more than 15,000 institutions nationwide.[1] Incorporated as a stock life insurance company in the State of New York, we operate on a not-for-profit basis. TIAA-CREF offers retirement plans with a range of options that help institutions meet their retirement plan administration needs and individual clients meet their savings goals as well as their income and wealth protection needs.

As noted in our November 5, 2010 letter to the Financial Stability Oversight Council ("FSOC") concerning its study on issues arising from the Volcker Rule,[2] TIAA owns a small ancillary thrift institution that primarily serves the purpose of decreasing costs for our participants while increasing efficiencies in the services we provide our retirement clients. While our thrift comprises a very small portion of our overall assets, our ownership of this thrift institution could subject all affiliates of our thrift, including our insurance business, to the investment and sponsorship restrictions of the Volcker Rule.

Both the statutory language in Section 619 of the DFA and the legislative history behind it clearly establish that it was the intent of Congress not to subject the business of insurance to the restrictions of the Volcker Rule.[3] The Volcker Rule is designed to address specific risks to individuals, institutions, and the financial system as a whole that the business of insurance, as a highly regulated, minimally leveraged industry, simply does not present. As you proceed with the important work of implementing the Volcker Rule, we respectfully ask that you allow insurers to continue to conduct their normal business operations as long as such operations do not introduce undue risk to the overall economy. This includes investments in and sponsorship of private equity and hedge funds, both of which are important in allowing

[1] Market value as of December 31, 2010.
[2] See TIAA-CREF letter of comment dated, November 5, 2010, in FSOC comment file at http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1301.1
[3] Vol. 156, No. 79. Congressional Record. S4136-S4138, May 24, 2010; Vol. 156, No. 105. Congressional Record. S5896. July 15, 2010

TIAA-CREF and other insurers to continue to provide valuable investment services and assist clients with diversification of assets.

To allow insurers affiliated with banking entities to continue to conduct their current regulated investment activities after implementation of the Volcker Rule, Congress specifically enacted Section 619(d)(1)(F) of the DFA. Under Section 619(d)(1)(F), permitted activity includes the ability of insurance companies to continue to invest in a wide range of securities, including private equity funds, within the limits allowed under insurance investment laws. Section 619(d)(1)(F) also expressly permits regulated insurance companies to continue their general account investment activities as provided for and regulated under state insurance investment laws. This is clear recognition by Congress that insurers must be allowed to continue to carry out their fundamental business model, which requires investing the company's own money in a prudent manner that ensures a healthy investment portfolio for paying customer benefits over the long-term, but does not involve engaging in high risk or short-term profit seeking.

State insurance laws compel insurers to hold their investments in a diversified portfolio, but do not force insurers to utilize any one specific portfolio structure. State insurance regulators allow insurance companies to sponsor private equity funds up to state limits on equity investments. In light of such existing state regulation and the language of Section 619(d)(1)(F), we recommended in our previous comment letter to the FSOC that implementation of the Volcker Rule confirm that insurance companies affiliated with depository institutions will be able to continue to invest in and sponsor private equity funds, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system.

With respect to instituting conformance periods for those organizations that ultimately will become subject to the Volcker Rule restrictions, we believe the conformance regulations should provide the Board of Governors of the Federal Reserve System ("Board") with the appropriate level of discretion and maximum flexibility to grant approvals for restricted entities to maintain their activities and investments for the full amount of time permitted under the Volcker Rule for all affected funds, especially illiquid funds. In particular, we believe the Board should consider the potential harm to investors as well as conflicts of interests between entities that sponsor funds and their fund investors should entities that are fund sponsors be required under the Volcker Rule to relinquish their role as a general partner of funds or are incentivized to prematurely terminate or liquidate underlying fund investments at unattractive prices. Overly restrictive regulations or an unnecessarily rigid process will operate against the interests of fund investors as well as restricted entities.

We look forward to working with the Board and the FSOC as this issue progresses. Please feel free to contact me at any time with questions or concerns.

Very truly yours,

Brandon Becker

Brandon Becker
Executive Vice President and Chief Legal Officer

cc: Ms. Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. HOUSE FINANCIAL SERVICES SUCOMMITTEES ON FINANCIAL INSTITUTIONS & CONSUMER CREDIT AND CAPITAL MARKETS & GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON, DC

January 18, 2012

Good morning Chairman Capito and Chairman Garrett and members of the subcommittees. I thank you for inviting me to today's hearing on the Volcker Rule. I also am glad to join my fellow regulators in testifying today.

Three years ago, the financial system failed, and the financial regulatory system failed as well. We are still feeling the aftershocks of these twin failures. While the crisis had many causes, it is evident that swaps played a central role. Swaps added leverage to the financial system with more risk being backed by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market. They contributed to a system where large financial institutions were considered not only too big to fail, but too interconnected to fail. Swaps – developed to help manage and lower risk for end-users – also concentrated and heightened risk in the financial system and to the public.

Congress and the President responded to the 2008 crisis – they came together to pass the historic Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The law gave the CFTC and Securities and Exchange Commission (SEC) oversight of the more than $300 trillion swaps market. The CFTC and SEC are working hard to write new rules of the road to make the swaps market more transparent and safer for the American public.

Congress also included in Dodd-Frank the Volcker Rule. It prohibits certain banking entities from engaging in proprietary trading, yet also permits certain activities, such as market-making and risk-mitigating hedging. The law requires that banking entities with significant trading assets have policies and procedures in place to identify and prevent violations of the statutory prohibition on proprietary trading. In addition to swaps, the Volcker Rule applies to covered financial products, such as securities and futures.

Section 619 of the Dodd-Frank Act amended the Banking Holding Company Act to direct the CFTC to write rules implementing Volcker Rule requirements for banking entities for which the agency is the primary financial regulator. The CFTC's role regarding the Volcker Rule is significant, but as a supporting member. The bank regulators have the lead role.

Dodd-Frank requires the various financial regulators to consult and coordinate with each other to write consistent rules. The Secretary of the Treasury, as the Chairperson of the Financial Stability Oversight Council, is responsible for the coordination of the various regulations issued under Section 619.

Following Congress' mandate, the CFTC's proposal is consistent with the joint rule proposed in October 2011 by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the SEC. However, the Commission's proposal also includes several additional questions seeking public comment on whether certain provisions of the common rules are applicable to CFTC-regulated banking entities.

The CFTC's proposed rule would apply to the activities of the banking entities' CFTC-registered affiliates and subsidiaries, such as futures commission merchants (FCMs), swap dealers, and commodity pool operators. For example, for a joint FCM/broker-dealer that is a banking entity, the CFTC has Volcker Rule jurisdiction over the FCM's activities, while the SEC's regulations would apply to the broker-dealer activities.

The CFTC's limited enforcement authority under the Volcker Rule provisions includes recordkeeping and reporting, as well as examination of those books and records. In addition, the CFTC could order violators of the proprietary trading prohibition to terminate the activity and dispose of their investment. The banking regulators, particularly the Federal Reserve, have broader enforcement authority under the Banking Holding Company Act. The Federal Reserve also has authority regarding the possible extension of the time period for conforming with the rules.

The banking regulators and the SEC proposed the joint rule in October, and the CFTC did so January 11. The reason for the CFTC's delay was a matter of the capacity of the Commission

to give the rule consideration. Over the past year, the CFTC has been working diligently to implement the Dodd-Frank Act. To date, the Commission has held 23 public meetings on Dodd-Frank rules, considered more than 50 proposals and finalized 25 rules.

As with all of our rules, the CFTC is working to implement the Volcker Rule in a thoughtful, balanced way – not against a clock. The Commission is specifically requesting comments from the public regarding the costs and benefits and economic effects of the proposed rule, and we will carefully consider all of the incoming comments.

In your January 6 invitation letter to me, you asked a number of questions associated with Volcker Rule implementation. The Commission's rulemaking solicits public comment regarding the topics addressed in your letter.

In adopting the Volcker rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in market making, among other activities. One of the challenges in finalizing a rule is achieving these dual objectives. It will be critical to hear from the public on how to best achieve Congress' mandate. The public has been invited to comment on the CFTC's proposal for 60 days, and I very much look forward to the substantial public input I anticipate we will receive on this rule.

Thank you, and I would be happy to take questions.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

MARTIN J. GRUENBERG
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

"EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION"

before the

SUBCOMMITTEE ON CAPITAL MARKETS AND GSES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS & CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

January 18, 2012
2128 Rayburn House Office Building

Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the proposed regulations to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), also known as "the Volcker Rule."

Last November, the FDIC, jointly with the Federal Reserve Board of Governors (FRB), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC), published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the Volcker Rule requirements of the Dodd-Frank Act. On December 23, the four agencies extended the comment period for an additional 30 days until February 13, 2012. The comment period was extended as part of a coordinated interagency effort to allow interested persons more time to analyze the issues and prepare their comments, and to facilitate coordination of the rulemaking among the responsible agencies. In addition, on January 11, 2012, the Commodity Futures Trading Commission (CFTC) approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text as the interagency NPR. We look forward to receiving comments on the NPR.

In recognition of the potential impacts that may arise from the proposed rule and its implementation, the Agencies have requested comments on whether the rule represents a balanced and effective approach in implementing the Volcker Rule or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities

to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets.

My testimony today will include a brief overview of the statutory provisions, a description of the rulemaking process undertaken by the Agencies, an overview of the proposed Volcker Rule, and a discussion of our efforts to identify the potential impact of the proposed rule.

Overview of the Volcker Rule Statutory Provisions

Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, either directly or indirectly, from the federal safety net provided by federal insurance on customer deposits or access to the Federal Reserve's discount window. Specifically, section 619 amends section 13 of the Bank Holding Company Act (BHC Act) to prohibit banking entities from engaging in proprietary trading activities and to limit the ability of banking entities to invest in, or have certain relationships with, hedge funds and private equity funds.

The challenge to regulators in implementing the Volcker Rule is to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets. In general terms, proprietary trading occurs when an entity places its own capital at risk to engage in the short-term buying and selling of securities primarily to profit from short-term price movements, or enters into derivative products for similar purposes.

While section 619 broadly prohibits proprietary trading, it provides several "permitted activities" that allow banking entities to continue to provide important financial intermediation services and to ensure robust and liquid capital markets. Most notably, section 619 allows banking entities to take principal risk, to the extent necessary to engage in bona fide market making and underwriting activities, risk-mitigating hedging, and trading activities on behalf of customers. Other permitted activities include trading in certain domestic government obligations; investments in small business investment companies and those that promote the public welfare; trading for the general account of insurance companies; organizing and offering a covered fund (including limited investments in such funds); foreign markets trading by non-U.S. banking entities; and foreign covered fund activities by non-U.S. banking entities.

To prevent banking organizations from engaging in otherwise prohibited proprietary trading through one or more of the permissible activity exemptions described above, section 619 provides at least three prudential safeguards. First, section 619 requires the federal banking agencies, the SEC, and the CFTC to issue regulations that may include restrictions or limitations on the permitted activities if appropriate. Second, section 619 states that no transaction, class of transactions, or activity may be a permitted activity if it would: involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. Third, section 619 contains anti-evasion provisions that, in part, require the Agencies to include internal controls and recordkeeping requirements as

part of their implementing regulations. In addition, the appropriate federal agency has the authority to order a banking entity to terminate any activity or dispose of any investment, after due notice and opportunity for hearing, if the agency has reasonable cause to believe that a banking entity has engaged in an activity or made an investment in a manner that functions as an evasion of the general prohibitions under section 619.

FSOC Study

Section 619 required the Financial Stability Oversight Council (FSOC) to study and make recommendations for implementation of the Volcker Rule within six months after the effective date of the Dodd-Frank Act. Staff from the FSOC member agencies, including FDIC staff, actively participated in the development of the study.

Prior to developing the study, the FSOC solicited public comment and recommendations on implementation through the issuance on October 6, 2010, in the *Federal Register*, of a notice and request for information (RFI).[1] In response to the RFI, the FSOC received more than 8,000 comments. Of the comments received, approximately 6,550 were substantially identical and supported robust implementation of the Volcker Rule. The remaining 1,450 comments were unique and provided the individual perspectives of banking organizations, trade associations, members of Congress and the general public. In addition, as part of the study, staff from the FSOC member agencies met with representatives from a variety of organizations with a broad spectrum of perspectives on the implementation of the Volcker Rule.

[1] 75 FR 61758 (October 6, 2010).

On January 18, 2011, the FSOC published its Volcker Rule study.[2] The FSOC study recommended that the Agencies' rulemaking and implementation efforts should be guided by five fundamental principles:

1. The regulations should prohibit improper proprietary trading activity using whatever combination of tools and methods are necessary to monitor and enforce compliance with the Volcker Rule.
2. The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate proprietary trading as new products and business practices emerge.
3. The regulations and supervision should be applied consistently across similar banking entities (e.g., large banks, hedge fund advisers, investment banks) and their affiliates. The regulations and supervision should endeavor to provide banking entities with clarity about criteria for designating a trading activity as impermissible proprietary trading.
4. The regulations and supervision should facilitate predictable evaluations of outcomes so Agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity.
5. The regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary, e.g., cash and derivatives markets.[3]

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[2] Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," January 18, 2011, available at: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%2018%2011rg.pdf.

The FSOC study further recommended that the Agencies adopt a four-part implementation and supervisory framework consisting of (1) a programmatic compliance regime, (2) analysis and reporting of quantitative metrics, (3) supervisory review and oversight, and (4) enforcement procedures for violations.[4] The remainder of the study provided the Agencies with a variety of recommendations and considerations regarding the implementation of each provision contained in section 619 as well as an extensive listing and discussion of various quantitative metrics.

The Rulemaking Process

Consistent with the requirements of section 619 of the Dodd-Frank Act, the FDIC participated in a coordinated interagency rulemaking effort with the FRB, the OCC, the SEC, and the CFTC. This mandated rulemaking effort was coordinated by staff from the Department of the Treasury, representing the Chairperson of the FSOC.

As part of this rulemaking effort, agency staffs carefully considered the recommendations of the FSOC study and separately reviewed and analyzed the public comments received on the study. In addition, agency staffs met with a variety of banking organizations and other interested parties to listen to their views regarding the FSOC study, including concerns and recommendations related to the study's proposed implementation framework and quantitative metrics.

In formulating the proposed rule, the Agencies have tried to carry out the statutory mandate to prevent banking entities from engaging in prohibited proprietary trading and

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[3] Id *at* 4.
[4] Id. *at* 5.

the statutory restrictions on the extent to which a banking entity may sponsor or invest in hedge funds or private equity funds. The Agencies have tried to implement the statutory restrictions in a way that ensures that permitted activities, such as providing essential client-oriented financial services and capital markets intermediation, continue in a manner consistent with statutory intent. However, given the complexities and challenges surrounding proprietary trading and hedge fund and private equity fund activities, the Agencies have requested comment on the potential economic impacts that may arise from the proposed rule and its implementation.

As mentioned earlier, on November 7, 2011, the FDIC, together with the FRB, the OCC, and the SEC, published a notice of proposed rulemaking (NPR) to implement the provisions of section 619 with a public comment period ending on January 13, 2012.[5] On January 3, 2012, the Agencies extended the comment period on the NPR until February 13, 2012.[6] Further, on January 11, 2012, the CFTC approved its notice of proposed rulemaking to implement the Volcker Rule, with a substantially identical proposed rule text as the interagency NPR.

In accordance with the statute, the provisions of the Volcker Rule will become effective on July 21, 2012. The statute provides a two-year period for a covered entity to bring its activities and investments into compliance.

Overview of the Proposed Rule

The NPR's proposed rule contains three main elements related to (1) proprietary trading restrictions, (2) covered funds and activities related to hedge funds or private

[5] 76 FR 68846 (November 7, 2011).
[6] 77 FR 23 (January 3, 2012).

equity funds, and (3) compliance and data reporting. Below is a brief description of each element.

Proprietary Trading Restrictions

The proposed rule describes the scope of the prohibition on proprietary trading and defines a number of terms related to proprietary trading, subject to certain exemptions. In general, a banking entity is prohibited from engaging in proprietary trading unless an activity is specifically permitted under the exemptions.

The proposed rule defines a number of key terms, including "proprietary trading" and "trading account" that define activities and financial products subject to the prohibition on proprietary trading. Proprietary trading is defined as engaging as principal for the trading account of a banking entity in any transaction to purchase or sell certain types of financial positions. The term "trading account" then delineates which positions will be considered to have been taken principally for the purpose of short-term resale or benefiting from actual or expected short-term price movements, which ultimately defines the scope of accounts subject to the prohibition on proprietary trading.

As mentioned earlier, the statute includes certain exemptions. For example, the proposed rule articulates a number of requirements that must be met in order for a banking entity to rely on the underwriting and market making-related exemptions. These requirements are designed to ensure that the activities, revenues and other characteristics of the banking entity's trading activities are consistent with underwriting and market making-related activities and not prohibited proprietary trading.

Other key statutory exemptions that are defined in the proposed rule include: (1) risk-mitigating hedging, (2) trading in certain government obligations, (3) trading on

behalf of customers, (4) trading by a regulated insurance company, and (5) trading by certain foreign banking entities outside the United States.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports to the relevant Agency regarding a variety of quantitative measurements related to their covered trading activities and maintain records documenting their preparation and content of these reports. These proposed reporting and recordkeeping requirements vary depending on the scope and size of covered trading activities. For instance, a banking entity must comply with the requirements of Appendix A of the proposed rule only if it has, together with its affiliates and subsidiaries, trading assets and liabilities greater than $1 billion. If its trading assets and liabilities are less than $5 billion, it would only be required to report for trading units that are engaged in market making-related activities. A banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities of $5 billion or more would be required to calculate a more complex series of quantitative measures and would be required to report them for all trading units with activities covered under the proposed rule. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The quantitative measurements required are designed to reflect characteristics of trading activities that appear to be particularly useful in differentiating permitted market-making-related activities from prohibited proprietary trading and in identifying whether trading activities result in a material exposure to high-risk assets and high-risk trading strategies. In addition, the proposed rule contains commentary to help banking entities

identify permitted market making activities and distinguish such activities from prohibited proprietary trading.

Finally, the proposed rule also prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Covered Fund Activities and Investments

Another element of the proposed rule is the statutory prohibition on acquiring and retaining an ownership interest in, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. In general, the proposed rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including "covered fund" and "ownership interest."

The proposed rule also includes several statutory exemptions. Some notable exemptions include:

- *Organizing and offering a covered fund.* This exemption is intended to allow a banking entity to continue to engage in certain traditional asset management and advisory businesses.
- *Investments in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a de minimis investment in the covered fund in compliance with applicable requirements.* Limitations, however,

are imposed regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments.

- *Certain risk-mitigating hedging investments.* These are allowed if the investments represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in the covered fund arising out of that transaction.
- *Investments in certain non-U.S. funds.* This activity is allowed if it occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) or 4(c)(13) of the BHC Act.
- *Any covered fund activity or investment that the Agencies determine promotes and protects the safety and soundness of banking entities and the financial stability of the United States.* The Agencies have proposed to permit three activities at this time under this authority: (i) acquiring and retaining an ownership interest in, or acting as sponsor to, certain bank owned life insurance separate accounts, (ii) investments in and sponsoring of certain asset-backed securitizations, and (iii) investments in and sponsoring of certain entities that rely on the exclusion from the definition of investment company in section 3(c)(1) and/or 3(c)(7) of the Investment Company Act of 1940 that are common corporate organizational vehicles.

Compliance Program Requirements

While most proprietary trading has been conducted by the largest bank holding companies, the FDIC and the other agencies have carefully considered and taken into account the potential impact of the proposed rule on small banking entities and banking

entities that engage in little or no covered trading activities or covered fund activities and investments. Accordingly, the Agencies have proposed to limit the application of certain requirements, such as reporting and recordkeeping requirements and compliance program requirements, for those banking entities that engage in less than $1 billion of covered trading activities or covered fund activities and investments. Further, the Agencies have also requested comment on a number of questions related to the impact associated with particular aspects of the proposal, as well as on any significant alternatives that would minimize the impact of the proposal on smaller banking entities.

For a banking entity with significant covered trading activities or covered fund activities and investments, the compliance program must meet a number of minimum standards that are specified in the proposed rule. The application of detailed minimum standards for these types of banking entities is intended to reflect the heightened compliance risks of large covered trading activities and covered fund activities and investments and to provide clear, specific guidance to such banking entities regarding the compliance measures that would be required for purposes of the proposed rule. These types of banking entities must, at a minimum, establish, maintain, and enforce an effective compliance program, consisting of written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping, that:

- Is designed to clearly document, describe, and monitor the covered trading and covered fund activities or investments and the risks of the covered banking entity related to such activities or investments, identify potential areas of

noncompliance, and prevent activities or investments prohibited by section 13 of the BHC Act as amended by the Volcker Rule;

- Specifically addresses the varying nature of activities or investments conducted by different units of the covered banking entity's organization;
- Subjects the effectiveness of the compliance program to independent review and testing;
- Makes senior management and intermediate managers accountable for the effective implementation of the compliance program, and ensures that the board of directors and CEO review the effectiveness of the program; and
- Facilitates supervision and examination of the covered banking entity's covered trading and covered fund activities or investments by the Agencies.

However, for banking entities with less than $1 billion in covered trading activities or covered fund activities and investments, these minimum standards are not applicable, although the Agencies expect that such entities will consider these minimum standards as guidance in designing an appropriate compliance program.

Regulatory Impact

Overall, the Agencies seek to develop a proposed rule that would impose the lowest cost, while achieving the statutory requirements of section 619. For example, when developing the proposed provision that the sale of securities outside of a banking entity's trading book would be presumed a proprietary trade if the sale occurred within 60 days of the purchase of the security, the Agencies carefully considered instances where

banking entities frequently and legitimately dispose of securities within that timeframe. As a result, the Agencies excluded bona fide liquidity management activities, securities borrowing and lending activities, and repurchase agreements from this "rebuttable presumption" requirement. By doing so, the Agencies greatly reduced the burden associated with the basic definition of "proprietary trading." However, the Agencies did not ignore the potential that prohibited proprietary trading could occur in these activities. Rather, the Agencies chose to impose conditions for purposes of the definition of key terms, such as liquidity management, and to ensure that the banking entities' compliance framework monitored for prohibited proprietary trading. Therefore, banking organizations would not be required to explain on a transaction-by-transaction basis why buying and selling securities to manage their liquidity to meet their near-term funding needs is not prohibited proprietary trading.

In addition, the Agencies have recognized that there are economic impacts that may arise from the proposed rule and its implementation. Therefore, we have requested public comment on several questions on this issue. Some examples of the types of economic impact questions that the Agencies have requested comment on relate to: the services or products that banks offer to clients, customers, or counterparties; operational costs or benefits; benefits and costs associated with the underwriting exemption; material conflicts of interest; costs associated with compliance; and recordkeeping requirements.

The Agencies have also requested comments on whether the proposed rule represents a balanced and effective approach to implementing the Volcker Rule or whether alternative approaches exist that would provide greater benefits or involve fewer costs. Moreover, the Agencies have encouraged commenters to provide quantitative

information with respect to the proposed rule's compliance costs and benefits and effect on competition, and any other economic impact.

In terms of the proposed rule's impact on banking entities, compliance costs are likely to be higher for those banking entities that are significantly engaged in covered trading activities or investments. But as mentioned earlier, the proposed rule takes into consideration the size, scope, and complexity of a banking entity's covered activities and investments in developing the compliance program requirements. Accordingly, entities with less than $1 billion in covered trading activities or covered fund activities and investments would be subjected to greatly reduced compliance requirements.

In accordance with the Paperwork Reduction Act, the Agencies have made initial estimates of the paperwork burden of the proposed rule on entities affected by the rule. In developing the final rule, the Agencies will take into account all comments received on the paperwork burden estimates. Once the final rule is ready for publication, the FRB will submit to the Office of Management and Budget information on the burden for all of the Agencies' supervised institutions, including the FDIC.

The Agencies have also taken an initial look at the potential economic impact on small banking entities as required under the Regulatory Flexibility Act and concluded that the proposed rule will not result in a significant economic impact on small banks. The Agencies based this conclusion on two primary factors: (1) while the proposed rule, per statutory requirements, covers all banking entities, significant reporting and recordkeeping requirements apply only to banking entities with trading assets and liabilities and aggregate covered fund investments greater than $1 billion, respectively; and (2) the compliance program requirements under the proposed rule are established in a

manner that mainly impact entities engaged in covered trading or fund activities – activities that are not typical of small banks. Nevertheless, the Agencies have encouraged public comments on this issue and have asked commenters to include empirical data to illustrate and support the potential impact on small banks.

The FDIC is subject to the Small Business Regulatory Enforcement Fairness Act of 1996, which, among other things, requires agencies to submit to Congress for review rules which have been determined to be "major" under the Act. A rule is considered to be "major" if it results in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment, or innovation. The FDIC will complete this analysis in the final rulemaking in part based on the responses to the questions raised in the NPR.

Conclusion

The proposed rule is intended to carry out the statutory requirements to prohibit proprietary trading and establish prudent limitations on interest in, and relationships with, hedge funds and private equity funds consistent with section 619 of the Dodd-Frank Act. The proposed rule is intended to allow banking entities to continue to engage in permitted activities, including bona fide market making and underwriting activities, risk-mitigating hedging, trading activities on behalf of customers, and investments in covered funds consistent with the statutory mandates. As such, the intended goal of the proposed rule is to allow banking organizations to continue to provide important financial intermediation services and to facilitate robust and liquid capital markets.

Further, the FDIC and its fellow Agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation and therefore, we have specifically requested public comment and information on this issue. The Agencies will analyze the potential impact of the rule based on the comments received through the Notice of Proposed Rulemaking, and work to minimize the burden on the industry and the public while meeting the statutory requirements set by Congress. This approach is consistent with our longstanding policy of ensuring that our regulations will meet the requirements and objectives of the statute while minimizing the costs to the industry and the public.

We look forward to comments on the NPR and will carefully consider them in finalizing the rule.

Testimony submitted to the House Financial Services Committee, Joint Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit Subcommittee Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation," January 18, 2012.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. General Points

1) Sound principles lie behind the "Volcker Rule" (Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; P.L. 111-203).[2] Very large banks in the United States are perceived as "too big to fail", because their failure would likely cause massive damage to the rest of the financial system. As a result, the downside risks created by these institutions are borne, in part, by the government and the Federal Reserve – as a way to protect the rest of the economy.
2) In effect, these banks benefit from unfair, nontransparent and dangerous government subsidies that encourage reckless gambling. When things go well, the benefits of these arrangements are garnered by the executives who run these firms (and perhaps shareholders). When things go badly, the downside costs are pushed in various ways onto the taxpayers and all citizens.
3) These costs are huge. For example, the increase in federal government debt (held by the private sector) as a direct result of the financial crisis is estimated by the Congressional Budget Office as likely to end up over 40 percent of GDP.[3] In addition, the financial crisis destroyed more than 8 million jobs and seriously disrupted the lives of ordinary Americans in many other ways.
4) Megabanks with a great deal of debt and little equity (i.e., dangerously low capital levels) are prone to major collapses.[4] These structures create a nontransparent contingent liability for the

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[1] This testimony draws on joint work with James Kwak, particularly *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* and *White House Burning: The Founding Fathers, Our National Debt, and Why It Matters To You* (forthcoming April 2012), and Peter Boone, including *Europe on the Brink*. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy. For additional affiliations and disclosures, please see this page: http://BaselineScenario.com/about/.

[2] See http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf and the proposed Rule at http://fdic.gov/news/board/2011Octno6.pdf.

[3] To measure just the fiscal impact of the finance-induced recession, compare changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years, debt would rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.

[4] There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially increasing the

federal budget in the United States. They also damage the nonfinancial business sector both directly – e.g., when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.

5) The funding advantage of megabanks relative to other financial institutions creates an incentive to become even larger and even more global – thus making them even harder to control and more dangerous in an economic downturn (as seen now in Europe's euro area).
6) One major mechanism through which banks gamble is through various forms of "proprietary trading," although this risk-taking is not always accurately described as such when banks report on their activities.
7) The legislative intent of the Volcker Rule is to clamp down on these activities, forcing the largest banks to become safer.
8) Not surprisingly, there is a great deal of pushback from these banks, arguing that the Volcker Rule will create costs for the broader economy. These concerns are exaggerated and the evidence in support of the banks' main propositions is tenuous at best. Such defenses of existing banking practices also neglect the costs imposed on the broader economy due to the financial crisis – and hence the benefits we can gain from limiting the ability of executives at big banks to destroy their companies and thus damage the economy.

B. Specific Concerns Expressed By Banks

First, bankers express concern that the Volcker Rule would discriminate against "safe" foreign sovereign debt. But if a bank is holding sovereign debt as a classic long-term banking investment, then this is in the "banking book" and hence not prohibited under the Rule. Similarly, if a bank is underwriting or market-making for sovereign debt, then this is also a permitted activity. The only restriction in question is whether a US banking entity can purely "prop trade" sovereign debt, i.e., buying and selling (or engaging in derivative transactions) for the purpose of short-term capital gain.

Proprietary trading in foreign sovereign debt is inherently risky. This is exactly the kind of gambling that led to the recent demise of MF Global. Just because someone claims that the debt of a foreign government is "safe" does not mean that is true. In fact, financial history is full of examples in which investment bankers (including those based in the U.S.) miscalculate or make exaggerated claims regarding sovereign risks. This point is only reaffirmed by recent experience in Western Europe, for example for Greece and Italy.

U.S. government debt is treated differently under the Rule – and this is appropriate. Trading in U.S. government securities was principally included as a permitted activity because treasuries are the major instrument used by banks as collateral for a range of transactions and for asset-liability management. No further statutory extension or definition of permitted activity for Treasuries is needed – and the same holds for municipal debt. Underwriting and market-making are already permitted, and classic "banking book" holdings are also permitted for U.S. government debt.

Second, there is concern that the Volcker Rule would hurt liquidity and capital markets. In this regard, some attention is being paid to a report by Oliver Wyman, "The Volcker Rule:

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required equity funding for large banks (i.e., their capital) would not be costly from a social point of view (e.g., see the work of Anat Admati of Stanford University and her colleagues).

Implications for the US corporate bond market," commissioned by the Securities Industry and Financial Markets Association (SIFMA).[5]

The current chair of SIFMA is Jerry del Missier, a top executive at Barclays Capital,.[6] The board also includes executives from Morgan Stanley, Societe General, UBS, BNP Paribas, HSBC, Deutsche Bank, Goldman Sachs, Citigroup, RBS, JP Morgan Chase, Credit Suisse, RBC, and Merrill Lynch. All of these companies would be affected by the Volcker Rule (according to the Oliver Wyman report, p. 11).

The Volcker Rule is designed to remove subsidies from large banks that also operate proprietary trading at any significant scale. We should expect executives from these firms to oppose removal of these subsidies. To the extent that such subsidies may be expected to benefit shareholders, it can be argued that these executives also have a fiduciary responsibility to do all they to ensure the subsidies continue (i.e., that the effectiveness of the Volcker Rule be undermined).

SIFMA's statement of its mission is clear: "On behalf of our members, SIFMA is engaged in conversations throughout the country and across international borders with legislators, regulators, media and industry participants."[7] There is nothing in their public materials to suggest the research they sponsor is designed to uncover true social costs and benefits; rather their goal is to advance the interests of their members – this is a lobby group. SIFMA claims to represent the entire securities industry but more than 1/3 of its board is drawn from very large banks that would find their implicit subsidies cut and constrained by an effective Volcker Rule. Given this context, it is not clear why the Olivier Wyman study would be regarded as anything other than a form of special interest lobbying.

There is also a serious methodological issue. The Oliver Wyman study draws heavily on a paper by Jens Dick-Nelson, Peter Feldhutter, and David Lando, which looks at the liquidity premia for corporate debt.[8] The Olivier Wyman study claims that the Volcker Rule will make corporate bonds less liquid and therefore increase interest rates on such securities, but their approach assumes the answer – which is not generally an appealing way to conduct research.

Specifically, the Oliver Wyman study assumes that every dollar disallowed in pure proprietary trading by banks will necessarily disappear. But if money can still be made (without subsidies), the same trading should continue in another form. For example, the bank could spin off the trading activity and associated capital at a fair market price. Alternatively, the trader – with

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[5] http://www.sifma.org/issues/item.aspx?id=8589936887. The report is available on the SIFMA webpage that contains its comment letters to regulators. On p. 36 of the report, the disclaimer begins, "This report sets forth the information required by the terms of Oliver Wyman's engagement by SIFMA and is prepared in the form expressly required thereby." The precise terms of this engagement are not stated in the document.

[6] http://www.sifma.org/about/board-and-officers/

[7] http://www.sifma.org/about/join-sifma/

[8] http://www.feldhutter.com/BondLiqFinalPaper.pdf. This paper shows, "Illiquidity premia in US corporate bonds were large during the subprime crisis. Bonds become less liquid when financial distress hits a lead underwriter" (http://www.feldhutter.com/).

valuable skills and experience – will raise outside capital and continue doing an equivalent version of his or her job.

If there is money to be made absent "too big to fail" subsidies, then an efficient capital market would suggest that the traders and the associated capital will remain engaged in some form. Now, however, these traders will bear more of their own downside risks. If it turns out that the previous form or extent of trading only existed because of the implicit government subsidies, then we should not mourn its end.

The Oliver Wyman study further assumes that the impact of the Volcker Rule will be similar to the financial crisis, and then seeks to measure that. This is ironic, given that the financial crisis severely disrupted liquidity and credit availability more generally – in fact this is the point of the Dick-Nelson, Feldhutter, and Lando paper.

The Volcker Rule may actually support more liquid markets by ensuring that the banks focus on providing liquidity as market-makers – rather than draining liquidity from the market in the course of "trading to beat" institutional buyers like pension funds, university endowments, and mutual funds.

More generally, Thomas Philippon finds limited or no social benefits from increased trading activities per se.[9] And the biggest disaster for the corporate bond market in recent years was a direct result of excessive risk-taking by big financial players.

C. The Proposed Rule

On the positive side, the proposed Volcker Rule would collect data, enabling regulators to know more about what firms are doing. It sensibly restricts proprietary trading – including by prohibiting traders from being compensated for making proprietary-type bets. There are also restrictions on investments in private funds of various kinds.

However, there is also definite room for Improvement. There are currently insufficiently clear lines on what is permitted; this makes it hard for regulators to enforce and for industry to comply. Much clearer presumptions could be provided – much as the industry does today on some trading desks.

More broadly, under the proposed Rule, firms would be allowed to set their own rules and compliance policies. This is a recipe for inconsistency between firms and loose regulation. If the banks are allowed to create large enough loopholes, the Rule will not be effective and big banks will again be able to use proprietary trading to gamble excessively – with their losses ultimately being borne by the American taxpayer.

[9] Thomas Philippon, "Has the U.S. Finance Industry Become Less Efficient?" http://pages.stern.nyu.edu/~tphilipp/papers/FinEff.pdf

Testimony of

Alexander Marx

Head of Global Bond Trading

Fidelity Investments

Before the
Financial Services Subcommittee on Financial Institutions and Consumer Credit
and the
Financial Services Subcommittee on
Capital Markets and Government Sponsored Enterprises

January 18, 2012

Chairmen Capito and Garrett, Ranking Members Maloney and Waters, and Members of the Subcommittees, thank you for the opportunity to testify today on the proposed restrictions on banking entities engaging in proprietary trading and from having certain relationships with hedge funds and private equity funds, more commonly known as the "Volcker Rule." My name is Alex Marx and I am the Head of Global Bond Trading for Fidelity Investments. In this role, I am responsible for the bond trading that supports the broad array of investment products for which Fidelity serves as investment adviser, including the Fidelity mutual funds.

Founded in 1946, Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.4 trillion, including managed assets of more than $1.5 trillion, as of December 31, 2011. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

Fidelity Investments is a market leader in asset management, offering over 400 mutual funds across a wide range of disciplines, including equity, investment grade bond, high income bond, asset allocation, and money market funds. In addition, Fidelity Investments offers comprehensive investment management solutions for institutional investors, such as defined benefit and defined contribution plans, insurance accounts, endowments and foundations. Fidelity is also a leading provider of asset allocation solutions for retail and institutional clients.

The assets that Fidelity manages across this comprehensive product offering belong not to Fidelity, but to the funds and the millions of shareholders and customers who have entrusted their savings with us. Fidelity's asset management offerings pool the investments of many individuals. Fidelity, in turn, then interacts and negotiates with Wall Street banks on behalf of these investors through our management of the funds. In carrying out these responsibilities, Fidelity has a fiduciary duty to serve in the best interest of the shareholders of the funds it manages.

These shareholders seek the benefits that come from investing in a diversified pool of securities under the direction of an experienced staff of investment professionals. This staff includes seasoned portfolio managers working closely with Fidelity's dedicated team of research staff to analyze and evaluate possible investments and with Fidelity's trading team, located around the globe, that executes their investment decisions. These trading operations span the full range of investment disciplines that Fidelity offers, including equity, bond and money market trading desks.

The Volcker Rule does not apply to Fidelity directly; however, implementation of the rule, in the form proposed by the agencies in October, may have a significant indirect

impact on our ability to manage our shareholders' funds and execute trades on their behalf. As Fidelity considers the impact of the proposed rule, we are mindful of the following concepts:

- Funds, including those managed by Fidelity, collectively represent a significant portion of the investments made by the American public. These funds rely on the liquidity provided by banks and their affiliates as market makers.
- Restrictions on the ability of banks and bank affiliates to provide crucial market making services to investors and to provide underwriting services to issuers of corporate and municipal securities should not jeopardize traditional sources of capital for issuers, investments for issuers, or liquidity for the market generally. Market illiquidity will result in price uncertainty, volatility, higher transaction costs and a reduced ability to access capital.
- The ultimate macro-economic effects of undue restrictions on banks and their affiliates would be to constrict significantly the ability to raise capital, to weaken U.S. job growth, to prevent U.S. financial institutions from competing with their foreign counterparts, and to erode the value of investment and retirement portfolios of American households.

The members of Fidelity's trading team, when executing the trades for the funds Fidelity manages, interact on a daily basis with banks and bank affiliates to whom the restrictions in the Volcker Rule will apply. Currently, these bank entities buy equity and fixed income securities from, and sell them to, our funds in their role as dealers. The

bank entities form a significant portion of the dealer community and are essential to the efficient operation of the securities markets.

Dealers Perform an Essential Function in the Capital Markets

Dealers play an integral role in the markets. For example, in the primary market for fixed income funds, which is an over-the-counter market, dealers purchase bonds and money market instruments from corporate and municipal issuers and, in turn, sell these securities to investors, such as Fidelity's funds. In these transactions, dealers serve as underwriters to the issuers and then to the trading counterparties to our funds. In doing so, dealers help establish the initial price for the securities and oversee the distribution of the securities to investors. In the secondary market, dealers perform an equally critical role by purchasing securities from investors who desire to sell them, and then selling those securities to other interested buyers.

This intermediary function of connecting buyers and sellers of securities is an important component of the efficient operation of the capital markets. Fidelity's funds rely on the fact that a dealer will be able, at any particular time, to provide an ample source of liquidity for the funds when they would like to purchase particular securities. Similarly, a dealer can purchase securities from Fidelity's funds upon request because the dealer can hold the securities in its inventory until it finds a purchaser for those securities.

In this manner, the process by which a fund buys or sells securities does not require the fund to find another investor in the market who is a perfect match for that particular trade. Rather, a dealer's ability to hold inventory on its books allows it to be a direct counterparty to the funds, thereby facilitating the funds' day-to-day trading needs. In this capacity, the dealer is not trading solely on behalf of a third-party client in its

transactions with the funds (a process known as trading on an "agency" basis), but instead on a principal basis. This type of principal trading differs from speculative proprietary trading. In customer-facing principal trading, the dealer is making a market in securities, which allows customers, such as the Fidelity mutual funds, to transact efficiently. There is risk and reward involved in this trading for the dealer – as the price of the security may decline or increase in the time between the purchase from one customer and the sale to another. This type of trading also requires the dealers to commit a certain amount of capital to make securities trades.

If the ability of banks to engage in principal-based trading were hampered, there would be a significant risk that the difference between the price that a buyer is willing to pay for a security, compared with the price for which a seller is willing to sell it (known as a "bid-ask spread"), would increase dramatically. A wide bid-ask spread is a sign of market inefficiency: in the primary market, issuers would have to pay higher rates to raise capital, while in the secondary market, investors would need to pay a market premium in order to purchase desired securities and absorb a market discount in order to sell securities. In addition, this lack of predictable and fluid market dynamics creates an environment that is ripe for significant market volatility. Wider bid-ask spreads, a reduction in market liquidity and an increase in market volatility could severely damage the funds' ability to trade in the markets on behalf of their investors.

The Volcker Proposal Has Unintended Consequences and Would Harm the Economy

The Volcker Rule provisions in the Dodd-Frank Act generally prohibit banks and their affiliates from engaging in proprietary trading, but also expressly permit banks and

their affiliates to engage in activities that are critical to the functioning of the U.S. financial markets, including market making and underwriting activities. These activities are part of the customer-facing principal trading on which our funds rely. By creating these categories of permissible activities, Congress recognized the critical role that banks and their affiliates play in providing such services to U.S. businesses and to individual investors, many of whom utilize mutual funds and other investment vehicles as their primary means of investing.

The Volcker Rule regulations, in the form proposed by the agencies in October (the "Volcker Proposal"), acknowledges the permissible activities set forth in the Dodd-Frank Act by including exemptions for each of these activities, including market making, underwriting, and hedging. Fidelity is concerned, however, that these exemptions are too narrowly crafted, include too many conditions to be workable in practice and rest on the presumption that critical market practices that occur today should be prohibited unless the onerous criteria are met. We believe these factors would combine to have a chilling effect on capital formation and market liquidity and, in turn, will negatively impact individuals seeking to invest their savings (including the shareholders of the funds we manage) and businesses accessing the capital markets to help grow their operations.

A. The Volcker Proposal Would Reduce Market Liquidity

Banks and their affiliates provide critical liquidity to financial markets. Liquidity is a measure of how easily an asset can be bought or sold with minimal impact to its value. If a market is highly liquid, investors have the ability to buy or sell assets quickly and easily at prices that appropriately reflect their true value, as the assets are regularly traded and there are sufficient numbers of willing buyers and sellers. A closely related

concept is the "depth" of a market. If a market is deep, investors can trade large volumes without substantially affecting the price of an asset.

We believe that the Volcker Proposal presents risks to market liquidity. The proposal would restrict the ability of banks and their affiliates to hold an adequate inventory of securities. Under the current regulatory landscape, banks and their affiliates are able to make available for sale to investors securities with a wide array of characteristics (such as varying maturities, issuer profiles, and levels of creditworthiness) that allow investors to manage their portfolios efficiently. In order to comply with the Volcker Proposal in its current form, a bank would be more likely, at any point in time, to have less inventory on its books that includes the particular securities that investors desire. This is because the exemptions to the prohibition on proprietary trading (chiefly the exemption for market making-related activities, underwriting and hedging) are drafted narrowly and are likely to cause untenable hurdles that banks are unlikely to overcome.

There are at least three potential negative outcomes arising from this reduced liquidity:

- Business growth and activity will be hampered as the result of companies and municipalities having less efficient access to capital, with resulting deleterious effects on employment and the economy.
- Security transactions will be more challenging to carry out and there will be negative effects on the investment performance of the funds that individual investors, pension plans, and other institutional investors hold.

- A less predictable flow of purchases and sales of securities, caused by the foregoing factors, will result in price uncertainty and higher volatility, which would ultimately damage issuers and investors alike.

1. The Market Making Exemption is Too Narrow and the Uncertainty around Its Application Would Negatively Impact Shareholders

Under the Volcker Proposal, banks and their affiliates generally would have to satisfy seven criteria in order to rely on the market making exemption. However, because certain markets, such as certain asset classes within the fixed income market, are complex and less liquid than others, the strict requirements may have the unintended consequence of further limiting liquidity in the markets. For example, the typical role of market maker banks in over-the-counter markets, including fixed income markets, is to bridge the gap between buyers and sellers and to provide the liquidity necessary for these markets to function. This results in the ability for mutual funds to be more fully invested in the capital markets. However, based on the criteria for the market making exemption under the Volcker Proposal, this activity would not qualify as market making.

Significant uncertainty about the application of the market making provisions in the Volcker Proposal would be detrimental to the financial markets and would negatively impact fund shareholders. Uncertainty about the ability of a bank to transact would increase the risk of purchasing securities and would be reflected in higher funding costs. Importantly, because of the nature of the risks presented and the lack of liquidity, there would be no net benefit to investors.

2. *Fidelity Has Similar Concerns with the Underwriting Exemption*

The Volcker Proposal permits a bank to purchase or sell securities in connection with the bank's underwriting activities if the activities satisfy certain criteria. The transaction must be effected solely in connection with a distribution of securities for which the bank is acting as an underwriter and the bank's underwriting activities with respect to the security must be designed not to exceed the reasonably expected near-term demands of clients. This ignores the basic risk-taking function of underwriting. The primary reason for an issuer to engage an underwriter is to transfer the risk of selling the securities from the issuer to a single dealer (or small group of dealers). To perform this function, dealers at times need to commit their own capital to purchasing the securities from the issuer. If the dealer is successful in marketing the securities to clients, then the dealer will not have any securities left in inventory. If the dealer is not successful, then the firm will have securities left on its books until they are able to sell all of them to customers.

In its current form, the conditions that the regulators have proposed in connection with underwriting would make it untenable for banks and their affiliates to purchase securities for their own account should investor demand fall short of expectations. Because banks likely would be unwilling to assume this risk, higher rates would be required to lure investors, causing the cost to businesses of raising capital to increase. Thus, the Volcker Proposal has the potential to rearrange current market practice in underwriting to the detriment of both issuers and underwriters. This likely would result in a more concentrated supply of securities, thereby decreasing the opportunity for diversification in the portfolios of shareholders' funds.

B. Both the Equity and Fixed Income Markets Would Be Affected by the Volcker Proposal

While much of the focus surrounding the proposed regulations is on fixed income markets, it is important to note that the Volcker Proposal is also a significant issue for investors in equity markets. Block trading is an important investment strategy used by mutual funds and other investment funds, in both equity and fixed income markets. Block trades refer to transactions in which a significant amount of shares of stock or bonds are traded with a bank at one time. Large block trades can be structured in several ways, but generally speaking, sellers require banks acting as dealers to guarantee a minimum price or volume for the block trade. As a result, block trading relies heavily on banks acting as market makers undertaking principal risk.

Contrary to some misperceptions, equity trading is not conducted exclusively on an agency basis. A significant portion of equity trading is often done on a principal basis. While retail investors often trade under an agency-based "last sale" model (in which transaction prices would represent the scrolling tickers common on financial news televisions networks), larger investors, such as mutual funds, trade in myriad ways with market making activities, such as block trades, conducted by banks in efforts to reduce transaction execution costs, mitigate shareholder risk, and, ultimately improve shareholder returns.

Fidelity achieves these goals for its funds by trading with market makers that use generally available hedges to bridge the gap in terms of price and/or time where different types of investors are willing to assume the risks. Banks also conduct program risk trading, which enables fund advisers to swiftly and efficiently trade multiple securities in a single transaction and manage significant flows into and out of funds in a cost-effective

manner. Fidelity believes that the Volcker Proposal must take a broad enough view of what constitutes a "trading unit," which is also commonly referred to as an "aggregation unit," to permit banks to adequately aggregate their positions for purposes of hedging their trades with institutional clients and to avoid a reduction in market liquidity. It is crucial for fund advisers to have access to banks' traditional equity securities market making activities, including their ability to enter into block trades and to hedge without undue restriction, so that shareholders will not be faced with unnecessarily increased costs and risks. It is not likely, however, that such activities would qualify for an exemption under the Volcker Proposal in its current form.

C. The Volcker Proposal's Impact on Key Financial Products Would be Harmful to Fund Shareholders

In addition to the overarching impact on the financial markets, we are concerned that the Volcker Proposal will have harmful effects, without the corresponding benefits, on certain instruments that are critical to the U.S. economy and financial markets, and as a result will be disadvantageous to investors in our funds.

The Volcker Rule provisions in the Dodd-Frank Act (Section 619) contemplate that the agencies will exclude certain types of securities from the general prohibition on proprietary trading by banking entities, including securities issued by the federal government, states and political subdivisions of states. We believe that the drafters of the Dodd-Frank Act correctly recognized that government securities should be beyond the scope of the proprietary trading prohibition for a variety of reasons.

As currently drafted, however, the Volcker Proposal does not include securities issued by state agencies or instrumentalities within its exemption for municipal securities.

The result is that, with respect to a significant number of the securities offered by issuers in the municipal market, the exemption from the proprietary trading prohibition would not apply. We believe that the distinction between securities issued by states and their political subdivisions, on the one hand, and securities issued by state agencies or other instrumentalities, on the other hand, is without basis and would lead to a bifurcated municipal securities market in which the ability of tax-exempt organizations to raise capital would be unreasonably hampered. It would also be likely to have a negative effect on the liquidity of the municipal securities market as a whole. Accordingly, we believe that the agencies should revise the definition of "municipal securities" in the Volcker Proposal to cross-reference that term as it is already defined in Section 3(a)(29) of the Securities Exchange Act of 1934. The definition of the term in that section properly includes state agencies and instrumentalities, as well as states and their political subdivisions. This revision to the Volcker Proposal would be within the spirit of Section 619 of the Dodd-Frank Act and would prevent unreasonable impairment of the municipal securities market.

Section 619 of the Dodd-Frank Act also states that a banking entity, in addition to being subject to the general prohibition on proprietary trading, cannot own or sponsor a hedge fund or private equity fund. The agencies have significantly expanded upon this basic prohibition by utilizing the term "covered fund" in the Volcker Proposal, which they have defined to include not only hedge funds and private equity funds as contemplated by the Dodd-Frank Act, but also other structures that are not considered investment companies under the Investment Company Act of 1940. The result is that the proposed regulation casts a very broad net, capturing certain other widely accepted

financing structures that rely on these exemptions. There are few similarities between the hedge funds and private equity funds that were the target of the Dodd-Frank Act and these other types of structures. Accordingly, we do not agree with the Volcker Proposal's treatment of these entities in the same manner.

Two examples of structures that would likely fall under the "covered fund" prohibition, by default, are asset-backed commercial paper programs and tender option bond programs. These types of structures provide a critical source of financing for corporations and municipalities by providing short-term and long-term financing needs. Additionally, these programs enable investors, such as Fidelity's funds, to access an important supply of securities. We believe the problem presented by the current version of the Volcker Proposal can be solved by appropriately tailoring the definition of a "covered fund" and coupling it with stringent anti-avoidance rules. This would satisfy the statutory intent of Section 619 of the Dodd-Frank Act regarding hedge funds and private equity funds, while allowing other types of financing structures to continue to be available in the market.

D. The Proposed Volcker Rule Would Have a Negative Effect on the U.S. Economy and U.S. Competitiveness

An economy is considered healthy when it has high employment levels, stable prices and sustained growth. Capital markets directly impact each of these objectives by providing the means for the development of and investment in businesses. Any changes in the availability and cost of funds in capital markets affect the overall economy. Excessive constraints upon market making, underwriting and hedging activities will cause an increase in the cost of funding in affected markets. When businesses face higher

funding costs, they typically respond by constricting their plans for growth, which also has a direct effect on their role as employers.

Banks and their affiliates provide a number of unique services that are vital to economic development and that historically have kept capital costs low for borrowers. Foremost, banks serve as intermediaries to match investors who have capital with borrowers who seek it. Borrowers use such capital to grow and expand their businesses, in turn creating jobs that create critical stimulation for the U.S. economy.

Given the role that banks and their affiliates play in the financial markets, it is important to consider the negative impact that the Volcker Proposal could have on the banks' ability to compete in the global market to provide financial services. Because other countries have not proposed equivalent limitations on market making, underwriting, and hedging activities, we foresee certain potential negative outcomes that would be caused by the Volcker Proposal. U.S. banks will become less competitive than their foreign counterparts as they contribute less liquidity in the global marketplace and are forced to devote significant resources in their efforts to comply with the Volcker Proposal. Alternatively, foreign banks with U.S. operations may be forced to relocate their operations overseas to avoid the overly burdensome restrictions under the rule. This would deprive U.S. issuers of the underwriting services of such foreign banks and would deprive U.S. investors of a critical source of market making. In each case the potential impact on the U.S. economy as a whole could be significant.

Conclusion

Fidelity is concerned about the impact that the Volcker Proposal, if adopted in its current form, would have on market making, risk management, underwriting and other

crucial activities carried out by banks and their affiliates that serve as dealers. We believe that, unless properly tailored, the proposal will impede the U.S. economic recovery. Strong capital markets are critical to restoring a robust economy. If the Volcker Proposal is implemented in an unduly restrictive manner, the result would be to adversely impact the ability of markets to function efficiently, thereby hindering investors' efforts to preserve and increase their assets.

These consequences are avoidable. Congress specifically exempted market making-related, underwriting, and risk-mitigating hedging activities from the Volcker Rule. While we recognize the difficulties faced by the regulators in ensuring these exemptions do not undermine the general prohibition on proprietary trading, we believe the Volcker Rule need not be implemented in a way that impedes these crucial activities.

We plan to submit comments to the agencies on the Volcker Proposal and we look forward to working with Congress and the regulators to ensure that any final rulemaking is appropriately tailored and will not create negative unintended consequences for investors, capital formation, and economic growth.

* * *

We appreciate the Subcommittees' focus on the issues presented by the Volcker Proposal and for the opportunity to testify today.

sifma
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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

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.

Testimony on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

by Mary L. Schapiro, Chairman
U.S. Securities and Exchange Commission

Before the Capital Markets and Government Sponsored Enterprises Subcommittee and Financial Institution and Consumer Credit Subcommittee of the U.S. House of Representatives Committee on Financial Services

Wednesday, January 18, 2012

Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees:

Thank you for the opportunity to testify regarding the Commission's joint proposal with the Federal banking agencies to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), commonly referred to as the "Volcker Rule."[1]

The proposal reflects a collective and extensive effort by the four agencies involved — the Board of Governors of the Federal Reserve System ("Board of Governors"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Securities and Exchange Commission ("the Commission" or "SEC") — to design a rule, as mandated by the Dodd-Frank Act, to implement the required prohibitions and restrictions in a way that is consistent with the language and purpose of the statute. To create this proposal, staffs from each of the agencies, along with staff from the Commodity Futures Trading Commission ("CFTC"), engaged in weekly meetings under the leadership of the

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.

Department of the Treasury to discuss issues and share ideas related to effective implementation of the statute.

Section 619 of the Dodd-Frank Act applies to any "banking entity," defined as any insured depository institution, any company that controls an insured depository institution, any company treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliates or subsidiaries of any of the foregoing entities. The Commission has rulewriting authority for banking entities for which the Commission is the primary financial regulatory agency, principally SEC-registered broker-dealers, investment advisers, and security-based swap dealers — collectively defined as "covered banking entities" in the proposed rule.

The statute generally defines the term "proprietary trading" to mean engaging in the purchase or sale of certain financial instruments as principal for the trading account of a banking entity. The trading account concept is a key element of the statutory framework because any position that is not in the banking entity's trading account is outside the scope of the prohibition on proprietary trading. The statute's definition of "trading account" includes any account used by a banking entity to acquire or take a position in certain financial instruments "for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)." The proposal establishes three tests for determining whether a position held by a covered banking entity is in the entity's "trading account," including an independent test for registered dealers and security-based swap dealers. Because a registered dealer generally holds positions for sale to customers upon request or to support the firm's trading activities (for

example, by hedging its dealing positions), the proposal considers all positions held in connection with a registered dealer's dealing activities to involve the requisite short-term intent and to be captured within the statutory definition of "trading account." Specifically, any position in a security or derivative held by a covered banking entity that is a registered dealer or security-based swap dealer in connection with the activities that require that entity to register would be within the entity's trading account and subject to the prohibition on proprietary trading.

Although the proposed rule broadly captures all securities dealer and security-based swap dealer accounts, consistent with the statute the proposal recognizes the need for these entities to be able to provide essential financial services necessary to provide liquidity to our markets, continued capital raising activities for issuers, and intermediation services to customers. As a result, though the proposal generally prohibits proprietary trading, it allows market making, underwriting, and risk-mitigating hedging, among other permitted activities. In drafting proposed rules, the Commission and its staff focused in particular on these three activities for several reasons. First, the statute specifically identifies underwriting, market making-related activity, and risk-mitigating hedging as "permitted activities." Second, these exemptions involve activities that generally are engaged in by SEC-registered dealers. Third, these activities are integral to the effective operations of the securities markets.

In particular, underwriting activity is important to facilitate capital formation and to promote economic growth. The proposal, like the statute, continues to permit legitimate underwriting and certain trading activities that serve an important role in effective underwriting.

Much like underwriting, the proposal recognizes the important benefits provided by market making activity, including customer intermediation and market liquidity, and would permit market making activities in different markets and asset classes. Permitting legitimate market making in its different forms should facilitate market liquidity and efficiency by allowing covered banking entities to continue to provide customer intermediation and liquidity services in both liquid and illiquid instruments. As acknowledged in the proposal, effective market making also involves hedging of market making positions and some anticipatory market making-related trading activity.

The proposal recognizes that an overly broad interpretation of underwriting, market making, or risk-mitigating hedging could result in these exemptions potentially being used for evasive purposes. Each of the requirements set forth in the proposed exemptions are intended to reflect these considerations and strike an appropriate balance between preserving important market functions and preventing proprietary trading unrelated to such functions. The agencies requested comment on the proposed implementation of the exemptions for market making-related activity, underwriting activity, and hedging. For example, we sought comment on the proposed exemptions' potential impact on the market — including, for example, liquidity, price efficiency, and competition — and whether there are more cost-effective alternatives to implementation that would also be consistent with the purpose and language of the Volcker Rule.

The availability of these exemptions also is limited by the statutory backstop provisions, as implemented in the proposal. Specifically, consistent with the statute, an exemption is not available if the transaction or activity involves a material conflict of interest, high-risk assets or

trading strategies, or a threat to a covered banking entity's safety and soundness or to U.S. financial stability. Further, the compliance program requirement contained in the proposal provides that a covered banking entity must establish, maintain, and enforce a program reasonably designed to monitor its permitted activities — including underwriting, market making, and hedging — and to ensure compliance with the specific requirements of the statute and the proposal. We recognize that there are both benefits and costs associated with the compliance program requirement. Although outlined more fully in the proposal, benefits include promoting a covered banking entity's review and assessment of its compliance with the statute and rule, as well as facilitating agency examination and supervision. Costs identified in the proposal include those associated with hiring and training personnel and creating and maintaining appropriate policies and procedures, internal controls, and records. The agencies sought commenters' input on the costs and benefits of the proposed compliance program, particularly seeking quantitative data, where possible. At this time, it appears that covered banking entities are in the best position to provide estimated dollar costs for implementation and ongoing maintenance of the proposed compliance program. Specifically, covered banking entities are familiar with the structure and costs of their current compliance framework pursuant to existing regulatory requirements, which can serve as a baseline for estimating the potential dollar costs associated with the proposed requirements.

As an additional means to monitor market making activities and prevent evasion of the prohibition on proprietary trading, the proposal sets forth specific quantitative measurements that certain covered banking entities would be required to calculate, report, and record for their trading units engaged in market making activities. The proposed quantitative measurements are

designed to identify trading activities that warrant further review or examination by the covered banking entity or the Commission to determine compliance with the proposal. As recognized in the proposal, potential benefits related to this requirement include enhanced ability to distinguish permitted market making-related activity from prohibited proprietary trading and identifying trading activity that warrants further analysis or review for compliance. The proposal also identifies certain costs that may arise from this proposed requirement, such as systems, personnel, and recordkeeping costs. Similar to the compliance program requirement, covered banking entities may be in the best position to provide estimates of the dollar costs of this proposed requirement, as they are familiar with the scope of quantitative measurements that are currently utilized by their firm for risk management and other purposes. Overall, I believe that this aspect of the proposal will be informed greatly by public comment regarding the strengths, weaknesses, costs and benefits of each quantitative measurement.

The joint proposal also implements the statute's prohibitions and restrictions on investments in, and relationships with, hedge funds and private equity funds. These provisions are designed to prevent a banking entity from engaging in proprietary trading indirectly through an investment in a hedge fund or a private equity fund or investing in such funds in a manner that may subject bank capital to risk of loss. The proposed rule implements these provisions by adhering closely to the statutory text, while also providing clarifying terms and definitions. As is the case of the proprietary trading restriction, the SEC's proposed rule applies to banking entities for which the SEC is the primary financial regulatory agency.

The statute specifies that a banking entity may not invest in or sponsor a hedge fund or private equity fund, which is defined in the proposed rule as a "covered fund." The proposed rule's definition of covered fund also includes commodity pools and foreign funds, investment funds which trade in a manner similar to typical hedge funds but may be structured differently. The proposed rule, however, recognizes that banks may use investment vehicles to hold assets related to the business of banking. Thus, although these types of investment funds may satisfy the statutory definition, they do not raise the types of concerns that the statute was intended to address. As a result, the proposal would exclude from the statutory prohibition certain investments in, or sponsorship of, bank-owned life insurance separate accounts and common corporate vehicles that hold assets in connection with liquidity management or related to collateral obligations of borrowers. As noted in the preamble, the Commission recognizes that it is important to define "covered fund" in a manner that would implement the purposes of the statute, and therefore the proposal seeks extensive comment on the proposed approach as well as alternative approaches. We expect that commenter input will help inform our understanding of the potential scope and impact of the proposed definition.

By largely mirroring the statutory language, the proposal also implements the statutory exemptions that would enable a banking entity to invest in a hedge fund or private equity fund under specified conditions. These exemptions recognize that these banking entities, often investment advisers, provide important customer-oriented advisory activities, and that, provided certain safeguards are implemented, investments in hedge funds and private equity funds may continue. Thus, for example, a banking entity may own up to 3 percent of a hedge fund that the entity advises and offers to its clients, provided that the entity does not subject bank capital to

loss by bailing out that fund. Banking entities may also invest in a hedge fund if the investment is made in connection with effecting a customer transaction, because in these instances, the amount of bank capital subject to loss is mitigated. We recognize a banking entity may incur costs to avail itself of one or more of the proposed exemptions, in particular, costs associated with implementing internal controls reasonably designed to ensure compliance with the elements of an exemption. The proposal seeks commenter views on the scope and effectiveness of each proposed exemption, including each specified exemption element and whether alternative, more cost-effective approaches exist.

These banking entities also would be required to implement a compliance program to ensure that investments in, and relationships with, covered funds comply with the proposed rule. Similar to the proprietary trading provisions, any permitted activity would nonetheless be prohibited if it involved a material conflict of interest, resulted in a material exposure to high-risk assets or high-risk trading strategies, or posed a threat to safety and soundness of the banking entity or the financial stability of the United States.

As in the case of designing a program to ensure compliance with the proprietary trading restrictions, the extent and scope of a banking entity's compliance program in connection with covered fund restrictions would depend on the extent of its activities. A banking entity that does not engage in prohibited covered fund activities would only need to implement a compliance program reasonably designed to ensure it does not engage in these activities, whereas others may incur higher costs if they have more extensive and complex relationships and investments with

covered funds. Because of the diversity of covered fund activities, we have sought commenter input on these potential impacts.

The conceptual approach to the Commission's proposed rule regarding a banking entity's covered fund investments is to require a registered investment adviser to comply with the provisions on covered fund activities contained in rules issued by the Federal banking agency that regulates the bank with which the adviser is affiliated. As a consequence, registered investment advisers would look to the appropriate Federal banking agency's rules and related interpretations to comply with the statute's provisions on covered fund activities. This proposed approach ensures that activities conducted by registered investment advisers can be evaluated by their potential impact on the capital levels of the affiliated bank. Moreover, this approach will facilitate compliance by banks and their affiliated registered investment advisers with the requirements of Section 619 of the Dodd-Frank Act and the rules adopted under it.

The proposal includes a joint request for comment on the potential impacts of the proposed implementation of the statute, including, among others, the potential compliance costs, competitive effects, and impacts on market liquidity and efficiency. For example, the proposal recognizes that implementation of the statutory exemption for proprietary trading solely outside of the United States may result in certain competitive advantages for foreign-controlled banking entities over U.S.-controlled banking entities. In addition, the proposal seeks commenters' views on the costs and benefits of all aspects of the proposal, as well as comment on whether alternative approaches to implementing the Volcker Rule would provide greater benefits or involve fewer costs. Further, we encourage commenters to provide quantitative data, to the

extent possible, in support of comments regarding the potential economic impact of the proposal. We would also very much welcome receiving studies, in particular those that provide quantitative data and empirical analysis with clearly stated assumptions.

The SEC also proposed certain of the rule's requirements — reporting, recordkeeping, and compliance program requirements — under both the Bank Holding Company Act and the Securities Exchange Act of 1934. The proposal includes a separate SEC-prepared discussion of efficiency, competition, and capital formation addressing those specific requirements.

Moreover, the agencies conducted an initial analysis in the joint proposal pursuant to the Regulatory Flexibility Act, which requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. In analyzing this requirement, we determined that the proposal would not appear to have a significant economic impact on small entities. We encourage public comment on the potential impact on small entities, however, including the nature of the impact and empirical data in support of such comments.

We look forward to robust public comment on all aspects of the joint Volcker proposal. To facilitate comments on the complex issues and questions raised, the Commission and the Federal banking agencies recently extended the comment period for the joint proposal to February 13, 2012. This extended comment period will provide commenters additional time to review, assess, and provide comments on the proposal, and also will help us coordinate our rulemaking with the CFTC's recent proposal to implement Section 619 of the Dodd-Frank Act.

Thank you again for the opportunity to speak about the joint Volcker Rule proposal. I would also like to express my thanks to my colleagues at the Board of Governors, the FDIC, the OCC, the Department of the Treasury, and the CFTC for their efforts related to this proposal. We are committed to continuing to work with them to further refine the rule prior to adoption. I am happy to answer any questions.

Testimony of

Mark Standish

On Behalf Of The

Institute of International Bankers

Before the

U.S. House of Representatives

Subcommittee on Financial Institutions and Consumer Credit

Subcommittee on Capital Markets and Government Sponsored Enterprises

Committee on Financial Services

"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

January 18, 2012

Chairman Capito, Chairman Garrett, Ranking Member Maloney, Ranking Member Waters, and members of the subcommittees: good morning. My name is Mark Standish. I serve as President and Co-CEO of RBC Capital Markets. I also am a member of the Group Executive, the executive management body responsible for the global operations of Royal Bank of Canada ("RBC"). As Co-CEO of RBC Capital Markets, I share responsibility for the management of the global Corporate and Investment Banking operations of RBC, with specific emphasis on capital markets activities, including financing and balance sheet management. I joined RBC in 1995,

preceded by years of business leadership at other financial institutions. In all, I have nearly 35 years of experience working in the capital markets.

Today, I am pleased to be here to testify on behalf of the Institute of International Bankers ("IIB") regarding the implementation of Section 619 of the Dodd-Frank Act (the "Volcker Rule"). The regulations proposed by the Federal banking agencies, the Securities and Exchange Commission and, just last week, by the Commodity Futures Trading Commission ("the Agencies") to implement the Volcker Rule have raised significant concerns for the IIB's members, which are comprised of internationally-headquartered financial institutions from over 35 countries around the world doing business in the United States. The IIB's members consist principally of foreign banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States. In the aggregate, our members' U.S. operations have approximately $5 trillion in assets and provide 25% of all commercial and industrial bank loans made in this country and contribute to the depth and liquidity of U.S. financial markets. Our members also contribute more than $50 billion each year to the economies of major cities across the country in the form of employee compensation, tax payments to local, state and federal authorities, as well as other operating and capital expenditures.

Let me establish at the outset: the IIB supports the goals of financial reform – namely, increased transparency; stronger capital and liquidity standards; and reduced risk to financial stability and to the taxpayer. It is also important to make clear that, as with U.S. domestic banks, the U.S. risk-taking operations of international banks are subject to the statutory limitations set forth in the Volcker Rule. While IIB member firms generally share many of the concerns expressed by others regarding the Volcker Rule's impact on their operations, in my

testimony today I will focus on the significant cross-border and extraterritorial effects of the proposed regulations on the head offices and other non-U.S. operations of our member firms.

We have three major concerns:

- First, the proposed limitations on proprietary trading and fund activities conducted "solely outside of the United States" will have severe extraterritorial consequences that were not intended by Congress and are not justified by the policy behind the Volcker Rule;
- Second, the proposed regulations should provide an exemption for trading in foreign government securities comparable to the exemption for U.S. government securities to avoid unintended adverse effects on foreign government bond markets; and,
- Third, the imposition of the proposed complex compliance regime and reporting requirements on the non-U.S. operations of international banks will cause unprecedented extraterritorial interference with those operations and conflict with the regulatory regimes of their home countries.

While the IIB acknowledges the hard work of the Agencies and the challenges faced in developing the proposed rule, we strongly disagree with a number of key aspects of the proposal where we think the Agencies' interpretation is inconsistent with:

- the plain language of the statute;
- Congressional intent;
- the policy objectives of the Volcker Rule; and,
- longstanding U.S. policies limiting the extraterritorial scope of U.S. laws.

In our view, the current proposal to implement the Volcker Rule will not advance our shared goals. It may, instead, work to undermine them and ultimately adversely affect U.S. capital markets and economic growth.

Conduct Permitted "Solely Outside of the United States"

Congress amended earlier drafts of the Volcker Rule to make clear that proprietary trading and investment in, and sponsorship of, private equity and hedge funds conducted "solely outside of the United States" by international banks should not be subject to the Volcker Rule's prohibitions. Congress recognized the need to limit the extraterritorial reach of the Volcker Rule and to provide appropriate deference to the laws of other countries. As explained by one of the principal co-sponsors of the Volcker Rule, these exclusions are intended to "recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States, to engage in activities permitted under relevant foreign law."[1]

Congress plainly indicated that the exclusions for "proprietary trading" and the "sponsorship of" or "investment in" hedge and private equity funds "solely outside the United States" is based on where the risk, as principal, is both taken and resides, regardless of whether there may be some type of incidental relationship to the United States. This aligns exactly with the policy objectives of the Volcker Rule, which are to limit risks to U.S. financial stability and protect the American taxpayer.

Unfortunately, where Congress specifically took steps to limit the extraterritorial application of the Volcker Rule, the proposed regulations significantly expand its extraterritorial reach in a manner that not only constitutes an unwarranted interference in the non-U.S. activities of international banks conducted in accordance with home country laws and regulations, but also exacerbates the adverse impact of the Volcker Rule on U.S. markets and the U.S. economy.

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[1] 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (colloquy between Sen. Merkley and Sen. Levin).

In the case of proprietary trading activities, the proposal would prohibit an international bank from conducting a broad range of trading activity outside the United States if there is present any one of a number of possible connections with the United States. For example, the proposal would prohibit an international bank's trading desk in London, Toronto, Tokyo or anywhere else outside the United States from buying or selling for the account of the bank any security traded on a U.S. exchange or trading platform. In addition, trading by the head office or a non-U.S. affiliate of an international bank for its own account would be prohibited if its counterparty is a "resident of the United States", which term includes, for example, not only U.S. institutional investors, corporations, banks and their non-U.S. branches, but also, in certain circumstances, their non-U.S. affiliates. The proposal would also prohibit the international bank's trading desk outside the United States from executing an order for the account of the bank as principal through its U.S. broker-dealer affiliate as agent. None of these connections to the United States bear any relationship to where the risk of such trading activity is taken and resides.

By restricting the ability of international banking entities operating outside the U.S. to engage in proprietary trading, as may be permitted by their home country regulators, the proposed rule could impede the ability of those institutions to manage and mitigate risk. And while the rule purportedly would allow for "liquidity management", that particular exemption is too narrowly drawn to encompass activities necessary for meaningful asset/liability management.

For example, just three weeks ago, OSFI – the Canadian bank regulator – wrote to its U.S. counterparts to say that the Volcker Rule proposal's restriction on principal transactions with U.S. firms could interfere with Canadian financial institutions' ability to conduct transactions through U.S.-owned infrastructure firms (such as DTC), which, in turn, "could inadvertently hinder the ability of foreign financial institutions to efficiently manage their risks,

thereby potentially undermining the financial condition of those entities and the systemic stability of foreign financial systems." We strongly agree.

Subjecting trading activities outside the United States to such intrusive U.S. regulation also would have a significant adverse impact on U.S. capital markets, on U.S. businesses seeking capital, and ultimately on U.S. job growth. The prohibition on trading with U.S. firms will provide incentives for capital markets activity to migrate from the U.S. to jurisdictions that have determined not to impose Volcker-like trading restrictions and compliance burdens. Trading volumes – and the jobs of those involved in generating those volumes – could migrate from the U.S. to these foreign platforms. The migration of capital to outside the U.S. could raise borrowing costs for, and reduce the availability of capital to, U.S. businesses and individuals. Similarly, in the case of fund activities permissible "solely outside of the U.S." the proposed rule creates unjustified and adverse extraterritorial consequences. For instance, the Volcker Rule explicitly prohibits marketing investments in foreign funds to residents of the United States. However, the Agencies have taken this statutory prohibition further and proposed to prohibit U.S. personnel from marketing interests in a non-U.S. fund to a non-U.S. investor. This would have a direct impact on U.S. jobs: for example, Houston-based personnel working for an international bank would be precluded from marketing a bank-sponsored non-U.S. oil and gas private equity fund to investors in South America or Europe.

Moreover, the proposed rule extends the Volcker Rule's extraterritorial reach even further, by:

- not permitting international banks to invest from outside the United States in third-party funds, unless they could gain the assurance of fund managers that no U.S. residents had been or would be solicited or accepted by the funds – assurances that no fund manager likely would be able to provide; and,

- not permitting international banks to sponsor or sell non-U.S. funds to non-U.S. investors if, among other things, they could not ensure that non-U.S. investors would not, at some point in the future, sell their non-U.S. fund interests to U.S. residents — again, no fund manager likely would be able to provide any such assurance.

As a result, the proposal would impose severe restrictions on international banks' ability to sponsor and sell non-U.S. fund interests to non-U.S. persons and to invest in third party non-U.S. funds.

The proposal would also subject to the Volcker Rule many foreign investment companies that are publicly offered outside the U.S. pursuant to their home country regulations. In many countries, the principal sponsors of such funds are the home country's largest banks, which in most cases will be subject to the Volcker Rule by virtue of their U.S. operations. Under the proposal, such foreign investment companies, including Canadian mutual funds, would be prohibited from making even limited offers of these funds in the U.S. For example, a firm such as RBC would be precluded from selling interests in such funds to its own Canadian clients who travel to the U.S. on business or pleasure. Congress properly determined that U.S. mutual funds should not be subject to the Volcker Rule. The Agencies should be similarly guided and not limit the ability of Canadian and other financial firms, consistent with prevailing securities laws, to offer publicly traded foreign investment companies in the U.S.

Finally, and contrary to the view taken by the Agencies in the proposal, the Volcker Rule should not be applied extraterritorially to prohibit international banks from engaging in otherwise legally permissible lending to, and similar transactions with, any of their non-U.S. funds. Interpreting the Volcker Rule in this manner as proposed by the Agencies is contrary to both

Congressional intent and longstanding U.S. policy limiting the extraterritorial application of U.S. banking law.

In sum, the restrictions proposed by the Agencies go well beyond the requirements of the statute by impairing an international bank's ability to conduct legitimate and legally permissible funds business outside of the U.S. Equally important, these fund restrictions represent an extraordinary and unprecedented extraterritorial expansion of U.S. banking regulation into the core prudential regulation of the non-U.S. activities of international banks by their home country regulators.

Congress in enacting the Volcker Rule focused on the location where the principal risk is taken and resides (i.e., if the risk sits outside of the U.S., it is not subject to the Volcker Rule), thereby appropriately limiting the extraterritorial effects of the Volcker Rule in a manner that is consistent with longstanding principles of international comity. Those principles require U.S. and foreign authorities alike to provide appropriate deference to the laws of other countries and to limit the extraterritorial application of host country laws. Finally, focusing on the location where the principal risk is taken and resides is consistent with the policy objectives of the Volcker Rule, which are to ensure the financial stability of the U.S. and protect the American taxpayer.

The Agencies' justify their overly-restrictive interpretation of what constitutes activities conducted solely outside of the U.S. on ensuring "competitive parity" between U.S. financial institutions and internationally-headquartered firms. "Competitive parity" does not justify, we would submit, expanding the extraterritorial scope of the rule to interfere with international banks' non-U.S. activities and impose, as we discuss below, compliance and reporting burdens

on home offices. Considering their potential adverse impact on U.S. capital markets and U.S. job growth, these "competitive parity" restrictions will likely have the opposite effect and could provide precedent for foreign jurisdictions to respond similarly.

Imposing additional restrictions not called for by the statute not only undermines the intent of the provisions, but ignores the broader competitive landscape. It is important to remember that international banks not operating within the U.S. are not subject to the Volcker Rule. By further restricting activities that are otherwise permitted under the Volcker Rule the Agencies' proposal could very well lead internationally-headquartered firms to reassess their continued presence in the U.S., as well as their participation and interactions with U.S. firms and markets. Collectively, the overall impact of the Volcker Rule may lead internationally-headquartered firms to shift their trading activities to other financial centers outside of the U.S., creating a significantly adverse impact on U.S. markets.

Trading in Foreign Government and Development Bank Securities

Congress excluded from the Volcker Rule's prohibitions the purchase and sale of U.S. government, agency and municipal securities ("U.S. government securities"). This exclusion is grounded in the recognition that enabling all banks, wherever headquartered, to freely trade as principal in U.S. government securities contributes to the safety and soundness of the bank, the liquidity of these markets, and the financial stability of the U.S., including by lowering the borrowing costs of the government. Unfortunately, no exception was provided for the government securities of other countries.

Without such an exception, international banks may be forced to eliminate trading in foreign government securities with U.S. counterparties or, alternatively, build an extensive

compliance program to prove to the Agencies that their foreign government securities trading activities conform to the requirements of one of the activities permitted under the Volcker Rule, e.g., market making activities. Collectively, the ban on proprietary trading in foreign government securities and the complex and burdensome requirements associated with complying with the Volcker Rule's other trading exemptions could have a significant adverse impact on liquidity in, and pricing of, foreign government securities. This is especially troubling given that U.S. banks play a major role, even serving as primary dealers, in several key non-U.S. government securities markets around the world.

The Agencies have inquired whether they should exercise their authority under the Volcker Rule to create a regulatory exception for trading, as principal, in securities issued by other countries or by international and multilateral development banks. The IIB strongly favors such an exception and looks forward to working with the Agencies in developing appropriate criteria for its application. As OFSI has noted in its recent letter to the Agencies, many international banks "actively rely on government securities of their home jurisdictions to efficiently manage their liquidity and fund requirements at a global enterprise-wide level …". The Japanese Financial Services Agency and the Bank of Japan have jointly expressed similar concerns to the Agencies. Failure to create a regulatory exception for trading, as principal, in foreign government securities could undermine the liquidity of government debt markets outside of the U.S.

At a minimum, the requirements of the Volcker Rule should be conformed to U.S. trade agreement and treaty obligations so that, for example, debt obligations backed by Canada and its political subdivisions would be given equal treatment as required by the North American Free

Trade Agreement. To prohibit RBC and other similarly situated Canadian firms from selling, as principal, Canadian bonds to institutional U.S. clients would, we submit, violate that Agreement.

Compliance and Reporting Requirements

The proposed rule would impose complex and detailed compliance requirements on banks with substantial trading and/or fund operations. In addition, it would impose extensive quantitative reporting requirements for banks that engage in permissible forms of trading as principal – including market-making, risk-mitigating hedging, and underwriting. With respect to international firms, the proposed rule doesn't make clear whether these reporting requirements will apply to trading and fund activities both inside and outside the U.S., only within the U.S., or some combination thereof.

Further complicating this issue for international banks is that banks with consolidated trading assets and liabilities of over $1 billion or 10% of their total assets have to meet enhanced compliance and reporting standards. The proposed rule does not indicate how these thresholds would apply to international banks. Not only would there be very significant costs to implement these enhanced standards, imposing these detailed requirements on their internal operations and management of international banks outside of the United States would represent an unprecedented expansion of U.S. regulatory supervisory powers into their home country operations. This approach provides no benefit to the safety, soundness or stability of the U.S. financial system that could justify the costs related to the efforts of international banks to comply with, and the Agencies to enforce, these requirements.

Finally, the proposed rule would appear to require banks to establish and implement compliance programs as of the July 21, 2012, effective date. Given the number of outstanding

questions with respect to the scope of the exemptions and the compliance and reporting requirements for international banks, and the likelihood that the final rule will not be adopted significantly in advance of the effective date, international banks doing business in the U.S. may be placed in the utterly untenable position of deciding whether to exit the U.S. banking market, possibly violate the Volcker Rule or build a compliance system based on an overly complex and restrictive proposed compliance regime that is yet, at this time, ill-defined with respect to its application to international banks. It is critical that banks be given sufficient time to adjust to the requirements of the final rule. At a minimum, the Agencies' should make full use of the conformance period provided by the statute to give banks the time needed to come into compliance and avoid market disruptions.

Conclusion

Again, let me again thank the two chairman and ranking members, as well as the other members of the Subcommittees, for the privilege of testifying this morning. We hope that we have sufficiently highlighted the extraterritorial concerns associated with the implementation of the Volcker Rule. We believe it is imperative that the Agencies work to address the extraterritorial concerns associated with the implementation of the Volcker Rule and avoid many of the unintended consequences we have highlighted here in our testimony.

Failure to re-think the proposal could have far-reaching impact on U.S. and foreign markets. The vast prohibitions, narrow exceptions, and extensive compliance burdens of the Volcker Rule proposal will, in our view, limit banks' ability to facilitate lending, to hold inventory at levels sufficient to meet investor demand, and to actively participate in the market to price assets efficiently – thus reducing liquidity across a wide range of asset classes. The ripple

effect of that reduced liquidity could discourage investment, limit credit availability and increase the cost of capital for U.S. companies – stifling economic growth and job creation.

I look forward to your questions.

For release on delivery
9:30 a.m EDT
January 18, 2012

Statement by

Governor Daniel K. Tarullo

before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

and the Subcommittee on Financial Institutions and Consumer Credit

of the Committee on Financial Services

U.S. House of Representatives

January 18, 2012

Chairman Capito, Chairman Garrett, Ranking Member Maloney, Ranking Member Waters, and other members of the subcommittees, thank you for the opportunity to testify on the interagency proposal to implement the requirements of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), commonly known as the Volcker Rule. My remarks today will focus on some of the issues faced in developing the interagency proposal. As I have previously noted in Congressional testimony, the goal of the Federal Reserve with respect to this and all other provisions of the Dodd-Frank Act, is to implement the statute in a manner that is faithful to the language of the statute and that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth.

The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) (collectively, the "agencies") in November sought public comment on a proposal to implement the Volcker Rule. The Commodities Futures Trading Commission (CFTC) recently issued its substantially similar proposal for comment. Because of the importance and complexity of the issues raised by the statutory provisions that make up the Volcker Rule, the agencies initially provided the public a 90-day opportunity to submit comments. We recently extended the comment period for an additional 30 days, until February 13, 2012. The Federal Reserve welcomes comments on Volcker Rule implementation and has had numerous meetings with members of the public on this subject. We continue to post on our website all the comments that we receive and a summary of all the meetings that the Federal Reserve has had with members of the public about the Volcker Rule and all other provisions of the Dodd-Frank Act.

Summary of statute and proposal

The statutory provisions that make up the Volcker Rule generally prohibit banking entities from engaging in two types of activities: 1) proprietary trading and 2) acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (each a covered fund). These statutory provisions apply, in general, to insured depository institutions; companies that control an insured depository institution; and foreign banks with a branch, agency, or subsidiary bank in the United States, as well as to an affiliate of one of these entities.

Under the statute, proprietary trading is defined as taking a position as principal in any security, derivative, option, or contract for sale of a commodity for future delivery for the purpose of selling that position in the near term or otherwise with the intent to resell to profit from short-term price movements. The statute applies only to positions taken by a banking entity as principal for the purpose of making short-term profits; it does not apply to positions taken for long-term or investment purposes. Moreover, the statute contains a number of exemptions, including for underwriting, market making-related activities, and risk-mitigating hedging activities. The implementing rule proposed by the agencies incorporates all of these statutory definitions and exemptions. The statute also authorizes the relevant regulatory agencies to permit additional activities if they would promote and protect safety and soundness of the banking entity and the financial stability of the United States.

The second major prohibition in the statute forbids any banking entity from acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund. Again, the statute contains a number of exceptions, including for organizing and offering a covered

fund, making limited investments in a covered fund, sponsoring and investing in loan securitizations, and risk-mitigating hedging activities. The statutory definition of a fund covered under the Volcker Rule is quite broad. The statute also quite broadly prohibits any banking entity that serves as the investment manager, adviser, or sponsor to a covered fund, or that organizes and offers a covered fund, from engaging in certain transactions with the fund, including lending to, or purchasing assets from, the fund.

The statute also prohibits otherwise permissible trading and investment activities when there is a material conflict of interest with customers, clients, or counterparties, or when the activity results in an exposure to high-risk assets or trading strategies. These are significant provisions and the agencies have specifically solicited comment on disclosure requirements and other approaches to implementing these parts of the statute.

Differentiating proprietary trading from market making

One of the more difficult tasks in implementing the statutory prohibitions is distinguishing between prohibited proprietary trading activities and permissible market-making activities. This distinction is important because of the key role that market makers play in facilitating liquid markets in securities, derivatives, and other assets.

At the ends of the spectrum, the distinction between pure proprietary trading and market making is straightforward. At one end, for instance, trading activities that are organized within a discrete business unit, and that are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation, are not difficult to identify. These "internal hedge fund" operations existed at many bank affiliates for quite some time before the Volcker Rule was

enacted. Firms that either are or were engaged in these non-client-oriented, purely proprietary trading businesses can readily identify and wind down these activities. Indeed, some have already done so for a number of reasons, including anticipatory compliance with the Volcker Rule.

At the other end of the spectrum, a textbook example would be a pure agency-based market maker that acts as an intermediary, instantaneously matching a large pool of buyers and sellers of an underlying asset without ever having to take a position in the asset itself. Profits are earned either solely by charging buyers a higher price than is paid to sellers of the asset, or in some cases by charging a commission. Buyers and sellers willingly pay this "spread" fee or commission because the market maker is able to more quickly and efficiently match buyers with sellers than if they were left to find each other on their own.

I refer to this as a textbook example because instances of such riskless market making in our trading markets are rare. In actual markets, buyers and sellers arrive at different times, in staggered numbers and often have demands for similar but not identical assets. Market makers hold inventory and manage exposures to the assets in which they make markets to ensure that they can continuously serve the needs of their customers.

Accordingly, in the broad middle that exists between these two clear examples, the distinction between prohibited proprietary trading and permissible market making can be difficult to draw, because these activities share several important characteristics. In both activities, the banking entity generally acts as principal in trading the underlying position, holds that position for only a relatively short period of time, and enjoys profits (and suffers losses) from any price variation in the position over the period the position is held. Thus, the purchase

or sale of a specific block of securities is not obviously permissible or forbidden based solely on the features of the transaction itself. The statute instead distinguishes between these activities by looking to the purpose of the trade and the intent of the trader. These subjective characteristics can be difficult to discern in practice, particularly in the context of complex global trading markets in which a firm may engage in thousands or more transactions per day. A similar challenge attaches to efforts to distinguish a hedging trade from a proprietary trade.

Implementation framework

The agencies have proposed a framework for implementation of the Volcker Rule that combines: 1) an explanation of the factors the agencies expect to use to differentiate prohibited activities from permitted activities, 2) a requirement that banking entities with significant trading activities implement a program to monitor their activities to ensure compliance with the statute, and 3) data collection and reporting requirements, to facilitate both compliance monitoring and the development of more specific guidance over time. In addition, the agencies will use their supervisory and examination processes to monitor compliance with the statute.

The third element of the interagency proposal bears some additional comment. In order to help differentiate between permitted market-making activities and prohibited proprietary trading activities, the agencies have proposed to collect data from trading firms on a number of quantitative measurements. These metrics are designed to assist both the agencies and banking entities in identifying the risks and characteristics of prohibited proprietary trading and exempt activities. The proposal makes clear that metrics would be used as a tool, but not as a dispositive factor for defining permissible activities. The agencies instead propose to use metrics to identify activity that merits special scrutiny by banking entities and examiners in their evaluation of the

activities of firms. The proposed rule does not include specific thresholds to trigger further scrutiny for individual metrics, but requests comment on whether thresholds would be useful, and notes that the agencies expect to propose them in the future. The proposal also makes clear that the agencies expect to take a heuristic approach to metrics, revising and refining them over time as greater experience is gained in reviewing, analyzing, and applying these measurements for purposes of identifying prohibited proprietary trading.

Additionally, since some banking entities engage in few or no activities covered by the statute, the proposal also includes a number of elements intended to reduce the burden of the proposed rule on smaller, less-complex banking entities. In particular, the agencies have proposed very limited compliance programs and have reduced or eliminated the data collection requirements for these banking entities.

Potential effects of the proposal

The proprietary trading prohibition in the Volcker Rule statute itself will undoubtedly affect the trading behavior of banking entities. Indeed, that is what Congress intended in enacting these provisions. Congress has itself made the judgment that this prohibition will enhance financial stability and is socially desirable. The task of the agencies is to implement Congressional intentions, as manifest in the statute itself, as efficiently and effectively as possible.

The approach taken in the proposed rulemaking is concededly not a simple one. But, at least to date, it has seemed the most feasible. Two alternative approaches have been suggested, and we considered each prior to issuing the proposed regulation. One considerably simpler approach would be to articulate high-level principles for differentiating prohibited and permitted

activities and then leave it to the firms to self-report violations based on internal models or other devices, presumably with compliance and systems monitoring by regulatory agencies. While having the virtue of simplicity at the outset, this approach would provide little clarity about whether an activity is permitted or prohibited. It seems quite likely that, either formally or informally, the regulatory agencies would regularly be asked to offer guidance or approve specific practices. Otherwise, this approach would essentially rely on self-policing by banking entities.

A second alternative would be to establish definitive bright lines for determining whether an activity is permitted or prohibited. This approach would be very difficult in practice, at least with current information and data, because of the many asset classes, business models, and transaction types covered by the statutory provisions. Hard-and-fast rules would also run the risk of being either too restrictive, and thus inadvertently classifying legitimate, customer-driven market-making or hedging activity as prohibited, or too narrow, and thus failing adequately to capture the full range of activities that are prohibited under the statute.

The more nuanced framework contained in our proposal was designed to realize some of the advantages of both of these approaches while minimizing their potential adverse effects. The Dodd-Frank Act provides a long conformance period for firms that are subject to the Volcker Rule. The agencies have proposed to use that conformance period to study the effects of the statutory prohibitions on the activities of banking entities before the Volcker Rule is fully implemented. To assist in this undertaking, the agencies have proposed to begin collecting and reviewing trading data that should help firms subject to the statutory provisions, as well as the agencies in our efforts, to monitor and understand the contours of the activities that are

prohibited, permitted, and affected by the statutory provisions that make up the Volcker Rule. As I mentioned earlier, we are hopeful that the data collection and reporting required in our proposal will eventually facilitate more specific guidance on market-making, hedging, and other exemptions from the general prohibition. After the Volcker Rule becomes fully effective, we would continue to monitor the effects of the rule and look for opportunities to refine it.

Having said all this, the Federal Reserve is more than open to alternatives that would be superior to the approach proposed. Indeed, the agencies requested comment on alternative approaches in the *Federal Register* notice.

Thank you for your attention. I would be pleased to answer any questions you might have.

Testimony of

Wallace C. Turbeville on Behalf of Americans for Financial Reform

The Committee on Financial Services of the United States House of Representatives

Subcommittee on Capital Markets and Government Sponsored Enterprises

Subcommittee on Financial Institutions and Consumer Credit

Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

January 18, 2012

Chairman Garrett, Chairman Capito, Chairman Renacci, Ranking Member Waters, Ranking Member Maloney and Members of the Subcommittees, good morning and thank you for the opportunity to provide testimony on the centrally important Volcker Rule.

For me, today's hearing evokes memories of a time 33 years ago when, as a young attorney, I was commissioned to write testimony for a partner of Goldman Sachs to be delivered to a committee of Congress on behalf of the Securities Industry Association, one of the predecessors of SIFMA that represented the interests of investment banks. The goal of the testimony was to resist the repeal of Glass-Steagall, and so to protect investment banks from competition fueled by the massive cheap capital of the commercial banks.

After seven years as a lawyer specializing in public and private securities offerings, I was an investment banker at Goldman Sachs for more than a decade and then managed a small advisory firm. I also served as CEO of a firm providing counterparty credit management services in the derivatives markets. For the last two years, I have focused my efforts on financial system reforms, most recently working at a non-profit organization, Better Markets, during the period of proposed rulemaking on derivatives markets, participating in dozens of formal comments and various roundtable discussions. Today, I speak on behalf of Americans for Financial Reform, a coalition of more than 250 organizations who have come together to advocate for reform of the financial sector.

Circumstances are different today, but some fundamental principles remain the same. Trading requires sophisticated IT and quick witted and quantitatively gifted employees. But these can be bought and hired. The engine that generates trading businesses is capital, the cheaper the better in terms of competitive advantages.

Today's hearing focuses on implementation of the Volcker Rule that prohibits institutions that enjoy the benefits of a federal safety net from engaging in the risky businesses of proprietary trading and hedge fund sponsorship and ownership. The notion is that the safety net and sheer size of the consequence of a default practically will compel another taxpayer bailout should this risky behavior lead to failure. The way chosen by Congress to avoid this result is to prohibit institutions that benefit from the safety net from engaging in the behavior. Proprietary trading is not made illegal. Trading demand can and, under the Volcker Rule will be, met by other institutions and market participants, but not the taxpayer-protected banks.

Congress approved section 619 of the Dodd-Frank Act to address massive risks taken by financial institutions subsequently bailed out by taxpayers. These failures led to the recession that festers to this day. Proprietary trading losses precipitated some $17 billion in investment losses around the globe.[1] As Senators Merkley and Levin observed,

> Trading revenues at the largest banks had increased from under fifteen percent of net operating revenues in 2004 to nearly thirty percent at the start of the crisis. However, the same trading exposures left the banks highly vulnerable, and in the fourth quarter of 2007 losses from trading almost entirely offset positive net operating revenues from all other sources combined, with trading losses equaling nearly 250 percent of net operating revenue, devastating the capital bases of many firms.

It is impossible to predict the triggering events for the next financial crisis. As experienced in 2007-08, the series of events will likely be complex. However, the Volcker Rule addresses the consequences of future disruptions. Proprietary trading and relations with hedge finds and private equity funds leaves banks exposed to the modern equivalent of a run on the banks, fueled by difficult-to-value complex positions subject to liquidity demands for margin and fragile financing through repurchase arrangements and securities lending. The concern is no longer depositor demands for their money. But liquidity demands to fund positions are an even greater threat.

Capital Allocation

These covered banks may well reduce their capital bases since it will not be needed to support the risks of proprietary trading of securities and derivatives. After all, the massive growth of their assets and the capital to hold them dates from about 1980 when they started a race to

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1 "The Dodd-Frank Act Restrictions On Proprietary Trading And Conflicts Of Interest: New Tools To Address Evolving Threats," by Senator Jeff Merkley & Senator Carl Levin, available at http://www.harvardjol.com/wp-content/uploads/2011/07/Merkley-Levin_Policy-Essay.pdf

compete with each other in the increasingly de-regulated trading markets.[2] Like gamblers being staked to work the casino, the banks needed capital to get into the game. The safety net was intended to assure intermediation between savings and lending. As capital exploded in size, the too-big-to-fail consequence of the safety net grew to dwarf the original purpose for public involvement.

An overall capital reduction to a level that is both prudent and sized to meet the needs of a narrower business model is a good thing for the public. Every day until the Volcker Rule is implemented, the American people bear the risk associated with de facto guaranteeing these bloated capital bases. (This is compounded to the extent that capital continues to be sourced at imprudently high levels from short-term sources such as repos.) Any investment banker worth his or her salt would tell you that is a real but unrealized cost incurred by the public each day. In the financial crisis of 2008, the financial sector cashed the guarantee check and the public is now suffering the consequences. This will recur unless the guarantee no longer covers proprietary trading.

It is also a good thing because it will eliminate the distortion arising from the inflated amount of low-cost capital used by the banks to trade risk on their proprietary book. Bank capital is cheap because of the too-big–to-fail guarantee. Investors in banks require lower returns. In addition leverage, in all of its complex forms (many of which expose banks to cash liquidity risks), is readily available to the banks. Cheap and plentiful capital induces risk taking by traders who relish the "heads I win, tails you lose" marketplace. The rationalization is so obvious: no one will get hurt, only the government.

Where proprietary trading proves profitable and useful, this business will migrate out of government-guaranteed banks. The capital backing bank proprietary trading will not evaporate, but will be re-allocated to other institutions that will expand to provide the needed trading activity. The capital to support the expanding competitors might appear to be more expensive – but that is good news for the public since it will only appear to be more expensive if no one counts the costs borne by the public in the pre-Volcker Rule, too-big-to-fail model.

Moreover, with true free market capital engaged in proprietary trading, the trading activity will be more disciplined because the actual, legitimate costs of the capital needed to trade will be reflected. Perhaps some transaction types will not be available. But, if that is a function of the unavailability of cheap capital (subsidized by the public) that induces financially unsound trades, it is a good thing.

From the banks' perspective (but not the economy's), the capital will seem to evaporate along with the opportunity to trade risk using it. Perhaps that is why their comments, and more surprisingly the analysis of their experts, are all founded on the irrational assumption that, once

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2 See the discussion of the increasing size of financial institutions in S. Johnson and J. Kwak, "Thirteen Bankers," Pantheon Books, 2010, especially pages 57-87.

bank proprietary trading ceases under the Volcker Rule, others will not expand to meet demand. It is specious to the point of misleading to suggest that the needs for liquidity currently provided by banks will not be filled.

For example, the last-listed assumption in the recently published Oliver Wyman study[3] is "We do not directly analyze a wide range of potential knock-on effects, including… [t]he potential replacement of some proportion of intermediation currently provided by Volcker-affected dealers by dealers not so affected." This is hardly a "knock-on" effect. Rather, "replacement" is central to any study that honestly aims to explore the impact of the Volcker Rule. One imagines that this assumption was included at the end of the "Purpose and Scope of Analysis" chart in hope that it would go unnoticed.[4]

Buy-side Perspective

Many on the buy-side fall into a similar logic trap. Large market participants, such as mutual funds, can direct massive flows of trading activity to banks and commonly take advantage of this market power. For such prized customers, the banks will take on large, block trades on favorable terms, since the banks have the capital base to take on such risk. In effect, the customer is renting the balance sheet of the bank, and the rent reflects both the favored customer position and the low-cost, subsidized capital of the federally guaranteed institution. In the post-Volcker Rule environment a given block trade may have to be transacted in smaller units. This is because the non-bank institution will be more sensitive to risk, and because the capital charge will reflect reality, not public subsidy.

It is not a surprise that certain buy-side customers like the current setup. They are indirectly benefiting from a public subsidy, after all. But the public is no longer satisfied with that trade and the Volcker Rule will reverse it.

Furthermore, Sections 619 and 621 of the Dodd-Frank Act put an end to conflicts of interest between banks and other dealers and their customers. This will be a great benefit to the buy-side.

Indeed, the buy-side has recognized the harm to their bottom line posed by proprietary traders trading against them. In its 2009 report on financial reform, the Council of Institutional Investors ("CII") prominently highlighted the need to address proprietary trading, noting that "Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially

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3 Oliver Wyman, "The Volcker Rule restrictions on proprietary trading – Implications for the US corporate bond market," December 2011, study conducted for SIFMA (the "Oliver Wyman Study").

4 Note that a review of the Oliver Wyman Study raises many questions as to its reliability as a measure of cost, only some of which are discussed herein.

at institutions that operate with explicit or implicit government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans."[5] As one member of the CII Investors' Working Group panel explained it, proprietary trading has significantly harmed the institutional investors:

> Proprietary trading by banks has become by degrees over recent years an egregious conflict of interest with their clients. Most if not all banks that prop trade now gather information from their institutional clients and exploit it. In complete contrast, 30 years ago, Goldman Sachs, for example, would never, ever have traded against its clients. How quaint that scrupulousness now seems. Indeed, from, say, 1935 to 1980, any banker who suggested such behavior would have been fired as both unprincipled and a threat to the partners' money.[6]

Furthermore, the bipartisan Levin-Coburn Report by the Senate Permanent Subcommittee on Investigations offers a detailed description of some of the conflicts of interest that directly cost investors billions of dollars.[7]

Complexity of the Proposed Rules

The Proposed Rules are long and complicated, but the reason is not the desire of regulators to burden the banks with rules. Section 619 of the Dodd-Frank Act surgically excises only those elements of trading that pose the greatest risks, allowing banks to continue activities such as market making, underwriting and restrained participation in hedge funds and private equity funds. The intent was to limit bank activities as little as possible.

However, the banks themselves had allowed the proprietary trading fever to infect the client-oriented businesses that the Volcker Rule seeks to exclude. For instance, desks engaged in client-oriented market making could never hope to generate revenues to match their colleagues on desks explicitly dedicated to prop trading. As a result, market-making desks migrated into prop trading by seeking client business that justified the accumulation of huge positions that they

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5 CII Investors' Working Group, "U.S. Financial Regulatory Reform: The Investor's Perspective," July 2009, page 3, available at http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf)

6 Jeremy Grantham, "Lesson Not Learned: On Redesigning Our Current Financial System," GMO Q. LETTER SPECIAL TOPIC, 2 (Oct. 2009), available at http://www.scribd.com/doc/21682547/Jeremy-Grantham.

7 United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Majority and Minority Staff Report, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," April 2011.

called "inventory" using logic that is best described as Orwellian. There is no better illustration than the recent Oliver Wyman study that describes inventory levels at 4.6 times average daily volume for less liquid products.[8] The conclusion is inescapable: this is not making a market by any conventional meaning of the concept; it is proprietary trading using a more benign name.

As a result, to preserve certain activities that are less risky, client oriented businesses, the regulators were compelled to define and describe them using legitimate, non-Orwellian rules and monitoring regimes.

Moreover, many of the complexities of the Volcker Rule stem from endless entreaties of financial institutions, which met with the regulatory agencies some 350 times. Having prevailed with the insertion of numerous exceptions and permissions, it is ironic that banks now complain about the complexity that is an inescapable consequence.

Liquidity Issues

The forecasting of liquidity post Volcker Rule implementation and measurement of its consequences in terms of liquidity premia and bid/ask spreads is analytically difficult. Many factors intervene. For instance, liquidity is related to credit spreads (the interest rate impact of the credit quality of the issuer of debt) in complicated ways. Conditions in the financial markets can affect the appetite for higher yielding, lower credit quality debt. When there is great confidence in the economy and interest rates are generally low, investor appetite for the yields generated by relatively lower credit quality will be higher. As a result, liquidity is relatively higher for this debt. In contrast, when the economic outlook is weak and financial markets are more concerned about failures, relative liquidity is lower for this debt. This represents a "flight to quality."

Oliver Wyman Approach. The recently published Oliver Wyman study relies on a prior study entitled "Corporate bond liquidity before and after the onset of the subprime crisis."[9] The purpose of this study was to examine the effects of the crisis on liquidity premia. One thing is for certain: extrapolation of liquidity premia based on data from the most stressed economic and financial conditions in modern times to forecast liquidity costs is a bad idea. The forces affecting liquidity costs distort relationships in the extreme.

As a result of using this study to estimate the premium for lower liquidity, the flaws in the assumptions for the amount of reduced liquidity (*i.e.*, no replacement for bank liquidity from other sources was assumed) were compounded by application of cost factor derived from distorted, extraordinarily stressed conditions.[10] The Oliver Wyman Study obtains the result it

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8 Oliver Wyman Study, page 9.

9 J. Dick-Nielson, P. Feldhutter and D. Lando," Corporate bond liquidity before and after the onset of the subprime crisis." May 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364635.

10 To calculate the cost of power liquidity, the Oliver Wyman Study used values calculated by Dick-Neilson,

seeks because it has assumed the result as the starting point.

In addition, the overall approach misses a critically important point. Higher liquidity premia have a self-correcting effect. Liquidity premia are related to bid/ask spreads. When liquidity is low, the spreads will be high because liquidity providers will require greater compensation for the service they provide. (I will buy your bond, but only if my expected compensation is relatively high, since there is greater risk of re-selling it because of low liquidity.) As bid/ask spreads increase because of lower liquidity, more capital will be attracted to the market to take advantage of the profit potential. This, in turn, moderates bid/ask spreads and liquidity premia until equilibrium is achieved.

It is remarkable that the financial services industry puts forth arguments that simply ignore the laws of supply and demand as they apply to capital.

Volume vs. Liquidity. Much of the analysis and comment is based on confusion between volume and liquidity. Trading activity that provides liquidity, in particular market making, provides real value to the economy. Other activity generates volume, but the value is less clear, to say the least. In fact, this activity may impose a drag on the economy. Recent academic studies indicate that

- dealer activity is overwhelmingly weighted toward trading that does not provide liquidity;
- activity that represents the greatest volume increases the costs of accessing liquidity; and
- the layers of intermediation that have arisen from trading practices other than market making, while efficiently executed to generate profits for traders, involve costs to the rest of the economy that result in an inefficient financial system for the economy as a whole.

As a result, the assertions of economic cost of the Volcker Rule are extremely questionable, and the better analysis is that the real economy will be benefitted. These studies are reviewed below.

A study by professors at MIT's Sloan School of Management examines this issue in the context of modern market behavior.[11] The Wang Study focuses on a phenomenon illustrated most graphically by the Flash Crash. While trading volumes may be extremely high, dealer trading does not appear to be providing market making since it does not work to provide liquidity to investors so as to provide stable and efficient pricing. Key points of observation are times of market stress.

Feldhutter and Lando. Oliver Wyman describes how they selected the particular cost percentages for their study: "DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects."

11 J. Chae and A. Wang, "Who Makes Markets? Do Dealers Provide or Take Liquidity?," August 2003 (the Wang Study") available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364635

> Not only is the social function of liquidity provision most important to other market participants during these periods, it is also these periods (when prices have likely diverged from fundamentals) during which expected profits from providing liquidity should theoretically be the highest. Therefore, if market makers are providing liquidity by accommodating order imbalances, we should observe greater dealer trade activity during periods of higher volatility and kurtosis.[12]

The Wang Study finds that such greater activity does not occur at these times. Further, the study finds substantial evidence that trading activity is largely based on information and designed to profit from short-term price movements. "We have shown that dealers do not provide liquidity to the market; instead, they trade on information."[13]

In contrast with the Oliver Wyman Study, a better analysis of the Volcker Rule is that the effects on liquidity will largely center on the unavailability of subsidized capital chasing transactions that would not make sense but for the subsidy. Capital raised by short-term leverage (which is so dangerous to the markets) may also recede as lenders can no longer depend on a too-big-to-fail bail out. It can also be anticipated that high frequency, algorithmic trading activity will moderate as more demanding and socially useful rationales for capital deployment are imposed.

Liquidity may be affected, though the Oliver Wyman Study provides little guidance on how. But the best analysis is that the effects will be, on the whole, healthy for the economy and the public. A recent study by Thomas Philippon of New York University's Stern School of Business undertakes a quantitative analysis of the economy-wide cost of financial intermediation over the last century through the device of a "finance cost index."[14] The Philippon Study concludes that, historically, the cost of intermediation has been remarkably stable. However, the further conclusion is particularly relevant to the liquidity discussion:

> [T]he finance cost index has been trending upward, especially since the 1970s. This is counter-intuitive. If anything, the technological development of the past 40 years (IT in particular) should have disproportionately increased efficiency in the finance industry. How is it possible for today's finance industry not to be significantly more efficient that the finance industry of John Pierpont Morgan? I conclude from Figure 11 [*i.e.*, the historic trends] that there is a puzzle.[15]

At least a part of the answer to this puzzle may well be the inefficient deployment of bank capital to layers of uneconomic intermediation as banks seek higher returns from the spreads between

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12 Wang Study, pages 17-18.

13 Wang Study, page 30.

14 Thomas Philippon, "Has the U.S. Finance Industry Become Less Efficient," November 2011 ("Philippon Study"), available at (SSRN-id1972808[1]).pdf.

15 Phillipon Study, pages 16-17.

cheap capital costs and exotic securities and derivatives. This is completely consistent with the answer suggested by Professor Philippon.

> Finance has obviously benefited from the IT revolution and this has certainly lowered the cost of retail finance. Yet, even accounting for all the financial assets created in the US, the cost of intermediation appears to have increased. So why is the non-financial sector transferring so much income to the financial sector? Mechanically, the reason is an enormous increase in trading.[16]

The layers of socially unproductive intermediation are best illustrated by the algorithmic trading that dominates today's market volume. In fact, it is clear that the dominance of algorithmically driven trading using techniques associated with high frequency trading does not provide liquidity. Rather, it consumes liquidity with adverse consequences. A recent study of these issues draws conclusions that are summarized as follows:

> We analyze the impact of high frequency trading in financial markets based on a model with three types of traders: liquidity traders (LTs), professional traders (PTs), and high frequency traders (HFTs). Our four main findings are: i) The price impact of liquidity trades is higher in the presence of the HFTs and is increasing with the size of the trade. In particular, we show that HFTs reduce (increase) the prices that LTs receive when selling (buying) their equity holdings. ii) Although PTs lose revenue in every trade intermediated by HFTs, they are compensated with a higher liquidity discount in the market price. iii) HF trading increases the microstructure noise of prices. iv) The volume of trades increases as the HFTs intermediate trades between the LTs and PTs. This additional volume is a consequence of trades which are carefully tailored for surplus extraction and are neither driven by fundamentals nor is it noise trading. In equilibrium, HF trading and PTs coexist as competition drives down the profits for new HFTs while the presence of HFTs does not drive out traditional PTs.[17]

Thus, algorithmic and high frequency trading actually extracts value by intermediating between liquidity providers (market makers) and liquidity traders (large scale investors) and extracts value so as to widen spreads. This volume, in part targeted by the Volcker Rule, does not provide liquidity; it exploits the liquidity process at a cost to the investors.

The consequences to the shape of the American economy are potentially dramatic. Professor

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16 Phillippon Study, page 22.

17 A. Cartea and J. Penalva, "Where is the Value in High Frequency Trading?," December 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712765.

Philippon eloquently poses this issue as follows: "the finance industry that sustained the expansion of railroads, steel and chemical industries, and the electricity and automobile revolutions was more efficient than the current finance industry."[18]

Sovereign Debt

There has been a significant amount of discussion related to sovereign debt. It is important to note that there is no prohibition of underwriting or making a market in sovereign debt. And sovereign debt can be held by banks, but not in trading accounts. One class of market participant, covered banks, is not permitted to engage in proprietary trading of foreign sovereign bonds.

The rationale behind this could not be better illustrated than the recent events relating to MF Global. The firm failed because of a bet on sovereign debt that was focused on issues of political will as much as quantitative analysis of credit quality.

Inevitably, sovereign credits are difficult to assess and are subject to political factors that defy quantitative analytics. This is clear from the rationale expressed by credit rating agencies relating to the downgrade of US debt and the downgrade of various European sovereign credits. Liquidity cannot be reliably assumed.

The Proposed Rules

The regulatory agencies have proposed rules implementing portions of Section 619 of the Dodd-Frank Act. Generally, the Proposed Rules address the principles laid out by the Volcker Rule. However, significant changes are needed if the intent of Congress is to be fulfilled.

The Proposed Rules do not fully implement the statutory provisions in certain critical aspects. Section 619 recognizes that the purpose of the Volcker Rule cannot be achieved unless the activities of systemically important non-bank financial entities are addressed harmoniously with the prohibitions imposed on banks.

> Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to *additional capital requirements for and additional quantitative limits* with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund.., as if the nonbank financial company supervised by the Board were a banking entity. [Emphasis added.]

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18 Philippon Study, page 2.

This provision wisely recognizes the interconnectedness of systemically important non-bank financial entities with the banking system. Prohibition of bank activities is, by itself, insufficient. Prohibitions may well induce some institutions to change their regulatory categorizations. They are also likely to increase proprietary trading activity by non-banks. Protection from the migration of this risk back into the banking system through points of interconnectedness is needed. The implementing rules should address this factor so that it is harmonized with the direct prohibitions.

Further guidance is needed regarding the general, overriding prohibition of exposures to high-risk assets and trading strategies and activities that could pose a threat to the financial stability of the United States. These overriding limitations were intended to affect behavior and clarity is needed if they are to have a practical impact. The failure to provide such clarity suggests that they can be ignored.

Implementing provisions for a third overriding limitation related to conflicts of interest must also be refined. Disclosure is too often allowed to substitute for substantive prohibition. The legislative history makes clear that disclosure cannot be adequate for certain conflicts and this must be reflected in the rules. Furthermore, information barriers, which are also permitted as avenues to satisfy the conflicts prohibition, are ineffective for many kinds of conflicts of interest. Structural remedies for conflicts such as information barriers can easily morph into safe harbors that give license to behavior that Congress sought to limit.

The Proposed Rules address the permitted activities of market making, underwriting and risk-mitigating hedging in great detail. These provisions suffer from overly broad and loose definitions. The financial services industry has sought to stretch the meaning of the terms beyond rationality. To an extent, the regulatory agencies have succumbed to this tactic. The Proposed Rules establish sensible principles in a number of places, and then proceed to struggle with fitting real-world activities based on the tactical semantics that fill industry comments into the obviously sound set of principles. Several important points must be reflected in the rules:

- Market making is a customer service in which a financial institution serves client needs to access markets by offering two-sided buy and sell prices. In normal conditions, the financial institution is compensated for facilitating access by realizing the spread between the prices. This is simply not a service that can be provided in respect of securities and derivatives for which there is no discernable two-sided market.

- Underwriting is a service to a client that seeks to issue securities in a public offering. The financial institution is allowed a discount in price from the reasonably forecasted price at which the offering will clear the market. If this price cannot be reasonably forecasted, the concept of the client service in exchange for a price discount does not make sense.

- Risk-mitigating hedging is an exception that flows from an underlying permitted activity. It is important for the regulatory agencies to address the inescapable truth that it is in the interest of market participants that seek to limit the restrictions on their activities to denote trading strategies that result in proprietary risks as "hedging." The rules must adhere to a straightforward concept. A transaction that embeds market price risk different from the permitted exposure that is purported to be hedged constitutes, at least

in part, a proprietary risk position notwithstanding rationalizations and technical semantics.

The Proposed Rules also provide categorical exceptions that can easily evolve into dangerous loopholes. Activities like repurchase agreements, securities lending and liquidity management can have important and essential benefits. They can also be used as vehicles for dangerous risk taking in proprietary positions. Categorical exceptions must be excluded and the rules must rely, instead, on the purposes behind these activities.

Finally, the restrictions on hedge fund and private equity fund activity must be tightened. In particular, the breadth of permissible activity related to asset-backed securities that fall within the hedge fund definition must be aligned with the intent to avoid unnecessary restrictions on the legitimate need to securitize loans and similar assets. The rules must not go beyond this intent.

There are a number of other improvements of the Proposed Rules that are needed. This is inevitable given the breadth of the Volcker Rule and the many provisions designed to accommodate the perceived needs of industry. However, the overwhelmingly important fact is that the basic principles reflected in Section 619 of the Dodd-Frank Act and in the effort of the regulatory agencies to implement it are a critically important step toward protecting the American economy from the devastations of another financial crisis.

Thank you for the opportunity to present my views.

TESTIMONY OF

JOHN WALSH

ACTING COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEES ON

CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

And

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

U.S. HOUSE OF REPRESENTATIVES

January 18, 2012

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees, I appreciate the opportunity to appear today to provide an update on the work of the Office of the Comptroller of the Currency (OCC) in implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), also known as the "Volcker Rule." The letter of invitation requests the agencies to address various aspects of the joint notice of proposed rulemaking implementing the Volcker Rule (the Proposal), including the effect of the Proposal on the financial sector and the economy.

Because we are in the midst of the public comment process on this rulemaking, I must note that there are limitations on the views I should express on the merits of many of the issues raised in the letter of invitation, in order to avoid the appearance of prejudging any of the issues presented by the rulemaking. That said, I can identify areas of the Proposal that present significant issues, and where we have emphasized the importance of input from commenters.

Accordingly, my testimony will describe the Proposal and address the implementation challenges posed by the complexity of section 619, and the questions posed by the Committee. As you are aware, the agencies recently extended the deadline for providing comments on the Proposal from January 13 to February 13, 2012. We are hopeful that this extended comment period will give the public more time to evaluate and provide meaningful comments on the Proposal, and time to evaluate and comment on the proposed rule implementing section 619 that was approved by the Commodity Futures Trading Commission (CFTC) on January 11, 2012.

Implementation of Section 619

The OCC, together with the other banking agencies and the Securities and Exchange Commission, jointly published the Proposal for public comment on November 7, 2011. The Proposal took into consideration the language of section 619 and its legislative history, the Financial Stability Oversight Council's study on implementing section 619 published in January 2011, and the agencies' supervisory experience with the banking entities to which the Volcker Rule is applicable. The Proposal reflects the agencies' rigorous discussions of these elements in a constructive interagency rulemaking process. The CFTC, while not a party to the Proposal, was actively involved in these interagency discussions and in formulating the Proposal.

The Statute. Section 619 prohibits a "banking entity", which is an insured depository institution,[1] a company that controls an insured depository institution, a foreign banking organization, and an affiliate or subsidiary of any of the above, from engaging in "proprietary trading" and from acquiring or retaining an ownership interest in, or sponsoring, a "hedge fund" or "private equity fund." The definition of these terms and the structure of section 619 are complex, which results in the complexities of the Proposal. For example, "proprietary trading" is defined as a banking entity engaging as "principal" in acquiring or disposing of securities, derivatives, commodity futures contracts, or options on any of these instruments for an account (the "trading account") that the entity uses for taking positions "principally for the purpose of selling in the near-term" or "with the intent to resell in order to profit from short-term price movements." This term and many of the other terms and concepts contained in section 619 are

[1] Section 619 defines "insured depository institution" to exclude certain limited purpose banks that function solely in a trust or fiduciary capacity.

imprecise and at times over- or under-inclusive as applied in practice, and therefore required further refinement in the Proposal.

Section 619 also expressly exempts certain permitted activities from these prohibitions, including:

- Trading in certain government obligations, including U.S. government and agency obligations;
- Trading in connection with underwriting and market-making-related activities designed not to exceed reasonably expected near-term demands of customers;
- Risk-mitigating hedging activities on an individual or portfolio basis;
- Trading on behalf of customers;
- Investments in small business investment companies and investments designed to promote the public welfare;
- Organizing and offering a fund for trust, fiduciary and advisory customers subject to certain investment, ownership and other limits; and
- Trading and fund activities by certain qualifying foreign banking entities solely outside of the United States.

In addition, section 619 generally prohibits a banking entity from entering into any transaction with a fund that it manages, advises or sponsors that would be a "covered transaction" under section 23A of the Federal Reserve Act. A covered transaction includes a loan or extension of credit, a guarantee, and a purchase of securities or assets. This restriction is known as "Super 23A" because it is a flat prohibition on all covered transactions, regardless of the statutory quantitative and qualitative limits otherwise applicable under section 23A or any of the permitted activity exceptions.

Section 619 also imposes statutory "backstops" on all permitted activities. A banking entity may not engage in any activity expressly permitted by section 619 if the activity would involve or result in (1) a material conflict of interest between the banking entity and its customers; (2) a material exposure to a high-risk asset or trading strategy; (3) a threat to the safety and soundness of the banking entity; or (4) a threat to the financial stability of the United States. The statute directs the agencies to define the first two backstops concerning conflicts of interest and high-risk asset and trading strategy. Finally, section 619 directs the agencies to implement internal controls and recordkeeping requirements to ensure compliance with the statute.

Section 619 also contains three rules of construction. First, the prohibitions and restrictions under section 619 apply to all activities of a banking entity even if those activities are authorized under other statutory authorities. In other words, the restrictions and prohibitions of section 619 trump any statutory provision that may permit the activities in question. Second, nothing in section 619 can be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law. This provision presents various issues regarding its scope that were flagged in questions contained in the preamble to the Proposal. Third, nothing in section 619 can be construed to limit the inherent authority of any Federal or state agency under applicable law.

Section 619 becomes effective on July 21, 2012, even without a final rule. In such a case, covered banking entities would be required to comply with the statutory provisions. The statute provides a two year conformance period for banking entities to bring their existing activities and investments into compliance with section 619. Banking entities may request up to

three one-year extensions of this conformance period and another five-year extension to divest of certain illiquid funds as described in the Federal Reserve Board's conformance period rule.

The Proposal. The Proposal implements the complex statutory structure of section 619, including its prohibitions, restrictions, permitted activity exceptions, backstops, and rules of construction. The Proposal establishes requirements for engaging in statutorily permitted activities and interprets many of the exceptions narrowly, including, in particular, the exceptions for underwriting, market-making-related activities, and risk-mitigating hedging. The Proposal's approach for implementing these statutorily-permitted activities introduces a number of operational complexities because of the difficulties of trying to draw precise distinctions between permissible and prohibited activities.

An area that is particularly challenging and that had drawn much attention is how to distinguish permissible market-making-related activities from prohibited proprietary trading -- specifically how to distinguish whether a banking entity is taking principal risk to provide intermediation and liquidity services to customers or as part of a speculative proprietary trading strategy. The Proposal addresses this challenge through a multi-faceted approach consisting of (1) seven criteria that a banking entity's activities must meet to rely on the market-making exception, including establishment of a compliance program, (2) six principles that the agencies will use as a guide in distinguishing bona fide market-making from prohibited proprietary trading, and (3) seventeen quantitative metrics that a banking entity with significant trading activities must report for each of its trading units at every level of the organization.

In addition to the specific prohibitions and exceptions that relate to proprietary trading and covered fund activities, the Proposal also elaborates on two of the four statutory backstops:

the prohibitions on engaging in an activity that would involve or result in either a material conflict of interest between the banking entity and its customers, or in a material exposure by the banking entity to a high-risk asset or trading strategy. Banking entities with significant trading activities are required to report quantitative metrics designed to allow the agencies to evaluate the extent to which these activities expose the institution to high-risk assets or trading strategies.

The Proposal further requires banking entities engaged in any permitted proprietary trading or hedge fund or private equity fund activities or investments to develop and implement a compliance program that must address internal policies and procedures, internal controls, a management framework, independent testing, training, and record-keeping. The extent of these requirements escalates depending on the volume of the activity. Banking entities with significant trading or fund activities or investments must adopt a more detailed compliance program. Banking entities that do not engage in any proprietary trading or hedge or private equity fund activities or investments must put in place policies and procedures that are designed to prevent them from becoming engaged in those activities.

Many have noted that the Proposal contains an unusually large number of questions. This reflects the complexity of the issues involved and the agencies' desire to gain maximum information about the practical operational impact of various implementation alternatives. Without such feedback on the practical impact of the requirements contained in the Proposal, the effects of the Volcker rule on the financial sector and the economy as a whole are difficult to estimate. While the number of questions may seem daunting, they were driven by the agencies' desire to understand what may be quite complex and significant consequences of the Proposal.

As the regulator of many of the banks that will be most affected by the Volcker Rule, the OCC is particularly concerned with how to strike the right balance in identifying and preventing impermissible activities without undermining activities that are safe, sound and profitable and help to reduce a bank's overall risk profile. We also recognize the compliance burdens on banking entities of all sizes arising from the Proposal and therefore will be interested in whether comparably effective compliance results could be achieved through less burdensome approaches.

To date, the OCC has completed an assessment of the impact of the Proposal on OCC-regulated entities under the Unfunded Mandates Reform Act[2] and the Regulatory Flexibility Act.[3] In doing so, OCC economists considered the impact of any mandates imposed by the Proposal on expenditures by the private sector or state, local and tribal governments and its impact on small entities. In particular, we focused on mandates contained in the compliance, recordkeeping, reporting, disclosure, and training requirements of the Proposal. OCC economists ultimately concluded that the Proposal does not contain any mandates, beyond those required by statute, that would result in *expenditures* by *OCC-regulated entities* of over $100 million in any one year.[4]

Nevertheless, the Proposal solicits extensive comments on the full economic impact of the Proposal, including its impact on market-making and liquidity, costs of borrowing by

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[2] The Unfunded Mandates Reform Act, Pub. L. No. 104-4 (codified at 2 U.S.C. 1532) generally requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in any Federal mandates, beyond those required by statute, that would result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more in any one year.

[3] The Regulatory Flexibility Act, Pub. L. No. 96-354 (codified at 5 U.S.C. 601) generally requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. A banking entity is generally considered a small entity for purposes of the Regulatory Flexibility Act if it, together with its domestic and foreign affiliates, has assets less than or equal to $175 million.

[4] Consistent with the scope of our obligations under the Unfunded Mandates Act, our impact assessment of the Proposal did not take into account (1) costs of mandates specifically required by statute, (2) costs to the banking industry or to the economy as a whole, or (3) costs to banking entities not regulated by the OCC.

businesses and consumers, and the prices of financial assets. We strongly encourage comments on these issues and hope that the extended comment period will facilitate thoughtful and robust responses from commenters.

The letter of invitation also solicits our views on whether the Proposal places U.S. banking entities at a competitive disadvantage. The Proposal will have a competitive impact but the competitive consequences are the result of provisions of the statute that reflect certain policy choices that differ from approaches that have been adopted in other countries. Section 619 prohibits any banking entity, which includes a U.S. banking entity and a foreign bank with certain U.S. operations,[5] from engaging in proprietary trading and from making investments in or sponsoring a hedge fund or private equity fund unless an exception applies. Under the statute, these prohibitions apply on a global basis to any covered banking entity. Foreign jurisdictions have not adopted restrictions resembling those in the Volcker Rule. So a foreign bank that is not subject to section 619 because it does not have the requisite U.S. banking operations will remain unaffected by the Volcker Rule. Accordingly, U.S. banks competing with these foreign banks will operate at a competitive disadvantage.

Section 619 creates a limited exception for certain overseas activities of qualifying foreign banking entities that are subject to the Volcker Rule. Specifically, section 619 permits a qualifying foreign banking entity to engage in prohibited proprietary trading and hedge fund and private equity fund activities and investments "solely outside of the United States." This exception, by its terms, is not available to any banking entity that is controlled by a U.S. banking entity. This means that a qualifying foreign banking entity subject to section 619 may continue

[5] Section 619 applies to any foreign bank that "is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978."

to engage in prohibited activities solely outside of the United States, subject to regulation by its respective home country supervisors, while a U.S. banking entity may do so only in reliance on another statutory permitted activity exception, such as in connection with its market-making-related activities, underwriting or risk-mitigating hedging.

I note, however, that while a foreign banking entity that is covered by the Volcker Rule may avail itself of the statutory exception for activities occurring solely outside of the United States, the statutory backstops under section 619 continue to apply to such overseas activities. In addition, the Proposal imposes compliance program and reporting requirements on all banking entities engaging in activities permitted under section 619, including on foreign banking entities covered by the Volcker Rule engaged in activities occurring solely outside of the United States.

We welcome comments on the impact of the Proposal on the competitiveness of U.S. banking entities and how the statutory requirements could be interpreted differently.

Conclusion

I appreciate the opportunity to update the Committee on the work we have done to implement the Volcker Rule. This is a complex rulemaking and very much a work in progress. We appreciate the Committee's concerns and will certainly keep the Committee advised of the status of this rulemaking effort. I am happy to answer your questions.

January 18, 2012

The Honorable Scott Garrett
Subcommittee on Capital Markets and
Government Sponsored Enterprises
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Shelley Moore Capito
Subcommittee on Financial Institutions
and Consumer Credit
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Subcommittee on Capital Markets and
Government Sponsored Enterprises
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn B. Maloney
Subcommittee on Financial Institutions
and Consumer Credit
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Representatives Garrett, Capito, Waters, and Maloney,

As the trade association representing Small Business Investment Companies (SBICs); small private equity funds; and their investors, the Small Business Investor Alliance thanks you for holding this joint-subcommittee hearing on the proposed Volcker Rule. This key provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) will have a great impact on small business investment and is worthy of review and discussion.

Beginning in only a few months the Volcker Rule will restrict many types of investments and activities by banks, particularly investments in private equity funds. As the engines of job creation, we support continuing the long held practice of having an explicit permission granted for bank sponsorship and investment in Small Business Investment Companies (SBICs). Dodd-Frank contained language continuing this longstanding policy. However, we have concerns that the language in the proposed rule is unclear and may restrict banks relationships with SBICs more than intended by the statute.

Since its establishment by Congress in 1958, SBICs have bridged the gap between entrepreneurs' need for capital and traditional financing sources, and have been providing capital to small businesses that would otherwise lack access to capital. SBICs are small, highly regulated private investment funds that by law invest capital exclusively in domestic small businesses.

Many SBICs rely heavily on bank capital to make up a significant portion of their private capital pool. Even under the highly restrictive Glass-Steagall regulatory framework, banks were permitted to sponsor, extend credit to, and invest in SBICs. We are troubled that the most recent proposed regulations appear to have limits on sponsorship and investment in SBICs. Additionally, it appears that banks will be unable to extend credit to some SBICs and may have to take a special charge for SBIC investments. In writing Dodd-Frank, Congress recognized how critical SBICs are for small business and their lack of any systemic risk. This is why banks were explicitly permitted to sponsor and invest in SBICs under both Glass-Steagall and Dodd-Frank. SBICs are filling a critical void for small businesses accessing capital and the final regulations should not further restrict bank relationships or investments them. SBICs are not systemically risky and did not contribute to the financial meltdown.

Federal regulators have a legitimate focus on systemic risk and other issues affecting large financial institutions, but small business investing is important too. Banks are important partners to small business investors. To ensure American small businesses can continue to turn to SBIC funds for capital to grow and create new jobs, the Volcker Rule should be implemented in a way that is minimally onerous to banks and clearly permits bank investment, sponsorship, and lending to SBICs without restriction.

Thank you for taking the time to consider our viewpoints and recommendations.

Sincerely,

Brett Palmer
President

1100 H Street, NW Suite 610 Washington, DC 20005 (202) 628-5055 **sbia.org**

5. Market making and position taking: valuable up to a point?

One of the functions which banks and investment banks perform in the market for credit securities and credit derivatives is to trade and thus provide liquidity, enabling end investors and other market users to buy and sell at reasonably low bid-offer spreads. That activity is one among many trading activities in which banks have been increasingly involved, with, as shown in Section 3(iv), an explosion over the last 30 years in the volume of trading activity relative to real economic variables.

What value did this explosion of trading actually deliver: how valuable is the liquidity which position-taking, or as some would label it, speculation, makes possible?

The question is a politically sensitive one, because market making and proprietary trading to support it are at times highly profitable for firms and for individuals. Lending officers guilty of lending badly to commercial real estate firms in an irrationally exuberant upswing may have been overpaid relative to the economic value added of their activity for society, but it is not in that area of financial services but within the trading rooms of banks, investment banks and hedge funds that remuneration sometimes reaches levels which to the ordinary citizen are simply bewildering. There is therefore strong popular support for measures to curtail either trading volume or the profits derived from it, whether by direct regulation of trading room bonuses, 'Volcker rule limits on commercial banks' involvement in proprietary trading, or financial transaction taxes such as that proposed by James Tobin.

The high profitability of market making and proprietary trading – to the firms and to individuals – reflects two facts: first that end customers appear to place great value on market liquidity; second that market makers with large market share and high skills are able to use their knowledge of underlying order flow and of interconnections between different traded markets to make position taking and complex arbitrage profits.[26]

And the fact that end customers greatly value liquidity is in turn taken by the proponents of ever more active trading as proof that more trading and more liquidity must be socially valuable as well as privately profitable. The dominant ideology of financial

[26] The proponents of separating 'casino' banking from commercial banking often argue in support that proprietary trading activity and market making is only profitable because risk taking is cross-subsidised by "Too Big To Fail" status and a significant tax payer guarantee. It is notable however that some of the most profitable market making activities, either at all times (eg, spot and FX) or at particular times (government bonds during 2009) are actually relatively low risk, and have very rarely resulted in losses which have harmed individual bank solvency or total system stability. Several market making functions appear to deliver super normal returns even when fully risk adjusted.

liberalisation and innovation, has therefore argued that increased liquidity is wholly beneficial in all markets for five reasons.

- Increased liquidity enables end customers to trade at low bid offer spreads and in large amounts: for any given scale of activity this decreases their costs.
- If faced with this lower cost per transaction, customers transact more and therefore provide more net revenues to the market makers and professional position takers, that must be because they derive value from it.
- Liquidity indeed is directly valuable because – in the classic argument of market completion – it provides investors with a wider set of options, in this case the option to sell whenever they want.
- And liquidity creates value by ensuring efficient 'price discovery', with a wider set of market participants able to contribute to the collective judgement of the rational market and with correct prices driving allocative efficiency.
- Finally, these benefits of liquidity are likely to be accompanied by reduced volatility, since liquidity is in part created by professional position takers who spot divergences of prices from rational levels and by their speculation correct these divergences.

These arguments reflect the dominant conventional wisdom of the last several decades based on the assumptions of rational expectations and of efficient and self-equilibriating markets. And they have been frequently and effectively deployed to argue against regulations which might limit trading activity. And some of these arguments are compelling, up to a point – reduced bid offer spreads on forward Foreign Exchange (FX), must for instance have delivered value to exporters and importers.

But Keynes believed that 'of the maxims of orthodox finance, none surely, is more anti-social than the fetish of liquidity and the doctrine that it is a positive value on the part of institutional investors to concentrate their resources on the holding of "liquid" securities'. And scepticism about the limitless benefits of market liquidity supported by speculative trading is justified on at least three grounds.

- First, the fact that the benefits of market liquidity must be, like the benefits of any market completion, of declining marginal utility as more market liquidity is attained. The additional benefits deliverable, for instance, by the extra liquidity which derives from flash or algorithmic training, exploiting price divergences present for a fraction of a second, must be of minimal value compared to the benefits from having an equity market which is reasonably liquid on a day-by-day basis.

- Second, the fact that greater market liquidity and the position taking and speculation required to deliver it, can in some markets produce destabilising and harmful momentum effects – cycles of over and then under valuation. Such swings can be explained by the insights of behavioural economics – human tendencies, rooted in our evolutionary history, which condition us to be swept along with herd psychology[27], or they can be explained in terms of relationships between different market participants, operating under conditions of inherent irreducible uncertainty, imperfect information and complex principal/agent relationships, which make it rational for individual participants to act in ways which produce collective unstable results, with continual oscillations around rational equilibrium levels.[28]
- And third, an emerging body of analysis which suggests that the multiple and complex principal/agent relationships which exist throughout the financial system, mean that active trading which both requires and creates liquid markets, can be used not to deliver additional value to end investors or users of markets, but to extract economic rent. Additional trading, for instance, can create volatility against which customers then seek to protect themselves by placing value on the provision of market liquidity. The fact that customers place great value on market liquidity, and thus support large market-marking profits, therefore in no way proving that the increased trading activity is value added at the social level.

So faced with these two schools of thought – what should we conclude? Has all the increased trading activity of the last 30 years delivered economic value via lower transaction costs and more efficient and liquid markets, or has it generated harmful volatility and enabled market traders to extract economic rent? My answer is that I don't know the precise balance of these possible positives and negatives, because there are many issues of complex theory and empirical analysis not yet resolved and very difficult to resolve. But we certainly need to have the debate rather than accepting as given the dominant argument of the last 30 years which has asserted that increased liquidity, supported by increased position taking, is axiomatically beneficial. And a reasonable judgement on the economic value added of increased liquidity may be that increased liquidity does deliver benefits but subject to diminishing marginal utility, and that the increased financial speculation required to deliver increased liquidity creates an increasing danger of destabilising herd and momentum effects the larger pure financial activity becomes relative to underlying real economic activity (Chart 38).

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[27] See Kuhneman, Slovic and Tversky *"Judgement Under Uncertainty heuristics and biases"* (1982) for discussion of how economic agents made decisions on the bases of rough heuristics, i.e. rules of thumb. The widespread application of these rules by multiple agents can then generate self-reinforcing herd effects.

[28] See Vayano and Woolley, *An Institutional Theory of Momentum and Reversal"* (LSE November 2008), and George Soros *The New Paradigm for Financial Markets* (2008).

So that there is an optimal level of liquidity, with increased liquidity and speculation valuable up to a point but not beyond that point, but with the complication for practical policy makers that the point of optimal benefit is impossible to define with any precision, that it varies by market, and that we have highly imperfect instruments through which to gain the benefits without the disadvantages. There is, for instance, no economic value that I can discern from the operation of speculators in currency 'carry trades', which are among purest examples of what Professor John Kay labels 'tailgating strategies' – riding an unsustainable trend in the hope that you will be clever enough to get out just ahead of the crash.[29] But there may be no instruments that can eliminate carry-trade activities without undermining useful Forex market liquidity of value to non-financial corporations.

But the fact that we do not have perfect discriminatory instruments does not mean that a more nuanced assessment of the benefits of market liquidity will have no implications for public policy. Instead three implications follow:

- The first is that in setting trading book capital requirements for commercial and investment banks, we should shift from a bias in favour of liquidity to a bias to conservatism. If regulators believe that the level of capital required for prudential purposes needs to increase, and the industry argues that this will restrict liquidity in some specific markets, we should be more willing to question whether the liquidity serves a useful economic purpose and more willing in some cases to wave it goodbye.

- The second is that policymakers need to be concerned with the potential danger of destabilising speculative activity, even if it is performed by non-banks. Speculative trading activity can cause harm, even when it poses no threat to commercial bank solvency. If necessary, highly leveraged hedge fund speculation should be constrained by leverage limits.

- And third, we should certainly not exclude the potential role for financial transaction taxes which might, in James Tobin's words, 'throw some sand in the wheels' of speculative activity. It may well be the case that a generalised and internationally agreed financial transactions tax, whether on Forex flows or on a wider set of financial transactions, is not achievable. One of the interesting features of the transaction tax debate is that it is littered with articles by academics who have been convinced of the theoretical case in favour of a financial transaction tax, but who have subsequently failed to promote the idea. In 1989, Larry Summers co-authored an article entitled: *When financial markets work too well: a cautious case for a securities transaction tax*[30], but in office subsequently he did not pursue it.

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[29] See John Kay, *Tailgating blights markets and motorways*, Financial Times, January 19, 2010.

[30] L.H Summers and V.P. Summers, Journal of Financial Service Research, 1989.

Rudi Dornbusch argued in 1990 that 'it's time for a financial transactions tax', but was subsequently sceptical about the feasibility of comprehensive capital controls.[31] But at very least we should take financial transaction taxes out of the 'index of forbidden thoughts'

[31] Rudiger Dornbusch, *"It's time for a financial transactions tax"*, The International Economy, August/September 1990. Note that while Dani Rodrik has argued that Dornbusch's subsequent scepticism about capital controls ("Capital controls: an idea whose time is past" 1997) is inconsistent with Dornbusch's earlier position, in fact it is quite possible to be opposed to legislated prohibition of capital flows but in favour of taxing them .

American Bankers Association
Building Success. Together.

Frank Keating
President and CEO
202-663-5111
fkeating@aba.com

January 17, 2012

The Honorable Shelley Moore Capito
Chairman, Subcommittee on Financial Institutions and Consumer Credit
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Scott Garrett
Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Proposed Rules on Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Volcker Rule")

Dear Chairman Capito and Chairman Garrett:

I am writing on behalf of the members of the American Bankers Association (ABA) concerning the January 18, 2012, hearing on the Volcker Rule in the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit. ABA represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. In analyzing the federal regulatory agencies' Notice of Proposed Rulemaking to implement the Volcker Rule, we wish to raise a number of issues for your consideration as you review this complex rule and its implementing regulations.

(1) In spite of the Volcker Rule's objective to eliminate proprietary trading undertaken by more complex banks, the proposed rules are drafted to apply to every bank, regardless of size or activity; therefore, all community and regional banks will be required to adapt their compliance programs to the Volcker Rule's requirements.

(2) While the objective of regulatory rulemaking is to clarify legislative intent, the proposed rules are pockmarked with hundreds of questions and open-ended issues, making it exceedingly difficult to know what the proposed rules might look like when finalized.[1]

(3) Notwithstanding regulatory rulemaking's goal to provide certainty, the proposed rules are much too vague and complex. As a result, banks will neither know how to comply nor whether, at any time, they are in compliance with regulatory requirements.

(4) The proposed rules unnecessarily constrain liquidity across domestic and global markets with restrictions on asset liability management and other principal trading by banks.

(5) The proposed rules call for supervision and enforcement of the same statutory mandate by multiple regulators – all looking at the same bank – setting the stage for a disordered

[1] Indeed, the Proposed Rules appear much more like an Advanced Notice of Proposed Rulemaking than an ordinary rulemaking release, thereby raising process issues, including the ability of the public to comment on a clearly drawn and directed set of proposed rules.

patchwork quilt of conflicting regulations and interpretations and further eroding compliance planning and regulatory certainty.

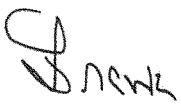
Congress has already sounded the alarm on the consequences to global competitiveness. As stated in a recent letter from you, Chairman Bachus, and Representative Hensarling to the agencies, the proposed rules may diminish the strength of U.S. banks in the global financial marketplace.[2] There is the additional concern that a number of the activities prohibited under the Volcker Rule would simply migrate to other sectors of the economy or even overseas, particularly to unregulated or lightly regulated financial entities where much of the recent financial turmoil found its origins.

At the same time, we note that after enactment of the Volcker Rule, a report by the U.S. Government Accountability Office (GAO) concluded that neither proprietary trading nor investments in hedge funds/private equity funds by banks were a proximate cause of the financial crisis of 2008.[3] The GAO further stated in the report that "FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from stand-alone proprietary trading."[4] The ban on bank proprietary trading and investment activity, therefore, should be narrowly and precisely tailored to properly achieve the Volcker Rule's objectives.

The proposed rules as written are unworkable and fail to carry out the intent of Congress to clearly define prohibited activity in proprietary trading and investments in hedge funds and private equity funds. ABA therefore requests that Congress (i) communicate its Volcker Rule objectives to the agencies in writing and at the hearing, and (ii) call for a re-proposed set of rules for public comment that readily align with such objectives.

Thank you for your attention to this very important matter. ABA stands ready to work with the Committee on this important issue.

Sincerely,



Frank Keating

Cc: The Honorable Spencer Bachus, Chairman, Financial Services Committee
The Honorable Barney Frank, Ranking Member, Financial Services Committee
The Honorable Carolyn Maloney, Ranking Member, Financial Institutions Subcommittee
The Honorable Maxine Waters, Ranking Member, Capital Markets Subcommittee
The Honorable Tim Johnson, Chairman, Senate Banking Committee
The Honorable Richard Shelby, Ranking Member, Senate Banking Committee
Members of the House Financial Services Committee
Members of the Senate Banking Committee

[2] Letter from Reps. Bachus, Hensarling, Capito, and Garrett to the Agencies (Dec. 7, 2011).
[3] GAO Report, "Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented" (July 2011).
[4] Id.

Statement of BlackRock, Inc.

Joint Hearing on Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation

The Capital Markets and Government Sponsored Enterprises Subcommittee and the Financial Institutions and Consumer Credit Subcommittee

House Financial Services Committee
January 18, 2012

BlackRock, Inc. appreciates the opportunity to provide the Committee with its comments regarding the Volcker Rule and the potential impact of the pending rule proposal[1] on the U.S. capital markets.

BlackRock is one of the world's leading asset management firms, managing over $3.3 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party mutual funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world.

BlackRock supports the policy behind the statutory provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that are commonly referred to as the Volcker Rule – restricting certain proprietary trading and investing activities by banking institutions that are eligible to receive government support. However, as a fiduciary for our clients and a major participant in global markets, we are concerned that the Proposed Rule as drafted will lead to a

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationship with, Hedge Funds and Private Equity Funds (proposed Oct. 11 and 12, 2011 and January 11, 2012) (the "Proposed Rule"")

significant number of adverse impacts and unintended consequences that should be resolved in the final rule.

Impact of the Volcker Rule on Financial Markets

We have significant concerns that the impact of the Proposed Rule on the market making activities of banking entities will have unintended and undesirable consequences for financial markets in general. These consequences will include negative impacts on the performance of investor portfolios. The Volcker Rule specifically carves out market making and customer facilitation activities from the proprietary trading ban. It is critical that the implementation of these exclusions provide a clear framework for these activities to continue without creating regulatory risk and uncertainty for U.S. banks.

BlackRock believes the Proposed Rule creates significant uncertainties for market makers which will disrupt the markets for certain securities. The uncertainties are particularly acute for fixed income securities, where the ability of dealers to hold inventory and commit capital are critical to the efficient operation of the market. A disruption in dealer activities will lead to less liquidity in the market, resulting in wider bid-ask spreads and higher borrowing costs, which will have significant negative economic consequences for savers as well as for corporate and municipal borrowers.

While we appreciate that the Volcker Rule requires the regulatory agencies charged with its implementation to delineate activities that are considered proprietary trading from those that are market making and facilitating client activities, we believe the rule as proposed creates uncertainty for brokers and an overly complex compliance regime. The result of both these factors likely will be decreased liquidity, especially for credit and securitized fixed income

instruments. We note that liquidity in investment grade securities has already been reduced as primary dealer balance sheets have contracted. In addition to the general reduction in liquidity, normal seasonality periods will further hamper liquidity, creating periods when it may become difficult to cost effectively execute transactions in certain securities.

Investment decisions are heavily dependent on a liquidity factor input – investment strategies and decisions require that not only the initial procurement of the securities is considered, but that there also needs to be a degree of confidence that the securities can be sold in a timely, cost-effective manner. Otherwise, those securities will appeal only to a very limited number of investors and strategies. This is particularly true for strategies that are actively managed, as compared to "buy and hold" portfolios. Regarding "buy and hold" strategies, it should be noted that fixed income portfolios, which are often thought of as "buy and hold" portfolios, are not without relevant risks and require comprehensive risk management, which may include selling selected securities based on a change of credit outlook. Credit risks as well as interest rate risk are both very real and can greatly affect the performance of a fixed income portfolio. As liquidity dissipates, investment strategies become more limited, and returns to investors are reduced by wider spreads and higher transaction costs. Diminished returns impact the ability of investors, such as pension funds, to meet their obligations to their participants and beneficiaries, and also negatively impact savers.

Reduced liquidity will also impact issuers of fixed income securities. We can expect that new issue concessions will increase as liquidity diminishes, as brokers manage the risk of decreased liquidity and the ability to comply with the new rules. We expect that all issuers will be impacted to some degree, including both large, frequent issuers and smaller, more episodic issuers.

In light of the issues outlined above, we urge that careful consideration be given as to the breadth of the proprietary trading ban contained in the Proposed Rule and provide greater certainty around what constitutes permissible activity. The rule proposal considers several factors in delineating proprietary activities from acceptable market making and customer facilitation. We suggest that dealer "market facilitation" books can be monitored most effectively by focusing first and foremost on aging, followed by value at risk (VAR), correlation, concentration, average tenor, average credit rating, positions in issues where the dealer participated in the syndicate, as well as positions in issues where the dealer did not participate in the syndicate.

As we have seen in the equity markets, evolution does occur and we fully expect over time that fixed income markets will evolve into an "all to all" marketplace with a mix of agency, principal and end-user participants. We welcome a fully integrated market, with an open order book and streaming prices by a myriad of participants providing liquidity. However, until the fixed income markets reach this stage, creating regulatory uncertainty for market makers will likely have a material negative impact on liquidity, resulting in higher borrowing costs for issuers as well as lower returns for investors.

We have additional, specific concerns with respect to the impact of the Proposed Rule on the market for U.S. municipal securities. The municipal market is highly fragmented, made up of millions of individual securities issued by tens of thousands of issuers. A decrease in liquidity in this market could have particularly dramatic impacts for both municipal issuers and market participants. Fortunately, as drafted, the Proposed Rule exempts obligations of any State or of any political subdivision thereof. However, the Proposed Rule fails to extend this exemption to debt issued by an agency of any State or political subdivision thereof, leaving out a significant

portion of the current municipal market for no apparent policy reason. This includes the revenue bond market, creating a negative impact on the ability of municipal issuers to borrow for important projects such as roads, airports, and hospitals. We urge that action be taken to address this inconsistency and adopt a broad exclusion for municipal debt.

Impact on Global Competitiveness of Asset Management

Similar to our concerns with respect to proprietary trading, we believe that the implementation of the prohibition on sponsoring and investing in hedge funds and private equity funds has been drawn too broadly in the Proposed Rule, and impacts activity that Congress did not intend to restrict through the Volcker Rule. Specifically, the proposed definition of "similar funds" is overly expansive and would capture, we believe unintentionally, a wide variety of funds that a diversified asset management firm offers to its clients globally[2]. While a firm that engages solely in the U.S. hedge fund or private equity fund businesses would feel little impact from such an expansive definition, it creates adverse consequences for any firm that offers other types of funds to clients within and outside the United States.

This provision, with its reference to the Investment Company Act of 1940 (the "Investment Company Act"), lacks enough clarity to permit a clear interpretation and as a result could have a significant impact on global-scale asset managers. It effectively represents an extra-territorial expansion of U.S. law, as it requires asset managers to consider each fund that they offer outside the United States and assume that such fund is being offered in the United States. Asset managers then have to determine whether a fund would fit within the broad definition of "investment company" under the Investment Company Act, and if so analyze on what basis the fund could be offered to U.S. persons. Unless the fund

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[2] The Proposed Rule defines similar funds to include: any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(22)), that is organized or offered outside of the United States that would be a covered fund as defined in paragraphs (b)(1)(i), (ii), or (iv) of this section, were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States. Proposed Rule § __.10(b)(1)(iii).

could theoretically register as an investment company under the Investment Company Act or satisfy the specific conditions of another exemption or exclusion under the Investment Company Act, the only available means of offering in the United States would be under either Sections 3(c)(1) or 3(c)(7). Therefore, this proposal would appear to turn nearly any non-U.S. fund (including traditional long-only fixed income and equity funds) into a covered fund simply because they could be offered privately in the U.S.

The proposed rule appears to capture most funds sponsored around the world by asset management businesses subject to the Volcker Rule, including the equivalent product to a U.S. registered fund but offered outside the U.S. under another country's regulatory framework (i.e., UCITS funds). Aside from the impact on U.S. based asset management firms that offer funds outside the United States, it seems overreaching and inappropriate to export the requirements of the Investment Company Act to other regulatory jurisdictions.

The result of this expansion is to create dramatic impacts on the activities of asset managers subject to the Volcker Rule that offer funds outside the United States. The repercussions are that numerous funds that were never intended to be captured by the Volcker Rule become subject to its requirements, without any commensurate protection to taxpayers. We recognize the regulators' desire to capture certain funds operating outside the United States that have characteristics similar to those of hedge funds and private equity funds. Unfortunately, the mechanism in the Proposed Rule does not appropriately accomplish that goal, but is instead overbroad and captures almost every fund offered outside the U.S. We believe the right way to capture funds that are "similar" to hedge fund and private equity funds is to create a definition that is based on the characteristics of those funds. This was the

approach proposed in the Volcker Rule study issued last year by the Financial Stability Oversight Council.[3]

* * *

We thank the Subcommittees for providing BlackRock the opportunity to express its views on these important aspects of the Volcker Rule and its proposed implementation. We welcome a continued dialogue on these significant issues.

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[3] Financial Stability Oversight Council, Study and Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds (January 18, 2011).

BDA Bond Dealers of America

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STATEMENT OF WILLIAM DALY
SENIOR VICE PRESIDENT, GOVERNMENT RELATIONS
BOND DEALERS OF AMERICA

SUBMITTED FOR THE RECORD TO
THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
AND
THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
HOUSE FINANCIAL SERVICES COMMITTEE

EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION

JANUARY 18, 2012
2128 RAYBURN HOUSE OFFICE BUILDING

Chairman Garrett, Chairman Capito, Ranking Member Waters, Ranking Member Maloney and members of the Subcommittees:

Thank you for the opportunity to submit for the record this statement from the Bond Dealers of America.

The Bond Dealers of America ("the BDA") is the only trade association exclusively focused on U.S. fixed income markets and represents middle-market brokers and dealers who are headquartered in cities all over the country, doing business throughout the United States coast to coast. Our members are the "Main Street" firms, not the Wall Street firms. 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. Many of our members are affiliated with banks and will be subject to the restrictions on proprietary trading and investments under the Dodd-Frank Act 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.

We have very serious concerns with the proposed Volcker Rule. As proposed, the rule will 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.

By way of background, the market in fixed-income securities is 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 (FINRA) and the Municipal Securities Rulemaking Board (MSRB). An investor goes to 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 you can tell from that description, that looks a lot like proprietary trading but it in fact is crucial to the operation of these markets. The proposed Volcker Rule would disrupt these markets.

The Volcker Rule is supposed to have several exceptions that we believe 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. The proposed rule, however, is too narrow, complex and ultimately unworkable for the exceptions to be meaningful.

The exemption for market makers is very complex. It is also particularly troubling when it comes to fixed-income securities. The proposed rule states that it is based on the definition of market making under the Securities Act because that definition is "generally well-understood by market participants."

The simple fact is that the SEC has never put forward a definition of market making for fixed-income securities. There is, therefore, no reference point for market participants, nothing for them to "generally well understand." The Bond Dealers of America has repeatedly urged the SEC to establish a definition of market making for fixed-income securities. To date, the SEC has not done so.

Moreover, the seven criteria in the proposed rule are very complicated and rely heavily on commentary in appendices. A firm simply will not know with certainty when it engages in a trade whether a regulator will, at some later point in time, judge whether or not the trade met the seven criteria and the commentary in the appendices. Consequently, firms will err on the side of caution and liquidity will be lost.

The proposed Volcker Rule would also exempt only part of the market in state and local bonds. Under the proposal, 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 would face a much diminished market as bank-affiliated broker dealers would not be able to purchase or sell them from their inventory. The result would be that the issuers of these bonds would face higher costs because there would be fewer investors and those investors would demand higher returns to compensate them for the lower liquidity. The investors would have lower liquidity because this rule, combined with the unworkable market maker provision, means that bank-affiliated broker dealers would not be able to buy the bonds into their inventory.

We believe that the proposed rule should be amended to allow all state and local government bonds, including those of agencies and instrumentalities to be exempt from the Volcker Rule. The provision in the proposed rule derives from a comparison of language in the Bank Holding Company Act with that of the Securities Exchange Act, which is broader. This technical reading should give way to the intent of Dodd-Frank and the agencies should use the authority granted to them by Dodd-Frank to expand the definition.

The proposed rule would also capture a common municipal financing vehicle called the Tender Option Bonds (TOB) because the trust arrangement integral to the TOB would be included in the definition of a "covered fund" just as a hedge fund. TOBs are common financing vehicles that allow state and local governments to issue debt at a reasonable interest rate. The bond is deposited in a trust and serves to provide the underlying credit for variable rate bonds which are sold to investors. Investors can, at specified intervals, put or tender the bonds. Because these trusts that hold the underlying bonds would be considered covered funds under the proposed rule, banks could no longer set up these trusts and would have to divest themselves of their existing interests. Because the underlying asset in the trust is a state or local bond, we believe that the TOB arrangement should be exempted from the definition of covered fund. TOB

arrangements are transparent, the trusts generally have bonds of a single issuer and there is no "tranching."

The result of these provisions in the proposed rule will be that investors will have less liquidity, issuers will have higher costs and the current network of middle market broker-dealers who have served those investors and issuers will face greater stress.

Finally, we note that the purpose of the Volcker Rule was to prevent banks from using Federally-insured deposits to engage in proprietary trading. However, the SEC has capitalization rules that apply to broker-dealers. Further, as mentioned above, the SEC, FINRA and the MSRB regulate how much can be earned on a trade. Consequently, in the case of broker-dealers, the risks that the Volcker Rule was meant to address are very small. On the other side, that small benefit is coupled with large costs, not only administrative costs to broker-dealers, but also harm to investors and issuers. A fair cost-benefit analysis of the proposed rule, especially as applied to fixed-income broker-dealers, would show that this proposed regulation is simply not worth the cost.

Business Roundtable

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January 17, 2012

The Hon. Scott Garrett
Chairman, Subcommittee on Capital Markets and Government-Sponsored Enterprises
House Financial Services Committee
Washington, DC 20515

The Hon. Maxine Waters
Ranking Member, Subcommittee on Capital Markets and Government-Sponsored Enterprises
House Financial Services Committee
Washington, DC 20515

The Hon. Shelley Moore Capito
Chairman, Subcommittee on Financial Institutions and Consumer Credit
House Financial Services Committee
Washington, DC 20515

The Hon. Carolyn Maloney
Ranking Member, Subcommittee on Financial Institutions and Consumer Credit
House Financial Services Committee
Washington, DC 20515

Dear Chairman Garrett, Chairwoman Capito, Ranking Member Waters and Ranking Member Maloney:

As an association of chief executive officers of leading U.S. companies that employ more than 14 million Americans and generate more than $6 trillion in annual revenues, Business Roundtable is committed to meaningful financial regulatory reform that safeguards market liquidity, ensures access to capital markets, and protects investors.

Business Roundtable is concerned that several provisions of the proposed rules to implement the Volcker Rule of the Dodd-Frank Act will undermine liquidity in the markets and hamstring companies seeking to raise capital. Any reform must ensure the preservation of functioning capital markets, which are the lifeblood of the American economy and drive economic growth and jobs creation. Our concerns are briefly outlined below.

In general, Business Roundtable does not support the needless restriction of market-making or underwriting activities. These services are required by U.S. companies that are accessing the capital markets to achieve growth. They are critical to ensuring that the markets for corporate bonds and other securities are liquid, which reduces the cost of capital, reduces transaction costs, and increases investor returns.

The Dodd-Frank Act exempts market-making and underwriting activities from the Volcker Rule because of the centrality of those activities to sound capital markets. Yet, in implementing those exemptions, the proposed administrative rules unduly restrict market-making and underwriting activities. For example, they permit only passive intermediation activities by market-makers and underwriters, even though in all but the most liquid markets market-makers must actively engage the markets to ascertain prices, anticipate customer demands, and facilitate transactions. One study estimates that the proposed rules' restrictions on market-making could cause immediate corporate bond value losses to investors of $90 to $300 billion, increased annual transaction costs to corporate bond investors of $1 to $4 billion, and increased corporate bond borrowing costs to companies of $43 billion annually. In total, these regulation-generated costs amount to $1000 per household each year.

In addition, Business Roundtable does not support the restriction of investments in entities that finance growing firms and innovative solutions to societal problems. Congress enacted the Dodd-Frank Act with the understanding that it would not be interpreted to restrict such investments. Yet, in implementing the Volcker Rule, regulators are proposing to needlessly restrict investments by companies in joint ventures, wholly-owned subsidiaries, and other similar funds—the very type of investment vehicles that Congress explicitly indicated should not be restricted by the Volcker Rule.

While Business Roundtable supports beneficial reforms of the U.S. financial regulatory system, America's business leaders are concerned that the proposed Volcker Rule would significantly reduce liquidity and beneficial investments in the capital markets, thereby harming the American economy at a sensitive time and potentially threatening the United States' role as a leading financial center. At bottom, this rule will impose tangible costs both in terms of job loss and economic growth. In contrast, any benefits to the complicated new regulatory structure are undefined and have not been quantified. It is hard to see why such a market-dampening new set of restrictions is needed, and no analysis appears to have been undertaken to determine whether a less onerous rule could achieve the risk-reduction sought by Congress in enacting the Volcker Rule provisions.

We look forward to working with you and your colleagues on the Committee to improve these rules and to help ensure meaningful reform that preserves market liquidity and encourages beneficial investments.

Sincerely,

John Engler

JE/lb

An Integrated Energy Company

Thomas J. Webb
Executive Vice President
and Chief Financial Officer

January 17, 2012

The Hon. Scott Garrett
Chairman, Subcommittee on Capital Markets
and Government-Sponsored Enterprises
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Washington, D.C. 20515

The Hon. Carolyn Maloney
Ranking Member, Subcommittee on Financial
Institutions and Consumer Credit
House Financial Services Committee
Washington, D.C. 20515

Dear Chairmen Garrett and Capito and Ranking Members Waters and Maloney:

I am writing in connection with the January 18, 2012 joint subcommittee hearing titled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation." We very much appreciate you holding this timely hearing. CMS Energy Corporation ("CMS Energy") and its wholly-owned subsidiary, EnerBank USA ("EnerBank") have several concerns with the Volcker Rule as proposed by the prudential banking regulators and the Securities and Exchange Commission, but we are focusing in this letter on one of particular importance to CMS Energy.

Our primary concern is the negative impact on CMS Energy's ability to retain and/or raise capital as a result of the potential inclusion of our investors in the definition of "banking entity" under the proposed rule. We believe an overbroad interpretation of the Volker Rule will have the unintended consequence of limiting access to capital and thus weakening, not strengthening, the banking system.

CMS Energy (NYSE: CMS) is a Fortune 500 company with a primary focus on its principal subsidiary, Consumers Energy, a combination electric and gas utility serving approximately 6.8 million of Michigan's 10 million residents. CMS Energy has roughly $16 billion in total assets and approximately $5 billion in shareowner market equity.

EnerBank is an FDIC-insured industrial bank based in Salt Lake City, Utah. EnerBank primarily makes unsecured home improvement loans nationwide marketed through referrals from unaffiliated home remodeling contractors and has approximately $500 million in total assets and approximately $50 million in stockholders' equity. While CMS Energy is, in relative terms, a small "banking entity" for purposes of the proposed new regulatory structure, it is a significant "source of strength" for EnerBank and could recapitalize EnerBank essentially overnight in the unlikely event such action were ever needed.

CMS Energy owns and controls EnerBank due to the industrial bank exemption in the Bank Holding Company Act ("BHCA"). The industrial bank exemption in our case has worked exactly as the sponsors intended. The exemption has allowed a non-bank company (CMS Energy) to capitalize and own an FDIC-insured bank (EnerBank) for the benefit of American consumers and businesses. During the recent financial crisis, while other banks and bank holding companies failed or scaled back their lending, EnerBank not only remained strong but grew significantly. This year, EnerBank will make more than $600 million in consumer loans to households nationwide for home-improvement projects. None of EnerBank's loans are refinancings and, therefore, all $600 million in loan proceeds will go directly toward home-improvement projects and, as a result, will support thousands of contractors and the manufacturers (many American) that provide materials for the jobs.

EnerBank does not engage in proprietary trading and it does not sponsor or invest in private equity funds. Thus, it presents no risk to the financial system. Likewise, CMS Energy engages in no material activities that the Volcker Rule would prohibit. Nonetheless, CMS Energy is a "banking entity" under the Rule, even though it is not a bank holding company due to the industrial bank exemption. This fact leads to a potentially significant problem for CMS Energy; namely, that the corporation itself *and its investors* (also potentially "banking entities" under the proposed rule) could be affected by the proposed Volcker Rule requirements, which highlights its overreach.

A "banking entity" under the proposed rule is any bank or company that "controls" a bank or is under common control. For purposes of an industrial bank holding company, "Control" incorporates the definition in the BHCA.[1] Regarding "control," the BHCA provides that a company "has control over a bank or over any company if—

(A) the company directly or indirectly or acting through one or more other persons, owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;

(B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or

(C) the [Federal Reserve] determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company."[2]

Notably, regarding subparagraph (C), the BHCA establishes "a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 per centum of any class of voting securities of a given bank or company does not have control over that bank or company."[3] For other bank regulatory purposes, control for an industrial bank is presumed to occur at 10%. Accordingly, prudential banking regulators could find "control" under the proposed Volcker Rule when a company owns as little as 10% or even 5% of another company. Thus, even a minority

1 12 U.S.C. § 1841(a)(2).
2 12 U.S.C. § 1841(a)(2).
3 12 U.S.C. § 1841(a)(3).

investor in CMS Energy with a fractional ownership interest could be found to be a "banking entity" subject to the Volcker Rule, even though, from the investor's perspective, it is a relatively small and passive owner of a publicly-traded utility.

Professional money managers and institutional investors such as retirement funds and mutual funds represent a significant percentage of CMS Energy's investor base. The prospect of becoming subject to the Rule, which would also prohibit some investment options, as yet not clearly defined, will become a disincentive to invest in CMS Energy and have the practical effect of driving capital away, which in turn would weaken both CMS Energy and EnerBank.

CMS Energy most often needs additional capital to upgrade power plants and support programs to increase energy efficiency and environmentally sound technologies. The Volker Rule was never intended to impact such programs; nor do such restrictions further any goals that the Dodd-Frank Act was intended to achieve. Indeed, the effect of restricting access to capital will undermine a primary goal of the Dodd-Frank Act, which is to extend the source of strength doctrine to all owners of insured banks.

As noted, the BHCA establishes a bright line test for "control" under the banking laws at 25% ownership of voting securities. We support that bright line test and believe that it should be adopted by the regulators to determine whether an investment in, or an investment by, a commercial owner of an insured depository institution should be subject to the requirements of the Volcker Rule. While we can appreciate the need for a more restrictive "controlling influence" test in other circumstances, if that vague test were applied in the context of the vague and market dampening proposed Volcker Rule, the result would be broad market uncertainly that would be bad for American business and the financial system, costing both jobs and economic growth.

Accordingly, we respectfully request that this Committee clarify that "control" under the proposed rule should be found only when bright-line threshold of 25% ownership of voting securities is exceeded.

We look forward to working with you and your colleagues on the Committee to ensure that the Volcker Rule implements meaningful reform that preserves market liquidity and encourages beneficial investments.

Best regards,

Thomas J. Webb
Executive Vice President
and Chief Financial Officer

For more information, contact Barbara Buell, Director of Communications, Stanford Graduate School of Business at buell_barbara@gsb.stanford.edu or (650) 723-1771

Stanford Finance Expert: Federal Interpretation of Volcker Rule Would Lead to Constraints on U.S. Economic Growth and Recovery

Finance professor Darrell Duffie of the Stanford Graduate School of Business proposes alternative capital requirements for banks to eliminate potential unintended consequences of financial reform

January 17, 2012

STANFORD, CA—When the Dodd-Frank financial regulations became law in 2010, the reforms were put in place to promote safety and soundness within the U.S. financial system and lower the risk of future financial crises. However, the government's interpretation of one of those reforms, "the Volcker Rule," could have unintended and adverse consequences for the U.S. economy, says Professor Darrell Duffie of the Stanford Graduate School of Business.

Duffie, the Dean Witter Distinguished Professor of Finance at Stanford, details these potential consequences and proposes an alternative solution in an analysis submitted January 17 to the responsible agencies. They include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission. The agencies are taking open comments from experts on the Volcker Rule until February 13. They will finalize their interpretations of the rule by July 12 when the Dodd-Frank reform legislation takes effect.

Duffie reveals a host of potential outcomes from the agencies' current regulatory interpretation, which would effectively reduce the quality and capacity of market-making services that banks now provide to U.S. investors by discouraging market makers from significantly increasing their risk levels in order to handle large imbalanced requests to buy and sell. This would limit an important source of liquidity for financial transactions and create less efficient markets and higher capital-raising and borrowing costs for homeowners and corporations. Duffie argues that it would also eventually lead to the migration of market making outside the banking sector, with potentially bad effects on financial stability.

"These consequences would potentially hurt economic growth at a time when we can least afford it," observes Duffie. "However, we're in a position now to make adjustments

in the agencies' interpretation of the Volcker Rule so as to allow effective market making while maintaining low systemic risk through high capital and liquidity requirements for banks engaged in these activities."

Market makers provide immediacy by selling assets to investors that wish to buy them, and buying assets from investors that want to sell. The agencies' proposed restrictions would substantially discourage market makers from doing so, except for trades with predictable risks and predictable profits from bid-ask spreads. The bigger or riskier trades requested by investors would often be shunned by market makers, leading to thinner markets and more price volatility.

Duffie warns that under the proposed rule interpretation, some banks may exit the market-making business altogether, while others may significantly reduce the amount of capital that they devote to market making. This would contribute to higher trade execution costs for investors; greater difficulty in obtaining liquidity; higher borrowing costs for corporations, homeowners, and governments; and higher costs of equity capital for firms issuing common shares.

Duffie suggests that non-bank providers of market-making services would fill some or all of the lost market-making capacity, with unpredictable impacts on financial stability. "These non-bank firms would be outside of the bank regulatory framework," says Duffie. "Our experience with non-bank broker-dealers in the last crisis was not a happy one. Further, Dodd-Frank does not allow individual non-bank market makers to access lender-of-last resort financing from the Federal Reserve," says Duffie. His report points to the relevance of lender-of-last-resort liquidity provided by the European Central Bank during the current Eurozone debt crisis.

As an alternative, Duffie recommends establishing rigorous capital and liquidity requirements for market makers, combined with effective supervisory monitoring, with the objective of ensuring that banks have abundant capital and liquidity to cover their market-making risks. These requirements should continue to be strengthened as deemed appropriate by regulators to robustly protect the Deposit Insurance Fund and the soundness of the financial system.

Duffie cites the work of Stanford Graduate School of Business finance colleagues Anat Admati, Peter DeMarzo, and Paul Pfleiderer in their paper with economist Martin Hellwig of Germany's Max Planck Institute, regarding why high capital requirements should not lead banks to cut back inefficiently on their provision of banking services.

After being approached to prepare an analysis of the Volcker Rule for the Securities Industry and Financial Markets Association (SIFMA), Duffie declined consulting fees in lieu of SIFMA's charitable contribution of $50,000 to the Michael J. Fox Foundation for Parkinson's Research.

Market Making Under the Proposed Volcker Rule

Darrell Duffie*
Stanford University

January 16, 2012

Abstract

This submission discusses implications for the quality and safety of financial markets of proposed rules implementing the market-making provisions of section 13 of the Bank Holding Company Act, commonly known as the "Volcker Rule." The proposed rules[1] have been described by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission. The Agencies' proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to U.S. investors. Investors and issuers of securities would find it more costly to borrow, raise capital, invest, hedge risks, and obtain liquidity for their existing positions. Eventually, non-bank providers of market-making services would fill some or all of the lost market making capacity, but with an unpredictable and potentially adverse impact on the safety and soundness of the financial system. These near-term and longer-run impacts should be considered carefully in the Agencies' cost-benefit analysis of their final proposed rule. Regulatory capital and liquidity requirements for market making are a more cost effective method of treating the associated systemic risks.

*Dean Witter Distinguished Professor of Finance, Graduate School of Business, Stanford University. This submission is also a report requested from the author by SIFMA. Rather than compensating the author, SIFMA will make a charitable contribution of $50,000 to the The Michael J. Fox Foundation for Parkinson's Research. For other potential conflicts of interest, see www.stanford.edu/~duffie/ I am pleased to acknowledge comments from Viral Acharya, Yakov Amihud, Markus Brunnermeier, Vincent de Martel, Peter DeMarzo, Peter Fisher, Michael Fleming, Andrew Lo, Gene Ludwig, Jeff Meli, Andrew Metrick, Lasse Heje Pedersen, Jacques Rolfo, Gabriel Rosenberg, Jeremy Stein, John Taylor, and Haoxiang Zhu. The opinions expressed here are entirely my own, and do not necessarily reflect the views of anyone else.

[1]See PROHIBITIONS AND RESTRICTIONS ON PROPRIETARY TRADING AND CERTAIN INTERESTS IN, AND RELATIONSHIPS WITH, HEDGE FUNDS AND PRIVATE EQUITY FUNDS, authored by Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Securities and Exchange Commission (SEC). Reference: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 12 CFR Part 248, Docket No. R-1432, RIN: 7100 AD 82. From this proposal document, I focus primarily on Questions 80, 81, 82, 83, 84, 87, 89, 92, 93, 96, and 97 posed by the Agencies.

1 Executive Summary

In a section of the Dodd-Frank Act commonly known as "the Volcker Rule," Congress banned proprietary trading by banks and their affiliates, but exempted proprietary trading that is related to market making, among other exemptions. Proprietary trading is the purchase and sale of financial instruments with the intent to profit from the difference between the purchase price and the sale price. Market making is proprietary trading that is designed to provide "immediacy" to investors. For example, an investor anxious to sell an asset relies on a market maker's standing ability to buy the asset for itself, immediately. Likewise, a investor who wishes to buy an asset often calls on a market maker to sell the asset out of its inventory. Market makers handle the majority of trading in government, municipal, and corporate bonds; over-the-counter derivatives; currencies; commodities; mortgage-related securities; currencies; and large blocks of equities. (The Volcker Rule exempts currencies, United States treasuries, federal agency bonds, as well as certain types of state and municipal bonds.) Most market making, both in the U.S. and abroad, is conducted by bank-affiliated broker-dealers.

Several federal agencies are now writing the specific rules by which they will implement the Volcker Rule, which comes into force in July, 2012. In particular, these agencies are charged with designing rules that implement the exemption for market making. I believe the restrictions on market making by banks in their proposed rules would have two major unintended consequences:

1. Over the years during which the financial industry adjusts to the Volcker Rule, investors would experience higher market execution costs and delays. Prices would be more volatile in the face of supply and demand shocks. This loss of market liquidity would also entail a loss of price discovery and higher costs of financing for homeowners, municipalities, and businesses.

2. The financial industry would eventually adjust through a significant migration of market making to the outside of the regulated bank sector. This would have unpredictable and potentially important adverse consequences for financial stability.

I will elaborate on these consequences and suggest an alternative approach, of using capital and liquidity requirements to conservatively buffer market-making risks. Market making risks, and other risks taken by a bank, are unsafe whenever they are large relative to the capital and liquidity of the bank.

2 Summary

This report discusses implications for the quality and safety of financial markets of proposed rules for market making by banks under section 13 of the Bank Holding Company Act, the "Volcker Rule." These rules have been proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (the "Agencies"). The Agencies' proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to investors. Investors and issuers of securities would find it more costly to borrow, raise capital, invest, hedge risks, and obtain liquidity for their existing positions. Eventually, non-bank providers of market-making services would fill some of the resulting void in market making capacity, but with an unpredictable impact on the safety and soundness of financial markets. I believe these near-term and long-run impacts should be considered carefully in the Agencies' cost-benefit analysis and final rule making.

Perhaps in light of these potential adverse consequences, Congress exempted proprietary trading related to market making and certain other client-oriented services from its proprietary trading restrictions on banks. The Agencies state that they have therefore "endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services." In my opinion, the proposed implementing rules would not succeed in this respect. I suggest instead rigorous capital and liquidity requirements for market makers, combined with effective supervisory monitoring, with the objective of ensuring that banks have abundant capital and liquidity to cover their market-making risks.

The Agencies' proposed implementation of the Volcker Rule seems to be written from the viewpoint that a trade involving significant risk of gain or loss, or taken with the objective of profiting from expected changes in market prices, is not consistent with bona fide market making. This is not the case. Market making is inherently a form of proprietary trading. A market maker acquires a position from a client at one price and then lays off the position over time at an uncertain average price. The goal is to "buy low, sell high." In order to accomplish this goal on average over many trades, with an acceptable level of risk for the expected profit, a market maker relies on its expectation of the future path of market prices. Future prices are uncertain because of unforeseen changes in economic fundamentals and market conditions. The length of time over which a position must be held is subject to the unpredictable timing and direction of client demands for immediacy. These risks vary significantly across time because of changes in market volatility and significant variation in the sizes of positions that market making clients may wish to acquire or liquidate. A market maker is also sometimes exposed to investors that are better informed than itself.

The greater the extent to which the proposed rule is successful at reducing market making risk, the more it will reduce the effective amount of market making services provided to clients. This would not benefit our financial system, relative to the alternative of capital requirements that force a market maker to safely absorb its own losses.

In order to provide significant immediacy to its customers, a market maker requires substantial discretion and incentives regarding the pricing, sizing, and timing of trades. It must also have wide latitude and incentives for initiating trades, rather than merely reacting to customer requests for quotes, in order to properly risk manage its positions or to prepare for anticipated customer demand or supply. Likewise, in order to efficiently provide liquidity to its clients, a market maker relies heavily on the option to buy and sell from other market makers.

While the Agencies accurately describe the relevance of these forms of market-making discretion and make some allowance for them, the criteria and metrics that are proposed would nevertheless substantially discourage the use of market making discretion. Banks would frequently find that meeting a client's demands for immediacy would be unattractively risky relative to the expected profit. In particular, a bank that continues to offer substantial market making capacity to its clients would face a risk of regulatory sanction (and the attendant stigma) due to significant and unpredictable time variation in the proposed metrics for risk and for profit associated with changes in market prices. Likewise, the norms that are likely to arise from the proposed regulatory metrics would discourage discretion by individual market making traders in the face of career concerns. A trader's incentives and discretion would also be dampened by the proposed approach to compensation.

Consequently, some banks may wish to exit the market making business. Alternatively, under the proposed rule, a bank could significantly reduce the amount of capital that it devotes to market making, merely offering this service within modest risk limits in order to cream-skim the easiest market-making opportunities. Having modest risk limits is inconsistent with the ability to provide substantial immediacy to clients.

The resulting increase in investors' execution costs and loss of market liquidity would also cause issuers of securities to be harmed by lower prices. The fact that the Volcker Rule exempts U.S. government securities is a recognition by Congress that it would harm the U.S. government as an issuer if it were to apply the Rule to its own debt issues. The Bank of Japan and Japanese Financial Services Agency have written[2] to the Agencies about their concern "that the proposed Restrictions would have an adverse impact on Japanese Government Bonds (JGBs) trading. They would raise the operational and transactional costs of trading

[2]See the letter of Masamichi Kono, Vice Commissioner for International Affairs Financial Services Agency, Government of Japan, and Kenzo Yamamoto, Executive Director Bank of Japan, dated December 28, 2011. The Canadian government has written to the Agencies with a related concern about the impact of the proposed restrictions on the liquidity of non-U.S. government bonds. See the letter of Julie Dickson, Superintendant, Office of the Superintendant of Financial Institutions, Government of Canada, December 28, 2011.

in JGBs and could lead to the exit from Tokyo of Japanese subsidiaries of US banks. Some of the Japanese banks might be forced to cease or dramatically reduce their US operations. Those reactions could further adversely affect liquidity and pricing of the JGBs. We could also see the same picture in sovereign bond markets worldwide at this critical juncture. We would appreciate your expanding the range of exempted securities substantially, to include JGBs." The Agencies' proposed restrictions would likewise adversely affect U.S. corporations and home buyers who, like the United States and foreign governments, benefit from liquid capital markets through lower interest expense. If investors anticipate a secondary market with higher execution costs and delays due to a lack of market making capacity, along with higher price volatility, then they will demand higher bond yields on new issues. The markets for U.S. corporate bonds and non-agency mortgage-related securities are particularly important examples of markets that would be harmed by the proposed rule. Corporations would likewise face a higher cost of capital due to lower liquidity in the secondary market for their common shares.

Although treasury, agency, and some types of municipal debt securities are exempted, the proposed rule would reduce the liquidity of markets for interest rate swaps and other derivatives used to hedge these securities. Thus, the rule could somewhat elevate government borrowing costs.

The proposed rule would also hamper efficient price discovery, lowering the quality of information about economic fundamentals that is revealed by markets. For example, during the financial crisis of 2007-2009, the reduced market making capacity of major dealer banks caused by their insufficient capital levels resulted in dramatic downward distortions in corporate bond prices.

In the long term, the proposed disincentives for market making by U.S. banks would probably lead to a significant migration of market making and investment activities. Some of these activities could move outside of the United States. Within the U.S., the proposed rule could spur the emergence of large non-bank broker dealers. For example, the proposed rule may lead some current banks whose business models depend heavily on market making to give up their banking charters. Given the difficulty of competing when subject to the proposed market making rules, other large banks could choose to spin off their market making businesses.

Some of the lost market-making capacity might be filled by existing non-bank firms such as hedge funds or insurance companies. Insurance firms might not, under the proposed rule, be significantly constrained in their effective market-making activities. Insurance firms fall under a system of regulatory transparency, capital, and liquidity requirements which is not designed to treat market making risk. Hedge funds have extremely limited regulatory oversight. Some market making could be replaced by a new form of brokerage conducted

by large asset-management firms. For example, an investor who wishes to enter or exit a position could notify the associated trading desk of a large asset-management firm. By a prior contractual arrangement with the clients of the asset-management firm, that trading desk could have been given the discretion to temporarily adjust the clients' portfolios within specified asset-allocation bands so as to accommodate the desired trade.

These outcomes seem inconsistent with congressional intent, and have unpredictable and potentially adverse consequences for the safety and soundness of our financial system. Leading up to the financial crisis of 2007-2009, the United States was unique in having several of the world's largest broker-dealers outside of its regulated banking sector. The failure of some of these and near failure of others dramatically exacerbated that crisis. By spurring a somewhat unpredictable transition to non-bank dealers, the proposed rule could reduce financial stability. This concern is reduced somewhat by the prospect that large non-bank dealers will be designated as systemically important by the Financial Stability Oversight Council. Access to the liquidity support of the central bank, however, is more cumbersome to arrange for non-banks, especially given the Dodd-Frank prohibition of emergency liquidity provision by the Federal Reserve to individual non-banks. Further, Basel III liquidity and capital requirements do not apply to non-bank broker dealers.

Thus, it is premature at best to assume that non-bank market makers will have regulatory supervision, access to liquidity, and capital and liquidity requirements that are as effective as those for regulated banks. The failure or sudden loss of capacity of a large broker dealer is at least as adverse for the economy as the failure of a similarly large financial institution devoted to conventional lending and deposit taking. I believe the costs and benefits of the potential migration of market making services to non-banks should be carefully considered by the Agencies before their rules are finalized.

The proposed rule would directly discourage the discretion of market makers to efficiently absorb significant risks from their clients through the provision of immediacy. As a consequence, the rule would also reduce the allocation of capital to market making businesses. These direct and indirect effects would increase trading costs for investors, reduce the resiliency of markets, reduce the quality of information revealed through security prices, and increase the interest expense and capital-raising costs of corporations, individuals, and others. These outcomes would lead to somewhat lower expected economic growth. The migration of a significant amount of market making outside of the regulated banking sector was not intended by Congress, would be likely under the proposed rule, and has potential adverse consequences for systemic risk.

This report is not a comprehensive analysis of the proposed rule. Rather, my objective is to focus on some key principles. I do not propose alternative metrics for detecting "risky market making." Although some forms of trading that clearly serve no market making intent

can be proscribed, an attempt to separate "legitimate and acceptable" market making from "speculative and risky" market making is not productive, in my opinion. The objective should be to ensure that market makers clearly have abundant capital and liquidity to cover the risks they take.

The next section of this report describes how and why market makers provide immediacy, and illustrates the adverse price distortions that can be caused by a limited supply of immediacy. In the following section, I discuss the impact of the proposed rules on the ability or incentives of market makers to provide immediacy, and the likely negative consequences. Finally, after a concluding section, I raise and respond to some questions that may be raised by this report.

3 The Provision of Immediacy by Market Makers

As opposed to a broker, who merely matches buyers and sellers, a market maker itself buys and sells assets, placing its own capital at risk. The service that it provides is "immediacy," the ability to immediately absorb a client's demand or supply of an asset into its own inventory. At any given point in time, the set of other investors who would in principle be prepared to bid competitively for the client's trade is not generally known or directly accessible to the client. The client could conduct an auction or a search for another suitable counterparty, but this takes time. Even if interested counterparties could be quickly identified, they would not necessarily have the infrastructure or balance-sheet capacity required to quickly take the client's trade. The client is therefore often willing to offer a price concession to a market maker in order to trade immediately rather than suffer a delay that exposes the client to price risk. If the client wishes to liquidate a position for cash, it may also have an opportunity cost for delayed access to the cash.[3]

If the asset is traded on an exchange, the client could obtain some degree of immediacy from the exchange limit-order book, but with an adverse price impact that is increasing in the client's trade amount. A market maker can often handle large "block" trades with lower price impact than an exchange. The vast majority of transactions in over-the-counter (OTC) markets are with a market maker. The OTC market covers essentially all trade in bonds (corporate, municipal, U.S. government, and foreign sovereign bonds), loans, mortgage related securities, currencies, and commodities, and about 60% of the outstanding notional amount of derivatives.

When a market maker serves a client's demand for immediacy its inventory often moves away from a desired target level. If the inventory is abnormally high or low, the market

[3]For a supporting theoretical model, see Duffie, Gârleanu, and Pedersen (2005). A client may also seek immediacy from a market maker in order to avoid a broader release of information about its positions or trading intentions, which could harm its average execution price.

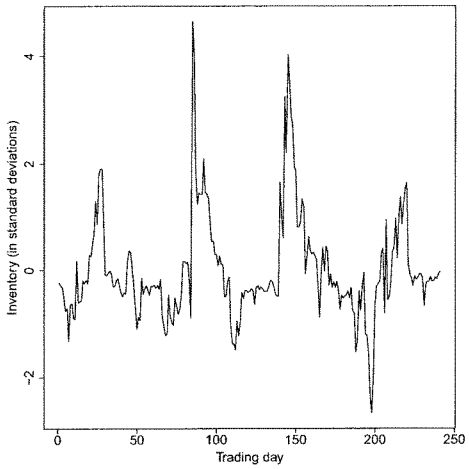

Figure 1: A plot of the inventory of the U.S.-dollar position of a block market making desk of a major broker-dealer for a single equity, Apple Inc., including effective positions implied by derivatives (on a "delta-equivalent" basis) and other effective exposures. The inventory levels are shown after scaling by the sample standard deviation of the dollar inventory levels for the sample period, a contiguous period of 2010-2011. Source: SIFMA-member data.

maker typically shifts its bid and ask quotes with the goal of moving its inventory back toward its target over time. The market maker may wish to accelerate the reduction of an inventory imbalance, lowering its risk, by requesting trades from others, including other market makers. Inventory risk management includes hedging with related financial instruments. In the meantime, the market maker continues to absorb supply and demand shocks from its clients. The general objective is to buy low and sell high, balancing the risk of loss against expected profit.

Demands for immediacy by customers can vary from moderate to extremely large, as illustrated in Figures 1 and 2, which were prepared by a major broker-dealer at the request of the author for the purpose of this report, based on the actual daily U.S.-dollar inventory[4] of common shares of Apple Incorporated held by that broker-dealer during a contiguous period of 2010-2011. Figure 1 shows the daily inventory[5] in units of sample standard deviations. Figure 2 is a frequency plot of unexpected shocks to inventory, showing the number of

[4]Derivatives are included on a "delta-equivalent" basis.

[5]The inventories shown include the effect of derivatives (on a "delta-equivalent" basis) and other effective exposures.

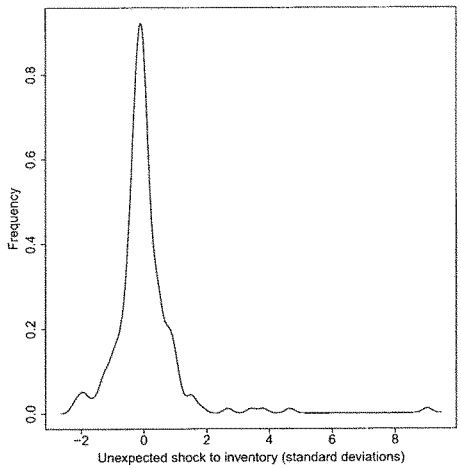

Figure 2: A frequency plot of unexpected shocks to the U.S.-dollar position of a block market making desk in the common shares of Apple Inc., including effective positions implied by derivatives and other effective exposures, based on the data shown in Figure 1. The shocks are scaled by their sample standard deviation. Source: SIFMA-member data.

standard deviations by which the inventory changed unexpectedly from one day to the next. These "shocks" are estimated using a simple statistical model,[6] which indicates that the market maker's inventory of this security is expected to revert approximately 20% of the way toward normal each day.[7] This implies a roughly 3-day "expected half-life" of inventory imbalances. Across other individual equities handled by the same market maker, the same statistical analysis shows that the expected half life of inventory imbalances is greatest for those equities with the highest bid-ask spreads and the lowest trading volume, as one would expect for a provider of immediacy.

Most market making done by large banks involves substantial granularity in both trade frequency and trade size. Particularly in fixed-income markets, trades are widely and unpredictably spaced in time, and sometimes are effectively "by appointment." For example, research by Goldstein, Hotchkiss, and Sirri (2007), Bao, Pan, and Wang (2011), and Chen,

[6]The autoregressive model $X_{t+1} = a + bX_t + Z_t$ was fit to the time series of inventory X_t on each trading day t during the sample period. The "persistence parameter" b is estimated at 0.80, with a standard error of 0.04. Figure 2 is a density plot of estimates of the "inventory surprise" Z_t, using kernel smoothing with a band width of 0.146. The Appendix provides a "QQ" plot of the quantiles of these shocks, more clearly indicating the "fat tails."

[7]Evidence of the targeting of inventory by market makers is abundant, beginning with the work of Amihud and Mendelson (1980).

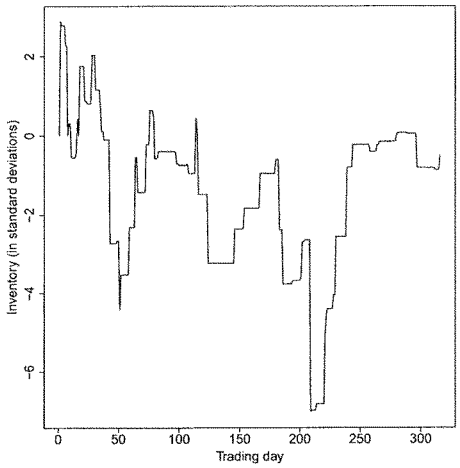

Figure 3: A plot of the inventory of the U.S.-dollar position of a market making desk of a major broker-dealer for a single investment-grade corporate bond. The inventory levels are shown after scaling by an estimate of the sample standard deviation of the dollar inventory levels for the sample period, a contiguous period of 2010-2011. Source: SIFMA-member data.

Fleming, Jackson, Li, and Sarkar (2011) shows that trades in individual U.S. corporate bonds or individual corporate credit default swaps typically occur a few times per day at most, in total across the entire market.[8]

Figure 3 shows the market making position in a particular investment-grade corporate bond for the broker-dealer that provided the data for Figure 1. During the illustrated time period, the market maker facilitated significant client sales that caused the market maker's inventory to become negative (that is, the market maker was "short"). As illustrated, the market maker targeted reductions in the resulting inventory imbalances between these client-sale events, subject to the constraints of illiquidity and continuing to provide immediacy. Because demands for immediacy in individual corporate bonds are sparsely spaced in time, as illustrated by the "step-like" inventory path shown in Figure 3, and because of the rel-

[8]For the sample of BBB-rated corporate bonds studied by Goldstein, Hotchkiss, and Sirri (2007), the fraction of days on which a given bond was traded was 26.9%, on average across bonds. The sample of more actively traded bonds studied by Bao, Pan, and Wang (2011) were traded on average 174 times per month, in total across all market makers. For the credit default swap study of Chen, Fleming, Jackson, Li, and Sarkar (2011), "The 48 actively traded corporate reference entities traded an average of 10 times daily, with the top reference entity trading an average of 22 times per day. Less actively traded reference entities traded on average 4 times daily and infrequently traded reference entities traded on average less than once per day. The actively traded sovereign reference entities traded on average 30 times daily; less actively traded sovereigns traded on average 15 times per day and infrequently traded sovereign contracts traded an average of 2 times daily."

ative illiquidity of the corporate bond market in other respects, the expected half life of inventory imbalances in a corporate bond is typically much longer than those for equities. For the illustrated corporate bond, the expected half life of inventory shocks is estimated at approximately two weeks, which is typical of the cross section of investment-grade corporate bonds handled by this broker-dealer.[9]

In general, a market maker's target inventory level and preferred rate of reversion of inventory levels toward the target vary with the asset type, current market conditions, and the level of capital that the market maker currently allocates to the associated trading desk. Whenever the market maker has limited capacity to warehouse risk on its balance sheet, its target inventory level is low, and it avoids requests for immediacy from clients that would move its inventory far from the target inventory level. The lower is the market maker's tolerance for risk, the less capacity it has to absorb supply and demand imbalances from the market, and the more it may demand immediacy for itself from other investors. Given the size and volatility of modern financial markets, market liquidity relies on the presence of highly capitalized market makers.

In compensation for bearing the risk that it will suffer a loss on its inventory due to unforeseen changes in fundamental or market conditions, or due to trades with a particularly well informed client, a market maker requires an expected return. Absent this compensation, it would be irrational for the market maker to supply immediacy to the client. The greater the inventory risk relative to the capital or risk limits allocated to the market making desk, the greater is the required expected return, other things equal.[10] A market maker's bids and offers apply to trade sizes up to a moderate and conventional "round-lot" amount, which varies by asset type. For clients who wish to trade a larger amount, a price and quantity negotiation is likely to result in a trade for an amount less than that desired by the client, or a larger price concession to the market maker for taking additional risk, or no trade. Even moderate-sized trades may require a larger-than-normal expected return to the market maker if they threaten to increase an imbalance in inventory that is already close to the market maker's risk limit for the asset type or broader asset class.

Because an astute market making trader is aware of changes in market conditions, he or she can often anticipate periods of time over which an imbalance in the demand for immediacy on one side of the market is likely to present an opportunity to profit by allowing inventory to diverge significantly from normal. The imbalance is later reduced over time through trades at prices that are expected to result in a net profit. This positioning of

[9]The estimated persistence coefficient of the autoregressive (AR1) model applied to weekly inventory data for the illustrated corporate bond is 0.73. The median of the weekly inventory persistence coefficients across all investment-grade corporate bonds in the firm's sample is 0.75. When estimated on a daily basis, the sample median of the estimated persistence coefficients is 0.938, which corresponds to roughly the same effective half life in weeks (because 0.938^5 is approximately 0.73).

[10]For supporting empirical evidence on the determination of federal fund loan rates, see Chapter 2 of Duffie (2012), based on research conducted for Ashcraft and Duffie (2007).

inventory to profit from expected changes in market prices is an essential aspect of market making that improves market liquidity and benefits market participants, as supported by considerable theoretical and empirical research.[11] If market makers were to refrain from absorbing supply and demand imbalances into their inventory in anticipation of likely price improvements, the price impacts suffered by those seeking immediacy would be deeper, and the corresponding distortions in prices would be larger and more persistent. Brunnermeier and Pedersen (2009) consider the adverse consequences on market liquidity of tightening a market maker's inventory risk limit. As Comerton-Forde, Hendershott, Jones, Moulton, and Seasholes (2010) explain and support with empirical evidence, "market makers face short-run limits on the amount of risk they can bear. As their inventory positions grow larger (in either direction, long or short), market makers become increasingly hesitant to take on more inventory, and quote accordingly. Similarly, losses from trading reduce market makers equity capital. If leverage ratios remain relatively constant, as suggested by the evidence in Adrian and Shin (2007), market makers' position limits decrease proportionately, which should similarly reduce market makers' willingness to provide liquidity."

Some of the supply and demand shocks absorbed by market makers are idiosyncratic, tied to investor-specific trading motives. Other supply or demand shocks are more episodic, related to market-wide events. As a motivating example, Figure 4 illustrates the average price impact of deletions of equities from the S&P 500 stock index, and the associated average price reversal over time. These deletions occur when the list of firms comprising the S&P500 index is adjusted. The underlying data, provided to me by Professor Jeremy Graveline, cover the period from December 1990 through July 2002, and include 61 such deletions. At these events, index-tracking investors are effectively forced to immediately sell large blocks of the deleted equities. Suppliers of liquidity including market makers were therefore offered substantial price concessions for absorbing the supply shocks into their own inventories of the equity. They hoped to subsequently profit by laying off their positions over time at higher prices.[12] While the illustrated average path of recovery in prices after

[11] Grossman and Miller (1988) provide a seminal model. Subsequent theoretical foundations have been provided by Weill (2007), Gromb and Vayanos (2002), He and Krishnamurthy (2009), Gromb and Vayanos (2010), Lagos, Rocheteau, and Weill (2009), Rinne and Suominen (2009), Brunnermeier and Pedersen (2009), and Duffie (2010a). Nagel (2009), Lou (2009), Rinne and Suominen (2010), and Bao, Pan, and Wang (2011) offer supporting evidence of return reversals due to price pressure. A wealth of empirical evidence of price surges and return reversals caused by specialist inventory imbalances has been provided by Andrade, Chang, and Seasholes (2005), Comerton-Forde, Hendershott, Jones, Moulton, and Seasholes (2010), Hendershott and Seasholes (2007), and Hendershott and Menkveld (2009).

[12] As reported by Chen, Noronha, and Singhal (2004) for a similar data set, deleted stocks suffered a loss of approximately 8% on the deletion announcement date and an additional loss of 6% between the announcement date and the effective deletion date. Quoting from Chen, Noronha, and Singhal (2004), who cite several studies that further support this remarkable price impact and reversal, "The negative effect of deletions disappears completely 60 days after the effective date. The cumulative abnormal return from announcement to 60 days after the effective date is not significantly negative, and always economically small." Related studies of price impacts and recoveries associated with index recompositions, including both debt and equity indices, include those of Shleifer (1986), Harris and Gurel (1986), Madhavan (2001), Greenwood (2005), Mitchell, Pulvino, and Stafford (2002), Wurgler and Zhuravskaya (2002), Kaul, Mehrotra, and Morck (2000), Chen, Lookman, Schürhoff, and Seppi (2009), and Feldhütter (2009). Petajisto (2009) provides a model in which the pressure is borne by intermediaries, and applies his model to explain the empirical evidence on index deletions.

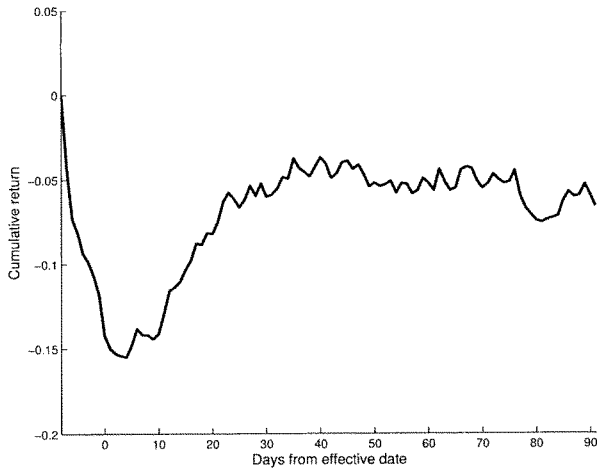

Figure 4: Average cumulative returns for deleted S&P 500 stocks, 1990-2002. The average number of days between the announcement and effective deletion dates is 7.56. The passage of time from announcement to deletion for each equity is re-scaled to 8 days before averaging the cumulative returns during this period across the equities. The original data provided by Jeremy Graveline were augmented by Haoxiang Zhu. Source: Duffie (2010a).

deletions represents a significant enticement to providers of immediacy on average, there was nevertheless substantial uncertainty regarding the profitability of supplying liquidity at any particular deletion event. Were market makers to stand back from the opportunity to offer immediacy to investors anxious to unload large quantities of the affected equity, the initial price impact of the supply shock would be greater and the time period over which the price distortion is expected to persist would be greater.[13]

As investors learn over time about trading opportunities presented by a specific type of supply shock such as an index recomposition, asset-management practices adjust and tend to reduce the cost of large demands for immediacy. The role of liquidity provision by market makers in the face of the particular type of supply or demand shock then declines. New forms of demand and supply shocks emerge, however, from changes in the institutional structure of markets and the macroeconomy, for which market makers are once again at the front line of liquidity provision. This is especially true in bond and OTC derivatives markets, where essentially all demands for immediacy are served by market makers.

As motivated by the last example, once a market maker has absorbed part of a large supply

[13]Duffie (2010a) provides a model of the impact on the expected price impact of a supply shock and the subsequent time pattern of price distortions associated, including the effect of reducing the risk tolerance or quantity of providers of immediacy.

shock into its inventory, it begins to lay off its position to other investors over time at higher anticipated prices. (The case of a demand shock is symmetric.) Immediacy-seeking investors will trade at the market maker's ask price. For these trades, the market maker hopes to profit from both the bid-ask spread and also from the expected recovery in price from the time at which the market maker first expanded its inventory. The price is expected to increase during this period because of the diminishing overhang of inventories held by suppliers of immediacy. The market maker may at the same time seek immediacy from other investors, including other market makers, in order to reduce its inventory in a prudently rapid manner. When it seeks immediacy from others to lower its excess inventory, the market maker expects to profit from any price recovery since the original supply shock, *less* the effective spread that it pays to its counterparties. A more passive approach of waiting to reduce its inventory over time exclusively through trades initiated by clients would expose the market maker to the additional risk associated with a more prolonged exposure to unexpected changes in price.

The incentive of a market maker to provide immediacy is increasing in the expected profit associated with *both* anticipated changes in market prices and from the net effect of bid-ask spreads (received net of paid).

As another illustration, Figure 5, from Kulak (2008), shows the average pattern of equity prices around the time of seasoned equity offerings. In this case, anticipation of the announced supply shock causes the price to decline, on average, as the issuance date approaches. During this period, market makers and other providers of liquidity generally wish to reduce their inventory below a normal target level in order to "make space" on their balance sheets for the anticipated new supply. Once suppliers of immediacy have absorbed the supply shock at a relatively deep average price concession, they lay off their inventory over time to other investors at an expected profit. The longer they are willing to hold inventory, the greater the expected profit, accompanied of course by an extended exposure to loss associated with unexpected fundamental news.[14] Market makers and underwriters are among the most important providers of liquidity.

Figure 6, provided to the author by Professor Honjun Yan, shows the impact of U.S. Treasury note auctions on the associated treasury yields. Note yields go up as the date of the anticipated new supply of treasuries approaches, and then recover in subsequent days. Fleming and Rosenberg (2007) show that Treasury dealers adjust their positions to absorb these issuance supply shocks. They describe how "dealers seem to be compensated for the risks associated with these inventory changes via price appreciation the subsequent week." The figure shows that the auction supply temporarily raises not only the yields of the security issued, but also those of the previously issued ("off the run") treasuries of the same maturity

[14] That secondary offerings are made at substantial price concessions has been documented by Mikkelson and Partch (1985). At least as early as the work of Scholes (1972), researchers have focused on the presence of temporary price impacts at secondary equity issuances. Additional empirical evidence is offered by Loughran and Ritter (1995), Chaisurote (2008), and Gao and Ritter (2010).

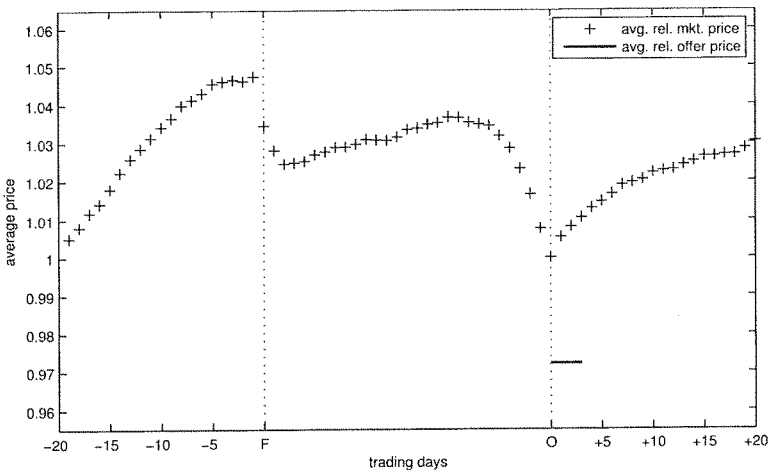

Figure 5: Average price dynamics around seasoned equity offerings. The figure, kindly supplied to the author by Jan Peter Kulak, covers 3850 U.S. industrial firms that undertook a firm-commitment public seasoned offering in the United States between 1986 and 2007. The plotted line shows the average across issuances of the ratio of secondary market price of the equity to the closing price of the equity on the offering date. Because offerings differ in the number of trading days between the filing announcement and the offering date, the times between filing and offering date are rescaled interpolated to the average across the sample of the number of trading days between the filing and the issuance date. Source: Kulak (2008), published in Duffie (2010a).

class, because their returns are highly correlated with those of the issued note. Although treasury securities are exempted from the proposed rule, the same principles apply to other markets, to an even greater degree given the high liquidity of treasury markets relative to other security markets.

For example, Figure 7, from Newman and Rierson (2003), shows the expected pattern of yield impacts around the time of a large corporate bond issuance. In this example, the illustrated impact is for corporate bonds of firms *other than the issuer*, that are in the same industry as the issuer, the European telecom industry. When a company in this sector scheduled a significant issuance of bonds during the period 1999-2001, the entire related market for European telecom bonds suffered from higher bond yields. The figure shows the estimated path of yield impacts on European telecom bonds, not including those of the issuer, Deutsche Telekom, associated with a particular 16-billion-Euro issuance. As for the case of treasury note issuances, yields increased as the issuance date approached, and then recovered toward normal. The degree to which the yields of corporate bonds are adversely affected

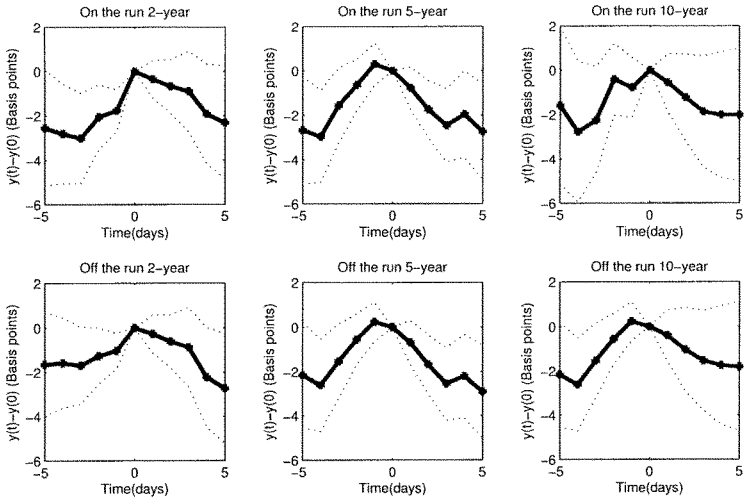

Figure 6: Yield elevation at the issuance of U.S. Treasuries, with 95% "confidence" bands. The figure, kindly provided to the author by Professor Honjun Yan, covers U.S. Treasury issuances from January 1980 to March 2008. Yields are based on averages of bid and ask prices obtained from CRSP. Auction dates are from the U.S. Treasury Department. The sample includes 332 2-year note auctions, 210 5-year note auctions, and 132 10-year note auctions. For each maturity, the differences between the yield on the issuance date and the yield on dates within 5 days of the issuance date are averaged across issuances, for both on-the-run and off-the-run notes. Source: Honjun Yan, published in Duffie (2010a).

by issuance shocks is greater than that for treasuries because the liquidity of the corporate bond market is lower by comparison, and because corporate bonds are riskier than treasuries, exposing suppliers of immediacy to greater inventory risk. If market makers were to lower their risk limits, or have inflexible risk limits in the face of market-wide supply shocks, the yield impacts of these and other supply shocks would be deeper and more persistent.[15]

Figure 8 illustrates the concept that, particularly in an over-the-counter market, the provision of immediacy is facilitated by a network of market makers and inter-dealer brokers. A market maker is able to provide immediacy more efficiently (at lower cost to clients and at lower risk to itself), through the opportunity to lay off positions with other market makers,

[15] Chen, Lookman, Schürhoff, and Seppi (2009) document the impact on the yields of corporate bonds in the automotive sector caused by the downgrade of General Motors in 2005. Because some institutional investors in corporate bonds are required to hold only investment-grade bonds, the prospect of a downgrade caused forced sales. Chen, Lookman, Schürhoff, and Seppi (2009) are able to demonstrate the impact of this supply shock, above and beyond the implications of the information related to the downgrade.

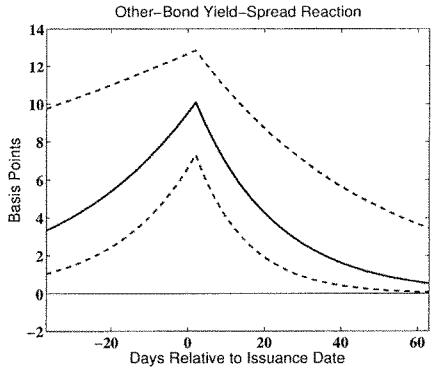

Figure 7: Capital immobility in the telecom debt market. The estimated impacts on the yields of European Telekom issuers, not including Deutsche Telekom, associated with a particular 16-billion-Euro issuance by Deutsche Telekom, using an econometric method explained by Newman and Rierson (2003). Source: Newman and Rierson (2003), published in Duffie (2010a).

who may be better aware of ultimate investors who are interested in trading in the opposite direction. This intermediation of immediacy occurs through direct dealer-to-dealer trades, or indirectly through inter-dealer brokers. Because of search and contracting frictions as well as the benefit of confidentiality in reducing price impacts for large trades, it is often inefficient for client investors to negotiate simultaneously and directly with a large number of market makers. It is even more costly for ultimate investors to conduct large trades, or trades in illiquid products, directly with ultimate investors. Instead, investors may request quotes from one or a subset of market makers.[16] These contacts can lead to a trade with a particular market maker, who may then wish to rebalance its inventory relatively quickly through the inter-dealer network. This is often more efficient for the market maker than requesting immediacy from another ultimate investor, or waiting for an ultimate investor who might wish to trade in the opposite direction. In effect, the inter-dealer network acts as a broader mechanism for transmitting supply and demand shocks from ultimate investors to ultimate investors.[17] Bech and Garratt (2003) provide strong evidence of the inter-dealer network effect in re-distributing supply and demand shocks in the federal funds market.

[16] Large institutional investors can initiate "requests for quotes" or "dealer runs," sometimes through swap execution facilities (SEFs). The cost of a sequential search, one market maker at a time, is analyzed by Zhu (2012).

[17] Concerns over the transparency and competitiveness of OTC markets remain, and have been partially addressed by recent requirements for price transparency in corporate bond markets, and by the Dodd-Frank requirements for transactions disclosure and the use of swap execution facilities in the standardized OTC derivatives market.

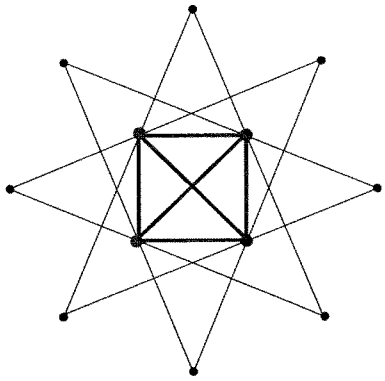

Figure 8: A schematic of an over-the-counter market with a "core" inter-dealer market in which market makers and inter-dealer brokers act as a network that collectively provides immediacy to ultimate investors.

4 Impact of the Proposed Rule on Investors and Issuers

The proposed rule would discourage the provision of immediacy by market makers, particularly through the threat of sanctions for significant increases in market making risk or for significant profits caused by price changes (as opposed to profits associated with a bid-ask spread revenues).

At page 94, the Agencies write that "Market making and related activities seek to generate profitability primarily by generating fees, commissions, spreads and other forms of customer revenue that are relatively, though not completely, insensitive to market fluctuations and generally result in a high level of revenue relative to risk over an appropriate time frame." This statement does not accurately characterize market making. The Agencies' explanation of their proposed rules clearly indicates the intention to use the various proposed risk and profit metrics to restrict market making activities to those consistent with this definition. For example, at page 94, immediately before this characterization of market making, one reads: "The Agencies expect that these realized-risk and revenue-relative-to-realized-risk measurements would provide information useful in assessing whether trading activities are producing revenues that are consistent, in terms of the degree of risk that is being assumed, with typical market making related activities." At page 92, the Agencies suggest they will use the proposed risk metrics to "to determine whether these activities involve prohibited proprietary trading because the trading activity either is inconsistent with permitted market making-related activities or presents a material exposure to high-risk assets or high-risk

trading strategies." At page 93: "Significant, abrupt or inconsistent changes to key risk management measures, such as VaR, that are inconsistent with prior experience, the experience of similarly situated trading units and managements stated expectations for such measures may indicate impermissible proprietary trading."

Were this approach to be reflected in the Agencies' final rule, the intent of Congress to exempt market making by banks would be thwarted and U.S. financial market liquidity would suffer, with the adverse consequences outlined in Section 2 of this report.

Under the proposed implementing rules, market makers would retain the ability and incentive to absorb only moderately sized demands for immediacy. It is precisely through their ability to service heightened demands for immediacy, however, that market makers mitigate the most significant associated price distortions and execution costs to investors. The ability of market makers to buffer unexpectedly large supply and demand imbalances depends on significant and flexible market making capacity and on the incentive to profit from expected price changes. Were the proposed rule to be implemented, market makers who absorb large demand and supply shocks into their inventories would experience a "deterioration" in the proposed metrics for their market-making risk, and the associated threat of regulatory sanction. They would also be less inclined to absorb the associated risks given the likely sanctions for significant profits from price changes. Further, under the proposed rules for trader compensation, market making traders would have significantly lower incentives to accept trades involving significant increases in risk or profit.

Under the proposed rule, imbalances in the demand or supply of immediacy would therefore cause larger and more persistent distortions in market prices. Price discovery would suffer. Home owners, businesses, and some municipalities would face higher borrowing costs. Firms would face higher costs for raising new capital. These increased costs would occur directly in the form of higher price impacts at the point of financing, and indirectly from the lower appetite of investors to own securities that would trade in thinner and more volatile secondary markets.

In addition to the research that I have already cited, there is significant empirical evidence that a limited risk-taking capacity of marker makers leads to price distortions.[18] As a relatively extreme but illustrative example, Mitchell and Pulvino (2009) describe a dramatic distortion in corporate bond yields that arose during the financial crisis due to an insufficient risk-taking capacity of market makers. As shown in Figure 9, corporate bond yields were elevated well above those implied by credit default swap (CDS) rates.[19] The difference

[18]For example, Meli (2004) found evidence that changes in dealer capital are strongly related to changes in swap spreads (the difference between swap rates and treasury rates). Etula (2009) describes how variation over time in broker-dealer assets is significantly correlated with crude oil returns. Further evidence on the relationship between dealer risk-bearing capacity and distortions in risk premia is provided by Adrian, Etula, and Shin (2009) and Adrian, Moench, and Shin (2011).

[19]In a frictionless market, the CDS rate is, within a small tolerance for technical contract differences, equal to the yield spread on a par bond of the maturity of the CDS of the same issuer, that is, the bond yield less the associated risk-free yield. If, for example, the basis for a particular corporate bond becomes negative, as illustrated in Figure 9, one could short a risk-free

between the CDS-implied bond yield and the actual bond yield is known as the "basis." The exceptional CDS basis violations that appeared during the financial crisis across broad portfolios of investment-grade and high-yield bonds were due to the extremely low levels of capital of dealer banks.[20] Investment-grade corporations issuing bonds in late 2008 and early 2009 had to pay roughly 2% higher interest rates due to this market inefficiency. For lower rated firms, as illustrated, the distortion in borrowing rates would have been far greater, for any that actually attempted to issue bonds during this period. As large dealers regained some balance-sheet capacity, the CDS basis went back toward normal, as illustrated.

Musto, Nini, and Schwarz (2011) show that even U.S. treasury prices were severely distorted at the height of the financial crisis through a loss of market liquidity. Particularly around December 2008, portfolios of treasuries promising equivalent cash flows were often trading at substantial price differences. The cornerstone of treasury market liquidity is the market making desks of primary dealers. Although U.S. treasuries are exempted from the Volcker Rule, many important classes of securities, that already trade in less liquid markets than those for U.S. treasuries, will be affected. As mentioned in Section 2, foreign governments have asked that their bonds also be exempted.

The incentive and discretion to supply immediacy by taking extra risk in light of extra expected profit is also important at the level of an individual trader on a market-making desk. The proposed rule world lead the compensation of market-making traders to be more like that of flow-based brokerage agents. Coupled with the reputational risk of exceeding likely regulatory norms for "low-risk market making" that would arise from the proposed metrics, a market making trader would often avoid taking the discretion needed to meet a customer's demand for immediacy. Under the proposed rule, a trader would frequently fail to offer two-sided markets for significant quantities at efficient prices. For example, the proposed rule would encourage a trader faced with the extra risk of taking a large position to quote prices for only a limited fraction of the customer's desired amount. When the efficient approach to a trade enquiry with extra risk is a widening of the bid-ask spread, especially when facing a well informed client, the proposed metrics would discourage the trader from taking the position at all, or encourage the trader to take the position at a small expected profit relative to the risk of loss, out of fear of drawing attention to himself or herself over trades that adversely affect the regulatory metrics of the proposed rule. Indeed, one of the

bond, invest the proceeds in the corporate bond, and buy default protection on the corporate bond with a credit default swap. Putting aside some technical issues and ignoring counterparty risk, the net income of this strategy per year, at no net initial investment, is the principal debt position multiplied by the absolute magnitude of the basis. If the basis becomes negative, the opposite trade is likewise highly profitable, although holding a short position in corporate bonds is somewhat cumbersome and can involve extra costs or risks. Institutional details can cause the basis to diverge somewhat from zero. See Duffie (1999). The CDS basis can also be elevated by counterparty risk, although this effect is tiny by comparison with the basis shown in Figure9.

[20] Exploiting the CDS basis "arbitrage" calls for a substantial amount of balance-sheet capacity at dealer banks, both to make markets in the underlying bond (which calls for finding or holding the underlying bonds) and to handle two CDS counterparty positions, one with the arbitrageur and one with a counterparty taking the opposite position. Exacerbating the capital shortage of dealers, the amount of capital necessary to hold corporate bonds increased because of an increase in the "haircut" applied to finance corporate bonds in the repo markets, as explained by Mitchell and Pulvino (2009).

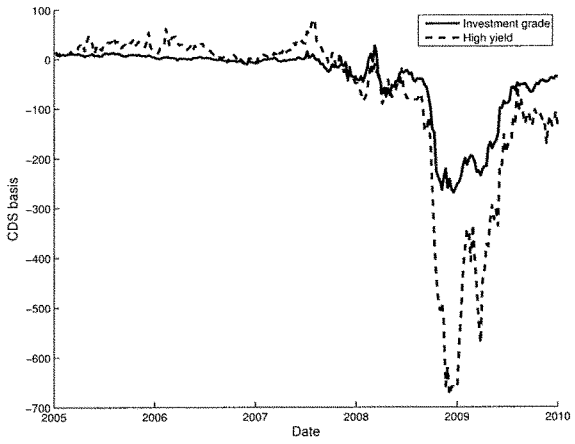

Figure 9: Average basis of U.S. corporate bond portfolios. The CDS basis for a given bond is the difference between the yield spread of a bond that is implied by the associated credit default swap (CDS) rate and the actual bond yield spread. The CDS basis is near zero in frictionless markets. As shown, the average CDS basis across portfolios of U.S. investment-grade bonds and high-yield bonds widened dramatically during the financial crisis and then narrowed as the crisis subsided. The underlying data, kindly provided to the author by Mark Mitchell and Todd Pulvino, cover an average of 484 investment-grades issuers per week and 208 high-yield issuers per week. Source: Mitchell and Pulvino (2010)., published in Duffie (2010a).

proposed metrics seems to suggest that trades should not be unduly profitable, relative to what they would be at historically normal bid-ask spreads. In the event that a trade turns out to be "overly profitable" because of an unexpectedly favorable price change, would a trader then have an incentive to incur an offsetting loss in order to avoid scrutiny? Similarly, in the face of a likely market-wide imbalance of supply or demand, a market making trader should have the discretion and incentive to significantly reposition his or her firm's inventory in order to absorb some of the supply imbalances. The proposed rule, including its compensation norms, would reduce the trader's discretion and incentive to do so, exacerbating the adverse consequences that I have described.

A trader's incentives for undue risk taking can be held in check by vesting incentive-based compensation over a substantial period of time. Pending compensation can thus be forfeited if a trader's negligence causes substantial losses or if his or her employer fails. The pool of pending compensation is thus effectively contributing to the capital of the firm, consistent with a recommendation of the Squam Lake Group.[21]

[21] See *The Squam Lake Report: Fixing the Financial System*, Princeton University Press, 2010. I am one of 15 authors.

5 Concluding Remarks

Section 13 of BHC Act (Section 619 of the Dodd-Frank Act) exempts market making from its proprietary trading restrictions on banks "to the extent that any such activities permitted by this subparagraph [including "market making related activities"] are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." From the viewpoint of impact on market participants, including ultimate investors and those seeking to raise capital and finance themselves, I believe the Agencies' interpretation of this language is overly narrow and would cause undue costs to the economy. The Agencies did not provide a cost-benefit analysis that suggests otherwise. The potential for systemic risk and costs to the Deposit Insurance Fund associated with market making by banks can be treated more effectively through regulatory capital and liquidity requirements. In any case, if implemented, the proposed rule could inadvertently *increase* systemic risk because of a migration of market making activities to outside of the regulated banking sector, as I have outlined in Section 2.

Capital and liquidity requirements are a more direct and effective means of handling the legislated exemption for market making. The proposed restrictions on market making instead attempt to identify and eliminate specific patterns of trading. This attempt to disentangle those trades that have market making intent from those that do not is likely to be effective only in reducing the capacity of market making services provided by banks. Capital and liquidity requirements directly consider the soundness of a financial institution and its potential for causing systemic risk and costs to the Deposit Insurance Fund. In the case of market making, capital requirements treat risk on a portfolio-wide basis, an appropriate approach.

Leading up to the financial crisis of 2007-2009, the regulatory capital and liquidity requirements of financial institutions were clearly insufficient. These requirements should continue to be strengthened as deemed appropriate by regulators to robustly protect the Deposit Insurance Fund and the soundness of the financial system. An alternative to heightened capital and liquidity requirements could be some form of "ring-fencing" requirement that allows separately capitalized bankruptcy-remote market-making affiliates, an approach under adoption in the United Kingdom. This approach is significantly less efficient from the perspective of risk diversification, although generally consistent with the primary legislative motive of insulating banks from proprietary trading risks. In any case, whether market making is conducted by banks or others, market makers should be required to meet robust capital and liquidity requirements. A crucial point is that the market making and other risks taken by a financial institution are unsafe precisely when they are large relative to the institution's capital and liquidity buffers.

6 Additional Questions and Answers

I offer some questions that may be raised by my report, and responses.

1. *If significant market making activities are permitted, wouldn't banks be in a position to conduct proprietary trading that has no market making intent?* The legislated exemption for market making creates an unfortunate moral hazard that cannot be cured by the Agencies' rule writing. Some forms of proprietary trading that are clearly unrelated to market making can be identified and proscribed. Even with the Agencies' proposed restrictions, however, there will remain an incentive and ability to disguise as "exempted market making" certain forms of speculative trading that do not serve an ultimate objective of providing market making services to clients. As the Agencies recognize, effective market making involves some trades that are similar or identical to trades that would be conducted without market-making intent.[22] Intent is difficult to measure and therefore to regulate. The proposed rule attempts to do so with the use of criteria that "are intended to ensure that the banking entity is engaged in bona fide market making." I expect that this intent would be not achieved. Instead, an application of the proposed criteria would lead to *less* market making.

2. *Hasn't the financial crisis shown us that derivatives trading by large banks is an important source of systemic risk?* The Dodd-Frank Act addresses systemic risk in the market for OTC derivatives by heightened requirements for collateral, a requirement for the central clearing of standardized products, requirements for post-trade price transparency, and the requirement to trade standardized derivatives in swap execution facilities. Strong collateral standards and effective clearing will lower counterparty risk. All of these requirements are likely to reduce the degree of concentration of market making among a small set of systemically important banks. The Basel III accord substantially increases the capital and liquidity requirements associated with OTC derivatives. These measures therefore significantly alter the cost-benefit tradeoffs to be considered when implementing the Volcker Rule. In any case, further improvements in the cost-benefit tradeoff associated with market making risk are more efficiently achieved through further improvements in capital and liquidity requirements, wherever deemed appropriate by regulators, than by the proposed rule.

3. *Are the Basel III regulatory capital and liquidity requirements associated with market making sufficient?* This is a subject for more study. The Basel Committee on Banking

[22] At page 53, the Agencies write: "In particular, it may be difficult to determine whether principal risk has been retained because (i) the retention of such risk is necessary to provide intermediation and liquidity services for a relevant financial instrument or (ii) the position is part of a speculative trading strategy designed to realize profits from price movements in retained principal risk."

Supervision (2011) is currently conducting a "fundamental review" of capital requirements for the trading books of regulated banks. Their results are to be released in 2012. It makes sense for the Agencies' to adopt a conservative approach from the viewpoint of safety and soundness of the financial system, and to "harmonize" capital and liquidity requirements across regulatory jurisdictions so as to avoid a significant incentive for market making to migrate or to "morph" unsafely.

4. *Don't higher capital requirements lower the incentives of banks to provide banking services?* Higher capital requirements are costly to current shareholders because they lower the value of the limited-liability option held by equity owners. This leads to a rational reluctance by banks to raise capital even in some cases for which additional capital would significantly reduce distress costs, a problem known as "debt overhang." (See Chapter 4 of Duffie (2010b).) Relatively few banking activities that are profitable at low capital levels would would cease to be profitable at higher capital levels, at least across the range of capital requirements that are likely to be considered. I have not seen any reliable evidence or a conceptual foundation for the contrary view. The reduced return on equity of a banking activity implied by higher equity levels does not itself change the set of profitable banking activities, a point explained in detail by Admati, DeMarzo, Hellwig, and Pfleiderer (2011).[23] There is an exception, to the extent that a bank is "too big to fail." In this case, a higher capital requirement also reduces the effective government subsidy to the bank associated with lower debt financing rates charged to the bank by creditors who consider the likelihood of government support in lowering their expected default losses. A reduction of this effective subsidy through higher capital requirements would reduce the set of profitable investments by a bank, including some of those associated with lending and market making. I have not considered the impact of higher capital requirements through the potential loss of this subsidy. Leading up to the financial crisis of 2007-2009, it seems apparent that regulatory capital and liquidity requirements were not effective, and that many of the largest U.S. financial institutions were not well supervised. This could be viewed as an argument against the effectiveness of capital and liquidity requirements, and therefore in favor of reducing market making risk by other means, such as the proposed implementation of the Volcker Rule. In my view, the failure of capital and liquidity requirements to be effective in the financial crisis of 2007-2009 can be corrected. The Basel III requirements are an example of that.

5. *Isn't it true that the losses incurred by banks through market making have been responsible for past banking crises?* No. Most banking crises are caused by losses that banks incur through loan defaults, as explained by Reinhart and Rogoff (2009). Losses due

[23] Bolton and Sanama (2010) describes why "contingent capital" may be a relatively cost effective approach to meeting capital requirements.

to borrower defaults on conventional banking activities, such as loans to sovereigns, mortgages, and loans to commercial real estate projects, tend to be far greater in magnitude than losses on market making. This was certainly true in the financial crisis of 2007-2009. That crisis was nevertheless exacerbated by the proprietary trading losses of some large broker dealers, particularly Bear Stearns, Lehman Bothers, Merrill Lynch, and the broker-dealer affiliates of Citibank and some foreign banks.[24] Although I have not seen a systematic study of the available data, most of the largest trading losses seem to have been associated with forms of proprietary trading that are not market making or otherwise exempted by section 13 of the BHC Act. (The case of Bear Stearns may be an exception.) According to the United States Government Accountability Office (2011), trading losses during the last financial crisis were relatively small for the largest bank holding companies, including market making and all other proprietary trading-related gains or losses. Figure 10 shows total industry securities trading gains and losses from 2007 to 2011, breaking out those for the largest dealers.[25] I am not aware of reliable data bearing on the market-making component of these total trading gains and losses. Market making risks make relatively high demands on a bank's liquidity, in proportion to assets, because of contractual margin and collateral requirements, the potential adverse effects of fire sales and other market dislocations, and the need for a market maker to continue to offer clients immediacy, including through trades that drain cash from the market maker. A market maker that refuses to provide significant liquidity to clients risks signaling its financial weakness, which would likely exacerbate its own liquidity position by creating an incentive for creditors, counterparties, and clients to further withdraw effective financing. (See Duffie (2010b), Chapters 2 and 3.)

6. *Don't the proposed risk metrics provide useful additional information to the Agencies for supervising the market making risks of regulated banks?* Yes. Some of the proposed metrics, such as the "Risk and Position Limits" metric, VaR, Stress VaR, or Risk Factor Sensitivities, would provide useful supervisory information, especially if they are measured effectively and for a carefully considered menu of asset classes. The United States Government Accountability Office (2011) points out that the largest six bank holding companies had proprietary trading losses that frequently exceeded their VaR estimates, more frequently than consistent with an effective risk measure. The design and supervision of these risk measures should be revisited, given that they are used for

[24] The significant losses of the Royal Bank of Scotland in credit trading are reviewed in Section 4.1 of the report on the failure of RBS of the Financial Services Authority (2011).

[25] As of the fourth quarter of 2008, the "Major Firms" are BANC OF AMERICA SECURITIES LLC, BARCLAYS CAPITAL INC., CITIGROUP GLOBAL MARKETS INC., CREDIT SUISSE SECURITIES (USA) LLC, DEUTSCHE BANK SECURITIES INC., GOLDMAN, SACHS & CO., J.P. MORGAN SECURITIES INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, MORGAN STANLEY & CO. INCORPORATED, UBS FINANCIAL SERVICES INC., UBS SECURITIES LLC, and WACHOVIA SECURITIES, LLC. Since 2009, SIFMA does not report the individual names of the "top 10" firms.

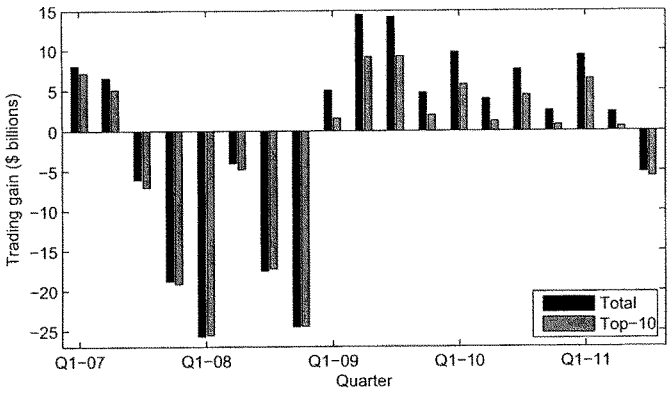

Figure 10: Quarterly trading gains and losses of US broker dealers, 2007-2011, in total, and for the largest dealers. FINRA defines these data as "realized and unrealized gains and losses on securities held for sale in the ordinary course of business (net of dividends and interest earned on such securities but not reduced by floor costs or taxes)." The data are from the SECs Financial and Operational Combined Uniform Single (FOCUS) Report regulatory filings, and cover the U.S. domestic operations of broker-dealer units doing a public business. Before 2009, the data shown here for the "Top 10" are instead reported by SIFMA for "major firms," which are sometimes 12 or 13 in number. Since 2009, SIFMA provides data for the "Top 10" without reporting the individual firm names comprising these top 10 firms. Data source: SIFMA DataBank.

supervisory purposes and also for determining capital requirements. I also suggest the use of counterparty risk exposure measures, not only to the risk of counterparty default but also to potential gains and losses to major counterparties for each of a specified list of systemically important scenarios. These measures should cover both exposure to changes in market value and also exposure to cash flows. The collection and use by regulators of these and other risk measures for supervisory purposes, if done broadly across bank and non-bank financial firms, could improve the ability of regulators to detect and mitigate risks to individual institutions and to the financial system as a whole. The collection and use of these and similar metrics is already authorized under existing broad supervisory mandates of the Agencies, including those applicable to banks, registered broker dealers, and non-bank financial firms that will be designated by the Financial Stability Oversight Council as systemically important.

7. *Wouldn't it be prudent to lower the risk to the economy associated with bank failures by forcing banks to stop making markets?* Congress concluded otherwise by exempting market making from the Volcker Rule. I believe that Congress got this right. Although

separating market making from traditional banking would make banks less complex and thus simpler for regulators to supervise, systemic risk could nevertheless rise. Large broker dealers would be outside of the regime of Basel III capital and liquidity requirements, with a different supervisory regime and with reduced access to lender-of-last-resort liquidity from the central bank. As demonstrated during the financial crisis of 2007-2009 and in the current Eurozone crisis, access to central bank liquidity can be crucial in mitigating the damage caused by a financial crisis. If there is an argument in favor of separation of market makers from conventional regulated banks, it would be more easily based instead on the view that systemically crucial market-making services offered by banks could suddenly be impaired when a bank suffers large losses on its conventional lending. (The current situation in the Eurozone includes this risk.) This argument is in my view trumped by the potential systemic risk posed by the migration of market making outside of the regulated banking environment.

A Technical Annex

Figure 11, based on the same market making inventory data for a single equity shown in Figure 1, illustrates the fact that unexpected shocks to inventory are "fat tailed," meaning that there are the inventory sometimes increases or drops dramatically.

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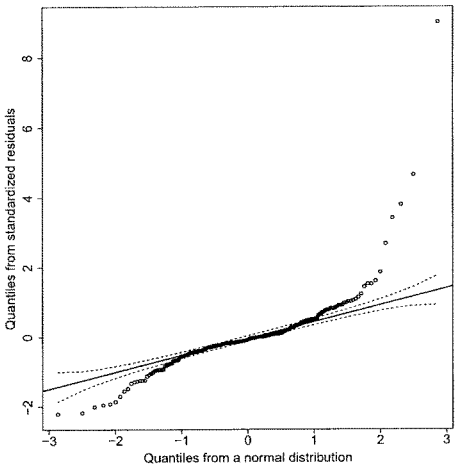

Figure 11: A "QQ" plot of quantiles of the distribution of unexpected shocks to the U.S.-dollar position in a Apple Inc. common shares of a block market making desk of a major broker-dealer, relative to the quantiles of the standard normal distribution. The quantile outcomes outside of the dashed-line "error" bands indicate a statistically significantly divergence from normality. The raw data include effective positions implied by derivatives and other effective exposures, and are those for the plot shown in Figure 1. The shocks are scaled by their sample standard deviation. Source: SIFMA-member data.

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Statement of ICI Global
Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
Subcommittee on Capital Markets and Government Sponsored Enterprises
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives

January 18, 2012

ICI Global ("ICIG") is pleased to provide this written statement in connection with the hearing on Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act – commonly known as the "Volcker Rule." Organized in October 2011, ICIG is a global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICIG manage total assets in excess of US $1 trillion. They engage in a global fund business, interacting with regulators, investors and market participants around the world, and they therefore have a strong interest in the effects of the proposed implementing regulations ("Proposal")[1] on global funds, their managers, and investors, and on the markets in which such funds invest.

For the reasons set forth below, ICIG submits that the Proposal neither implements in a reasonable manner Congress' intent in enacting the Volcker Rule, nor gives effect to the limitations in the Volcker Rule that Congress specified. If adopted as drafted, the Proposal would impede the organization, sponsorship and normal activities of non-U.S. retail funds and harm certain financial markets, market participants, and financial instruments.

I. Introduction

The Volcker Rule and the Proposal seek to limit perceived risks associated with activities of banks and their affiliates related to proprietary trading and investments in, and sponsorship of, hedge funds, private equity funds and other similar funds (referred to as "covered funds"). The prohibitions apply to banking entities, which are broadly defined to include in effect virtually all non-U.S. banks of international dimension. For the restrictions related to covered funds, the Proposal is drafted so broadly that it includes as a covered fund essentially all non-U.S. funds, including those that are similar to tightly regulated U.S. mutual funds. The rule as adopted by Congress was not directed at

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[1] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011) available at http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf.

publicly offered, substantively regulated funds like U.S. mutual funds[2] or their non-U.S. corollaries ("non-U.S. retail funds").[3] Therefore, the Proposal should not expansively sweep these non-U.S. retail funds within the meaning of covered funds. Further, although there are exemptions to the Volcker Rule's restrictions for activities outside the United States, the Proposal implements those exemptions in a manner that is exceedingly complex, and that in practice likely will be so difficult to use as to render them unworkable.

As a consequence, the Proposal, if adopted, would unnecessarily disrupt and harm the activities of non-U.S. retail funds, including those affiliated with U.S. financial institutions, as well as non-U.S. financial markets in which U.S. investors, including mutual funds, participate. If non-U.S. retail funds are not accorded the same treatment as U.S. mutual funds, U.S. financial institutions that offer global fund products will be substantially disadvantaged when competing globally in the non-U.S. retail fund business – an altogether inappropriate and unintended result, as these funds are not "hedge funds" and do not pose the risks intended to be addressed by the Volcker Rule.

We outline below changes that we believe must be made to regulations implementing the Volcker Rule as proposed, so that they do not impede the organization, sponsorship and normal activities of non-U.S. retail funds and harm certain financial markets, market participants, and financial instruments. The issues highlighted below will be discussed in greater detail in ICIG's comment letter on the Proposal, which we plan to file by the February 13 deadline.

II. Non-U.S. retail funds must be treated like U.S. mutual funds and excluded from the definition of covered fund.

Like U.S. mutual funds, which are not intended to be covered by the Volcker Rule, non-U.S. retail funds are designed for retail investors and are subject to home country oversight and regulation of a nature consistent with a fund that is offered and sold to the general public, including regulation limiting the ways in which such a fund may invest. Under the Volcker Rule, a banking entity is prohibited from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or "similar fund" as the regulators determine by rule.[4] The Proposal, however, greatly expands the reach of the Volcker Rule by broadening the definition of "covered fund" potentially *to encompass*

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[2] U.S. mutual funds are investment companies registered under the Investment Company Act of 1940 ("1940 Act") and therefore do not rely on an exemption from the definition of investment company in Section 3(c)(1) or 3(c)(7) of the 1940 Act.

[3] For purposes of this document, we include in the term "non-U.S. retail fund" any fund that has its principal office and place of business outside the United States, makes a public offering of its securities in a country outside the United States, and is substantively regulated as a public investment company under the laws of the country other than the United States.

[4] The Volcker Rule gives the regulators the authority to include funds that are "similar" to funds that would be investment companies under the 1940 Act but for Section 3(c)(1) or 3(c)(7) of that Act. *See* 12 U.S.C. § 1851(h)(2). These funds, however, are excluded from substantive regulation and required to be offered to a tightly circumscribed number or type of investors.

every securities or futures related investment fund in the world, other than U.S. mutual funds.[5] This effectively treats all non-U.S. retail funds as the equivalent of hedge funds and private equity funds, rather than like U.S. mutual funds to which they are far more analogous. Treating all non-U.S. retail funds as equivalent to a hedge fund or private equity fund is simply inaccurate and contrary to Congressional intent.

Further, failing to treat non-U.S. retail funds similarly to U.S. mutual funds may be inconsistent with U.S. "national treatment" trade commitments. By treating non-U.S. retail funds like hedge funds, non-U.S. banking entities will face added costs and complexities in their domestic, non-U.S. retail fund businesses as a result of accessing the U.S. banking market, while bank affiliated U.S. mutual fund businesses will not suffer the same negative impacts. These impacts would be substantial for many funds. For example, many banks in Europe and Asia will be subject to the Volcker Rule.[6] These banks are actively involved in the management and distribution of retail funds. These fund management groups would be forced to comply with the foreign fund exception or the sponsored fund exception (discussed below) in order to run their non-U.S. retail fund business, requiring dramatic changes to the operation and management of such funds, including their launch and distribution.

Providing an express exclusion for non-U.S. retail funds from the definition of "covered fund" would avoid this result. The definition of "covered fund" should be revised to exclude any fund that has its principal office and place of business outside the United States, makes a public offering of its securities in a country outside the United States, and is regulated as a public investment company under the laws of a country other than the United States.

III. Regulation S should be used to define who is a U.S. person and therefore what constitutes the non-U.S. securities markets for purposes of defining the parameters of the exemption for proprietary trading by non-U.S. banks occurring solely outside of the United States.

The Volcker Rule contains an exemption to the general prohibition on proprietary trading for non-U.S. banks that engage in that activity solely outside of the United States (the "foreign trading exemption"). Due to the complexities and burdens of relying upon the market making and other possible exemptions to the Volcker Rule's general prohibition on proprietary trading, we believe that many non-U.S. banks will seek to rely on this exemption.[7]

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[5] *See* § ___.10(b)(1). As discussed in a statement filed today with this Subcommittee by the Investment Company Institute, the Proposal's broad expansion of "covered fund" could also sweep in a number of U.S. mutual funds – a result not intended by Congress.

[6] Under the Volcker Rule and the Proposal, any foreign bank that maintains a branch in the United States is included in the definition of banking entity.

[7] The statement filed today by the Investment Company Institute includes a discussion of the difficulties complying with the Proposal's market maker exemption, and the resulting likely negative impact on the structure and operation of the markets.

The Proposal defines those circumstances in which proprietary trading will be considered to have occurred outside the United States. A key condition here is that no party to a trade that is made in reliance on this exemption may be a "resident of the United States." The Proposal, however, with no explanation or justification, defines "resident of the United States" for purposes of this exemption differently and much more broadly than Regulation S under the Securities Act of 1933, as amended ("1933 Act"). That regulation defines the term "U.S. person"[8] for purposes of determining whether an offer or sale takes place in the U.S. securities markets and is consequently subject to the U.S. securities laws. Regulation S is well understood and, for more than 20 years, has been the global standard for defining the line between the U.S. securities markets and the non-U.S. securities markets.

The Proposal's interpretation leads to troubling results. If the Proposal is adopted in its current form, confusion inevitably will result, as there will be two different definitions governing when an entity will be subject to our jurisdiction as a U.S. person. This will have significant negative consequences for market participants and liquidity. For example, in contrast to the approach under Regulation S, the Proposal would treat a non-U.S. retail fund with a U.S. investment adviser as a U.S. person. Therefore, such fund would not be able to trade with a non-U.S. banking entity relying on the foreign trading exemption, leading to likely market disruption and substantially less liquidity in those markets.[9]

The Proposal is inconsistent with the presumed Congressional intent to avoid extraterritorial application to activities outside the United States. Instead, Regulation S should be used to define who is a U.S. person, and therefore what constitutes the non-U.S. securities markets for purposes of the foreign trading exemption.

IV. Non-U.S. government obligations should be exempted from the proprietary trading restrictions.

While the Proposal exempts U.S. government obligations from the Volcker Rule's proprietary trading prohibitions, it does not similarly provide an exemption for non-U.S. government obligations. As a result, substantial and negative impacts will occur in the trading of obligations of foreign governments and international and multinational development banks if the Proposal is not revised. Non-U.S. retail funds invest in non-U.S. government obligations and harm to the trading and liquidity of these instruments directly impacts investors in these funds. Exempting non-U.S. government securities is consistent with limiting the extraterritorial reach of the Volcker Rule and would not undermine the purposes of the Volcker Rule.[10]

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[8] *See* 17 C.F.R. § 230.902(k).

[9] The Proposal also surprisingly treats the International Monetary Fund and the International Bank for Reconstruction and Development (the "World Bank") as U.S. residents under the proposed rules, although these organizations are not U.S. persons for purposes of Regulation S.

[10] Regulatory authorities in Japan and Canada have similarly advocated for an exemption from the proprietary trading restrictions for non-U.S. government obligations. *See* Letter from Financial Services Agency, Government of Japan, and

V. The exemption for covered fund activities solely outside the United States ("foreign fund exemption") is so narrow that it is essentially unusable.

Under the Volcker Rule, covered fund activities occurring solely outside the United States are permitted to a banking entity when that entity is not directly or indirectly controlled by a banking entity organized under U.S. law. The Proposal so narrowly interprets this exemption, however, that it would be practically unusable. This interpretation fails to fulfill presumed Congressional intent to avoid extraterritorial application to activities outside the United States.

In particular, the foreign fund exemption, like the foreign trading exemption, without explanation or justification, relies on a different and broader definition of "U.S. resident" than the widely accepted Regulation S definition. Unless the definition is changed to mirror Regulation S, non-U.S. retail funds will be required to go through the extraordinary expense of revamping their entire offering and compliance processes to accommodate an additional definition. There is a well established regime that is currently in place and used by issuers to guard against offers and sales to U.S. persons (i.e., to ensure that the transaction is "offshore").

In addition, the foreign fund exemption, if adopted as proposed, would disallow incidental U.S. contacts, which is wholly inconsistent with current market practice and investor realities, particularly with the global nature of fund businesses. As a result, the foreign fund exemption is too narrow to be useable. Such a result would mean non-U.S. retail funds, even though they are offshore, would have to comply with the sponsored fund exemption (described below) or be subject to the full Volcker Rule restrictions and prohibitions applicable to hedge funds.

VI. Non-U.S. retail funds should be excluded from the definition of "banking entity."

Non-U.S. retail funds do not raise issues the Volcker Rule was designed to prevent. Such funds should be excluded from the definition of banking entity. Otherwise, banking entity status would subject such funds themselves to the Volcker rule, e.g., the prohibitions on proprietary trading – a result at odds with the nature of their business as collective investment vehicles. Providing an express exclusion for non-U.S. retail funds from the definition of "banking entity" would avoid this result without thwarting in any way the policy goals of the Volcker Rule.

The Proposal does provide an exemption from the definition of "banking entity" to any covered fund that is organized, offered and held by a banking entity as a customer fund (the "sponsored fund exemption"). As the Proposal is drafted, however, other types of covered funds that are affiliates of a banking entity would constitute banking entities, including non-U.S. retail funds relying on the foreign fund exemption. Such funds similarly should be excluded from the definition of banking entity.

Bank of Japan, to Mr. John G. Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency, and others, dated December 28, 2011 and Letter from Julie Dickson, Superintendent, Office of the Superintendent of Financial Institutions Canada, to Department of the Treasury, Office of the Comptroller of the Currency, and others, dated December 28, 2011.

VII. The "Super 23A" limitations should not apply to covered funds managed by non-U.S. banking entities that satisfy the foreign fund exemption.

The Volcker Rule prohibits a banking entity that serves as an investment manager or sponsor of a covered fund from entering into transactions with that fund if the transaction would constitute a "covered transaction" under Section 23A of the Federal Reserve Act ("Super 23A limitations"). There is no exemption under the Proposal for covered funds that rely on the foreign fund exemption. Applying the Super 23A limitations in such a case frustrates the intent of Congress in the foreign fund exemption and is an expansive application of U.S. prudential standards to entities outside of the jurisdiction of the United States. The 23A limitations should not be apply to covered funds and banking entities relying on the foreign fund exemption.

VIII. The exemptions for proprietary trading by insurance companies should be clarified to extend to investments by insurance companies in covered funds.

The Proposal, if adopted, could have a disproportionate and negative effect on non-U.S. retail funds as opposed to U.S. mutual funds with respect to investments in those funds by insurance companies that are covered banking entities. The Proposal provides that "[t]he prohibition on proprietary trading contained in § ___.3(a) does not apply to the purchase or sale of a covered financial position by an insurance company or an affiliate of an insurance company" if certain other requirements are met and the purchases or sales are solely for the general account of the insurance company. In addition, the Proposal contains an exemption from the proprietary trading restrictions for the "purchase or sale of a covered financial position by a covered banking entity on behalf of its customers" if "[t]he covered banking entity is an insurance company that purchases or sells a covered financial position for a separate account," and other requirements are met. The Proposal, however, includes no comparable exemptions for insurance companies with regard to the covered fund restrictions, suggesting, oddly, that insurance companies, either through their general accounts or separate accounts, may not invest in covered funds, but may engage in proprietary trading.

Such a result disproportionately would affect non-U.S. retail funds (which are treated as covered funds under the Proposal) as compared to U.S. mutual funds. Under this scenario, investments by insurance companies or their separate accounts in U.S. mutual funds would not be prohibited, but the same types of investments by insurance companies or their separate accounts in non-U.S. retail funds would be subject to the restrictions of the Volcker Rule if the Proposal were adopted. There is no policy reason, however, to be more restrictive toward the activities of non-U.S. retail funds than to their U.S. counterparts. The statutory language supports this conclusion as there is no suggestion that the permitted activity exemption for insurance companies applies only to the proprietary trading restrictions. Further, the agencies recognize this fact in the Proposal, noting that "section 13(d)(1) of the [BHCA] expressly includes exemptions from these prohibitions [referring to the proprietary trading and covered fund activity prohibitions] for certain permitted activities," including trading for the general account of insurance companies.[11] The Proposal, however, provides

[11] Proposal, 76 Fed. Reg. at 68,848.

no explanation for why the permitted activity exemptions should be limited to the proprietary trading prohibitions.

IX. There are other significant and adverse consequences impacting non-U.S. retail funds as well as other areas requiring clarification or revisions.

In addition to the issues specifically addressed above, the Proposal raises other substantial issues and concerns with respect to non-U.S. retail funds that require clarification including, but not limited to, questions related to non-U.S. retail fund distribution arrangements with banking entities, custody and depositary services by banking entities for non-U.S. retail funds, and the activities of banking entities that are authorized participants in connection with non-U.S. retail ETFs. These topics will be discussed more fully in ICIG's comment letter on the Proposal.

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Subcommittee on Capital Markets and Government Sponsored Enterprises
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United States House of Representatives

January 18, 2012

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing on Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—commonly known as the "Volcker Rule." This provision was enacted to restrict banks from using their own resources to trade for purposes unrelated to serving clients. Section 619 was not directed at U.S. mutual funds and other registered investment companies ("registered funds"), which manage total assets of $12.47 trillion and serve over 90 million shareholders. Unfortunately, the current proposal to implement the Volcker Rule ("Proposal") nonetheless raises deep concerns for the U.S. registered fund industry.

If adopted in its current form, the Proposal would reach much farther than Congress ever intended. For example, the Proposal would treat many registered investment companies as hedge funds—a result that contradicts the plain language that Congress passed. In part one of our statement, we discuss this and other ways in which the proposed implementation of the Volcker Rule would impede the organization, sponsorship and normal activities of registered funds.[2]

The Proposal, as currently drafted, could also restrict banks from playing their historic role as market makers buying and selling securities—despite the fact that Congress specifically designated "market making related activity" as a "permitted activity" for banks under the Volcker Rule. If banks cannot provide these services, particularly in the less liquid fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors could face wider spreads, higher transaction costs, and diminished returns. The Proposal also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. In part two of our statement, we describe this and other ways in which the financial markets would be affected.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.47 trillion and serve over 90 million shareholders.

[2] The Proposal's overreach extends beyond U.S. borders, negatively impacting investors, funds, and global markets. A separate statement by our new voice overseas, ICI Global, discusses these issues.

Finally, part three of our statement describes ways in which the Proposal, as currently drafted, could limit investment opportunities for registered funds and their shareholders.

The issues highlighted below will be discussed in greater detail in ICI's comment letter on the Proposal, which we plan to file by the February 13 deadline.

I. The Proposal Would Impede the Organization, Sponsorship and Normal Activities of Registered Funds

Section 619 of the Dodd-Frank Act, which adds new Section 13 to the Bank Holding Company Act, generally prohibits banking entities from engaging in proprietary trading and from having certain relationships with hedge funds and private equity funds. In enacting Section 13, Congress sought to reduce the potential negative consequences that certain types of speculative risk-taking by, and conflicting relationships of, banking entities—which benefit from federal deposit insurance and access to the Federal Reserve discount window—could have on banks, taxpayers, or U.S. financial stability.[3] There is no indication that Congress intended to restrict a banking entity's activities with and relationships to registered funds, or to impede the normal operations of registered funds themselves. Yet in several ways, the Proposal would do just that. It is important, therefore, that the Proposal be modified to avoid improperly affecting registered funds and their long-permitted relationships with banking entities.

A. The Proposal Should Clarify That a Registered Fund is Not a "Covered Fund"

Section 619 generally prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund or private equity fund. The statute defines "hedge fund" and "private equity fund" as "any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act," or "such similar funds" as the regulators may determine by rule. The Proposal refers to these investment vehicles as "covered funds" and includes within "covered fund" any investment vehicle that is considered a "commodity pool" as defined in the Commodity Exchange Act ("CEA"). The CEA broadly defines "commodity pool" to include "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests."

By treating all "commodity pools" as "covered funds," the Proposal would greatly expand the reach of the Volcker Rule—even to the extent of sweeping in some *registered funds*.[4] This result would

[3] *See, e.g.*, Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (January 2011), at 15-16.

[4] A registered investment company might use commodity futures, commodity options or swaps in varying ways to manage its investment portfolio, including for reasons wholly unrelated to speculation or providing exposure to the commodity markets. Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (such as if the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.*, seeking to maintain a stated duration of seven years as a fund's fixed income

be contrary to Congressional intent. A plain reading of Section 619 indicates that Congress did not intend for the Volcker Rule to be applied to registered funds. Put simply, a registered fund is not "similar" to a hedge fund or private equity fund. Registered funds are subject to comprehensive, substantive regulation under the Investment Company Act, which focuses first and foremost on investor protection, and such funds are designed to be publicly offered to investors "of all stripes."[5] Hedge funds and private equity funds, on the other hand, are identified in Section 619 by two sections of the Investment Company Act that keep those funds *outside* that Act's regulatory protections. In addition, shares of a hedge fund or private equity fund cannot be offered publicly but rather only to a limited number of investors (in the case of a Section 3(c)(1) fund) or to sophisticated investors (in the case of a Section 3(c)(7) fund).

Moreover, the legislative history of the Dodd-Frank Act does not support a broad reading of the term "similar fund." To the contrary, former Senator Christopher Dodd (D-CT), Representative Barney Frank (D-MA) and other members of Congress appear to have been concerned that the Section 619 definition of hedge fund and private equity fund could be interpreted too broadly. As the legislative record reflects, members engaged in colloquies in order to clarify that references to the Section 3(c)(1) and 3(c)(7) exclusions under the Investment Company Act should not be read broadly for fear of sweeping in subsidiaries, joint ventures, venture capital funds and other structures that rely on those exclusions but "will not cause the harms at which the Volcker rule is directed."[6] These efforts by legislators to constrain the scope of the Volcker Rule have been undermined by the regulators' inclusion of "commodity pools" in the definition of "covered fund."

Based on the foregoing, ICI strongly recommends that the regulators modify the Proposal's definition of "covered fund" by including an express statement that any registered fund is *not* a covered fund.

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securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objective stated in the fund's prospectus (*e.g.*, an S&P 500 index fund that tracks the S&P 500 using a "sampling algorithm" that relies in part on S&P 500 or other futures).

[5] *See, e.g.*, 2011 Investment Company Fact Book, Core Principles Underlying The Regulation of U.S. Investment Companies, available at http://www.icifactbook.org/fb_appa.html#core.

[6] *See, e.g.*, 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sens. Dodd and Boxer).

B. The Proposal Should Expressly Exclude Registered Funds from the Definition of "Banking Entity"

The Volcker Rule's prohibition on proprietary trading and restrictions on activities involving hedge funds and private equity funds apply to "banking entities."[7] A registered fund such as a mutual fund would fall within the definition of "banking entity" if it were considered a subsidiary or affiliate of a banking entity (*e.g.*, its sponsor or investment adviser). In this event, the registered fund itself would be subject to all of the requirements of the Volcker Rule, as implemented by the Proposal. There is no indication that Congress intended this result.

The proposing release suggests that a mutual fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it.[8] This language is helpful, but without an express exclusion in the rule text, it is possible that some registered funds could become subject to all of the prohibitions and restrictions in the Volcker Rule. For example, during the period following the launch of a new mutual fund by a bank-affiliated sponsor, when all or nearly all of the fund's shares are owned by that sponsor/adviser, the mutual fund could be considered an affiliate of the banking entity, and thus subject to the Volcker Rule in its own right. This could have the perverse effect of essentially barring banking entities from sponsoring the most highly regulated type of investment vehicle and, thereby, limiting important investment options for retail investors. Further, it would ban banking entities from engaging in an activity that is permitted under the Bank Holding Company Act and other federal banking laws and that was never intended to be affected by the Volcker Rule.

Providing an express exclusion for registered funds from the definition of "banking entity" would avoid this result without thwarting in any way the policy goals of the Volcker Rule. Even during the post-launch period when a banking entity owns all or nearly all of a fund's shares, the registered fund must be operated in accordance with the comprehensive regulatory regime administered by the Securities and Exchange Commission ("SEC") under the Investment Company Act and other federal securities laws. Of particular significance in this context, registered funds are subject to oversight by an independent board of directors,[9] strong conflict of interest protections through prohibitions on

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[7] The Proposal generally defines "banking entity" to include: (1) an insured depository institution; (2) a company that controls an insured depository institution; (3) a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and (4) subject to certain exceptions, an affiliate or subsidiary of any of the foregoing.

[8] 76 Fed. Reg. at 68856.

[9] *See* Section 10(a) of the Investment Company Act (requiring a board of directors at least 40 percent of which must be independent directors). Importantly, certain exemptive rules under the Investment Company Act upon which nearly all registered funds rely require as a condition of reliance that at least a majority of a fund's directors must be independent directors. *See, e.g.*, Rule 17a-7 under the Investment Company Act. As a practical matter, most registered fund boards have a far higher percentage of independent directors than the Investment Company Act requires. As of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes. Independent Directors Council and Investment Company Institute, *Overview of Fund Governance Practices, 1994–2010* (October 2011). A small

affiliated transactions,[10] and strict restrictions on leverage.[11]

C. The Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds Should Not be Constrained

The proposing release asks whether "particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed" in the Proposal.[12] In fact, the proprietary trading provisions of the Proposal call into question whether banking entities could continue to serve as Authorized Participants ("APs") for registered exchange-traded funds ("ETFs").

ETFs are similar to mutual funds, except that their shares are listed on a securities exchange, allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. ETFs transact directly with APs pursuant to contract, in large transactions (typically involving 50,000 to 100,000 ETF shares) that are based not on market prices but on the ETF's daily net asset value. How these transactions must take place, and the substantial market disclosures that the ETF must make to facilitate them, are spelled out in the SEC order pursuant to which the ETF operates.[13]

APs may trade in ETF shares as traditional market makers, on behalf of their own clients, or for their own accounts. In all of these cases, AP transactions with an ETF are a unique and controlled form of arbitrage trading, and such transactions have the effect of minimizing differences between the market price for ETF shares and the underlying net asset value of those shares. The SEC views AP trading as a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors from the risks of substantial and sustained discounts to net asset value.

Many of the leading APs in the ETF market are banking entities. As currently drafted, the Proposal creates substantial uncertainty regarding the extent to which an AP's trading would come within the permitted trading exemptions discussed below. If left unchanged, these uncertainties would create substantial risks that banking entities would cease to serve as APs to ETFs. It is therefore important that the Proposal be revised or clarified to avoid this result.

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number of ETFs are structured as unit investment trusts, a form of registered investment company that has no board of directors or investment adviser.

[10] *See* Section 17(a) of the Investment Company Act; Section 23A of the Federal Reserve Act.

[11] *See* Section 18 of the Investment Company Act.

[12] 76 Fed. Reg. 68873 (Question 91).

[13] For a detailed discussion of ETFs, including how they trade, *see* 2011 Investment Company Fact Book, Exchange-Traded Funds, available at http://www.icifactbook.org/fb_ch3.html.

II. The Proposal Could Greatly Impair the Financial Markets

Section 619 of the Dodd-Frank Act prohibits a banking entity from engaging in proprietary trading of any security, derivative, and certain other financial instruments for its own account. Notwithstanding this broad prohibition, the statute provides exemptions for a banking entity to engage in certain "permitted activities." Exemptions are provided for positions taken in connection with market making activities, risk-mitigating hedging activities, and trading in certain U.S. government securities.[14]

ICI supports the overall goals of the Volcker Rule's proprietary trading prohibition, particularly the need to address concerns surrounding the impact on the markets of truly speculative proprietary trading. We do not believe, however, that the Proposal's proprietary trading restrictions, as currently drafted, will achieve these goals. Instead, they may adversely impact the financial markets and the ability for registered funds and other investors to participate in the markets.[15] The implications of the Proposal for the markets may actually be inconsistent with the goals of Section 619 by increasing—not decreasing—systemic risk.

A. Sufficient Liquidity and Efficient Markets are Important for Registered Funds

For registered funds, the availability of sufficient liquidity is a critical element of efficient markets. Banking entities are key participants in providing this liquidity, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading.

We are deeply concerned that the Proposal would decrease liquidity, particularly for markets that rely most on banking entities to provide liquidity, such as the fixed-income and derivatives markets and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to, among other things, wider spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders. Sufficient liquidity is particularly important in the everyday operations of mutual funds, which typically continuously offer

[14] Exemptions also are provided for trading "on behalf of customers," activities conducted solely outside of the United States by certain non-U.S. banking entities, underwriting activities, and trading by regulated insurance companies.

[15] A recent study by Oliver Wyman estimates the harm to investors from the proposed implementation of the Volcker Rule. For example, the study suggests that based on current holdings of U.S. corporate bonds ($7.7 trillion), investors may lose between $90-315 billion in immediate value in those securities due to decreased liquidity. Ongoing transaction costs for this asset class could further impair investor returns by $1-4 billion. Oliver Wyman, *The Volcker Rule restrictions on proprietary trading, Implications for the US corporate bond market*, December 2011. As of year-end 2010, registered funds held approximately $1.5 trillion in corporate bonds or 13% of the corporate bond market. *See* 2011 Investment Company Fact Book, Role of Investment Companies in Financial Markets, available at http://www.icifactbook.org/fb_ch1.html#role. As a result, the shareholders in those funds likely would face immediate and ongoing losses of a very substantial amount.

their shares and are required under the Investment Company Act to issue "redeemable securities."[16] Mutual funds must have efficient markets to invest cash they receive when investors purchase fund shares as well as to meet investor redemption requests on a daily basis. There is also a high likelihood that the Proposal will affect the manner in which non-U.S. banking entities interact with registered funds. For example, if such entities outside the United States are reluctant to provide liquidity to U.S. entities, an important source of liquidity for registered funds will dry up. Finally, adequate liquidity in the markets also helps dampen volatility; the impact of volatility on the costs of trading for investors, as well as investor confidence overall, cannot be discounted. Given the volatility experienced by the financial markets in the past year, ensuring adequate liquidity is that much more important. Banking entities providing market making functions therefore play an important role for registered funds and their millions of shareholders.

B. The Complexity of, and Difficulties Complying with, the Exemptions from the Proprietary Trading Prohibition Threaten Market Liquidity

Much of the concern surrounding the effect of the Proposal on liquidity arises from the complexities of several of the exemptions from the proprietary trading prohibition and uncertainty about how the exemptions will be applied. So complex are the conditions that must be met by a banking entity that the exemptions effectively are unworkable. Moreover, they simply do not reflect the manner in which the financial markets operate.

1. Market Making Exemption

The Proposal's implementation of Section 619's market making exemption contains numerous conditions that must be met by a banking entity.[17] These conditions, as currently drafted, make the exemption extremely complex and so difficult to comply with as to be effectively unworkable in a number of key financial markets or for a significant number of financial instruments. For example, the Proposal would require banking entities to ensure that their market making activities generate revenues primarily from fees, commissions, bid/ask spreads or other income that is not attributable to appreciation in the value of covered financial positions held as inventory. Market making in many fixed-income instruments, however, simply does not function in that way. Moreover, this condition ignores the likelihood that market makers holding inventory may generate revenue and profit from the

[16] *See* Section 2(a)(32) of the Investment Company Act (generally defining "redeemable security" as "any security . . . under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.").

[17] These conditions include, among other things: establishing an internal compliance program; ensuring that the trading desk that makes a market in a covered financial position holds itself out as being willing to buy and sell the covered financial position, for its own account, on a regular or continuous basis; ensuring that market making-related activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; ensuring that market making-related activities generate revenues primarily from fees, commissions, bid/ask spreads, or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or their hedges; and that compensation arrangements for employees performing market making-related activities must be designed not to reward proprietary risk-taking.

appreciation of the covered financial position during the time the position is held in inventory. Similarly, in less liquid markets where trades are infrequent and customer demand is hard to predict, it may be difficult for a market maker to satisfy the condition that its activity must be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." In addition, given the difficulties of overcoming the Proposal's rebuttable presumption that an account held by a banking entity will be a "trading account" for purposes of the Volcker Rule, market makers understandably will be highly reluctant to provide liquidity with respect to any instrument they are not reasonably confident they can resell immediately.

2. Risk Mitigating Hedging Exemption

The ability of banking entities to hedge their positions and manage the risks taken in connection with their market making activities is a critical part of a liquid and efficient market. It is therefore imperative to ensure that banking entities can appropriately hedge their positions to allow them to effectively provide needed services to registered funds. The exemptions provided for hedging under the Proposal appear to raise a number of potential concerns for the activities of banking entities and overall market liquidity. In particular, the uncertainty faced by banking entities as to whether a specific hedge fulfills the requirements of the exemption will adversely impact their ability to conduct market making functions. We therefore recommend that the risk mitigating hedging exemption be flexible enough to allow banking entities to manage appropriately all possible risks and facilitate hedging against overall portfolio risk.

3. Government Obligations Exemption

One of the permitted activities specified in Section 619 is trading in certain government obligations, including obligations of any State or political subdivision.[18] The language of the permitted activity provision, however, does not extend to transactions in obligations of an *agency* of any State or political subdivision. The Proposal carries forth this statutory language into the proposed government obligations exemption.

Some believe that excluding obligations of an agency of a State or political subdivision will subject more than half of the securities currently outstanding in the municipal securities market to the proprietary trading prohibition.[19] Banking entities currently play a significant role in facilitating a

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[18] Specifically, new Section 13(d)(1)(A) of the Bank Holding Company Act (added by Section 619 of the Dodd-Frank Act) includes as one of the permitted activities the "purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution ... **and obligations of any State or of any political subdivision thereof.**" (Emphasis added.)

[19] *See* Citigroup Global Markets, US Municipal Strategy Special Focus, *Volcker Rule – Potentially Negative Implications for Municipals*, November 20, 2011.

secondary market for municipal securities. These instruments represent one of the more conservative asset classes in the capital markets, and registered funds are significant investors in these securities. If trading in these instruments is restricted, registered funds could face reduced liquidity and wider bid-ask spreads. The fixed-income market as a whole is more dependent on market makers than other markets; the municipal securities market arguably is even more dependent on market makers than the other parts of the fixed-income market. Institutional investor involvement is lower in the municipal securities market as compared to other fixed-income markets and banking entities therefore play an increased role as liquidity providers.[20] We recommend that the permitted activity exemption for government obligations be expanded to include *all* municipal securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934.[21]

C. The Proprietary Trading Prohibition Will Impact the Structure and Operation of the Financial Markets

The proprietary trading prohibition could have negative implications for the overall structure and operation of the U.S. financial markets. For example, this prohibition may negatively impact overall capital formation in the markets. Banking entities also may find it difficult to remain in the market making business, which could lead to a shift to less regulated and less transparent financial institutions. We therefore believe the stringent restrictions of the Proposal, which go well beyond what is necessary to effectuate Congress' intent in enacting Section 619 of the Dodd-Frank Act, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.

1. Impact on Capital Formation

As currently drafted, the proprietary trading prohibition likely will impact overall capital formation. Registered funds and other investors are dependent on adequate liquidity in the secondary markets to trade the instruments in which they invest. If registered funds cannot transact effectively in the secondary markets due to a lack of liquidity, they may be reluctant to invest in these instruments at all.

Banking entities also play a critical role in initial capital formation, often providing companies with the capital necessary to go public. If banking entities find that the restrictions contemplated by the Proposal prohibit or greatly impede their serving this role, the availability of investments for registered funds will decline. Similarly, if issuers and dealers face increased costs in the capital formation process due to the Proposal, this too could restrict access for registered funds to suitable investments, particularly in the fixed-income markets.

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[20] As of September 2011, retail investors held about half of all tax-exempt debt directly and another 23 percent of tax-exempt debt through registered funds (Sources: Flow of Funds Accounts published by the Federal Reserve and ICI).

[21] The Securities Exchange Act of 1934 defines "municipal securities" as "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, **or any agency or instrumentality of a State or any political subdivision thereof,** or any municipal corporate instrumentality of one or more States, ..." (Emphasis added.) Exchange Act Section 3(a)(29).

2. Changes to the Adequacy and Availability of Liquidity Providers

If banking entities currently serving as market makers are unable to continue to provide necessary services to registered funds and other investors, or are forced to exit the market making business altogether, the non-banking entity market makers that remain may be unable to provide the liquidity necessary for funds to conduct trades efficiently in the markets. We are skeptical that other entities that purport to conduct market making activities will be able to replace banking entities that currently provide needed services to funds, particularly in less liquid markets. It is not clear that other entities will be able to step in to replace market makers that may exit the business due to an aggressive implementation of the Volcker Rule. Even if they do, this likely will not occur immediately. It may take some time for a new trading environment to evolve, following a period of potentially significant market dislocation. We urge careful consideration of whether a more nuanced implementation of the Volcker Rule could avoid or mitigate this upheaval and its attendant costs (*i.e.*, wider spreads and diminished shareholder confidence).

III. The Proposal Could Limit Investment Opportunities for Registered Funds and their Shareholders

A. The Foreign Trading Exemption Should Be Revised To Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities

As noted above, trading outside of the United States is a "permitted activity," evidencing Congressional recognition that there should be limits on the extraterritorial reach of the Volcker Rule. The Proposal greatly limits the utility of this exemption, however, by departing—without explanation—from an existing and well-understood U.S. securities regulation that governs whether an offering takes place outside of the United States and therefore is not subject to U.S. registration requirements.[22] If adopted as proposed, the Proposal would have negative consequences for registered funds and their shareholders.

Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow exemption for trading outside of the United States may cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would

[22] *See* Regulation S (Rules Governing Offers and Sales Made Outside of the United States without Registration under the Securities Act of 1933), 17 C.F.R. §§230.901-230.905. *See also* Offshore Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990) ("Regulation S Adopting Release") (noting that, under Regulation S, "where a non-U.S. person makes investment decisions for the account of a U.S. person, that account is not treated as a U.S. person"). By contrast, the Proposal provides that a "resident of the United States" includes "any discretionary or non-discretionary account . . . held by a dealer or fiduciary for the benefit or account of a resident of the United States."

comport fully with well-established and widely understood standards under the U.S. securities laws.[23] As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly. By limiting the counterparties with which non-U.S. banking entities may effect securities transactions, the Proposal's approach also may reduce liquidity in some markets. There is no indication that Congress intended to create a new or different standard for determining when a securities transaction takes place outside of the United States. We therefore urge that the Proposal expressly conform to the approach under existing U.S. securities laws so as to avoid the highly undesirable results described above.

B. The Proposal Should Provide Sufficient Exemptions for Asset-Backed Commercial Paper and Tender Option Bond Programs

The Proposal would adversely impact two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs.[24] This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are ICI members.

Under the Proposal, ABCP and TOB programs would fall within the definition of "covered fund" because they are typically issued by special purpose trusts or corporations that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Similarly, an ABCP or TOB program would fall within the definition of "banking entity" if it were considered a subsidiary or affiliate of a banking entity (*e.g.*, because the banking entity is acting as sponsor of that ABCP or TOB program), subjecting the program itself to all of the requirements of the Volcker Rule and the Proposal. Even in circumstances where an ABCP or TOB program is not necessarily viewed as part of the banking entity, the proprietary trading rules could be construed to impede these securitization activities by preventing banking entities from engaging in transactions with ABCP or TOB programs.

There is no indication, however, that Congress intended to include ABCP or TOB programs within the scope of the Volcker Rule. Quite the opposite—the Volcker Rule was intended to constrain

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[23] Indeed, the SEC specifically indicated when it adopted Regulation S that if an authorized person employed by a U.S. registered fund or its investment adviser places a buy order outside the United States on behalf of the registered fund, the requirement that the buyer be outside the United States will be met. *See* Regulation S Adopting Release. By contrast, in these circumstances the Proposal would treat the U.S. registered fund as a "resident of the United States," and thus would preclude a non-U.S. bank counterparty relying on the foreign trading exception from trading with the U.S. registered fund.

[24] ABCP programs are issued by a special purpose trust or corporation established by the program's sponsor, which is often a major commercial bank, that own, or have security interests in, multiple pools of various types of receivables from a wide variety of corporations, such as manufacturers, banks, finance companies, and broker-dealers, looking to obtain low-cost financing for a diverse range of trade and financial receivables, including manufacturing account receivables, commercial loans, equipment loan and lease receivables, consumer loans, auto loans and leases, and student loans. TOB programs are created by a sponsor bank that deposits one or more high-quality municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term security that is supported by a liquidity facility and an inverse floating rate security. TOBs provide an important source of demand for municipal bonds, which benefit municipalities with funding needs.

certain types of risk taking by banking entities but specifically sought to avoid "interfer[ing] inadvertently with longstanding, traditional banking activities that do not produce high levels of risks or significant conflicts of interest."[25] The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from any type of high-risk, conflict-ridden financial activities that Congress may have intended to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposal be revised to provide sufficient exemptions for ABCP and TOB programs.

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We thank the Subcommittees for this opportunity to outline ICI's significant concerns regarding this Proposal to implement the Volcker Rule. While focused on the specific ways in which the Proposal could negatively affect registered funds and their shareholders, our comments echo the same overarching theme that has been voiced by many stakeholders—this Proposal would reach farther than Congress ever intended and could greatly impair the U.S. financial markets. We urge the regulators to modify the Proposal to avoid such outcomes.

[25] S. Rep. No. 111-176, at 91 (2009).

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Invested in America

Testimony of the Securities Industry and Financial Markets Association submitted for the record to a joint hearing of the House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit

January 18, 2012

SIFMA[1] welcomes the opportunity to submit testimony in connection with the joint hearing of the Subcommittees on Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit on the impact of the Volcker Rule on markets, businesses, investors and job creation. SIFMA represents hundreds of firms engaged in the financial services industry. Our members have sought to provide constructive input throughout the policy debate over the Volcker Rule. While clearly SIFMA did not support the Volcker Rule during the legislative process, our members recognize that it was enacted by Congress and is now the law of the land. Indeed, many of our members have already begun the process of complying

[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.

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with the Volcker Rule by terminating their walled-off proprietary trading operations in anticipation of the Rule's effective date.

On November 7, 2011, four out of the five Agencies tasked with promulgating regulations to implement the Volcker Rule published a proposal that seeks public comment on 1,400 questions of increasing detail and complexity. The fifth Agency released its proposal just last week. We are deeply concerned that the proposed regulations issued by the Agencies take an overly prescriptive and granular approach, extending beyond congressional intent and endangering the liquidity of U.S. markets, the safety and soundness of its financial institutions, and the ability of U.S. corporations to raise capital, all of which are necessary for economic growth and job creation.

The statutory text explicitly preserves economic and socially useful trading and market activities which the Agencies should carefully implement.

In drafting the statutory Volcker Rule, Congress identified a number of important and socially useful trading functions that are traditional to banking entities, and explicitly preserved these functions as "permitted activities" in the statutory text. These permitted activities include market making-related activities, risk-mitigating hedging, underwriting, and trading on behalf of customers, among others. These are not "loopholes" as some would argue, but deliberate choices made by Congress to preserve liquidity in U.S. financial markets. Congress appreciated the impact that freezing up markets in many asset classes would have on the real economy. These

important trading activities are crucial to U.S. corporations, asset managers and their Main Street investors, capital formation, and employment and job creation. Unfortunately, in drafting the proposed regulations the Agencies have proposed a compliance and enforcement regime that would ultimately restrict these permitted activities in a manner that exceeds their statutory authority and conflicts with congressional intent. By adopting an overly rigid, prescriptive and burdensome construct, the proposed regulations will have a severe chilling effect on these traditional and economically beneficial trading activities that Congress explicitly identified as necessary to the proper functioning of U.S. markets. The proposed regulations will severely impair U.S. markets in many asset classes, up to now the deepest and most liquid capital markets in the world. As a result of the unnecessarily rigid restrictions on trading activity in these markets, U.S. issuers and investors would suffer from less liquid markets resulting in greater costs of issuance and transaction costs, and ultimately cost of capital, creating dislocation at a sensitive time for the economy.

For instance, the proposed rules are unclear regarding whether the entire municipal securities market is subject to the provisions for permitted trading in state and local government obligations. Subjecting portions of the municipal market to the proposed Rule's restrictions will lead to immense confusion, result in less liquidity,

and less access for municipal issuers to low cost financing for essential government projects.

[The proposed regulations request comments on whether permitted trading activities in obligations of any State or political subdivision thereof should be extended to State or municipal agency obligations. The municipal market is made up of over 50,000 different issuing entities and one million CUSIPS outstanding. Depending on the law of a particular state, an affordable housing or transportation bond in one state may be issued by a state or county, whereas in a different state a bond for the same purpose might be issued by a state or county agency or authority. Unless all municipal securities (as defined by Section 3(a)(29) of the Securities Exchange Act of 1934) are subject to the provision for permitted trading in state and local government obligations, there will be no consistency as to the types of municipal securities that are exempt from the Volcker Rule. This disparate result will lead to immense confusion in the municipal securities market and affect the safety and soundness of the municipal market – by some estimates at least 30% of municipal bond issuances may fall outside the permitted trading in government obligations.]

Another fundamental problem with the proposed regulations is their strong bias toward agency, as opposed to principal, markets. Market makers provide liquidity by acting as a principal, not an agent, in most asset classes. In serving as a market maker for a customer in the U.S. corporate bond market, for example, a banking entity buys a

bond from or sells a bond to a customer with the knowledge that there may be little chance of rapidly reselling the bond and a high likelihood they will have to hold onto that bond for a significant period of time. The market maker thus becomes exposed, as principal, to the risk of the market value of the bond in a way that a market maker in liquid equity securities, who may be able to buy and sell nearly contemporaneously and generate revenue off of the spread, is not. This model of taking principal positions as part of market making operates in most other markets as well. Most markets have low liquidity, few participants and no centralized exchanges. The markets for commodities, derivatives, municipal securities, securitized products and emerging market securities, among many others, are characterized by even less liquidity and less frequent trading than U.S. corporate bonds. As just one of many possible examples, the Agencies' proposal so restricts market making activities as to seriously impair the ability of market makers to make markets in illiquid products by effectively removing the discretion of market makers to enter into transactions to build inventory, which is one of the most important elements of market making. An overly restrictive market making-related permitted activity will significantly decrease liquidity and increase price volatility in these markets, making it more difficult for market participants to use the financial markets to invest or hedge commercial exposures. In addition, a narrow market making-related permitted activity will impair capital formation, which is dependent upon the liquidity of secondary markets. A study that explains potential

impacts on that liquidity was released last month by SIFMA in conjunction with Oliver Wyman.[2]

The statutory text also contains an explicit provision permitting risk-mitigating hedging activity, which is crucial to the safety and soundness of financial institutions. Unfortunately, the proposed regulations impinge upon legitimate hedging activities, which must be protected for the health of banking institutions and the financial markets. As just one of many possible examples, the requirement that each hedge be "reasonably correlated" to a particular underlying position is particularly problematic for scenario hedges, where trading units enter into hedges to mitigate the risk of unlikely "tail" events that might otherwise have a devastating impact on the trading unit. Scenario hedging, due to the significant but infrequent risk it is trying to mitigate, requires knowledgeable traders to consider how major yet infrequent events might affect various markets. The instruments used for scenario hedges may not have high correlation with movements in the price of assets in normal times, and as a result may appear to be weakly correlated with the risk and not appropriate for purposes of the permitted activity. Such hedges, however, are critical to ensuring that particularly problematic scenarios do not jeopardize the stability of the financial institution. Indeed, given that the Federal Reserve requires banking entities to perform stress tests

[2] Oliver Wyman – SIFMA, The Volcker Rule Restrictions on Proprietary Trading: Implications for the U.S. Corporate Bond Market (December 2011).

based upon scenarios, it is puzzling that the proposed regulations do not expressly permit such activity.

SIFMA understands the difficult task the Agencies have been given. However, by crafting a compliance regime targeted at the individual trade and trader level, the Agencies have established compliance and enforcement liability for otherwise explicitly permitted activities and thus restricted the ability of banking entities to engage in permitted and economically useful market making and hedging activity. Perhaps one of the most glaring indications of this quest to eradicate each and every potential proprietary trade is the requirement for banking institutions to create and maintain vast amounts of data at the granular trading unit level using seventeen different metrics for market making activity to be captured on a daily basis and reported monthly to the Agencies.

The original purpose for limiting investments in hedge funds and private equity funds has been lost in the Agencies' proposal.

The funds restrictions were intended to serve as a backstop to the proprietary trading prohibition. As Senator Merkley stated, "if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided." Unfortunately, however, these restrictions have taken on a life of their own well beyond the intent of Congress. The statutory text and proposed regulations have swept within the purview of the Volcker Rule any number of entities that no one would

consider to be "hedge funds" or "private equity funds" – a risk that Representative Frank, Senator Dodd and others noted on the record at the time of enactment and urged the Agencies to address. For example, Representative Himes noted that "[b]ecause the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds, [but] I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings." The proposed regulations, however, defined "covered funds" in a manner that appears to make the prohibitions of the Volcker Rule applicable to virtually every affiliate in a banking group, including FDIC-insured depository institutions, SEC-registered broker-dealers, parent holding companies, wholly owned subsidiaries, joint ventures, acquisition vehicles, minority investments in regulated market utilities such as securities exchanges and clearing houses, and various other non-fund subsidiaries and affiliates. This is an absurd result that Congress could not possibly have intended, and is not required by the language of the statute. It is difficult to overstate the time, effort and expense banks will have to commit to identifying, monitoring and conforming thousands of entities in their ownership structures that in no way resemble hedge funds or private equity funds. If the Agencies define the term "covered fund" in a manner

that sweeps in a substantial number of non-fund entities or creates a serious risk of doing so, it would have a devastating effect on the ability of banking entities to fund, guarantee or enter into derivatives with non-fund subsidiaries and affiliates, preventing parent banking entities from acting as a source of strength to thousands of nonbank subsidiaries by prohibiting ordinary course internal financing, liquidity and risk management transactions. Further, because asset-backed securities issuers and insurance-linked securities issues are not hedge funds or private equity funds, the Agencies should, as intended by the Securitization Exclusion in the legislation, exclude such issuers from the Proposed Rules' definition of "covered funds." Another example of a financing structure that has been caught up in the definition of "covered funds" is the repackaging of municipal securities into a structure known as tender obligation bonds (TOBs) which would be restricted under the proposed Volcker Rule, yet these products in no way take the form of hedge funds.

The proposed regulations are more like a concept release than a concrete proposal.

The Agencies' proposal contains 1,347 questions, runs 298 pages, and includes a rule text and 3 appendices. It appears to be the result of committee drafting, contains inconsistencies and doesn't even use the same defined terms throughout. How the different parts of the proposed regulations interrelate, both to each other and to existing law, is unclear.

The proposal published by the Agencies is not sufficiently complete to be a proper notice of proposed rulemaking. The proposal acknowledges that the Agencies are implementing a complex statute, and the number of questions makes clear that there is much more work to be done before the proposal is complete. Depending on how the questions are addressed, there are likely to be changes so fundamental to the nature and characteristics of the rule that a reproposal will be necessary.

The conformance period should be given real meaning, as Congress intended.

The Volcker Rule will become effective on July 21, 2012, whether or not implementing regulations are in place. On its own, the Volcker Rule will bring about meaningful behavioral changes in market structures. Combined with other changes made by the Dodd-Frank Act, it is a paradigm shift.

The Agencies have the power and flexibility to create a workable phase-in to ensure that the implementation of the Volcker Rule will not unduly disrupt financial markets. The statutory Volcker Rule explicitly allows for a two-year transition period after the effective date, ensuring that banks would have sufficient time to prepare for the new restrictions on their activities. The transition period was intended, as Senator Merkley put it, to "minimize market disruption while still steadily moving firms away from the risks of the restricted activities." Underscoring the importance of a smooth transition, the statute permits the Federal Reserve to extend the conformance period,

but does not contemplate any mechanism for shortening or restricting the conformance period.

By contrast, the proposed regulations would require that metrics and compliance systems be in place by July 21, 2012. Moreover, while Congress gave banking entities two years to "bring [their] activities and investments into compliance," the Federal Reserve's conformance rules impermissibly restrict this conformance period, providing that the 2-year transition period applies only to "activities, investments, and relationships . . . that were *commenced, acquired, or entered into* before the Volcker Rule's effective date." Implementation by banks in the time frame provided by the Agencies will be extremely difficult for an institution of any size, particularly in light of the level of granularity at which the compliance program must be implemented. This herculean feat is not only impossible but is not required by the statute. Congress contemplated that final regulations would be in place nine months ahead of effectiveness and provided a two-year transition period; it was not the intent of Congress that banks would be left scrambling to erect massive compliance structures within the span of a few short weeks.

In addition, Congress included in the Volcker Rule an extended transition for investments in illiquid funds, which permits the Federal Reserve to extend the period during which a banking entity may take or retain its interest in an illiquid fund to the extent necessary to fulfill a pre-existing contractual obligation. As the Federal

Reserve has acknowledged, the purpose of this extended transition period is "to minimize disruption of existing investments in illiquid funds and permit banking entities to fulfill existing obligations to illiquid funds." Congress provided the longest potential conformance period for investments in illiquid funds because it understood that the difficulty of divesting or conforming those investments pose the greatest risk of harm to banking entities and other stakeholders. In implementing this transition period, however, the Federal Reserve again placed unnecessary restrictions on the transition period that were not contemplated by Congress, and in fact would largely read the extension out of the statute. The problems arise primarily from the conformance rules' definitions of various terms that are not defined in the statute, including "illiquid fund," "illiquid assets," "principally invested," "invested," "contractually committed," "contractual obligations" and "necessary to fulfill a contractual obligation." SIFMA believes that the current definitions of these terms are inconsistent with congressional intent and would result in the exclusion of many genuinely illiquid funds from the transition periods.

As banks attempt to become fully compliant by July 21, 2012 – a mere six months from now – the result will be extreme dislocations in many markets for financial assets at a sensitive economic time. This problem is exacerbated by the fact that the proposal itself leaves so many open questions. Even if the Agencies were to adopt final regulations immediately after the close of the comment period, without

giving any consideration to the comments received, banks would have only five months to develop significant compliance and reporting structures, new policies and procedures, including individual trader mandates, and ensure that all new trades were fully in compliance with the stringent new regulations. In reality, of course, the Agencies will have received a number of comments addressing hundreds of questions from the release, which will require their careful review. The Agencies will not be able to adopt the final rule for some time, leaving banking entities even less time to prepare for a July 21 effective date. The delay in finalizing regulations makes it even more critical for the Agencies to respect the Congressionally mandated conformance period.

It is not clear who should be regulating and enforcing the Volcker Rule.

The statutory Volcker Rule sets forth the rulemaking responsibilities of each Agency, but is silent as to the division of responsibility for supervision, examination and enforcement of the implementing regulations. Given the structure of the proposed regulations, which contemplate the extensive use of principles, metrics and analysis of explanatory facts and circumstances, the question of which Agency will take the lead on supervision and enforcement across banking entities and trading units is a critical one, but is left unanswered in the proposed regulations.

The proposed regulations specify that each Agency will have supervisory, examination and enforcement authority for the legal entities for which it has

rulemaking authority. It is unclear how the Agencies will coordinate the exercise of their authorities with respect to entities that are subject to supervision by multiple Agencies, particularly at the trading unit level, where a trading unit and its reportable quantitative metrics will almost certainly cut across legal entities. SIFMA is deeply concerned that the Agencies may exercise overlapping jurisdiction, providing inconsistent or contradictory views on the interpretive questions that will inevitably arise. As a result, banking entities could be left with the impossible task of complying with the disparate interpretations of multiple Agencies.

SIFMA believes that one primary regulator should take the lead for any particular banking entity and its subsidiaries. As the Federal Reserve is the Agency responsible for enforcement of the Bank Holding Company Act, in which the Volcker Rule is codified, the Federal Reserve should take primary responsibility for enforcement of the Volcker Rule. Designating the Federal Reserve as primary regulator for all banking entities will eliminate the concern of inconsistent or contradictory enforcement within banking entities as well as the potential for disparate treatment of different types of banking entities. In addition, the designation of one primary regulator for all banking entities would avoid duplicative costs between the Agencies.

The benefits of the Volcker Rule as implemented in the proposed regulations will be dwarfed by the costs.

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 a sudden and overly restrictive interpretation of the Volcker Rule. The negative impact will reverberate on Main Street as well as Wall Street. SIFMA, in conjunction with Oliver Wyman, conducted a study that outlines the potential effect of such regulations on the corporate bond market. We have attached the study as a supplement to our testimony. With nearly $1 trillion raised in each of the last several years, the corporate credit market is a critical source of funding for American businesses. It is also an essential element of a diversified investment strategy for U.S. household investors who hold approximately $3 trillion, or almost half of the overall outstanding corporate debt issuance across direct holdings, pensions, and mutual funds. As proposed, the Volcker Rule regulations could result in the reduction of liquidity across a wide spectrum of asset classes and could ultimately cost investors as much as $90 billion to $315 billion in mark-to-market losses on their existing holdings due to these assets becoming less liquid and therefore less valuable. Corporate issuers could incur $12 billion to $43 billion in additional annual borrowing costs while investors could experience $1 billion to $4 billion in incremental annual transaction costs as the level and depth of liquidity in asset classes are reduced. These costs reflect the far-reaching consequences the

Volcker Rule will have not only on financial firms but average American investors if not appropriately implemented.

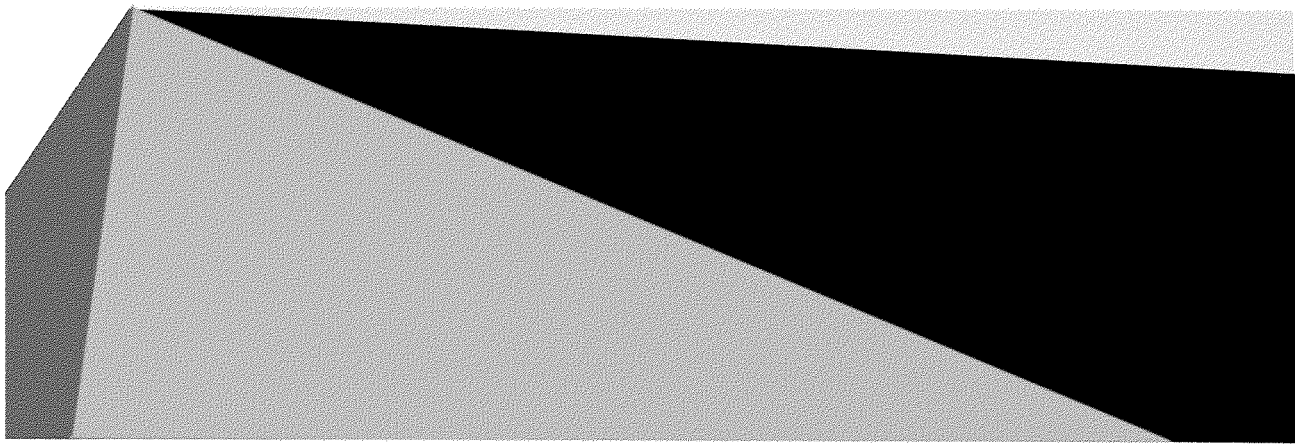
Thank you for the opportunity to submit our views. SIFMA appreciates the attention of the Subcommittees to the vitally important issues for the markets, businesses, investors and job creation that the Volcker Rule regulations raise.

OLIVER WYMAN

sifma
Invested in America

The Volcker Rule restrictions on proprietary trading Implications for the US corporate bond market

December 2011



FINANCIAL SERVICES

MARSH & McLENNAN COMPANIES

The Volcker Rule restrictions on proprietary trading
Implications for the US corporate bond market

Contents

Executive summary

- Oliver Wyman has estimated the impact of an overly restrictive implementation of the Volcker rule statute on the US corporate credit market – specifically US corporate bonds
- The corporate credit market is a critical source of funding for American businesses (with nearly $1 TN raised each year) and an essential element of a diversified investment strategy for US investors, who hold approximately $3 TN in corporate debt across direct holdings, pensions, and mutual funds[1]
- An overly restrictive implementation of the Volcker rule (as proposed) would artificially limit banking entities' ability to facilitate trading, hold inventory at levels sufficient to meet investor demand, and actively participate in the market to price assets efficiently – reducing liquidity across a wide spectrum of asset classes
- In the US corporate bond market, any meaningful reduction in liquidity could have significant effects:
  - Cost investors ~ $90 to 315 BN in mark-to-market loss of value on their existing holdings, as these assets become less liquid and therefore less valuable
  - Cost corporate issuers ~ $12 to 43 BN per annum in borrowing costs over time, as investors demand higher interest payments on the less liquid securities they hold
  - Cost investors an additional ~ $1 to 4 BN in annual transaction costs, as the level and depth of liquidity in the asset class is reduced
- Our analysis focuses on the US corporate bond market as an example – the Volcker rule obviously covers other asset classes where liquidity provision by banks also has significant value to the economy as a whole

1. Based on SIFMA and Federal Reserve Flow of Funds data

Summary results of analysis

	One-time costs	Recurring costs
Asset valuations Illiquidity discount	Section 2 **Borne by investors:** Asset holders will be directly affected by the market value depreciation *Potential mark-to-market valuation loss for investors of $90 to 315 BN*	Section 3 **Borne by issuers:** Issuers will have to pay higher yields on new debt raised to compensate investors for holding less liquid assets *Potential annual costs to issuers of $2 to 6 BN in year one, and $12 to 43 BN at steady state* [1]
Transaction costs	N/A	Section 4 **Borne by investors:** Investors will have to pay more to trade bonds that are now systematically less liquid *Potential annual costs to investors of $1 to 4 BN*

1. Steady state implies that all outstanding debt has been refinanced at the higher borrowing cost
Source: Oliver Wyman analysis

Purpose and scope of analysis

- Quantifying potential economic effects of major policy innovations is inherently difficult, especially when the changes concern the full complexity and range of today's capital markets
- Our aim in this analysis is to provide a robust view of the magnitude of potential effects of an overly restrictive implementation of the proposed Volcker rule on a single asset class – US corporate bonds
- Our analysis is limited to clear first-order impacts, including
  - Mark-to-market decrease in value on existing bonds due to loss of liquidity
  - Higher interest rates paid by corporate bond issuers, due to investors demanding greater liquidity premia
  - Increases in transactions costs paid by investors, directly due to trading lower liquidity instruments
- Many of these first-order effects would be realized as transfers from one economic group to another (e.g. higher interest rates paid by issuers would be received by investors), but for brevity we refer to each by the most negatively affected group
- We do not directly analyze a wide range of potential knock-on effects, including
  - Effects due to the Volcker rule that are not directly attributable to loss of liquidity in the US corporate bond market (e.g. changes in transaction costs caused by shifting economics for Volcker-affected dealers)
  - The potential replacement of some proportion of intermediation currently provided by Volcker-affected dealers by dealers not so affected

Section 1

Liquidity in the US markets

A rigid implementation of the Volcker rule (as proposed) will almost certainly reduce market liquidity across several asset classes in the United States

Analytical approach

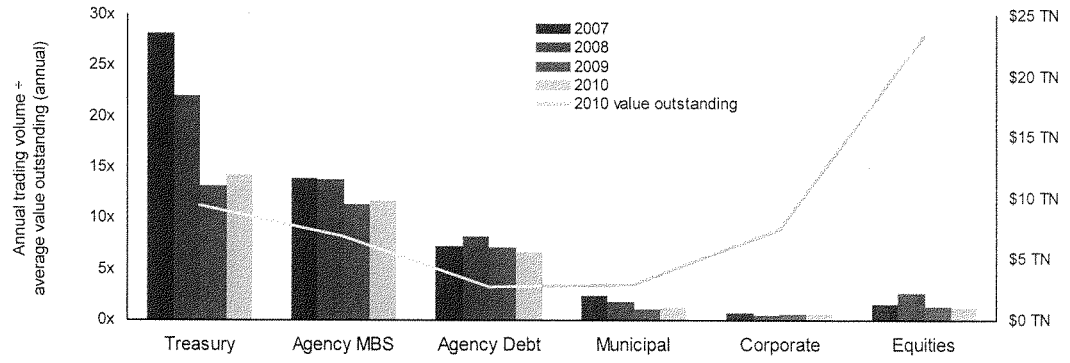
- The vast majority of asset classes are not agency markets – dealers consistently provide liquidity to these markets as principals
- Even highly liquid asset classes like US Treasuries require significant dealer intermediation and inter-dealer activity
- The main providers of liquidity to these markets are institutions covered by the Volcker that will face at least some restrictions on trading activity
- The Volcker rule therefore risks constraining market liquidity across a number of dimensions (as summarized to the right)
- We frame our analyses of the potential effects of a rigid interpretation of Volcker using three scenarios of overall loss of corporate bond market liquidity

Provisions of the Volcker rule that risk constraining market liquidity

1. Artificial limits on size of inventory and retained risk
2. Artificial limits on duration of inventory and retained risk
3. Restrictions on inter-dealer trading
4. Restrictions on active trading to price assets
5. Requirement to show consistent revenue and risk dynamics
6. Fragmented regulatory oversight and enforcement

Liquidity varies considerably across markets

Annual turnover and value outstanding
Turnover, 2006-2010; Value outstanding (in $TN), 2010

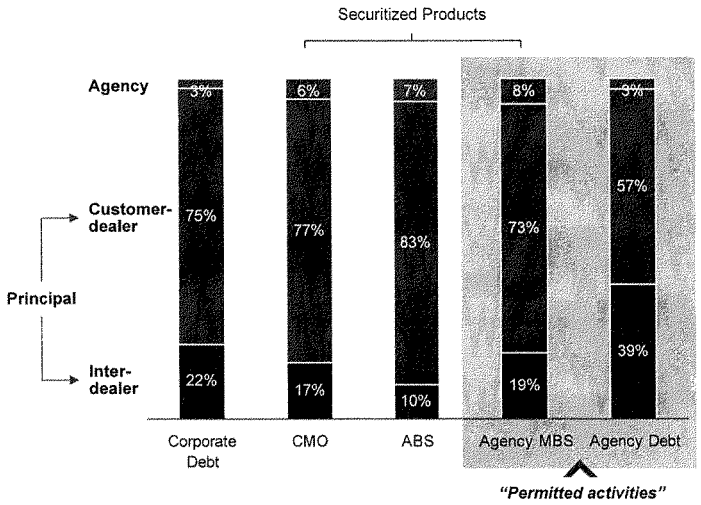


2010						
Number of securities [2]	~300	>50,000	~12,000	~15,000	~25,000	~5,000
Total outstanding	$9.4 TN	$6.9 TN	$2.7 TN	$2.9 TN	$7.5 TN	$23.3 TN
Average daily volume	$528 BN	$321 BN	$72 BN	$13 BN	$16 BN	$114 BN
Annual turnover ratio	14.2x	11.8x	6.6x	1.1x	0.5x	1.2x

1. Annual trading volume defined = average daily volume * 252
2. Based on publicly traded securities only. Agency MBS trading largely done in more liquid TBA market.
Sources: SIFMA, Treasury, Federal Reserve Bank of New York, TRACE, MSRB, NYSE, NASDAQ, Oliver Wyman analysis

Few asset classes are agency markets; even highly liquid products require significant dealer intermediation (as principals) and inter-dealer activity to support liquidity

Principal vs. agency par value traded
Percent share of Average Daily Volume in US markets, Q3 2011



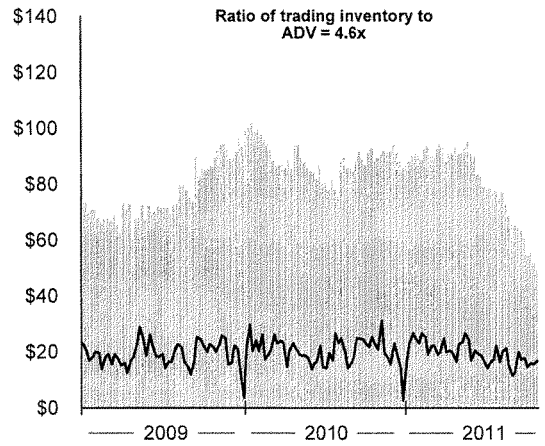
- Debt markets rely heavily on intermediation by dealers on a 'principal basis'
  - Majority of trading volume is directly driven by customer demand
  - However, inter-dealer trading is critical to facilitating these transactions
- Agency trading is naturally limited in scope in these markets
  - Relatively low levels of overall market liquidity
  - Enormous variety of individual bond issues
- Market observers (including the FRB) have noted the "importance of market makers, who are willing to take on a position in a rarely traded asset and hold the risk for some time" when these market features are present[1]
- This concept extends even to liquid markets like Agency Debt and US Treasuries, which were explicitly exempted from the Volcker rule[2]

1. "An Analysis of CDS Transactions: Implications for Public Reporting" (Staff Report 517, Federal Reserve Bank of New York, September 2011)
2. The Federal Reserve Bank of New York reports Primary Dealer transaction volume for US Treasury securities with (1) Inter-Dealer Brokers and (2) All Other counterparties; trades with Inter-Dealer Brokers (which represent a subset of Inter-Dealer activity) have contributed 40% of volume in 2011 year to date

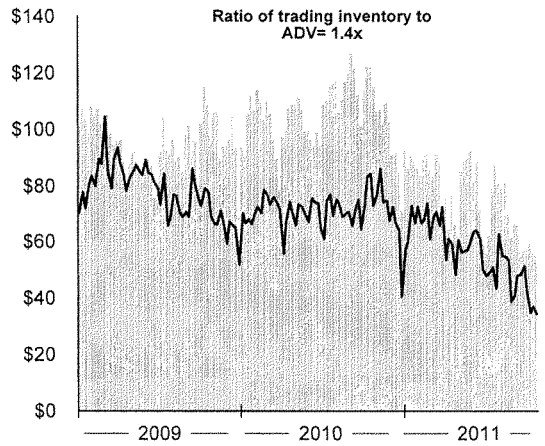
Sources: TRACE, Federal Reserve Bank of New York, Oliver Wyman analysis

And to serve customers in less liquid asset classes, dealers must hold inventory well in excess of trading volume

US corporate securities
Dealer inventory and daily trading volume (in $BN), 09-11 YTD[1,2]



Federal agency securities
Dealer inventory and daily trading volume (in $BN), 09-11 YTD[1,2]



Trading inventory
ADV

1. Inventory net of long and short positions; volume represents average daily transaction value
2. US corporate securities includes corporate bonds, non-agency MBS, etc. with maturities >1 year
Sources: Federal Reserve Bank of New York, Markit

The proposed Volcker rule risks reducing market-making activity by affected institutions, and thereby lowering overall market liquidity

1	**Artificial limits on size of inventory and retained risk**	• Implicit or explicit limits on the size of dealer inventories could lead market makers to ration their support of customer needs not on the basis of economic and risk considerations • Less liquid instruments or markets would likely be disproportionately affected
2	**Artificial limits on duration of inventory and retained risk**	• General restrictions on how long market makers can remain in a position are likely to be an overly blunt tool, given how widely liquidity varies by asset class, instrument, and market conditions • Dealers may be less willing to facilitate large transactions ("block trades") if they have a limited window of time in which to work down the position without unduly affecting the market price
3	**Restrictions on inter-dealer trading**	• Virtually all markets rely on some degree of inter-dealer trading, which serves to more efficiently match natural investor order flows, spread concentrated risk positions, and hedge individual and portfolio risks that market makers incur • Explicit or implicit limits on inter-dealer trading could have negative knock-on consequences on the willingness of market-makers to facilitate customer trades (e.g. due to inability to efficiently hedge risk)
4	**Restrictions on active trading to price assets**	• In many asset classes, market makers are able and willing to economically offer hedging and trade facilitation services to customers because they are active participants in the markets for related instruments • Active participation allows market makers to understand and maintain current views on market risk and pricing dynamics, which in turn support customer facilitation • Restrictions on the degree and manner in which covered dealers can participate in trading could reduce their capacity to assume risk on behalf of customers
5	**Requirement to show consistent revenue and risk dynamics**	• Many elements of the compliance regime in the proposed rule seem to be based on an assumption that market making functions should show consistent revenue, risk taking, and trading patterns, both over short time periods (day to day) and across different periods of market conditions • In both more and less liquid markets, customer flows are often "lumpy" (e.g. via facilitating block trades), and volatile risk-taking and revenue are natural consequences for market makers • In addition, market conditions – and the way market makers both serve customer needs and manage their own risks – can shift substantially over time
6	**Fragmented regulatory oversight and enforcement**	• The proposed rule leaves supervision and enforcement at one institution as an activity potentially shared by several regulatory agencies • This will needlessly complicate the regulatory oversight process, and could lead to inconsistent or unpredictable application of restrictions among different legal entities within one institution

The main providers of liquidity across asset classes are the institutions that will be most affected by the Volcker rule

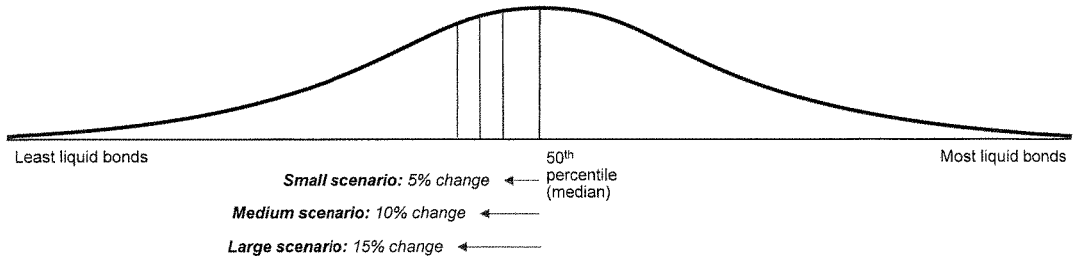
Primary dealer	Covered by Volcker
Bank of Nova Scotia	✓
Barclays Capital	✓
BMO Capital Markets	✓
BNP Paribas Securities	✓
Cantor Fitzgerald & Co.	
Citigroup Global Capital Markets	✓
Credit Suisse Securities (USA)	✓
Daiwa Capital Markets Americas	
Deutsche Bank Securities	✓
Goldman, Sachs & Co.	✓
HSBC Securities (USA)	✓
J.P. Morgan Securities	✓
Jefferies & Company	
Merrill Lynch, Pierce, Fenner & Smith	✓
Mizuho Securities USA	✓
Morgan Stanley & Co.	✓
Nomura Securities International	
RBC Capital Markets	✓
RBS Securities	✓
SG Americas Securities	✓
UBS Securities	✓

Source: Federal Reserve Bank of New York

We frame our analyses of the potential effects of a rigid interpretation of the Volcker rule on US corporate bonds using three scenarios of the decline in market liquidity

- We use robust, empirically tested measures of liquidity to understand the distribution of liquidity among the universe of US corporate bonds
- Liquidity measures are based on
  - Movements of a bond's market price in response to trades of different sizes (price impact)
  - Transaction costs (effectively) paid to market makers for trades in that bond
  - The volatility of price impact and transaction costs over time
- Each liquidity scenario is defined in terms of a market-wide shift equivalent to the differences between the median liquidity bond and a less liquid bond

Distribution of observed liquidity across US corporate bonds
Illustrative - observed liquidity is not normally distributed



Section 2

Impact on investors' asset valuations

A significant reduction in liquidity will have a material adverse impact on investor wealth held in the US corporate bond market

Analytical approach

- The effects of liquidity on asset values are well studied in academic finance, both theoretically and empirically
- In the US corporate bond market, the FINRA trade database (known as TRACE) provides a rich sample of historical transaction-level data
- The most recent and robust analysis is "Corporate bond liquidity before and after the onset of the subprime crisis" by Dick-Nielsen, Feldhutter, and Lando (DFL) [1]
- DFL uses the same core method used by all investigations into liquidity effects on corporate bonds: a disaggregation of credit risk and liquidity risk contributions to observed yields
- For our investigations of the potential effects of the removal of dealer liquidity, we rely on the core liquidity impact analysis by DFL – estimates for yield differences among bonds of different liquidities (i.e. bond liquidity premia)
- We have also undertaken complementary analytical work in order to extend the baseline DFL analysis, to be able to better estimate the effects of specific changes in liquidity

Summary findings and takeaways

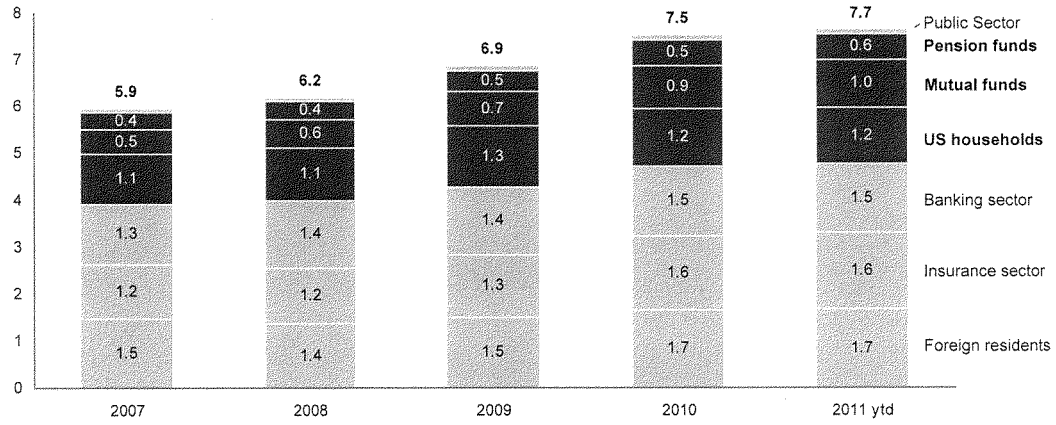
- DFL finds a significant impact from liquidity effects on bond yields and ultimately asset values
- The impact of a liquidity shift is highly dependent on the credit of the underlying assets
  - A shift from the 50th percentile to the 25th percentile on the liquidity spectrum would drive an increase in yield of just 10 bps for AAA rated bonds
  - By contrast, a shift from the 50th percentile to the 25th percentile would drive an increase in yield of nearly 230 bps for high yield bonds
- The increase in yield due to a decrease in liquidity would result in a decline in bond valuations
- We model three 'liquidity shift' scenarios to reflect the potential impact of the implementation of Volcker rule on 'median liquidity' securities
- Based on 2010 holdings of US corporate bonds ($7.5 TN) our estimate of the range of possible outcomes is ~ $90-315 BN in value reduction across investors

1. DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects.

The US corporate bond market is a critical asset class for investors

Exposure to US corporate credit
Holdings of US corporate bonds by investor, in $TN

Highlighted cells represent direct and indirect holdings of corporate bonds by individual investors in the US - $2.8 TN in total



Source: SIFMA, Federal Reserve Flow of Funds (Q2 2011), Oliver Wyman analysis

Liquidity is a significant driver of yield on US corporate bonds – particularly at the lower end of the credit spectrum

Liquidity premium relative to a bond with median liquidity [1]
in bps

Percentile liquidity	Rating bucket				
	AAA	AA	A	BBB	HY
99	-6 bps	-57 bps	-57 bps	-77 bps	-155 bps
95	-6 bps	-55 bps	-55 bps	-74 bps	-149 bps
75	-4 bps	-39 bps	-40 bps	-53 bps	-107 bps
60	-2 bps	-19 bps	-20 bps	-26 bps	-53 bps
50	0 bps	0 bps	0 bps	0 bps	0 bps
40	3 bps	26 bps	27 bps	35 bps	72 bps
25	10 bps	85 bps	85 bps	114 bps	230 bps
5	25 bps	219 bps	220 bps	293 bps	593 bps
1	29 bps	258 bps	258 bps	344 bps	696 bps

More liquid ↑

For example:
The liquidity premium of a HY bond with 40th percentile liquidity is 72 bps higher than that of a bond with median liquidity

1. DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects.

Sources: TRACE, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011), Oliver Wyman analysis

Reduced market liquidity is likely to drive substantial mark-to-market loss of value for investors, ranging from $90-315 BN under a range of modeled scenarios

Level of the potential effect	% liquidity decrease from median		Average effect on yield premium [1]		Estimated mark-to-market loss of value [2]		Share lost on outstanding debt
Small	5%	>	16bps	>	$90 BN	=	1.2%
Medium	10%	>	34bps	>	$200 BN	=	2.5%
Large	15%	>	55bps	>	$315 BN	=	4.1%

"A 15 percentile decrease in liquidity from the median results in an average increase in liquidity premium of 55bps. Given this increase in yield, the market overall would lose an estimated **$315 BN** of mark-to-market value, which corresponds to 4.1% of outstanding debt."

1. DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects.
2. Mark-to-market loss calculated as the percent reduction in price of outstanding bonds from face value as a result of yield premium increase (where price is calculated for each rating classification using average coupon and average maturity from Dealogic data) multiplied by the total debt outstanding

Sources: Dealogic, TRACE, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011), Oliver Wyman analysis

The impact of reduced liquidity will have a disproportionate impact on the value of bonds backed by (generally smaller) firms at the lower end of the credit spectrum

Estimated increase in liquidity premium as a result of liquidity change [1]
in bps

Change in premium

Rating bucket	Liquidity change: small (50^{th} to 45^{th})	medium (50^{th} to 40^{th})	large (50^{th} to 35^{th})
AAA	1 bps	3 bps	5 bps
AA	12 bps	26 bps	43 bps
A	12 bps	27 bps	43 bps
BBB	16 bps	35 bps	58 bps
HY	33 bps	72 bps	116 bps
Total	**16 bps**	**34 bps**	**55 bps**

Estimated mark-to-market loss of value from reduction in bond prices [2]
in $BN

Mark-to-market loss of value

Rating bucket	Liquidity change: small (50^{th} to 45^{th})	medium (50^{th} to 40^{th})	large (50^{th} to 35^{th})
AAA	$1 BN	$1 BN	$2 BN
AA	$14 BN	$31 BN	$50 BN
A	$24 BN	$51 BN	$82 BN
BBB	$27 BN	$58 BN	$93 BN
HY	$25 BN	$54 BN	$86 BN
Total	**$91 BN**	**$195 BN**	**$313 BN**

1. DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects.
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Sources: Dealogic, TRACE, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011), Oliver Wyman analysis

Section 3

Impact on issuers' borrowing costs

Increased liquidity premia on corporate bonds will also get passed on to issuers over time in the form of higher coupon rates

Analytical approach

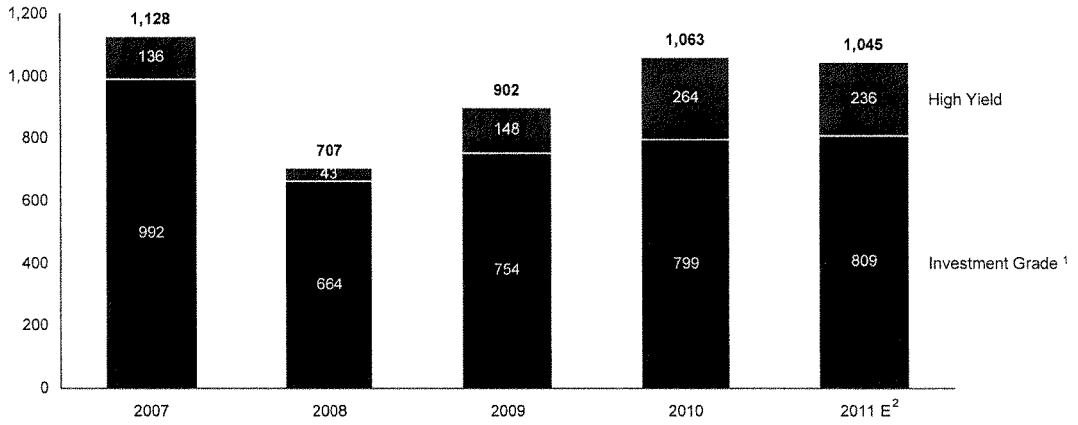
- We apply the same methodology for estimating overall changes in liquidity premia for corporate bonds as a baseline for assessing additional costs to issuers
  - Use DFL analysis of liquidity premia differences across bonds
  - Refine DFL results to assess effects of specific liquidity differences
- We assume that new issuance would pay coupons incorporating any increased liquidity premia, gradually increasing the annual net new cost to corporate debt issuers over time

Summary findings and takeaways

- Again, DFL finds a significant impact from liquidity effects on bond yields and asset values
- Investors will demand higher interest payments to compensate for the increased liquidity risk associated with holding corporate bonds
- Taking the DFL estimate of changes in liquidity premia, we can estimate total incremental borrowing costs for corporate bond issuers
- Based on total issuance in 2010 (approximately $1 TN across investment grade and high yield bonds)
  - The outer bound for the first year impact on newly issued bonds is approximately $6 BN, assuming full effect
  - Over time, the steady state level will rise closer to $43 BN as a greater proportion of outstanding bonds absorb the liquidity premium

US corporate bond issuance averages approximately $1 TN across the investment grade and high yield markets

US corporate issuance
Investment grade and high yield issuance, in $BN



1. Investment grade includes all non-convertible corporate debt, medium-term notes, and Yankee bonds, but excludes all issues with maturities of one year or less and CDs
2. 2011 estimated based on 10 months of data
Sources: SIFMA, Oliver Wyman analysis

Investors will demand higher interest payments on newly issued bonds to compensate for the increased liquidity risk

Estimated increase in liquidity premium as a result of liquidity change [1]
in bps

Change in premium

Rating bucket	Liquidity change: small (50th to 45th)	medium (50th to 40th)	large (50th to 35th)
AAA	1 bps	3 bps	5 bps
AA	12 bps	26 bps	43 bps
A	12 bps	27 bps	43 bps
BBB	16 bps	35 bps	58 bps
HY	33 bps	72 bps	116 bps
Total	16 bps	34 bps	55 bps

Estimated annual incremental issuance cost due to reduction in bond prices
In $MM

Change in issuer cost

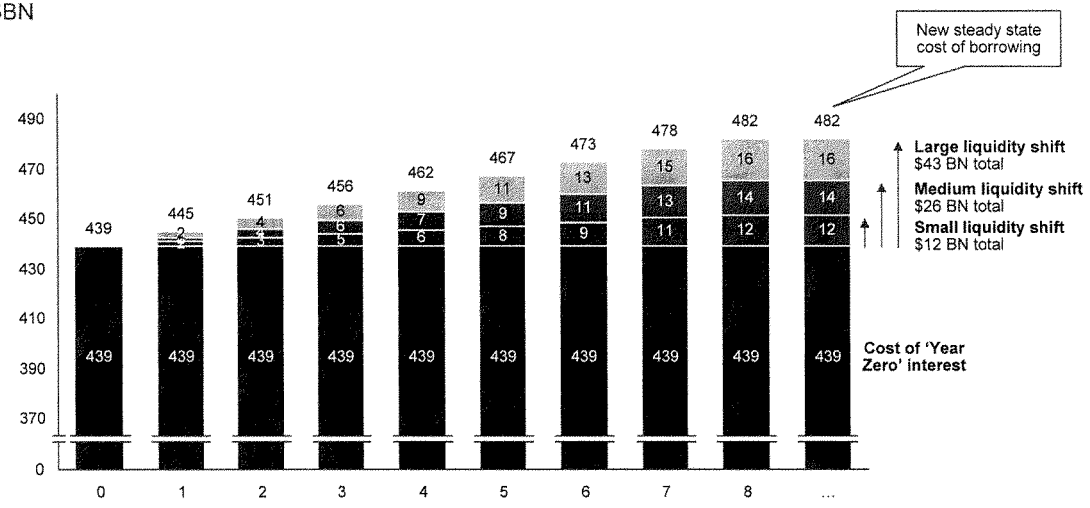
Rating bucket	Liquidity change: small (50th to 45th)	medium (50th to 40th)	large (50th to 35th)
AAA	$15 MM	$30 MM	$50 MM
AA	$235 MM	$510 MM	$830 MM
A	$350 MM	$760 MM	$1,240 MM
BBB	$400 MM	$870 MM	$1,410 MM
HY	$570 MM	$1,235 MM	$2,010 MM
Total	$1,570 MM	$3,405 MM	$5,540 MM

1. DFL construct two independent 'panels' of bond liquidity data – one for the Q3 2005-Q2 2007 period, one for the Q3 2007-Q2 2009 period – using TRACE data. The most recently available panel is used in our analysis; the earlier period shows smaller, but still significant effects.

Sources: Dealogic, TRACE, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011), Oliver Wyman analysis

The impact on issuers will grow as outstanding debt is retired and new issues are priced at higher yields

Simulated cumulative increase in corporate issuance cost [1]
In $BN



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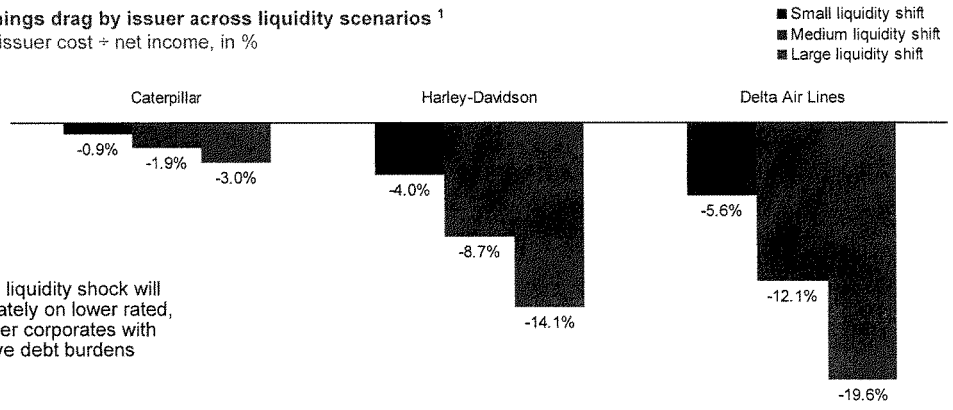
Sources: Dealogic, TRACE, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011), Oliver Wyman analysis

The impact of higher issuer costs is most visible in the potential earnings drag for individual firms

Steady state earnings drag by issuer across liquidity scenarios [1]
Dollar increase in issuer cost ÷ net income, in %



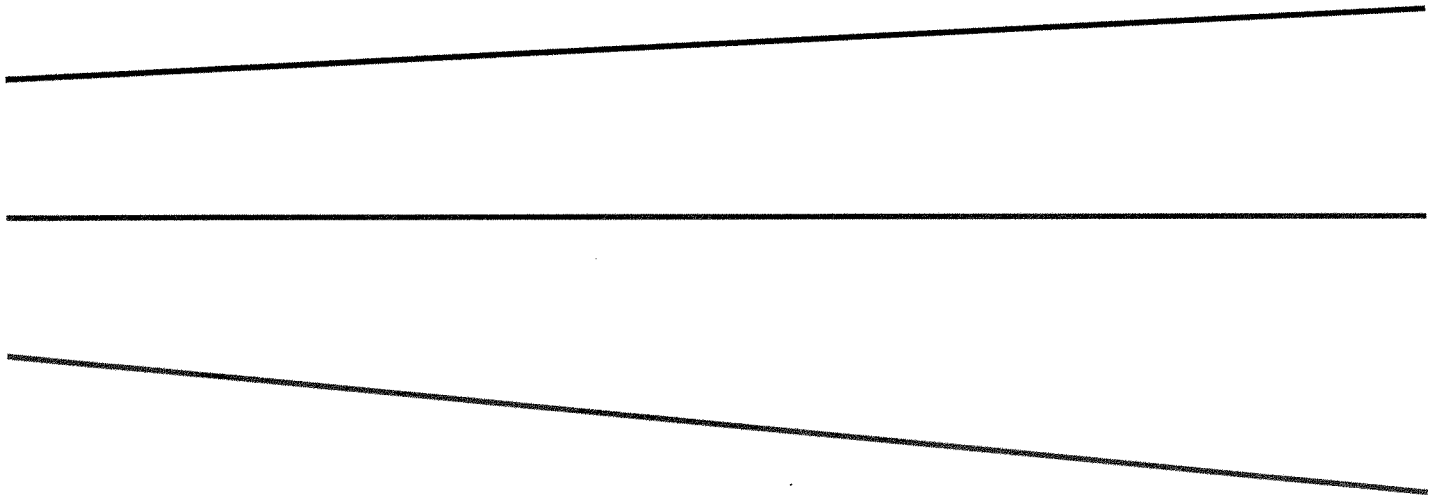
The impact of a liquidity shock will fall disproportionately on lower rated, generally smaller corporates with higher relative debt burdens

Rating bucket	A	BBB	High Yield
Average annual issuance [2]	$6.4 BN	$0.4 BN	$1.4 BN
Debt outstanding	$19.4 BN	$4.5 BN	$14.4 BN
2010 earnings	$2,782 MM	$147 MM	$593 MM
Similarly rated corporates [3] (large liquidity shift % drag)	Walt Disney (-1.4%) Coca-Cola (-0.5%)	Kraft Foods (-3.8%) Clorox (-2.4%)	Sears (-20.0%) Del Monte Foods (-6.2%)

1. Steady state implies that all outstanding debt has been refinanced at the higher (post liquidity premium) borrowing cost
2. Average annual issuance based on 2005 - H1 2011
3. Similarly rated corporates are those with ratings in the same rating bucket: A+/A/A-, BBB+/BBB/BBB-, High Yield
Sources: Dealogic, TRACE, Oliver Wyman analysis

Section 4

Impact on transaction costs



Liquidity is a significant driver of transaction costs in the corporate bond market, and a reduction in liquidity would lead to a material increase in costs paid by investors

Analytical approach

- Our analysis of realized purchase and sales prices was designed to understand the impact of changes in liquidity on transaction costs for investors
- Transaction costs could also be significantly affected in other ways by the Volcker rule that our analysis does not address directly
- Bid-offer spreads are not directly observable in the corporate bond market, and no central repository of bid-offer data exists in the US market today – so transaction costs must be estimated
- We use the FINRA database of corporate bond transactions (known as TRACE) to impute transaction costs from realized purchase and sale prices reported
- Investors' realized transaction costs are imputed by matching buy and sell transactions for the same security on the same day and averaging dealers' realized purchase and sale price
- For 2009, this yields a rich database of > 250 k observations covering ~ $2.5 TN in transaction value

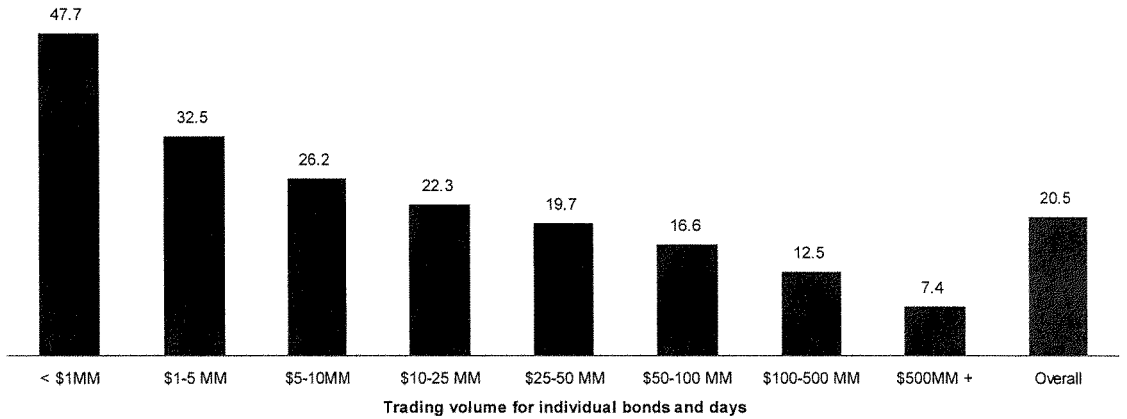
Summary findings and takeaways

- There is a clear relationship between liquidity and transaction costs in the corporate bond market
- Using historical data on corporate bond trading from TRACE, we observe
  - Significant dispersion (40 bps) in average imputed transaction costs[1] driven by liquidity
  - Average imputed transaction costs for the most liquid securities ($500 MM+ in daily volume) of 7 bps
  - Average imputed transaction costs for the least liquid securities (less than $1 MM in daily volume) of 48 bps
- The average imputed transaction costs for all securities is approximately 20.5 bps, which translates into approximately $6.7 BN in imputed annual transaction costs paid by investors
- A 10% change in liquidity (equivalent to the change in transaction costs between the median bond and the 40th percentile bond) would mean an average increase of 8bps, adding $2.4 BN in costs for investors

1 Transaction costs proxied using 50% of average purchase and sale price range

There is a clear relationship between decreasing liquidity and increasing transaction costs

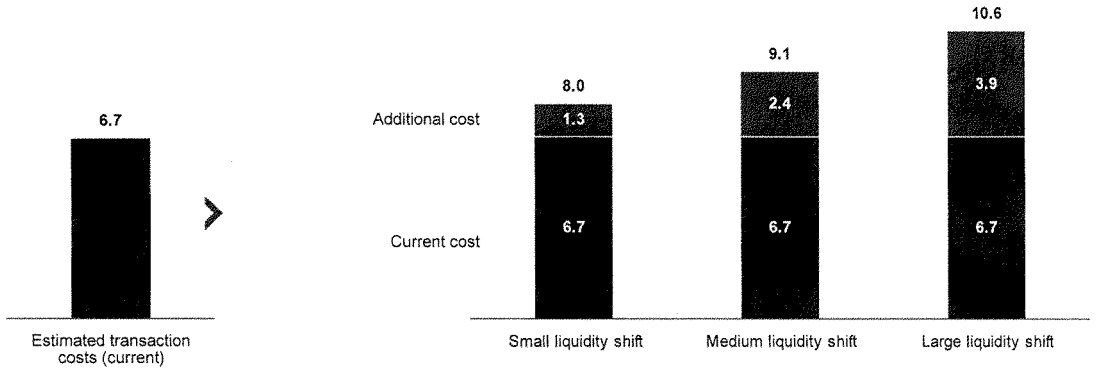
Imputed transaction costs by liquidity bucket [1]
Transaction costs in bps, liquidity buckets in $ MM of trading volume for each security and day



1 Transaction costs proxied using 50% of average purchase and sale price range
Sources: TRACE, Oliver Wyman analysis

Reduced liquidity in the corporate bond market could increase transaction costs to investors from $7 BN to $11 BN

Imputed transaction costs for investors [1]
Current and simulated, in $BN



$3.3 TN in annual volume for customer-to-dealer trades

X

20.5 bps on average transaction across corporate bonds

Estimated impact			
Percentile increase in transaction costs	5%	10%	15%
Additional Transaction costs	4 bps	8 bps	12 bps

1 Transaction costs proxied using 50% of average purchase and sale price range
Sources: TRACE, Oliver Wyman analysis

Appendix

Liquidity impact calculation methodology

Dick-Nielsen, Feldhutter and Lando conducted the most recent and robust analysis of the effect of reduced liquidity on bond prices, which we use as our starting point

- Dick-Nielsen, Feldhutter and Lando (DFL) clean available data, test different liquidity factors, and analyze liquidity effects across two periods: pre-subprime (Q1 2005 – Q1 2007) and post-subprime (Q2 2007 – Q2 2009)

Clean data

- Dataset of 5,376 bonds with 8.2 MM trades obtained after cross-referencing data from TRACE, Bloomberg, Datastream, and IBES and removing retail-sized and erroneous trades
- Treasury yields and LIBOR rates obtained from the British Bankers' Association

Test factors

- Using yield spread to swap rate as the dependent variable, eight liquidity measures are regressed to determine which correlated more highly with yield spread
- Credit risk contribution to the yield spread is controlled with 12 additional factors
  - Bond age
  - Amount issued
  - Coupon size
  - Time-to-Maturity
  - Equity volatility
  - Ratio of operating income to sales
  - Leverage ratio
  - Ratio of long term debt to assets
  - Interest rate coverage
  - 10y swap rate
  - 10y - 1y swap rate
  - Earnings forecast dispersion

Analyze effects

- DFL create a composite liquidity measure using a normalized average of 4 liquidity measures: Amihud, Imputed Roundtrip Cost, and their standard deviations
- Running the regression using the liquidity measure reveals that the liquidity component of bond yields strongly increased from higher credit rating to lower
- Liquidity component increases at the onset of subprime crisis for all but AAA-rated bonds, which is explained by the flight-to-quality phenomenon

DFL develop a composite measure of liquidity and find its yield spread regression coefficient for each rating bucket

Sources: "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011)

The DFL composite liquidity measure and its regression coefficients are used to assess the impact of liquidity on our dataset

- After running regressions with eight measures of liquidity, Dick-Nielsen, Feldhutter, and Lando develop a composite liquidity measure, λ, calculated as an equally weighted sum of Amihud's measure of price impact, a measure of roundtrip cost of trading, and the standard deviations of both, all normalized
- DFL provides certain percentile values of λ and coefficients of λ in regressions on the yield spread for each rating
- We perform an exponential regression on the percentile values of λ to interpolate values at other percentiles
- We use the coefficients from the most recently available period (Q3 2007-Q2 2009) for our analysis of the present

Sources: "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011)

We use Dealogic data to supplement the results of the DFL paper and calculate estimates of the effect of a decrease in liquidity on asset values in various scenarios

- Use Dealogic data to calculate current yield of outstanding debt using average maturity and average coupon for each rating bucket

- Estimate corporate debt outstanding for each rating bucket by assuming same proportions as across 2005 through H1 2011 issuance, for which we have data

- Find the difference in liquidity premia between a median liquidity bond and a bond with lower liquidity as per each scenario by multiplying the difference in the liquidity measure by the corresponding regression coefficient for each rating bucket

- Calculate the percent mark-to-market loss of value as a result of increasing the bond yield by the liquidity component change
- Estimate the mark-to-market loss of value in absolute terms by multiplying by outstanding corporate debt in each rating bucket
- Find the share of total outstanding debt lost by dividing absolute mark-to-market loss of value by the total outstanding debt

Sources: Dealogic, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011)

A similar process is used to obtain estimates of costs of credit for future issuance

1 Approximate annual issuance

- Approximate annual issuance for each rating bucket as that across 2005 through H1 2011

2 Find liquidity component

- Find the difference in liquidity premia between a median liquidity bond and a bond with lower liquidity as per each scenario by multiplying the difference in the liquidity measure by the corresponding regression coefficient for each rating bucket

3 Estimate percentile shift costs

- Calculate the estimated additional annual cost in absolute terms by multiplying annual issuance by the increase in liquidity premium
- Project annual issuance cost by assuming that each year bonds mature and are replaced with more costly bonds as dictated by the maturity rate, so that annual cost increases at the rate of the additional annual cost each year for the amount of time of average maturity, at which point it plateaus to steady state

Sources: Dealogic, "Corporate bond liquidity before and after the onset of the subprime crisis" (Dick-Nielsen, Feldhutter, Lando 2011)

We use TRACE data to impute transaction costs from realized buy and sell prices reported and calculate the effect of different shift scenarios

1 Clean TRACE data

- Clean data to remove
  - Corrected, cancelled, or removed trades
  - Equity linked and agency trades
  - Trades with trading volume <$100,000

2 Impute transaction costs

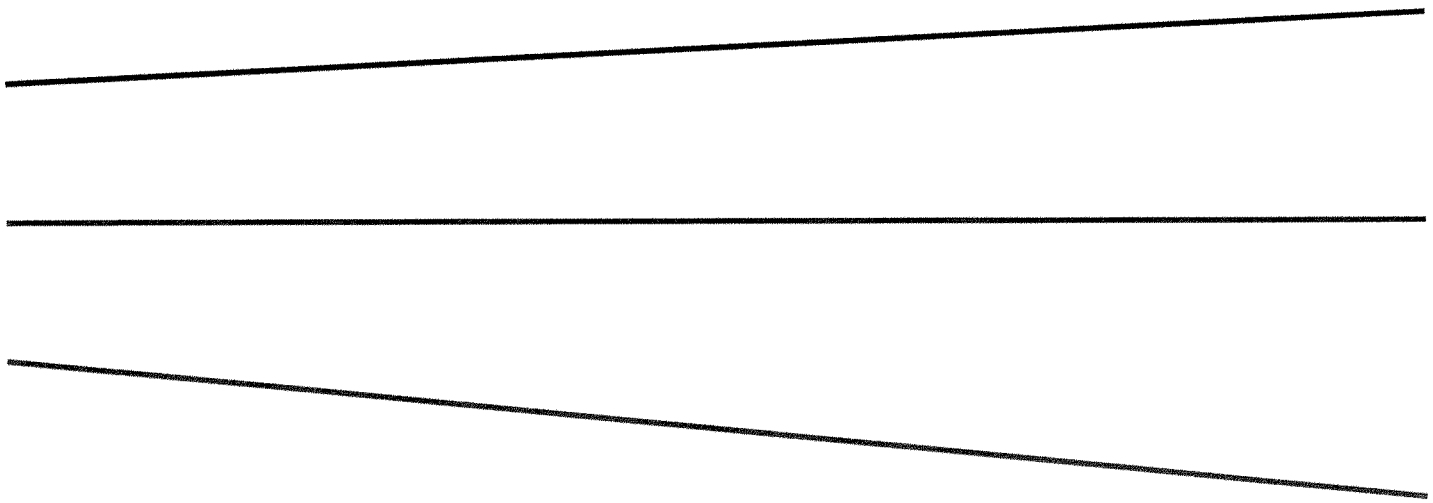
- Aggregate data by security and day
- Calculate average buy and sell prices weighted by trading volume for each security and day
- Compute transaction costs in absolute terms as half of the difference between the average sell and buy prices, multiplied by the total trading volume for each security and day
- Translate into transaction costs per traded dollar for each security and day by dividing absolute transaction cost by the total price

3 Estimate percentile shift costs

- Calculate the increase in transaction costs under different scenarios of shift in transaction cost percentiles
- Translate into dollar costs by applying premium to outstanding debt for each rating bucket for each scenario

Sources: TRACE

Disclaimers



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Before the

House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises
Subcommittee on Financial Institutions and Consumer Credit

Joint Hearing

"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

January 18, 2012

STATEMENT OF SVB FINANCIAL GROUP

Chairpersons, Ranking Members, and Members of the Subcommittees:

Thank you for holding this hearing and for allowing us to submit this statement for the record. We commend you for using this opportunity to highlight a set of issues we feel cut across partisan lines and reflect the shared goals of the Committee, its Subcommittees, and the Administration – specifically, ensuring that the regulatory agencies implementing Dodd-Frank strike a sound balance between solving the problems that caused the devastating financial crisis, on the one hand, and avoiding new regulations that will impede job creation and economic recovery, on the other.

The specific focus of this hearing – commonly referred to as the "Volcker Rule" – is a complex undertaking that potentially touches upon a wide range of activities, as evidenced by the length of the Agencies' joint proposed rulemaking. SVB Financial Group ("SVB") does not engage in the activities at which the Rule was aimed, including proprietary trading and sponsoring and investing hedge funds and private equity funds. We do, however, work daily with start-up companies across the United States and with the venture capital funds that finance high growth start-ups and the innovative technologies they are working to develop.

Due to our focus on the innovation sector, we are passionate about the issue of whether the Volcker Rule will be applied in a way that will impede the flow of capital to start-up companies that are creating jobs and fueling our economy's growth. We feel that it should not.

As the premier provider of financial services for high-growth companies in the technology, life science, and clean technology sectors, SVB is uniquely positioned to see how changes in laws and regulations may affect the vibrant but increasingly challenged U.S. innovation ecosystem. We remain extremely optimistic about the number of American entrepreneurs and the power of their ideas. However, we are deeply concerned that policy decisions could have negative, unintended consequences for America's continued leadership in innovation-based economic growth.[1]

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[1] *See, e.g.,* The European-American Business Council and The Information Technology and Innovation Foundation, *"The Atlantic Century II: Benchmarking EU and U.S. Innovation and Competitiveness"* (July 2011). This report studied sixteen key indicators of innovation competitiveness across forty countries and four regions. It found that the United States ranks fourth in innovation competitiveness – not first, as many would assume – and ranks *second to last* in terms of progress over the last decade. In terms of venture capital investment specifically, the study found the United States ranked 11th (on a per capita basis), and 23rd out of 25 in terms of progress over the past decade, with per capita venture investing falling 67.5% during that

SVB filed extensive comments with the Financial Stability Oversight Council in November 2010, and we plan to file comments in response to the Agencies' joint notice of proposed rulemaking. We will not repeat in this statement all of the data demonstrating the critical role venture capital plays in helping drive U.S. economic growth, creating jobs, and aggregating capital to make the kinds of long-term investments that promote a strong, stable financial system. Similarly, we will not discuss at length of the attributes that make venture capital investments well suited to regulation under existing "safety and soundness" approaches. Rather, we will touch on a few highlights and attempt to dispel a few common misconceptions, in an effort to help the Subcommittees understand why this issue is so important to our country.

Why It Matters

Venture capital investments fund the high-growth start-up companies that develop new technologies, create jobs, promote economic growth, and help the United States compete in the global marketplace. Although venture as a sector is very small (venture investments constitute only one to two percent of U.S. GDP annually), it yields outsized returns. Companies funded by venture capital are responsible for 11 percent of all U.S. private sector employment and 21 percent of U.S. GDP.[2] Even during the financial downturn, venture-funded companies have outperformed the broader economy in terms of creating jobs and growing revenues.[3]

In addition, venture-funded companies create entire new industries.[4] Nine out of ten people employed in the software industry work for a company with venture capital roots; more than seven out of ten people employed in the semiconductor/electronics and biotechnology industries industries work for a company with venture capital roots; and more than half of the people employed in the computer industry work for a company with venture capital roots.[5] Venture-backed companies include a long list of household names — from Apple, Google, Facebook, Amazon, Cisco, Oracle, Home Depot and Staples to Starbucks, eBay, Whole Foods Market, Genentech, Amgen, Intel, Microsoft, JetBlue, Zipcar, Costco and Zynga — that have transformed the way Americans live and work.[6]

The innovations created by venture-backed companies help drive economic growth and global competitiveness not only within the companies themselves, but across the economy more broadly. They enhance productivity, create a "virtuous cycle" of employment growth, and serve as an innovation

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period. The authors conclude that "America's ... major challenge is not timidity, but torpidity. Far too many in America believe that the United States has been number one for so long that it will continue to be number one regardless of whether it acts decisively." *Id.* at page 2.

2 *See* IHS Global Insight/National Venture Capital Ass'n, *"Venture Impact: The Economic Importance of Venture Capital-Backed Companies to the U.S. Economy"* (2011) at pages 2, 3.

3 *"Venture Impact"* at page 2.

4 *See, e.g., "Venture Impact"* at pages 6-7 (highlighting venture-created industries in the health care sector (including in the areas of biotechnology, medical devices, diagnostics, and healthcare services/IT), the information technology sector (including in the areas of computer hardware, computer software, semiconductors/electronics, the Internet, and communications), and the clean technology sector (including in the areas of natural gas, alternative energy, pollution control, rare earth mineral mining, energy efficiency, and energy storage).

5 *"Venture Impact"* at page 9.

6 *See "Venture Impact"* at page 10.

pipeline that helps larger, more mature firms continue growing. Our country will need the kinds of innovative solutions these companies are creating to provide affordable health care to an aging population, supply sustainable, cost-effective energy to U.S. homes and businesses, address cyber- and national security challenges, and maintain an acceptable balance of trade.[7]

Some acknowledge the importance of venture capital, but argue that banks can be excluded from investing in this sector without materially affect the flow of capital to start-ups or the overall health of the U.S. innovation sector. This ignores several important facts. One, venture fundraising is at historically low levels, and the relative share of venture capital being invested in the United States is declining and is expected to continue to decline. Two, broader trends – such as the movement away from defined benefit pension plans – will likely constrict the total capital available to long term investment funds, including venture capital funds, over time. Three, banking entities supply at least 7% of the total capital invested in venture capital funds and represent the sixth largest investor class in the sector.[8] There is no reason to believe other investors will replace the capital banks have historically provided. At a rough order of magnitude, preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5 percent and eliminate nearly one million U.S. jobs over the long term.[9] In fact, since banks often sponsor funds that also include third party capital, limiting banking entities' ability to sponsor venture funds could reduce the amount of capital flowing to start-up companies by an even greater amount.

In addition, now is a particularly bad time to restrict the flow of capital to start-ups. While the pace of innovation is robust, there is no question that funding for companies in capital intensive sectors that are crucial to America's future and to its continued global leadership – such as biotechnology and energy – is scarce.[10]

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[7] For example, in the health care field, virtually the entire biotechnology industry and most of the significant breakthroughs in the medical devices industry would not exist without the support of the venture capital industry. In total, more than one in three Americans has been positively affected by an innovation developed and launched by a venture-backed life sciences company during the past 20 years. National Venture Capital Ass'n, *"Patient Capital: How Venture Capital Investment Drives Revolutionary Medical Innovation"* (2007) at pages 3, 4, and 10.

[8] *See* Preqin Ltd., *"The Venture Capital Industry: A Preqin Special Report"* (Oct. 2010) at page 9. These figures almost surely underestimate the impact of banking entities (as defined in the Volcker Rule) exiting this industry, since these figures are taken from a study that distinguishes banks from other investors, such as insurers and asset managers, that also may be subject to the Volcker Rule.

[9] These approximations are based on the data cited above regarding venture's contributions to U.S. GDP and private sector employment (21 percent of U.S. GDP and 11.9 million venture-backed jobs, respectively), multiplied by the percent of venture capital provided by banking entities (7 percent).

[10] *See* Silicon Valley Bank, *"Startup Outlook 2011"* (2011) at page 16 (58% of life science start-ups and 68% of cleantech start-ups cited access to equity financing as a significant challenge facing their business), *available at* www.svb.com; *"Venture Capital Investments Decline in Dollars and Deal Volume in Q3 2011: Life Sciences and Clean Tech Investing Falls as Software Surges to a 10-Year High"* (Oct. 19, 2011) (reporting marked decreases in both dollars invested and number of deals in life sciences and clean technology sectors in the third quarter of 2011, and describing more fundamental shifts away from new investments in these sectors), *available at* www.nvca.org. Capital scarcity, combined with other challenges – including the regulatory/political environment – is affecting these companies optimism about their future growth. *Startup Outlook 2011* at pages 11-12 (life sciences and cleantech start-ups were substantially more likely than their peers in the software and hardware sectors to say that business conditions were worse than a year earlier,

We continue to believe strongly in the future of U.S. innovation. We also believe that the United States has a number of fundamental strengths that fuel its innovation-based economy.[11] As a general rule, we also believe that individual investors – not the government – should decide how much capital to invest in start-ups. That said, we believe that policymakers should take extreme care before imposing new restrictions that artificially restrict the flow of capital into venture capital funds and, through these funds, into America's fastest growing companies.

Why We Are Concerned

In their notice, the Agencies ask whether the Volcker Rule should apply to venture capital investments. We commend them for including this question. However, we remain concerned because the proposed rules, if adopted without change, would apply Volcker's restrictions to venture and restrict the flow of capital to start-up companies. We hope this hearing will help focus attention on the need for leadership on this question and highlight the high costs – and at best limited benefits – of defaulting into a rule that artificially and unnecessarily stifles banking entities' ability to invest in venture capital funds.

As a threshold matter, we would like to make clear that we are not arguing that banking entities' investments in venture funds should not be regulated. We fully understand the obligation a banking entity takes on when it becomes an insured deposit-taking institution. We believe, however, that the Agencies can continue to regulate venture capital investments effectively under existing "safety and soundness" principles and do not need to subject them to Volcker's more rigid framework.

Venture funds are fundamentally different from private equity and hedge funds in a number of ways that make them well suited to "safety and soundness" regulation.

First, they move at a pace that is consistent with the pace of bank supervision. Investments are made, and returns are realized, over a period of years – not seconds or minutes. Venture funds invest almost exclusively in privately held companies; consequently, investment values are not affected by movements in the public markets and the funds do not experience the kind of volatile, rapid movements that hedge funds and private equity funds can experience. Valuations change relatively infrequently – such as when a company raises additional equity from third parties.

Second, venture funds do not rely on leverage. As a result, the scale of a venture investment portfolio and the risk of potential losses can be clearly understood and assessed.

Third, the venture sector is not interconnected across financial institutions or the broader financial system. Venture funds use cash to fund equity investments, do not rely on complex financial instruments, and make investments using straightforward structures – not complicated derivatives. As a result, losses within an institution – were they to occur – would not cascade across institutions or the broader economy. In addition, since investors generally may not redeem investments during the fund's life, and neither investors nor fund managers receive returns until individual companies in the venture fund's portfolio are sold or go public, venture investments do not serve as a source of liquidity for third parties.

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had a less optimistic view of the coming year, and reported they were less likely to hire new employees in the coming year).

[11] *See "Startup Outlook 2011"* at pages 3, 22-23.

The size of the venture sector adds yet another layer of protection. Over the past decade, venture funds have typically raised and invested on the order of $15-30 billion annually; in 2011, they raised $18.17 billion.[12] As an asset class, as of 2010 venture funds had total capital under management of just $176 billion,[13] while hedge funds managed roughly $1.5 trillion.[14] If the entire venture capital sector – all 1,183 funds – were a single bank, it would only be the 17th largest bank in the United States based on asset size.

To put venture's scale in context, in the year and a half leading up to the financial crisis, Lehman Brothers reportedly lost more than $32 billion from proprietary trading and principal transactions – more than the entire venture sector, nationwide, invested that year. Said another way, in order for the venture sector *as a whole* to lose the amount a *single* large institution lost through proprietary trading and related activities, thousands of individual businesses, in different industries and at different stages of their life cycle, located across the United States, would have to simultaneously and suddenly fail.

Finally, venture funds are structured to minimize the risk of capital losses. They are considered risky based on investors' view of their ability to deliver returns that justify their long term and illiquid nature, not because they pose a material risk of failing to return invested capital. Over the past 28 years, venture as a class has returned more than the amount of invested capital for fund vintages covering every year but two, and those two vintages returned 92 cents on the dollar. Top performing funds have *never* failed to return capital, even following the dot-com bust, and even the worst performing (bottom quartile) funds have consistently returned much or all of invested capital. And as noted above, venture funds do not use leverage, so even in the relatively infrequent case where capital is lost, losses are not amplified and do not cascade through the financial system.

To understand the risk of venture investing from a safety and soundness perspective, it is helpful to compare venture investing with lending. If a bank raised a moderately sized venture fund (say, $150 million) every one or two years, and contributed 10% of the capital in the fund (more than three times the Volcker Rule's limit), it would be making a $15 million investment every year or two. The returns on this investment would turn on the performance of on the order of five to ten companies for a direct investment fund, and on the order of 50 to 100 companies for a fund-of-funds, and would be realized over a period of a decade or more. Banks routinely make loans in the $15 million range. These loans, in contrast, mature over a much shorter period and turn on the performance of a single borrower. Thus, while venture investments are admittedly equity investments, they have a scale, tempo and diversified risk profile that very substantially mitigates the inherent risk of equity investments.

For all of these reasons, we believe that venture investing can be effectively regulated through existing safety and soundness oversight, and that the significant costs of Volcker's more rigid approach cannot be justified.[15]

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[12] *"Venture Capital Firms Raised $5.6 Billion in Fourth Quarter, as Industry Continued to Consolidate in 2011,"* (January 9, 2012), *available at* www.nvca.org.

[13] National Venture Capital Ass'n, *"Yearbook 2011"* (2011) at page 9, *available at* www.nvca.org.

[14] Todd Groome, *Regulation: Tackling Systemic Risk*, AIMA Journal (Q1 2010) at 16.

[15] In addition to constricting the flow of capital to start-ups, applying Volcker to venture could also be counterproductive by forcing banking entities that sponsor venture funds to limit their investments in the funds, focusing instead on fee income to drive returns. This would destroy the alignment between fund managers and investors that is so important to ensuring venture's strength. *See, e.g., Yearbook 2011* at page

A Way Forward

As the Financial Stability Oversight Council recognized, the question of whether the Volcker Rule should apply to venture funds and investments is a "significant" issue. We believe – and the FSOC appeared to confirm – that the statute gives the Agencies the discretion they need to reach the outcome that is right for our economy and our financial system.

First, the Agencies can refine the definition of "covered funds" so that it reaches the two types of funds specifically named in the statute without sweeping in a host of other investment vehicles. Had Congress intended to reach all private funds, it easily could have referred generally to "funds" or "private funds" – just as it did in other sections of the Dodd-Frank Act.[16] It did not. Rather, it referred consistently to hedge funds and private equity funds, and gave the regulators discretion to adjust the definition to expand its scope (if they conclude that is necessary to prevent banking entities from evading Volcker's intended reach) *and* to narrow its scope (to avoid applying Volcker to funds that are neither "hedge funds" nor "private equity funds"), by including the phrase "or such similar fund" in the definition.[17] Chairman Dodd and other members, from both bodies and both sides of the aisle, are on the record clarifying any ambiguity that may exist.[18]

In addition, the Agencies may permit banking entities to sponsor and invest in venture capital funds as a "permitted activity" under Section (d)(1)(J). Under this provision, the Agencies may permit banking entities to engage in an activity otherwise prohibited by the Volcker Rule if they determine, by rule, that the activity "would promote the safety and soundness of the banking entity and the financial stability of the United States." Chairman Dodd specifically noted that properly conducted venture capital investing

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8 (describing the unique alignment that exists within venture, because this asset class is not driven by quick returns or transaction fees).

16 *Compare* Title IV of the Act (in which Congress intended to reach a broader array of funds and therefore used the broader term "private fund.") to Section 619 of the Act (in which Congress used the much more specific terms "hedge fund" and "private equity fund").

17 *See* Section 619(h)(2) ("The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.") (emphasis added) (internal citations omitted).

18 *See, e.g.,* Colloquy between Senators Dodd and Boxer, 156 Cong. Rec. S5904 – S5905 (July 15, 2010); Statement of Representative Eshoo, 156 Cong. Rec. E1295 (July 13, 2010); *see also* Letter from Paul A. Volcker to the Hon. Timothy Geithner (Oct. 29, 2010) (any ambiguities within the language of the law "need to be resolved in light of carrying out the basic intent of the law"); Colloquy between Representatives Representative Frank and Himes, 156 Cong. Rec. H5226 (June 30, 2010) (confirming that the definition of "hedge fund" and "private equity fund" was not intended to include all issuers that rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act); *see generally* Letter from Rep. Spencer Bachus to Members of the Financial Services Oversight Council (Nov. 3, 2010) at 8 (urging the FSOC and implementing Regulatory Agencies to avoid interpreting the Volcker Rule in an expansive, rigid way that would damage U.S. competitiveness and job creation); Government Accounting Office, "*Proprietary Trading*", GAO-11-529 at page 1 (July 2011) (using abbreviated definitions that focus on the common understanding of the terms "hedge fund" and "private equity fund" rather than relying on the statutory definition of the terms "hedge fund" and "private equity fund" to conduct its study of the Volcker Rule).

meets this test, and the FSOC implicitly confirmed this by citing this provision when discussing venture capital funds in its Report and Recommendations.

Properly conducted venture capital investing can promote safety and soundness. Silicon Valley Bank is a case in point. Our ability to lend effectively depends on our deep understanding of the sectors we serve, our individual client companies, and the external trends that affect our clients and markets. Through our venture capital investing activities, we have opportunities to work directly with the sources of capital for high growth companies (the limited partners who invest in venture capital funds), the investors in high growth companies (the general partners in venture capital funds) and, in some cases, the companies' themselves. These interactions help broaden and deepen our insights into client sectors and emerging trends, as well as our relationships with key decision-makers. This, in turn, helps SVB distinguish real risk from perceived risk and maintain a proactive, forward-looking view of the sectors we serve.

SVB's high market share, strong loan growth, solid credit quality and consistent financial performance illustrate how its model creates positive outcomes for it and for its clients. While we cannot quantify the precise extent to which our venture capital investments help promote our strong performance, we believe that our focus, the breadth and depth of the ways in which we interact with our target markets, and our overall business model – serving clients throughout the cycle of capital formation, investment, growth, and liquidity – are mutually reinforcing and promote our strength and effectiveness.

We also believe that properly conducted venture investing promotes financial stability. While the statute does not define this term and there is no generally agreed definition, commentators typically focus on a number of factors that are positively correlated with venture investing.[19]

Some definitions focus relatively more narrowly on the financial system's ability to consistently supply credit intermediation and payment services.[20] Venture investing promotes financial stability in this narrow sense, by creating new companies and new industries characterized by strong, sustained earnings growth – thereby increasing both the aggregate demand for the financial system's core credit intermediation and payment services, as well as the aggregate financial strength of the companies to whom the financial system provides these services.

Other definitions are somewhat broader, focusing on the financial system's ability to facilitate the efficient allocation of economic resources and the effectiveness of economic processes and to assess, price, allocate and manage risks – or, more succinctly, to facilitate the performance of an economy and dissipate financial imbalances.[21] Venture capital even more clearly promotes financial stability under this broader view. Venture capital investments contribute substantially to the efficient allocation of economic resources and the effectiveness of economic processes, drive meaningful wealth

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[19] *See, e.g.,* Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies,* 76 Fed. Reg. 17 (Jan. 26, 2011) at page 4561 (electing to rely on a framework that uses qualitative metrics rather than an explicit definition of the term "financial stability" to determine when non-bank financial companies pose a threat to financial stability and require increased prudential regulation); Eric S. Rosengren, President & Chief Executive Officer, Federal Reserve Bank of Boston, *Defining Financial Stability, and Some Policy Implications of Applying the Definition* (June 3, 2011) at page 1, Garry J. Schinasi, *Defining Financial Stability*, IMF Working Paper WP/04/187 (Oct. 2004) at page 3.

[20] Rosengren, *Defining Financial Stability,* at page 2.

[21] Shinasi, *Defining Financial Stability,* at page 8.

accumulation for the economy at large (and for some individual investors and entrepreneurs), increase economic growth, and promote social prosperity. Bank sponsored venture capital funds give third-party investors access to high performing companies and top tier venture funds, thus facilitating the efficient allocation of resources, the rate of growth of output, and the processes of saving, investment, and wealth creation. In fact, SVB's model – which includes working with its clients throughout the entire cycle of investing capital, growing companies, and creating liquidity (which can then be reinvested, re-starting the cycle) – is well aligned with this description of financial stability as occurring across a set of variables that quantify "how well finance is facilitating economic and financial processes such as savings and investment, lending and borrowing, liquidity creation and distribution, asset pricing, and ultimately wealth accumulation and growth."[22]

Finally, financial stability can be understood at an even broader, more fundamental level. Under this view, financial stability is a counterpart to economic stability, economic growth, job creation and strong employment levels.[23] For the reasons discussed earlier in this statement, venture capital unquestionably promotes financial stability when viewed through this lens.

Venture capital investing also promotes financial stability by discouraging activities that increase financial *instability*. According to the Financial Stability Oversight Council, three "classic symptoms of financial instability" are "a broad seizing up of financial markets, stress at other financial firms, and a deep global recession with a considerable drop in employment."[24] As discussed above, venture investing does not contribute to the first two indicators of financial stability, since venture investments are not interconnected with public markets and do not create stresses that migrate across financial firms. Yet venture investing does help alleviate employment declines, the third "classic symptom" of financial instability. In fact, venture investing has a fundamentally counter-cyclical nature that can help dissipate financial imbalances and mitigate periods of financial (and economic) instability.[25] In many notable cases, entrepreneurs and venture investors have moved aggressively during financial downturns

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22 Shinasi, *Defining Financial Stability,* at page 8.

23 *See, e.g.,* Shinasi, *Defining Financial Stability,* at page 7 (arguing that financial stability should be considered in light of the potential consequences for the real economy) and page 10 ("A stable financial system is one that enhances economic performance in many dimensions, whereas an unstable financial system is one that detracts from economic performance."); John Chant and others from the Bank of Canada, cited in Shinasi, *Defining Financial Stability,* at page 13 ("Financial instability refers to conditions in financial markets that harm, or threaten to harm, an economy's performance through their impact on the working of the financial system"); Michael Foot, Managing Director, U.K. Financial Services Authority, *What is Financial Stability and How Do We Get It?,* at paragraph 16 (April 3, 2003) ("...we have financial stability where there is: (a) monetary stability ...; (b) employment levels close to the economy's natural rate; (c) confidence in the operation of the generality of key financial institutions and markets in the economy; and (d) where there are no relative price movements of either real or financial assets within the economy that will undermine (a) or (b)").

24 Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies,* at 4556.

25 *See, e.g., "Venture Impact"* at page 2 (during the 2008-2010 financial downturn, venture-backed companies outperformed the overall economy, growing revenues by 1.6 percent (compared to an overall decline of 1.5 percent) and limiting job losses to 2 percent (compared to an overall decline of 3.1 percent), while the 500 largest public companies with venture roots increased their collective market capitalization by approximately $700 billion).

to create successful companies, creating a counterweight to the downturn and increasing the economy's upward trajectory over the longer term by building highly innovative, high growth companies.

Conclusion

The Administration has made clear that it intends to implement Dodd-Frank (and carry out its other responsibilities) in a way that "promot[es] economic growth, innovation, competitiveness, and job creation," and has committed itself to making regulatory decisions only after accounting for the costs and benefits of regulatory actions.[26]

For all of the reasons discussed above, we believe that the venture issue presents squarely the question of whether Dodd-Frank will be applied in a way that moves this country forward – by addressing the regulatory gaps that gave rise to the financial meltdown – or moves this country backwards – by over-extending regulations in a way that is not needed, and that will destroy jobs and economic growth. We appreciate the work the Committees and the Agencies are doing to help ensure we achieve the latter.

Respectfully submitted,

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[26] *See* 76 Fed. Reg. 41587 (Jul. 14, 2011); Office of the Inspector General, FDIC, *"Evaluation of the FDIC's Economic Analysis of Three Rulemakings to Implement Provisions of the Dodd-Frank Act,"* Report No. EVAL-11-003 (June 2011) at page 1 of the Executive Summary, *available at* www.fdicoig.gov/reports11/11-003EV.pdf); Office of the Inspector General, Treasury Dep't, *"Dodd-Frank Act: Congressional Request for Information Regarding Economic Analysis by OCC,"* (June 13, 2011) at page 4, *available at* www.treasury.gov/about/organizational-structure/ig/Documents/OIG-CA-11-006.pdf; Office of the Inspector General, Federal Reserve Board, *"Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings,"* (June 13, 2011) at page 9, *available at* www.federalreserve.gov/oig/files/Congressional_Response_web.pdf; Office of the Inspector General, SEC, *"Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Rulemakings,"* (June 13, 2011) at page 4, *available at* www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf; *see also Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

OVERVIEW OF SVB FINANCIAL GROUP

SVB is a bank and financial holding company. Our principal subsidiary, Silicon Valley Bank, is a California-chartered bank and a member of the Federal Reserve System. As of September 30, 2011, SVB had total assets of $19.2 billion.

We are the premier provider of financial services for start-up and growing companies in the technology, life science, and clean technology sectors, as well as for the venture capital funds that finance their growth. Over the past thirty years, we have become the most respected bank serving the technology industry and have developed a comprehensive array of banking products and services specifically tailored to meet our clients' needs at every stage of their growth. Today, we serve approximately one-half of the venture-backed companies across the United States through 26 U.S. offices and through international offices located in China, India, Israel and the United Kingdom.

We earn the vast majority of our income by providing traditional banking and financial services to our clients. Throughout the downturn, we have continued to lend to our clients and have maintained the highest standards for credit quality and capital and liquidity management. As one measure of our performance, Forbes Magazine recently listed SVB as one of the ten best performing banks in the United States, for the third year in a row.

In addition to our core banking business, SVB (the holding company) has sponsored venture capital funds, through our SVB Capital division, and made investments in certain third-party venture funds. Our regulators, the Federal Reserve Board and the California Department of Financial Institutions, regularly examine our funds business to ensure that it is being conducted safely and soundly and in accordance with all applicable rules and regulations.

Our sponsored funds, managed by SVB Capital, are predominantly made up of third-party capital. We manage this capital for our fund investors, which include pension plans, charitable foundations and university endowments. We currently manage nine "funds-of-funds" that invest in venture capital funds managed by third parties, and five "direct investment funds" that invest directly into operating companies. Our direct investment funds, and the funds in which our funds of funds invest, make long-term investments in privately held companies in the information technology, life science and cleantech sectors.

March 5, 2012

Terrie Allison
Editor
Committee on Financial Services
Washington D.C.

Dear Ms. Allison and Representatives Peters, Grimm, and McCarthy,

Thank you for the opportunity to testify before you on the impacts of the Volcker Rule. As requested, I have prepared the following responses to your questions for inclusion within the official record.

Question: Do you agree that covered entities may decrease market making activity?

Response: Yes, we would expect that the number of covered entities performing market making activities will decrease and financing will be restricted to the largest, most highly rated, and well-known issuers. Businesses without the highest ratings and recognition will not be served.

Question: If so, do you believe that other parties will step forward to provide liquidity?

Response: Yes. Businesses will be able to secure financing through other providers or markets, but the question is – at what price? Businesses quite simply must meet their liquidity needs or they will be out of business. To meet this need it is quite likely that new businesses will arise to serve this audience, however they will likely structure themselves in such a way as to be exempt from the myriad regulations, outside of regulatory oversight, and with far less capital than current market-makers. Providing these services will also be far more expensive as these new players will not have the scale or efficiency of current market-makers.

Additionally, whether new forms of financing emerge or not, companies will be forced to realign their strategies which will impact their means of deploying capital. One of the potential means of doing this is to increase cash reserves. This will effectively sideline capital and reduce opportunities for capital formation.

Question: If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to

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provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to?

Response: In evaluating this question, it is very important to understand that liquidity is fungible and can be provided from anywhere in the world, far from regulatory oversight. In fact, these new businesses would likely not be much different than the pawnshops, payday lenders, or currency exchanges that have arisen to provide personal liquidity. Furthermore, if this liquidity does come from abroad, the increased capital formation overseas will harm economic growth in the United States.

Question: Are there any negative consequences that can be anticipated from this change?

Response: We would expect that these new shadow markets would arise with far less transparency, oversight, scale, and efficiency than current providers and would therefore end up costing businesses more to meet their liquidity needs, especially small businesses.

Question: [Paraphrased] What is your view of the apparent contradiction between Chairwoman Shapiro's response to the hypothetical scenario and the response from Governor Tarullo to the same hypothetical?

Response: Under the scenario posited with the question, several considerations must be taken into account. First, currently, the financial institution could and would hold the commercial paper pending finding a buyer. Second, under the Volcker Rule some regulators may see this as falling within the market making exception while others may not. Indeed, if trades will be treated by a subjective individual basis, there may be inconsistencies among regulators and within an agency itself. This will not provide businesses with a clear means of operating. Third, even if this falls within the market making exception, financial institutions may not want to engage in this type of permitted practice to avoid regulatory scrutiny and questioning that may make such transactions unprofitable.

Chairwoman Shapiro's statements indicate that she *believes,* but does not appear *certain* of the impacts under this scenario. If the rules are not clear enough for the certainty of the Chairwoman then the rules are clearly deficient. Furthermore, the fact that the individuals in charge of writing this rule are in apparent contraction to each other is evidence of the ambiguity and uncertainty within this rule. That uncertainty will lead market participants to withdraw and as a result, will cause capital markets to become less efficient.

It is just simply unclear how regulators can regulate accepted practices that they do not understand or have any history with.

Question: Do you believe that the effect [that the Volcker Rule] would have on small to mid size firms would be different than the effect on larger firms looking to float commercial paper to meet short term financing needs?

Response: The effect of the Volcker Rule on small to mid-size firms will manifest itself in a number of ways. For one, since broker/dealers would only be able to hold securities for sixty days, smaller firms may find that banks are less willing to underwrite their securities. The reason for this is that the broker/dealer would carry a larger risk of being unable to place the securities within this sixty day time period. In contrast, larger firms that are highly rated and have very recognizable names are more likely to have a market-demand for their securities and therefore dealers would be more likely to hold these securities in their inventory and "make a market" for these larger businesses.

Additionally, if broker/dealers opt to not make a market for these securities, the affected companies will need to turn to alternative sources of financing such as traditional bank lending. However, larger firms with well-established payment histories and readily available collateral are more likely to secure this type of financing. These larger firms will then use up the majority of the bank's lending capacity, leaving smaller firms unable to secure their needed financing.

Question: I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions. What are some proposed changes and revisions the regulators should think about as they seek to finalize the rule?

Response: We believe that not much has been offered in the way of solutions because the rule itself seems to be a solution that is in search of a problem. In the absence of a well-articulated problem to be solved and a tight definition of proprietary trading, market participants are unable to craft an adequate solution. Once a well-articulated problem and definition of proprietary trading are established, market participants such as us will be quite able to propose solid solutions.

Question: Do you feel substantive changes may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?

Response: Regulators have asked hundreds of questions with respect to an undefined problem and definition. This leads us to conclude that substantive changes to the rule are not the appropriate answer, but rather that regulators should start over in crafting a rule that is built on the firm foundation of a clear problem and definition. Any changes to a foundation built on quicksand will simply not be effective.

Thank you again for the opportunity to testify and answer questions on this issue. I am happy to further to discuss this issue if you should have any further questions.

Sincerely,

Anthony J. Carfang

Rep. Carolyn McCarthy Questions for the Record

Q1. I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions. What are some proposed changes and revisions the regulators should think about as they seek to finalize the rule?

A2. The Federal Agencies' recently proposed regulations to implement the Volcker Rule provisions outlined in Section 619 of the Dodd-Frank Act could impede the ability of insurance companies to participate in certain investments for their general accounts. This is despite a provision in the Dodd-Frank Act that exempts from the Volcker Rule restrictions trading in an insurance company's general account and thus allows proprietary trading and investments in "covered funds" within general accounts, which are used by insurers to provide policyholders with guarantees of principal and a certain rate of interest in exchange for premiums paid.

While the proposed regulations include an exemption from the proprietary trading restrictions for the general account of an insurer, this exemption does not expressly allow a general account to hold an ownership interest in a covered fund, which as defined essentially designates all private equity funds as covered funds. Failure to extend the insurer exemption to covered funds could directly affect the ability of insurers to continue to invest in a way that would provide adequate returns for policyholders who have come to depend on such organizations to help ensure their long-term financial security.

In enacting the Volcker Rule provisions in the Dodd-Frank Act, Congress recognized the special nature of insurance company operations and, in particular, the comprehensive state regulatory infrastructure governing investment activity of insurance companies and their affiliated entities. The statutory language of the Dodd-Frank Act clearly establishes that the business of insurance should not be subject to the Volcker Rule and statements made by Members of Congress strongly support the intent of this language. As regulators proceed to a final rule, it is imperative they follow this intent and, accordingly recognize that the business of insurance should not be subject to either the proprietary trading restrictions or the restrictions on investing in and sponsoring covered funds and provide a clear exemption for insurer investment activities in general accounts.

Q2. Do you feel substantive changes may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?

A2. Yes, we believe it will be necessary for the Agencies to take the time to consider carefully the comments and feedback they have received on the proposed rule.

TIAA-CREF Responses to Questions for the Record from the Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Capital Markets and Government Sponsored Enterprises Joint Hearing entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation"

Rep. Gary Peters Questions for the Record

Many observers have raised concerns that the Volcker Rule could lead to a decrease in market liquidity because banks would be wary of holding large inventories of certain types of assets. There has also been speculation that if banks are unable to engage in as much market making activity, that other actors or new entrants could find an economic incentive to engage in market making. My questions for the above witnesses are:

Q1. Do you agree that covered entities may decrease market making activity?

A1. With respect to the Volcker Rule implementation process, TIAA-CREF's focus has been on ensuring that insurers are able to continue investing in covered funds for their general accounts. As significant institutional investors, we believe implementation of the Volcker Rule likely could have some affects on market liquidity, but it is difficult to say with certainty to what degree. If fewer industry players engage in ordinary course trading activities because it may be deemed proprietary trading, it is quite possible that market making activities would be hindered. We urge regulators to examine this issue closely and strike the right balance between appropriate regulation and protecting market making.

For more information on the affects of the Volcker Rule on market making activities from the insurer perspective, we would direct you to the comment letter submitted to the Agencies by the American Council of Life Insurers (ACLI) on February 13, 2012.

Q2. If so, do you believe that other parties will step forward to provide liquidity?

A2. See response to Q1.

Q3. If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well-functioning markets, and what kind of regulatory scrutiny are those institutions subject to?

A3. See response to Q1.

Q4. Are there any negative consequences that can be anticipated from this change?

A4. See response to Q1.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

June 4, 2012

Honorable Spencer T. Bachus
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your follow-up questions to the joint hearing of the Subcommittee on Capital Markets and Government Sponsored Entities and the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation." I apologize for the delay in responding.

As I testified during the hearing, the agencies' proposal for the implementation of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Volcker Rule) is intended to allow banking entities to continue to engage in permitted activities consistent with the statutory mandates and without undue impact on market liquidity. Such activities include bona fide market making and underwriting activities, risk-mitigating hedging, trading activities on behalf of customers, and investments in covered funds.

Your questions concern the manner in which the FDIC plans to respond to various specific comments that have been received in conjunction with the agencies' joint notice of proposed rulemaking (NPR). The issues you raised were important enough that the agencies posed questions and requested comment on each one in the NPR. I assure you that we will seriously consider all comments received as we move forward in the final rulemaking.

Regarding question 9, which recommended the agencies' development of a general cost-benefit analysis of the proposal, please note that for rulemakings, the FDIC conducts various types of economic impact assessments for all proposed and final rules. For final rules, under the Congressional Review Act, the FDIC determines, among other factors, whether a final rule is likely to result in a $100 million or more annual effect on the economy. For proposed and final rules, under the Regulatory Flexibility Act, the FDIC determines if a proposed or final rule is likely to have a "significant economic impact on a substantial number of small entities." As noted in my testimony, the agencies have taken an initial look at the potential economic impact on small banking entities and concluded that the proposed rule will not result in a significant economic impact on small banks. The Agencies based this conclusion on two primary factors: (1) while the proposed rule, per statutory requirements, covers all banking entities, significant reporting and recordkeeping requirements apply only to banking entities with consolidated

trading assets and liabilities and aggregate covered fund investments greater than $1 billion, respectively, or where trading assets are more than 10 percent of total assets; and (2) the compliance program requirements under the proposed rule are established in a manner that mainly impacts entities engaged in covered trading or fund activities–activities that are not typical of small banks. In addition, in this rulemaking the agencies have encouraged public comments on this issue and have asked commenters to include empirical data to illustrate and support the potential impact on small banks.[1] Also, see questions 348 – 383 in the NPR, which concern the economic impact of various provisions in the joint proposed rule.[2]

Enclosed are responses to the questions from other Members of the Committee. I also have sent responses to the Members directly.

If you have additional comments on the Volcker Rule NPR, please feel free to contact me at (202) 898-3888, or Alice C. Goodman, Acting Director, Office of Legislative Affairs, at (202) 898-8730.

Sincerely,

Martin J. Gruenberg

Martin J. Gruenberg
Acting Chairman

Enclosures

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[1] *See* 76 Fed. Reg.68846, 68939 (November 7, 2011).
[2] *Id.* at 68933 – 68936.

Response to Questions from the Honorable Judy Biggert
by Martin J. Gruenberg, Acting Chairman,
Federal Deposit Insurance Corporation

Your questions concern the timing for the issuance of the interagency final rule to implement the Volcker Rule, the process for a phased-in implementation of the final rule's compliance regime, and the regulatory authority for the respective agencies in achieving regulatory compliance with the Volcker Rule in a measured manner.

While it remains our desire to finalize the regulations by July 21, 2012, we note that full conformance is not required by that date. The Federal Reserve Board on April 19, 2012, issued a Statement of Policy that clarified the implementation of the Volcker Rule during the conformance period for banking entities engaged in prohibited proprietary trading or sponsored private equity fund or hedge fund activities.[3] In addition, the notice of proposed rulemaking on the Volcker Rule, which was issued by the federal banking agencies and the U.S. Securities and Exchange Commission on November 7, 2011, provides further clarification of those conformance regulations by the Federal Reserve Board.[4]

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[3] *See* Board of Governors of the Federal Reserve System, *Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, April 19, 2012.

[4] *See* 76 Fed. Reg. 68846, 68922 - 68923 (November 7, 2011).

Response to Questions from the Honorable Gary Peters
by Martin J. Gruenberg, Acting Chairman,
Federal Deposit Insurance Corporation

Your questions concern whether the agencies agree that covered entities under the Volcker Rule might decrease market-making activity as a result of the Volcker Rule. In such a financial markets situation, you asked whether any such decreases in liquidity would result in other parties providing the requisite liquidity. Regarding such new market-making participants, you asked "what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to?"

You also had questions which involve issues on the application of the Volcker Rule to affiliates of insured depository institutions, including commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate."

Since we currently are reviewing the various issues presented in this rulemaking for purposes of the final rule, we cannot provide a definitive answer to your questions, which also were raised by certain commenters. Note that question 83 as provided in the preamble of the NPR asked similar questions involving the impact on the "liquidity, efficiency, and price transparency of capital markets."[5]

We agree that the issues you raise are important, and the agencies posed questions and requested comment on them. I can assure you that we will carefully consider your concerns and all comments received as we move forward in the final rulemaking.

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[5] *Id.* at 68870.

Response to Questions from the Honorable Bill Huizenga
by Martin J. Gruenberg, Acting Chairman,
Federal Deposit Insurance Corporation

Your questions involve issues on the application of the Volcker Rule to affiliates of insured depository institutions, including commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate."

Since we are reviewing the options for the various issues presented in this rulemaking to implement the Volcker Rule, we cannot provide a definitive answer to your questions, which also were raised by certain commenters. Please be assured that we will carefully consider your questions in conjunction with our development of the final rule. Question 6 of the preamble of the NPR asked for comments on entities that should not be covered in the definition of "covered entity" in the proposed rule.[6]

The questions you raise present significant issues of law and policy that will be addressed in the final rule for the implementation of the Volcker Rule.

[6] Id. at.68856.

Response to Questions from the Honorable Michael Grimm
by Martin J. Gruenberg, Acting Chairman,
Federal Deposit Insurance Corporation

Your questions involve the impact of the Notice of Proposed Rulemaking for the Volcker Rule on various proprietary trading activities conducted by "non-U.S. based institutions" with various categories of U.S. and foreign counterparties. Please note that the Volcker Rule applies to proprietary trading and covered fund activities by certain "covered entities" that generally are U.S. insured depository institutions and their affiliates and subsidiaries.

Since we currently are reviewing the various issues presented in this rulemaking for purposes of the final rule, we cannot provide a definitive answer to your questions, which also were raised by certain commenters. Please be assured that we will carefully consider your questions in conjunction with our development of the final rule.

The questions you raise present significant issues of law and policy that will be addressed in the final rule for the implementation of the Volcker Rule.

Response to Questions from the Honorable Carolyn McCarthy
by Martin J. Gruenberg, Acting Chairman,
Federal Deposit Insurance Corporation

You ask what possible changes the regulators should be thinking about or are necessary as the result of stakeholder feedback on the Notice of Proposed Rulemaking (NPR) for the Volcker Rule. This section of the Dodd-Frank Act is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit from the safety net provided by federal deposit insurance or access to the Federal Reserve's discount window. The challenge to regulators in implementing the Volcker Rule is to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets.

In response to the NPR, the regulators have received a high volume of comments from stakeholders, suggesting many issues and changes that we should think about in drafting the final rule. We are carefully reviewing these comments as they raise significant issues of law and policy.

Alexander Marx
Head of Global Bond Trading
Fidelity Investments
One Spartan Way, Merrimack, NH 03054

March 21, 2012

Responses to Questions for the Record Submitted by Representatives Gary Peters and Carolyn McCarthy on January 18, 2012 Joint Hearing Entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation"

Fidelity Investments ("Fidelity") appreciates the opportunity to provide answers to questions submitted for the record by Rep. Gary Peters (D-MI) and Rep. Carolyn McCarthy (D-NY) for the January 18, 2012 joint subcommittee hearing on the proposed rules to implement the Volcker Rule.

Questions from Representative Peters:

1. Do you agree that covered entities may decrease market making activity?

   Response: Yes. Fidelity believes that if the regulators adopt the proposed rules to implement the Volcker Rule in their current form, covered banking entities will decrease or eliminate their market making activity because the proposed market making exemption is crafted too narrowly, includes too many conditions to be workable in practice, and rests on the presumption that critical market practices that occur today should be prohibited unless the criteria are met. We believe the downstream effect of reducing market making activity will be to restrict market liquidity and, in turn, will negatively impact individuals seeking to invest their savings (including the shareholders of the funds we manage) and businesses that depend on access to the capital markets to help grow their operations.

2. If so, do you believe that other parties will step forward to provide liquidity? If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to? Are there any negative consequences that can be anticipated from this change?

   Response: We are concerned that other parties will not be able to step forward to provide the liquidity necessary to keep the U.S. capital markets the most efficient in the world.

   By pooling the assets of more than 20 million investors, Fidelity is able to achieve institutional pricing and trading for individual investors. Because of the significant size of the assets we manage for those investors, we only trade with large, well-capitalized counterparties, such as the covered entities that may be limited in their market making under the rules as proposed. These market making activities require a dealer to commit significant capital resources.

In today's market, we do not believe there is any entity or group that could step forward to provide liquidity in place of banks in the near term because of the amount of capital required. Some have suggested that hedge funds or start-up broker-dealers will seek to fill the potential void. Those counterparties will not have the capital commitment or the consistent market participation needed for our funds to execute the necessary trades. Although new entities could grow to a sufficient size over many years, capital markets would suffer significant disruptions in the near term as the banks curtail their market making activities at a time when the economy is already fragile.

Questions from Representative McCarthy:

1. I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions.

    a. What are some proposed changes and revisions the regulators should think about as they seek to finalize the rule?

Response: On February 13, 2012, Fidelity filed a comment letter with each of the agencies that issued the proposed rules. In the letter, a copy of which is attached, we identify steps the agencies could take to ensure that the Volcker Rule does not negatively impact investors in Fidelity's mutual funds, investment pools, and separate accounts.

For example, one of the changes that we requested in our letter is that the agencies expand the definition of "municipal securities." We believe that in drafting the Dodd-Frank Act, Congress correctly recognized that government securities should be beyond the scope of the proprietary trading prohibition for a variety of reasons. As currently drafted, however, the proposed rules do not include securities issued by state agencies or instrumentalities in the exemption for municipal securities. Securities issued by state agencies and instrumentalities represent approximately half of the securities offered by issuers in the municipal market. Failing to include these securities in the exemptions will bifurcate the municipal securities market by treating state agencies and instrumentalities differently than towns, counties and other municipalities. This will reduce liquidity in the municipal securities market and, accordingly, increase the trading costs to shareholders and clients in Fidelity's funds.

In addition, non-profit organizations that raise capital through state agencies and instrumentalities will face higher costs to raise capital. Finally, some states have established conduit agencies as political subdivisions while others have not, resulting in inconsistent application of the municipal securities exemption across different states.

Accordingly, we request in our letter that the regulators broaden the scope of the government obligations exemption by revising the definition of "municipal securities" to cross-reference that term as it is defined in the Securities Exchange Act of 1934, which includes state agencies and instrumentalities, as well as states and their political subdivisions.

Additionally, our letter discusses in greater detail other recommendations that the agencies should adopt. For example, asset-backed commercial paper and tender option bond programs

should be exempt from the definition of a "covered fund." These structures do not have the same attributes or raise the same concerns that Congress was attempting to address by restricting the ability of banks to own or sponsor hedge funds or private equity funds.

Finally, our comment letter urges the agencies to revise the market making exemption to allow banks to perform appropriate market making activities in the OTC derivatives market.

2. Do you feel substantive changes may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?

   Response: Yes. We believe that the hundreds of questions posed in the agencies' release underscore the complexity of the proposal. We understand that the agencies have received over 18,000 comment letters in response to their proposal, which the agencies must digest before finalizing any rulemaking. We believe that the volume of comment letters and the complexity of issues involved suggest that substantive changes are necessary in order to provide the capital markets with greater certainty in the application of the Volcker Rule. We discuss our proposed changes in the response to the previous question and in our comment letter.

   Given the volume of comments and need for further changes, we have concerns with the statutory effective date of Section 13 of the Bank Holding Company Act, which was added by Section 619 of the Dodd-Frank Act. Under Section 13, the Volcker Rule takes effect on July 21, 2012; however, public officials have stated recently that final rules will not be issued before this deadline. Accordingly, to avoid unnecessary market disruption, we urge the regulators to issue appropriate relief assuring that they will not enforce the Volcker Rule until an appropriate period of time after the effective date of the joint final rules.

3. Your testimony outlines potential negative consequences as a result of the proposed rule that could result in damaging effects on our economy. Please walk us through an example of how this would impact an individual who would seek Fidelity investment services.

   Response: By restricting the banks' ability to engage in principal-based trading, the proposed rules would reduce the inventory of securities that the banks could hold. As a result, it is possible that a bank would not hold a particular security or type of security that a Fidelity fund seeks to purchase or be able to purchase a security that a fund seeks to sell. This lack of easily accessible supply (or, conversely, the regulatory risk and costs a bank would incur by attempting to make markets) would increase the difference between the price that the buyer is willing to pay for a security and the price at which a seller is willing to sell it (known as a "bid-ask spread"). A wide bid-ask spread is a sign of market inefficiency and would require our funds to purchase securities at a market premium and sell securities at a market discount. These premiums and discounts would reduce returns for our fund's shareholders. In other words, trading would be less efficient.

   A highly simplified example may help explain this impact. In our hypothetical, there is a 10 year bond with a $100 par value and an annual interest rate of 5%, issued by a large financial institution with a BBB rating. Imagine a bond fund with $102 in assets wants to purchase the

bond. In an efficient market, a dealer will charge the fund a small spread for the right to purchase the bond and to receive the income from the 5% interest rate. To make the math straightforward, assume the dealer charges a spread of $1 to purchase the bond. Thus, the fund will pay $101 to purchase the bond with a par amount of $100. At the end of the year, the fund will have $106 in assets: the $100 bond, $5 in income and $1 in cash. This results in a 3.92% return for the fund.

If, however, the dealer were to charge more for the bond, the return would be lower. For example, if the dealer were to charge $2 to purchase the bond, the fund would pay $102 for the $100 par value bond. This would leave the fund with $105 in assets at the end of the year: $100 bond and $5 in income. This portfolio results in a 2.94% return for one year. Thus, the higher spread charged by the dealer directly reduces the return to the investor.

In addition, fund managers may not be able to sell securities as easily to meet shareholder redemptions because of the decrease in market liquidity. Prudent investment advisers would manage their funds to have larger cash balances (with fewer assets invested in securities) to accommodate such redemptions. The combination of the higher transaction costs and less opportunity for the funds to be fully invested in securities would reduce returns for our funds' shareholders.

Thank you again for the opportunity to testify on this important topic. We look forward to continuing to work with Congress and the agencies to ensure that any final rulemaking does not have unintended consequences for investors, capital formation and economic growth.

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February 13, 2012

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Secretary
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20th Street and Constitution Avenue, N.W.
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Docket No. R-1432 & RIN 7100 AD 82

Mr. John Walsh
Department of the Treasury
Office of the Comptroller of the Currency
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Docket ID OCC-2011-14 & RIN 1557-AD44

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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RIN 3064-AD85

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
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Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
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RIN 3038-AD05

Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to comment on the Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, issued by the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal

[1] Fidelity is one of the world's largest providers of financial services, with assets under administration of nearly $3.4 trillion, including managed assets of over $1.5 trillion. Fidelity provides investment management, retirement planning and many other financial products and services to more than 20 million individuals and institutions. Among these services, Fidelity serves as an investment adviser in connection with managing the assets of mutual funds, investment pools and separate accounts. Investors in these funds, pools and accounts include individuals, 401(k) contributors, pension plan beneficiaries, and state and local government pensions.

Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System,[2] as well as the counterpart proposal issued by the Commodity Futures Trading Commission[3] (collectively, the "Volcker Proposal").

We recognize the challenges faced by the Agencies[4] in formulating the Volcker Proposal as required by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the concerns that Section 619 was intended to address. Fidelity is not a "banking entity" to which Section 619 directly applies. However, implementation of the Volcker Proposal in the form proposed by the Agencies would have a significant impact on our mutual funds, investment pools and separate accounts that we manage for investors (collectively, the "Fidelity Funds and Accounts"), each of which engages in a significant number of transactions with banking entities and their affiliates and subsidiaries (collectively, "Covered Banking Entities"). These transactions include, among other things, the purchase and sale of equity and fixed income securities, derivatives and other financial instruments ("Financial Instruments") from and to Covered Banking Entities as part of their market making or underwriting services.

Congress has recognized the critical role played by Covered Banking Entities in providing capital, finance, and related services to businesses in the United States and, ultimately, to mutual funds and other investors.[5] Section 619 expressly permits activities that are critical to the functioning of U.S. financial markets, such as market making, underwriting, and hedging activities, as well as activities conducted on behalf of customers.[6] The Volcker Proposal includes exemptions to the prohibition on proprietary trading with regard to these activities.[7] However, Fidelity is concerned that the market making and underwriting exemptions are drafted too narrowly and will restrict liquidity and depth in the capital markets in which the Fidelity Funds and Accounts transact every day. We are also concerned that the proposed hedging exemption is drawn so narrowly that hedging transactions that serve to offset a portion of the risk of the original trade, that are done on a portfolio basis, or that cross multiple trading desks or groups within a Covered Banking Entity may not qualify for the exemption. Fidelity presented

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[2] Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (jointly proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248, 351 and 255).

[3] CFTC Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (issued Jan. 11, 2012) (to be codified at 17 C.F.R. pt.75).

[4] The Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission are referred to in this letter collectively as the "Agencies."

[5] *See* 156 CONG. REC. S5902 (daily ed. July 15, 2010) (statement of Sen. Bayh). Senator Bayh sought and received confirmation from Chairman Dodd that the permissible activities under the Volcker Proposal would "allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without flexibility, market makers would not be able to provide liquidity to markets."

[6] *See* Dodd-Frank Act § 619(d), 12 U.S.C. § 1851(d).

[7] Volcker Proposal §§ _.4(b), _.4(a), _.5, _.6(a) _.6(b) _.6(c) and _.6(d), respectively.

our concerns regarding the Volcker Proposal at a recent Congressional hearing,[8] where Alexander Marx, Head of Global Bond Trading for Fidelity, described some of the unintended consequences that the Volcker Proposal in its current form would have on certain market making and underwriting activities. His written testimony is attached as an addendum to this letter.

The Fidelity Funds and Accounts rely on the ability of Covered Banking Entities to trade both fixed income and equity securities on a principal basis using generally available hedges to bridge gaps in price and/or time that occur until other market participants may be willing to assume the risks from the Covered Banking Entity in multiple trades. It is crucial for the Fidelity Funds and Accounts that Covered Banking Entities have the ability to make markets and hedge, without undue restriction. On behalf of the shareholders and clients in the Fidelity Funds and Accounts, we request that the Volcker Proposal be revised to provide the broadest exemptions possible under the statute for market making, underwriting and hedging activities.

Covered Banking Entities Perform Essential Functions for Fidelity Funds and Accounts

On each day markets are open, the Fidelity Funds and Accounts engage in trades totaling billions of dollars with Covered Banking Entities. In the primary market for fixed income Financial Instruments, which is an over-the-counter ("OTC") market, Covered Banking Entities serve as underwriters by purchasing bonds and money market instruments from corporate and municipal issuers and, in turn, selling those Financial Instruments to a wide range of investors, including the Fidelity Funds and Accounts. This is an essential function for the Fidelity Funds and Accounts, as the Covered Banking Entities facilitate the creation of new securities for the Fidelity Funds and Accounts to invest in by purchasing securities of issuers, an essential role in capital formation.

In the secondary market, the Fidelity Funds and Accounts rely on a Covered Banking Entity's ability, at any particular time, to buy and sell Financial Instruments. This is also a vital market function as the Fidelity Funds and Accounts can trade Financial Instruments with Covered Banking Entities without spending time and money to find another investor in the market who is a perfect match for a particular trade. Many of these trades simply would not occur if Covered Banking Entities were not able to commit capital to purchase securities and hold Financial Instruments until another buyer is located. This ability allows the Covered Banking Entity to serve as a direct counterparty to each Fidelity Fund or Account, thereby facilitating the Fidelity Fund or Account's day-to-day trading needs.

In these transactions, the Covered Banking Entity is not trading solely on behalf of a third-party client (a process known as trading on an "agency" basis), but rather on a customer-facing principal basis. We believe that this type of principal trading is distinguishable from speculative proprietary trading. In customer-facing principal trading, the dealer is making a market in securities, which allows the Fidelity Funds and Accounts to transact efficiently.

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[8] Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Joint Hearing Before the H. Comm. on Financial Services, 112th Cong. (2012), available at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=274322.

Principal trading is commonplace in fixed income markets. In the equity markets, although a significant portion of trading is done on an agency basis, larger investors, such as the Fidelity Funds and Accounts, also engage in a considerable amount of trading with Covered Banking Entities on a principal basis to reduce transaction costs and to mitigate shareholder risk.

Block trading represents one important example of how both equities and fixed income securities are traded by Fidelity Funds and Accounts with Covered Banking Entities on a principal basis. Block trading relies heavily on Covered Banking Entities' ability to act as market makers undertaking principal risk because, generally, an investor selling securities requires a Covered Banking Entity acting as a dealer to guarantee a minimum price or volume for the block trade. This principal trading by Covered Banking Entities benefits investors by facilitating trading at a more favorable execution price in a single transaction, rather than requiring trade execution in smaller increments over a longer period of time. We are concerned that the Volcker Proposal in its current form will unnecessarily impair the ability of Covered Banking Entities to facilitate block trading, because they may not be able to qualify for the market making exemption when entering into block trades. We encourage the Agencies to recognize the legitimate investment and trading needs of investors like the Fidelity Funds and Accounts by explicitly recognizing that customer-facing principal trades and block trades qualify for the market making exemption.

Volcker Proposal's Impact on Key Financial Products

In addition to the overarching impact on the liquidity of the financial markets, we are concerned that the Volcker Proposal will have harmful effects, without commensurate benefits, on certain instruments that are critical to the Fidelity Funds and Accounts.

A. The Definition of "Municipal Securities" Should be Expanded

The Volcker Rule provisions in the Dodd-Frank Act contemplate that the Agencies will exclude certain types of securities from the general prohibition on proprietary trading, including securities issued by the federal government, states and political subdivisions of states. We believe that the drafters of the Dodd-Frank Act correctly recognized that government securities should be beyond the scope of the proprietary trading prohibition for a variety of reasons. Municipal securities, for example, are the primary source for financing important governmental, municipal and non-profit community projects. The Fidelity Funds and Accounts hold over $90 billion of municipal securities.

As currently drafted, however, the Volcker Proposal does not include securities issued by state agencies or instrumentalities in its exemption for municipal securities.[9] These securities represent approximately half of the securities offered by issuers in the municipal market.[10]

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[9] Volcker Proposal §_.6(a); n. 165.

[10] *US Municipal Strategy Special Focus*, Citigroup Global Markets Research Report, Nov. 20, 2011, *available at* http://www.nabl.org/uploads/cms/documents/Volcker_Muni_Proposal.pdf.

Failing to include such municipal securities in the statutory exemptions will increase the trading costs to shareholders and clients in the Fidelity Funds and Accounts.

We believe that in this context the distinction between securities issued by states and their political subdivisions, on the one hand, and securities issued by state agencies or other instrumentalities, on the other hand, is without basis. This approach would lead to a bifurcated municipal securities market in which tax-exempt organizations would have to pay higher costs to raise capital. In addition, splitting the municipal securities definition would reduce the liquidity of the municipal securities market as a whole. The Fidelity Funds and Accounts hold a variety of municipal securities: some would be covered by the current version of the municipal securities exemption, and others would not. This unnecessarily limited exemption would significantly increase the trading costs of managing a municipal fund, leading to lower returns for its investors. Furthermore, some states, but not all, have established agencies as political subdivisions; this would mean that the application of the Volcker Proposal's definition of "municipal securities" would have inconsistent application across different states.

Accordingly, we request that the Agencies broaden the scope of the government obligations exemption by revising the definition of "municipal securities" in the Volcker Proposal to cross-reference that term as it is defined in Section 3(a)(29) of the Securities Exchange Act of 1934.[11] The definition of the term in that section properly includes state agencies and instrumentalities, as well as states and their political subdivisions.

B. Covered Funds: Asset-Backed Commercial Paper and Tender Option Bonds

In addition to the restrictions on proprietary trading, Section 619 of the Dodd-Frank Act limits the ability of a Covered Banking Entity to own or sponsor a hedge fund or private equity fund.[12] The Volcker Proposal utilizes the term "covered fund", which is defined to include any "issuer that would be an investment company, as defined in the Investment Company Act of 1940 . . . *but for* section 3(c)(1) or 3(c)(7) of that Act."[13] This definition sweeps in not just private equity funds and hedge funds, but any other financing vehicle that meets the criteria for one of these sections.[14] These other vehicles include structures used in asset-backed commercial paper ("ABCP") and tender option bond ("TOB") programs. The result is that Covered Banking Entities would be prohibited from owning or sponsoring these financing structures. Fidelity Funds and Accounts owned $8.4 billion of ABCP and $12.3 billion of TOB securities, as of January 31, 2012.

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[11] The Securities and Exchange Act of 1934, §3(a)(29), 15 U.S.C. § 78c (a)(29).

[12] *See* Dodd-Frank Act § 619(a)(1)(B), 12 U. S.C. § 1851(a)(1)(B).

[13] Volcker Proposal §_.10(b)(1); *see also* Investment Company Act of 1940, 15 U.S.C. §§ 80a-3(c)(1) and (7) (exempting certain funds that are not offered publicly from registration requirements that govern other investment companies). The Investment Company Act of 1940 is referred to in this letter as the "Investment Company Act."

[14] Id.

Section 619 provides the Agencies with the flexibility to define private equity fund and hedge fund appropriately,[15] as acknowledged by the Agencies in the Volcker Proposal.[16] Simply because other investment vehicles, particularly those involved in structured finance, may also rely on Section 3(c)(1) or 3(c)(7) to avoid being classified as an investment company, does not mean that such vehicles have the same attributes or raise the same concerns that Congress was attempting to address by restricting the ability of Covered Banking Entities from owning or sponsoring hedge funds or private equity funds. Fidelity urges the Agencies to use the discretion granted to them by Congress under Section 619 to exempt ABCP and TOB structures from the definition of "covered fund."

(1) Tender Option Bonds

TOB trusts are funding vehicles that were developed to finance municipal securities for which traditional taxable financing structures are not a viable option. The TOB structure allows issuers to secure stable funding at short-term rates. The sponsor of a TOB structure purchases high quality municipal bonds in the primary or secondary market and transfers those bonds into a trust. Typically, the trust issues two classes of certificates: floating rate certificates and residual certificates. The floating rate investors are generally interested in short-term, tax-exempt investments, and they provide a principal investment equal to 99% or more of the price of the underlying bonds. The investors in the residual certificates are generally Covered Banking Entity sponsors or third party investors, which provide the balance of the capital. The floating rate certificate holder receives a short-term rate of interest that is reset at specified intervals. The holder has the right to sell (i.e., tender) its certificates back to the bank sponsor, and such right is backed by a liquidity provider. The residual holder receives the coupon on the underlying bonds, less the sum of (1) interest paid to the floating rate certificate investors and (2) fees paid to the bank sponsor and trustee. The liquidity provider supports the tender, allowing the holder of the floating rate certificate to receive face value of the security plus accrued interest, either from remarketing proceeds or a draw on the liquidity facility.

TOB trusts hold highly-rated municipal securities, and do not present the types of risk that Section 619 was intended to address. Under the Volcker Proposal, a TOB trust would be deemed a "covered fund" by cross-reference to the Investment Company Act provisions and, accordingly, a Covered Banking Entity would be prevented from sponsoring it or investing in it. This could result in the elimination of TOB trusts entirely, which would remove an important source of short-term investments for investors, including the Fidelity Funds and Accounts. It also would reduce overall demand for municipal securities and have a detrimental impact on the states and municipalities that rely on municipal securities as a critical source of financing. The

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[15] *See* Dodd-Frank Act § 619(h)(2), 12 U.S.C. § 1851(h)(2) ("[t]he terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 [citation omitted], but for section 3(c)(1) or 3(c)(7) of that Act, ***or*** such similar funds as the [Agencies] may, by rule, as provided in subsection (b)(2), determine" (emphasis added).

[16] *See* Volcker Proposal, Question 221, in which the Agencies query whether the "covered fund" definition should "focus on the characteristics of an entity rather than whether it would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act."

Volcker Proposal should expressly state that TOB structures will be excluded from the definition of "covered fund" and that TOBs are exempted from the proprietary trading prohibition.

(2) Asset-Backed Commercial Paper

ABCP programs are senior-secured working capital financing vehicles that issue instruments in the money markets. Manufacturers, banks, finance companies, and broker-dealers all use ABCP programs to obtain low-cost financing for a diverse range of trade and financial receivables, including manufacturing account receivables, commercial loans, equipment loan and lease receivables, consumer loans, auto loans and leases and student loans. Historically, ABCP has been an important investment for money market mutual funds, including those managed by Fidelity. The sponsorship of ABCP programs is part of traditional banking activities and not comparable to hedge fund or private equity fund activities, which are the focus of Section 619.

Generally, a Covered Banking Entity will be involved in the creation of an ABCP program, which could be interpreted to be a "covered fund" under the Volcker Proposal since it relies on the same statutory exemptions from investment company status. The sponsoring Covered Banking Entity will typically provide critical support facilities to the ABCP program. These support facilities – a traditional banking function – serve to enhance the liquidity and credit profile of the issued debt instruments. Any application of the Volcker Proposal to ABCP would be inappropriate and, accordingly, we believe the Volcker Proposal should be revised to expressly exclude ABCP programs and to exempt the related securities from the proprietary trading prohibition.

(3) Additional Impact on ABCP and TOB Programs

In addition to the foregoing, another complication would arise if ABCP or TOB structures were considered to be "covered funds." Specifically, subject to limited exceptions, newly codified Section 13(f) of the Bank Holding Company Act prohibits all "covered transactions"[17] between a Covered Banking Entity and any covered fund it sponsors or manages. This means that if ABCP and TOB structures are not carved out of the definition of "covered fund," a sponsoring Covered Banking Entity would be prohibited from providing a liquidity facility to support the ABCP or TOB program under the Volcker Proposal.[18] Eliminating the liquidity facility from the standard structure for ABCP and TOB programs would jeopardize the low risk nature of investments in such programs, which would ultimately harm shareholders and clients of the Fidelity Funds and Accounts. We do not believe this issue needs to be addressed if the Agencies properly exempt ABCP and TOB programs from the definition of "covered fund" in the Volcker Proposal. However, if the Agencies do not revise the Volcker Proposal in that manner, they should expressly (i) include ABCP and TOB structures within the loan securitization exemption and (ii) permit the liquidity support and credit enhancement for such programs to be provided by Covered Banking Entities.

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[17] *See* 12 U.S.C. 371c (defining "covered transactions").

[18] Volcker Proposal §_.16(a)(1). *See also* Dodd-Frank Act § 619(f), 12 U.S.C § 1851(f).

C. OTC Derivatives

The Fidelity Funds and Accounts use derivatives to take market risk, diversify risk exposure, or to gain or hedge against risks related to particular investments, issuers or sectors. Shareholders and clients in Fidelity Funds and Accounts benefit from the ability of our portfolio managers to use derivatives in these ways, consistent with the relevant investment strategy.

The counterparties to the Fidelity Funds and Accounts for OTC derivatives trades are generally Covered Banking Entities. Currently, Covered Banking Entities typically manage ongoing residual risks on a portfolio basis, often looking at the OTC derivatives business as part of their overall equity or fixed income businesses.

The supplementary information included with the Volcker Proposal recognizes that dealers do not make markets in OTC derivatives in the same way that brokers make markets in securities. Notwithstanding this difference, market making is essential to well functioning OTC derivatives markets. The current version of the Volcker Proposal's market making exemption does not adequately reflect the unique nature of the OTC derivatives market. We believe the effect is that Covered Banking Entity trading in OTC derivatives would be unnecessarily limited, which would result in reduced liquidity and increased volatility in the OTC derivatives market and the diminished ability for market participants to manage and take market risk. Accordingly, the Fidelity Funds and Accounts would have less access to these Financial Instruments. We urge the Agencies to revise the exemption to allow appropriate market making activities in the OTC derivatives market to be performed by Covered Banking Entities.

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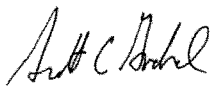
We appreciate the opportunity to comment on the Volcker Proposal. Fidelity would be pleased to provide any further information or respond to any questions that the Agencies' staff may have.

Sincerely,



cc:
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
Gary Gensler, Chairman, Commodity Futures Trading Commission
Timothy F. Geithner, Secretary of the Treasury
Mary L. Schapiro, Chairman, Securities and Exchange Commission

Thank you for asking these very important questions. Please find my answers to those questions below.

1. ***Do you agree that covered entities may decrease market making activity?***
   Yes. As we indicated in our letter to the agencies, dated November 16, 2011, the way in which the Volcker Rule Proposal, and specifically the market making exemption, has been written leads us to the conclusion that banking entities will no longer have the capacity or desire to make markets in all but the most liquid exchange traded securities. The presumption that all transactions are violations and the requirement that transactions that do not generate a profit or loss beyond a spread or commission will need to be justified ex post will cause banking entities to avoid the situation entirely.

2. ***Do you believe that other parties will step forward to provide liquidity if banking entities retreat from market making activity?***
   Other parties may fill the market gap but it could take a long time for this void to be filled. Given the size of the markets that are likely to be affected, for instance, the $7 trillion corporate fixed income market, it is reasonable to conclude that there will be a significant lag between when the banking entities are no longer in a position to provide market making activities and when substitute capacity can be built. It is not clear that enough substitute capacity can be built to completely offset the amount of lost activity. Although regional firms may grow to meet some of the demand, their knowledge base and the smaller size of their capital base may prohibit them from reaching the critical mass needed to effectuate the majority of transactions.

3. ***If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning market? What kind of regulatory scrutiny are those institutions subject to?***
   In many ways, the lost capacity may not be replaced. For some transactions there may be a mix of counterparties that will attempt to replace the banking entities. For example, smaller regional broker-dealers may try to replace the lost market making capacity. However, these companies may not have the ability or skill to provide the market with the required level of liquidity.

4. ***Are there any negative consequences that can be anticipated from this change in liquidity providers?***
   There are a number of potential outcomes that are concerning. First, the market for many products might simply evaporate. This would increase the costs borne by investors, who are most often retirement plans, pension plans and individuals. In addition, there is the likelihood that issuers will experience increased costs. As the AMG points out in their letter, dated February 13, 2012, a reduction in the amount of liquidity could increase costs to issuers who are both frequent and well known. Those that issue with less frequency, or who are less well known, could effectively experience a shutdown in their ability to raise funds.

5. ***What are some proposed changes and revisions the regulators should think about as they seek to finalize the rule?***

Entities should be confident that their activities meet the requirements for market making if they: 1). Engage in customer-focused market making-related activities; 2). Develop reasonable policies and procedures that outline qualitative factors indicating customer directed activity consistent with guidance provided by the supervisory/regulatory agencies; and 3). Develop a regime of quantitative metrics—reportable to supervisors—that will trigger escalation within the individual institutions and that is approved and reviewed by supervisors/regulators.

6. ***Do you feel substantive changes may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?***

See attached the SIFMA Asset Management Group and AllianceBernstein comment letters to regulators on the joint proposal dated February 13, 2012 and November 16, 2011, respectively.

ALLIANCEBERNSTEIN

Peter S. Kraus
Chairman and CEO

November 16, 2011

By electronic submission

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Securities and Exchange Commission
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Washington DC 20549

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW.
Washington, DC 20551

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, SW.
Washington, DC 20219

Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

Dear Madames/Sirs:

AllianceBernstein L.P. ("AllianceBernstein") is a global asset management firm with approximately $424 billion in assets under management as of October 31, 2011. AllianceBernstein provides investment management services to both institutional and individual investors through a broad line of investment products. 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. The investors we serve include savers, pension beneficiaries, mutual fund investors and other "main street" stakeholders.

AllianceBernstein recognizes and supports the effort of the Office of the Comptroller of the Currency, Treasury ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); and Securities and Exchange Commission ("SEC") (collectively the "Agencies") to

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promulgate appropriate rules (the "Proposal") to implement Section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We appreciate having the opportunity to comment on the Proposal and, as described in more detail below, believe that significant changes to the approach taken by the Agencies are necessary, particularly with respect to the provisions effectuating the market making exemption contained in the Dodd-Frank Act.

Market making is a core function of banking entities and provides liquidity needed by all market participants, including the pension funds, endowments and individual investors that are our investment management clients. We believe it is crucial that the steps mandated by the Dodd-Frank Act be implemented in a manner that does not disrupt the liquidity necessary for functioning securities markets and impose potentially prohibitive costs and burdens on market participants.

Market Making: Necessary and Vital for Functioning Markets

Market makers transact with investors at a price that reflects the general risk of the security, including (i) the perceived demand from buyer's of the security, (ii) the cost to carry the security if it had to be held until a buyer is found, (iii) the general credit risk and price volatility of the security, and (iv) the incremental impact that the market makers position would have on its liquidity, overall risk positions, and expected return on the capital required to hold the security. In short, the market maker is required to evaluate all risks in purchasing the security which would inure to an owner of the risk.

The simplest of market making activities involve exchange traded securities. Over time and with the help of improved regulation, liquidity in this market has vastly improved and transaction costs have declined significantly, largely because the buyers and sellers of an issuer's equity always transact in a fungible unit representing ownership of an issuer (the issuer's common stock). The homogeneity of the equity structure helps to ensure there is a steady stream of liquidity for the majority of issues being traded[1]. Accordingly market makers can reasonably expect in most cases to be able to quickly dispose of securities purchased in these markets.

Other markets, however, are more complex and less liquid. In the fixed income market, for example, each issuer typically has multiple securities trading in the market and each individual issue is vastly smaller than the related equity capitalization of the issuer. In other words, unlike equities there is no single, homogenous, tradable unit of credit risk for an issuer and as a result there is fragmentation and intermittent liquidity for any single issue. By definition it is much harder for these transactions to find liquidity, and it is the responsibility of market makers to bridge the gap between buyers and sellers and provide the immediate liquidity necessary for these markets to function.

If banking entity market makers are essentially prohibited from holding inventory due to the Proposal, this will be reflected in both the ability of the market makers to

[1] This does not necessarily apply to block-sized trades, where there may be liquidity constraints and the corresponding need for market makers to take principal positions.

provide liquidity and transactions costs. The uncertainty created will also increase volatility since in markets when uncertainty rises, the search and demand for liquidity at the lowest possible transaction price still occurs but at the expense of price volatility.

The Impact of the Proposal on Market Making Activities

While Section 619 of the Dodd-Frank Act generally prohibits any "covered banking entity" from engaging in "proprietary trading," there are certain statutory exceptions. The legislation specifically provides an exemption for *"The purchase, sale, acquisition, or disposition of securities and other instruments . . . . . in connection with underwriting or market-making-related activities . . . . ."*

Rather than acknowledge this tenet and setting forth broadly applicable standards to govern permitted market making activities, the Proposal creates a presumption that any covered financial position[2] that a covered banking entity holds for a period of sixty days or less is a prohibited proprietary transaction. While the presumption is "rebuttable" we respectfully submit that the framework for rebutting the presumption contained in the Proposal and accompanying documentation is unworkable for a number of reasons, including: (i) an inability to predict the financial impact of market making activities (a) for purposes of complying with the metrics set forth in the Proposal and (b) due to the acceleration of market instability caused by limitations on price discovery in periods of rising market volatility, where banking entity market makers could otherwise have provided liquidity; (ii) the general erosion of investor confidence by limiting price discovery in periods of rising market volatility, again where market makers could otherwise provide liquidity; (iii) the failure of the Proposal to identify and account for different types of market making environments, particularly those related to the fixed income markets and other OTC markets; (iv) the creation of perverse incentives through mandates on how compensation is calculated; and (v) the onerous and potentially contentious compliance mandates that could encourage covered banking entities to abandon less liquid and more volatile segments of various markets.

With respect to (ii) above, we believe that the Proposal was drafted solely from the perspective of regulated market making activities in organized markets where intermediaries generally act as agents, such as those for listed securities, with the exception of block trades, which also require market makers to commit capital and hold positions. The description of market making activities set forth in the Proposal clearly do not take into account unregulated over-the-counter market making activities that covered banking entities provide to these markets, which require intermediaries to regularly trade as principal due to the high degree of fragmentation and intermittent liquidity of said markets[3] or where market makers provide capital as a principal for listed securities.

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[2] A "covered financial position" is any of the list of securities listed in Subpart B, Section __.3, which includes a security, derivative, commodity futures contract, or an option on any of the preceding, but does not include any loan, or direct purchase or sale of a commodity or foreign currency.

[3] The release specifically states at page 56 that *"The language used in § __.4(b)(2)(ii) of the proposed rule to describe bona fide market making-related activity is similar to the definition of "market maker" under section 3(a)(38) of the Exchange Act. The Agencies have proposed to use similar language because the Exchange Act definition is*

While our comments reflect our view as to the application of the Proposal to all markets, one of our greatest concerns is the devastating effect that the Proposal would have on the fixed income markets that exhibit intermittent liquidity and thus require market makers to act as principal in order to ensure liquidity or for that matter any market where rising and spiking uncertainty requires market makers taking principal positions to provide capital to insure normal liquidity. We respectfully submit that the failure to take into account over-the-counter market making activities reflects a major oversight and must be addressed in the final analysis and rulemaking. The final rules must take into account other scenarios when committing capital is essential to ensuring normal markets prevail.

The ability of corporate issuers to place their debt securities in the US capital markets is fundamentally dependent on the availability of adequate secondary market liquidity for these securities. Purchasers of these securities, including large pension funds, mutual funds, insurance companies and college and other endowments, and their investment managers, are willing to purchase these securities only because of adequate secondary market liquidity (so that they can meet their ongoing cash needs) which depends in large part on the market making activities of banking entities. We believe that any significant reduction in liquidity provided by market makers will, until another source of liquidity develops, have a dramatic adverse effect on the ability of corporate issuers to access needed funds in the US capital markets. We are convinced that the Proposal will in fact 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.

In summary, we believe that the inability to confidently engage in market making activities on a principal basis under the Proposal, along with the onerous recordkeeping and compliance burdens required will have a material and detrimental impact on the ability of covered banking entities to engage in market making activity. The Proposal, as drafted, will likely dramatically reduce market liquidity, increase costs and in some cases impact the ability of market participants to meet their legally required obligations to investors and other stakeholders. The net effect of this will be to reduce returns to savers, increase transaction costs, and increase the risk of investments by reducing liquidity to savers.

A more detailed explanation of some of our concerns is set forth below.

Holding Period

The Proposal generally prohibits a covered banking entity from acting as principal in the purchase or sale of a covered financial position for its own trading account. As noted above, the Proposal creates a presumption that any account that holds a covered financial position for a period of sixty days or less is a trading account

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generally well-understood by market participants and is consistent with the scope of bona fide market making-related activities in which banking entities typically engage"

and thus such transaction is presumptively prohibited. The Proposal allows this presumption to be rebutted if the covered banking entity can demonstrate that the position was not acquired principally for any of the purposes list in Subpart B, Section __.3(b)(2)(i)(A). We submit that the combination of this negative presumption combined with rebuttals that may be difficult (if not impossible) to demonstrate, will provide a strong incentive to covered banking entities to dispose of each and every position as quickly as possible in order to avoid any taint that could result in the transaction being considered a prohibited proprietary transaction.

As a result, banking entity market makers are going to be reluctant to make a market in any securities they are not reasonably confident they can dispose of immediately. Since the market maker is disincentivized from holding a security, it must charge a fee that is commensurate with the inherent risk of the position, particularly the risk associated with having to quickly dispose of it. The fee will be of necessity greater than current levels, as banking entity market makers' can no longer rely on mitigating the risk and cost associated with committing capital on behalf of clients by holding positions. Additionally, since the possibility of holding the security until natural buyer demand is located is not viable, the market maker must charge an additional amount compensate for the pricing risk involved with finding immediate buyer interest.

On top of this, the market maker employee is incentivized under the Proposal to maximize the fee charged on individual transactions without concern for the underlying profitability of the trade as their personal compensation depends solely on the amount of the spread and fees earned. From a market making and client facing perspective, this is a perverse arrangement that will further inflate spreads and in some cases dissuade the market maker from providing liquidity at all.

Competition among market makers will certainly provide some respite for the sellers, but all banking entity market makers will share the same constraints, competitive aspirations and compensation objectives. The banking entity market makers possessing strong distribution systems will be able to charge more to sellers, since they have distribution strength and can only commercialize that strength by increasing the spread or fees charged, which are to be the sole economic drivers for these market makers.

The final rules must take into account the fact that market making often involves the need to take short-term positions that will result in profit and loss. This activity is distinguishable from proprietary trading activity and is the natural economic result flowing from the willingness of the market maker to commit capital to facilitate orderly trading. Moreover, this is a necessary requirement for functioning markets.

Hedging

The market making exemption in the Proposal appears to be predicated on the incorrect assumption that there is a perfect hedge for all securities and that all risks can be hedged for any given holding period for any position. The Proposal relies heavily on

the use of hedging as a means of enabling market makers to offset the risks associated with taking short term positions, and perhaps more importantly in the context of compliance with the Proposal, avoiding realized profits or losses in connection with positions held by a banking entity market maker. The Proposal ignores the fact that there are not perfect hedges for all securities. Certainly there are segments of fixed income markets and OTC markets where such hedges do not exist or markets where even the best structured hedges fail to protect the hedging party fully. 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. Also, as is the case with all of the requirements of the Proposal, each trade is looked at individually, which multiplies the probability that a covered banking entity is deemed to have engaged in a prohibited activity. Also, hedging transactions involve a cost which the market makers will pass on to their customers. This will only add to the additional expense borne by investors as a result of the Proposal.

Given these facts, and the emphasis the Proposal places on avoiding profit or loss on positions taken by market makers, intermediaries are not going to be able to place great confidence in the use of hedging as a means of staying within the exemption.

Compliance Costs and Burdens

As noted previously, the Proposal starts with the presumption that taking a position for a period of sixty days or less is a prohibited proprietary transaction. While the market-making exemption provides a mechanism for rebutting this presumption, this involves analyzing the market making activity of a covered banking entity on almost a transaction by transaction basis. Not only would the compliance program, tasked with preventing prohibited proprietary trading, be extremely complex, onerous, and require a significant build-out of resources, manpower and systems, but the process would be vulnerable to hindsight interpretations that fail to capture or downplay important facts and color that justified the trade at time of execution.

The operational burdens and costs associated with this process are going to be magnified by the costs involved in providing the new reports and tracking the information that the covered banking entities are required to provide. The compliance process will also require numerous performance and profit/loss calculations in order to track the many metrics enumerated in the Proposal. Additionally, given the presumption created by the Proposal, there is a risk, given the dynamics of a particular firm, that the compliance process could become a contentious and adversarial process with compliance focused on generating reasons why a transaction should be classified as prohibited activity.

Impact on Open End Mutual Funds

As of year-end 2010, mutual funds accounted for approximately 22 percent of household financial assets in the US. The liquidity needs of open end mutual funds are largely driven by the need to respond to both redemptions and subscriptions. Section 22(e) of Investment Company Act of 1940 requires open end funds to meet redemptions requests within seven days and limit the ability of open end funds to borrow money to fund redemptions. Effectively, during a period of material redemptions a fund is a forced seller of securities and during a period of heavy inflows a fund is more or less a forced buyer.

Currently mutual funds can rely on intermediaries to commit capital and facilitate an orderly market. This not only benefits funds and their managers, but it ultimately benefits the millions of small investors that are served by the mutual fund industry. Implementation of the Proposal will immediately convert a significant number of these intermediaries from market makers, in the sense we see them now, to themselves being forced sellers or buyers of securities they are still willing to make markets in. Not only will this immediately impact funds in terms of higher trading costs and reduced liquidity, but in fixed income and other markets the value of the securities traded will be reduced due to long term uncertainty about the availability of liquidity. Also, in periods of significant financial system stress, liquidity could be so limited that many fixed income mutual funds could be forced to suspend redemptions, which would have a severe adverse effect on mutual fund shareholders and contribute greatly to systemic financial system risk.

"High Risk" Assets

The Proposal prohibits any transaction that results in material exposure to "high-risk assets." Section __.8(c)(1) defines a "high-risk asset" as an asset or group of assets that would, if held by the covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail. We respectfully submit that this is unacceptably vague and open ended. To put the danger of moving forward with such an open-ended definition into perspective, we submit that during 2008, many of the securities traded in the mortgage market and other financial markets would likely have been characterized as "high risk assets" under the relevant language of the Proposal. It is vital for our markets that regulation not force market makers to exit their markets in times of stress and yet this is exactly what would happen if the Proposal is adopted as written. When considering a definition for "high risk assets," we encourage the Agencies to consider whether their definition would have forced covered banking entities to exit markets during the recent financial crisis. It is very clear that the intent of the Dodd-Frank Act is not to constrain liquidity during times of crisis since this would exacerbate the impact upon the economy.

Exception for Government Securities

Section __.6(a) of the Proposal describes the government obligations in which a covered banking entity may trade notwithstanding the prohibition on proprietary trading, which include US government and agency obligations, obligations and other instruments of certain government sponsored entities, and state and municipal obligations. We respectfully submit that to continue to permit covered banking entities to accumulate significant risk in these markets in a manner that is not readily distinguishable from the risk associated with other asset classes, such as corporate bonds, is not reconcilable. On the one hand, the Proposal recognizes the importance of maintaining liquidity and access to capital for the US and state and local governments, while on the other hand ignoring the obvious danger of limiting liquidity and access to private capital for private businesses across the country. In short, we do not see the basis for permitting bank-owned broker dealers to assume the risks of providing unrestricted liquidity for US Government Obligations and other government related obligations, while prohibiting them from assuming the same risks for non-Government debt. The importance of insuring liquidity for US and state and local government obligations is obvious. We believe that the importance of providing the same liquidity for obligations of corporate issues, the principal drivers of US employment, is just as obvious.

Costs Versus Benefits

Assuming the Proposal is adopted in its current form, we believe that liquidity and trading costs will be significantly and adversely impacted. Implementation of the Proposal would, in our opinion, cause significant market dislocation and permanent changes in market liquidity available to transactions with no assurance that the outcomes they are designed to prevent will be avoided. What we can be certain of is that the US economy will be forced to bear both short-term and long-term costs associated with the reduction in market liquidity. While it is impossible to accurately predict what these costs would be, a simple example can give some indication of their magnitude.

Taking just the US corporate bond market and assuming: (i) the outstanding daily value of publicly traded debt securities is $16.4 billion; (ii) the average annual turnover of the outstanding float is 1X and (iii) the increased average cost per-trade resulting from the Proposal would be 1% would give us an annual cost of $41 billion. Not only would anything approximating this be a huge amount to pay for protection that is dubious at best, but it does not consider the indirect costs and adverse economic impact (e.g., from more limited access to debt financing) the Proposal would have on the financial markets and the US economy.

Economic and Competitive Risks

Based on the concerns and examples we have set forth, we believe implementation of the Proposal will have serious negative implications for the cost of

capital to US businesses, liquidity in the US financial markets and the US economy. Implementation should also be examined within the context of the global financial markets, recognizing the risk that financial activity may migrate to the unregulated shadow banking system or to foreign financial centers such as Hong Kong, Singapore, London, Frankfurt, Paris or Zurich, or future foreign locations where investors can access reliable and properly-priced liquidity. The resulting negative effects on the strength and competitiveness of the United States as a global financial center and on employment for many thousands of individuals would be serious and irreversible. Investors will transact at the most economically viable point, physical locations will ebb and flow around that point.

Conclusion

If the Proposal is adopted in its current form, it can reasonably be expected that covered banking entities will be forced to severely curtail their traditional market making activities for all but the most liquid of securities. While this may be the intended effect of the Proposal, it ignores the fact that much of the current market making activities in this country are provided by covered banking entities. The short time frame provided for the covered banking entities to implement the Act almost insures a dramatic reduction in liquidity in the marketplace, as there does not now exist enough capacity among non-bank market makers to provide the necessary liquidity to the markets abandoned by the covered banking entities. The economic impact at a time when the economy is struggling is worrisome. Long term, we are concerned that a potential unintended consequence of the Proposal is that much of the market making activities currently provided by the covered banking entities may over time relocate offshore, along with much needed jobs.

Making a wholesale change of this magnitude to an activity so essential to the efficient functioning of our capital markets without the support of any empirical or academic studies analyzing the likely consequences is just not prudent or responsible.

We strongly urge the Agencies to re-think the approach taken in the Proposal by addressing the points raised in this letter in order to create a regulatory framework that accomplishes the narrow mandate of Section 619 of the Dodd-Frank Act, to prohibit speculative "proprietary trading" by covered banking entities, without adversely affecting the efficient functioning of US markets.

Very truly yours,

Peter S. Kraus
Chairman and CEO

sifma
Invested in America

asset management group

February 13, 2012

By electronic submission

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Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "**Agencies**") with our comments on their proposals to implement the proprietary trading provisions of the Volcker Rule (together, the "**Proposal**").[1]

AMG represents U.S. asset management firms whose combined assets under management exceed $20 trillion. Our clients include, among others, registered

[1] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (proposed Jan. 13, 2012).

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 our capacity as fiduciaries for millions of individual investors, AMG members rely on the essential liquidity provided by banking entities acting as market makers. As asset managers, we believe that the proprietary trading provisions of the Proposal, if implemented, would drastically disrupt the liquidity that banking entities provide to our clients. As a result, the value of our clients' portfolios would decline, the transaction costs of investing will increase and returns on investments will shrink. The Proposal will also reduce the ability of corporations to raise capital by raising costs, which would harm the real economy by reducing production, wages and job growth.

This harm to the financial markets and real economy is unnecessary. We believe that the Volcker Rule intended to preserve market making liquidity and corporate capital raising by explicitly permitting banking entities to make markets, act as underwriters, hedge their risks and act on behalf of customers.[2] Congress made clear that the Volcker Rule should not be impair the ability of customers, such as our clients, to obtain essential market making and underwriting services from banking entities. The Volcker Rule was intended to orient banking entities toward serving customers like our clients and other end users, rather than proprietary trading. The Proposal does not adequately fulfill this congressional goal. Instead, by straining to eliminate any vestiges of prohibited *proprietary* trading by banking entities at all costs, the Proposal overshoots its purpose and would severely constrict *principal* trading that would benefit customers. We believe that the Proposal needs to be overhauled to achieve its main purpose without sacrificing the welfare of investors.

AMG members rely on the liquidity provided by banking entities acting as market makers.

AMG members are in the business of managing assets for our clients. The amount of assets that we collectively manage represents a significant portion of the financial markets. Thus, when we need to increase or decrease the holdings of our clients, we are liquidity seekers, not liquidity providers.[3] We rely on the financial markets to supply the assets our clients want to buy and absorb the assets we want to sell on behalf of our clients. Often, we can find the liquidity our clients need in some actively traded equities through executing many small orders on exchanges and other trading markets. But far more often, we can only find the liquidity our clients need, without suffering volatile price moves, by dealing with banking entities acting as market makers.

These banking entities act as principal to intermediate the financial markets. The need to sell a position by one asset manager typically does not coincide perfectly with another asset manager's desire to buy that position. Often, many asset managers choose to sell at the same time. Market makers bridge this gap, allowing markets to function

[2] Bank Holding Company Act § 13(d) (as added by Dodd-Frank § 619).

[3] When we refer to our activities as advisers or as market participants, we refer to the activities of AMG members acting individually, not activities of the AMG itself.

smoothly and, as a result, reducing bid/ask spreads. In today's marketplace, these market makers are largely affiliated with banks. Their market making function reduces customer transaction costs, mitigates customer risk and improves customer returns. If banking entity market makers did not provide this intermediation function, the time and size risks that they are now willing to absorb would instead be assumed by our clients. We do not believe that, at least in the short term, other market participants could fulfill this function.

As an example, AMG members and other asset managers often need to buy or sell a large amount of securities or financial instruments, known in some markets as a "block trade." Asset managers also may decide that it would be prudent to take large positions in interest rate swaps in order to hedge new interest rate exposure in a client's fund or account or may need to sell equity or fixed-income securities in order to satisfy rising redemption requests. Without market makers willing to take the other side of some or all of these positions as principal, an asset manager will likely move the market drastically by trying to access the small trading interest that might otherwise be available in the market. This would greatly increase the cost to our client and the risk of not being able to complete the full transaction. Today, bank market makers are willing and able to take on the position as principal if they are able to warehouse and then hedge the position while waiting to sell out the block over time in order to mitigate the price impact. In this way, banking entities provide a critical service to our clients, keeping prices and costs from escalating.

We believe that the proprietary trading provisions of the Proposal would drastically disrupt the liquidity that banking entities provide to our clients. We believe the Proposal should be amended to allow critical market making-related activities to continue.

The statutory Volcker Rule explicitly permits banking entities to engage in market making-related activity.[4] The Proposal's view of what constitutes this activity is too narrow and will not allow banking entities to provide ongoing liquidity as principal to our clients and other end users of financial instruments. Congress did not mean to disrupt this vital activity. Therefore, we believe the Proposal must be changed to allow banking entities to provide liquidity as underwriters and market makers. We wish to briefly highlight a few of the aspects of the Proposal that we find most problematic from the buy-side's perspective and that we think will most impair banking entities' ability to make markets for our members.

One major problem arises because the market making-related permitted activity assumes that markets themselves are highly liquid, electronic and open to a wide array of end users, similar to agency-based equity markets. Instead, market making, whether done manually or electronically, is a highly nuanced process of trying to assess the demand for an instrument, the likely price direction and the availability and cost of reasonable hedges. Most of this trading activity is conducted by banking entities on a principal basis and many markets are far from liquid. The Proposal's limits on a market maker's ability to hold inventory and derive revenue from market price movements[5] do not accord with

[4] Bank Holding Company Act § 13(d)(1)(B) (as added by Dodd-Frank § 619).

[5] *See* Proposal § __.4(b)(2)(iii), (v).

the fact that, in intermediating in less liquid markets, market makers must take into account, and sometimes benefit from, movements in prices.

Effectively, the Proposal assumes that market makers act like agents without risk of price falls or gains. In reality, this is the exception rather than the norm, particularly in markets other than equities. If market makers affiliated with banks come under suspicion when they buy a position and the price rises, they will no longer be willing to buy from the funds and accounts managed by our members, and these funds and accounts will be left with inefficient and far more costly alternatives for the purchase and sale of our investments. Thus, we strongly urge the Agencies to reorient the market making-related permitted activity to give market makers room to facilitate our orders as principal in the full range of instruments covered by the Volcker Rule.

We believe the Proposal's misunderstanding of markets is particularly problematic in the fixed income and derivatives markets. Fixed income markets comprise a wide range of instruments, with a single issuer often issuing multiple bonds with different spreads and maturities. With this range of bonds comes the benefit of a diverse market in which an asset manager has a number of bonds that may best meet its risk/return preferences, asset-liability management demands for insurance companies and other clients, maturity spectrum requirements or capital structure requirements. The multiplicity of instruments, however, means that liquidity of individual bonds is often relatively limited. As a result, in order to respond to the needs of asset managers and other investors, market makers may have to hold a range of inventory of fixed income securities over significant periods of time. The Proposal's restriction of inventory, which satisfies the near term demands of customers, and the restriction on deriving revenue primarily from related price moves, is therefore extremely problematic for fixed income securities. Market makers must also be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis, which is difficult under the onerous hedging restrictions that require, for example, all hedges to conform to an ambiguous, undefined concept of "reasonable correlation."[6]

In the over-the-counter ("**OTC**") derivatives markets, we enter into derivatives transactions on behalf of our clients in a range of instruments. For example, a member may enter into an interest rate swap to mitigate credit risk or a credit default swap to cost-effectively manage a client's exposure to a corporate issuer. While the Proposal states that a banking entity may be considered a market maker in derivatives when entering into a transaction in response to customer demand and hedging the related exposure,[7] we do not think the language in the Proposal provides sufficient guidance so that our banking entity counterparties can continue to respond to our needs. We think that the Proposal's resulting restrictions on inventory,[8] the use of equity-centric metrics such as Inventory

[6] *See* Proposal § __.5(b)(2)(iii); *see also* Proposal at 68,875 (Federal Reserve Proposal ("**FRB**") page 66).

[7] The Agencies note that "[i]n the case of a derivative contract, [customer-related] revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract." Proposal, Appendix B § III.A.

[8] Inventory accumulation is limited by the Proposal's requirement that a trading desk's market making-related activities are "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." Proposal § __.4(b)(2)(iii). The Agencies state elsewhere that "*bona fide* market making-related activity may include taking positions in securities in anticipation of customer

Risk Turnover[9] and the difficulty of finding suitable market making-related hedges[10] would create crippling uncertainty for the derivatives counterparties that we enter into trades with on behalf of our clients. We think the unfortunate result could be that these banking entity counterparties will be reluctant to continue to enter into such transactions with our clients.

We believe the Agencies should better reflect the role of derivatives dealers throughout the Proposal, including (as mentioned below) the ability to enter into bespoke trades requested by customers. Otherwise, AMG members will face increased risk from a reduced ability to hedge where banking entities cannot act as counterparties, and increased transaction costs where banking entities are discouraged from entering into derivatives transactions.

Another major problem with the Proposal is that it hinders market makers from entering into block trades. We turn to market makers to meet our demand for block trades for equity or fixed income securities. These block trades, which are entered into with banking entities on a principal basis, permit us to execute sizable trades on behalf of multiple clients in a single transaction at more favorable execution prices. We rely on banking entities to enter into block trades with the funds and accounts that we manage as part of the banking entities' market making activities to bridge the gap in price and time until others in the market are willing to trade on the positions. The Proposal appears to allow "block positioner" activity,[11] but turns for guidance to a narrow SEC rule designed to limit credit to market makers that requires, among other things, the market maker to "sell the shares composing the block as rapidly as possible commensurate with the circumstances."[12] This provision may be appropriate for certain liquid equities, but is not feasible for the less liquid financial positions that the Volcker Rule covers, including fixed income instruments, OTC derivatives and many equity securities. In any event, a mandate to sell the components of a large block of less liquid positions rapidly would overwhelm the market, undercutting the price the market maker can get as it works out of the block. In addition, the block positioner guidance in the Proposal only applies to the definition of market maker, and not the other restrictions on market maker activity. This requires market makers positioning blocks, for example, to second-guess whether, in working out of the position slowly to avoid depressing the price, they are seeking to

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demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties." Proposal at 68,871 (FRB 58). This statement's repetition of the "reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties" requirement will likewise prevent market makers from building the inventory in advance of customer demand.

[9] Proposal, Appendix A § IV.D.1.

[10] To qualify as market making-related permitted activity, the Proposal requires a purchase or sale of a covered financial position to be "purchased or sold to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts or other holdings acquired pursuant to [the market making-related permitted activity]" *and* to "meet[] all of the requirements described in [the risk-mitigating hedging permitted activity]." Proposal § __.4(b)(3). This requirement places a double burden to qualify as a hedge under the market making-related permitted activity.

[11] Proposal at 68,871 & n.151 (FRB 57 & n.151).

[12] *See* 12 C.F.R. § 240.3b-8(c)(4)(iii).

generate revenue from price movements. Finally, a market maker may only be willing to position a block if it is able to hedge the risk of that trade and, as a result, the fact that the risk-mitigating hedging is overly narrow is also problematic. Accordingly, the "block positioner" provision is not sufficient to ensure that the funds and accounts managed by our members will be able to continue to experience the efficiency and cost-effectiveness of block trades entered into with banking entities. We believe the Agencies should explicitly state that banking entities meet all the requirements of the market making-related permitted activity to the extent they enter into block trades for customers and for the related trades entered into to support that block trade. Otherwise, these banking entity counterparties may be reluctant to enter into such block trades with our clients.

A further problem with the Proposal is that its provisions, which are designed to purge banking entities of proprietary trading at all levels of the banking entities' organization, including probing trade-by-trade and "trading unit" functions,[13] interfere with banking entities' ability to structure their operations to hedge risks and allocate capital efficiently. As a result, the hedging exemption may not be available for trades that are otherwise used to hedge or manage a banking entity's risks. For example, program risk trading, a strategy often employed by investment funds trading equity securities or other instruments on a principal basis, enables these funds to trade multiple securities in a single transaction swiftly and efficiently. This enables fund advisers to trade securities for their clients more cost-efficiently and better manage flows into and out of funds. In conducting program risk trading, a banking entity may hedge trades with purchases or sales of securities or derivatives made by different trading desks or groups across the banking entity. The ability to aggregate correlated principal risks carried by the larger trading unit allows for a cost-effective hedge against the movement in the price of the underlying exposures. We believe the Agencies should avoid focusing on the microlevel operation of the banking entity and evaluate their activities across the wider trading organization to allow program-wide risk management.

A final problem that we would like to highlight is the negative approach the Proposal takes to the customer service activities of banking entities. The Proposal appears to assume that, even when banking entities are entering into principal transactions at our request, this principal activity is under suspicion unless proven otherwise.[14] We worry that this approach will chill the market making activities of the banking entity counterparties of our clients by making such activities subject to *ex post* inquiry by examiners. This is particularly problematic in the case of customized transactions, for which a banking entity would have limited ability to prove that there has historically been a market for the particular product. We believe that this approach should be reversed so not all trades are presumed to be proprietary trading, to encourage market makers to engage in market making-related transactions as part of customer-oriented business. We further believe that the Agencies should explicitly state that a banking entity's general willingness to engage in bespoke transactions is sufficient to make them a market maker in unique products.

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[13] *See* Proposal, Appendix A §§ I, III.A.

[14] *See* Proposal, Appendix B § III.A.

The Proposal's negative approach to banking entities' principal activities will harm our customers and the financial system more broadly.

As stated above, we rely on banking entities to serve as market makers and underwriters. We believe that the Proposal, as currently drafted, would deter them from continuing to serve in that those capacities. In this section, we provide three specific examples of the negative consequences that could result for our members and the financial markets more broadly.

Portfolio Values will Decrease

The price of a financial instrument depends, among other factors, on the buyer's perceived ability to resell it in the secondary market, and the cost of doing so, should he or she wish to sell. As a result, as liquidity decreases and bid/ask spreads increase, the demand for and price of financial instruments also decreases. The Proposal could, therefore, decrease the value of the assets held by our clients. This decrease in value would directly shrink the savings of the investors in the funds and accounts, retirees, pension plan beneficiaries and other investors who rely on us to invest their earnings.

Transaction Costs will Increase

As liquidity decreases, the cost of entering into transactions increases. These increased transaction costs will decrease the return of our clients' funds, which will ultimately decrease the value of investments of, for example, retiree 401(k) accounts. Oliver Wyman has estimated that the loss of liquidity could cost investors between $1 billion and $4 billion per year in transaction costs as the level and depth of liquidity decreases.[15]

Demand for, and Price of, Corporate Issuances Will Decrease

Corporate issuers rely on the capital markets to raise funds. Asset managers buy these issuers' securities and, by doing so, fund new projects and jobs at those issuers. Asset managers and other market participants are willing to pay the prices they do for primary issuances of corporate securities because of the existence of a liquid secondary market, intermediated by banking entities acting as market makers, that stands ready to purchase the securities from the funds and accounts managed by asset managers. If liquidity in the secondary market decreases and bid/ask spreads increase, the price investors will pay for issued securities will decrease also, reducing the amount of capital available to fund growth. This decrease will be significant—Oliver Wyman has projected that this liquidity reduction could increase issuer borrowing costs by $12-$43 billion.[16] The impact will be even more damaging if banking entities are limited in trading OTC derivatives as many of us will be unwilling to purchase corporate bond positions on behalf of our clients if we cannot hedge the credit risk.

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[15] Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity* (Jan. 2012), at 4.

[16] *Id.* at 4.

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The AMG thanks the Agencies for the opportunity to comment on the Proposal. Should you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Respectfully submitted,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

Capital Markets and Government Sponsored Enterprises Subcommittee and Financial Institution and Consumer Credit Subcommittee of the U.S. House of Representatives Committee on Financial Services

January 18, 2012 Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

Responses from Mary L. Schapiro, Chairman, Securities and Exchange Commission, to Questions for the Record

Questions from Chairman Bachus

Questions for the Federal Reserve, SEC and CFTC

1. **Congress enacted the Volcker Rule as a provision of the Bank Holding Company (BHC) Act and the Federal Reserve is generally vested with the exclusive authority to implement the provisions of the BHC Act and is given broad rulemaking, examination, enforcement and supervisory powers by that legislation. The legislative history to the Dodd Frank Act indicates that the Board should "coordinate with other Federal and state regulators of subsidiaries of [a] holding company, to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information".**

   The witnesses gave seemingly conflicting statements about the supervisory and enforcement framework for Volcker. Chairman Gensler noted his authority to supervise Swap Dealers; Governor Tarullo noted that the Fed has "primary" authority and other regulators have "backup" authority. What does this explanation mean? Which agency will have examiners ensuring compliance at the Swap Dealer or Security-Based Swap Dealer: the Federal Reserve, the SEC or the CFTC? Why would the Federal Reserve not be responsible for comprehensive compliance and uniform enforcement as the primary regulator? What policy objective is being achieved by having multiple agencies supervise and enforce, since having multiple regulators technically responsible for examination and enforcement, no regulator would be clearly responsible or accountable for compliance?

   Response

   As noted, the Volcker rule is a provision of the BHC Act. The BHC Act directs the SEC as the primary financial regulatory agency for registered broker-dealers and registered security-based swap dealers to prescribe rules for prohibited proprietary trading and prohibited investment in covered funds, and provides authority in section 13(e)(2) to bring administrative proceedings for violations of these rules. The sanctions for engaging in such prohibited conduct include terminating the activity and, as relevant, disposing of the investment. In addition, the SEC proposed to exercise its independent authority under the Securities Exchange Act of 1934 (Exchange Act) to adopt certain provisions of the proposed

rule regarding the compliance program requirement, quantitative metrics reporting and recordkeeping, and documentation of certain hedging transactions. Compliance with these provisions, if adopted, would be subject to SEC examination and enforcement authority under the Exchange Act.

As you point out, the Federal Reserve has a broad range of authority and responsibility for bank holding companies under the BHC Act. In general, the Federal Reserve is to avoid duplication in examination activities, reporting requirements, and requests for information from subsidiary companies that are registered broker-dealers. See 12 U.S.C. §§ 1844, 1848a, 1850a, and 5361-5362.

I anticipate that the agencies will work together to avoid duplication and have solicited comment to assist us in determining how best to carry out our respective responsibilities. For example, the proposing release solicited comment on enterprise-wide compliance programs and the use of a single data repository for metrics reporting. See, e.g., 76 Fed. Reg. 68846, 68921-22, Questions 328-32, and 337 (Nov. 7, 2011).

Questions for the Federal Reserve, SEC, CFTC, FDIC and OCC

1. **Since the "intent" of a trader cannot be determined, regulators have proposed seventeen metrics to deploy to gauge whether an institution is hiding proprietary trading within a market making desk. Since the proposed rule consistently notes that the quantitative measurements are designed for identifying trading activity that warrants additional scrutiny, why do the metrics not at the same time make evident that the activity tested is complying with the rule? What purpose are the metrics intended to serve?**

   Response

   The quantitative metrics are intended to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities which could result in material exposure to high-risk assets or high-risk trading strategies. These measurements were proposed to help banking entities and regulators assess whether actual trading activity is consistent with permitted trading activities in scope, type and profile. The quantitative metrics that would be required to be reported are generally designed to reflect, and to provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful in differentiating permitted market making-related activities from prohibited proprietary trading.

2. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding why the proposal's market making-related activity assumes that markets themselves are highly liquid and open to a wide array of end users when market making is in fact a highly nuanced process of trying to assess the demand for an instrument.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

3. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal's hedging restrictions, which require all hedges to conform to an ambiguous, undefined concept of "reasonable correlation," would restrict the ability of market makers to be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

4. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding the lack of sufficient guidance on market makers in derivatives as it relates to a banking entity's entering into a transaction in response to customer demand and hedging the related exposure.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

5. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal hinders market makers from entering into block trades since the block positions guidance in the proposal only applies to the definition of market maker which requires market makers positioning blocks to second-guess whether, in working out of the position slowly to avoid depressing the price, they are seeking to generate revenue from price movements.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

6. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the proposal's prohibited proprietary trading presumption is inconsistent with explicit congressional intent to allow useful principal activity.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

7. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding why the proposal takes a transaction-by-transaction approach to principal trading when such analysis does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

8. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the five Agencies will coordinate interpretation, examination and enforcement of the Volcker Rule regulations.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

9. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding your failure to conduct a general cost/benefit analysis of the proposed rules.**

Response

In the proposal, the agencies requested comment as to the potential economic impacts – including potential costs and benefits – that may arise from the proposed rule and its implementation of Section 13 of the BHC Act. The SEC staff will continue to carefully review and analyze the cost-benefit information provided by commenters as we consider a recommendation for further action on the proposal.

10. **Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal provides no consistency as to the types of municipal securities that are exempt from the proprietary trading prohibition under the Volcker Rule.**

Response

Section 13(d)(1) of the BHC Act provides an exemption for proprietary trading in certain government obligations. In particular, the statute permits a banking entity to purchase or sell "obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to provisions of the Farm Credit Act of 1971 (12 U.S.C. 2011 et seq.), and obligations of any State or of any political subdivision thereof."

The statute does not explicitly refer to obligations of an *agency* of a State or political subdivision, and the proposed rule generally mirrors the statute with respect to this exemption. In the proposal, the agencies sought comment on whether the proposed exemption should include obligations of an agency of any State or political subdivision or incorporate the definition of "municipal security" from the Securities Exchange Act of 1934. The Commission appreciates the many detailed comment letters we have received concerning these questions. The SEC staff will continue to carefully review and analyze the

comments on this issue, including the specific comment you have identified, as we consider a recommendation for further action on the proposal.

11. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal distinguishes between municipal securities based on the type of issuer, which would be inappropriate since different issuers may offer securities that offer the same credit exposure to investors.

Response

Section 13(d)(1) of the BHC Act provides an exemption for proprietary trading in certain government obligations. In particular, the statute permits a banking entity to purchase or sell "obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to provisions of the Farm Credit Act of 1971 (12 U.S.C. 2011 et seq.), and obligations of any State or of any political subdivision thereof."

The statute does not explicitly refer to obligations of an *agency* of a State or political subdivision, and the proposed rule generally mirrors the statute with respect to this exemption. In the proposal, the agencies sought comment on whether the proposed exemption should include obligations of an agency of any State or political subdivision or incorporate the definition of "municipal security" from the Securities Exchange Act of 1934. The Commission appreciates the many detailed comment letters we have received concerning these questions. The SEC staff will continue to carefully review and analyze the comments on this issue, including the specific comment you have identified, as we consider a recommendation for further action on the proposal.

12. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why tender option bonds would be captured in the definition of "covered fund" under the proposal when there is no evidence in the legislative history of the Volcker Rule suggesting that Congress intended tender option bond transactions to be included in the scope of the Volcker Rule.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

13. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal does not exclude issuers of asset-backed securities from the definition of "covered funds" despite the Financial Stability Oversight Council's findings that Congress did not intend for the Volcker Rule restrictions to apply to the sale or securitization of loans.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

14. Please address how your agency will solve the problem raised in the American Council of Life Insurers comment letter dated January 24, 2012, regarding why insurance company investment activities that are permitted activities under current law and the proposed regulations are subject to reporting and recordkeeping requirements and compliance monitoring in Subpart D.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

15. Please address how your agency will solve the problems raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making activities described in the proposal fail to take into account unregulated over-the-counter market making activities that covered banking entities provide to such markets.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

16. Please address how your agency will solve the problem raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making exemption appears to be predicated on the incorrect assumption that there is a perfect hedge for

all securities and that all risks can be hedged for any given holding period for any position.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

17. **Please address how your agency will solve the problems raised in the Bank of Japan and Financial Services Agency Government of Japan comment letter dated December 28, 2011, regarding how the proposed restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds will raise operational and transactional costs of trading in Japanese Government Bonds.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

18. **Please address how your agency will solve the problems raised by the Canadian Banks comment letter dated January 19, 2012, regarding how the Volcker Rule, as enacted, excludes funds registered for public sale in the U.S. under the Investment Company Act of 1940 yet the proposal fails to provide a similar exclusion for Canadian Public Funds from the proposed definition of "covered fund" which violates Canada's rights under the North American Free Trade Agreement.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

19. **Please address how your agency will solve the problems raised by Capital One Financial Corporation, Fifth Third Bancorp, and Regions Financial Corporation comment letter dated November 29, 2011, over how a narrowly construed insured depository institution exemption that does not extend to many of the swaps that banks and their customers consider to be core banking services could push even the smallest registered bank dealers over the Volcker Rule's $1 billion threshold which would result**

in additional burdensome recordkeeping and compliance requirements that may cause small dealers to exit the market.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

20. Please address how your agency will solve the problems raised by the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding how the proposed rule should be considered an economically significant rulemaking.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

21. Please address how your agency will solve the problem raised the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding why the definition of exempt state and municipal securities is narrower under the Volcker Rule provisions of the Dodd-Frank Act than under the Securities and Exchange Act of 1934 which will subject municipal securities issued by municipalities and authorities to Volcker Rule provisions.

Response

Section 13(d)(1) of the BHC Act provides an exemption for proprietary trading in certain government obligations. In particular, the statute permits a banking entity to purchase or sell "obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to provisions of the Farm Credit Act of 1971 (12 U.S.C. 2011 et seq.), and obligations of any State or of any political subdivision thereof."

The statute does not explicitly refer to obligations of an *agency* of a State or political subdivision, and the proposed rule generally mirrors the statute with respect to this exemption. In the proposal, the agencies sought comment on whether the proposed exemption should include obligations of an agency of any State or political subdivision or

incorporate the definition of "municipal security" from the Securities Exchange Act of 1934. The Commission appreciates the many detailed comment letters we have received concerning these questions. The SEC staff will continue to carefully review and analyze the comments on this issue, including the specific comment you have identified, as we consider a recommendation for further action on the proposal.

22. **Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding how the government obligations exemption will be consistently implemented when obligations of "agencies" of States and their political subdivisions are exempted, but each municipal jurisdiction applies its own definition of political subdivision to its issuer entities.**

Response

Section 13(d)(1) of the BHC Act provides an exemption for proprietary trading in certain government obligations. In particular, the statute permits a banking entity to purchase or sell "obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to provisions of the Farm Credit Act of 1971 (12 U.S.C. 2011 et seq.), and obligations of any State or of any political subdivision thereof."

The statute does not explicitly refer to obligations of an *agency* of a State or political subdivision, and the proposed rule generally mirrors the statute with respect to this exemption. In the proposal, the agencies sought comment on whether the proposed exemption should include obligations of an agency of any State or political subdivision or incorporate the definition of "municipal security" from the Securities Exchange Act of 1934. The Commission appreciates the many detailed comment letters we have received concerning these questions. The SEC staff will continue to carefully review and analyze the comments on this issue, including the specific comment you have identified, as we consider a recommendation for further action on the proposal.

23. **Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding the proposed rule's failure to expressly exempt tender option bond programs from its restrictions on covered fund activities and how covered transactions with covered funds will have a significant adverse effect on the municipal securities market.**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

24. Please address how your agency will solve the problem raised in the comment letters from Rep. Anna Eshoo dated December 13, 2011; Rep. Michael Honda dated December 20, 2011; Rep. Zoe Lofgren dated December 23, 2011; Rep. David Schweikert dated December 16, 2011; and Sen. Kay Hagan dated January 13, 2012, regarding how venture capital funds should not be covered by the Volcker Rule and how the Volcker Rule, as enacted, consistently used the specific term "private equity fund" – not the more general term "investment advisor" as it relates to venture capital funds.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

25. Please address how your agency will solve the problem raised in the comment letter from Sen. Kay Hagan dated January 13, 2012, regarding how the proposed regulations could inadequately clarify the treatment of certain investments made by insurers and why the rule does not conform to Section 619's directive to accommodate the "business of insurance" and includes investments in covered funds within the exemption for insurers.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

26. Please address how your agency will solve the problem raised by the Income Research and Management comment letter dated January 20, 2012, regarding how the proposed regulations outlining how market making banking entities can generate revenue compel market makers to trade on an agency basis rather than a principal basis and how the domestic corporate and securitized (i.e. commercial, residential, and asset-backed mortgage securities) credit markets are too large and heterogeneous to be served appropriately primarily by an agency trading-based model.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important

issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

27. Please address how your agency will solve the problem raised by the Investment Industry Association of Canada comment letter dated December 21, 2011, regarding the reasoning behind the extraterritorial application of the proposed Volcker Rule when there is nothing in the statutory text of the Volcker Rule or legislative history to suggest that Congress intended the Agencies to depart from their long-standing approach to apply U.S. banking and securities law to cross-border transactions.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

28. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding the need to broaden the "governmental obligations" exemption from the proposed rule's restriction on proprietary trading to include all "municipal securities" as defined in the Exchange Act in order to avoid a bifurcation of the municipal securities market that brings no additional benefit to the safety and soundness of the banking system.

Response

Section 13(d)(1) of the BHC Act provides an exemption for proprietary trading in certain government obligations. In particular, the statute permits a banking entity to purchase or sell "obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to provisions of the Farm Credit Act of 1971 (12 U.S.C. 2011 et seq.), and obligations of any State or of any political subdivision thereof."

The statute does not explicitly refer to obligations of an *agency* of a State or political subdivision, and the proposed rule generally mirrors the statute with respect to this exemption. In the proposal, the agencies sought comment on whether the proposed exemption should include obligations of an agency of any State or political subdivision or incorporate the definition of "municipal security" from the Securities Exchange Act of 1934. The Commission appreciates the many detailed comment letters we have received concerning these questions. The SEC staff will continue to carefully review and analyze the comments on this issue, including the specific comment you have identified, as we consider a recommendation for further action on the proposal.

29. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding how most municipal market participants consider a primary function of market making to be the generation of liquidity in the market by taking securities into inventory, and that a dealer may not always be able to demonstrate compliance with the requirement of the market maker exception, with respect to the covered financial position, as designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

30. Please address how your agency will solve the problem raised by the Norinchukin Bank comment letter dated January 25, 2012, that by applying the Volcker Rule to any transactions that take place outside of the U.S. based only on the fact that foreign banks have U.S.-based offices seems like an extraterritorial application which deviates from one of the main objectives of the Dodd-Frank Act of containing systemic risks.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

31. Please address how your agency will solve the problems raised by U.K. Chancellor of the Exchequer George Osborne's comment letter dated January 23, 2012, regarding how the proposed regulations would appear to make it more difficult and costlier to provide market-making services in non-U.S. sovereign markets.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

32. Please address how your agency will solve the problems raised by the Standish Mellon Asset Management comment letter dated January 19, 2012, regarding how the proposed prohibited principal trading could result in dealers being hesitant to transact in secondary cash bonds because of extraordinary compliance requirements and the lack of clarity surrounding the rules.

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

Questions from Representative Peters

Question for:

- The Hon. Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System
- The Hon. Mary Schapiro, Chairman, Securities and Exchange Commission
- The Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission
- The Hon. Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation
- Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency
- Mr. Anthony J. Carfang, Partner, Treasury Strategies, on behalf of the U.S. Chamber of Commerce
- Mr. Douglas J. Elliott, Fellow, Economic Studies, The Brookings Institution
- Mr. Scott Evans, Executive Vice President, President of Asset Management, TIAA-CREF
- Prof. Simon Johnson, Ronald A. Kurtz (1954) Professor of Entrepreneurship, MIT Sloan School of Management
- Mr. Alexander Marx, Head of Global Bond Trading, Fidelity Investments
- Mr. Douglas J. Peebles, Chief Investment Officer and Head of Fixed Income, AllianceBernstein, on behalf of the Securities Industry and Financial Markets Association Asset Management Group
- Mr. Mark Standish, President and Co-CEO, RBC Capital Markets, on behalf of the Institute of International Bankers
- Mr. Wallace Turbeville, on behalf of the Americans for Financial Reform

Thank you for your appearance before the January 18, 2012, House Financial Services Subcommittees on Capital Markets and Government Sponsored Enterprises and, Financial Institutions and Consumer Credit joint hearing entitled, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation." To follow up on the discussion, I would like to submit questions to the aforementioned witnesses and have the answers included in the official hearing record.

I support the goals of Section 619 of the law, otherwise known as the "Volcker Rule," which was included in the Dodd Frank Act to prohibit banks that have access to taxpayer funds from putting these funds at risk for their own benefit, or simply shift these proprietary trading operations to a separate entity under its control by investing in or sponsoring hedge funds and private equity funds.

Many observers have raised concerns that the Volcker Rule could lead to a decrease in market liquidity because banks would be wary of holding large inventories of certain types of assets. There has also been speculation that if banks are unable to engage in as much market making activity, that other actors or new entrants could find an economic incentive to engage in market making. My questions for the witnesses above witnesses are:

- Do you agree that covered entities may decrease market making activity?

- **If so, do you believe that other parties will step forward to provide liquidity?**

- **If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to?**

- **Are there any negative consequences that can be anticipated from this change?**

  Response
  The questions raised highlight issues identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. We appreciate the many detailed comment letters we have received concerning these important issues. The SEC staff will continue to carefully review and analyze the comment letters concerning the issues you have identified as we consider a recommendation for further action on the proposal.

Questions from Representative Huizenga and Peters

1. **Because of its ownership interest in EnerBank, CMS Energy would be considered a "banking entity" under the proposed Volcker Rule. Furthermore, an investor that owns as little as five percent of CMS Energy could also become subject to the Volcker Rule. This could create a significant disincentive for institutional investors to invest in CMS Energy. We would like to know whether the regulators who have proposed the Volcker Rule are aware of the problem outlined above, and if so, could it be addressed in revisions to the proposed rule?**

   Response

   The question raised highlights an issue identified by a commenter in connection with the regulators' proposed rule implementing Section 619 of the Dodd-Frank Act. Because CMS Energy is not required to register with the SEC, it will not be subject to the SEC's proposed rule. Nevertheless, the issue could arise with respect to a SEC registrant. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

2. **The proposed Volcker Rule appears to apply to commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate." While the Volcker Rule was designed to limit risks at insured depositories so that banks wouldn't be using government insured deposit funds to gamble through proprietary trading or fund investing, it appears that it will also cover all sorts of industrial and commercial companies that are in some way affiliated with a depository. Do the regulators believe that non-financial companies should be subject to the same restrictions as financial entities? What kind of enforcement and examination regime would regulators impose on non-financial entities that are required to comply with the Volcker Rule because of their affiliation with a financial entity?**

   Response

   The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

Questions from Representative Grimm

To be submitted to all members of Panel 1:

- **Hon. Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System**
- **Hon. Mary Schapiro, Chairman, Securities and Exchange Commission**
- **Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission**
- **Hon. Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation**
- **Mr. John Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency**

1. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a US corporation, and in order to realize this profit sells this bond to a US entity (in this example assume the US entity is subject to the Volcker rule.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a US corporation rather than a debt security?**

   Response

   As you know, the Volcker Rule generally applies separately to each entity involved in a transaction, not to the transaction as such. In the example provided, the U.S. entity that is assumed to be subject to the Volcker Rule would, of course, be required to comply with respect to its side of the transaction.

   With respect to the non-U.S. entity, the question of whether or not it would be subject to the Volcker Rule depends in part on whether it is a "banking entity". The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. To the extent that the non-U.S. based institution is within the definition of "banking entity," its proprietary trading activity must qualify for one of the exemptions in the proposed rule. The most relevant exemption for a non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institution is not a "banking entity," it is not subject to the Volcker Rule.

   The SEC has rule-writing authority for the types of "banking entities" for which we are the "primary financial regulatory agency," as defined in section 2(12)(B) of the Dodd-Frank Act, which includes SEC-registered broker-dealers, SEC-registered investment advisers, and SEC-registered security-based swap dealers. The SEC is not likely to be the "primary financial regulatory agency" for non-U.S. based institutions that are "banking entities" under the statute and the proposed rule.

2. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a foreign corporation, and in order to realize this profit sells this bond to a US entity (in this example assume the US entity is subject to the Volcker rule.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a foreign corporation rather than a debt security?**

   Response

   As you know, the Volcker Rule generally applies separately to each entity involved in a transaction, not to the transaction as such. In the example provided, the U.S. entity that is assumed to be subject to the Volcker Rule would, of course, be required to comply with respect to its side of the transaction.

   With respect to the non-U.S. entity, the question of whether or not it would be subject to the Volcker Rule depends in part on whether it is a "banking entity". The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. To the extent that the non-U.S. based institution is within the definition of "banking entity," its proprietary trading activity must qualify for one of the exemptions in the proposed rule. The most relevant exemption for a non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institution is not a "banking entity," it is not subject to the Volcker Rule.

   The SEC has rule-writing authority for the types of "banking entities" for which we are the "primary financial regulatory agency," as defined in section 2(12)(B) of the Dodd-Frank Act, which includes SEC-registered broker-dealers, SEC-registered investment advisers, and SEC-registered security-based swap dealers. The SEC is not likely to be the "primary financial regulatory agency" for non-U.S. based institutions that are "banking entities" under the statute and the proposed rule.

3. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a US corporation, and in order to realize this profit sells this bond to a US entity (in this example the assume the US entity is not subject to the Volcker rule, such a hedge fund or a pension fund.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a US corporation rather than a debt security?**

Response

As you know, the Volcker Rule generally applies separately to each entity involved in a transaction, not to the transaction as such. In the example provided, the U.S. entity is assumed to be not subject to the Volcker Rule.

The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. To the extent that the non-U.S. based institution is within the definition of "banking entity," its proprietary trading activity must qualify for one of the exemptions in the proposed rule. The most relevant exemption for a non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institution is not a "banking entity", it is not subject to the Volcker Rule.

The SEC has rule-writing authority for the types of "banking entities" for which we are the "primary financial regulatory agency," as defined in section 2(12)(B) of the Dodd-Frank Act, which includes SEC-registered broker-dealers, SEC-registered investment advisers, and SEC-registered security-based swap dealers. The SEC is not likely to be the "primary financial regulatory agency" for non-U.S. based institutions that are "banking entities" under the statute and the proposed rule.

4. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a foreign corporation, and in order to realize this profit sells this bond to a US entity (in this example assume the US entity is not subject to the Volcker rule, such a hedge fund or a pension fund.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a foreign corporation rather than a debt security?**

Response

As you know, the Volcker Rule generally applies separately to each entity involved in a transaction, not to the transaction as such. In the example provided, the U.S. entity is assumed to be not subject to the Volcker Rule.

The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. To the extent that the non-U.S. based institution is within the definition of "banking entity," its proprietary trading activity must qualify for one of the exemptions in the proposed rule. The most relevant exemption for a

non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institution is not a "banking entity", it is not subject to the Volcker Rule.

The SEC has rule-writing authority for the types of "banking entities" for which we are the "primary financial regulatory agency," as defined in section 2(12)(B) of the Dodd-Frank Act, which includes SEC-registered broker-dealers, SEC-registered investment advisers, and SEC-registered security-based swap dealers. The SEC is not likely to be the "primary financial regulatory agency" for non-U.S. based institutions that are "banking entities" under the statute and the proposed rule.

5. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a US corporation, and in order to realize this profit sells this bond to another foreign entity (in this example assume the foreign entity would be subject to the Volcker Rule if it was based in the US.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a US corporation rather than a debt security?**

Response

As you know, the Volcker Rule generally applies separately to each entity involved in a transaction, not to the transaction as such.

The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. To the extent that the non-U.S. based institution is within the definition of "banking entity," its proprietary trading activity must qualify for one of the exemptions in the proposed rule. The most relevant exemption for a non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institution is not a "banking entity", it is not subject to the Volcker Rule.

The SEC has rule-writing authority for the types of "banking entities" for which we are the "primary financial regulatory agency," as defined in section 2(12)(B) of the Dodd-Frank Act, which includes SEC-registered broker-dealers, SEC-registered investment advisers, and SEC-registered security-based swap dealers. The SEC is not likely to be the "primary financial regulatory agency" for non-U.S. based institutions that are "banking entities" under the statute and the proposed rule.

6. **If a non-US based institution (for clarification assume the Institution would fall under the Volcker Rule if it was a US entity) conducts a proprietary trade and makes a profit on a bond issued by a US corporation, and in order to realize this profit sells this bond to another foreign entity (in this example assume the foreign entity would not be subject to the Volcker Rule if it was based in the US.) Does this trade fall under the Volcker rule? If it does how would you go about enforcing this prohibition if your foreign regulatory counterparts have not adopted a proposal similar to the Volcker rule? Would any of these answers be different if the trade involved an equity security of a US corporation rather than a debt security?**

   Response

   The statute's definition of "banking entity" includes, among other things, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.) and any of its affiliates or subsidiaries. In this example it appears that both of the non-U.S. based institutions are not within the definition of "banking entity" because they are assumed to be not subject to the Volcker Rule. The most relevant exemption for a non-U.S. based institution is likely to be the exemption for trading solely outside of the United States, as established in section 13(d)(1)(H) of the BHC Act and as implemented in § __.6(d) of the proposed rule. If the non-U.S. based institutions are not "banking entities," they are not subject to the Volcker Rule.

Questions from Congressman Biggert

Questions for inclusion in the hearing record to Panel I witnesses:

- **Given the enormity of the task of crafting the Volcker Rule that your agency and the other relevant agencies face, do you agree that a comprehensive rulemaking may not be ready to take effect in July?**

Response

While I acknowledge that the collective task is complex, we continue to carefully review and analyze all comments received in an effort to develop the best possible rule.

- **Alone or in coordination with other relevant agencies, has your agency formulated any plans for a phased-in implementation of the Volcker Rule's compliance regime?**

Response

The question raised highlights an issue identified by commenters in connection with the SEC's proposed rule implementing Section 619 of the Dodd-Frank Act. I appreciate the many detailed comment letters the Commission has received concerning these important issues. The SEC staff will continue to carefully review and analyze the specific comment you have identified as we consider a recommendation for further action on the proposal.

- **Does your agency have the regulatory authority necessary to phase-in implementation of the Volcker Rule so that, if need be, your agency with other relevant agencies can continue perfecting the details of regulatory compliance in a measured manner, even as the core requirements of Volcker rule (such as the shuttering of proprietary trading desks) become effective?**

Response

The question raised highlights an issue identified by commenters in connection with the Commission's proposed rule implementing Section 619 of the Dodd-Frank Act. We note, however, that the statute requires the Federal Reserve Board, acting alone, to adopt rules to implement the provisions of section 13 of the Bank Holding Company Act ("BHC Act") – *i.e.*, the statutory piece of the Volcker Rule – that provide a banking entity or a nonbank financial company supervised by the Board a period of time after the effective date of section 13 of the BHC Act to bring the activities, investments, and relationships of the banking entity into compliance with that section and the agencies' implementing regulations. The Board issued its final conformance rule as required under section 13(c)(6) of the BHC Act on February 8, 2011.

The Commission has flexibility to establish compliance and effective dates for the regulations implementing the Volcker Rule, but not for section 13 of the BHC Act.

Questions from Congressman McCarthy

Panel 1: Governor Tarullo and Chairwoman Schapiro

Following up on a question that my colleague Mr. Watt asked with regard to the Dodd-Frank Act statute as it applies to the insurance industry, exempting them from proprietary trading but ambiguity as to whether the industry is exempt from the ban on investing in securities defined as "covered funds."

My understanding from my colleague's inquiry as well as your response is that there is a clear exemption for the business of insurance for trading, but not for investments, and you will use the feedback from the industry to determine if they should be exempt.

My question to you both is two-fold:

1. **What would be the public policy reason for not extending the exemption given that state investment laws applied to insurance companies domiciled in that sate already impose limitations on the categories of investments that insurance companies may hold?**

2. **Do you have the statutory authority to exempt the business of insurance from covered fund investment restrictions?**

Response

The Commission and the other financial regulators construed section 619 to provide for an exemption from the general prohibitions on proprietary trading investments by an insurance company through its general account but *not* to include an exemption for investments in covered funds. The rules proposed by the Commission and the other financial regulators followed that understanding of the statute. Section 619, however, provides authority for the Commission and financial regulators to provide exemptive relief that "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." The release proposing the rules requested comment on our approach to implementing the exemption for general account trading by insurance companies. The SEC staff currently is reviewing the comments received on the potential scope and impact of this approach.

"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012

Responses to Questions for the Record from Rep. Carolyn McCarthy

Submitted by Mark Standish, Testifying On Behalf of the Institute of International Bankers

1. **I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions:**

   a. **What are some of the proposed changes and revisions the regulators should think about as they seek to finalize the rule?**

   The Volcker Rule proposal could have significant implications for market liquidity and the regulators should strive to avoid potentially costly and unintended consequences by, among other things:

   - Exercising their authority **to exempt foreign sovereign debt** from the Rule's proprietary trading restrictions, along the lines suggested by more than eighteen foreign regulators from four continents. Bank trading in U.S. government securities is important to the safety and soundness of banking organizations, liquidity and demand in the markets for U.S. government debt, and financial stability generally. The same is true for bank trading in the government securities of countries other than the United States. It is vitally important – not only to the safety and soundness of foreign banks, to the liquidity and demand for foreign sovereign debt, and to the financial stability of foreign countries, but also to global financial stability, which is of vital importance to the United States. The proposed rule should exempt foreign sovereign debt in order to allow U.S. and foreign banking organizations to engage, both here and abroad, in market making activities in these securities and, very importantly, in order to comport with U.S. treaty obligations, e.g., NAFTA. Any concerns about the risks of bank trading in such securities can be more appropriately dealt with through capital requirements and other prudential risk limitations.

   - **Refraining from adding limitations that are not required by the statute** and are not justified by the underlying policy objectives of the Volcker Rule. Congress determined that activities that are conducted solely outside of the United States should not be subject to the Volcker Rule's restrictions on proprietary trading or investment in or sponsorship of hedge and equity funds because any risks associated with these activities are held outside of the United States and are properly subject to foreign law and foreign taxpayer backing, if any. The proposal expands beyond the statute's plain language to prohibit, for example, all other connections with the United States, including transactions with a U.S. counterparty or using a U.S. exchange or other trading platform to execute a transaction. The impact of these and other additional limitations would limit the

pool of purchasers of U.S. corporate debt and other capital-raising instruments, and could very well reduce liquidity in the U.S. markets, raise the costs associated with the sale of securities, and prompt the migration of trading activities to other financial centers outside of the United States, all in all likely resulting in job losses in the U.S.

- **Treating regulated foreign investment funds similar to U.S. mutual funds and other registered investment companies** which are excluded from the Volcker Rule's prohibitions.

- Conforming to longstanding principles of deference to home country supervision – as well as to the plain language of the statute and to congressional intent – and **making clear that head offices and international bank affiliates outside the U.S. are not required to implement the Volcker Rule prohibitions, compliance programs, and reporting requirements.** Judgments about the appropriate scope of activities outside of the United States should be deferred to the governments and supervisors of the relevant jurisdictions. If the Volcker Rule were applied beyond its plain language to reach international banks' non-U.S. trading and fund activities, it could result in the imposition of overlapping and inconsistent regulatory regimes on these institutions' non-U.S. operations. That type of imposition is inconsistent with principles of comity that have long applied to the application of countries' financial rules.

2. **Do you feel substantive changes may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?**

Yes and, in light of the current uncertainty about many of the fundamental issues in the proposal, the significant changes that will likely be required, and the broad impact of the rule on the banks and the markets, the Agencies should issue a new proposed rule following consideration of the hundreds of very thoughtful comments received. As Assistant Secretary for Financial Markets Mary John Miller recently said, it is important to "get.... the reforms right so that they reduce risk, improve transparency and help restore market discipline in our system, while preserving the best features of our markets and the competitiveness of our financial institutions."

"Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
January 18, 2012

Responses to Questions for the Record from Rep. Gary Peters

Submitted by Mark Standish, Testifying On Behalf of the Institute of International Bankers

- **Do you agree that covered entities may decrease market making activity?**

  In the view of the IIB, the rule proposed by the Agencies to implement the Volcker Rule significantly will limit or discourage principal risk-taking by the largest U.S. and international market-makers, because these firms are likely to reduce their commitments to maintaining orderly markets in order to avoid violating the Volcker Rule regulation. Similarly, participation in U.S. markets by foreign firms located outside of the United States may be expected to decrease, as such firms seek to limit their interactions with U.S. counterparties, U.S. agents, and U.S. exchanges. Such reactions would have serious consequences for the U.S. economy – including reduced liquidity in U.S. markets and securities, which could lead to higher borrowing costs for U.S. companies and individuals, and ultimately to slower economic growth and job losses.

- **If so, do you believe that other parties will step forward to provide liquidity?**

  It is unlikely that other parties will step forward to provide liquidity with the degree of stability, transparency, and sufficiency required to maintain the depth and liquidity that are the hallmarks of the U.S. capital markets, thus we believe that the markets will have a very difficult time attempting to compensate for the decrease in covered entities' market making activities.

- **If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kinds of regulatory scrutiny are those institutions subject to?**

  The likelihood that other parties would substitute for the decrease in market making activity by covered entities depends on a variety of factors, but a leading consideration is the additional costs that another party would have to bear in order to undertake the activity. Whether making markets in securities or swaps, the activity by its very nature involves transacting with customers and, as a result, is subject to extensive registration and regulatory requirements, including the commitment to maintain sufficient capital and market presence to support the activity.

  We anticipate that the regulatory obligations associated with establishing and maintaining a market making operation would discourage new entrants – in many instances, trading firms that heretofore have not been subject to regulation or supervisory oversight, and certainly not the type or degree of regulation and oversight that accompanies registration as a securities

dealer – with the overall result being a net loss of market making activity. In the case of those seeking to enter the business on a *de novo* basis, we believe that the financial resources and the acquisition and maintenance of the expertise that would be required to establish and develop a business on a scale necessary both to provide a sufficient return on capital and to contribute meaningfully to substituting for the lost activity attributable to the Volcker Rule would have a significant deterrent effect. The net effect could be more opaque markets, decreased price discovery, higher funding costs, and diminished economic growth.

- **Are there any negative consequences that can be anticipated from this change?**

The anticipated decrease in covered entities' market making activities would adversely affect their ability to facilitate issuers' efforts to raise capital through the offer and sale of equity and debt securities in the financial markets, to hold inventory at levels sufficient to meet investor demand, and to actively participate in the market to price assets efficiently. The resulting reduction in liquidity across a wide range of asset classes would have a ripple effect that could discourage investment, limit credit availability and increase the cost of capital for U.S. companies, thereby stifling economic growth and job creation in the United States. As discussed above, we do not believe that new entrants could be relied upon to compensate for these negative and far-reaching consequences.

Response to Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Chairman Bachus:

Section 1

1. Section 619(b)(2) of the Dodd-Frank Act itself divides authority for developing and adopting regulations to implement its prohibitions and restrictions between the Federal Reserve, the OCC, FDIC, SEC, and CFTC based on the type of entities for which each agency is explicitly charged or is the primary financial regulatory agency. The statute also requires these agencies, in developing and issuing implementing rules, to consult and coordinate with each other for the purposes of assuring that such rules are comparable and to provide for consistent application and implementation. Under the statutory framework, the CFTC is the primary federal regulatory agency with respect to a swap dealer and the SEC is the primary financial regulatory agency with respect to a security-based swap dealer; the Federal Reserve is explicitly charged with issuing regulations with respect to companies that control an insured depository institution, including bank holding companies. The OCC, Federal Reserve, and FDIC must jointly issue rules to implement section 619 with respect to insured depository institutions.

To enhance uniformity in both rules that implement section 619 and administration of the requirements of section 619, the Federal Reserve, OCC, FDIC, SEC and CFTC have been regularly consulting with each other in the development of rules and policies that implement section 619. The rule proposed by the agencies to implement section 619 contemplates that firms will develop and adopt a single, enterprise-wide compliance program and that the agencies would strive for uniform enforcement of section 619. We are carefully considering the public comments received on these points and will take those comments into account in crafting a final rule to implement section 619.

Section 2

1. Section 619 of the Dodd-Frank Act generally prohibits banking entities from engaging in proprietary trading for the purpose of profiting from short-term price movements, and from acquiring or retaining interests in, or having certain relationships with, hedge funds and private equity funds. In each case the statute explicitly provides certain exemptions from these prohibitions, as well as limitations on permitted activities.

Appropriate and effective implementation of the Act is a high priority for the Federal Reserve. As you note, the Federal Reserve, the OCC, the FDIC, SEC, and CFTC have issued proposed rulemakings to implement section 619; as part of those rulemakings, the agencies met with many interested representatives of the public, including banking firms, trade associations and consumer advocates, and provided an extended period of time for the public to submit comment to the agencies regarding the proposal. The agencies have received over 17,000 comments addressing a wide variety of aspects of the proposal, including each of the issues raised in your questions. The agencies are carefully reviewing those comments and considering the suggestions and issues they raise in light of the statutory restrictions and provisions. We will carefully consider the issues raised by your questions as we continue to review all comments submitted in implementing these important provisions.

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Chairman Bachus:

Section 1

1. Congress enacted the Volcker Rule as a provision of the Bank Holding Company (BHC) Act and the Federal Reserve is generally vested with the exclusive authority to implement the provisions of the BHC Act and is given broad rulemaking, examination, enforcement and supervisory powers by that legislation. The legislative history to the Dodd-Frank Act indicates that the Board should "coordinate with other Federal and state regulators of subsidiaries of [a] holding company, to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information".

The witnesses gave seemingly conflicting statements about the supervisory and enforcement framework for Volcker. Chairman Gensler noted his authority to supervise swap dealers; Governor Tarullo noted that the Fed has "primary" authority and other regulators have "backup" authority. What does this explanation mean? Which agency will have examiners ensuring compliance at the Swap Dealer or Security-based Swap Dealer; the Federal Reserve, the SEC or the CFTC? Why would the Federal Reserve not be responsible for comprehensive compliance and inform enforcement as the primary regulator? What policy objective is being achieved by having multiple agencies supervise and enforce, since having multiple regulators technically responsible for examination and enforcement, no regulator would be clearly responsible or accountable for compliance?

Section 2

1. Since the "intent" of a trader cannot be determined, regulators have proposed seventeen metrics to deploy to gauge whether an institution is hiding proprietary trading within a market making desk. Since the proposed rule consistently notes that the quantitative measurements are designed for identifying trading activity that warrants additional scrutiny, why do the metrics not at the same time make evident that the activity tested is complying with the rule? What purpose are the metrics intended to serve?

2. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding why the proposal's market making-related activity assumes that markets themselves are highly liquid and open to a wide array of end users when market making is in fact a highly nuanced process of trying to assess the demand for an instrument.

3. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal's hedging restrictions, which require all hedges to conform to an ambiguous, undefined concept of "reasonable correlation," would restrict

the ability of market makers to be able to cost-effectively hedge the fixed income securities they hold in inventory, including on a portfolio basis.

4. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding the lack of sufficient guidance on market makers in derivatives as it relates to a banking entity's entering into a transaction in response to customer demand and hedging the related exposure.

5. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets (SIFMA) Asset Management Group comment letter dated February 13, 2012, regarding how the proposal hinders market makers from entering into block trades since the block positions guidance in the proposal only applies to the definition of market maker which requires market makers positioning blocks to second-guess whether, in working out of the position slowly to avoid depressing the price, they are seeking to generate revenue from price movements.

6. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the proposal's prohibited proprietary trading presumption is inconsistent with explicit congressional intent to allow useful principal activity.

7. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding why the proposal takes a transaction-by-transaction approach to principal trading when such analysis does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.

8. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding how the five Agencies will coordinate interpretation, examination and enforcement of the Volcker Rule regulations.

9. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association, The Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding your failure to conduct a general cost/benefit analysis of the proposed rules.

10. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012,

regarding why the proposal provides no consistency as to the types of municipal securities that are exempt from the proprietary trading prohibition under the Volcker Rule.

11. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal distinguishes between municipal securities based on the type of issuer, which would be inappropriate since different issuers may offer securities that offer the same credit exposure to investors.

12. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why tender option bonds would be captured in the definition of "covered fund" under the proposal when there is no evidence in the legislative history of the Volcker Rule suggesting that Congress intended tender option bond transactions to be included in the scope of the Volcker Rule.

13. Please address how your agency will solve the problem raised by the Securities Industry and Financial Markets Association comment letter dated February 13, 2012, regarding why the proposal does not exclude issuers of asset-backed securities from the definition of "covered funds" despite the Financial Stability Oversight Council's findings that Congress did not intend for the Volcker Rule restrictions to apply to the sale or securitization of loans.

14. Please address how your agency will solve the problem raised in the American Council of Life Insurers comment letter dated January 24, 2012, regarding why insurance company investment activities that are permitted activities under current law and the proposed regulations are subject to reporting and record keeping requirements and compliance monitoring in Subpart D.

15. Please address how your agency will solve the problems raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making activities described in the proposal fail to take into account unregulated over-the-counter market making activities that covered banking entitles provide to such markets.

16. Please address how your agency will solve the problem raised in the AllianceBernstein comment letter dated November 16, 2011, regarding how the market making exemption appears to be predicated on the incorrect assumption that there is a perfect hedge for all securities and that all risks can be hedged for any given holding period for any position.

17. Please address how your agency will solve the problems raised in the Bank of Japan and Financial Services Agency Government of Japan comment letter dated December 28, 2011, regarding how the proposed restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds will raise operational and transactional costs of trading in Japanese Government Bonds.

18. Please address how your agency will solve the problems raised by the Canadian Banks comment letter dated January 19, 2012, regarding how the Volcker Rule, as enacted, excludes funds registered for public sale in the U.S. under the Investment Company Act of 1940 yet the proposal fails to provide a similar exclusion for Canadian Public Funds from the proposed definition of "covered fund" which violates Canada's rights under the North American Free Trade Agreement.

19. Please address how your agency will solve the problems raised by Capital One Financial Corporation, Fifth Third Bancorp, and Regions Financial Corporation comment letter dated November 29, 2011, over how a narrowly construed insured depository institution exemption that does not extend to many of the swaps that banks and their customers consider to be core banking services could push even the smallest registered bank dealers over the Volcker Rule's $1 billion threshold which would result in additional burdensome record keeping and compliance requirements that may cause small dealers to exit the market.

20. Please address how your agency will solve the problems raised by the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding how the proposed rule should be considered an economically significant rulemaking.

21. Please address how your agency will solve the problem raised the U.S. Chamber of Commerce Center for Capital Markets Competitiveness comment letter dated December 15, 2011, regarding why the definition of exempt state and municipal securities is narrower under the Volcker Rule provisions of the Dodd-Frank Act than under the Securities and Exchange Act of 1934 which will subject municipal securities issued by municipalities and authorities to Volcker Rule provisions.

22. Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding how the government obligations exemption will be consistently implemented when obligations of "agencies" of States and their political subdivisions are exempted, but each municipal jurisdiction applies its own definition of political subdivision to its issuer entities.

23. Please address how your agency will solve the problem raised by the Citigroup Global Markets comment letter dated January 27, 2012, regarding the proposed rule's failure to expressly exempt tender option bond programs from its restrictions on covered fund activities and how covered transactions with covered funds will have a significant adverse effect on the municipal securities market.

24. Please address how your agency will solve the problem raised in the comment letters from Rep. Anna Eshoo dated December 13, 2011,; Rep. Michael Honda dated December 20, 2011,; Rep. Zoe Lofgren dated December 23, 2011,; Rep. David Schweikert dated December 16, 2011,; and Sen. Kay Hagan dated January 13, 2012, regarding how

venture capital funds should not be covered by the Volcker Rule and how the Volcker Rule, as enacted, consistently used the specific term "private equity fund" - not the more general term "investment advisor" as it relates to venture capital funds.

25. Please address how your agency will solve the problem raised in the comment letter from Sen. Kay Hagan dated January 13, 2012, regarding how the proposed regulations could inadequately clarify the treatment of certain investments made by insurers and why the rule does not conform to Section 619's directive to accommodate the "business of insurance" and includes investments in covered funds within the exemption for insurers.

26. Please address how your agency will solve the problem raised by the Income Research and Management comment letter dated January 20, 2012, regarding how the proposed regulations outlining how market making banking entities can generate revenue compel market makers to trade on an agency basis rather than a principal basis and how the domestic corporate and securitized (i.e. commercial, residential, and asset-backed mortgage securities) credit markets are too large and heterogeneous to be served appropriately primarily by an agency trading based model.

27. Please address how your agency will solve the problem raised by the Investment Industry Association of Canada comment letter dated December 21, 2011, regarding the reasoning behind the extraterritorial application of the proposed Volcker Rule when there is nothing in the statutory text of the Volcker Rule or legislative history to suggest that Congress intended the Agencies to depart from their long-standing approach to apply U.S. banking and securities law to cross-border transactions.

28. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding the need to broaden the "governmental obligations" exemption from the proposed rule's restriction on proprietary trading to include all "municipal securities" as defined in the Exchange Act in order to avoid a bifurcation of the municipal securities market that brings no additional benefit to the safety and soundness of the banking system.

29. Please address how your agency will solve the problem raised by the Municipal Securities Rulemaking Board comment letter dated January 31, 2012, regarding how most municipal market participants consider a primary function of market making to be the generation of liquidity in the market by taking securities into inventory, and that a dealer may not always be able to demonstrate compliance with the requirement of the market maker exception, with respect to the covered financial position, as designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.

30. Please address how your agency will solve the problem raised by the Norinchukin Bank comment letter dated January 25, 2012, that by applying the Volcker Rule to any transactions that take place outside of the U.S. based only on the fact that foreign banks

have U.S.-based offices seems like an extraterritorial application which deviates from one of the main objectives of the Dodd-Frank Act of containing systemic risks.

31. Please address how your agency will solve the problems raised by U.K. Chancellor of the Exchequer George Osborne's comment letter dated January 23, 2012, regarding how the proposed regulations would appear to make it more difficult and costlier to provide market-making services in non-U.S. sovereign markets.

32. Please address how your agency will solve the problems raised by the Standish Mellon Asset Management comment letter dated January 19, 2012, regarding how the proposed prohibited principal trading could result in dealers being hesitant to transact in secondary cash bonds because of extraordinary compliance requirements and the lack of clarity surrounding the rules.

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representatives Huizenga and Peters:

1. Because of its ownership interest in EnerBank, CMS Energy would be considered a "banking entity" under the proposed Volcker Rule. Furthermore, an investor that owns as little as five percent of CMS Energy could also become subject to the Volcker Rule. This could create a significant disincentive for institutional investors to invest in CMs Energy. We would like to know whether the regulators have proposed the Volcker Rule are aware of the problem outlines above, and if so, could it be addressed in revisions to the proposed rule?

2.. The proposed Volcker Rule appears to apply to commercial companies that own a thrift or an industrial loan company, as well as all of the companies in which these covered entities may have a significant investment that makes the recipient of the investment an "affiliate." While the Volcker Rule was designed to limit risks at insured depositories so that banks wouldn't be using government insured deposit funds to gamble through proprietary trading or fund investing, it appears that it will also cover all sorts of industrial and commercial companies that are in some way affiliated with a depository. Do the regulators believe that non-financial companies should be subject to the same restrictions as financial entities? What kind of enforcement and examination regime would regulators impose on non-financial entities that are required to comply with the Volcker Rule because of their affiliation with a financial entity?

The prohibitions and restrictions of section 619 of the Dodd-Frank Act apply by their terms not only to insured depository institutions (e.g., insured banks, savings associations, industrial loan companies), but also to any affiliate or subsidiary of an insured depository institution, without regard to the nature of activities (e.g., financial or commercial) in which the affiliate or subsidiary engages. See Section 619(h)(1) of the Dodd-Frank Act. The joint proposal issued by the Federal Reserve, OCC, FDIC, and SEC requested comment on a wide variety of issues, including with respect to the definition of "banking entity." The Federal Reserve is carefully reviewing comments received on these issues, and we are considering these comments as we work to finalize implementing rules.

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representative Peters:

Many observers have raised concerns that the Volcker Rule could lead to a decrease in market liquidity because banks would be wary of holding large inventories of certain types of assets. There has also been speculation that if banks are unable to engage in as much market making activity, that other actors or new entrants could find an economic incentive to engage in market making. My questions for the witnesses are:

- **Do you agree that covered entities may decrease market making activity?**
- **If, so do you believe that other parties will step forward to provide liquidity.**
- **If institutions covered by the Volcker Rule reduce their market making activities, what kinds of institutions do you expect will emerge to provide the liquidity necessary for well-functioning markets, and what kinds of regulatory scrutiny are those institutions subject to?**
- **Are there any negative consequences that can be anticipated from this change?**

Section 619 of the Dodd-Frank Act prohibits proprietary trading, but provides an exemption for market making-related activities. The implementing rule proposed by the agencies contains the same market making exemption contained in the statute. Consistent with the statutory exemption for market making-related activities, the proposal is designed to permit firms to continue to engage in market-making activity and provide liquidity in all areas of the trading markets.

The proposal is designed to take into account the fact that features of market making activities will vary depending on the type of asset involved and the relative liquidity of a particular market. For example, the proposal suggested a number of metrics for the purpose of helping banking firms and supervisors identify trading activity that warrants in-depth review to ensure compliance with the prohibition on proprietary trading. As explained in the interagency proposal, some metrics may be more useful for a given asset class than others, thereby allowing firms and the agencies flexibility in designing an approach that is most effective in meeting the statutory prohibitions in the Dodd-Frank Act and the exemption for market making-related activities. The Federal Reserve and other rulemaking agencies have requested comment on the potential impact that particular parts of the rule might have on market liquidity and how any negative impacts might be minimized. We will carefully consider the public comments received on these points and take those comments into account in crafting a final rule to implement section 619.

Questions for The Honorable Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, from Representative McCarthy:

Following up on a question that my colleague Mr. Watt asked with regard to the Dodd-Frank Act statute as it applies to the insurance industry, exempting them from proprietary trading but ambiguity as to whether the industry is exempt from the ban on investing in securities defined as "covered funds."

My understanding from my colleague's inquiry as well as your responses is that there is a clear exemption for the business of insurance for trading, but not for investments, and you will use the feedback from the industry to determine if they should be exempt.

My question to you both is two-fold:

1. What would be the public policy reason for not extending the exemption given that state investment laws applied to insurance companies domiciled in that state already impose limitations on the categories of investments that insurance companies may hold?

2. Do you have the statutory authority to exempt the business of insurance from covered fund investment restrictions?

Section 619 of the Dodd-Frank Act itself provides an exemption for the purchase, sale, acquisition, or disposition of specified financial products by a regulated insurance company directly engaged in the business of insurance for the general account of the company, so long as the enumerated criteria are satisfied. Additionally, the statute provides a separate exemption that authorizes the Federal Reserve, the OCC, FDIC, SEC, and CFTC to permit additional activities if it is determined they would promote and protect the safety and soundness of banking entities and the financial stability of the United States. The Federal Reserve has received comments on the treatment of insurance company's interests in covered funds and is carefully considering these comments in crafting a final rule consistent with the statute.

Questions from Rep. Peters

Do you agree that covered entities may decrease market making activity?

The threshold issue in answering this question is: what is the scope of market making as that term is used in section 619 of the Dodd-Frank Act? I believe that it is clear from the text and legislative history that a central element is that the outcome of the transaction for the bank is reasonably predictable at the time the transaction is entered into. For example, if a bank buys a security from a customer, if there is an identifiable market price to sell the security and the bank will profit from the difference, the outcome is predictable. This is consistent with the historic meaning of the term and the SEC's interpretation of this activity in other contexts. Under this interpretation, the bank would be taking only minimal market risk and the activity would be predominantly a customer service, not a proprietary risk motivated activity. As a further definition, the securities and derivatives held in inventory would need to be commensurate with the reasonably anticipated market making activity to avoid "back-door" proprietary trading.

Unfortunately, market making desks at banks have often engaged in a broader scope of activity in recent years. This was clearly outlined in the Senate Permanent Subcommittee on Investigations Hearings in the summer of 2010 relating to Goldman Sachs' activities in the mortgage-backed securities markets. They have executed transactions for which there is no discernable market-based price. They have also built up inventory far in excess of amounts needed to conduct the basic business. Having consulted with individuals in the business, the reason appears to be the perceived need to enhance the profit and loss potential of the desk so that results (and compensation potential) are more aligned with other trading desks at the bank. Regardless, the expanded scope of activity is, in my view based on the statute and legislative history, beyond the appropriate scope of market making.

The proposed rules and discussion with agencies have led me to believe that the issue of the scope of market making must be refined in the final rule. Assuming that the scope of market making is properly restricted as described in the first paragraph, significant activity engaged in by market making desks in recent years will be prohibited. This is appropriate because this business is not primarily engaged in as a customer service, but rather as a way to take on risk positions.

If this is the result, market making will be restricted to the legitimate, low risk and moderately profitable business that it has historically been. The proprietary trading that is undertaken as an adjunct to market making will be prohibited. Since the banks do the pure business now, presumably it will continue unless the only reason they are in the business is to shoehorn into proprietary trading by another name.

Importantly, should the Volcker Rule be properly implemented, market making businesses will not be mingled with proprietary position taking and potential conflicts of interest will be eliminated. Under the current system, the market

making desk can easily have proprietary risk interests that conflict with customers.. The cost of the service will be transparently appropriate to the service performed. There may be cases in which the actual explicit "fee" might be higher. This is largely because customers will no longer benefit indirectly from the lower capital costs for banks that are protected by the federal safety net. But it will also be because the customer business will no longer be used to support accumulation of proprietary risk positions and will be cost based on the value of the service provided to the customer. However, the elimination of the conflict of interest would be far more valuable to the customer than any fee impact.

If so, do you believe that other entities will step forward to provide liquidity?

To the extent that covered banks decide to exit or reduce market making for any asset class, it is highly likely that other market participants will take up the business. The business is profitable if done correctly. If fees increase because of less bank activity, other market participants will be induced to step in and a supply/demand equilibrium will emerge. The resources exist in institutions outside the taxpayer safety net to provide liquidity and market making services in thinly traded assets. For example, current hedge fund assets are over $2 trillion, which is about ten times the peak inventory level of roughly $200 billion in corporate bonds held by primary dealers before the crisis, and many times the current level of $43 billion.

It is important that the provisions of Section 619 related to capital requirements for systemically important non-bank entities engaging in proprietary trading are implemented in addition to the covered bank prohibition. If proprietary trading activity is pushed into non-bank institutions that are large and central enough to be systemically important the agencies must address the reallocation of risk. They must make it clear that a regulatory balance will be maintained.

If institutions covered by the Volcker Rule reduce their market making activities, what kind of institutions do you expect will emerge to provide the liquidity necessary for well functioning markets, and what kind of regulatory scrutiny are those institutions subject to?

Hedge funds are an obvious candidate. Investment banks are also likely to take up the business. Some investment banks might be spun off from covered banks and become separate entities not covered by the Volcker Rule and without access to the Federal safety net.

The fundamental point is that, to the extent the business is profitable, other institutions that are not supported by the federal safety net will undoubtedly compete for it. The IT and personnel necessary to support the business will be developed. And, most importantly, the capital necessary to support the trading activity will be raised on terms that are not distorted by the too-big-to-fail subsidy. There is no doubt that the free market system will support the business that makes sense, but in the new model incentives will not be distorted in ways that generate

massive risks to the financial system. It will be healthier and safer and more sustainable. In other words, legitimate services will more reliably and efficiently provided to the public.

Are there negative consequences that can be anticipated from this change?

There will, of course, be consequences to covered banks. Since business lines will be prohibited, they will lose potential profit, but they will also shed risks that history has shown could threaten their very existence. The Dodd-Frank Act clearly establishes a policy that the risk is not worth the consequences of systemic financial collapse and bailouts. The relevant point is that the consequences to the public will be positive on a net basis. For instance, elimination of conflicts of interest, described above is a net positive, even if nominally fees increased. The costs would simply be made transparent. And elimination of the market-distorted effects of the subsidy embedded in the use of capital that is supported by the federal safety net is a tremendous value. If the costs and benefits are properly calculated, it is compelling that the consequences will be positive measured appropriately.

Questions from Rep Carson

Can you explain why the Volcker Rule is equated with Glass-Steagall?

Glass-Steagall prohibited commercial banks generally from engaging in a number of activities associated with the securities markets, though there were exceptions. Commercial banks were permitted to transact in government securities and to underwrite municipal bond offerings, for instance. Similarly, the Volcker Rule places strong limits on securities market activities of bank holding companies, restricting them to an enumerated set of low-risk, traditional activities conducted in service of customers.

Glass-Steagall was in many ways simpler than the Volcker Rule because it permitted fewer securities market activities. Among the list of permitted Volcker Rule activities are some that could easily be used to camouflaged proprietary trading, such as market making and forms of hedging, unless they are carefully defined and circumscribed. Glass Steagall also did not address the derivatives markets (and the fact that it did not do so eventually opened up significant loopholes in the Glass-Steagall regime).

As a result, the Volcker Rule shares the fundamental purpose of Glass-Steagall in that it seeks to limit bank exposures to trading markets. However, the Volcker Rule is more targeted. A large part of the complexity in the Volcker Rule involves the proper regulation of certain securities businesses that are permitted in some forms under the Volcker Rule, but must be carefully controlled to avoid disguised proprietary trading and excessive risk to the financial system. Therefore, the Agencies have to craft rules that not only carve out permitted activities, but

establish mechanisms to detect a drift into proprietary risk taking, and prevent excessive risk to the system and conflicts of interest.

Does the Volcker Rule accomplish the goals of those who advocate reinstating Glass-Steagall?

One benefit of the Glass-Steagall approach is that it establishes clearer boundaries. The Volcker Rule is a powerful reform but is less restrictive on covered banks than Glass-Steagall. Properly implemented, the Volcker Rule could accomplish many of the goals of Glass-Steagall advocates. However, we do not yet know if the Volcker Rule regulation will properly implement the statute, and we do know that there is massive industry lobbying against effective implementation. Once a regulation is written, it will also be more susceptible to erosion if regulators are not vigilant or lack the resources to monitor effectively.

Do you believe that the Volcker Rule is a better solution to the problem of inappropriate risk-taking by banks in reliance on the federal safety net than reinstating the formal separation of commercial banking from investment banking would be?

As discussed above, a full separation between commercial and investment banking would extend further than the Volcker rule in certain areas, and it would be in certain ways easier to maintain and police. However, the prohibitions in the Volcker Rule can be effective in making the financial system safer if certain changes are made to the proposed rules including appropriately circumscribing exceptions for market making, underwriting and other activities (as described in the response to Representative McCarthy's questions, below, and in comments submitted by AFR on the proposed rule).The rules must also be administered properly by the regulators. For the Volcker rule to be effective it is critical that the rules are tight and that the regulators have the comittment and the resources to enforce them.

How did proprietary trading and market making work before depositary institutions were permitted to own investment banks?

These businesses were dominated by strong and sophisticated investment banks. These institutions were highly profitable but were subject to enormous risks as well. Their management had clear "skin in the game," many being structured as partnerships or hybrids in which access to outside capital was assured, but partners also had clear positive and negative incentives because their personal wealth was at risk. Importantly, they were able to raise necessary capital without reliance on deposits and the federal safety net. Generally speaking, the commercial banks sought to participate in the traded markets and advocated the elimination of restrictions. Once the banks could participate, many (but by no means all) investment banks combined with commercial banks to get access to cheaper capital. This was a dangerous and unfortunate result.

The Oliver Wyman study commissioned by SIFMA suggests that transaction costs in the bond market are going to skyrocket and market liquidity will be significantly impaired if the Volcker Rule is implemented as proposed. Do you agree with this analysis?

I emphatically do not agree with the analysis. There are multiple flaws in the study, each of which skews the results toward higher "cost" results. These issues are so fundamental that a proper, corrected study would not yield modestly different results, but results that are enormously different. Most troubling is that this study is transparently an advocacy piece disguised as the work of an independent minded expert. It has been widely reported as an expert study that has some value in the public discourse concerning the Volcker Rule, one notable journalist remarking that if the study were half wrong, the costs would still be high. There is no way to know "how wrong" the study is (strictly from the perspective of the methodology used). But the errors are so fundamental that speculating about a 50% error clearly misrepresents the problems with the study.

First, the study assumes that every unit of trading volume that the banks will no longer undertake will simply evaporate from the markets. The study explicitly states that it assumes no other market participant will fill the void created by the proprietary trading prohibition of the Volcker Rule. This is completely illogical. It also flies in the face of history – after the passage of Glass-Steagall sophisticated investment banks emerged to handle the securities business that commercial banks were no longer able to engage in

The illogic is illustrated vividly when one considers the massive cost in terms of higher bid/ask spreads calculated in the study. Every dollar of that "cost" represents profit potential for other market participants. Logically, they would take advantage of this by expanding capacity to increase their business in this area.

The fact is that reduced liquidity does increase bid/ask spreads, which in turn incentivizes other market participants to increase trading activity (and raise the capital needed to do so) until equilibrium is reached. The equilibrium may be a different level from the current structure because of higher cost capital for the new entrants, *but that is because the American public will not be subsidizing the newly deployed capital with a "too-big-to-fail" guarantee.*

That is a good result. The implicit guarantee is a cost borne by the public every day as the risk of a new bailout looms. The value of avoiding that cost does not appear in the Oliver Wyman study.

The assumption that volume will evaporate into thin air is by no means the end of the story. A second concern is that the effects of volume reduction on liquidity premia are highly variable and extremely dependent on market conditions. Volume reduction may tend to increase bid/ask spreads and liquidity premia, but these effects do not apply uniformly across all levels of volume reduction. In other words, a reduction of $10 of volume does not have 10% of the affect of a reduction of $100

of volume. This relationship is ignored in the study delivered to the committee. Market crashes or panics are marked by "liquidity crises" where buyers exit the market and prices drop. Such market crashes can be preceded by periods of *excessive* liquidity, for example a bubble period prior to the crash. Liquidity is a complex and dynamic phenomenon, and it is important not to ascribe the losses due to a market crash in liquidity to regulations intended to make markets more stable over time.

The Oliver Wyman study unfortunately does precisely this. It uses factors developed by academics to measure the effects of the loss of liquidity during the financial crisis itself. This was an extreme and historically unprecedented evaporation of liquidity, which in fact was so extreme that the Fed had to pump trillions of dollars into the marketplace to avoid a total melt down. By using these factors, the study implicitly ascribes the losses due to the financial crisis to the Volcker Rule.

It should be noted that the follow-up work done by Oliver Wyman provides a range of liquidity price estimates, with the low end drawn from a pre-crisis period. This may have been in response to concerns expressed at the hearing. The cost calculations drawn from the pre-crisis period yield results that are 80-90% lower. Unfortunately, the larger figure that was the only one available at the time of the hearing is the amount that is still discussed.

Finally, the study assumes that the rules will massively reduce market making by the banks. The explicit assumption is that the regulators will apply the rules in the most extreme ways possible. For example, the study states:

> Whether limits on holding inventory or inter-dealer trading are explicit or the effective result of behavioral changes, the result would be an overly restrictive implementation of the statute. Despite the proposed rule containing no specific limits, we view the emergence of effective versions of such limits as a plausible outcome of the proposed rule.

The report repeatedly describes the assumed affect on market making as "plausible." This standard transparently describes a study that is not based on likely outcomes, but ones that are merely plausible.

The compounded flaws in this study are problematic. However, the apparent bias is even more troubling. The best approach would be, in my view, to disregard the results.

Questions from Rep McCarthy

I have had meetings with many stakeholders on this issue, and while I have a good sense of the areas of concern, not much has been offered as solutions.

What are some proposed changes and revisions the regulators should think about as they seek to finalize the rules?

Do you feel substantive changes that may be necessary as a result of stakeholder feedback on the hundreds of questions within the proposed rule?

Broadly speaking, the proposed rules establish a well-reasoned and useful framework for implementation of the Volcker Rule. At the same time, there are many crucial areas that need improvement and clarification. These concerns are not merely technical, but involve substantive issues that must be addressed if the Congressional intent behind the Volcker Rule is to be implemented. Without such changes, the boundaries of the permitted securities market activities in the Volcker Rule cannot be effectively policed. The Comment Letter submitted to the Agencies by Americans for Financial Reform, a copy of which is provided herewith and incorporated herein, discusses these issues in detail. Some important highlights include the following:

- Market making must be limited to customer-based activities in which the financial outcome to the covered bank can be reasonably anticipated. There must be a reasonably liquid market for the security or derivative (or at a minimum for a rational hedge for the security or derivative) that enables the covered bank to close out the position promptly at a foreseeable price based on real market transactions. This is required for two reasons. If the instrument cannot be valued by referring to market prices, the price risk is straightforwardly proprietary. It is a bet on market price moves. Moreover, the overwhelming purpose of the transaction, as demonstrated by the way profit is derived from the transaction, is to take on a proprietary position, not to provide as service to a customer. Simply stated, a class of securities that trade infrequently or by appointment and cannot be valued by reference to an objective, independent market price cannot be the subject of market making.
- Inventory held to support a market making business must be appropriate to the business itself. Otherwise, large positions could be disguised as inventory. This is not a hypothetical problem. It has been a common practice at many covered banks. The appropriateness of inventory can be measured by two standards, each of which must be met. First, inventory must be for the purpose of meeting near term customer demand (just like inventory in any commercial enterprise). The size and, importantly, the turnover of the inventory must be appropriate to the business. In the proposed rule these metrics are referenced. Principles for analysis must be provided. Turnover

standards must be based on the market and the business, but must in all cases be shorter than total market turnover. The business must also expressly be monitored for the ratio of profit to risk (as in the commonly used Sharpe's Ratio) to detect excessive inventory positions, among other things. If the ratio depicts a business that is more like a hedge fund than a customer based service, the bank could well be engaging in proprietary trading. While the elements are in the proposed rules, the application must be made explicit.

- Hedging rules must be made clear to assure that a hedge cannot have an additional, additive risk embedded. This is a common way of taking on proprietary positions in the guise of hedging and can be exceedingly risky. The proposed rules support this principle, but in several places create a level of ambiguity that must be corrected. Hedging rules must also be clarified to ensure that 'aggregate hedging' does not become a generalized excuse for proprietary trading.
- Repurchase agreements must not be categorically excluded from the definition of proprietary trading. These are extremely dangerous forms of leverage that were at the very core of the financial crisis in 2008. Their use must be carefully controlled. If repurchase agreements are used for proprietary trading, they should be prohibited. If they are used for liquid financing, they must be controlled carefully.
- The covered fund rules must better reflect the text and the intent of the statute. For instance, the "seeding" provision providing leeway for startup hedge funds was clearly intended to permit only small investments to prove viability. Under the proposed rules, there is no restriction that would prohibit exploitation of the provision. Furthermore, the applicability to asset-backed securitizations is clear. The proposed rules are far to accommodative to this activity.

The proposed rules need to establish robust application of general safety and soundness standards, excessive risk prohibitions and capital requirements for systemically important non-covered institutions, all in accordance with Section 619 of the Dodd-Frank Act. These provisions are integrally important to the basic prohibitions and the implementing rules must be strengthened.

Questions for the Record
Joint Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
Wednesday, January 18, 2012

Congressman Spencer Bachus
Questions 1 – 8 and 10 - 32:

Thank you for your questions concerning the joint notice of proposed rulemaking (Proposal) implementing section 619 of the Dodd-Frank Act. Because we are in the midst of this joint rulemaking, we are unable to express our views on the merits of any of the questions raised or provide interpretive advice on provisions of the Proposal.

The comment period on the Proposal closed on February 13, 2012, and the agencies are now in the process of reviewing and analyzing the over 18,000-comment letters received. We plan to carefully review and analyze these comment letters as we work towards a final rule. Rest assured we will carefully consider the issues you have identified and plan to address these issues with the other agencies involved in this rulemaking in connection with development of a final rule.

Question 9: Please address how your agency will resolve the problem raised by the Securities Industry and Financial Markets Association, the Clearing House, Financial Services Roundtable, and American Bankers Association comment letter dated February 13, 2012, regarding your failure to conduct a general cost/benefit analysis of the proposal.

The OCC conducts several types of economic impact assessments for all proposed and final rules. This includes any analysis required by the Unfunded Mandates Reform Act (UMRA), the Congressional Review Act (CRA), and the Regulatory Flexibility Act (RFA).[1] Specifically, under UMRA, the OCC assesses whether a proposed or final rule includes a "Federal mandate" that may result in the expenditure by state, local, or tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year (adjusted for inflation). If this threshold is met, the OCC prepares a more detailed economic assessment of the rule's anticipated costs and benefits. Under the CRA, the OCC determines, among other things, whether a final rule is likely to result in a $100 million or more annual effect on the economy. Under the RFA, the OCC determines if a proposed or final rule is likely to have a "significant economic impact on a substantial number of small entities."

The Proposal solicited comments on the full economic impact of the Proposal. We plan to carefully consider all comments received on this issue in our assessment of the final rule under UMRA, RFA, and the Congressional Review Act.

[1] UMRA: 2 U.S.C. 1501 *et seq.*; CRA: 5 U.S.C 801 *et seq.;* and RFA: 5 U.S.C. 601 *et seq.*

Congressman Gary Peters

Thank you for your questions concerning the joint notice of proposed rulemaking (Proposal) implementing section 619 of the Dodd-Frank Act. Specifically, you asked whether banking entities covered by the Proposal would decrease their market making activities, whether other parties would step forward to provide liquidity (and what kinds of entities and subject to what supervision these other parties are), and whether there are any negative consequences that can be anticipated from this change.

Because we are in the midst of this joint rulemaking, we are unable to express our views on the merits of any of the questions raised or provide interpretive advice on provisions of the Proposal.

The comment period on the Proposal closed on February 13, 2012, and the agencies are now in the process of reviewing and analyzing the over 18,000-comment letters received. Rest assured we will carefully consider the issues you have identified in your questions and plan to address these issues with the other agencies involved in this rulemaking in connection with development of a final rule.

Congressmen Bill Huizenga and Gary Peters
Questions 1 and 2:

Thank you for your questions concerning the joint notice of proposed rulemaking (Proposal) implementing section 619 of the Dodd-Frank Act. Specifically, you asked about the impact of the Proposal on commercial companies that own a thrift or an industrial loan company and their affiliates, including in particular CMS Energy.

Because we are in the midst of this joint rulemaking, we are unable to express our views on the merits of any of the questions raised or provide interpretive advice on provisions of the Proposal.

The comment period on the Proposal closed on February 13, 2012, and the agencies are now in the process of reviewing and analyzing the over 18,000-comment letters received. Rest assured we will carefully consider the issues you have identified in your questions and plan to address these issues with the other agencies involved in this rulemaking in connection with development of a final rule.

Congressman Grimm
Questions 1 – 6:

Thank you for your questions relating to the joint notice of proposed rulemaking (Proposal) implementing section 619 of the Dodd-Frank Act. Specifically, you asked about the impact of the Proposal on various proprietary trading transactions conducted by "non-U.S. based institutions" with U.S. and foreign counterparties in bonds issued by U.S. and/or foreign entities.

Because we are in the midst of this joint rulemaking, we are unable to express our views on the merits of any of the questions raised or provide interpretive advice on provisions of the Proposal.

The comment period on the Proposal closed on February 13, 2012, and the agencies are now in the process of reviewing and analyzing the over 18,000-comment letters received. Rest assured we will carefully consider the issues you have identified in your questions and plan to address these issues with the other agencies involved in this rulemaking in connection with development of a final rule.

Congresswoman Judy Biggert

Given the enormity of the task of crafting the Volcker Rule that your agency and the other relevant agencies face, do you agree that a comprehensive rulemaking may not be ready to take effect in July?

We agree that finalizing the joint notice of proposed rulemaking (Proposal) implementing section 619 of the Dodd-Frank Act (the Volcker Rule) by the statutory effective date of July 21, 2012, will be a difficult task. While we continue to work towards this goal with the other rulemaking agencies, we will not sacrifice quality over speed. As you are aware, the comment period on the Proposal closed on February 13, 2012, and the agencies are now in the process of reviewing and analyzing the over 18,000-comment letters received. The agencies plan to begin work on a final rule after they have completed their review and analysis of the comment letters.

Alone or in coordination with other relevant agencies, has your agency formulated plans for a phased-in implementation of the Volcker Rule's compliance regime?

Much of the timing for compliance with the final regulations implementing the Volcker Rule is dictated by section 619 of the Dodd-Frank Act. Section 619 goes into effect on July 21, 2012 (even without final rules), and provides a two-year conformance period that runs until July 2014. Banking entities may use this conformance period to bring their activities, investments and relationships into compliance with section 619. In addition, section 619 provides that banking entities may request up to three one-year extensions of this conformance period from the Federal Reserve Board and another 5-year extension from the Board to divest of certain illiquid funds. The Board has issued a final rule implementing the conformance provisions of section 619.

In addition, the Proposal expressly requests comment on whether the agencies should use a gradual, phased-in approach to implement the statute rather than having the implementing rules become effective at one time and asks banking entities to identify prohibitions and restrictions that should be implemented first, if the agencies choose to implement a phased-in approach. We plan to carefully consider any comments received on this issue.

Does your agency have the regulatory authority necessary to phase-in implementation of the Volcker Rule so that, if need be, your agency with the other relevant agencies can continue perfecting the details of regulatory compliance in a measured manner, even as the core requirements of the Volcker Rule (such as shuttering of the proprietary trading desks) become effective?

As noted above, much of the timing of implementation of the Volcker Rule is dictated by section 619, including the conformance period thereunder. The Board is charged with implementing the statutory conformance period.

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