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On behalf of the Securities Industry and Financial Markets Association

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Committee on Financial Services

Subcommittee on Capital Markets, Securities, and Investment

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Chairman Huizenga, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify today on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1] and to share our views on the market effects of the Volcker Rule. SIFMA represents a broad range of financial services firms active in the capital markets and dedicated to promoting investor opportunity, access to capital, and an efficient market system that stimulates economic growth and job creation.

I have been CEO of Stifel Financial Corp. (Stifel) since 1997, and have over 30 years' experience in the securities industry. As Chairman and Chief Executive Officer of Stifel, I appreciate the opportunity to bring my company's experience with this law to the Committee. For those of you who don't know Stifel, we are a financial services holding company headquartered in St. Louis, Missouri. Stifel was founded in 1890 and, as such, this year marks our company's 127th anniversary. Stifel's affiliates are primarily engaged in wealth management, Investment Banking, Institutional Services and traditional banking conducted through a federally insured depository. As to our size, Stifel has revenue of approximately $2.6 billion, $20 billion in assets, and manages approximately $240 billion for our clients. Stifel employs over 7,000 people and enjoys a market cap of nearly $4 billion.

First, I must say, I sincerely wish the Volcker Rule had another name. Why? Well, as my testimony will illustrate, I am not a proponent of this rule. I believe the Volcker Rule provides little benefit regarding its purpose when enacted which was to reduce systemic financial risk by banning proprietary trading.

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

On the other hand, I have the utmost respect for Mr. Volcker and want to be clear that my criticism of a rule which bears his name is not a criticism of Mr. Volcker. I remember all too well the accomplishments of Mr. Volcker, as Fed Chairman, in fighting the rampant inflation of the early 1980s.

Thus, let me begin with my conclusion. It is my personal view that the Volcker Rule needs to be taken off the books, repealed. But if repeal is not possible, it must be materially amended to avoid further damage to the markets my company serves.

The Volcker Rule is the product of years of statutory and regulatory wrangling, involving the Congress, the Department of the Treasury, and five independent regulatory agencies. As many stakeholders and policymakers predicted, the rule as formulated, implemented, and enforced has had a deleterious impact on the ability of American businesses to raise capital and grow the economy. Put simply, the Volcker Rule discourages legitimate and needed customer-supporting market-making activities by imposing an overly complex and intent-based compliance regime. To determine whether an activity was proprietary trading or legitimate market making, a compliance expert would also need to be a psychiatrist trained in determining the intent of each trade by a trader. The Rule has raised the cost of capital for businesses and encouraged pro-cyclical effects on liquidity in financial markets.[2]

I know that saying the Volcker Rule should be repealed is a bold statement. Why be so bold? Simple cost/benefit analysis. Before I discuss the cost/benefit of Volcker, allow me to provide you with Stifel's perspective and whether my testimony is merely "talking my own book".

[2] A paper from Anjan Thakor from Washington University in St. Louis noted that previous scholarship on the cost of capital for businesses found a relationship between higher bid-ask spreads and a higher cost of capital. Because illiquidity due to constrained market-making will likely drive up bid-ask spreads, Thakor concluded businesses will likely face higher costs of capital due to Volcker. Darrell Duffie (from Stanford University) came to a similar conclusion in a 2012 paper, arguing that U.S. corporate bonds and non-agency mortgage-backed securities will face higher costs of capital because of the Volcker Rule, due to lower liquidity in secondary markets.

As previously stated, Stifel has been around for over 125 years. We did not take TARP during the financial crisis and are not looking at betting the proverbial ranch on any one strategy. Said another way, Stifel does not directly and materially benefit from a proprietary trading model.

Importantly for today's testimony, Stifel serves small and middle-market companies and the investors in these same companies. We therefore have a front row seat to comment on the impact of Volcker on these companies. As I already stated, the purported benefit of the Volcker Rule is to reduce the systemic risk to our economy caused by proprietary trading.

Make no mistake, I do not believe deposit taking banks should be making risky short term, speculative bets, and in fact the law has long prohibited such activity. But I do not believe the way to regulate risk, systemic or otherwise, is by inhibiting trading or traditional market making, which provides liquidity and depth to our capital markets, but rather through capital and liquidity rules addressing the balance sheet of our financial institutions.

It is important to note that the financial crisis was rooted in the loan book, not the trading book, of our financial institutions.

Since the financial crisis, several rules have been implemented which have significantly increased the quantity and quality of capital and increased internal liquidity of our financial institutions, most more stringent than internationally agreed standards. But the Volcker Rule doesn't do anything to increase capital or internal liquidity at firms, but it does impact firms' ability to make markets and provide liquidity, particularly in times of stress, as the Federal Reserve itself has written.

As to the Volcker Rule itself, let me make three observations:

1) The Rule is beyond complex. While only 11 pages of the Statute, the regulatory rule text is over 950 pages and included 2800 footnotes. You need a team of law firms – not just

lawyers – to be able to decipher it, and even then, many times the answer is that there is no clear answer.

2) The Volcker Rule includes a provision called "RENT-D," a concept only the government could devise. RENT-D limits market making so it does not exceed the '*reasonably expected near term demand*' of clients, customers and counter-parties. Seven years after the enactment of Dodd-Frank, I am no closer to understanding what that term means or how to implement something so amorphous. The ability to provide market liquidity requires an anticipation of supply or demand, which if proven wrong with the benefit of hindsight, would violate the Volcker Rule.
3) Compliance with Volcker is governed by five separate agencies.

The five separate agency construct, each with their own congressional mandate, their own philosophy and own approach, creates an uncertain and unwieldy bureaucracy. In turn, this leads to numerous and overlapping exams and inquiries. Furthermore, this has resulted in an utter lack of guidance, under an overly complex rule that is screaming out for interpretations and FAQs.

History of the Volcker Rule

Controversy has surrounded the Volcker Rule before, during, and after its inclusion in the Dodd-Frank Act. The Rule was not part of the first Treasury Department or Obama Administration blueprints, nor was it found in the initial versions of the financial reform efforts that became Dodd-Frank. Its eleventh-hour inclusion in the Senate version of the bill was criticized by members of both parties, and even within the Obama Administration there were major disagreements over its necessity. Treasury Secretary Geithner testified before the Congressional Oversight Panel in 2009 that in the financial crisis "most of the losses that were material . . . did not come from [proprietary trading] activities." Paul Volcker himself even conceded in March 2010 that proprietary trading was "not central" to the crisis.[3] Simply put, it was the loan book, not the trading book, that fueled the crisis.

Volcker's proponents assured the public that the rule would prohibit only certain activities that put taxpayers at risk while preserving beneficial customer-supporting market making. However, the distinction between proprietary trading –the purchasing and reselling of financial instruments to profit from short-term price changes – and market making – the purchase and reselling of financial instruments as a service to customers – has turned out to be very difficult to determine in practice. Unfortunately, the rule's current overly-broad definition of proprietary trading, its negative presumption that activity is prohibited and its complex, intent based compliance structure constrains, and will continue to constrain, legitimate market making whose costs will be felt throughout the economy.

Bad Policy

Looking at the benefit side of the cost-benefit tradeoff, I believe there is little incremental benefit provided by the Volcker Rule. What about the cost side of this equation? Simply put, the Volcker Rule makes our capital markets less liquid which increases the cost of capital for Stifel's clients, especially smaller companies which are the major contributors to job-creation.

Stifel helps our clients by assisting them raise growth capital in both the equity and debt markets. As part of this equation, Stifel commits to make markets, which benefits both the issuing company and the purchaser of the equity or debt. Volcker materially impacts our ability to

[3] https://piie.com/events/volcker-essential-elements-financial-reform

effectively make markets. This in turn causes the buy-side to demand higher compensation, reflected in lower equity valuations or higher interest rates. And, higher cost of capital.

Market liquidity is critical for a well-functioning, high growth economy that continues to create jobs as it gives businesses of all shapes and sizes the ability to access capital in a timely and efficient manner. Market makers, such as bank affiliated broker-dealers, provide liquidity by buying, selling and holding infrequently traded financial products in their inventory, granting buyers and sellers immediacy in transactions that may not be otherwise available. This immediacy is especially important for financial products that are traded over-the counter (OTC) and the overwhelming majority of bond trading is done in this manner.

The Volcker Rule threatens market liquidity by making the trading of OTC financial products both slower and costlier for issuers and investors. The current regulatory framework limits some trading that is connected to customer activity by relying on a broad definition of proprietary trading and providing prescriptive, conditional exemptions for allowed market making activities. The narrow set of permissible activities and the prescriptive conditions for engaging in those activities has led many financial institutions subject to the Volcker Rule to scale back their trading operations as well as their inventories of financial assets to remain within the Rule's strict guidelines.[4] Financial institutions subject to the Rule are forced to take a conservative approach even to permitted activities in order to remain within the confusing and complex parameters of the Rule. Taken together, these changes reduce liquidity in financial markets broadly, and have resulted in higher market execution costs and delays for would-be issuers and investors. A recent Federal Reserve staff paper found that the Rule has negatively affected liquidity in corporate bond markets, quantifies this effect and notes that this effect may be stronger in times of market stress when liquidity may be

[4] https://www.wsj.com/articles/volcker-bank-risk-rule-set-to-start-with-little-fanfare-1437517061

most essential to maintain financial market stability and efficiency.[5] This potentially pro-cyclical impact on market liquidity for corporate debt could cause problems in one part of the financial sector to spread quickly to the broader economy, exacerbating any crisis.

I would note that while many of the studies of market liquidity have focused on aggregate conditions, my experience indicates that small cap and mid-cap issuers appear to have experienced a disproportionately negative impact from a number of the structural and regulatory changes meant to improve transparency in markets and financial stability in our financial system, including the Volcker Rule. In addition, the significant increase in the size of the corporate bond market, with a relatively smaller secondary market, has increased the liquidity premium for smaller issuers. Investors now demand a significant liquidity premium for bonds issued by smaller firms. Despite the fact that the corporate bond market has seen record issuance in recent years, most of this has been in large deals. The number of smaller new debt issues coming to the market has fallen, illustrated by the fact that the average size of new debt issuance has steadily increased. My analysis shows:

1) As of mid-April 2016, the average new investment grade deal size was $921 million, the highest on record and more than 2.5 times the average seen in just 2013.
2) Since 2010, the number of deals sized at $2 billion and above has doubled, whereas the number of smaller deals (below $2 billion) has fallen by nearly half.

[5]The paper compared the illiquidity of corporate bonds that were downgraded from investment-grade to speculative-grade, both before and after the Volcker Rule was implemented. The paper concluded that "bond liquidity deterioration around rating downgrades has worsened following the implementation of the Volcker Rule." The paper also found that "the relative deterioration in liquidity around these stress events is as high during the post-Volcker period as during the Financial Crisis. Given how badly liquidity deteriorated during the financial crisis, this finding suggests that the Volcker Rule may have serious consequences for corporate bond market functioning in stress times." The full study is available at https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf

3) Credit spreads for small-cap issuers are on average 75 to 100 basis points wider than large-cap issuers, controlling for credit rating and maturity, due to the liquidity differences perceived by investors.[6]

The fact that smaller firms are challenged in effectively financing themselves in the debt market has many potential implications for the economy – all of them negative. Because it is difficult to raise capital, small firms increasingly are finding it difficult to compete with larger firms. Instead, they are selling themselves to their larger competitors. Much of the increased corporate bond issuance is from large firms financing the acquisitions of small firms – the highest share in 15 years. As a result, the likely risk to the economy is less job creation, less competition, less research and development and capex – and less dynamism overall.

Indeed, prominent voices in the regulatory community have recognized the negative impact of the Rule and called for an examination of its effects. For example, the president of the Federal Reserve Bank of New York, William Dudley, addressed his concern about liquidity in remarks in February:

> "You could probably do the Volcker Rule in a more efficient way to achieve the same objectives without the burden of regulation that you have right now. You know, right now, if you're an equity trading desk and the equity market falls very violently, you really aren't supposed to go in and buy equities unless you actually have customer orders. So, you actually have this crazy situation where the equity desk can't actually buy equities to support the market.
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> So, I'd like to see the Volcker Rule looked at to see if there's a way of doing it in a way that – if you're a client-facing business, and you're trading your own asset class, you have a little bit more freedom to buy and sell when markets are volatile and maybe provide actually a little liquidity support in the market. But also make it a lot easier, I think, to enforce the Volcker Rule."[7]

[6] Record of Meeting, Federal Advisory Council and Board of Governors, May 4, 2016, available at https://www.federalreserve.gov/aboutthefed/fac-20160504.pdf.
[7] https://www.newyorkfed.org/newsevents/speeches/2017/dud170215

In addition, former Federal Reserve Governor Jeremy Stein co-authored an article which noted that:

> "There are reasons to be skeptical about the usefulness of the Volcker Rule. By discouraging "speculation" at broker-dealer banks, the rule may dissuade dealers from providing liquidity during a market correction. Most fundamentally, market-making and proprietary trading are almost impossible to distinguish in practice, making the rule difficult to enforce, while at the same time creating large compliance and supervisory costs. This is not to say that concerns about the risks associated with bank trading operations are unfounded. However, these risks can be more effectively addressed by imposing stiff capital charges on banks' trading books, without attempting to divine whether the underlying trades themselves are driven by market-making or speculative motives. Thus, on balance, we believe that the Volcker Rule should be repealed."[8]

Burdens of the Volcker Rule's Covered Funds Provisions

The covered funds provisions of the Volcker Rule result in a scope far beyond the intended focus on the use of hedge funds and private equity funds to facilitate indirect, impermissible proprietary trading. The provisions are highly technical and are not focused on the actual activities of the entities that are captured. Some of the issues these rules have created include, but are not limited to:

1) **Challenges in identifying what is, and what is not, a covered fund.** The status of tens of thousands of transactions executed prior to the implementation of the Volcker Rule is unclear. The result for banks has been the expenditure of significant resources on internal and external counsel to review transactions and structures, and impacts to market making. The industry has come together to develop electronic identification tools at great

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[8] "The Financial Regulatory Reform Agenda in 2017," Robin Greenwood, Samuel G. Hanson, Jeremy Stein, Adi Sunderam, Working Paper 2017-09, Project on Behavioral Finance and Financial Stability, available at http://www.hbs.edu/faculty/initiatives/behavioral-finance-and-financial-stability/Documents/2017-09%20The%20Financial%20Regulatory%20Reform%20Agenda%20in%202017.pdf.
[8] https://www.newyorkfed.org/newsevents/speeches/2017/dud170215

expense, but these are incomplete at best. The bottom line is that banks have had to spend (and continue to spend) millions of dollars annually to unnecessarily prove a negative with these products which are neither hedge funds nor private equity funds.

2) **Impacts to ordinary-course relationships with clients.** For covered funds, many transactions that are provided as part of normal client service are prohibited by the Volcker Rule, including: ordinary checking and transaction accounts with overdraft protection, custodial services, family wealth vehicles, clearing and settlement, providing margin and other intraday extensions of credit, and plain vanilla extensions of credit.

3) **Funds that are not covered funds but become subject to proprietary trading restrictions**. Certain foreign funds, which are expressly *not* covered funds, may instead be categorized as banking entities and thus subject to the Volcker Rule's proprietary trading restrictions.

4) **Requirements to Change the Name of Existing Funds.** The Rule includes a number of limitations on the ability of a banking organizations to sponsor a fund which includes its name or the name of its affiliates. In practice these requirements are more form over function, as they do not go to the core issue Volcker was intended to address.

The covered funds provisions of the Volcker Rule should be amended to limit the definition of covered fund only to funds that engage in proprietary trading. This would achieve the goal of prohibiting indirect, impermissible proprietary trading through a fund without sweeping in core asset management and related activities that are far removed from the policy goal.

Poorly Implemented

Beyond its bumpy legislative history and flawed concept, interpretation and enforcement of the Rule is overly complicated and requires the involvement of five regulators, creating significant compliance challenges. The Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Commodities Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve must jointly determine Volcker compliance, and while they have assured the public they will cooperate on enforcement and supervision, we believe it will be very difficult, if not impossible, for five different, independent regulators to jointly enforce a rule this complex. Recent anecdotes from SIFMA's membership indeed confirm a lack of coordination.

Additionally, regulators are relying on quantitative metrics to calculate the purpose and market risk of trades to determine which trades are proprietary and which trades are not – essentially using formulas to determine the intent of individual traders who use firm principal to take positions. The inherent difficulty in operationalizing an intent-based prohibition has resulted in regulations that are overly complex, require an outsized compliance infrastructure and metrics, and often capture beneficial activities beyond the professed goals of the Rule. Federal Reserve Governor Jerome Powell recognized this difficulty. When asked about the Volcker Rule and echoing the concerns of market participants, Governor Powell noted that "[w]hat the current law and rule do is effectively force you to look into the mind and heart of every trader on every trade to see what the intent is." He highlighted the difficulties in determining what is permitted and what is restricted under the Rule: "Is it propriety trading or something else? If that is the test you set yourself, you are going to wind up with tremendous expense and burden." Finally, he suggested that "Congress should take another look at it."[9]

[9] https://www.bloomberg.com/news/articles/2017-01-07/fed-s-powell-urges-congress-to-take-another-look-at-volcker-rule

Most absurd is the fact that regulatory metrics for calculating intent will penalize traders who are unable to sell inventory in a certain time frame, even if the trader *intended* to sell the product within the Volcker approved window. The entire implementation regime of the Volcker Rule has been poorly thought out and even the rule's hypothetical benefits are being drowned in a flood of unnecessary costs.

Principles for Change

As I stated, I personally believe the Volcker rule should be repealed. If not repealed, at a minimum, the Volcker Rule should be modified to:

1) Reverse language that assumes all trades are proprietary unless proven otherwise.
2) Eliminate the "reasonable expected near term demand" requirement.

Any changes should be consistent with the following fundamental principles:

1) the Rule should not impede market liquidity and capital formation;
2) the restriction on proprietary trading should be plainly written and not based on trader intent;
3) restricted proprietary trading should limit only trading wholly unrelated to customer activity or risk management;
4) the regulatory regime should be rationalized with a single agency responsible for implementing, interpreting and enforcing the Rule;
5) the restrictions on covered funds should target indirect, impermissible proprietary trading.

These principles recognize the clear benefits of market making activity to the capital markets but also to the entities that access these markets in order to grow their businesses and invest in future job growth.

Conclusion

Our economy has now had enough experience with the Volcker Rule to reasonably conclude that its existence has needlessly impeded beneficial market functions without producing any measurable improvement to the safety of our system. Its true impact has been felt on Main Street in the form of higher costs of capital and diminished liquidity. SIFMA and Stifel were opposed to the Volcker Rule when it was first proposed and have consistently questioned the need for its existence ever since. SIFMA is committed to assisting policymakers in the Administration, the agencies, and the Congress, as they study the effects of Volcker and what do to next.

In summary, the Volcker Rule is a solution in search of a problem. We should not be debating whether or not the banks should get relief from Volcker. Instead, we should be debating whether our economy benefits from this rule. From my vantage point based on the clients I serve, it does not.

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