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November 4, 2010

**VIA ELECTRONIC MAIL**

Alastair Fitzpayne  
Deputy Chief of Staff and Executive Secretary  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

**Re: Information on the FSOC Notice 2010-0002: Request for Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds; 75 Federal Register 61758, October 6, 2010**

Dear Mr. Fitzpayne:

The ABA Securities Association (ABASA)<sup>1</sup> appreciates the opportunity to submit this letter in response to the request by the Financial Stability Oversight Counsel (FSOC) for comments on FSOC Notice 2010-0002 (October 1, 2010), wherein the FSOC seeks public input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (the Study) required by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 619 of the Dodd-Frank Act (the Volcker Rule) was added as a new section to the Bank Holding Company Act of 1956, as amended.

The Volcker Rule generally prohibits any banking entity from engaging in proprietary trading, subject to certain exceptions. To accomplish the complex purposes of the Volcker Rule, the statute sets a multi-staged regulatory implementation schedule. First, the FSOC must conduct the Study and make recommendations by January 21, 2011. After the Study is complete, and recommendations are made, the agencies responsible for implementing the Volcker Rule have nine months to issue final regulations that consider the FSOC's Study and recommendations.

ABASA offers the following comments on certain aspects of proprietary trading as defined and limited pursuant to the Volcker Rule. We make these observations to assist the FSOC in conducting its Study and urge that the FSOC Study be undertaken with an eye toward amassing relevant empirical data and a concrete appreciation of market realities. Further, we urge that the FSOC's recommendations be tied to implementation of the basic intent of the law. A contrary approach could result in overly broad application of the ban and could have negative implications for liquidity in the marketplace and U.S. economic growth and recovery.

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<sup>1</sup> ABASA is a separately chartered trade association representing those holding company members of the American Bankers Association (ABA) actively engaged in capital markets, investment banking, and broker-dealer activities.

## **Identification of Proprietary Trading Activities**

ABASA members have already begun identifying their discrete proprietary trading businesses (otherwise known as walled-off proprietary trading businesses), and, as has been widely reported in the press, have been closing or selling proprietary trading desks well in advance of the regulatory deadline to halt such activities under the Volcker Rule. Thus, financial institutions have already made headway toward satisfying the primary purpose of the Volcker Rule as intended by Congress. The FSOC, should as a first step, work closely with the affected institutions to understand the principles underpinning the distinctions that affected institutions are making, the consequences of the proprietary trading designation, as well as the practical steps that institutions are taking to implement these principles. ABASA and its members already have engaged in discussions with regulators regarding the identification of proprietary trading activities, and we are available for additional and more detailed discussions and analysis of how to identify proprietary trading so that the congressional intent of the Volcker Rule is fulfilled.

## **Principal Trading Activities**

Once the FSOC identifies the universe of presumptively banned proprietary trading, it is crucial that the FSOC carefully and expeditiously consider and make recommendations for implementing regulations that will identify other principal trading activities that do not exhibit the types of characteristics that were meant to be curtailed by the proprietary trading ban.

For example, asset liability management and treasury activities are core commercial bank activities that are highly regulated and carefully examined by the bank regulators. These activities are inherent in managing risks arising from the traditional business of banking and essential to bank safety and soundness, providing protection against interest, credit and liquidity risks. They should not be restricted by the implementation of the Volcker Rule.

Armed with a more complete understanding of the attributes of activities that should be outside the scope of the ban, the Study should recommend that implementing regulations ensure that these types of activities are specifically permitted by regulation or order, consistent with the purposes of the Volcker Rule. Other examples of permissible principal activities would include, among others:

- All trading in government securities (U.S. and non-U.S.), including derivatives on all government securities;
- Long dated/held investments and capital investments/financing transactions;
- Portfolio and macro hedging activity at the trade level, desk level, business level, legal entity level, multi-business level and enterprise-wide level; and
- Positions accumulated in connection with market-making activities, including unsold allotments; stabilization; trades that maintain two-way, liquid markets; and warehousing.

## **Study of Mechanisms to Ensure Adherence to Prohibitions**

In addition to the broader points above, it is fundamental to understand (and have that understanding inform the development of implementing regulations) that market-making activity is critical to the continued functioning of markets. Congress recognized this fact by including market-making as an expressly permitted activity under the Volcker Rule. Principal positions need to be permitted for markets to function. It is not possible for market-makers to undertake trades only where a “fee” is made for intermediating a trade between a buyer and seller. In all but the most

liquid markets (and, even then, with only smaller trades and under ordinary market conditions), market-makers must take positions with a view to price movements, either in anticipation of customer demand to buy or sell or in response to customer demand to sell. The amount of positions held and the length of time these positions are held are a function of asset class, liquidity and other market conditions. In addition, customers look to market-makers to manage basis risks that arise between the risks in their businesses and the available standardized products that hedge those risks. Market-makers are the only entities that will hold this basis risk.

We believe it is critical to the successful implementation of the Volcker Rule that there is recognition that, unlike agency trading, market-making inherently involves taking principal positions and bearing the resulting risks from price movements. Any need to create distinguishing characteristics of market-making must be flexible enough to take into account differences in approaches to market-making for different products. In virtually all financial instruments, market liquidity for customers depends on banking entities acting as market makers, and there are too few other entities to provide the liquidity that the market needs to function. Therefore, the FSOC should ensure that regulators take into account the constantly increasing diversity in the marketplace arising from differing asset classes, trade sizes, markets, market infrastructure, and geography. A failure to take these factors into consideration risks significant market disruption and drying up of market liquidity, especially in times of market stress.

Because of the impracticality of precisely defining the entire universe of permissible activities, ABASA urges that the following principles and recommendations inform the Study and FSOC guidance provided to the regulators on this topic:

*Preconditions to Crafting Effective Rules Regarding Market-Making:*

1. Further study – Crafting regulations under the Volcker Rule for varied markets and their multitude of participants is extremely difficult. The Study mandated for the FSOC cannot be the end of the development of a broader market understanding necessary to craft effective rules. Therefore, prior to publishing rules, the regulators should continue the study of the functioning of markets and market-making and other related matters so that implementation of the Volcker Rule occurs in a manner that achieves its objectives while minimizing unnecessary disruptions to market functions that may limit liquidity and hamper economic recovery. Even after the promulgation of rules, the FSOC should continue to monitor the market effects of those rules.
2. Importance of Examination– As regulations are developed, firms’ development of appropriate measures to confirm that activities fall within permitted parameters and questionable activities are reported, investigated, documented, escalated and addressed should be a component of effective implementation. Examination staff will play an important role in reviewing the books of business, portfolio strategies, policies, procedures and trading limits of the institution in order to have a proper understanding that a portfolio continues to exhibit the characteristics of a permissible market-making book. In effect, rules and regulations will not be the final determining factor – appropriate policies and procedures, collaborative analyses and subjective reviews between the business and examiners will need to occur to understand fully the business and implement the limits placed on businesses.
3. Portfolio compliance – The FSOC should recommend that regulation be crafted to take into account portfolio offsetting positions, the time to offset a position with hedges or customer trades, differing trading strategies and other characteristics of permissible market-making that ultimately make the market function. Regulations that rest on an initial trade-by-trade approach

would be inappropriate. Only if an activity falls outside permitted bounds or breaches limits, would further investigation on an individual trade level potentially become appropriate.

*Principles to be Followed When Implementing and Reviewing Risk and Inventory Duration Limits/Policies Related to Permissible Market-Making*

ABASA recognizes that, within the scope of permissible activities, financial institutions still must manage the risks of such activities. Thus, all permissible market-making activities should be conducted under robust policies and procedures that are reviewed and are subject to supervision by the regulators' examination staff. Examination staff will be able to determine, through a review of the institution's activities as well as a review of the institution's policies, procedures and systems, that a set of policies and procedures are characteristic of a business engaged in permissible activities rather than non-permitted proprietary trading. While financial institutions are currently working to improve and maintain appropriate policies and procedures, it seems reasonable that a combination of risk and inventory duration policies/limits will generally (a) cause a business continuously to review positions, (b) cause a business to deal quickly with positions that haven't yielded a customer trade and (c) prevent improper speculation. These policies/limits would be equally applicable when a market-maker is purchasing a principal position in anticipation of customer demand or taking a position from a customer when a customer desires to sell positions.

However, because of the complex and varied nature of our capital markets, it would be impracticable and unwise to attempt to formulate rigid or "one-size-fits-all" policies and procedures. As a consequence, ABASA suggests that the FSOC study the appropriateness of the following principles for institutions to consider when drafting policies and procedures designed to ensure that trading activities are permissible under the Volcker Rule:

1. Asset Class – Both risk and inventory duration limits will be affected by the asset class, and potentially even sub-classes. Different strategies and market characteristics exist among equity, fixed income, FX, rates, and commodities markets, and even among instruments in those classes. Furthermore, derivative trades are different and should be recognized as such. "Aging" or "turnover" in a derivative book is not an appropriate concept. Policies and regulator examinations should focus on the ability of the business to put on offsetting, balancing or hedging trades, even if the contractual terms of the trades themselves are long-dated.
2. Liquidity – Although most market-making positions are liquidated in the near term, in some asset classes, there will be a need to warehouse positions or hold positions for an intermediate or longer term. More illiquid markets will require longer time frames before distributing to customers or hedging positions taken from customers. Duration would be a function of the average frequency and size of trades in the market relative to the position held by the dealer (i.e., liquid standard sized positions would likely be moved at a quicker pace than larger or illiquid positions, but illiquid positions would likely be more limited in size).
3. Capital Base of Business/Portfolio -- Generally, the size of the limits would also be a function of the capital allocated to the business and volume of customer business (i.e., a small trading business with few customers and comparatively little allocated capital would have relatively low risk limits compared to a highly capitalized desk with many customers).

## Exemption Process

Finally, ABASA recommends that the FSOC recommend that a process be established for the Federal Reserve to provide exemptions from all or part of the Volcker Rule, consistent with the intent of that Rule, so that there is a mechanism to address readily any unintended application of the Rule, in order to facilitate the orderly functioning of the markets affected by the Rule.

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We appreciate the opportunity to share our views on this important topic. We stand ready to work constructively with regulators in development of appropriate regulation to implement the statutory mandate. If you have any questions, please do not hesitate to contact the undersigned.

Sincerely,



Carolyn Walsh  
Deputy General Counsel  
ABA Securities Association