BETTER MARKETS

October 17, 2018

By Electronic Submission

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket ID R-1608, RIN 7100-AF 06

Federal Deposit Insurance Corporation
Robert E. Feldman, Secretary
Attention: Comments/Legal ESS
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Washington, D.C. 20429
RIN 3064-AE67

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
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Docket ID OCC-2018-0010, RIN 1557-AE27

Securities and Exchange Commission
Secretary
100 F Street, N.E.
Washington, DC 20549-1090
Release No. BHCA-3, File Number S7-14-18,
RIN 3235-AM10

Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20520

Commodity Futures Trading Commission
Christopher Kirkpatrick, Secretary
1155 21st Street, N.W.
Washington, D.C. 20581
RIN 3038-AE72

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and gentlemen,

Better Markets, Inc.[1] appreciates the opportunity to submit comments on the above notice of proposed rulemaking ("New Volcker Rule Proposal")[2] issued by the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (together, "the Agencies"). The New Volcker Rule Proposal would enact significant revisions to the Agencies' regulations implementing section 13 of the Bank Holding Company Act ("BHCA"),[3] commonly known as the "Volcker Rule." Although elements of

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432 (July 17, 2018), available at https://www.gpo.gov/fdsys/pkg/FR-2018-07-17/pdf/2018-13502.pdf.

3 12 U.S.C. 1841 et. seq. BHCA section 13 is codified at 12 U.S.C. 1851. Section 13 of the Bank Holding Company Act of 1956 was added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111-203, 124 Stat. 1376 (2010), available at https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

the proposal would improve the supervisory framework for legal entities subject to BHCA section 13 ("Banking Entities"),[4] the New Volcker Rule Proposal generally would revise regulations implementing BHCA section 13 ("Final Volcker Rule")[5] in a manner that is contrary to the language and intent of the statute, is premised on an overly optimistic view of the compliance culture and risk management incentives of Banking Entities, impedes effective supervision and enforcement of BHCA section 13 and the Final Volcker Rule, and is based on unsupported assertions of Banking Entities subject to the trading prohibitions and restrictions.

The New Volcker Rule Proposal, in addition, violates the Administrative Procedures Act ("APA") by failing to provide sufficient (any) data and other information that would permit meaningful public comment on numerous provisions.[6]

Context for the New Volcker Rule Proposal

With the 10th anniversary of the collapse of Lehman Brothers just one month ago on September 15th, 2018, the New Volcker Rule Proposal must be considered in light of the 2008 financial crash and the onset of the worst financial crisis since 1929, which, in turn, caused the worst economy since the Great Depression of the 1930s.[7] Sadly, much of the economic devastation caused by that crash is ongoing for tens of millions of Americans, and the economic, social and political upheavals it caused are continuing as well. Avoiding that—or worse—from happening again has to be the foremost priority of all policymakers and regulators.

However, too many are forgetting or ignoring some of the most important and basic lessons of that financial crisis. In particular, without vigilant, independent and robust oversight and

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4 See 12 U.S.C. 1851(h)(1). BHCA section 13(h)(1) defines Banking Entities to include the following: (i) any FDIC-insured depository institution; (ii) any company that controls an FDIC-insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (iv) any affiliate or subsidiary of any entity described in clauses (i), (ii), or (iii), with certain exclusions.

5 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014), available at https://www.federalregister.gov/d/2013-31511; see also 79 Fed. Reg. 5808 (Jan. 31, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31476.pdf. Each of the Agencies codified the Final Volcker Rule in different sections of the Code Federal Regulations: 12 C.F.R. Part 248 (Federal Reserve); 12 C.F.R. Part 44, (OCC); 12 C.F.R. Part 351 (FDIC); 17 C.F.R. Part 255 (SEC); and 15 C.F.R. Part 75 (CFTC). References to specific provisions in the Final Volcker Rule and the New Volcker Rule Proposal throughout this comment letter therefore distinguish implementing regulations solely by subsection (e.g., permitted risk mitigating hedging activities are cited in this format, § ___.5, and proposed amendments to those provisions are cited in this format, Proposed § ___.5).

6 See, e.g., Am. Radio Relay League, Inc. v. F.C.C., 524 F.3d 227 (D.C. Cir. 2008). The APA directs federal agencies to give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process. 5 U.S.C. § 553(c). Rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests. See also, e.g., Mid Continent Nail Corporation v. United States, 846 F.3d 1364, 1373-1374 (Jan. 27, 2017); U.S. Telecom Ass'n v. F.C.C., 825 F.3d 674, 700 (June 14, 2016), citing Honeywell Int'l, Inc. v. E.P.A., 372 F.3d 441, 445 (June 29, 2004); Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259-1260 (May 24, 2005); Am. Medical Ass'n v. Reno, 57 F.3d 1129, 1132-1133 (June 27, 1995); Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (May 13, 1988).

7 See Better Markets, The Cost of Crisis, $20 Trillion and Counting (July, 2015), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis-2.pdf, and Federal Reserve Bank of San Francisco, The Financial Crisis at 10: Will We Ever Recover (August 13, 2018), available at https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/.

regulation, financial institutions of various sizes, activities and complexity, often deeply interconnected and highly leveraged, can build up so much risk, often unseen and poorly understood, that they eventually threaten the economic stability of the financial system and the entire country. That is what happened in the years before the last crash and, unfortunately, that is what is happening again as memories fade and as the private sector rebounds, responds to incentives promising irresistible riches, and pursues its interests in maximizing profits. That is why ***independent*** oversight and regulation are so critically important to protect the public interest and avoid future crashes, taxpayer bailouts and economic catastrophes.

Importantly, those events do not require evil actors in or motives by the private sector. It is the nature of markets and financial firms, individually and, ultimately, collectively. That is the unsettling, but undeniable, truth behind former Citigroup Chief Executive Officer Chuck Prince's infamous and much misunderstood quote in July 2007:[8]

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[9]

Translation: when a financial institution and its peer group are making lots of money doing roughly the same thing (i.e., the market "music" is playing), they have to keep doing the same thing ("dancing") or their revenues, profits, bonuses and stock will go down ***relative*** to their peer group. While doing otherwise may be tolerated by a board, the executives, and stockholders for a short time, it will not last long as revenues, profits and stock drop relative to their peers, which is why Mr. Prince was right: "as long as the music is playing, you've got to get up and dance" or you will be replaced with someone who will.

That is the (oversimplified) history of Morgan Stanley in the 2000s. John Mack was CEO until ousted in 2001, when Paul Purcell was appointed CEO. Morgan Stanley then pursued a business diversification strategy, seeking relatively stable revenues and profits from a broad mix of businesses that avoided the high-risk, high leverage and high return trading gambling that was taking off at its rivals. As its revenues, profits, bonuses and stock lagged its rivals, the board ousted Mr. Purcell and in June 2005, brought back Mr. Mack as CEO, clearly with the mandate to catch its rivals by doing what they were doing. As the Siren song of deregulatory music played, he got Morgan Stanley up and dancing to the tune of big prop trading, structured products, and subprime mortgage activities. However, in just a little over two years later in the fall of 2007, Morgan Stanley was forced to recognize gigantic prop trading losses at the same time it was forced to take substantial subprime-related write downs, which eventually were cumulatively so crippling

8 It is telling that this statement was just one month after Bear Stearns had to bail out one of its hedge funds and just days before the collapse of two of its hedge funds, which had been unsuccessfully shopping their positions since the first quarter of 2007. That is to say, in July 2007, there were clear, strong and concrete indications of a coming crash visible to the major financial institutions on Wall Street, but the "music" continued to play. See, e.g., 2 Bear Stearns funds Are Almost Worthless, Reuters (July 17, 2007), available at https://www.nytimes.com/2007/07/17/business/17cnd-bond.html.

9 Citigroup chief stays bullish on buy-outs, Michiyo Nakamoto and David Wighton (July 9, 2007), The Financial Times, available at https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac.

that Morgan Stanley was on the verge of failure in the days following Lehman's bankruptcy and required a bailout by the Fed to survive.[10]

This cautionary tale and the broader history before, during, and after the 2008 crash demonstrate why banking regulators and supervisors as well as oversight, regulation, and enforcement generally are so critically important. Put differently, they have to step in and slow the tune if not change the song or stop the "music" altogether, regardless of how much "dancing" the private sector is doing or wants to do. Without taking such independent and, at times, unpopular actions, the public interest is subordinated and exposed to the erratic and volatile dynamics of the marketplace, with devastating crashes the inevitable result.

Unfortunately, the New Volcker Rule Proposal is the equivalent of the Agencies shouting "strike up the band" and cranking up the music. If the New Volcker Rule Proposal is finalized as proposed, there can be little doubt that there will be a substantial increase in prop trading at Banking Entities in violation of the law. This will mostly be unseen due to the innumerable ways the New Volcker Rule Proposal intentionally blinds regulators by eliminating reporting requirements and the broad-based delegation to the banks to self-regulate. With billions of dollars on the line, it is simply wrong to go back to a "trust us" model of regulation where regulators defer to the financial industry to police itself. Everyone knows how spectacularly unsuccessful that was before the catastrophic crash of 2008.

The inevitable result will be future substantial trading losses at a Banking Entity, at which point there will be a dispute about whether the trade was an impermissible if not illegal proprietary trade or permitted under the New Volcker Rule Proposal, long finalized by then. While the finger pointing will no doubt be vigorous, the sad truth will almost certainly be that the ambiguities, exclusions, exemptions, loopholes and poor drafting in the New Volcker Rule Proposal will almost certainly prevent a definitive answer.

This is all unnecessary. While imperfect, the Final Volcker Rule has worked pretty well. First, it has reduced dangerous, high-risk and socially useless speculative trading at taxpayer supported Banking Entities. Second, it has made those Banking Entities more stable and better positioned to have capital available as a buffer for losses and downturns. Third, it has reduced the corrosive gambling culture that infected too many Banking Entities pre-crash, which diverted attention and business activities away from supporting the productive economy, which is, after all, the only reason they are supported by taxpayers in the first instance.

For the reasons detailed below, the New Volcker Rule Proposal risks snatching defeat from the jaws of victory, given the progress made by the Final Volcker Rule.

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[10] To his credit, Mr. Mack recognized what had happened and embraced financial reform, regulation and regulators. In fact, he went so far as to say "**[w]e cannot control ourselves**. You [lawmakers and regulators] have to step in and control the Street. Regulators? We just love them." "Regulators? We Just Love 'em, says John Mack," The Evening Standard (November 19, 2009), https://www.standard.co.uk/business/regulators-we-just-love-em-says-john-mack-6744822.html; Morgan Stanley's Mack: 'We Cannot Control Ourselves, Dealbook, The New York Times (November 19, 2009), https://dealbook.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves/

I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[11] was adopted in the aftermath of the banking crisis in 2008 to address deficiencies in the regulation and management of financial institutions and substantial risks that too often arise from speculative trading activities.[12] Section 619 of the Dodd-Frank Act, known as the Volcker Rule, amended the BHCA to add new section 13 to broadly prohibit Banking Entities from engaging in proprietary trading and from investing in or sponsoring hedge funds or private equity funds ("Covered Funds"), subject to authorized exemptions in BHCA section 13(d).[13] BHCA section 13 defines "proprietary trading" to mean, in essence, engaging as principal for the "trading account"[14] of the Banking Entity in any transaction to purchase and sell specified financial instruments[15] and sets forth additional definitions and provisions relevant to Covered Funds activities.[16]

BHCA section 13(d)(1) authorizes the Agencies to permit certain trading activities, notwithstanding BHCA section 13(a)(1)'s prohibitions on proprietary trading and Covered Funds activities and investments. These authorized trading activities include[17] the following:

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11 Public Law 111-203, 124 Stat. 1376 (2010).

12 The Dodd-Frank Act's legislative history is replete with statements to this effect. See, e.g., Statement of Sen. Merkley 161 Cong. Rec. S5448 (daily ed. July 22, 2015) (stating that section 619 of the Dodd-Frank Act ended "the proprietary trading that was basically large hedge funds embodied within banks being essentially done on the backs of Federal deposit insurance"); see also, e.g., 56 Cong. Rec. S5897 (daily ed. July 15, 2010) (stating that the intent of the Volcker Rule is to "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" and noting that it "is a critical part of ending too big to fail financial firms"); see also, e.g., Report from the Committee on Banking, Housing, and Urban Affairs: The Restoring American Financial Stability Act of 2010, Report 111-176 (Apr. 30, 2010) (stating "[t]he prohibitions in section 619 . . . will reduce potential taxpayer losses at institutions protected by the federal safety net, and reduce threats to financial stability, by lowering their exposure to risk").

13 12 U.S.C. 1851(d). Better Markets notes that the permitted activities exemptions in BHCA section 13(d) are authorized, not mandated, and that such authorization explicitly provides that permitted activities are subject to the broad limitations on permitted activities in BHCA section 13(d)(2) and "any restrictions or limitations" that the Agencies may determine appropriate. See 12 U.S.C. 1851(d)(2). The structure of BHCA section 13—which includes a broad prohibition on proprietary trading in BHCA section 13(a), broad statutory limits on permitted activities in BHCA section 13(d)(2), and broad authority for the Agencies to further restrict or limit permitted activities in BHCA section 13(d)(1)—makes clear that Congress intended permitted activities under the statute to be narrowly confined.

14 The term "trading account" means, at a minimum, any account used for acquiring or taking positions in specified financial instruments 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) ("Trading Account"). 12 U.S.C. 1851(h)(6). The Agencies have the authority to define the term Trading Account to include "any such other accounts" as the Agencies determine appropriate. Id.

15 12 U.S.C. 1851(h)(4). BHCA section 13(h)(4)'s definition of "proprietary trading" includes the purchase or sale for the Trading Account of "any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument" the Agencies determine to include in the BHCA section 13 analysis (collectively, "Financial Instruments" and individually, a "Financial Instrument").

16 See, e.g., 12 U.S.C. 1851(a)(1)(B); 12 U.S.C. 1851(h)(2); 12 U.S.C. 1851(f). BHCA section 13(a)(1)(B) generally prohibits Banking Entities from acquiring or retaining any ownership interest in, or sponsoring, a covered fund, subject to authorized exemptions in BHCA section 13(d) as implemented in subpart C of the Final Volcker Rule. 12 U.S.C. 1851(a)(1)(B).

17 BHCA section 13(d)(1) authorizes the Agencies to permit additional trading activities, including, for example, trading for the general accounts of insurance companies, 12 U.S.C. 1851(d)(1)(F), and investments and involvements in Covered Funds, 12 U.S.C. 1851(d)(1)(G).

(1) trading in U.S. government, agency, or municipal obligations;[18]
(2) underwriting and market-making-related activities, to the extent such activities do not the exceed reasonably expected near term demands of clients, customers, or counterparties;[19]
(3) risk mitigating hedging activities designed to reduce specific risks;[20]
(4) trading on behalf of customers;[21] and
(5) certain Banking Entities' trading activities solely outside of the United States ("U.S.").[22]

However, BHCA section 13(d)(2) ***limits*** the Agencies' discretion to permit such trading activities if they involve or result in the following:

(1) material conflicts of interest;
(2) material exposures to high-risk assets or trading strategies;
(3) threats to the safety and soundness of Banking Entities; or
(4) threats to U.S. financial stability.[23]

In addition, an exclusion from the definition of Banking Entity in BHCA section 13(h)(1), in effect, exempts certain financial institutions that do not have (1) more than $10 billion in total consolidated assets and (2) trading assets and liabilities comprising more than five percent of total consolidated assets.[24]

The Notice of Final Rulemaking implementing BHCA section 13 ("Final Volcker Rule") was published in January 2014,[25] setting forth a regulatory framework intended not only to ensure that Banking Entities do not engage in prohibited activities or investments but also that Banking Entities "engage in permitted trading and investment activities in a manner designed to identify, monitor and limit the risks

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18 12 U.S.C. 1851(d)(1)(A).

19 12 U.S.C. 1851(d)(1)(B).

20 12 U.S.C. 1851(d)(1)(C).

21 12 U.S.C. 1851(d)(1)(D).

22 12 U.S.C. 1851(d)(1)(H).

23 12 U.S.C. 1851(d)(2).

24 12 U.S.C. 1851(h)(1)(B); see also the Economic Growth, Regulatory Relief, and Consumer Protection Act, Public Law 115-174, 132 Stat. 1296-1368 (2018). The New Volcker Rule Proposal does not implement that legislation, although the Agencies state that they will not enforce the Final Volcker Rule in a manner inconsistent with the recent BHCA amendments. Because the New Volcker Rule Proposal does not implement this legislation, and the Agencies indicate that a separate rulemaking is forthcoming, we have not provided additional analysis or commentary. See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33434 (July 17, 2018), available at https://www.gpo.gov/fdsys/pkg/FR-2018-07-17/pdf/2018-13502.pdf (stating that "[t]he Agencies plan to address these statutory amendments through a separate rulemaking process" and noting that "no changes have been proposed herein that would implement these amendments").

25 See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014), available at https://www.federalregister.gov/d/2013-31511. Better Markets and others detailed the Agencies' 40-month rulemaking process leading to the Final Volcker Rule in another comment letter in the administrative record for the New Volcker Rule Proposal, available at https://www.federalreserve.gov/SECRS/2018/August/20180810/R-1608/R-1608_071018_132125_524954579536_1.pdf.

posed by these activities and investments."[26] The Final Volcker Rule relies upon compliance and risk management program requirements as the key means for ensuring that Banking Entities conduct trading activities in accordance with BHCA section 13.[27] Unfortunately, the New Volcker Rule Proposal seeks to eliminate or substantially revise these critical compliance and risk management requirements, deferring too extensively to Banking Entities to decide for themselves the manner in which trading desks[28] identify, measure, monitor, and manage risks, and improperly limiting supervisory information available to regulators.

Better Markets begins its comments by discussing the New Volcker Rule Proposal's provisions that would seriously weaken oversight and enforcement of BHCA section 13 and the Final Volcker Rule. In Sections II through VII below, we emphasize that in proposing to permit even the largest and most sophisticated Banking Entities to avoid or be "presumed" compliant with critical compliance, risk management, and supervisory measures, the Agencies largely abdicate their traditional roles to examine and supervise Banking Entities' restricted activities.[29]

- Section II discusses the presumption of compliance relating to Trading Desks that would be brought into scope for the Final Volcker Rule solely on account of activities meeting the new fair value accounting test ("FVA Test").

- Section III discusses a similar presumption of compliance relating to the reasonably expected near term demand limitation on permitted underwriting and market-making activities.

- Section IV discusses the proposed elimination of requirements and restrictions relating to the risk mitigating hedging exemption, including elimination of correlation analyses and demonstrable risk reduction requirements.

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26 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5541 (Jan. 31, 2014) (emphasis added).

27 The Final Volcker Rule is divided into four subparts: (1) Subpart A, among other things, defines terms used throughout the regulations; (2) Subpart B prohibits proprietary trading, defines terms relevant to trading activities, establishes related exemptions and limitations on such exemptions, and requires certain Banking Entities to report quantitative measurements with respect to their trading activities; (3) Subpart C prohibits or restricts investments in Covered Funds, defines terms relating to Covered Fund activities, and establishes exemptions and limitations on such exemptions; and (4) Subpart D requires compliance programs specifically addressing BHCA section 13 and the Final Volcker Rule, including reasonably designed policies and procedures, internal controls, management frameworks, independent testing, training, and recordkeeping. In addition, Appendix A to the Final Volcker Rule details quantitative measurements that certain Banking Entities may be required to compute and report with respect to certain trading activities, and Appendix B details enhanced minimum standards for compliance programs that certain Banking Entities must implement. Id.

28 The term, "trading desk," is defined in § ___.3(e)(13) of the Final Volcker Rule to mean the "smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof" ("Trading Desk").

29 Better Markets notes that it would have made many additional comments with respect to elements of the New Volcker Rule Proposal if the Agencies had provided a public comment period commensurate with the rulemaking's length, complexity, and importance. See Letter from Better Markets, Americans for Financial Reform, Public Citizen, and the Center for American Progress, Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Petition for Extension of Public Comment Period (July 10, 2018), available at https://www.federalreserve.gov/SECRS/2018/August/20180810/R-1608/R-1608_071018_132125_524954579536_1.pdf. Because the comment period was insufficient and insufficiently extended, Better Markets could not provide fulsome, meaningful comment on each aspect of the proposal.

- Section V discusses the proposed expansion of permitted foreign Banking Entity trading activities to include U.S. financing of proprietary trading and other trading activities.

- Section VI provides suggestions relating to the proposed error account exclusion.

- Section VII details a number of areas in which we agree and disagree with proposed amendments to the Trading Account definition.

Finally, Better Markets concludes that the Agencies must re-propose these and other provisions in a future rulemaking, given the dearth of data and other relevant information to support the proposal and the inability of the public to reasonably foresee and comment meaningfully on a broad range of potential regulatory outcomes.

II. The presumption of compliance based on the Absolute P&L Test would cause conceptual, interpretive, and compliance problems and be inconsistent with BHCA section 13 and longstanding supervisory practices.

The New Volcker Rule Proposal includes a "presumption of compliance" for activities on Trading Desks involving the purchase or sale of Financial Instruments that (1) are recorded at fair value on a recurring basis in accordance with the FVA Test but (2) do not satisfy the market risk capital or dealing activities prongs of the Trading Account definition ("Trading Desk Presumption").[30] Trading Desks eligible to rely upon the Trading Desk Presumption for such activities must at all times remain below a specific $25 million aggregate profit-and-loss threshold over rolling 90-day periods ("Absolute P&L Test").[31] The Agencies explain that "the presumption of compliance would limit the expansion of the definition of 'trading account' to include—unless the presumption is rebutted—only the activities of a trading desk that engages in a greater than de minimis amount of activity."[32]

The Absolute P&L Test is imprecise and conceptually unrelated to the Trading Account, is insufficiently explained and supported to permit meaningful public comment as required under the APA, and improperly facilitates the avoidance of BHCA section 13 and the Final Volcker Rule.

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30 Proposed § ___.3(c)(1)-(3). There may be overlap in the fair value standards incorporated in the FVA Test and the MRC Test. In these cases, the presumption of compliance would be unavailable for covered Banking Entities engaging in covered trading activities. The Final Volcker Rule provides a three-part disjunctive test for determining whether trading activities involving Financial Instruments must be included in Banking Entities' Trading Accounts: (1) they are purchased or sold with near-term trading intent ("Purpose Test"); see § ___.3(b)(1)(i) of the Final Volcker Rule; (2) they constitute a trading book positions subject to market risk capital requirements ("MRC Test"); see § ___.3(b)(1)(ii) of the Final Volcker Rule; or (3) they are relevant to determining whether a Banking Entity must register as a securities dealer, swap dealer, or securities-based swap dealer ("Dealing Activities Test"); see § ___.3(b)(1)(iii) of the Final Volcker Rule. The Final Volcker Rule includes a rebuttable presumption within the Purpose Test that Financial Instruments should be included in the Trading Account if Banking Entities hold the positions for fewer than 60 days or substantially transfer risk of those positions within 60 days ("Rebuttable Presumption"). See § __.3(b)(2) of the Final Rule. The Purpose Test presently includes any account used by a Banking Entity to purchase or sell one or more Financial Instruments principally for the following purposes: (1) short-term resale, (2) benefitting from short-term price movements, (3) realizing short-term arbitrage profits, or (4) hedging any of the Financial Instruments in the Trading Account. See § ___.3(b)(1)(i)(A)-(D) of the Final Volcker Rule.

31 The precise methodology for calculating the Absolute P&L Test would be codified in Proposed § ___.3(c)(1)(i)-(ii).

32 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33449, fn. 63 (July 17, 2018).

The Absolute P&L Test does not have a close logical connection to the Trading Account. The Trading Account analysis turns on the foundational issue of whether particular trading activities involve the subjective trading intent contemplated for prohibition and restriction by BHCA section 13 and the Final Volcker Rule. The Absolute P&L Test, in contrast, measures trading performance, and the volatility of trading performance, which may or may not be indicative of the trading intent and activities pursued by BHCA section 13 and the Final Volcker Rule. For example, a Trading Desk's purchase of a debt security that appreciates or depreciates substantially could result in significant unrealized P&L, even if the security is never again traded or intended to be traded. **Because trading intent and activities and performance are not inextricably tied, the Agencies must not tie the Absolute P&L Test and the related Trading Desk Presumption to the FVA Test.**

The Absolute P&L Test is methodologically flawed in several additional respects. First, the Absolute P&L Test can be only as restrictive as the Trading Desk definition permits, because the Absolute P&L Test depends on a calculation made at the Trading Desk level.[33] For a hypothetical 63 trading days within the proposed 90-day timeframe, the Absolute P&L Test would permit Trading Desks an average of $396,825 in daily net profits-or-losses ("P&L").[34] The significance of this figure with respect to a Trading Desk cannot be known, however, because it is dependent on the nature and scope of activities included in the Absolute P&L Test, which, in turn, depends on the Trading Desk structure.[35] **Therefore, without additional information, the public cannot provide meaningful comment on either the proposed threshold or the methodology for calculating it.** There can be no doubt, though, based on the limited information provided, that creative lawyers would seek to re-structure Trading Desks in manner that optimizes reliance on the Trading Desk Presumption.

Moreover, the Absolute P&L Test is an imprecise measure of the scale and nature of a Trading Desk's activities.[36] P&L generated by a particular Trading Desk may arise from a number of sources, some of which would be relevant to the scale and nature of the desk's trading activities and some of which would not. Transaction thresholds, or a combination of transaction thresholds and value-at-risk (or perhaps other

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33 § ___.3(e)(13) of the Final Volcker Rule. See also Proposed § ___.3(c)(1)(ii) (providing that "the activities of the trading desk shall be presumed to be in compliance with the proprietary trading prohibition in § ___.3(a)). If the Agencies choose to proceed with the Trading Desk Presumption, the Agencies must provide additional reporting and structure on the Trading Desk definition. In this regard, Banking Entities must be required to uniformly structure Trading Desks in compliance with both market risk capital and Final Volcker Rule regulations and report the proposed Trading Desk reporting information, as it materially improves supervisory information.

34 This calculation arises from the following formula: 21 trading days per month divided by $25 million = $396,825 on average over the three-month period.

35 The term "Trading Desk" is defined to mean the "smallest discrete unit of organization" of a Banking Entity that purchases or sells Financial Instruments for the Trading Account of the Banking Entity (or an affiliate thereof). § ___.3(e)(13) of the Final Volcker Rule.

36 See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33449 (July 17, 2018) (stating that the Absolute P&L Test is an appropriate means for establishing which trading desks can rely upon the Presumption of Compliance, because "this measure tends to correlate with the scale and nature of a trading desk's trading activities"). The preamble states that "each trading desk that operates under the presumption of compliance with the prohibition on proprietary trading would be required determine on a daily basis the absolute value of its net realized and unrealized gains and losses on its portfolio of financial instruments." Id. at 33450.

risk) volatility measures,[37] would better calibrate the Trading Desk Presumption to the "scale and nature" of trading desk activities.[38] Such thresholds and measures also would better incentivize Trading Desks to limit activities and risks.[39]

In addition, the scope, significance, and reasonableness of the $25 million Absolute P&L Test is not possible to meaningfully address without an indication of the P&L distribution across Banking Entities over the period of time and methodology specified. The Agencies state that "[b]ased on the metrics collected . . . since the issuance of the 2013 final rule, 90 calendar-day absolute P&L values below $25 million dollars are typically indicative of trading desks not engaged in prohibited proprietary trading."[40] **But the Agencies do not further support this conclusory statement or provide anonymized trading statistics or other information reviewed in developing the Absolute P&L Test as required by the APA.** The public cannot comment meaningfully on specific thresholds or activities and risk-based measures relevant to the Trading Desk Presumption without a rational, data-based explanation for the Agencies' exercise of discretion.[41]

If the Agencies choose to proceed with the Absolute P&L Test, this is a solvable issue. The Agencies possess three-years of reported metrics and other information for certain Banking Entities, including comprehensive profit and loss attribution, which should have been, and still can be, analyzed and publicly disclosed as an anonymized reference point. For this reason, **the Agencies must re-propose the Absolute P&L Test with data and information relevant to its use as a condition on the Trading Desk Presumption.** This would provide a minimum basis for the public to understand the proposal and the implications of the Absolute P&L Test, potential alternatives, and limitations on data used to arrive at the proposed P&L threshold.[42]

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[37] As stated above, Better Markets does not support the Trading Desk Presumption or the Absolute P&L Test for determining Trading Desks that may rely upon it. However, if the Agencies proceed with the Trading Desk Presumption, only a combination of transaction and risk measures would be consistent with the Agencies' stated purposes, because, as the Agencies state, "modeled estimates" are more malleable than "realized outcomes." See Id. at 33449 (acknowledging the importance of seeking an objective Trading Desk Presumption measure). Measures of trading activities could include trading volume and gross notional exchanged as a "scale" proxy and measures of risk could include P&L volatility or changes in value-at-risk as a "nature" proxy.

[38] Although the Absolute P&L Test would "indicate the realized outcomes of the risks of a trading desk's positions, rather than modeled estimates," the objectivity of the threshold does not answer the question of whether the threshold is advisable, relevant, and appropriately calibrated. Id. at 33449.

[39] The Agencies reason that the "lesser activity of these trading desks [meeting the Absolute P&L Test] does not justify the costs of an extensive ongoing compliance regime for those trading desks in order to ensure compliance with section 13 of the BHC Act and the implementing regulations." Id. at 33449 (emphasis added). However, absolute P&L neither measures activity nor suggests that Trading Desks have lesser activity, because frequent trading can result in stable, minimal P&L and minimal trading activities can result in significant P&L. Better Markets acknowledges that prolonged periods of sufficiently low and stable P&L (within a properly defined Trading Desk structure and methodology) may be ***one*** indication of whether a Trading Desk engages in proprietary trading, but that indication alone would not be adequate to achieve the objectives of BHCA section 13.

[40] Id. at 33450.

[41] If the Agencies observed, for example, that there is a strong correlation between the Absolute P&L Test and measures of trading activities or risks, that analysis, its assumptions, and the source of the data used to perform it would be necessary for the public to understand and comment on the Agencies' rationale for the proposal.

[42] For the reasons noted above, the Absolute P&L Test should not be imported into the Trading Account definition. Id. at 33450.

Finally, the Absolute P&L Test— contrary to the Agencies stated objective of reducing compliance complexities and costs—would implicitly require Banking Entities to establish new compliance and controls frameworks reasonably designed to ensure the P&L threshold is not exceeded.[43] Banking Entities would be required to file notifications that a particular Trading Desk exceeded the Absolute P&L Test at any point in time during the rolling 90-day period.[44] Such Banking Entities therefore would have to implement reasonably designed preventative and detective controls, including exception reports with aggregated daily P&L information for each Trading Desk for a varying number of trading days in each rolling 90-day period.[45]

If the Agencies nevertheless proceed with an Absolute P&L Test,[46] they must at least clarify that underlying P&L calculations and such exception reports reflect P&L that is not adjusted for revenue attribution arrangements, sales credits, and other common practices of allocating P&L across Trading Desks, lines-of-business, and supervisory hierarchies.[47] The Absolute P&L Test must net all P&L generated daily through a particular, properly defined Trading Desk.

The Trading Desk Presumption is inconsistent the usual supervisory means of ensuring the safety and soundness of Banking Entities.

The Trading Desk Presumption is inconsistent with longstanding supervisory practice. The Agencies state explicitly, for example, that Banking Entities would "not be obligated to demonstrate that the activities of the [relevant] trading desk[s] comply with subpart B on an ongoing basis,"[48] provided they trade in Financial Instruments included in the Trading Account solely on account of the FVA Test and remain within the $25 million threshold of the Absolute P&L Test. **If Banking Entities would not be required to demonstrate compliance with subpart B, it logically follows that supervisors generally would not be authorized to insist upon a demonstration of compliance, absent a "red flag" or noteworthy risk management or compliance failure.** That supervisory approach is inconsistent with the Agencies' mandates and would further erode public confidence and trust in Banking Entities and the U.S. financial system.

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43 The Agencies' contend that a Trading Desk that "consistently does not generate more than a threshold amount of absolute P&L does not engage in trading activities of a sufficient scale to warrant" requiring that Trading Desk to "demonstrate compliance with the prohibition on proprietary trading." Id. at 33449. This statement, again, is conclusory and does not account for the methodological and conceptual flaws in the Absolute P&L Test (discussed above).

44 Proposed § ___.3(c)(3).

45 Id. at 33450. If the Agencies nevertheless proceed with the Absolute P&L Test, Better Markets would not support a mere escalation or recordkeeping requirement.

46 In this regard, it is critical that the Agencies retain the proposed authority to determine that a purchase or sale of specific Financial Instruments must be included in the Trading Account and that the relevant Trading Desk(s) must demonstrate its compliance with subpart B on an ongoing basis. Id. at 33447.

47 Banking Entities should be required, at a minimum, to specify any sales credits or other P&L adjustments that apply to the daily P&L calculations. Revenue attribution and sales credits would provide useful supervisory information for oversight of BHCA section 13 and the Final Volcker Rule.

48 Id. at 33449.

In theory, Trading Desk activities eligible for the Trading Desk Presumption would remain subject to the proprietary trading prohibition in BHCA section 13 and the Final Volcker Rule.[49] However, in practice, the Trading Desk Presumption would make the proprietary trading prohibition and related violations, if any, exceedingly difficult to supervise and prove**. Supervisors and examiners cannot be expected to uncover evidence to rebut the Trading Desk Presumption if they are not provided information to "demonstrate" that Trading Desks remain in compliance in the first instance. That, in reality, invites non-compliance and is inconsistent with supervisory practices across prudential and market conduct regulatory regimes.** It is also inconsistent with the Dodd-Frank Act's purpose in ensuring that expertise is brought to bear on the oversight of Banking Entities within the Agencies' respective mandates.

Moreover, supervisory findings frequently require remediation of ineffective controls and improvements to policies and procedures that are initially identified through business risk controls and compliance testing. If Trading Desks are not required to "demonstrate" compliance with subpart B, Banking Entities likely would withhold testing findings or reallocate testing resources to compliance and risk management programs with greater regulatory risk. This, in time, would diminish the oversight and effectiveness of the compliance and controls frameworks applicable to Trading Desks meeting the Absolute P&L Test.[50]

The Agencies' proposal is an exemption for <u>all</u> revenue generating trading activities below an arbitrary P&L threshold, which appears to be supported by little more than conclusory industry assertions. Banking Entities should be in compliance with applicable law, and able to demonstrate as much. The burden should not fall on the Agencies to use scarce resources drafting notices, findings, and responses to accommodate a "presumption" of compliance that is unclear, novel, divorced from statutory mandates and authorizations in BHCA section 13, and overly deferential to institutional judgments too often driven by incentives unrelated to compliance. In essence, the Agencies substitute their own judgements for that of Congress and abrogate the activities-based prohibitions in BHCA section 13 without a data-driven, compelling rationale.

<u>The Trading Desk Presumption, if adopted, should retain elements necessary to confine reliance by Banking Entities.</u>

If the Agencies proceed with the Trading Desk Presumption (and they should not), the Absolute P&L Test must continue to confine reliance by Banking Entities.

Banking Entities are likely to advocate for a reduction in the Absolute P&L Test's 90-day period or perhaps for an increase in the $25 million Absolute P&L threshold (or, more likely, both). The Agencies must not expand the Trading Desk Presumption in response to such comments. However unwise the notion of providing a "presumption of compliance," there is a certain logic to the quarterly Absolute P&L measure,

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49 <u>Id.</u> at 33447, 33449.

50 The Agencies note that "the presumption of compliance with the prohibition on proprietary trading is optional for a banking entity" and that "if a banking entity prefers to demonstrate ongoing compliance for activity captured by the accounting prong rather than calculating the threshold for presumed compliance described below, it may do so at its discretion." <u>Id.</u> at 33449. The notion that Banking Entities have the option, but are not required, to rely on the presumption of compliance and therefore to choose to "demonstrate" compliance is willfully blind to the practical realities of managing regulatory risks. Banking Entities are not likely to ***volunteer*** to subject themselves to examination and enforcement risks if there is a means to avoid such oversight and the expenses that come with it.

which mirrors internal and external P&L financial reporting requirements. Moreover, the Agencies would have to re-propose any increase to the P&L threshold in compliance with the APA and applicable case law.[51] **The New Volcker Rule Proposal provides no information to support the $25 million Absolute P&L threshold, making informed public comment on that specific threshold impossible**. Relying upon mere assertions of Banking Entities to increase it—without a response comment period that includes publication of necessary information—would plainly deny the public yet another meaningful opportunity to comment on a proposal that has the potential to affect the safety and soundness of Banking Entities and the stability of the U.S. financial system.

The Agencies should instead adopt a lower Absolute P&L threshold. **Indeed, if the Agencies properly defined the contours of Permitted Activities and other trading exclusions, there is no reason to permit Trading Desks to rely upon a Trading Account-related exemption at all.** Zero would be the appropriate threshold. In the alternative, however, the Agencies could at least (1) provide additional restrictions on the Trading Desk definition, some which would be consistent with the Agencies' discussion in the proposal; (2) require Banking Entities to provide the Agencies a list of Trading Desks relying on the Trading Desk Presumption, along with policies and procedures, controls, and testing results that confirm eligible Trading Desks remain below the Absolute P&L threshold; and (3) limit the Trading Desk Presumption to Banking Entities with total assets equal to or below $10 billion, and trading assets and liabilities comprising more than five percent of total consolidated assets.[52]

Banking Entities may contend, separately, that unrealized gains and losses should be excluded from the Absolute P&L Test**. The Agencies must require Banking Entities to include all gains and losses included in income statements; that is, both realized and unrealized gains on Financial Instruments relevant to the Absolute P&L Test.** This information is already monitored. Moreover, unrealized losses would better ensure that the Absolute P&L Test contemplates the P&L volatility measures most suggestive of speculative trading. Realized and unrealized losses similarly must be retained in the Absolute P&L Test**. In addition, the Trading Desk Presumption must remain unavailable for the MRC Test and Dealing Activities Test.** These prongs of the Trading Account definition are associated with regulated Permitted Activities subject to longstanding compliance, risk management, and other prudential and market conduct requirements that align with the Final Volcker Rule.

III. The RENT-D Presumptions within the Underwriting and the Market-Making Exemptions are imprecise, too deferential to Banking Entities' risk management programs, unsupported by data or other evidence, and inconsistent with the letter and intent of BHCA section 13 and longstanding supervisory practices.

51 See supra.

52 This would limit the Trading Desk Presumption to Banking Entities with $10 billion in total consolidated assets that are not exempt from BHCA section 13's prohibitions and restrictions on account of the trading assets and liabilities threshold. See supra.

The New Volcker Rule Proposal would establish "presumptions of compliance" with respect to the Underwriting Exemption[53] and Market-Making Exemption[54] requirements that (1) underwriting positions be designed not to exceed reasonably expected near-term demands of clients, customers, and counterparties ("RENT-D"), taking into account liquidity, maturity, and depth of the market for the relevant type of security ("Underwriting RENT-D Presumption"),[55] and (2) market-making activities be designed not to exceed, on an ongoing basis, RENT-D[56] ("Market-Making RENT-D Presumption")[57] (collectively, "RENT-D Presumptions").

To rely upon the Underwriting RENT-D Presumption, Trading Desks must implement[58] internal risk limits, subject to conditions, along with mechanisms to ensure that risks arising from the Trading Desk's Financial Instruments do not exceed such limits.[59] Risk limits must be designed not to exceed RENT-D based on the nature and amount of underwriting activities, specifically the amount, types, and risks of underwriting positions, the level of exposures to risk factors arising from underwriting positions, and securities holding periods.[60] In addition, Banking Entities relying upon the Underwriting RENT-D Presumption would be required to implement policies and procedures for setting and reviewing risk limits according to "internal analyses and processes around conducting its underwriting activities."[61] To rely upon

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53 Trading Desks relying upon the Final Volcker Rule's underwriting exemption under BHCA section 13(d)(1)(B) ("Underwriting Exemption") must act as underwriters for distributions of securities; and exempted underwriting positions must be related to such distributions. 12 U.S.C. 1851(d)(1)(B). See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5836 (Jan. 31, 2014). The Final Volcker Rule also requires (1) that the amount and types of securities in Trading Desk underwriting positions be designed not to exceed RENT-D, and (2) that reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security. § ____.4(a)(2)(ii) of the Final Volcker Rule.

54 Trading Desks relying upon the Final Volcker Rule's market-making-related activities exemption under BHCA section 13(d)(1)(B) ("Market-Making Exemption") must, in essence, be willing and available to routinely enter into Financial Instruments in commercially reasonable amounts throughout market cycles. § ___.4(b)(2)(i) of the Final Volcker Rule. The amount, types, and risks of Financial Instruments in the Trading Desk's market-making inventory must be designed not to exceed, on an ongoing basis, RENT-D as informed by (1) the liquidity, maturity, and depth of the market for the relevant Financial Instrument(s); and (2) demonstrable analyses of historical customer demand, current inventory of Financial Instruments, and market and other factors regarding the amounts, types, and risks of or associated with the Financial Instruments in which the Trading Desk makes a market. Id. at 33459.

55 Proposed §___.4(a)(2)(ii)(A).

56 BHCA section 13(d)(1)(B) authorizes the Agencies to permit Banking Entities to engage in the purchase, sale, or acquisition of Financial Instruments "in connection with" underwriting or market-making activities, provided "any such activities" are designed not to exceed RENT-D. 12 U.S.C. 1851(d)(1)(B).

57 Proposed §___.4(b)(2)(ii).

58 The term "implement" for purposes of this comment letter includes establishing, implementing, maintaining, and enforcing risk limits and policies and procedures.

59 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33456 (July 17, 2018).

60 Proposed §___.4(a)(8)(i)(B)(1)-(3). Risk limits would be subject to review and oversight by the appropriate Agency, though the proposal would "presume that all trading activity conducted within the limits meets the requirements that the underwriting activity be based on [RENT-D]." Id. Banking Entities also would be required to report exceedances in the event that a Trading Desk either exceeds or increases a risk limit.

61 The Underwriting RENT-D Presumption would not, however, require that Banking Entities' internal risk limits be based on "any specific or mandated analysis." Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33456 (July 17, 2018).

the Market-Making RENT-D Presumption, Trading Desks similarly must implement internal risk limits, subject to conditions, along with mechanisms to ensure that risks arising from the Trading Desk's Financial Instruments do not exceed such limits. Risk limits, as above, must be designed not to exceed RENT-D based on the nature and amount of market-making-related activities, specifically the amount, types, and risks of market-making positions, the amount, types, and risks of the products, instruments, and exposures the Trading Desk may use for risk management, the level of exposures to risk factors arising from market-making-related exposures, and securities holding periods.[62] Banking Entities relying upon the Market-Making RENT-D Presumption would be required to implement policies and procedures for setting and reviewing risk limits according to "internal analyses and processes around conducting its market-making activities" as well[63]

Importantly, with respect to the Market-Making RENT-D Presumption, the New Volcker Rule Proposal would eliminate the requirement that Trading Desks conduct demonstrable analyses of historical customer demand, the current inventory of Financial Instruments, and market and other factors regarding the amount, types, and risks of or associated with Financial Instruments in which the Trading Desk makes a market.[64]

The RENT-D Presumptions would be available to Banking Entities, regardless of whether they meet specific assets and liabilities thresholds, provided Trading Desks remain within the internally set risk limits.[65] Banking Entities that have significant trading assets and liabilities ("Significant TALs")[66] would continue to be required to maintain risk limits as part of the Underwriting Exemption and the Market-Making Exemption's compliance program requirements. Banking Entities that do not have Significant TALs, however, would not be required to comply with the Underwriting Exemption and the Market-Making Exemption's compliance program requirements.[67] In theory, the "removal of the[se] exemption[s']

62 Proposed §___.4(b)(6)(i)(B)(1)-(4). Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33460 (July 17, 2018). Risk limits would be subject to review and oversight by the appropriate Agency, as above, though the proposal would "presume that all trading activity conducted within the limits meets the requirements that the market making activity be based on [RENT-D]." Id. at 33460. Banking Entities also would be required to report exceedances in the event that a Trading Desk either exceeds or increases a risk limit. Id.

63 Id. The proposal notes that the internal risk limit approach "would not require that a banking entity's risk limits be based on any specific or mandated analysis." Id. at 33456. Elsewhere, the Agencies affirm that "a banking entity would not be required to adhere to any specific, pre-defined requirements for the limit-setting process beyond the banking entity's own ongoing and internal assessment of the amount of activity that is required to conduct underwriting." Id. at 33456. The Agencies provide that internally set risk limits in each case are subject to supervisory review and oversight on an ongoing basis and include an "assessment of whether the limits" are designed not to exceed RENT-D. See Proposed §___.4(a)(8)(ii); Proposed §___.4(b)(6)(ii).

64 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33461 (July 17, 2018).

65 Id. at 33455.

66 Proposed §___.2(ff). The New Volcker Rule Proposal would add a definition of "significant trading assets and liabilities" that applies to Banking Entities, together with their affiliates and subsidiaries, having trading assets and liabilities (with certain exclusions), the average gross sum of which on a worldwide consolidated basis equals or exceeds $10 billion at any time over the previous four consecutive quarters. In addition, pursuant to §___.2(ff)(1)(ii), the Agencies may determine that Banking Entities should be treated as having Significant TALs. For foreign banking entities ("FBEs"), including subsidiaries of FBEs, the "significant trading assets and liabilities" calculation includes trading assets and liabilities of combined U.S. operations. See §__.2(ff)(3)(i)-(ii).

67 The New Volcker Rule Proposal would add a definition of "limited trading assets and liabilities" that includes Banking Entities, together with affiliates and subsidiaries, having trading assets and liabilities (with certain exclusions), the average

compliance program requirements . . . would not relieve those banking entities of the obligation to comply with the prohibitions on proprietary trading."[68]

The RENT-D Presumptions based on internal risk limits provide too much discretion for Banking Entities to avoid or evade prohibitions and restrictions in BHCA section 13 and Final Volcker Rule.

Internal risk limits do not provide a meaningful limitation on Banking Entities' discretion to avoid or evade BHCA section 13 and the Final Volcker Rule. The RENT-D Presumptions would require Trading Desks to implement risk limits designed not to exceed RENT-D. **However, these risk limits would be based on majestically broad, malleable factors[69] that would not meaningfully constrain speculative trading activities.** This approach, in effect, further transforms the prohibitions and restrictions in BHCA section 13 into a principles-based risk management program; and that is neither what Congress intended nor provided by statute in prohibiting proprietary trading.

For this reason, and others, the Agencies rejected a limits-based approach to Permitted Activities exemptions in the Final Volcker Rule. They stated, then, the following:

> "[T]he existence of a risk management framework or risk limits, while important, would not ensure that a trading desk is . . . engaging in customer-facing activity and providing intermediation and liquidity services."[70]

The Agencies also correctly cautioned as follows:

> "[I]t is important to require . . . demonstrable analysis to allow determinations of [RENT-D] and associated inventory levels to be monitored and tested to ensure compliance with the statute and the final rule."[71]

The Agencies properly observed that "an approach that does not provide for any consideration of historical trends could result in a heightened risk of evasion."[72] Frankly, we view it beyond doubt that "an approach

gross sum of which on a worldwide consolidated basis do not exceed $1 billion at any time over the previous four consecutive quarters ("Limited TALs"). See §___.2(t). The proposal also would add a definition of "moderate trading assets and liabilities" that includes Banking Entities, together with affiliates and subsidiaries, having trading assets and liabilities (with certain exclusions), the average gross sum of which on a worldwide consolidated basis meets neither the definition of Limited TALs nor the definition of Significant TALs. See §___.2(v).

68 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33462 (July 17, 2018).

69 For example, the Market-Making Exemption's factors include the following: (1) amount, types, and risks of its market maker positions; (2) amounts, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes; (3) level of exposures to relevant risk factors arising from its financial exposure; and (4) period of time a financial instrument may be held. Id. at 33460.

70 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5855 (Jan. 31, 2014),

71 Id. at 5882 (emphasis added).

72 Id. at 5882, fn. 938.

that does not provide for any consideration of historical trends ***would*** result in a heightened risk of evasion." Such an approach not only invites such evasion; it incentivizes it.

The RENT-D Presumptions (and the proposed elimination of the Market-Making Exemption's demonstrable analysis requirement in particular) grant too much discretion for institutional judgment and prevent regulators from credibly deterring proprietary trading. Trading Desks relying upon the RENT-D Presumptions would be presented minimal, if any, regulatory risk in retaining or acquiring Financial Instruments to benefit from short-term exposures within established risk limits, and perhaps even outside of them.

The best demonstration of this undue deference to Banking Entities is the explanation of the Market-Making RENT-D Presumption, where the Agencies state the following:

> . . . . A transport company customer may seek to . . . to create a structured ten-year fuel swap with a notional amount of $1 billion . . . A trading desk at the banking entity that makes a market in energy swaps may respond to this customer's hedging needs by executing a custom fuel swap with the customer. <u>If the risk resulting from activities related to the transaction does not exceed the internal risk limits for the trading desk that makes a market in energy swaps, the banking entity shall be presumed to be engaged in permissible market making-related activity that is designed not to exceed, on an ongoing basis, [RENT-D]</u>. Moreover, <u>**if assuming the position would result in an exposure exceeding the trading desk's limits, the banking entity could increase the risk limit in accordance with its internal policies and procedures for reviewing and increasing risk limits**</u> so long as the increase was consistent with meeting [RENT-D] . . . .[73]

The Agencies, in other words, rely upon a risk ***limits*** framework that cannot, and would not, limit. Based on the <u>above</u>, the Agencies would presume compliance not solely on the basis of a transaction's permissible risk exposure but also on the basis of risk tolerances contemplated by Banking Entities' self-imposed, implemented, and enforced policies and procedures governing increases in risk limits.

Moreover, in this risk limits framework, Trading Desks would be permitted to trade within limits based on <u>desk-level</u> internal analyses and RENT-D for categories of Financial Instruments.[74] Such risk limits would not prevent, and indeed could facilitate, speculative trading, however, because individual directional trades could occur within the Trading <u>Desk</u>'s overall limits**. It is unclear how the New Volcker Rule Proposal would distinguish a market-making transaction within the Trading Desk's risk limits from a transaction in the same Financial Instrument—on the same desk—within the same risk limits—but executed for speculative purposes.** That, in effect, demonstrates that the New Volcker Rule Proposal, and the RENT-D Presumptions specifically, would permit proprietary trading in violation of BHCA section 13.

Even if the RENT-D Presumptions were adopted (and they should not be), the New Volcker Rule Proposal is too imprecise with respect to the scope, nature, and timing of the required risk limits. Risk

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[73] <u>Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds</u>, 83 Fed. Reg. 33432, 33460 (July 17, 2018).

[74] That aggregate activity would be based on the amount, types, and risks of market-making positions, the amount, types, and risks of the products, instruments, and exposures the Trading Desk may use for risk management purposes, the level of exposures to relevant risk factors arising from market-making-related financial exposure, and securities holding periods. <u>See</u> § ___.3(b)(6)(i)(B)(1)-(4). These are not difficult factors to navigate.

functions monitor numerous categories of risk limits, ranging from individual risk sensitivities to country-specific, credit, and market risk limits on specific types of Financial Instruments. There is little proposed guidance in this regard.[75] For example, the proposal does not establish whether end-of-day or intra-day risk limits would be required in reliance upon the RENT-D Presumptions, and it similarly does not address limit allocation across sales and trading books (e.g., in a single Trading Desk limit structure with multiple books relying upon value-at-risk measures, as the correlation between two component books decreases, we might expect the permissible value-at-risk for each component book to increase). The Agencies, at a minimum, should codify the elements of an acceptable risk limit framework.

Moreover, and perhaps most shockingly, the so-called risk limits required by the RENT-D Presumptions need not be limiting**.** Indeed, the Agencies expressly state the following:

> **"[T]he proposed approach would not require that a banking entity's risk limits be based on any specific or mandated analysis**."[76]

To ensure Banking Entities receive the clear and unequivocal message, though, the Agencies further state the following:

> "[The RENT-D analysis therefore] would no longer expressly require firms to, among other things, conduct a demonstrable analysis of historical demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments in which the trading desk makes a market."[77]

Because Banking Entities would not be required to provide demonstrable analyses to support limits and limit increases, Trading Desks would, in effect, decide for themselves whether a risk limit, tolerance, or limit override is justified within the self-imposes discretionary standards of their policies and procedures. In essence, the sole constraint on risk limits under the New Volcker Rule Proposal would be the risk appetites of the Banking Entities themselves.

If the Agencies proceed with this proposal—permitting even Banking Entities with Significant TALs to determine the trading, within internal risk limits, that satisfies the RENT-D standard**—the regulatory Permitted Activities exemptions will have been allowed to swallow the statutory rule. This, again, demonstrates that the New Volcker Rule Proposal is a clear violation of BHCA section 13.**

The RENT-D Presumptions based on the internal risk limits are inconsistent with the letter and intent of BHCA section 13 and longstanding supervisory practices and too deferential for the Agencies to oversee and challenge.

Neither the assessment nor the notification processes proposed by the Agencies would facilitate appropriate supervision of Banking Entities' implementation of the risk limits frameworks. Internal risk limits would be subject to supervisory review and oversight and include an "assessment" of whether the

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75 The guidance is effectively the majestically broad risk limit factors noted supra.

76 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33460 (July 17, 2018) (emphasis added).

77 Id. at 33461.

limits are designed not to exceed RENT-D.[78] However, the Agencies would not "assess" testable analyses of historical demand, current inventories, and other factors reasonably influencing Banking Entities' anticipated demands. **They would instead assess whether Trading Desks determined for themselves—pursuant to the majestically broad factors discussed above—that RENT-D permits them to acquire and retain positions and inventories.** This outsources, again, the Agencies' essential role to ensure that Banking Entities comply with applicable law.

Trading Desk positions and inventories therefore may be permitted to increase or decrease in value dramatically during holding periods, constrained only by the judgment of Banking Entities themselves. With billions, if not tens of billions, of dollars of Banking Entities' revenue and compensation at stake, this is hardly a meaningful constraint. The Agencies propose a notification process that would require filings upon breaches of internal risk limits, or upon temporary or permanent increases in those risk limits.[79] This is intended, we presume, to ensure Trading Desks do not abuse the risk limits structure to engage in risk-enhancing trading after initial risk limits have been approved. That objective, for the reasons detailed below, would not be achieved through a mere notification process.

First, there is a certain irony that a regulatory effort seeking to reduce compliance complexities and requirements proposes a new filing requirement based on the risk limits assigned to individual Trading Desks, itself requiring additional compliance and risk management processes and resources. Second, as we note above, if the Agencies do not anchor risk limits to demonstrable analyses of historical demand, current inventories of financial instruments, and market and other relevant factors,[80] Banking Entities are likely to respond to the notification requirement by increasing risk limits and tolerances to avoid exceedances and increases. That, in turn, would mean that the limits not only fail to limit, but also increase potential trading risks on account of regulatory actions purportedly intended to decrease them. That perverse incentive alone argues for maintaining the Market-Making Exemption's demonstrable analysis requirement. **If the Agencies are determined to proceed with the proposal, they should at least seek a methodology that would not induce the very risk-enhancing behavior that BHCA section 13 and the Final Volcker Rule is intended to and did mitigate.**

Third, the proposed notification process is ambiguous. For example, it is not clear whether increasing internal risk limits pursuant to pre-determined procedures would constitute "exceedances" or "temporary or permanent increases" requiring notification.[81] **Because such increases may be indicative of speculative and/or unauthorized trading, the Agencies should at least ensure that notification provisions apply to such pre-determined tolerances, which can increase the risk profile of Banking Entities and facilitate trading that is not moored to the proposal's minimal RENT-D analysis.** The reporting provisions also require Banking Entities to "promptly" report to the Agencies to the extent that any limit is exceeded or there is any temporary or permanent increase to any limit.[82] These provisions must at least provide more specific timeframes for risk limit notifications (e.g., by the end of the business day following the business day in which the limit breach occurred, or in which the limit increase was or should

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78 See Proposed §___.4(a)(8)(ii); Proposed ___.4(b)(6)(ii).

79 See Proposed §___.4(a)(8)(iii); Proposed ___.4(b)(6)(iii).

80 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33460 (July 17, 2018).

81 See, e.g., Proposed §___.(b)(6)(iii).

82 Id.

have been approved by the independent risk function of the Banking Entity in accordance with the Banking Entity's applicable policies and procedures).

The RENT-D Presumptions and related deletions would further undermine the ability of the Agencies to monitor compliance and properly confine Permitted Activities**. Indeed, it is difficult to understand how the Agencies could successfully challenge a limits structure within the New Volcker Rule Proposal's purported constraints.** The proposal would restrict testing, for example, to the risk limit approval and exception processes; it would not provide a means to test the nexus between RENT-D and the risk limits themselves. This, in time, can result only in interpretative expansions of the Underwriting Exemption and Market-Making Exemption. **Without pertinent testing to ensure compliance with RENT-D, examiners cannot be expected to uncover evidence to rebut the RENT-D Presumptions.** The information required to "demonstrate" that Trading Desks remain in compliance with RENT-D would remain in the hands of the Banking Entities, which would be entitled to rely upon the RENT-D Presumptions.

The malleable RENT-D standard inevitably lends itself to discretionary judgments that warrant oversight and documentation. Consider, for example, the recent Malafronte trades at Goldman Sachs' ("GS")—reportedly involving billions of dollars in high yield corporate debt—executed within months of the applicable compliance date for the Final Volcker Rule.[83] The GS trades, on certain trading days reportedly amounting to more than one-third of all trading volume (suggesting significant liquidity risks), were purchased from clients, held by GS for unspecified periods of time, and then resold at more than a $100 million profit.[84] GS reportedly held the risk for varying periods, ranging from one-day to several weeks.[85] GS contends that the trades were part of "a concerted effort to grow [its] market making franchise across credit,"[86] purchased from clients and resold once the firm could find another client buyer interested in the debt exposure.

This example demonstrates clearly the challenge of delineating proprietary trading and market-making activities. Today, regulators at least can monitor such trading by reviewing demonstrable analyses of RENT-D factors ostensibly permitting such activities. The New Volcker Rule Proposal, if adopted, in effect would presume that the Malafronte trades were exempted from the proprietary trading prohibitions, because they were executed within GS's approved internal risk limits (and even if such risk limits were increased to accommodate transactions with no specific buyer anticipated at that time). We do not cite to this specific example to single out any individual financial institution, but rather, to cite to a concrete example demonstrating the challenge of differentiating client-facing activities from proprietary trading under the current Final Volcker Rule. Efforts to further defer to the judgment of Banking Entities would exacerbate this challenge, not address it. They also would almost certainly result in BHCA section 13 being violated.

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[83] How One Goldman Sachs Trader Made More Than $100 Million: The gains from big trades on junk bonds are a throwback to an earlier era on Wall Street, Wall Street Journal (October 19, 2016), available at https://www.wsj.com/articles/how-one-goldman-sachs-trader-made-more-than-100-million-1476869402.

[84] Id.

[85] Id.

[86] Id.

In short, the New Volcker Rule Proposal would not only permit but encourage avoidance and turn active risk management and deterrence into formalistic paperwork exercise, with little effective regulatory oversight. If the Agencies nevertheless proceed with a supervisory framework based solely on limited assessments and notifications, the Agencies must at least provide a more objective standard of review for rebutting RENT-D Presumptions. The proposed facts-and-circumstances standard for reviewing whether trading activities are "based on" RENT-D increases, rather than decreases, regulatory uncertainty for Banking Entities (contrary to a stated objective of the proposal) and simultaneously makes enforcement of the RENT-D statutory standard more challenging.[87]

Unfortunately, using the Market-Making Exemption as an example, we are unable to recommend an alternative approach that does not retain the current—and eminently reasonable—Final Volcker Rule requirements that Banking Entities conduct a demonstrable analysis of historical demand (proposed for deletion), current inventory of financial instruments (proposed for deletion), and market and other factors regarding the amounts, types, and risks of or associated with positions (proposed for deletion). That information is minimal, tailored to the exemption's intended activities, consistent with proper risk management of trading activities, and necessary for properly confining the Market-Making Exemption, consistent with statutory purposes of prohibiting and restricting proprietary trading.

<u>The RENT-D Presumptions place unwarranted confidence in Banking Entities' risk management programs and processes, key weaknesses in the design of the pre-2008 financial regulatory framework.</u>

The RENT-D Presumptions misplace confidence in Banking Entities' risk management programs and processes, key weaknesses in the design of the pre-2008 financial regulatory framework. **This type of "market knows best" framework is simply too deferential to Banking Entities incentivized to engage in risk-enhancing trading activities and if permitted, undoubtedly will lead to proprietary trading losses and violations of the letter and intent of BHCA section 13.** Indeed, less than two years ago, the <u>Explanatory note on the revised minimum capital requirements for market risk</u> published by the Basel Committee on Banking Supervision had this to say about overreliance on internal risk management in the run-up to the banking crisis in 2008:

> The deficiencies in the pre-crisis framework included an inadequate definition of the regulatory boundary between the banking book and the trading book, which proved to be a key source of weakness in the design of the trading book regime. In addition, risk measurement methodologies were insufficiently robust. **In particular, the models-based capital framework for market risk relied (and still relies) heavily on risk drivers <u>determined by the banks</u>, which has not always led to sufficient capital for the banking system as a whole.**[88]

Despite the lessons of recent history, and the clear concerns of bank supervisors, the RENT-D Presumptions and other elements of the New Volcker Rule Proposal again place far too much confidence in the Banking

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[87] In addition, if the Agencies choose to proceed with the RENT-D Presumptions, they should at least amend Proposed § ___.4(a)(8)(ii) and Proposed ___.4(b)(6)(ii) to make clear that rebuttals of the RENT-D Presumptions based on assessments of limit structures would nullify a Trading Desk's <u>previous</u> reliance on the applicable exemption, constituting a violation of BHCA section 13 and the Final Volcker Rule.

[88] <u>Explanatory note on the revised minimum capital requirements for market risk</u> published by the Basel Committee on Banking Supervision, section 2.1, pg. 2 (2016), available at <u>https://www.bis.org/bcbs/publ/d352_note.pdf</u> (emphasis added).

Entities' internal risk management and modeling that served as "key source of weakness in the design of the trading book regime."[89] Risk management programs, including internal risk limits, governance, and escalation and approvals processes are necessary, but they have been proven, on occasion with disastrous consequences, to be grossly insufficient.

In this regard, consider one the lessons derived from the 2008 banking crisis by Eugene Ludwig, the former Comptroller of the Currency and founder of Promontory Group:

> Models are tools that can add value but are not wholly reliable and must be tested and understood by financial institutions that use them. Over the past decade there has been a growing reliance on models by financial firms and regulatory agencies. Regulators should enforce higher standards of model validation and governance, including verification that management actually understand the models they use. Regulators should insist that models take into account tail events and that a significant margin for error is built into model usage, as models can never be 100 percent predictive and are typically captive of available historical data and the assumptions used in their construction.[90]

The New Volcker Rule Proposal explores none of these measures. **The RENT-D statutory standard requires that customer demand must be "reasonably" expected.[91] In the absence of verification mechanisms, the RENT-D Presumptions—as just one example—would permit Banking Entities to engage in trading activities tied only in the most superficial manner to provable, data-driven estimates of customer demand, in violation of BHCA section 13 and the Agencies' reasoning in the Final Volcker Rule.**

Consider, finally, the following example: Jerome Kerviel, of Société Générale ("SocGen") engaged in proprietary trading that resulted in between $4.9 and $7 billion USD in proprietary trading losses. SocGen explained that Kervial's activities were fraudulent. However, an internal report made public after an investigation by the French banking regulator depicted SocGen as systemically failing to adopt reasonably designed controls on front-office trading activities, including desk-level trading limits. Facts remain in dispute. What is not disputed, however, is that at least $4.9 billion in losses arose from either blindness or willful blindness and exposed SocGen to more extraordinary risks than realized losses, mostly due to acknowledged deficiencies in their compliance, controls, and risk management framework.[92] A presumption of compliance and deference to SocGen's internal risk limits, it seems, would have placed undue confidence in its compliance, risk management, and controls frameworks.[93]

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89 Id.

90 Lessons Learned from the 2008 Financial Crisis, Group of Thirty, The William Taylor Memorial Lecture, Eugene A. Ludwig 1, 8 (2011), available at http://group30.org/images/uploads/publications/G30_LessonsLearned2008FinancialCrisis.pdf.

91 12 U.S.C. 1851(d)(1)(B).

92 See, e.g., New York Times, Société Générale loses $7 billion in trading fraud (Jan. 24, 2008), available at https://www.nytimes.com/2008/01/24/business/worldbusiness/24iht-socgen.5.9486501.html (citing Howard Lutnick, Chief Executive Officer of Cantor Fitzgerald, as stating the following: "One person could engineer it - but how could one person finance it?" . . . "The question for the risk management department is: how was this kind of fraud financed? Where did that money come from?").

93 For a more in-depth consideration of SocGen's compliance, risk management, and controls deficiencies, see C. Richard Baker, Bruno Cohanier, and Nancy J. Leo, Considerations Beyond the Fraud Triangle in the Fraud at Société Générale, Journal of Forensic and Investigative Accounting, Vol. 8, Issue 3 (Dec. 2016), available at http://web.nacva.com/JFIA/Issues/JFIA-2016-

Equally important, the SocGen losses manifested in in early 2008, and SocGen was forced to rapidly de-risk its derivatives positions into an already falling market. It was fortunate in one sense that the episode came to light in early 2008. J.P. Morgan and Morgan Stanley provided the €5.5 billion in new capital that very well may have been unavailable had the incident occurred only a few months later. In any event, the reliance on other Banking Entities further illustrates the dangers of proprietary trading, where correlated trading activities, losses, changes in risk appetite, and financial deterioration and other influences can be quickly transmitted throughout the markets. Indeed, at nearly the same time that the SocGen losses were made public, the bank also made public more than €2 billion of subprime losses.[94]

RENT-D compliance program requirements should not apply solely to Banking Entities that have Significance TALs.

The Agencies state that they "generally believe the compliance program requirements play an important role in facilitating and monitoring a banking entity's compliance" with exemptions.[95] Nevertheless, the New Volcker Proposal would eliminate the Underwriting Exemption and Market-Making Exemption compliance program requirements for all but those Banking Entities having Significant TALs.[96] The Agencies should require all Banking Entities to establish, implement, maintain, and enforce an Underwriting Exemption and Market-Making Exemption compliance program, independent of any presumption of compliance. However, **at a minimum, if the Agencies proceed to implement the RENT-D Presumptions, they should at least make reliance on the presumption dependent on meeting applicable compliance program requirements.**

First, the Agencies acknowledge that the Final Volcker Rule's compliance program requirements are "consistent with general standards of safety and soundness as well as diligent supervision, the implementation of which conforms with traditional risk management processes of ensuring governance, controls, and records appropriately tailored to the risks of each banking entity."[97] We agree. **For the reason noted by the Agencies, there are exceedingly low incremental costs associated with most elements of the RENT-D compliance and controls framework for the Underwriting Exemption and**

No3-5.pdf ("In a report prepared at the request of the Board of Directors of Société Générale issued in May 2008, PricewaterhouseCoopers (PwC) indicated that the breakdown in internal controls over the bank's trading information systems was due to a mismatch between the resources allocated to internal controls and a lack of supervision which diminished the effectiveness of the controls. Despite a significant amount of investment in internal controls over the bank's trading information systems, the information systems were unable to keep pace with the growing complexity of the trading environment or to process transactions correctly and efficiently. A heavy reliance on manual processing by back-office operating staff meant that some of the internal controls were not operating effectively. PwC further concluded that it was flaws in the control environment which led to ineffectiveness in the control activities.).

94 Interestingly, a French labor court awarded Kerviel damages for being fired without "real or serious cause," with the note that "Société Générale could not pretend it hadn't long been aware of the unauthorized trades conducted by Mr. Kerviel." Indeed, a class action lawsuit alleged that "[t]hroughout 2006 and into 2007, Kerviel's trading positions continued to increase and SocGen's exposure to losses increased dramatically – at one point reaching €50 billion or more than $70 billion in market risk, which is and was more than SocGen's entire market capitalization." In re Société Générale Securities Litigation, Second Amended and Consolidated Complaint for Violation of the Federal Securities Laws (Jan. 08, 2010), available at http://securities.stanford.edu/filings-documents/1039/SCGLYPK_01/201018_r02c_08CV02495.pdf.

95 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33457 (July 17, 2018); see also Id. at 33462.

96 See supra for definition of Significant TALs. See also Proposed § ___.4(a)(2)(iii); Proposed § ___.4(b)(2)(iii).

97 Id. at 33491.

the Market-Making Exemption, even for those Banking Entities with Limited TALs or Moderate TALs.[98]

The three lines-of-defense framework, for example, has been implicitly or explicitly codified not only by U.S. regulators (see, e.g., swap dealer chief compliance program requirements in CFTC Regulation 3.3[99] and compliance program requirements in the Final Volcker Rule[100]) but also by global regulators relying upon second line-of-defense functions to monitor risks arising from Banking Entities' trading activities (see, e.g., the European Securities and Financial Markets Authority's Guidance on the Application of the Markets in Financial Instruments Directive to the Compliance Function").[101] Banking Entities therefore already should have, among other things, clear and transparent governance and supervisory structures, standards for escalation of individual exceedances and issues of non-compliance, independent review and testing frameworks to ensure the appropriateness and effectiveness of processes and preventative and detective controls, issues management and remediation, training, and model risk and risk limits management.

Moreover, Banking Entities should have implemented these elements of their compliance and risk management frameworks as a best practice, even in the absence of a regulatory mandate. The OCC's Comptroller's Handbook on Compliance Management Systems, used by OCC examiners in connection with their examination and supervision of national banks and other financial institutions, sets forth basic consumer compliance program requirements applicable to national banks that include each compliance program pillar in the Final Volcker Rule.[102] Similar supervisory documentation and policies have been established by the FDIC, Federal Reserve, and other U.S. and non-U.S. regulators and policymaking bodies.[103] The Agencies acknowledge that "[t]he proposed approach would afford banking entities

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98 See supra. This is one reason that the chief executive officer ("CEO") attestation should be retained in current form for all Banking Entities. The CEO attestation encourages senior management oversight of BHCA section 13 implementation and reinforces the importance of creating and communicating an appropriate "tone at the top." See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33492-93 (July 17, 2018) (affirming the importance of "setting an appropriate culture of compliance, and establishing clear policies regarding the management of the firm's covered trading activities"). The New Volcker Rule Proposal proposes to eliminate the CEO attestation for Banking Entities with Limited TALs, and to modify the attestation for others. See Id. at 33489. The existing CEO attestation is eminently reasonable; it focuses, in essence, on ***process*** and ***design***. Moreover, the proposed elimination of compliance program requirements and the general approach of providing a presumption of compliance for Banking Entities with Limited TALs (and permitting reliance on other proposed presumptions) actually strengthens the argument for applying the current CEO attestation to all Banking Entities as a minimal accountability measure and deterrent to non-compliance.

99 17 C.F.R. 3.3 – Chief compliance officer.

100 See, e.g., Subpart D—Compliance Program Requirement (providing for development and continued administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading).

101 European Securities and Markets Authority, Guidelines on certain aspects of the MiFID compliance function requirements (Sept. 28, 2012), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-388_en.pdf.

102 Comptroller of the Currency, Consumer Compliance Compliance Management Systems: Comptroller's Handbook, CC-CMS V.1 (June 2018), available at https://occ.gov/publications/publications-by-type/comptrollers-handbook/compliance-mgmt-systems/pub-ch-compliance-management-systems.pdf.

103 Comprehensive consideration of compliance and risk management program requirements is beyond the scope of this comment letter, but supervisory agencies generally require an analytical framework for identifying, measuring, monitoring, and managing various types of specific risks within the compliance function, using elements applicable to Banking Entities for purposes of the Final Volcker Rule. See Basel Committee on Banking Supervision, Compliance and the compliance function in banks (April 2005), available at https://www.bis.org/publ/bcbs113.htm.

flexibility to integrate . . . compliance program requirements into other compliance programs of the banking entity, which may reduce complexity for banking entities currently subject to the enhanced compliance program requirements."[104] But this is equally true of the current Final Volcker Rule. The RENT-D compliance program requirements, as discussed, mirror existing compliance requirements across prudential and market conduct regulatory regimes.

The Final Volcker Rule's principles-based compliance, risk management, and reporting standards, if anything, should be strengthened, because they permit too much discretion for regulated institutions to implement "reasonably designed" policies, procedures, and controls. Moreover, in practice, judgments on the effectiveness of implemented controls depend on the methodologies used by Banking Entities' testing functions, which too often lack resources and independence to assess controls implementation comprehensively and objectively across multiple lines-of-business and requirements. Testing methodologies are rarely challenged. Eliminating testable, demonstrable analyses makes even the existing minimal oversight of proprietary trading challenging.

The minimal incremental costs arising from the Final Volcker Rule's compliance program requirements argue for retaining such requirements and **contradict the unsupported compliance cost and complexity rationales cited 116 times in the proposal.** In any event, the minimal costs of administering compliance program requirements are more than justified by the increased financial stability of financial institutions and the financial markets achieved by the Final Volcker Rule. Rather than reduce requirements, the Agencies should consider additional capital and activities-based requirements specifically tied to the reported inventory of trading assets, taking account of the total size of those trading assets, the overall capital position of the financial institution, and the average holding period or aging of trading assets that would suggest that inventories are unrelated to underwriting and market-making activities.

IV. <u>Banking Entities' hedging activities must demonstrably reduce specific risks relating to identified and existing exposures, assets, and liabilities</u>.

The New Volcker Rule Proposal would revise the Final Volcker Rule's Hedging Exemption and apply compliance, hedging activities, compensation arrangement, and enhanced documentation requirements differently to Banking Entities with Significant TALs and Banking Entities with Limited or Moderate TALs. For Banking Entities with Limited or Moderate TALs, the New Volcker Rule Proposal would eliminate the (1) the Hedging Exemption compliance program requirement;[105] (2) the specified review, monitoring, and management requirements and restrictions on introduction of new or additional risks on account of hedging activities;[106] (3) the prohibition on compensation arrangements for persons performing hedging activities;[107] and (4) enhanced documentation requirements for inter-desk and other activities conducted in reliance upon the Hedging Exemption.[108] Banking Entities with Limited or

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104 <u>Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds</u>, 83 Fed. Reg. 33432, 33488 (July 17, 2018).

105 Proposed § ___.5(b)(2).

106 <u>Id.</u>

107 <u>Id.</u>

108 Proposed § ___.5(c)(1) (limiting the documentation requirements to Banking Entities that have Significant TALs).

Moderate TALs would be required instead to perform risk mitigating hedging activities that (1) at inception, are designed to reduce or otherwise significantly mitigate specific, identifiable risks arising in connection with or related to identified positions, contracts, or other holdings; and (2) are subject, as appropriate, to ongoing recalibration to ensure that the hedge remains designed to reduce or otherwise significantly mitigate such specific, identifiable risks.[109]

For Banking Entities with Significant TALs, the New Volcker Rule Proposal would revise the Hedging Exemption compliance program requirement to eliminate the further requirement that Banking Entities conduct correlation analyses to ensure that positions, techniques, and strategies used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate specified, identifiable risks.[110] The proposal also eliminates related requirements that (1) correlation analyses demonstrate that hedging activities demonstrably reduce or otherwise significantly mitigate specific, identifiable risks;[111] (2) hedging activities actually demonstrably reduce or otherwise significantly mitigate specific, identifiable risks;[112] and (3) review, monitoring, and management programs demonstrably reduce or otherwise significantly mitigate specific, identifiable risks that develop over time from hedging activities.[113]

For Banking Entities with Significant TALs, the New Volcker Rule Proposal also would permit Banking Entities to avoid enhanced documentation requirements if Financial Instruments used in their hedging activities are (1) identified on a list of pre-approved hedging instruments that are commonly used by the Trading Desk for the specific type of hedging activities; and (2) the hedging activities comply with pre-approved hedging limits for the Trading Desk for hedging activities undertaken for one or more other Trading Desks, provided the hedging limits are appropriate for the following: (i) the size, types, and risks of the hedging activities commonly undertaken by the Trading Desk, (ii) the Financial Instruments for the hedging activities by the Trading Desk; and (iii) the levels and duration of the risk exposures being hedged.[114]

In violation of BHCA section 13, the New Volcker Rule Proposal would eliminate critical provisions within the Hedging Exclusion, facilitating avoidance of BHCA section 13(d)(1)(C) and making supervision of hedging activities exceedingly difficult.

The New Volcker Rule Proposal would revise the Final Volcker Rule's Hedging Exemption and apply, among other provisions, compliance, hedging activities, and compensation arrangement requirements differently to Banking Entities with Significant TALs and Banking Entities with Limited or Moderate TALs. For Banking Entities with Limited or Moderate TALs, the New Volcker Rule Proposal would eliminate, among other requirements, the (1) the Hedging Exemption compliance program requirement;[115] (2) the specified review, monitoring, and management requirements and restrictions on introduction of new or additional risks on account of hedging activities;[116] and (3) the prohibition on

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109 Proposed § ___.5(b)(2) (emphasis added).

110 Proposed § ___.5(b)(1)(C); see also § ___.5(b)(1)(iii) of the Final Volcker Rule.

111 Id.

112 Proposed § ___.5(b)(1)(ii)(B); see also § ___.5(b)(2)(ii) of the Final Volcker Rule.

113 Proposed § ___.5(b)(1)(ii)(D)(2); see also § ___.5(b)(2)(iv)(B) of the Final Volcker Rule.

114 Proposed § ___.5(c)(4); see also § ___.5(c)(1)-(3) of the Final Volcker Rule.

115 Proposed § ___.5(b)(2).

116 Id.

compensation arrangements for persons performing hedging activities.[117] Instead, Banking Entities with Limited or Moderate TALs would be required to perform risk mitigating hedging activities that (1) at inception, are designed to reduce or otherwise significantly mitigate specific, identifiable risks arising in connection with or related to identified positions, contracts, or other holdings; and (2) are subject, as appropriate, to ongoing recalibration to ensure that the hedge remains designed to reduce or otherwise significantly mitigate such specific, identifiable risks.[118]

For Banking Entities with Significant TALs, the New Volcker Rule Proposal would revise the mandated Hedging Exemption compliance program to eliminate the requirement that hedging activities be supported by correlation analyses designed to ensure positions, techniques, and strategies used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate specified, identifiable risks.[119] The proposal also would eliminate related requirements that (1) such correlation analyses demonstrate hedging activities demonstrably reduce or otherwise significantly mitigate specific, identifiable risks;[120] (2) risk mitigating hedging activities themselves demonstrably reduce or otherwise significantly mitigate specific, identifiable risks;[121] and (3) review, monitoring, and management programs demonstrably reduce or otherwise significantly mitigate specific, identifiable risks that develop over time in connection with hedging activities.[122]

The Hedging Exclusion must be confined to hedging activities that demonstrably reduce specific risks relating to identified and existing exposures, assets and liabilities, as documented in appropriate correlation analyses.

The New Volcker Rule Proposal offers three primary explanations for the determination to eliminate the correlation analysis requirement and demonstrable risk reduction requirements in the Hedging Exemption. First, it cites "practical difficulties" that "add delays, costs, and uncertainty" to compliance with the Hedging Exemption.[123] For example, the proposal claims that a Banking Entity may "sometimes develop or modify its hedging activities as the risks it seeks to hedge are occurring, and [that] the [B]anking [E]ntity may not have enough time to undertake a complete correlation analysis before it needs to put the hedging transaction in place."[124] The proposal also claims that hedging "may not be practical if delays or compliance costs resulting from undertaking a correlation analysis outweigh the benefits of performing the analysis."[125]

The Agencies provide no evidence to support the assertion that Banking Entities may avoid hedging activities due to documentation, correlation analysis, or other requirements. The lack of

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117 Id.

118 Proposed § ___.5(b)(2).

119 Proposed § ___.5(b)(1)(C); see also § ___.5(b)(1)(iii) of the Final Volcker Rule.

120 Id.

121 Proposed § ___.5(b)(1)(ii)(B); see also § ___.5(b)(2)(ii) of the Final Volcker Rule.

122 Proposed § ___.5(b)(1)(ii)(D)(2); see also § ___.5(b)(2)(iv)(B) of the Final Volcker Rule.

123 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33465 (July 17, 2018).

124 Id.

125 Id.

evidence to substantiate such "practical difficulties" therefore requires the public to comment on mere assertions that have been communicated confidentially by interested parties, the substance and merit of which cannot be known or meaningfully considered, much less challenged. The Agencies, on the other hand, have available to them information to consider the validity of such assertions.[126] Such information could be anonymized, aggregated, and published to facilitate public comment on potential changes, if any, necessitated by measured impacts on hedging activities that correspond to the industry's assertions**. Indeed, because industry assertions and confidential supervisory data are acknowledged to form a part of the rationale for the proposal,[127] the APA requires the Agencies to re-propose Hedging Exemption-related changes with information necessary and sufficient to provide the public a meaningful opportunity to comment.**

The timing-related contentions are not just unsupported but invalid. The correlation analysis requirement, in essence, requires ex ante consideration of the inverse relationships between assets and liabilities and the Financial Instruments that can be used to effectively hedge them.[128] If Banking Entities rely upon documented and stable risk relationships in effecting hedging strategies, there is no regulatory reason that Trading Desks should experience hedging-related inefficiencies or delays. Banking Entities would be required to engage in substantial, individualized analyses only if instruments or strategies have not been shown to maintain stable risk relationships with underlying assets or liabilities.[129] That is a good outcome. Regulators responsible for supervising the safety and soundness of Banking Entities cannot responsibly accommodate industry requests to facilitate hedging activities, in particular "as the risks . . . are occurring,"[130] if risk mitigating hedging instruments or strategies have not been shown to actually reduce risk.

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[126] For example, examinations of Hedging Exemption compliance programs should have yielded documentation and information on the risk measures used across Banking Entities, and ongoing monitoring should include analyses of changes in such information.

[127] See supra.

[128] The Final Volcker Rule provides that Banking Entities must establish, implement, maintain, and enforce a compliance program reasonably designed to ensure they properly rely upon the Hedging Exemption. § ___.5(b)(1) of the Final Volcker Rule. The Hedging Exemption compliance program must include reasonably designed (1) desk-level policies and procedures regarding the positions, techniques, and strategies that may be used for hedging, including documentation indicating Financial Instruments used in risk mitigating hedging activities, as well as position and aging limits with respect to such Financial Instruments, § ___.5(b)(1)(i) of the Final Volcker Rule; and (2) internal controls and ongoing monitoring, management, and authorization procedures, including escalation procedures, § ___.5(b)(1)(ii) of the Final Volcker Rule. Banking Entities also must conduct analyses, including correlation analyses, and independent testing designed to ensure that Financial Instruments that may be used for hedging may be reasonably expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged. § ___.5(b)(1)(iii) of the Final Volcker Rule. In addition, such correlation analyses must demonstrate that hedging activities actually do demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged. Id.

[129] Notably, the Agencies do not state that "hedging activity" must be preceded by a correlation analysis on a real-time, trade-by-trade basis. The Agencies already have made clear that "correlation [must] be analyzed as part of the compliance program before a [general form of] hedging activity is undertaken." Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5541, 5903 (Jan. 31, 2014)(emphasis added). They similarly provide that "correlation analysis be undertaken as part of the analysis of the hedging positions, techniques, and strategies that may be used," Id., and that correlation analyses "will, in many but not all instances, provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce." Id. Nothing in the language of the Final Volcker Rule suggests that individualized analysis must occur prior to each trade, which appears to be an assumption of the industry's comments. The best indication of whether Banking Entities believe real-time, trade-by-trade analyses are required would be to determine through a series of examinations limited in scope to Hedging Exemption compliance programs if such analyses are actually performed in that manner. The results of such examinations could be anonymized and published for public comment as a general set of observations and provide an informed basis for necessary changes, if any, to the Hedging Exemption.

[130] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33465 (July 17, 2018).

Even if the timing-related challenges were valid, the appropriate remedy would be to permit Banking Entities additional time to perform correlation analyses, not to eliminate them. A reasonably prompt but objective after-the-fact demonstration that a supposed hedging strategy actually hedges identified positions would remain a useful supervisory measure and encourage responsible risk management. Moreover, business risk controls, compliance, and audit testing and review of Trading Desks with hedging mandates would better ensure internal accountabilities for compliance with the Hedging Exemption than proposed analyses that neither include an evaluation of hedging correlations nor demonstrably reduce or otherwise significantly mitigate risk.

The New Volcker Rule Proposal emphasizes the challenges of maintaining effective hedges over time, noting that "the extent to which two activities are correlated and will remain correlated into the future can vary significantly from one position, strategy, or technique to another."[131] The proposal observes that "[a]ssessing whether a particular hedge is sufficiently correlated to satisfy the correlation requirement . . . **may** be difficult, especially if that assessment must be justified after the hedge is entered into . . . ."[132] In other words, Banking Entities contend—again, without presenting supporting evidence—that it is difficult to demonstrate that hedging activities remain risk reducing over time.

This is not an observation relating to compliance or implementation challenges but rather one relating to hedging and risk management. BHCA section 13(d)(1)(C) requires the Hedging Exclusion be confined to risk mitigating hedging activities, and Banking Entities therefore must be able to demonstrate, on an ongoing basis, that a particular hedging strategy is risk-mitigating. Banking Entities concerned about ineffective hedges, in reality, raise a much more concerning policy issue: namely, that risk management programs are not equipped to distinguish trading activities that reduce their risks from those that increase them**. From a statutory and financial stability standpoint, it is concerning that Banking Entities apparently acknowledge that they are incapable of ensuring that hedging remains effective on an ongoing basis, especially because accounting and capital implications follow from the assumption that hedging is demonstrably risk-reducing over time.**

Moreover, eliminating requirements that hedging is risk reducing over time would make proprietary trading in violation of BHCA section 13(d)(1)(C) simple to execute and difficult to detect. In practice, proprietary trading could be affected by putting on inversely correlated positions at inception and subsequently taking off one or more of those positions to leave a desired residual exposure. Such residual exposures would be contrary to the clear import of the Hedging Exemption authorized by BHCA section 13(d)(1)(C), which specifically requires risk mitigating hedging activities that are designed to reduce the specific risks arising from positions, contracts, or other holdings.[133] **The Agencies are not authorized to permit such trading activities under the Hedging Exemption in BHCA section 13(d)(1)(C),[134] the plain language of which contemplates demonstrable, ongoing risk reduction.**[135]

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131 Id.

132 Id (emphasis added).

133 See 12 U.S.C. 1851(d)(1)(C).

134 Id.

135 The Merriam-Webster definition of "mitigate" is "to cause to become less harsh or hostile," "to make less severe or painful," or "extenuate," which is further defined "to lesson the strength or effect of (something)" or "weaken." See https://www.merriam-webster.com/dictionary/mitigate and https://www.merriam-webster.com/dictionary/weaken. See also Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5905 (Jan. 31, 2014) (affirming the Agencies' views that "the statute requires that, to be exempt under section 13(d)(1)(C), hedging activity must be risk mitigating").

Nevertheless, the New Volcker Rule Proposal not only eliminates a particular means by which Banking Entities might demonstrate risk reduction—that is, through a correlation analysis documenting stable risk relationships—but it eliminates the very requirement that hedging activities "demonstrably" reduce risks in the first instance. The Agencies reason that "unforeseeable changes in market conditions, event risk, sovereign risk, and other factors that cannot be known in advance could reduce or eliminate the otherwise intended hedging benefits."[136] They conclude therefore "[i]n these events, it would be very difficult, if not impossible, for a banking entity to comply with the continuous requirement to demonstrably reduce or significantly mitigate the identifiable risks."[137] In a sense, they conclude that Banking Entities must violate the law.

However, the Agencies misinterpret the "continuous requirement" for demonstrable analyses. **Indeed, the Final Volcker Rule already is far too permissive with respect to the correlation analysis requirement and the demonstrable risk reduction requirements.** In this regard, the explanation of the revised correlation analysis requirement within the Final Volcker Rule is worth quoting in its entirety:

> The final rule also adds that correlation analysis be undertaken as part of the analysis of the hedging positions, techniques, and strategies that may be used. This provision effectively changes the requirement . . . that the hedge must maintain correlation into a requirement that correlation be analyzed as part of the compliance program before a hedging activity is undertaken. This provision incorporates the concept . . . that a hedge should be correlated (negatively, when sign is considered) to the risk being hedged. However, the Agencies recognize that some effective hedging activities . . . may not be exhibit a strong linear correlation to the risks being hedged and also that **correlation over a period of time between two financial positions does not necessarily mean one position will in fact reduce or mitigate a risk of the other.** Rather, the Agencies expect the banking entity to undertake a correlation analysis that will, in many but **not all instances,** provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce. It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods. Rather, **the nature and extent of the correlation analysis undertaken would be dependent on the facts and circumstances**

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136 The proposed deletion of the phrase "demonstrably reduces or otherwise significantly mitigates" from risk-mitigating hedging activities restrictions in § ___.5(b)(2) of the Final Volcker Rule would apply, by its terms, only to the design of the hedge "[a]t the inception of the hedging activity." See Proposed § ___.5(b)(1)(ii)(B); § ___.5(b)(2)(ii) of the Final Volcker Rule. Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33465 (July 17, 2018). In this regard, although the "inception" language and permissive interpretation of anticipatory hedging first appeared in the Final Volcker Rule, there is no language in BHCA section 13(d)(1)(C) that limits the hedging analysis to the design of hedging activities solely at the inception of a trade. BHCA sections 13(d)(1)(A)-(I) provide authority to the Agencies to permit specified trading activities, notwithstanding prohibitions and restrictions of BHCA section 13(h)(4). BHCA section 13(d)(1)(C) specifically authorizes the Agencies to permit Banking Entities to engage in risk mitigating hedging activities in connection with or related to individual or aggregated positions, contracts, or other holdings designed to reduce the specific risks to the Banking Entity. 12 U.S.C. 1851(d)(1)(C). Supposed hedging activities that result in reasonably foreseeable exposures to risks cannot be reasonably characterized as designed to reduce specific risks, even at inception, and would plainly contradict prudent statutory limitations on the Hedging Exemption. Moreover, hedging activities conducted in reliance upon the Hedging Exemption must be risk reducing in their entirety. Permitting individual risks or risk factors to arise from "dynamic" hedging or portfolio hedging strategies easily can transform individual trades that appear or are risk reducing, at inception, into prohibited proprietary trading.

137 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33465 (July 17, 2018).

> **of the hedge** and the underlying risks targeted. If correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation.[138]

To recap, the correlation analysis requirement in the Final Volcker Rule already may not require, in all instances, Banking Entities to do the following: (1) reasonably ensure hedging positions actually reduce the risks of underlying positions; (2) demonstrate an inverse mathematical relationship between hedging and underlying positions; (3) maintain the effectiveness of a hedge across positions and time; and (4) rely upon correlation as the threshold element of any analysis demonstrating that a particular trading activity constitutes hedging.

But the flexibility provided by the correlation analysis requirement not only contradicts the assertion that it is impracticable and overly prescriptive but raises the question of whether such a permissive standard for meeting the correlation analysis requirement actually does more harm than good. It may do more harm than good, for example, if the requirement suggests to the public that Banking Entities are subject to greater constraints and are required to conduct much more disciplined analysis than contemplated by the Final Volcker Rule in practice. Indeed, one could reasonably contend that the New Volcker Rule Proposal simply corrects that defect by making transparent the little understood, but indisputable, reality of this element of the Hedging Exemption.

The statutorily required path forward, however, is to adopt a correlation analysis requirement that provides more meaningful constraints on hedging and gives effect to statutory restrictions. There are numerous means for doing so. For example, as we have previously acknowledged, "[i]n practice, it may be at times difficult to hedge some positions perfectly" and "[a]s a consequence, the combined rate of return on the position and its hedge may at time be non-zero: sometimes positive and sometimes negative."[139] But the "returns on hedged positions should vary randomly around zero" and therefore to ensure "permitted activity of risk mitigating hedging is not used to disguise illegal proprietary trading," the Agencies should apply one of "the well-known statistical tests for randomness . . . to the observed returns on the claimed hedged positions."[140]

In addition, the Agencies could at least require a nexus between hedging activities and existing, not solely identifiable, risks (i.e., prohibit or severely restrict so-called anticipatory hedging).[141] The Agencies

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138 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5902 (Jan. 31, 2014) (emphasis added).

139 Better Markets Comment Letter, Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds; File Number S7-41-11 (June 19, 2012), available at https://bettermarkets.com/sites/default/files/documents/SEC-%20CL-%20Supplemental%20Letter%20on%20Volcker%20Rule%206-19-12.pdf.

140 Id.

141 The Agencies expressly permit anticipatory hedging in the Final Volcker Rule and do not distinguish Hedging Exemption requirements based on whether hedging positions are designed to reduce existing or anticipated underlying risks. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5909 (Jan. 31, 2014). (explaining that the Final Volcker Rule would not retain the requirement that anticipatory hedging "be established slightly before the banking entity becomes exposed to the underlying risk" and noting, instead, that "policies and procedures should specifically address when anticipatory hedging is appropriate"). This continues to be permitted despite at least one U.S. court finding the practice tantamount to front-running. See Former Global Head of HSBC's Foreign Exchange Cash Trading Found Guilty of Orchestrating Multimillion-Dollar Front-Running Scheme, U.S. Department of Justice (Oct. 23, 2017), available at https://www.justice.gov/opa/pr/formerglobal-head-hsbcs-foreign-exchange-cash-trading-found-guilty-orchestrating. See

instead abandon any pretense of limiting hedging activities through testable requirements on hedging outcomes, proposing a risk limits framework that suffers from many of the same defects discussed above in connection with the RENT-D Presumptions. Even ostensibly risk-reducing trades can have a material impact on Banking Entities. **If neither a "demonstrable reduction of risk" nor a supporting "correlation analysis" is required to confirm that the transactions are risk reducing, the Hedging Exemption becomes nothing more than a clear avenue to avoid the statutory prohibition on proprietary trading.** As it is, the larger and more systemically important Banking Entities, the easier it is for them to enter into transactions that have an inverse relationship with some risk that can be identified upon request from somewhere within the firm.

Recent examples of misconduct and risk management failures relating to supposed "hedging" activities demonstrate that any deferential hedging standard is likely to facilitate violations of BHCA section 13 and the Final Volcker Rule.

In the Final Volcker Rule, the Agencies noted that the "limits and requirements [of the Hedging Exemption] are designed to prevent the type of activity conducted by banking entities in the past that involved taking large positions using novel strategies to attempt to profit from potential effects of general economic or market developments and thereby potentially offset the general effects of these events on the revenues or profits of the banking entity."[142] History is our guide. The "London Whale" episode involving J.P. Morgan Chase & Co.'s ("JPM") Chief Investment Office ("CIO") demonstrates the potential intersection of hedging, AFS securities (discussed in the Trading Account section below), and proprietary trading. In 2012, JPM realized a trading loss of at least $6.2 billion dollars primarily from credit derivatives trading.[143] One of JPM's many explanations for the losses was that an ineffective hedge of the CIO's AFS securities book had not been rebalanced and therefore had "morphed" into a speculative position.[144] The credit-related "hedge" was necessitated by a substantial increase in AFS securities within the CIO book in the aftermath of the 2008 banking crisis,[145] which "grew from $70 billion to $350 billion after 2008, acquiring substantial credit risk along the way."[146]

The supposed hedging strategy employed by JPM appeared to be a continuation of proprietary trading strategies that pre-dated the 2008 crisis; in fact, the particular trading strategy involved was identified by JPM internal audit as one of many "proprietary position strategies executed on credit and

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also, e.g., HSBC, Information about HSBC's Foreign Exchange and Metals Terms of Dealing, available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=8&ved=2ahUKEwjakc3W9XcAhWvslkKHV_3D9UQFjAHegQIAxAC&url=https%3A%2F%2Fwww.business.hsbc.com.kw%2F%2Fmedia%2Flibrary%2Fcommon%2Fmena%2Fpdf%2Ffx-terms-of-dealing.pdf%3Fla%3DenGB&usg=AOvVaw3rUoHwuqNwVHEehr7NDbai (stating that "[w]here a client indicates interest in a potential transaction, provides a request for quote or leaves an order, HSBC may use that information to engage in Pre-Hedging activities by dealing as principal with a view to facilitate a potential transaction" and disclosing that "[a]ny such Pre-Hedging transactions could be at different prices from the price at which HSBC transacts with a client, may affect the market price or liquidity, and may result in a profit or loss to HSBC").

142 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5902 (Jan. 31, 2014).

143 JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, United States Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, 1 (April 11, 2013), available at https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20(4-12-13).pdf.

144 Id. at 43-44.

145 Id. at 44.

146 Id.

asset-backed indices" as far back as 2007.[147] Although the 2012 realized London Whale trading losses were in connection with credit derivatives used to "hedge" the AFS securities portfolio,[148] we note also (1) that elements of the AFS securities portfolio may have been speculative and (2) that the purchase or sale of AFS securities used as the basis for risk mitigating hedging activities can leave Banking Entities with directional derivatives exposures unrelated to specific assets or risks.[149] In either case, as we note below, such AFS securities should be included in the Trading Account and subject to applicable BHCA section 13 and Final Volcker Rule prohibitions and restrictions, including the correlation analysis and demonstrable reduction requirement associated with the Hedging Exemption.

The London Whale episode is often cited, but JPM is not alone in generating dramatic losses from proprietary trading strategies disguised as hedging. For example, Morgan Stanley's Proprietary Trading Group lost approximately $9 billion through a supposed hedging strategy employed by Howard Hubler, a Morgan Stanley ("MS") Managing Director. In that case, MS's derivatives positions were intended to profit from a deterioration in the subprime mortgage market; MS's proprietary trading desk actually was on the right side of the market going into the 2008 banking crisis period. But, ironically, it was the ineffectiveness of the hedge that generated the multi-billion trading loss. Hubler is reported to have sold credit default swaps ("CDS") on AAA tranches as a hedge on short subprime positions in MS's proprietary trading book. However, the value of the AAA positions used to hedge the subprime positions imposed more extensive losses in the CDS hedging position than MS gained on the hedged risk position, effectively leaving him with a spread. In the end, the relative change in values of these positions exacerbated, rather than mitigated, losses in the MS proprietary trading book, demonstrating the importance of demonstrable analysis showing inverse correlation.

Banking Entities having Limited or Moderate TALs must be required to implement the Hedging Exemption compliance program requirement, the review, monitoring and management requirements, the restrictions on compensation arrangements, and the enhanced documentation requirements for inter-desk and other hedging activities.

For Banking Entities with Limited or Moderate TALs, the New Volcker Rule Proposal would eliminate the (1) the Hedging Exemption compliance program requirement;[150] (2) the specified review, monitoring, and management requirements and restrictions on introduction of new or additional risks on account of hedging activities;[151] (3) the prohibition on compensation arrangements for persons performing

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147 Id. at 38.

148 See discussion of the New Volcker Rule Proposal's changes to Permitted Activities exclusions, including risk mitigating hedging in section V below. This includes discussion of JPM's characterization of proprietary trading as "hedging" and the apparently changing views internally of the specific risk and/or assets ostensibly hedged through the CIO's synthetic credit portfolio.

149 In this regard, the Final Volcker Rule provides that the "short-term trading prong includes hedging one or more of the positions captured by this prong because the Agencies assume that a banking entity generally intends to hold the hedging position for only as long as the underlying position is held." Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5820 (Jan. 31, 2014). The Final Volcker Rule also explains that "provisions regarding price movements and arbitrage focus on the intent to engage in transactions to benefit from short-term price movements (e.g., entering into a subsequent transaction in the near term to offset or close out, rather than sell, the risks of a position held by the banking entity to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction) or to benefit from difference in multiple market prices, including scenarios where movement in those prices in not necessary to realize the intended profit." Id.

150 Proposed § ___.5(b)(2).

151 Id.

hedging activities;[152] and (4) enhanced documentation requirements for inter-desk and other activities conducted in reliance upon the Hedging Exemption.[153]

The Agencies recently agreed that a "robust compliance program and other internal controls . . . help to ensure that only genuine risk-mitigating hedges can be used in reliance on the [Hedging] [E]xemption."[154] In the Final Volcker Rule, again, the Agencies stated that "requiring banking entities to develop and follow detailed compliance policies and procedures related to risk-mitigating hedging activity will help both banking entities and examiners understand the risks to which banking entities are exposed and how these risks are managed in a safe and sound manner."[155] In addition, "[w]ith this increased understanding, banking entities and examiners will be better able to evaluate whether banking entities are engaged in legitimate, risk-reducing hedging activity, rather than impermissible proprietary trading."[156] The incremental costs of implementing the Final Volcker Rule's Hedging Exemption compliance requirements are exceedingly minimal, like the Underwriting Exemption and Market-Making Exemption compliance requirements (discussed above), because Banking Entities, in most cases, would have in place the compliance elements already.

Even if the compliance and controls requirements relating to the Hedging Exemption were abandoned, Banking Entities engaged in risk mitigating hedging activities should be required to continue to meet the effectiveness requirements of § ___.5(b)(2) of the Final Volcker Rule. For example, there is no persuasive rationale for the Agencies to permit any Banking Entities to design compensation arrangements to reward or incentivize prohibited proprietary trading. There is similarly no persuasive rationale to permit any Banking Entities to engage in hedging activities that, at inception, introduce new or additional risks that are not themselves hedged contemporaneously. These examples, and others, at a minimum, counsel for lesser requirements that are more carefully tailored to supposed complexities. **Unless the intent is to violate the law, there is nothing complex about ensuring that hedging does not increase risks at inception and that trading personnel are not compensated for doing so.**

Finally, for reasons discussed below, the enhanced documentation requirements are minimal supervisory controls applicable to the types of hedging activities most in need of regulatory scrutiny and therefore must be retained for all Banking Entities. In addition, although the Agencies provide no indication as to the scope of the proposed exclusion from enhanced documentation requirements,[157] many Banking Entities with Limited or Moderate TALs do not engage in the type of hedging activities requiring enhanced documentation in the first instance.

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152 Id.

153 Proposed § ___.5(c)(1) (limiting the documentation requirements to Banking Entities that have Significant TALs).

154 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5901 (Jan. 31, 2014).

155 Id. at 5903.

156 Id.

157 This is another example of the dearth of quantitative and qualitative information provided in support of the New Volcker Rule Proposal. Without quantitative and qualitative information explaining the basis for and implications of the New Volcker Rule Proposal, Better Markets cannot meaningfully comment on a number of proposed provisions, including the proposed presumptions of compliance and exclusions for Banking Entities with Limited or Moderate TALs.

Banking Entities must be required to document more than permitted instruments inventories and hedging limits, if their Trading Desks deviate from policies and procedures or otherwise engage in activities that may facilitate avoidance.

For Banking Entities with Limited or Moderate TALs, the New Volcker Rule Proposal would eliminate enhanced documentation requirements for inter-desk and other activities conducted in reliance upon the Hedging Exemption.[158] For Banking Entities with Significant TALs, however, the proposal would permit Banking Entities to avoid enhanced documentation requirements only if (1) Financial Instruments are identified on a list of pre-approved hedging instruments that are commonly used by the Trading Desk; and (2) for activities undertaken for one or more other Trading Desks, the hedging activities, at inception, comply with pre-approved hedging limits. Such hedging limits would be required to be appropriate for (i) the size, types, and risks of the hedging activities commonly undertaken by the Trading Desk, (ii) the Financial Instruments used in the hedging activities of the Trading Desk; and (iii) the levels and duration of the risk exposures being hedged.[159]

The Agencies are prudent to require documentation that sets forth hedging limits for inter-desk trading activities and identifies Financial Instruments commonly used to execute specific types of hedging strategies. In seeking to do so, however, the New Volcker Rule Proposal reaches beyond that objective to eliminate critical, unrelated constraints on hedging activities most in need of additional scrutiny. The Final Volcker Rule's enhanced documentation requirements apply only to hedging activities identified by the Agencies to be of particular concern, because such activities (1) do not occur through a Trading Desk with the underlying positions, contracts, or holdings being hedged;[160] (2) are not effected through Financial Instruments, exposures, techniques, or strategies identified in hedging policies and procedures;[161] or (3) manage risks relating to aggregated positions across multiple Trading Desks.[162] Because these hedging activities are "one step removed from some of the positions being hedged"[163] and have been acknowledged by the Agencies to present a heightened risk of avoidance, Banking Entities must document the following contemporaneous with execution: (1) the specific, identifiable risk(s) that such hedging activities are designed to reduce;[164] (2) the specific risk-mitigating strategy that such activities are designed to fulfill;[165] and (3) the Trading Desk establishing the hedging position.[166]

These documentation requirements are warranted and minimal. If Banking Entities have the discretion to deviate significantly from their own hedging policies and procedures and to execute inter-desk transactions, the Agencies would be required to repeatedly engage in the complex and resource-intensive exercise of untangling Trading Desk and risk management structures, without reliable documentation

158 Proposed § ___.5(c)(1) (limiting the documentation requirements to Banking Entities that have Significant TALs).

159 Proposed § ___.5(c)(4); see also § ___.5(c)(1)-(3) of the Final Volcker Rule.

160 § ___.5(c)(1)(i) of the Final Volcker Rule.

161 § ___.5(c)(1)(ii) of the Final Volcker Rule.

162 § ___.5(c)(1)(iii) of the Final Volcker Rule.

163 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5911 (Jan. 31, 2014).

164 § ___.5(c)(2)(i) of the Final Volcker Rule.

165 § ___.5(c)(2)(ii) of the Final Volcker Rule.

166 § ___.5(c)(2)(iii) of the Final Volcker Rule. In addition, Banking Entities must create and retain certain records for a period that is no less than five years in a form that allows prompt production of such records upon request. See § ___.5(c)(3) of the Final Volcker Rule.

explaining the relationship of hedging strategies to the specific risks that they are intended to hedge. Evaluation is made even more difficult when hedging activities occur on a different Trading Desk than holds the underlying risk(s). Therefore, if the Agencies proceed to eliminate the minimal documentation required by § ___.5(c)(2) of the Final Volcker Rule, they would make it all but impossible to examine Banking Entities' compliance with the Hedging Exemption and to fulfill their statutory mandates to promote responsible risk management and protect the safety and soundness of Banking Entities and the U.S. financial system.

Eliminating enhanced documentation, again, would defer too significantly to Banking Entities to decide for themselves whether their supposed hedging activities are conducted in accordance with the Hedging Exemption. In all likelihood, rather than reducing risk, the New Volcker Rule Proposal's Hedging Exemption-related changes would increase risk and violations of the law.

For Banking Entities with Significant TALs, as mentioned, the New Volcker Rule Proposal would permit Banking Entities to avoid enhanced documentation requirements only if Financial Instruments used in their hedging activities are (1) identified on a list of pre-approved hedging instruments that are commonly used by the Trading Desk; and (2) the hedging activities comply with pre-approved hedging limits for activities undertaken for one or more other Trading Desks. Hedging limits would be required to be appropriate to (i) the size, types, and risks of the hedging activities commonly undertaken by the Trading Desk, (ii) the Financial Instruments used in hedging activities by the Trading Desk; and (iii) the levels and duration of the risk exposures being hedged.[167]

Like the risk limits proposed in connection with the RENT-D Presumptions, the proposed hedging limits for the Hedging Exemption depart from usual supervisory means of ensuring compliance with applicable law and insufficiently deter avoidance of BHCA section 13 and the Final Volcker Rule. Indeed, in rejecting the limits-based approach to the Hedging Exemption, the Agencies previously stated that such an approach would "provide less specificity, which could make it difficult for banking entity personnel and the Agencies to determine whether an activity complies with the [Final Volcker] [R]ule and could lead to an increased risk of evasion of the statutory requirements."[168] We agree. **The enhanced documentation requirements are critical supervisory measures to facilitate scrutiny of hedging activities most likely to be used to avoid the restrictions of the Hedging Exemption.**

If the Agencies proceed with the proposed documentation exclusions, the standards for determining whether Banking Entities may avoid the enhanced documentation requirements at least must be revised. The enhanced documentation requirements would not apply to purchases and sales of Financial Instruments that are "identified on a written list of pre-approved financial instruments that are commonly used by the trading desk for the specific type of hedging activity for which the financial instrument is being purchased or sold."[169] The related hedging activities, in addition, must "comply with written, pre-approved hedging limits for the trading desk purchasing or selling the financial instrument, which would be required to be appropriate for the size, types, and risks of the hedging activities commonly undertaken by the trading desk; the financial instruments purchased and sold by the trading desk for hedging activities; and the levels and duration of the risk exposures being hedged."[170]

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[167] Proposed § ___.5(c)(4); see also § ___.5(c)(1)-(3) of the Final Volcker Rule.

[168] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5901 (Jan. 31, 2014).

[169] Proposed § ___.5(c)(4)(i). See also Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33467 (July 17, 2018).

[170] Id.

First, requiring Financial Instruments used in hedging activities to be included in permitted instruments inventories is a necessary but insufficient means to reasonably ensure that such Financial Instruments are used for legitimate hedging. Derivatives used to hedge underlying positions, for example, may be risk enhancing or risk reducing depending on the relationship of the derivative's exposures to the specific risks of the underlying position(s). Permitted instruments inventories therefore would be insufficient means to demonstrate compliance with the "risk mitigating" hedging requirement of BHCA section 13(d)(1)(C).

Second, the proposed hedging limits requirements are too narrow and would not prevent Banking Entities from engaging in proprietary trading in reliance upon the Hedging Exemption. The Agencies note that they would "expect that a banking entity's pre-approved [hedging] limits should be reasonable and set to correspond to the type of hedging activity commonly undertaken and at levels consistent with the hedging activity undertaken by the trading desk in the normal course."[171] Proposed § ___.5(c)(4)(ii)(A)-(C) therefore require that hedging limits be appropriate for (1) the size, types, and risks of the hedging activities commonly undertaken by the Trading Desk; (2) the Financial Instruments purchased and sold by the Trading Desk for hedging activities; and (3) the levels and duration of the risk exposures being hedged.[172] However, like limits relevant to the RENT-D Presumptions, hedging limits pursuant to the proposed standards may be insufficiently limiting.

The first two hedging limit restrictions, for example, require Banking Entities to account for the aggregate activities of Trading Desks, such as whether the overall desk-level limits appropriately account for the size, types, and risks of hedging activities and whether the overall desk-level limits appropriately account for the specific Financial Instruments used in hedging strategies.[173] These limit restrictions therefore would not prevent Banking Entities from executing ineffective hedges that provide speculative exposures to risks or individual risk factors within the Trading Desk's hedging limits. The third limit restriction, however, is ambiguous, providing that hedging limits must be appropriate to "levels and duration of the risk exposure being hedged."[174] Because market practices generally would not require a risk function to institute a trade-by-trade hedging limit, one reading of that restriction could be that it, again, refers to an overall Trading Desk limit that is calibrated to the level and duration of exposures generally hedged through the desk. **If that is the intended meaning, the proposed hedging limits would not prevent speculative trading, except as constrained on an aggregated desk-level basis.**

Perhaps most concerning, even Banking Entities with Significant TALs would have an avenue to avoid the trading accountabilities attendant to the enhanced documentation requirements. This is as puzzling as it is concerning, because the Agencies acknowledge that "[w]hile this documentation requirement results in more extensive compliance efforts," it also "permit[s] evaluation of the [hedging] activity" and "serves an important role to prevent evasion of the requirements of section 13 of the BHC Act and the 2013 final rule."[175] The Agencies instead emphasize the following:

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171 Id.

172 Proposed § ___.5(c)(4)(ii)(A)-(C).

173 The second limit restriction should be revised to contemplate "Financial instruments purchased and sold for the documented risk mitigating hedging activities ~~by~~ of the trading desk." See Proposed § ___.5(c)(4) (underlined and strikethrough added).

174 Proposed § ___.5(c)(4)(ii)(C).

175 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33466 (July 17, 2018). In this regard, the New Volcker Rule Proposal states that "[f]or Banking Entities that have significant trading assets and liabilities, the proposal would retain the enhanced documentation requirements for the hedging transactions identified in § ___.5(c)(1) to permit evaluation of the

> "Reducing the documentation requirement for common hedging activity undertaken in the normal course of business for the benefit of one or more other trading desks . . . would make beneficial risk mitigating activity more efficient and potentially improve the timeliness of important risk mitigating hedging activity, the effectiveness of which can be time sensitive."[176]

But there are few inefficiencies inextricably tied to the enhanced documentation requirements, which cannot be fairly characterized as "extensive" requirements. The "enhanced documentation" requirement is, in reality, a minimal notation of the underlying risk(s), hedging strategy, and Trading Desk relevant to hedging transactions with a heightened risk of avoidance. Moreover, each of these informational elements would be necessary, in any event, for Banking Entities to evaluate their own hedging strategies; therefore, they cannot be a burden or inefficiency.

The Agencies separately refer to the timeliness contemplated by the "contemporaneous" documentation requirement as a potential deterrent to legitimate hedging activities. However, the Final Volcker already explains that the term "contemporaneous" is a misnomer, because the Agencies interpret the requirement to permit enhanced documentation to be completed only "reasonably promptly <u>after</u> a trade is executed."[177] It is eminently reasonable to require Banking Entities to make minimal notations when or promptly after entering into hedging transactions that are supposed to be risk mitigating as required by BHCA section 13.

The enhanced documentation requirements relating to inter-desk hedging activities were adopted to permit supervisory evaluation of Banking Entities' reliance on the Hedging Exemption and prevent avoidance of BHCA section 13. For example, if a Banking Entity manages first and second-order risks arising from mortgage servicing rights ("MSRs"), or other rate-sensitive assets, through internal swaps with the Rates Trading Desk, the threshold inquiry into whether the Banking Entity engaged in proprietary trading must turn (1) on the nature of the activities leading to the initial asset exposures and (2) the effectiveness of related hedging activities intended to mitigate such exposures. The risk management of the MSR portfolio <u>above</u> through inter-desk "booking" is a critical supervisory consideration, because (1) it potentially complicates examination of the Banking Entity; (2) it potentially affects the risk profile of the Banking Entity; and (3) it potentially facilitates avoidance of BHCA section 13. If improperly managed, the inter-desk "hedge" could increase risk exposures for the Banking Entity as a whole. For example, the ineffective hedge could arise (1) if a street-facing trade intended to transfer the specific risks of the inter-desk transaction is not effective (<u>i.e.</u>, transfers only some or none of the inter-desk risks) or (2) the Rates Trading Desk does not enter into a hedging transaction to manage some or all of such risks arising from the inter-desk transaction, in which case such desk acts as an internal dealer providing the Banking Entity a unhedged exposure to risks or risk factors.

In either case, the enhanced documentation requirements would better ensure that supervisors have the information to understand and constrain speculative activities that might arise from ineffective hedges and other transactions performed through inter-desk transactions. **It simply is not possible to understand the overall risk profile of a set of positions without a view of both the hedg<u>ing</u> and hedg<u>ed</u> positions,**

activity." <u>Id.</u> That statement is incomplete. Proposed § ___.5(c)(1) would add the phrase, "unless the requirements of paragraph (c)(4) of this section are met," the clear intent of which is to permit Banking Entities with Significant TALs to avoid compliance with the enhanced documentation requirements. <u>Id.</u>

176 <u>Id.</u> at 33466.

177 <u>Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule</u>; 79 Fed. Reg. 5808, 5911 (Jan. 31, 2014) (emphasis added).

and that view can be obfuscated if a net position arises from multiple transactions across multiple Trading Desks.

The hedging limits conditions for Banking Entities with Significant TALs to avoid the enhanced documentation requirements must at least apply to all of such Banking Entities' hedging activities. The Agencies emphasize that Proposed § ___.5(c)(4)(ii) would require that "the hedging activity . . . complies with written, pre-approved hedging limits for the trading desk purchasing or selling the financial instrument for hedging activities undertaken for one or more other trading desks."[178] The further restrictions on hedging limits required for reliance on this proposed provision therefore would be confined to limits on inter-desk activities. The enhanced documentation requirements, however, are applicable to more than inter-desk hedging activities contemplated by Proposed § ___.5(c)(4)(ii). For example, risk mitigating hedging activities that relate to the Trading Desk's own inventory of underlying assets but are "effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures . . . as a product, instrument, exposure, technique, or strategy such trading desk may use for hedging" would be subject to the enhanced documentation requirements as well.[179] **The proposal's risk limits requirements appear not to apply to these hedging activities at all.**

The combination of the New Volcker Rule Proposal's above changes to the Hedging Exemption, if adopted, would transform the Hedging Exemption's compliance and controls framework into the regulatory equivalent of a Potemkin Village. As a whole, the proposal would ensure that the Agencies find it exceedingly challenging to determine whether supposed hedging activities are speculative (as in the case of J.P. Morgan's infamous "London Whale" transactions), even if they are executed within a "hedging" strategy that deviates significantly from policies and procedures, exceed typical risks presented by Trading Desk's hedging transactions, or involve complex inter-desk transactions. In addition, Banking Entities—including systemically important Banking Entities with Significant TALs—would have diminished incentives to remain disciplined in their execution of hedging activities, potentially implicating the safety and soundness of financial institutions and the U.S. financial markets as a whole.

Moreover, there is a repeated contradiction in comments that BHCA section 13 and the Final Volcker Rule at the same time provide (1) too much uncertainty by adopting principles-based standards (e.g., the demonstrable reduction requirement based on facts and circumstances); and (2) too much certainty by adopting prescriptive regulations (e.g., enhanced documentation requirements). In reality, Banking Entities seek a "heads we win, tails you lose" proposition. If principles-based standards are interpreted to provide too many constraints on hedging activities, they prefer more prescriptive detail on what is required; on the other hand, if the prescriptive standards provide too many constraints, they prefer a more principles-based approach. That is understandable logic from profit-seeking enterprises, but the Agencies should not permit Banking Entities to have it both ways—particularly when they and taxpayers are dramatically disadvantaged by allowing them to have it both ways.

V. Elimination of foreign bank restrictions facilitates avoidance of BHCA section 13 and exposes the U.S. financial system, U.S. depositors, and U.S. taxpayers to risks that inevitably will arise from foreign trading activities.

BHCA section 13(d)(1)(H) permits trading conducted by certain foreign banking entities ("FBEs"), provided each of the following conditions is satisfied: (1) such trading occurs solely outside of the U.S.;

[178] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33467 (July 17, 2018) (emphasis added).

[179] § ___.5(c)(1)(ii) of the Final Volcker Rule (emphasis added).

and (2) such trading is conducted by or on behalf of Banking Entities that are not directly or indirectly controlled by U.S.-organized Banking Entities.[180] The Final Volcker Rule interprets the BHCA phrase "solely outside of the U.S." to generally mean Banking Entities' trading activities having no nexus to U.S. trading personnel, U.S. counterparties, or U.S. financing.[181] The Final Volcker Rule restricts U.S.-nexus activities for FBEs seeking to rely upon the trading activities exemption under BHCA section 13(d)(1)(H) ('Foreign Permitted Activities Exemption"), unless each of the following is satisfied: (1) neither the Banking Entity acting as principal nor the personnel arranging, negotiating, or executing Financial Instruments are U.S.-located or U.S.-organized ("ANE Condition");[182] (2) neither the Banking Entity acting as principal nor the personnel arranging, negotiating, or executing Financial Instruments enter into transactions on behalf of Banking Entities or personnel that are U.S.-located or U.S.-organized and make such trading decisions ("Decisional Condition");[183] (3) neither the transaction nor any hedge of the transaction is accounted for directly or on a consolidated basis by any U.S.-located or U.S.-organized branch or affiliate ("Accounting Condition");[184] (4) no financing for the transaction is provided directly or indirectly by any U.S.-located or U.S.-organized branch or affiliate ("Financing Condition");[185] and (5) the transaction is not conducted with or through any U.S. legal entity, subject to certain exceptions ("Counterparty Condition").

The New Volcker Rule Proposal would eliminate the ANE Condition, the Financing Condition, and the Counterparty Condition. The Agencies state that "[t]he purpose of these modifications is to make clear that some limited involvement by U.S. personnel (e.g., arranging or negotiating) would be consistent with this [foreign activities] exemption so long as the principal bearing the risk of a purchase or sale is outside the United States."[186] The Agencies reason that FBEs have stated that "these requirements have unduly limited their ability to make use of the statutory exemption for proprietary trading and have resulted in an impact on foreign banking entities' operations <u>outside of the United States</u> that these banking entities believe is broader than necessary to achieve compliance with the requirements of section 13 of the BHC Act."[187]

The unsubstantiated statements of FBEs are not a persuasive rationale for eliminating the Final Volcker Rule's conditions to confine reliance on the Foreign Permitted Activities Exclusion. The Financing Condition and the Counterparty Condition prevent FBEs from introducing proprietary trading risks directly to the U.S., including to U.S.-located and U.S.-organized Banking Entities. The elimination of the Financing Condition, in contrast, <u>permits U.S.-located or U.S.-organized entities to provide financing for FBE trading activities, including proprietary trading directly</u>, due to practical concerns about tracing financing to individual risk positions taken by the recipient.[188] **The Agencies themselves**

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180 <u>See</u> 12 U.S.C. 1851(d)(1)(H).

181 <u>See</u> §___.6(e)(3)(i)-(v).

182 §___.6(e)(3)(i) of the Final Volcker Rule.

183 §___.6(e)(3)(ii) of the Final Volcker Rule.

184 §___.6(e)(3)(iii) of the Final Volcker Rule.

185 §___.6(e)(3)(iv) of the Final Volcker Rule.

186 83 Fed. Reg. 33432, 33468 (July 17, 2018).

187 <u>Id.</u> at 33468.

188 Id. at 33468-69. <u>See also Id.</u> at 33469 (stating that market participants have raised a number of questions about the financing prong and have indicated that identifying whether financing has been provided by a U.S. affiliate or branch can be exceedingly complex, in particular with respect to demonstrating that financing has not been provided by a U.S. affiliate or branch with respect to a particular transaction).

"recognize that a U.S. branch or affiliate that extends financing could bear some risks,"[189] even when transactions are booked outside of the U.S. in non-U.S. affiliates or parent companies.

Those providing financing for non-U.S. trading activities, including proprietary trading activities, inherit risks of those activities. If financing is provided pursuant to a typical creditor-debtor relationship, the risks of that loan would be incurred by the U.S. entity. There are risks attendant to inter-affiliate financial relationships as well, for example liquidity arrangements and derivatives transactions involving U.S.-located or U.S.-organized entities. Moreover, the supposed ambiguities and practical difficulties, even if such contentions are legitimate, argue in favor of revising the Financing Condition to be more precise and practical, not deleting it. **Permitting proprietary trading and other risks to be booked outside of the U.S. but for the risks from those activities to be retained, in part, in the U.S., with potential spillover effects on the U.S. financial system, simply is not a defensible policy position and it violates the statute.**

Similarly, the Counterparty Condition prevents FBEs from booking derivatives transactions with U.S. persons, which not only imposes direct credit, market, and other risks on U.S. persons (and therefore their other U.S. counterparties to some degree) but also presents none of the "practical" concerns or "inefficiencies" ostensibly associated with the Financing Condition. The Agencies reason that "market participants have indicated that this requirement has in practice led [FBEs] to overly restrict the range of counterparties with which transactions can be conducted, as well as disproportionately burdened compliance resources . . . including with respect to counterparties seeking to do business . . . in foreign jurisdictions**."[190] Given risks to the U.S. financial system, and the fact that the Foreign Permitted Activities Exemption is separate from and in addition to other Permitted Activities, there is no legally cognizable downside to the restriction of available counterparties for proprietary trading activities unrelated to market-making, underwriting, risk-mitigating hedging, and other socially useful activities under BHCA section 13(d)(1).**

<u>The Agencies should not permit U.S.-based personnel to participate in non-U.S. trading activities prohibited in the U.S. under BHCA section 13 nor should Agencies permit non-U.S. trading with U.S. counterparties in reliance on the Permitted Activities exclusion for foreign trading activities.</u>

The New Volcker Rule Proposal would modify the Final Volcker Rule to replace the requirement that any personnel that arrange, negotiate, or execute are not located in the United States with one that would restrict only the relevant personnel engaged in the Banking Entity's trading <u>decision</u>. The Agencies state that the purpose of this modification would be to "make clear that <u>some limited involvement by U.S. personnel</u> (<u>e.g.</u>, arranging or negotiating) would be consistent with this exemption so long as the principal bearing the risk of a purchase or sale is outside the United States."[191]

Permitting ongoing trading activities through U.S.-located personnel is inconsistent with BHCA section 13(d)(1)(H) and facilitates avoidance of prohibitions and restrictions in BHCA section 13 and the Final Volcker Rule. First, BHCA section 13(d)(1)(H) authorizes the Agencies to permit proprietary trading by Banking Entities, "provided that the trading occurs **<u>solely</u>** <u>outside of the United States</u>." If an FBE arranges, negotiates, or arranges trading through a New York desk, for example, the resulting transaction cannot be said to have occurred "<u>solely outside the United States</u>." The Agencies simply cannot redefine the statutory requirement of "solely."

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189 <u>Id.</u> at 33469.
190 <u>Id.</u> at 33469.

191 <u>Id.</u> at 33468.

Moreover, the Agencies' use of the phrase "limited involvement" is misleading, because such facilitation often is instrumental in finalizing terms and executing the Banking Entity's position. The Agencies are likely focused on the risk of the transaction borne by or carried on the balance sheet of the non-U.S. legal entity. However, Congress focused not on the incidence of risk but on the location of "trading."[192] **The Agencies are not empowered to second-guess that territorial emphasis and policy judgment in BHCA section 13(d)(1)(H), even if they take the view that ultimate risks remain in non-U.S. legal entities.**[193]

Second, the Agencies' proposal to eliminate the ANE Condition would have the effect permitting significant proprietary trading activities to occur through U.S.-located personnel. Permitting proprietary trading on Floor 13 of a New York skyscraper, while such trading is prohibited on Floor 12 (or more likely, a section of Floor 13) facilitates speculative trading in FBEs booking trades overseas but nevertheless relying on U.S.-located personnel, operations, and supervisory frameworks to do so. Such trading also creates a trading culture that encourages risk taking and U.S. involvement in various aspects of a directional risk-taking.

In addition, risks most often exist in FBEs as a consolidated group, affecting the U.S. trading operations even when risks are booked in non-U.S. affiliates.[194] Although less direct, significant losses occurring on account of U.S.-facilitated proprietary trading activities can affect U.S. financial institutions and markets, explaining Congress' concern that any such speculative trading occur solely outside of the United States. The "focus on the requirements of the foreign trading exemption on the location of a foreign banking entity's decision to trade, action as principal, and principal risk" therefore misses a fundamental point.[195]

Far from equalizing the competitive position of FBEs, the elimination of FBE conditions could potentially provide a competitive advantage to FBEs over U.S. Banking Entities. FBEs would be empowered to effect trades financed in the U.S. directly with U.S. counterparties using trading and risk personnel located in New York, for example, without being subject to certain reasonable limitations, compliance, and risk management requirements of the Final Volcker Rule, including those relating to Permitted Activities.[196] In turn, the competitive disparity facilitates regulatory arbitrage through global legal entity strategies.[197] And, of course, it is only a matter of time before US Banking Entities importune the Agencies to allow them to conduct the same type of activities due to the competitive implications of the FBEs' activities.

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192 12 U.S.C. 1851(d)(1)(H).

193 See, e.g., Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33469 (July 17, 2018) ("The proposal would implement this distinction with respect to transactions that occur outside of the United States where the principal risk is booked outside of the United States and the actions and decisions as principal occur outside of the United States by foreign operations of foreign banking entities").

194 Id. at 33469.

195 Id. at 33469.

196 The Agencies themselves appear to acknowledge this fact. See, e.g., Id. at 33469, fn. 140 (recognizing "the possibility that there may also be risks to U.S. banking entities and the U.S. economy as a result of allowing foreign banking entities to conduct a broader range of activities within the United States" and requesting public comment on whether "foreign banking entities [would be provided] a competitive advantage over U.S. banking entities with respect to identical trading activity in the United States").

197 Id. at 33470.

VI. The Error Account Exclusion does not provide sufficient protections to ensure Banking Entities (1) correct errors in a timely and comprehensive manner; and (2) do not use the exclusion to facilitate directional exposures.

The New Volcker Rule Proposal would introduce "a new exclusion from the definition of proprietary trading for trading errors and subsequent correcting transactions" ("Error Trade Exclusion").[198] The proposed Error Trade Exclusion has three elements: First, it must involve the "purchase (or sale) of one or more financial instruments that was made in error."[199] Second, the error must be made "in the course of conducting a permitted or excluded activit[ies]" or be "a subsequent transaction to correct such error."[200] Finally, the error trade must be "promptly transferred to a separately managed trade error account for disposition."[201]

The Error Account Exclusion sets forth a facts-and-circumstances analysis that the Agencies acknowledge cannot provide bright-lines and regulatory certainty.[202] Properly conceived as a narrow risk management expectation with respect to Permitted Activities—and not as an independent exclusion from the proprietary trading—the error account concept properly could promote transparency, appropriate risk management, and accountability**. However, as proposed, the Error Trade Exclusion relies too heavily on preamble guidance and "expectations" that have not been proposed as regulatory text and which therefore would be difficult to enforce.[203]**

For example, the Agencies state that "the failure of a banking entity to make reasonable efforts to prevent errors from occurring—as indicated, for example, by the magnitude or frequency of errors, taking into account the size, activities, and risk profile of the banking entity—or to identify and correct trading errors in a timely and appropriate manner may indicate trading activity that is not truly an error and therefore inconsistent with the exclusion."[204] The Agencies also state that they would expect the error trade account to be "monitored and managed by personnel independent from the traders who made the error and that banking entities should monitor and manage trade errors correction and trade error accounts."[205] Independent monitoring and management is intended to "prevent personnel from using these accounts to evade the prohibition on proprietary trading, such as by retaining positions in error accounts to benefit from short-term price movements or by intentionally and incorrectly classifying transaction as error trades or as corrections of error trades in order to realize short term profits."[206] These preamble statements and

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198 Id. at 33452. See § ___.3(e)(10).

199 Id.

200 Id.

201 Id.

202 Id. at 33452.

203 Proposed § ___.3(e)(10) excludes "[a]ny purchase (or sale) of one or more financial instruments that was made in error by a banking entity in the course of conducting a permitted or excluded activity or is a subsequent transaction to correct such an error, and the erroneously purchased (or sold) financial instrument is promptly transferred to a separately-managed trade error account for disposition."

204 Id.

205 Id.

206 Id.

expectations are reasonable. **However, none of the statements are codified in the proposed Error Trade Exclusion.**

The Error Trade Exclusion, if adopted and codified as suggested, requires more precise controls requirements as well. Trades executed in honest error should be excluded from the concept of proprietary trading, if promptly corrected and subject to independent review and an appropriate compliance and risk management framework. Those elements must be codified. In addition, Banking Entities must be required, by regulation, to establish reasonably designed preventative and detective controls, including periodic exception reports containing the following fields: (1) the nature of the error; (2) the trade ID based on internal and regulatory classifications that the error trade was replaced with, if any; (3) the date of the replacement trade, if any; (4) the date of the error trade; (5) the trading ID of the personnel involved in executing and separately, booking the initial error trade, including the trading ID of any front-office and middle-office personnel responsible for the trade or error; (6) the date that the breach was discovered; (7) an aging metric that equals the number of days between the date of execution and the date of the exception report; (8) a binary notation as to whether the error has been transferred to the Error Trade Account; and (9) the date that such transfer occurred.

Such exception reports should be required to be provided to independent personnel in the second-line-of-defense for the Banking Entities, including compliance and risk personnel, and escalated internally in accordance with internal policies and procedures. Error trade testing and audits should be required periodically, with any such testing being conducted in the second-line-of-defense. These requirements would impose minimal compliance and risk management costs on Banking Entities, if any, becuase such monitoring and escalation already should be implemented in Banking Entities.

VII. The proposed Fair Value Accounting Test would materially improve the Trading Account definition, but it would be best implemented as a new presumption within the Purpose Test.

The New Volcker Rule Proposal would replace the Purpose Test and the related Rebuttable Presumption with a new accounting prong, which proposes to include in the Trading Account the purchase or sale of any Financial Instrument recorded at fair value on a recurring basis under applicable accounting standards.[207] The FVA Test would include in the Trading Account, among other Financial Instruments, derivatives,[208] trading securities,[209] and available-for-sale ("AFS") securities.[210] The Agencies reason that

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[207] The New Volcker Rule Proposal explains that the term "fair value" refers to "a measurement basis of accounting, and is defined under GAAP as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33447 (July 17, 2018) (citing to Accounting Standards Codification ("ASC") 820-10-20 and International Reporting Standard 13.9).

[208] Id. at 33448 (stating that "[t]he proposed accounting prong would include all derivatives . . . since derivatives are required to be recorded at fair value").

[209] "Trading" is an accounting classification applicable to debt securities where the intent is to sell them in the short term to earn a profit. See ASC 320, Investments—Debt Securities. In addition, ASC Topic 321 Investments – Equity Securities requires equity investments with readily determinable fair values within its scope (i.e., not subject to other fair value provisions and exclusions, e.g., specialized accounting treatment or exclusions for derivatives under ASC 815) to be measured at fair value.

[210] "Available-for-sale" is a residual accounting classification used for debt securities that are neither classified as held-for-trading nor held-to-maturity. See ASC 320, Investments—Debt Securities. Because such debt securities are, by definition, classified

the FVA Test would "give greater clarity and certainty to banking entities about what financial instruments would be included in the trading account"[211] and avoid "scop[ing] in activities that do not involve the types of risks or transactions the statutory definition of proprietary trading appears to have been intended to cover."[212]

The FVA Test would be a material improvement to the Purpose Test and consistent with the policy objectives of BHCA section 13 and the Final Volcker Rule. First, the FVA Test would expand the Trading Account to include Financial Instruments that are recorded at fair value on a recurring basis[213] and presently excluded from the Final Volcker Rule. The New Volcker Rule Proposal therefore would address a deficiency in the Purpose Test, namely that it has been implemented under a malleable short-term intent standard that has been interpreted in a manner comparable to the accounting standard for classifying trading securities. That short-term intent standard conceivably excludes significant amounts of AFS securities from the Trading Account.[214]

Moreover, the FVA Test would adopt a well-settled accounting standard already applied by Banking Entities, which "classify financial instruments on a regular basis [under that standard] to satisfy reporting and related requirements."[215] Banking Entities also rely upon longstanding accounting guidance under the ASCs, and similar, which address technical fact patterns that may be relevant to the Trading Account analysis.[216] For this reason, Banking Entities' existing compliance and controls frameworks to classify, monitor, and report on Financial Instruments recorded at fair value should minimize compliance costs arising from the FVA Test.

Finally, the FVA Test would deter non-compliance and facilitate supervision of the Final Volcker Rule. Banking Entities' financial statements and accounting classifications frequently are subject to annual audits, disclosures and liabilities under U.S. securities laws, and prudential regulations and guidance relevant to Financial Instruments accounting. The potential for audit findings, supervisory mandates, monetary penalties, and litigation relating to accounting classifications would encourage Banking Entities'

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as AFS securities on account of the intent to transact prior to maturity, in many cases, they may be of a near-term nature intended to be addressed by BHCA section 13.

211 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33437 (July 17, 2018).

212 Id. at 33447; see also Id. at 33510 (stating that "the Agencies' experience suggests that the 60-day rebuttable presumption may be an overly inclusive instrument to determine whether a financial instrument is in the trading account").

213 See ASC 820 Fair Value Measurement. International accounting standards similarly define fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." See IFRS 13, Fair Value Measurement; see also supra.

214 The term "conceivably" is used above, because the Agencies have provided no data on the extent of new Financial Instruments and trading activities that would be included in the proposed Trading Account definition. It not possible, therefore, to address likely industry contentions that the expanded Trading Account would negatively impact liquidity in all or certain market segments. To the extent such effects are relevant to the Agencies' analyses of public comments and deliberations on the Trading Account, the Agencies must provide the public a meaningful opportunity to address or respond to such comments in the administrative record.

215 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33510 (July 17, 2018).

216 In addition, some of the Agencies have provided their own guidance on the application of ASC releases to Banking Entities. See, e.g., The OCC, Bank Accounting Advisory Series (August 2018), available at https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/baas.pdf.

to perform careful assessments of Trading Account determinations and provide supervisors a less discretionary Trading Account standard to enforce.

The FVA Test appropriately expands the Trading Account to include additional Financial Instruments, including AFS securities.

The FVA Test expands the Trading Account to include Financial Instruments that Banking Entities have excluded under the Final Volcker Rule's Purpose Test and neither classified as held-for-trading nor held-to-maturity.[217] Trading securities would continue to be included in the Trading Account and classified according to accounting standards that are similar to the standard used in the BHCA section 13(h)(6) definition of Trading Account.[218] This is necessary but insufficient. Congress substituted the term "trading account" for the term "trading book" in BHCA section 13(h)(6) precisely to ensure that the Trading Account would include more Financial Instruments than the trading concept used in market risk capital regulations.[219] The importance of respecting that distinction is demonstrated by the fact that trading assets and liabilities comprise less than fifty percent of securities assets and liabilities in segments of the banking industry.[220]

Derivatives also would be categorically included in the Trading Account under the FVA Test.[221] Because of the leverage embedded in many types of derivatives contracts, they are particularly useful Financial Instruments for speculative trading. In addition, derivatives activities and inventories played a key role in increasing leverage, transmitting risks, and imposing liquidity constraints on Banking Entities (and non-bank financial institutions acquired by Banking Entities) during the 2008 banking crisis. For these

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217 Held-for-trading is an accounting classification that applies to securities that are bought and held principally for the purpose of selling in the near term. See ASC 320, Investments—Debt Securities. There is a notable similarity in this standard to the BHCA section 13 proprietary trading definition. Held-to-maturity is an accounting classification that applies to debt securities that Banking Entities have the intent and ability to hold until the maturity of the debt instrument. This classification does not include equities. Id.

218 Both BHCA section 13(h)(6) and the held-for-trading standard include the phrase "principally for the purpose of selling in the near term." Id. 12 U.S.C. 1851(h)(6). Equity securities, including those subject to specialized guidance, subject to fair value accounting appropriately would be included in the Trading Account definition as well.

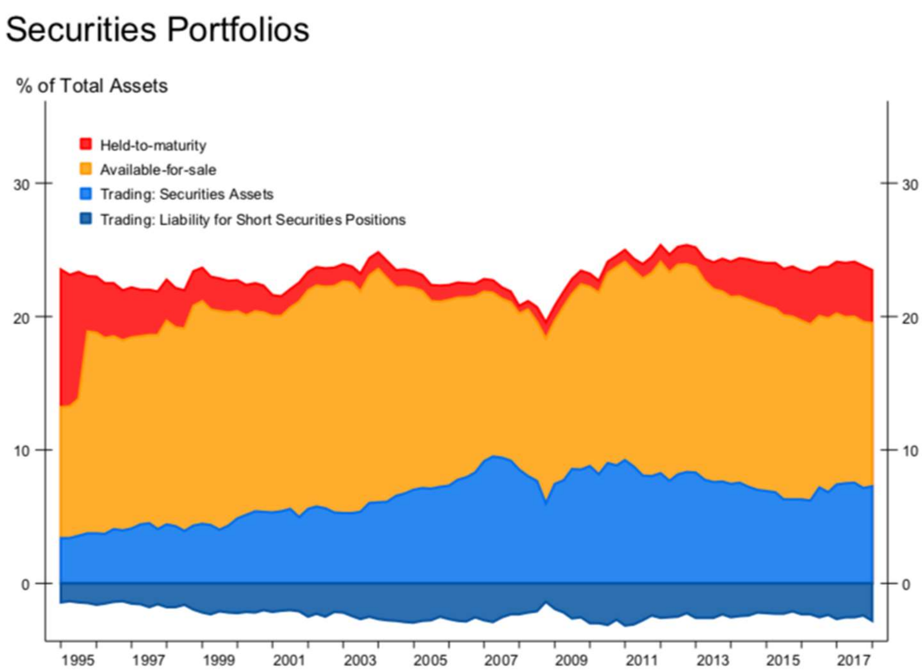
219 The congressional record makes clear that the statutory Trading Account definition was intended to be broadly construed by the Agencies. Consider the following statement by the primary sponsor of the amendment that ultimately led to the adoption of the Volcker Rule, explaining the legislative intent behind the use of the term Trading Account: "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 . . . [and] [i]n 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. See, e.g., Statement of Sen. Jeff Merkley, 156 Congressional Record—Senate, 111th Congress S5869, S5895 (July 15, 2010), available at https://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/pdf/CREC-2010-07-15-senate.pdf.

220 See Quarterly Trends for Consolidated U.S. Banking Organizations, First Quarter 2018, Federal Reserve Bank of New York, Research and Statistics Group, available at https://www.newyorkfed.org/medialibrary/media/research/banking_research/quarterlytrends2018q1.pdf?la=en.

221 ASC 815 requires that derivatives within its scope be recognized and subsequently measured on the balance sheet at fair value in accordance with ASC 820, Fair Value Measurement. If a derivative is not designated as a hedge, changes in its fair value are recorded in current earnings; the accounting treatment of a derivative designated as a hedge depends on the type of hedging relationship.

related reasons, derivatives must be categorically included in the Trading Account and if used in permitted activities, subject to the disciplining effects of compliance and risk management program requirements in the Final Volcker Rule.

The FVA Test also would include in the Trading Account AFS securities that Banking Entities frequently exclude under the Final Volcker Rule. This is consequential, because AFS securities can be a source of significant market and other risks in Banking Entities' portfolios. In fact, AFS securities across Bank Holding Companies ("BHCs") comprise a larger percentage of securities assets and liabilities than trading securities. Consider the composition of held-to-maturity securities, AFS securities, trading securities, and trading liabilities for short securities positions in BHCs as a percentage of total assets in the first quarter of 2018:[222]



Source: Federal Reserve Bank of New York

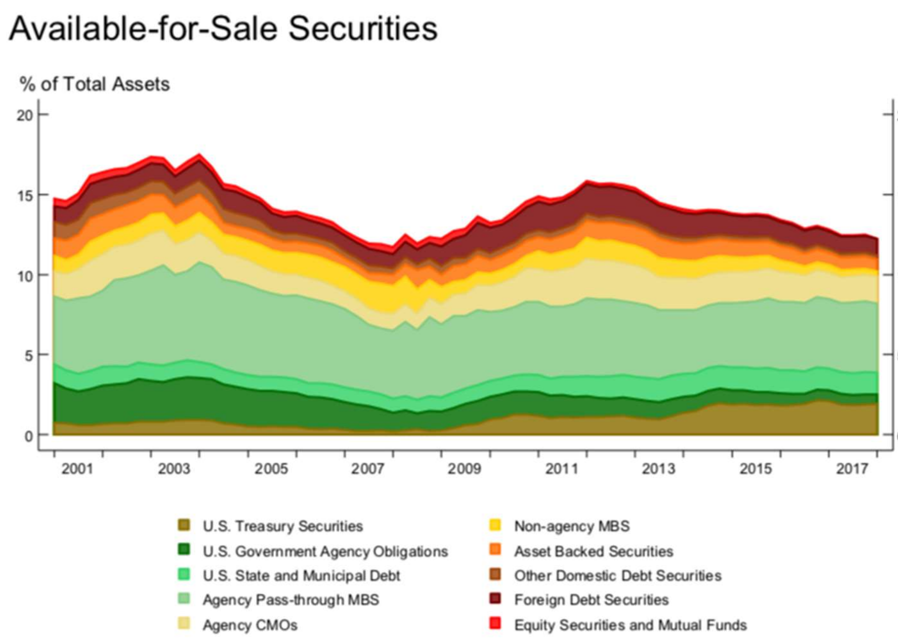
Trading securities, as the above chart demonstrates, comprise only a portion of total securities in BHC portfolios.[223] If these AFS securities can continue to be excluded from the Trading Account, Banking Entities would maintain an obvious avenue for trading outside of the prohibitions and restrictions of BHCA section 13 and the Final Volcker Rule.

Trading securities risks are most directly aligned to risks associated with short-term, speculative trading. But AFS securities-related risks also can involve near-term trading intent (i.e., intent to transact prior to maturity) and risks associated with, and even exceeding, many types of trading securities. Indeed,

222 Quarterly Trends for Consolidated U.S. Banking Organizations, First Quarter 2018, Federal Reserve Bank of New York, Research and Statistics Group, available at https://www.newyorkfed.org/medialibrary/media/research/banking_research/quarterlytrends2018q1.pdf?la=en.

223 In addition, the composition of securities portfolios appears to have shifted to include a greater proportion of AFS securities and held-to-maturity securities since the 2008 banking crisis.

trading securities and AFS securities portfolios include the same or similar types of assets with different trading intent, including asset-backed securities, non-agency mortgage-related assets, and domestic and foreign debt securities.[224] Both trading securities and AFS securities, moreover, include Financial Instruments that were at the center of the 2008 banking crisis, as demonstrated for AFS securities in the chart below:[225]



Source: Federal Reserve Bank of New York

That alone should be sufficient to ensure the Trading Account includes AFS securities and that Banking Entities identify, measure, monitor, and manage risks arising from Trading Desks brought into scope by the FVA Test.

There are potential capital implications of including AFS securities in the Trading Account as well. Trading securities are recorded at fair value and gains and losses are reflected in Banking Entities' income statements; realized gains and losses on held-to-maturity securities and equities are similarly reflected in income statements.[226] Banking Entities subject to or electing into the Advanced Approaches Basel regulatory framework, however, must include unrealized changes in the fair value of AFS securities in

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224 Better Markets supports the FVA Test. However, the Agencies provide no quantitative or qualitative information to support the FVA Test, inform the public of the potential scope of Financial Instruments included in the Trading Account, or provide information on the risk implications of potentially curbing or permitting certain trading activities pursuant to BHCA section 13 and the Final Volcker Rule. More meaningful public comment on the implications of the FVA Test is not possible without this and other information.

225 The tapering of higher risk AFS securities since the adoption of the Dodd-Frank Act is notable in the chart below and appears to continue subsequent to the adoption of the Final Volcker Rule, while AFS securities with lower liquidity and market risk profiles appear to remain constant.

226 See ASC 320, Investments—Debt Securities; see also ASC Topic 321 Investments – Equity Securities.

accumulated other comprehensive income, which affects a component of the BHC's equity calculation.[227] AFS securities therefore have implications for the regulatory capital requirements of the largest Banking Entities.

Prohibiting proprietary trading in AFS securities and applying compliance requirements should reduce capital volatility in the Banking Entities most in need of capital stability from a systemic risk standpoint. The panic that followed the initial Brexit vote a few years ago serves as a cautionary tale. It has been reported that "[i]n the first few frantic hours after markets opened, the primary concern for some treasurers was how their . . . available-for-sale (AFS) portfolio, where liquidity buffers are held, was going to look at the end of the day."[228] The concerns related to significant exposures to AFS securities involving European sovereign debt. BHCA section 13 and the Final Volcker Rule, in combination with the removal of AFS securities valuation filters, should incentivize Banking Entities to hold additional capital in expectation of such stress events. In the alternative, Banking Entities may shift to AFS securities whose valuations are expected to be less correlated with devaluations during stress events. Either way, Banking Entities required to adjust to this combination of activities-based and capital regulations would be more resilient and less prone to risk-enhancing proprietary trading affecting the AFS securities portfolio.

Permitting speculative trading in AFS securities, on the other hand, can be expected to produce losses at the very time that the capital position of the Banking Entities is most affected by AFS securities devaluations, potentially exacerbating financial losses when Banking Entities least want and can afford them.

The accounting classification approach to the Trading Account is logical and usefully blunt. However, if the Agencies proceed to delineate AFS securities that must be included in the Trading Account (and distinguish them from others), the New Volcker Rule Proposal will have introduced complexities and definitional issues, rather than simplified the Trading Account analysis. In addition, although the FVA Test would expand the Trading Account definition, it should not be expected to adversely impact client-oriented activities. If held in inventory or transacted prior to maturity to accommodate client demand, for example, Financial Instruments activities would be eligible for the permitted activities exemptions (e.g., market-making activities).[229]

The FVA Test simplifies the Trading Account analysis and improves regulatory certainty. It is not objective, however, nor does it have to be.

The New Volcker Rule Proposal seeks to provide "an objective means of ensuring that . . . positions entered into by banking entities 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, are incorporated in the definition of trading

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227 In the past, valuation changes relating to AFS securities were filtered out of the regulatory capital calculations. Basel III, however, requires accumulated other comprehensive income to be reflected in Common Equity Tier 1 capital requirements.

228 Andreas Fuster and James Vickery, Regulation and Risk Shuffling in Bank Securities Portfolios, Federal Reserve Bank of New York, Staff Report No. 851, 1, 2 (June 2018), available at https://www.nwyorkfed.org/medialibrary/media/research/staff_reports/sr851.pdf.

229 AFS securities would similarly be eligible for the liquidity risk management and other potentially applicable exclusions under the Final Volcker Rule. See § ___.3(d)(1)-(9) of the Final Volcker Rule (providing that proprietary trading excludes specific types of trading activities relating to repurchase agreements, securities lending transactions, liquidity risk management activities, cleared transactions, and others).

account."[230] In other words, the FVA Test is intended to "address [industry] concerns that the statutory definition of trading account may be read to contemplate an inquiry into the subjective intent underlying a trade,"[231] an intrinsically "qualitative" and "interpretative" analysis that "may not always result in a clear indication."[232]

The FVA Test materially simplifies and improves the Purpose Test. However, it would neither provide an "objective" means for Banking Entities to determine Financial Instruments that must be included in the Trading Account nor address concerns relating to the BHCA subjective intent standard.[233] Fortunately, it does not have to. BHCA section 13(h)(6) defines the Trading Account to mean any account used for acquiring or taking positions in Financial Instruments "principally for the purpose of selling in the near-term (or otherwise with intent to resell in order to profit from short-term price movements)."[234] The Agencies do not have the authority to define the Trading Account to exclude Financial Instruments meeting this statutory standard.[235] The FVA Test can only better ensure trading activities meeting the intent standard are properly "incorporated in the definition of trading account."[236]

The FVA Test therefore should be viewed as providing a useful reference standard for the Trading Account analysis. The New Volcker Proposal would eliminate the short-term trading intent prong, but it would not, and cannot, eliminate the statutory short-term trading intent standard. In this regard, the FVA Test is best viewed in the nature of a definitional safe harbor that is consistent with (and does not replace) the statutory trading intent standard. The safe harbor would provide the Agencies' view on the general application of the subjective intent standard, without precluding additional Financial Instruments from being included in the Trading Account definition or setting forth precise contours of BHCA section 13(h)(6).

These interpretive issues can be avoided by retaining the Purpose Test and supplementing the 60-day presumption under § ___.3(b)(2) of Final Volcker Rule with a new rebuttable presumption based on the language of the FVA Test.[237] This alternative would presume Financial Instruments meeting the FVA Test are included in the Trading Account (with little practical change in outcome), while affirming that the statutory standard codified in the Purpose Test controls the analysis.[238] We support the FVA Test but also

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230 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33448 (July 17, 2018).

231 Id. at 33448.

232 Id. at 33510.

233 Ironically, the 60-day rebuttable presumption was intended to provide a bright-line test responsive to industry concerns about the application of the short-term intent standard.

234 12 U.S.C. 1851(h)(6) (emphasis added).

235 Indeed, the Agencies note that they "recognize that the underlying statute sets forth elements of proprietary trading that are inherently subjective." Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33454 (July 17, 2018).

236 Id. at 33448.

237 See § ___.3(b)(2) of Final Volcker Rule.

238 In addition to the implicit authority of the Agencies to interpret the term Trading Account, BHCA 13(h)(6) provides explicit authority to include in the Trading Account "such other accounts" as the Agencies determine appropriate to achieve the purposes of BHCA section 13(h)(4). See 12 U.S.C. 1851(h)(6). If commenters contend that the FVA Test includes Financial

believe this approach would better and more accurately articulate the operation of the trading intent standard, again, with little change to practical outcomes. The Agencies therefore should consider this option.

There would, of course, remain an element of art and science in identifying Financial Instruments subject to the fair value accounting standards. The FVA Test, wherever located, would continue to require that inquiry into subjective trading intent, albeit as part of an accounting analysis that already must be performed. Held-for-trading securities recorded at fair value include securities that are bought and held principally for the purpose of selling them in the near term, mirroring language in BHCA section 13(h)(6) and the Purpose Test in the Final Volcker Rule.[239]

The supposed difficulties in applying the BHCA's subjective intent standard is overstated. The FVA Test relies upon a longstanding intent standard that Banking Entities routinely apply to Financial Instruments for accounting purposes and that the Agencies have incorporated into other fundamental aspects of prudential and market conduct regulation. The Federal Reserve's Form Y-9C, for example, contains seven references to "acquiring or taking positions . . . 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," or substantially identical formulations.[240] Those references are based on fair value accounting standards for trading assets and liabilities.

The market risk capital regulations include a substantially identical trading intent standard.[241] For covered Banking Entities, the MRC Test includes in the Trading Account "covered positions" as defined in those regulations.[242] MRC Test-related covered positions include positions held "for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or

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Instruments in the Trading Account that may not meet the BHCA section 13 trading intent standard, the FVA Test could be finalized pursuant to the Agencies' discretionary authority to establish "other" trading accounts, which would not require the intent standard be met.

239 Id.

240 See Federal Reserve Form Y-9C, Instructions for Preparation of Consolidated Financial Statements for Holding Companies, HC-4 (reporting on mutual funds and other equity securities defined in ACS Topic 321 with readily determinable fair values that are not held for trading); HC-7 (defining trading assets that must be consistently valued at fair value as defined in ACS Topic 820, including ACS 320 debt securities and certain derivatives); HC-B-1 (excluding from held-to-maturity securities all securities held for trading and debt securities reported at fair value, even if the BHC did not acquire the securities for the purpose of selling them in the near term); HC-D-1 (defining trading activities to include acquiring or taking positions in such items 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); HC-L-16 (defining derivatives trading activities to include acquiring or taking positions in such items principally for the purpose of selling in the near term or otherwise with the intent to resell (or repurchase) in order to profit from short-term price movements); GL-80 (noting that securities that are intended to be held principally for the purpose of selling them in the near term should be classified as trading assets); and GL-88 (defining the trading account to include acquiring or taking positions in such items 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) (March 2018), available at https://www.federalreserve.gov/reportforms/forms/FR_Y-9C20180731_i.pdf.

241 It is telling that multiple commenters contended that the market risk capital prong of the Trading Account definition was redundant in light of the short-term intent prong. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5820 (Jan. 31, 2014).

242 See 12 C.F.R. part 225, Appendix E.

to lock-in arbitrage profits."[243] The New Volcker Rule Proposal does not modify this aspect of the Trading Account definition. Yet, the Agencies acknowledge that the MRC Test's trading intent standard "largely parallels the provisions of section 13(h)(4) of the BHC Act and mirrors the short-term trading account prong."[244]

The Agencies once reasoned that "[t]o the extent that overlap exists between the prongs of th[e] [Trading Account] definition," the different prongs would be "mutually reinforcing" and "help to simplify the analysis."[245] We agree. Better Markets supports the proposed FVA Test, recognizing that it does not necessarily resolve the subjective elements of the Final Volcker Rule and comport with other reasons cited by the Agencies to support it.[246]

The compliance and controls costs arising from the proposed Trading Account definition would be minimal. To be sure, Banking Entities would be required to review the compliance and controls frameworks applicable to Trading Desks with activities newly included in the Trading Account. But Banking Entities would leverage existing policies, processes, controls, resourcing, and technologies used to implement and monitor the Final Volcker Rule and also manage regulatory obligations relating to the accounting standards. On the other hand, the financial stability and other benefits of using the well-settled fair value accounting standard substantially outweigh the minimal incremental costs of bringing additional Trading Desks into compliance.[247] **The 116 references to burdens, compliance costs, competitive disadvantages, and vague risks unsupported by any evidentiary basis in the rulemaking noted by the Agencies in the New Volcker Rule Proposal inaccurately and unfairly diminish and ignore the importance of the financial stability and other benefits of BHCA section 13.**

The FVA Test would improve supervision if drafted to provide the Agencies definitive authority to interpret the FVA Test and if the fair value accounting and FVA Test standards are required to be applied consistently.

The FVA Test undoubtedly would incentivize Banking Entities to attempt to influence fair value accounting standards or the application of fair value accounting standards. This is not solely a theoretical issue. Since the 2008 banking crisis, for example, there has been a significant change in the composition assets within the major accounting taxonomies. Consider the following chart showing this significant shift into held-to-maturity securities after implementation of capital requirements providing advantages to the classification, among other things:

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243 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5819, 5821 (Jan. 31, 2014).

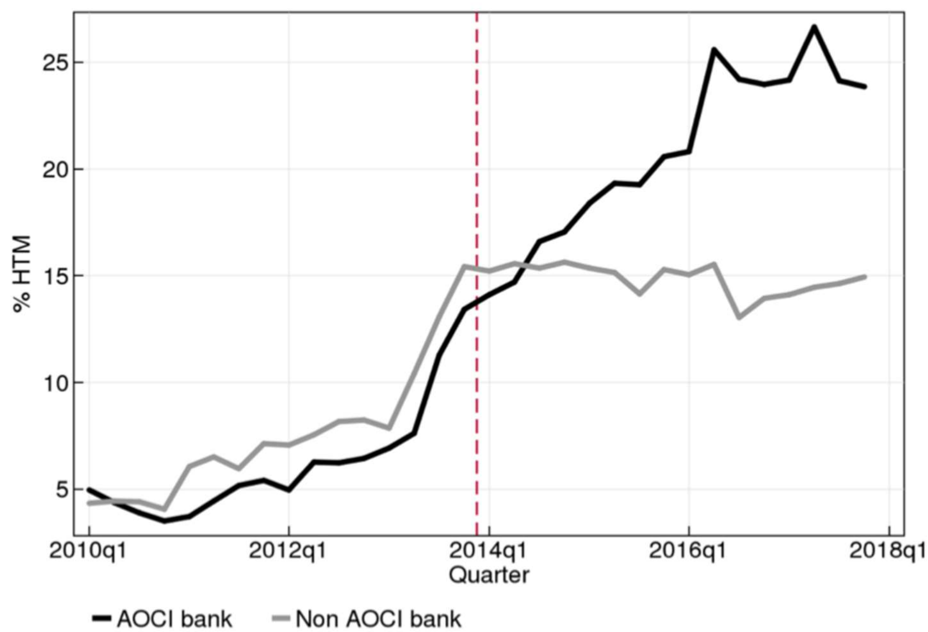
244 Id. at 5548.

245 Id.

246 Better Markets would like to emphasize, again, that the FVA Test would be better adopted as a supplemental presumption as part of the Purpose Test.

247 If the trading account definition merely implements the letter and intent of BHCA section 13, the incremental costs of the revised trading account definition would be zero from a regulatory cost-benefit analysis perspective. Congress determined the minimum scope of BHCA section 13 and the Final Volcker Rule, even as amended, and the Agencies must use that statutory reach as a baseline in any cost-benefit analyses of the new Trading Account definition.

Percentage of investment securities classified as held-to-maturity



Source: FR Y-9C Data, Federal Reserve Bank of New York Staff

There are numerous contributing factors to this change in the composition of such assets. However, it has been suggested that the interpretation and/or application of accounting standards on account of the regulatory capital implications of the ACS classifications may be part of the explanation.[248]

This trend, and Banking Entities' "discretion over whether certain [F]inancial [I]nstruments are recorded at fair value,"[249] counsels against a mere regulatory reference to "financial instruments . . . recorded at fair value on a recurring basis under applicable accounting standards."[250] The Agencies should revise the FVA Test to codify language from the applicable accounting standards, which could be coupled

248 See Andreas Fuster and James Vickery, Regulation and Risk Shuffling in Bank Securities Portfolios, Federal Reserve Bank of New York, Staff Report No. 851, 1, 2 (June 2018) (observing that "evidence supports the argument that the [accumulated other comprehensive income] rule induces substitution by banks into [held-to-maturity], partially insulating regulatory capital from the volatility associated with movements in security fair value" and concluding that "banks reclassify securities to shield their portfolios from the effects" of capital regulation, "particularly for [long-dated debt] securities with high levels of interest rate risk").

249 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33597, 33448 (July 17, 2018).

250 See Proposed Regulation 75.3(b)(3). Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33597 (July 17, 2018) (stating that the trading account includes any "financial instrument that is recorded at fair value on a recurring basis under applicable accounting standards").

with preamble language that confirms the Agencies' intent to interpret the FVA Test in a manner that is consistent with GAAP and international accounting codifications and guidance.[251] This approach also would anchor the new provision in core fair value concepts and regulatory text that can be definitively interpreted by the Agencies themselves, not accounting authorities that may not consider in guidance the implications of accounting updates for the Agencies' mandate under BHCA section 13.[252]

The FVA Test, separate and apart from other elements of the New Volcker Rule Proposal, is a material improvement to the Trading Account definition and does not supersede or conflict with the BHCA definition. The Trading Account is a fundamental definition affecting application of BHCA section 13(h)(4) and the Final Volcker Rule. The Agencies might usefully distinguish definitional issues affecting the scope of the Final Volcker Rule—e.g., the Trading Account—from other definitional issues that reasonably could be viewed as having an effect on implementation of the Final Volcker Rule (e.g., "trading desks"). Both are critical to giving effect to BHCA section 13. The Agencies should be especially conservative, however, in addressing definitional issues that affect the application of the Final Volcker Rule in the first instance.

The CFTC's proposed rulemaking to exclude certain swap dealing activities from the swap dealer registration threshold, if finalized, may have the effect of excluding swap dealing activities from the Trading Account.

The proposed Trading Account definition would include a new FVA Test that applies to all derivatives recorded at fair value on a recurring basis.[253] The proposal also retains the Dealing Activities Test, which continues to include in the Trading Account Financial Instruments purchased or sold for any purpose, if (1) Banking Entities are registered or "required to be registered" to engage in the business of a swap dealer or security-based swap dealer; and (2) such Financial Instruments are purchased or sold in connection with the activities requiring registration.[254] The dealing activities of swap dealers or security-based swap dealers conducted outside of the U.S. would continue to be included in the Dealing Activities Test.[255]

In June 2018, the CFTC issued a Notice of Proposed Rulemaking with a series of exclusions from the swap dealer de minimis threshold ostensibly pursuant to section 1a(49)(D) of the Commodity Exchange Act ("CEA").[256] The proposed swap dealer de minimis exemption would maintain an $8 billion registration

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[251] However, the FVA Test's language must be revised to include a requirement that Financial Instruments recorded at other than fair values constitute Financial Instruments in the Trading Account if the Agencies determine or discover that such instruments have been improperly recorded.

[252] Banking Entities will no doubt identify securities interests recorded at fair value in their investment portfolios and present an endless array of fact patterns supposedly requiring resolution before finalization of the FVA Test. Financial Instruments categorically viewed as improperly included in the Trading Account should be addressed on a fact-specific basis through an exemptive process. Otherwise, such Financial Instruments should be considered and addressed through the examinations processes of the Agencies, in accordance with applicable law.

[253] Proposed § __.3(b)(3).

[254] § __.3(b)(3). See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33586 (July 17, 2018).

[255] § __.3(b)(3). See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33447 (July 17, 2018).

[256] See De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018), available at https://www.cftc.gov/sites/default/files/2018-06/2018-12362a.pdf. See 12 U.S.C. 1a(49)(D). Because the CFTC's proposed

threshold but expand the exemption to exclude certain swap dealing activities from the threshold calculation.[257] Because such dealing activities would be excluded from the registration threshold, it could be contended that they do not constitute swap dealing activities requiring registration within the meaning of the Dealing Activities Test.

The Agencies appear to affirm that interpretation of the Dealing Activities Test in the following footnote:

> An insured depository institution may be registered as . . . a swap dealer and a security-based swap dealer, but only the swap and security-based [sic] dealing activities that require it to be so registered are included in the trading account by virtue of the dealer prong. If an insured depository institution purchases or sells a financial instrument in connection with activities of the insured depository institution that do not trigger registration as a swap dealer, such as lending, deposit-taking, the hedging of business risks, or other end-user activity, the financial instrument would be included in the trading account only if the purchase or sale of the financial instrument falls within the market risk capital trading account prong . . . or the proposed accounting prong.[258]

That outcome is inconsistent with clear intent of the Dealing Activities Test, especially as we read the CFTC's proposal to exclude supposed "hedging" and "end-user" activities directly related to swap dealing.[259] **Notably, the dealer-trader distinction framework already would exclude speculative trading activities from the analysis, the precise type of trading that the Volcker Rule is squarely intended to address.[260] Further hollowing of the Dealing Activities Test therefore is wholly inconsistent with the law.**

In addition, the SEC has not finalized certain rulemakings under Title VII of the Dodd-Frank Act to commence registration of security-based swap dealers.[261] The Dealing Activities Test, again, "applies

rulemaking exceeds its unilateral authority with respect to establishing factors for exempting a quantity of swap dealing activities, that rulemaking must be adopted, if at all, as a joint rulemaking with the SEC. See Section 712(d) of the Dodd-Frank Act.

[257] See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant;" 77 Final Rules, Fed. Reg. 30596, 30611 (May 23, 2012), available at https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.

[258] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432, 33447, fn. 63 (July 17, 2018).

[259] A more detailed explanation of the implications of proposed language regarding dealing-related hedging, for example, can be found in our recently filed comment letter on the De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 27444 (June 12, 2018), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20to%20CFTC%20on%20De%20Minimis%20Exception.pdf.

[260] See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant;" 77 Final Rules, Fed. Reg. 30596 (May 23, 2012) (generally setting forth a dealing analysis based on the dealer-trader distinction, which provides that dealing may not include activities conducted solely for a speculative, investment, or trading purpose, depending on the totality of the facts and circumstances).

[261] The CFTC and SEC's joint "swap dealer" and "security-based swap dealer" definitions rulemaking was published more than six years ago. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant;" 77 Final Rules, Fed. Reg. 30596, 30611 (May 23, 2012). The lack of a security-based swap dealer registration regime is especially puzzling, given the nexus of single-name

only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily all of the activities of that banking entity."[262] It may be interpreted therefore to exclude dealing activities that are conducted by Banking Entities not yet required to register as security-based swap dealers, **in contravention of the intended reach of the Trading Account**.

The FVA Test would broadly include derivatives dealing activities in the Trading Account, remedying the potential absence of these activities from the Dealing Activities Test under the Final Volcker Rule. However, the presumption of compliance for activities included in the Trading Account solely on account of the FVA Test, if adopted at all (discussed above) at least should not apply to routine derivatives dealing Trading Desks**. The Agencies must revise the Dealing Activities Test therefore both to ensure that derivatives activities remain in the Trading Account without regard to potential SEC and CFTC actions on the de minimis thresholds or other registration requirements and do not benefit from any presumption of compliance.**

Conclusion

The Agencies must re-propose the above discussed provisions in a future proposed rulemaking, given the dearth of data and other relevant information to support the proposal and the inability of the public to reasonably foresee and comment meaningfully on a broad range of potential regulatory outcomes.

We hope these comments are helpful and look forward to discussing them with you.

Sincerely,

Dennis M. Kelleher
President and CEO

Joseph R. Cisewski
Senior Derivatives Consultant and Special Counsel

Better Markets, Inc.

credit default swaps to the events of the 2008 banking crisis and the fact that Congress made clear in section 712(a)(3) of the Dodd-Frank Act that the commissions must issue regulations "in final form not later than 360 days from the date of enactment," which elapsed in July 2011, or more than seven years ago. See Title VII— Wall Street Transparency and Accountability, Subtitle A—Regulation of Over-the-Counter Swaps Markets, Part I— Regulatory Authority, Sec. 712(a)(3), Public Law 111–203, 124 Stat. 1376 (2010).

[262] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule; 79 Fed. Reg. 5808, 5819, 5821 (Jan. 31, 2014).

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