February 28, 2012

The Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Notice of Proposed Rulemaking: 17 CFR Part 75; *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds)*; RIN number 3038-AD05
Addressing: Subpart B, Subpart D, 1851(b)(2)(A)

The need for financial reform is clear. While I respectfully support the agency's attempt to create a more stable banking system, the proposed rule will not have the desired effect of creating a "sound economic foundation to grow jobs," nor will it "protect consumers, rein in Wall Street and big bonuses, end bailouts and too big to fail," or "prevent another financial crisis." The proposed rule will rein in Wall Street profits, but not the behavior and miscalculation that led to the global financial crisis. I fear that the end result of this perverse rule, as written, will be a less competitive financial services industry in the US, lower liquidity in exchange markets, further industry consolidation, more rent seeking behavior, and the proliferation of complex and veiled financial instruments, as firms pioneer new investment vehicles that are beyond the scope of the regulatory purview. The proposed rule is not all bad, but its focus is on punishing banks rather than improving the financial services industry as a whole; it is punitive in nature rather than rehabilitative. This approach will incentivize regulatory evasion and secrecy in the derivatives market, rather than prompting greater disclosure. Furthermore, implementing the rule's constraints by the arbitrary deadline of July 2012 will have severe dampening effects on the economic recovery in the US by weakening bank liquidity, increasing borrowing costs, and reducing firms' ability to carefully displace risk—thus undermining industry confidence even further. The Commodity Futures Trading Commission (CFTC) should consider making the following changes to the proposed rule, and indefinitely delay its implementation, to avoid unnecessary market volatility during a time of fragile recovery.

Proprietary Trading Restrictions

The agency's definitions of proprietary trading, trading account, covered funds, and risk mitigating hedging activity are far too broad and sweeping, making it unclear as to which activities fall under the prohibited trading or accepted risk management. These ambiguities will have negative effects on liquidity—resulting in a rigid, more volatile financial system, rather than a more stable one. If interpreted too narrowly, the rule will disrupt casual relationships with all covered funds; opportunities for lenders, and indirectly the customers and economy they service, to grow wealth and make responsible lending/market making activities that are made possible by dealing and financing in highly liquid financial instruments will be limited. Nearly 50 percent of US corporate bond classes are traded in secondary markets through the soon to be prohibited covered funds. The rule would thus eliminate many banks' access to these bonds, adding a barrier to moving capital in and out of markets on demand. Liquidity is an important function of venture capital and underwriting. These new requirements will ultimately lead to banks and large funds relying heavily on a smaller group of firms to provide capital to markets.

The proposed rule will also have serious consequences for domestic financial institutions. By requiring foreign banks to abide by the proposed rule when dealing with US investments, the government is effectively incentivizing them to avoid such investments and institutions, and shift financing activities outside of our jurisdiction entirely. Indeed, as the Institute of International Bankers and the British Banker's Association, which together represent more than 250 banking institutions in more than 50 countries, remind us:

> "To avoid triggering a Volcker violation or having to impose a very costly Volcker compliance framework on all of their non-US offices, some international banks are likely to be dissuaded from transacting with US customers and counterparties from their non-US offices, further disrupting US investor and corporate client access to international markets."

This will have enormous consequences on US liquidity, which is already suffering due to the European debt crisis. Furthermore, the limited exception to "foreign trading by non-US banking entities" in Section 13(d)(1) gives non-US banks a comparative advantage, while saddling US banks, who are already disadvantaged because they are subject to the world's highest corporate tax rates, with a heavier regulatory burden. The rule will have the effect of granting international banks exclusivity to lucrative hedge funds beyond the US. Rather than limiting the trading activities of certain companies and financial instruments, and carving out exceptions for others (i.e. US government bonds), the CFTC should focus primarily on information sharing and disclosure policies.

Disclosure

Subpart D of the proposed rule will require banks to create compliance programs, enhance internal controls, and conduct independent testing of compliance programs, training and recordkeeping. I recommend the CFTC develop these requirements further, rather than focus on prohibiting transaction based activities that will inadvertently restrict lending. Subpart D and its corresponding appendixes are true to the objective of reducing market volatility. Enhanced record keeping and financial disclosure to creditors and consumers in these areas will provide public investors, government agencies, and the financial services industry greater access to information about volatile leverage and potentially systemic risks. Had there been public record of the extent to which Lehman Brothers and AIG were increasingly engaged in credit default swaps before 2008, market forces would have gradually corrected the behavior and put a lien on creditor leverage.

The proposed rule does not go far enough, however, in prescribing internal controls and management frameworks. The language is particularly vague in its usage of such phrases as "reasonably designed" and its reliance on "qualified banking entity personnel" to demonstrate compliance. These ambiguities will lead to an environment of "technical compliance" (box checking) that undermines meaningful disclosure of leverage to creditors and regulators. Financial services companies will use the language to exploit the proposed rule's exceptions in 13(d)(1) for "risk-mitigating hedging activity." Banks cannot measure the true value of their assets, or the extent of their leverage, without knowing what other derivatives their assets depend upon; they do not operate within a vacuum. The requirements in Subpart D should be expanded and elaborated upon to require financial services companies to register all derivatives contracts (within or beyond depository banking to include hedge funds and other covered funds) with a federal agency and self-regulatory organizations. The CFTC should go further in requiring banking institutions to formulate and publish ratios quarterly which measure the level of consumer-facing trading activity against proprietary trading, and which measure the performance of the proprietor's portfolio versus that of its customers. The proposed rule should also require the CFTC to publish investor guidelines that include thresholds for measuring proprietary trading and identifying firms with potentially negative ratios. If investors know that certain banks are engaged in proprietary trading against their own positions, they will take their business elsewhere. In its current form, the proposed rule will not substantially increase public awareness of firm operations or shed light on the still murky derivatives market. In fact, by encouraging banks to shut down or separate their proprietary funds, agencies are incentivizing them to remove more money and trading into darker parts of the market, where oversight is dramatically limited. During the financial crisis, the Federal Reserve encouraged many institutions to adopt bank holding status. The proposed rule's new restrictions could reverse that policy and provoke banks to shed their holding status in an effort to avoid compliance with the new rule. This would result in enormous social waste and further instability.

Timeframe

Finally, the CFTC should wait to implement the rule until the economy has fully recovered and the European debt crisis has subsided, or at least grant banks the full two year statutory period to comply with the rule. It would be disruptive to current efforts to comply with existing regulatory policies, and it would hasten a decrease in liquidity at a time when needed most. The CFTC should strive to make the banking system as comfortable as it can during the recovery. The US cannot afford a lost decade caused by regulatory policy, as Japanese policy did in the 1990s. In addition to creating uncertainty and problems with liquidity, the Congressional Budget Office has estimated the proposed reforms will impose up to $19 billion in new fees for these institutions. These fees, new capital requirements, and efforts to discern and meet ambiguous regulatory standards simultaneously will have dampening effects on recovery in the US, without fixing the primary source of the financial crisis: derivatives. The proposed rule, as is, will continue to allow off balance-sheet transactions and over the counter derivatives to plague our economy. It incentivizes banks to find alternative forms of revenue rather than provoking them to voluntarily disclose liabilities. These incentives will inevitably lead to further complexities within the financial services industry and motivate firms not to disclose their dealings with covered funds, resulting in more “backroom deals” and further deadweight loss as the duel burden of regulatory compliance and evasion takes its toll on efficiency. As long as this occurs, banks and government regulators will continue to underprice credit risk, even with bans on proprietary trading.