STANY
The Security Traders Association of New York, Inc.

71 Broadway, 2K
New York, NY 10006
P. 212.344.0410
F. 212.943.8478
www.stany.org

KIMBERLY UNGER, ESQ
Executive Director

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By Electronic Submission

Department of the Treasury
Office of the Comptroller of the Currency
12 CFR Part 44
Docket No. OCC-2011-0014
RIN: 1557-AD44

Board of Governors of the Federal Reserve
12 CFR Part 248
Docket No. R-1432
RIN: 7100-AD82

Federal Deposit Insurance Corporation
12 CFR Part 351
RIN: 3064-AD85

Securities and Exchange Commission
17 CFR Part 255
Release No. 34-65545; File Bo. S7-41-11
RIN: 3235-AL07

Commodities Futures Trading Commission
17 CFR 75
RIN: 3038-AC

RE: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Dear Sirs and Madams:

The Security Traders Association of New York (STANY)[1], appreciates the opportunity to comment on the above referenced proposal of the Office of Comptroller of Currency, Federal Reserve Board,

[1] STANY is the voice of the trader in the New York metropolitan area and represents approximately 1,000 individuals who are engaged in the trading of securities. As such, we are uniquely qualified to discuss proposed rules and regulations affecting trading. STANY is the largest affiliate of the Security Traders Association ("STA"), a multinational professional association that is committed to being a leading advocate of policies and programs that foster investor trust, professional ethics and marketplace integrity and that support education of market participants, capital formation and marketplace innovation.

Neither STA, nor STANY, represent a single business or business model, but rather provide a forum for traders representing institutions, broker-dealers, ECNs, ATSs and floor brokers to share their unique perspectives on issues facing the securities markets. Our members work together to promote their shared interest in efficient, liquid markets, and their concern for investor protection. We believe that strong and efficient markets require an appropriate balance between effective regulation and innovation and competition.

Federal Deposit Insurance Corporation, the Securities and Exchange Commission ("SEC" or the "Commission") and the Commodities Futures Trading Commission ("CFTC") (collectively, the "Agencies") that would implement Section 619 commonly referred to as the Volcker Rule (the "Volcker Rule" or the "Rule") of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Agencies proposed regulations set forth to implement the Volcker Rule will herein be referred to as the "Volcker Proposal" or the "Proposal."

STANY and its members are primarily concerned with those portions of the Volcker Proposal, Section __.4.b, which define the exemption for market making to otherwise prohibited proprietary trading and the tests by which the Agencies propose to distinguish market making from proprietary trading. STANY recognizes that the Dodd-Frank Act requires the Agencies to implement restrictions on proprietary trading, as well as to provide an exemption for market making activities. We note, however, that the Agencies have some discretion in implementing these mandates. We submit that this discretion should be informed by the policy judgments made by Congress. So, while we believe that Congress sought to limit proprietary trading in the Dodd-Frank Act, we do not believe that Congress thought the issue to be of such import that every vestige of it should be stamped out within every depository institution and any of its affiliates.

<u>Congress and the Agencies recognize the vital role played by market-making</u>
The mandates of the Dodd-Frank Act are numerous and far reaching, however, in directing the implementation of legislation aimed at reducing systemic risk, Congress was careful to acknowledge and preserve certain functions performed by banks and banking related institutions which it deemed vital to the orderly functioning of the markets. These statutory, explicitly "permitted activities" include among others, market making and market making related activities, risk-mitigating hedging, and trading on behalf of customers. It is clear from the language of the Dodd-Frank Act that Congress recognized the value of these "permitted activities" and directed the Agencies to fashion regulation which, while mitigating risks to the over-all economy, would also preserve these critical trading functions.

STANY strongly supports the exemption for market making and customer facilitation related activities and believes that in order to make these exemptions meaningful, the Proposal must be reconsidered. The overly complex compliance requirements and uncertainty in a number of the Proposal's definitions, as well as the difficulty inherent in distinguishing legitimate marking making from proscribed activity are likely to result in decreased liquidity across effected markets. It is likely that banks and bank related entities currently making markets will reduce or limit the size and type of positions in which they make markets for fear of triggering prohibitions. Decreased liquidity will result in increased trading costs and have consequences on capital formation and the availability and cost of credit. Investors and issuers will find it more costly to find liquidity, invest, raise capital, borrow, and hedge risks.

<u>Background of the Volcker Rule</u>
Subject to certain exceptions set forth in the Volcker Rule and in the Volcker Proposal, the Rule prohibits a "banking entity" from engaging in "proprietary trading" and from investing in or sponsoring a "private equity fund or hedge fund." The Volcker Rule also prohibits certain transactions between a banking entity and a private equity fund or hedge fund that is advised, managed, or sponsored by the banking entity or any of its affiliates.

Under the Dodd- Frank Act, Congress tasked the Agencies with submitting a proposal to implement the Volcker Rule, clarify definitions and exceptions in the Rule and, in certain instances, establish additional exceptions to the Rule. Additionally in the Volcker Proposal, the Agencies set forth details regarding compliance programs which banking entities would be required to establish as well as detailed reports of trading activities, that banking entities, which rely on exemptions to the proprietary trading restrictions, will be required to maintain and submit to the Agencies. These trading reports will be used by the Agencies to distinguish trading activity which falls within the exemption for market making (and other exempt trading) from trading that is "proprietary" and prohibited by the Rule.

<u>Various provisions in the proposal are inconsistent with the intent of Congress</u>
Although there is little in the way of documented legislative history[2] behind the Rule, the underlying objective of the Volcker Rule is to restrict certain proprietary trading and investing activities by banking institutions that are eligible to receive government support. The Rule aims to prevent banks and banking entities which receive federal deposit insurance and beneficial access to the Federal Reserve discount window loans from using these government subsidies to engage in proprietary trading[3] and fund investing activities that could subject the banks and banking entities to undue risk. Certain banking activity, including proprietary trading has also been viewed as creating a potential conflict of interest between the banking entities and their customers and the Volcker Rule was made part of Dodd- Frank to restrict banks entities from using capital for purposes unrelated to servicing customers.

Despite these restrictions, in drafting Section 619 of the Dodd-Frank Act, Congress recognized certain vital functions performed by banking entities and explicitly protected these activities from the statutory prohibitions by providing a list of "permitted activities" not subject to the Volcker Rule. Congress specifically acknowledged that market-making, underwriting, asset management, and other activities listed in Section 619(d) of the Act were critical to capital formation in the economy and essential to preserving the robust liquidity in U.S. capital markets.

Although the Agencies have specifically carved out market making and customer facilitation activity from the ban on proprietary trading, and have sought "to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide these services", we are concerned that certain aspects of the Proposal are likely to narrow the scope of "permitted activities" that Congress specifically preserved. As expressed best by members of the House Committee on Financial Services, Chairman Spencer Bachus, Vice Chairman Jeb Hensarling, Chairman of the Subcommittee on Financial Institutions and Consumer Credit, Shelley Moore Capito and Chairman of the Subcommittee on Capital Markets and Government Sponsored Enterprises, in a letter to the Agencies dated December 7, 2011:

> To be implemented effectively, the Volcker Rule depends on regulators being able to identify and define the differences between "proprietary trading" and "market making." Yet as a matter of practice, and as the proposed rules abundantly demonstrate, making such distinctions will be difficult, if not impossible.

The authors further acknowledge:

> …the tremendous challenges [the] agencies face in implementing the statute, but the <u>current proposals are not clear and need work</u>. Despite assurances by

[2] The Volcker Rule was endorsed by President Obama in early 2010. In December, 2009 the House of Representatives passed (H.R. 4173) its version of financial reform legislation which did not include the Volcker Rule. In April, 2010 the financial reform legislation introduced by the Senate included the Volcker Rule - Senate Bill (S.3217) and passed without debate on the Rule. The Rule was then discussed in the discussed and passed with minor amendment in the House-Senate Conference Committee proceedings in June 2010.
[3] Letter from Senator Kay R. Hagan to the Agencies dates January 13, 2012, page 1.

the sponsors and supporters of the Dodd-Frank Act, European as well as Asian nations have all announced they will not be adopting the Volcker Rule. (Emphasis added)

This Congressional mandate was reiterated in a letter to the Agencies from Senator Kirsten E. Gillibrand dated January 25, 2012 stating the need for the Agencies to strike a proper balance between the safety and competitiveness of the US financial institutions:

> In crafting this legislation, Congress sought to balance the need of financial institutions to hold assets in order to maintain liquidity in the marketplace with the restrictions imposed by the rule. The ability of firms to continue to make markets, particularly in less liquid markets where buyers and sellers are not always immediately available, is important for the continued competitiveness of the US financial industry and the broader strength of the US economic system which relies on deeply liquid financial markets.

<u>The Nature of Market Making</u>
Market making and market making related transactions account for a significant percentage of trading volume in the listed options markets and equities markets, and an even higher percentage of the transactions in bond markets. Currently, most market making is conducted by bank affiliated broker-dealers who would be directly subject to the Dodd-Frank Act. It is therefore vital that regulations implemented by the Agencies preserve market making and that inadvertent or unintended harm does not come to the U.S. capital markets due to either a misunderstanding of the nature of market making or to the inherent difficulty of distinguishing between market making and proprietary trading.

While the Volcker Proposal as written relies heavily on existing market maker requirements, there are significant differences between market making in the various markets. Equities market makers are different than bond market makers which are different than option market makers. Each is governed by distinct sets of rules and requirements that are unique to each specific market. In the equities market certain distinctions are made in existing rules and requirements depending on such things as volume thresholds. The same rules for liquid securities are not universally applied to illiquid securities or to equities traded in the OTC Market. These differences are even more strongly highlighted in the options market, where the majority of trading is done in the top ten underlying names, but in which there are over three thousand listed option underlyings (with over 480,000 strikes) to which market makers, on many of the options exchanges, are required to continuously commit capital. Unlike current rules governing market making, the Volcker Proposal, would treat market makers across all asset classes similarly. The impact of the Proposal is likely to be much greater however in markets with less liquid securities which rely more heavily on market makers for liquidity.

Nevertheless, in liquid as well as illiquid markets, whether acting as agent for customers or as principal supplying liquidity; market makers contribute to maintaining fair and orderly markets. Market makers act as intermediaries and stand ready to buy and sell securities in response to demands from investors. Without market makers investors would have to find counterparties on their own. While counterparties often exist, especially in the most highly liquid stocks, it is beyond the abilities of investors to find those counterparties without an intermediary. Just as often, especially with illiquid stocks and large blocks of stock, there is no immediate counterparty. In the interests of immediacy, buyers and sellers will interact with market makers who, for a price, offer immediacy and certainty.

<u>The Proposal's Approach to the Market Making Exemption is Complex and Impracticable and is likely to have a chilling effect upon market-making activity.</u>

The Proposal carves out exemptions to the proscription against proprietary trading, but each of these exemptions has a number of criteria required to take advantage of the exemption. In addition to the complex monitoring regime, the Volcker Proposal provides a rebuttable presumption of non-compliance for certain types of trading activity. This prejudice against market makers is implicit in the approach that the Agencies have taken. The Proposal establishes a process by which trades are presumed prohibited unless, certain onerous tests were met.

Moreover, the metrics proposed by the Agencies to "determine" whether activity conducted by regulated entities constitutes legitimate and permitted "market making" labors under misunderstandings of both the nature of market making and the ways in which market makers are compensated for the significant risks that they assume.

Likewise, the Volcker Proposal shows a bias in favor of agency transactions, which we believe to be unwarranted and inconsistent with the way in which the majority of market makers transact legitimate bona fide market making activity. While market makers in liquid equities often buy and sell contemporaneously as agents, in less liquid equities, bonds, and other securities market makers more often provide liquidity by acting as principal.

As mentioned above, where there is no immediate counterparty to a trade, market makers take the contra side of the trade and in so doing assume risk and securities that they then hold in inventory. Effective market making requires that market makers retain discretion to hold positions in inventory. The amount of time that a market maker may hold a security varies and is dependent upon liquidity, market conditions and other variables, making "holding periods" an inadequate test to determine whether a position was obtained as part of bona fide market making or as a "proprietary" trade.

The bias against principal transactions seriously impedes the ability of market makers to provide liquidity in illiquid markets. Each time a market maker buys or sells securities as a riskless principal, these transactions by their very nature, could be deemed "proprietary."[4] Unfortunately, that is the very nature of market making and it cannot be expected that market making can be effectively performed simply by relying on agency transactions.

The Agencies intention is to use the various proposed risk and profit metrics to restrict market making activities to those that are consistent with their definition of market making and related activities as those that "seek to generate profitability primarily by generating fees, commissions, spreads and other forms of customer revenue that are relatively, though not completely insensitive to market fluctuations and generally result in a high level of revenue relative to risk over an appropriate time frame." [5] Unfortunately, this understanding of market making is flawed. This focus on the source of revenue ignores the fact that market makers assume risk in making markets and that positions purchased in furtherance of customer service will invariably result in either a profit or loss for the market maker. Acquiring positions in inventory (an essential part of market making) involves the assumption of risk and either the accumulation of profits or losses when those inventory positions are later sold. Profit or loss is part and parcel of the services provided by market makers to customers whether from providing liquidity due to mark imbalances, facilitating block trades, or hedging positions acquired as a part of market making. To ignore the risk and possible reward attendant to market making and to simply view fees and commissions as legitimate revenue is to miss the essence

[4] Section 13of the Bank Holding Company Act and the Proposal provided that "proprietary trading" includes engaging as principal for the "trading account" of a banking entity in any purchase or sale of one or more covered financial positions. Under the Proposal a "trading account" is any account used by a banking entity to acquire covered financial positions for short term resale, benefit from short term price movements or realize short term arbitrage profits.

[5] The Proposal at page 94

of market making and customer facilitation. By placing the emphasis on the source and nature of fees and revenues in determining whether activity is market making or propriety trading, the Proposal will unnecessarily restrict the ability of market makers to accumulate inventory and to manage their inventory.

Incentives to provide necessary immediacy are dependent on both flexibility and the opportunity to offset risk and make a profit on anticipated price changes. The threat of regulatory action and sanctions will cause market makers to be less inclined to accept trades at the times most necessary and expose themselves and their firms to the inherent risks.

The already overly complex standards for rebutting a presumption in favor of proprietary trading are made even more troubling by the fact that some of the standards for determining whether a transaction is permissible under an exemption look to intent rather than action. To provide additional clarity and guidance regarding the definition of a "trading account" the Proposal's supplemental commentary explains, "the proposed rule also includes a rebuttable presumption that any account used to acquire or take a covered financial position that is held for 60 days or less is a trading account…unless the banking entity can demonstrate that the position was not acquired principally for short term trading purposes." The rule further explains that intent, rather than actual liquidation of a position can bring a banking entity within the definition of trading account. "This part of the trading account definition does not require the resale of the position; rather it requires only an intent to engage in any form of transaction on a short term basis (including a transaction separate from, but related to, the initial acquisition of the position) for the purpose of benefitting from a short-term movement in the price of the underlying position."

This rebuttable presumption that any account that holds covered financial positions for sixty days or less is a "trading account "will act as a disincentive for banking entities to make markets in any but the most liquid securities, as any securities that cannot be immediately disposed of could be viewed as proprietary. The adverse impact on a banking entity's willingness to make markets will likely be felt more keenly in less liquid securities, making those securities even less liquid than they already are.

Likewise, the conditions needed to be met regarding the risk mitigating hedging exemption create uncertainty as to whether hedging activity will meet the exemption and whether the exemption can be applied to a bank and banking entity's entire portfolio. Although the Volcker Rule carves out a provision for risk-mitigating hedges, the Proposal limits that hedging activity by requiring that each hedge be "reasonably correlated" to an underlying position. This limitation fails to take into consideration that certain types of hedges, which are vital to risk mitigation, will not appear to be highly correlated.

<u>A broader definition of market making will serve the markets and economy better than the narrow interpretation offered in the Proposal</u>

We would also respectfully observe that the various regulatory bodies that supervise broker-dealers, despite decades of rule-making in this area, have not so far managed to construct a practical definition that meaningfully distinguishes "bona fide" market making from other trading activity. As a result, any exemption that is created by the Agencies is likely to be either too narrow, in that it exposes the banking entity and its affiliates to the sort of risks to safety and soundness that Congress sought to prevent, or too broad because it prevents the depository institution and its affiliates from engaging in useful activities that do not pose undue safety and soundness concerns.

In this case, STANY believes that the safety and soundness risks posed by proprietary trading are relatively small, while the useful activities that would be hampered by onerous limitations on market making are important to the national economy. Accordingly, the Agencies ought to err on the side of an overbroad definition of market making, as that is the approach most likely to be of greatest benefit to the national economy.

The Proposal, for example, would restrict market making that was too profitable and would prohibit firms from paying traders based on the profitability of the trading desk. However, in the highly competitive market for financial services, it is ruinous to maintain unprofitable or marginally profitable operations. While businesses sometimes speak about customer accommodation, the reality is that market forces will punish firms severely that accommodate customers unprofitably. The firms we know will not maintain such a market making operation, or any other marginally profitable customer accommodation, for very long. Since the bulk of market making is performed by firms that will be impacted by the Volcker Proposal, we believe the effect of this "profit-based" definition will be the elimination of the vast majority of market making functions.

The proposed rules for trader compensation will act as further disincentives for firms to risk their capital as market makers. The incentive and discretion to supply liquidity by taking extra risk in light of extra expected profit is important at the level of the individual trader on a market making desk. Firms generally base a trader's pay on profitability to make sure they are properly incentivized to avoid losses in a highly competitive and difficult business. It should be noted that such compensation arrangements are widely used by privately-owned partnerships with a personal interest in discouraging undue risk-taking behavior by their trader-employees. Profitability-based compensation arrangements encourage traders to exercise due care. The prevalence of the practice at privately-owned firms provides empirical evidence that profitability-based incentives are a less-risky and safer practice than salaried programs in market making operations. The Proposal would therefore, in our view, perversely impose greater risks of loss for depository institutions and their affiliates that continue to maintain market making operations than a rule that would permit profitability-based compensation programs.

In general, STANY believes that the Proposal should be amended to employ market disclosures intended to encourage competition as the means to limit excessively profitable proprietary trading in market making operations. We believe that these rule-making techniques, which have been applied successfully to cure other market issues, are more likely to yield socially beneficial behavior than draconian proscriptions. Rule-making is more successful when allied with competitive market forces.

<u>Negative Unintended Consequences on Markets, Investors and Issuers</u>

Unfortunately, the uncertainty and complexity of the Volcker Proposal is likely to have consequences that thwart the acknowledged intention of Congress to protect market making and related customer facilitation functions of banks and bank related entities. Well before implementation of the Volcker Proposal, but in anticipation of the Rule, banks and bank related entities have begun divesting themselves of their market making units and/or ceased providing market making functions.

The compliance oversight proscribed by the Volcker Proposal is enormous. Every transaction which is done in recognition of an exemption- all market making trades, risk mitigating hedges, etc. - will have to be justified as such. Given that many of these transactions involve the use of firm funds or require a firm to hold securities in inventory, even if for a limited time, pressure of after-the-fact judgment will be tremendous. Together with the regulatory uncertainty that comes with the need to justify each transaction, the compliance burden is likely to cause firms to exit the business of market making.

It is likely that the market making function currently performed by banking entities will shift to financial institutions that are less regulated and less transparent. In the short term we question whether hedge funds and non-bank affiliated broker dealers have access to sufficient capital to replace bank entities and their related affiliates. Likewise, potential migration of market making activities to firms outside the regulated banking sector could bring with it a whole new set of regulatory challenges which should be considered by the Agencies.

There has been a decline in the number of firms willing to make markets in equities since the markets moved from quoting in fractions to decimals. The implementation of Reg. NMS and the rise in electronic trading has further eroded market making. The complex compliance and record keeping requirements in the Volcker Proposal will push the economic viability of market making to the limit. The role performed by some of these former market makers has been filled by "high frequency traders" who, although under no obligation to do so, provide liquidity. Unfortunately, concerns have been raised that HFT do not adequately serve the place of market makers especially when needed most. We question whether the SEC, or any of the Agencies, has studied the potential impact upon the markets if these liquidity providers disappear or fade during times of extreme volatility. Rather than making it more difficult and costly for market makers to serve the markets, we believe that the Agencies should be incenting traditional market making as a valuable part of the financial services markets.

<u>Additional Areas of Concern</u>

STANY has focused its comments on those areas of the proposal of most concern to its members and the customers that they serve. Nevertheless, there are certainly other important aspects of the Proposal which are troubling and which we believe necessitate change before a final Volcker Proposal is implemented. We will briefly mention several other areas of concern.

<u>Enforcement and Oversight</u>
The regulatory uncertainty of the Volcker Proposal is exacerbated by the number of agencies involved in rulemaking and oversight. Absent a clear plan for implementation and enforcement, there exists the real possibility of inconsistent enforcement across regulatory agencies. We suggest that any version of the Volcker Proposal include a plan that would ensure a uniform approach to enforcement, as well as one that would avoid, or at least diminish, the duplication of enforcement efforts across agencies.

<u>There needs to be greater clarity regarding exemptions relating to Government and Municipal bonds</u>

Clearly, the Agencies and Congress recognize the potential impact of market making restrictions on liquidity as the Proposal conveniently exempts U.S. and certain municipal Bonds. Limiting market making would likely increase the government's funding costs and consequently, the Agencies have carved out an exception which will serve to protect the market for U.S. and some municipal securities. While we believe that it is appropriate that the liquidity in the markets for government securities remains intact, we think it prudent and appropriate that all municipal securities, including transactions in obligations of an agency of any state or political subdivision be specifically exempt.

<u>Definitions of "Hedge Funds", "Private Equity Funds", "Covered Fund", and "Banking Entity" are so broad as to capture a variety of funds and other legal entities that were not intended to be covered by Congress.</u>

The Volcker Rule prohibits a banking entity from having ownership interest in, or acting as a sponsor to a "hedge fund", "private equity fund" or "similar fund" ("covered funds") as determined and defined by the Agencies tasked with writing regulations to implement the Volcker Rule. The Volcker Proposal defines "hedge fund" and "private equity fund" to include any and all entities relying on either Section 3(c)(1) or Section 3 (c) (7) of the Investment Company Act of 1940 are overly-broad and extends way beyond what was intended by Congress. It also includes within “covered fund” any investment vehicle that is considered a “commodity pool” under Section 1a (10) of the Commodity Exchange Act.

These restrictions were intended to prevent a bank or banking entity from circumventing the restrictions on proprietary trading by structuring its proprietary positions as an investment in a hedge fund or private equity fund. However, as written the Proposal will impact a number of entities which neither advance the intention of Congress nor could reasonably be deemed to be “hedge funds” or “private equity funds.” We are concerned that the definition of covered fund could be seen to make the Volcker Proposal applicable to every affiliate of a bank, including SEC registered broker-dealers, insurance companies, issuers of asset backed securities, and venture capital firms. These interpretations extend far beyond what we believe was the intention of Congress in passing the Dodd-Frank Act and should be reviewed and reconsidered by the Agencies.

<u>Conclusion</u>

STANY appreciates that the task of implementing Dodd-Frank is enormous in both its scope and potential impact. The Agencies have been faced with making decisions which could result in unintended consequences that could undermine the stability of the U.S. financial system and have far reaching impact on the U.S. and global economies. It is clear that the Agencies have put a tremendous amount of effort into fashioning the instant Proposal, however, in its present form, the Volcker Proposal reads more like a concept release than a final rule. From the number of questions asked by the Agencies in the Proposal, it is evident that a significant amount of work still needs to be done on the Proposal.

We urge that additional consideration be given to the breadth of the proprietary trading ban and that greater clarity be provided concerning what constitutes permissible activity. An attempt to distinguish legitimate and permissible market making from “speculative and risky” market making is subjective and too difficult to be a practical. More effective than the multiple and confusing tests outlined in the proposal would be a requirement that banking entities engaged in market making have sufficient capital relative to risk.

We appreciate your consideration of our comments on the Proposed Rules. If we can answer any questions or provide further information, please do not hesitate to contact us at 212.344.0410.

Respectfully submitted,

Kimberly Unger
Executive Director