April 15, 2012

Re: Comment Letter on the Proposed Rulemaking Implementing the Volcker Rule **– Proprietary Trading**

Ladies and Gentlemen,

A financial disaster of the magnitude of the subprime crisis cries out for reforms that will help us avoid repeating this dire history. Some observers cry out for better regulators who would do more with the regulations they have, but more vocal are the people, often regulators, who claim we need better rules and institutions. The latter imply that had such reforms been in place earlier on, the Great Recession would have been avoided. Many proponents of the Volcker Rule believe it will reduce the chances of another crisis. I disagree, but I do not view its costs as particularly high and it may serve the purpose of reducing the discretionary powers afforded to regulators. Therefore, I do not oppose it.

A brief summary of the Volcker Rule, were one to explain it to the lay person, is that it is a way to ensure that banks do not use deposits to engage in proprietary trading. This is an extremely misleading statement that adds fodder to an already confused debate over the causes of the financial crisis. Thus, I focus my comments on clarifying what the Volcker Rule would do, as well as discussing why the rule may be useful in reducing regulatory discretion.

First, I want to point out that the Volcker Rule will not prevent a bank from using deposits to engage in proprietary trading. Proprietary trading is trading on one's own account. By definition, it means trading with one's own money, not someone else's money. So, the idea of proprietary trading with depositors' money is an oxymoron and not worthy of being outlawed. Some firms, such as MF Global, have been accused of using client's money as if it were their own (e.g., such as by taking a long position in sovereign debt with money that belongs to farmers who invested their funds to hedge crop prices). This behavior is already illegal and if it were proven that an employee of MF Global stole money from a client's account in order to cover bad bets by the company, that employee would be sent to jail. Thus, proprietary trading does not involve using customer's funds either legally or illegally.

So when Volcker said that banks should not be making bets with deposits, he was a little loose with his definition of "making bets" and he was misleading in implying that proprietary trading has anything to do with deposits. In actuality, it is legal for banks to make bets with deposits as long as they have sufficient capital and the bets always involve loans. For example, making a loan to a timeshare developer with deposits is not illegal but it is a bet that the timeshare will do well enough to repay the loan. So when Madison Guaranty made a loan to the Clintons to develop a timeshare named Whitewater, it was making a bet that the development would be successful enough to repay its depositors. In fact, the deal did not work out and the Clintons lost money on it, as did Madison, and this bad bet was a large part of the reason why Madison was shut down. The loan was made with deposits and the FDIC was forced to pay out funds to cover the losses after Madison was closed. A ban on prop trading would not have prevented such a loan or the losses associated with it.

One way in which proprietary trading could cause problems at banks that take in deposits is if prop trading is so unsuccessful that the firm loses all of its own money and then begins to make bets when it is insolvent. This is more likely to occur if regulators do not shut down the firms at the point of insolvency. But one could incur such a loss by making loans as easily as one could with prop trading and

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these other methods of imposing losses on the taxpayer are not outlawed by the Volcker Rule. They are not allowed under a law called FDICIA, but bank regulators routinely ignore that law.

The Examiner in the Lehman bankruptcy, who I think had a fairly balanced view of the factors that caused the firm's demise, did not mention proprietary trading as an important facet of this failure. Nor do many people mention prop trading as a major part of Bear Stearns' troubles. Both firms lost money by making long-term investments in real estate. Indeed, one could argue that if they had been trading these assets in a prop trading vehicle they might have survived longer because there is a chance they would have *sold* their stakes and not held onto the real estate all the way into 2008. In any case, neither of these failures owes to such trading behavior and the Volcker rule, if it had been in place before 2007, would not have helped to keep them healthy.

A more precise description of what the Volcker Rule attempts to do requires an understanding of the financial structure of a typical large financial firm. These firms are often structured as holding companies whose assets are mainly, but not entirely, equity stakes in subsidiaries. Some of the subsidiaries are set up to make markets in securities; others to take in deposits and make loans, and still others to act as brokers for customers who want to trade stock. Sometimes a subsidiary is set up to do trading for the holding company but such proprietary trading could be done by the parent company itself. A good example of such a firm is Drexel, which had a broker-dealer subsidiary for clients who wanted to trade stocks and bonds, and which had invested a substantial sum itself in speculative-grade bonds. Drexel is an interesting example because the holding company was forced into bankruptcy by the SEC. Besides changes in fundamentals that reduced its revenue, Drexel became distressed because of a large fine imposed on it by the SEC for insider trading violations. Shortly thereafter, Drexel management claimed that the losses were limited to the holding company and that its subsidiaries were in good shape. Indeed, they argued that the subs had excess capital and therefore Drexel intended to upstream those excess funds to its holding company so the parent could pay its debts. The SEC stepped in on the basis of "safety and soundness" rules and refused to grant Drexel permission to upstream the funds. As a result, Drexel's holding company was unable to pay its debts and it was forced into bankruptcy.

One can see from the example of Drexel that regulators already have the power to stop a financial firm from dangerous behavior under the umbrella of safety and soundness regulations. But regulators have been slow to use the powers that they already have. Thus, the CFTC might have stepped in much earlier in the case of MF Global and told the firm that it was unsafe and unsound to make large bets on sovereign debt. Likewise, the SEC could have forced Lehman to reduce its exposure to real estate back in 2007. And the Federal Reserve could have told Citicorp that its SIV structures were unsafe. Not only did these regulators not use their safety and soundness powers but most of them did not enforce rules that involve less discretion. For example, Lehman's Examiner states that it was obvious the firm was insolvent by summer 2008, but the SEC's Erik Sirri begged Lehman not to go bankrupt in September. Sirri and the SEC had the job of enforcing capital regulations, not begging the firm to consider adhering to them.

My second major comment then is to point out that the Volcker Rule is likely to be another rule that financial regulators ignore. They already routinely ignore rules that might have prevented the financial crisis. Nearly all of the regulators that are required to implement the Volcker Rule have suggested that they will ignore the law because it is too difficult for them to implement. Thus, the Volcker Rule provides an avenue for regulators to pick and choose which laws they want to enforce.

Because the rule is so poorly written, as is much of Dodd Frank, regulators think they should have discretion to ignore it and take matters into their own hands. This is indeed a slippery slope. Instead of sliding down it, the CFTC should ask Congress to revise Dodd Frank so that all of its components are either enforceable or taken out of the law.

So go ahead and finalize the Volcker Rule and then ignore it. Then people might have a better sense of the role of lax regulation in financial crises and take action to reduce the discretionary powers of financial regulators.

Sincerely,

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