

# AMERICAN ACTION FORUM

September 4, 2018

Commodity Futures Trading Commission,  
1155 21st Street NW,  
Washington, DC 20581

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

To Whom it May Concern:

The American Action Forum (“AAF”) scholars appreciate the opportunity to submit comments on the notice of proposed rulemaking (“proposed rule”) amending the regulations implementing section 13 of the Bank Holding Company Act (“BHC Act”), known as the Volcker Rule. This rule has been proposed by the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“Board”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities and Exchange Commission (“SEC”), and the Commodities and Futures Trading Commission (“CFTC”) (collectively the “Agencies”).

AAF is an independent, nonprofit 501(c)(3) organization that is not affiliated with or controlled by any political group. Its focus is to educate the public about the complex policy choices now facing the country and explain as cogently and forcefully as possible why solutions grounded in the center-right values that have guided the country thus far still represent the best way forward for America’s future.

AAF experts have long held that proprietary trading was not a cause of the 2007-2008 financial crisis. As then-Treasury Secretary Timothy Geithner remarked in 2010, the root cause was “classic extensions of credit.” As such, the crisis was caused by banks acting in their primary capacity as lenders of credit (albeit on poor risk assumptions) and not as a result of securities trading. Virtually every financial crisis in history has been a lending-related crisis. In point of fact, banks performing securities trading helped avert the worst of the crisis, as well-diversified organizations were able to partially absorb their losses and stabilize failing organizations.

The Volcker Rule has been described as a solution in search of a problem, but that description understates the cost. As European and Asian banks are not prevented from proprietary trading, U.S. banks are at an international competitive disadvantage, both in terms of the suite of products they can offer and in the unnecessary compliance burden they must assume. The OCC itself estimated that the Volcker Rule would cost the industry \$4.3 billion annually. By making it more difficult for U.S. banks to engage in securities trading, the Volcker Rule drives these activities

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from well supervised and regulated U.S. banks to the shadow banking industry, and at a time when the Federal Reserve must spread its resources to cover Volcker Rule compliance.

In seeking to ban proprietary trading, the Volcker Rule also imperiled the closely related market-making functions of banks. In the absence of an independent exchange for corporate securities, banks must be permitted to perform market-making activities. The current Volcker Rule requires banks to differentiate between proprietary trading and market-making—a distinction that lies only in the intent of the trader. Rather than risk infringement, banks are forced to close their market-making operations, which means that consumers lose their ability to trade quickly and at a steady price, or even at all. If large numbers of investors were to choose to sell their securities and were not able to, the resulting lack of market liquidity would likely bankrupt the industry. The Volcker Rule contributes to cost-of-capital increases and liquidity decreases, two goals entirely counter to the purpose of the reform. All this, and the Volcker Rule in no way makes the next financial crisis less likely.

Ten years after the financial crisis, the Agencies are now reassessing the regulatory framework in the form of Volcker 2.0. This rule, if finalized, would largely preserve the Volcker Rule intact but would have two key ramifications: it would both exempt smaller banks from the full scope of the Volcker Rule; and it would provide much needed guidance on what trades are prohibited under the standard.

Volcker 2.0 would remove one of the more controversial elements of the Volcker Rule, the 60-day “rebuttable presumption.” By removing the proscription against all investments held for less than 60 days, the proposed rule shifts the burden of proof as to the admissibility of holding an investment from the bank to the regulator. This proposed rule does not, however, mean that the regulator would have any greater success in proving the difference between proprietary trading and market making.

The proposal would no longer require banks to demonstrate, under the intent-based purpose test or “prong,” how their every trade either meets a customer demand or specifically hedges against a specific risk. This is a welcome reform in itself, but the intent prong would be replaced by an accounting “prong,” and it is not clear that this is an improvement. In seeking to establish a “bright line,” the Agencies open themselves to significant challenge in scope of application, as the new rule may cover more trades than the old. The accounting prong would also require the banks to do significant additional reporting, with some industry participants anticipating an exponential increase in data points that they must provide.

The key failing in the Volcker 2.0 proposal is the lack of further guidance over the definition of covered funds. The current definition applies the Volcker Rule to not just banks but, in certain cases, bank affiliates, impacting some registered investment funds. An over-broad definition of

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covered funds decreases the investment options available to banks and the availability of capital to the market.

The Volcker Rule is so inimical to the healthy functioning of the financial services industry that it is difficult to support reform, as opposed to wholesale repeal, although a reduction of unnecessary burden on U.S. banks is welcome. There are sufficient uncertainties as a result of the drafting process that we support the Agencies' efforts to clarify and streamline the Volcker Rule. While such efforts are helpful, the Agencies would do better to dismantle the rule entirely and begin from scratch with a robust risk governance apparatus that has a much better chance of preventing the next financial crisis.

AAF stands ready to provide research and additional assistance to the Agencies and other interested parties as needed.

Sincerely,



Douglas Holtz-Eakin  
President  
American Action Forum



Thomas Wade  
Director, Financial Services Policy  
American Action Forum