Testimony of the Securities Industry and Financial Markets Association submitted for the record to a joint hearing of the House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit

January 18, 2012

SIFMA[1] welcomes the opportunity to submit testimony in connection with the joint hearing of the Subcommittees on Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit on the impact of the Volcker Rule on markets, businesses, investors and job creation. SIFMA represents hundreds of firms engaged in the financial services industry. Our members have sought to provide constructive input throughout the policy debate over the Volcker Rule. While clearly SIFMA did not support the Volcker Rule during the legislative process, our members recognize that it was enacted by Congress and is now the law of the land. Indeed, many of our members have already begun the process of complying

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

with the Volcker Rule by terminating their walled-off proprietary trading operations in anticipation of the Rule's effective date.

On November 7, 2011, four out of the five Agencies tasked with promulgating regulations to implement the Volcker Rule published a proposal that seeks public comment on 1,400 questions of increasing detail and complexity. The fifth Agency released its proposal just last week. We are deeply concerned that the proposed regulations issued by the Agencies take an overly prescriptive and granular approach, extending beyond congressional intent and endangering the liquidity of U.S. markets, the safety and soundness of its financial institutions, and the ability of U.S. corporations to raise capital, all of which are necessary for economic growth and job creation.

The statutory text explicitly preserves economic and socially useful trading and market activities which the Agencies should carefully implement.

In drafting the statutory Volcker Rule, Congress identified a number of important and socially useful trading functions that are traditional to banking entities, and explicitly preserved these functions as "permitted activities" in the statutory text. These permitted activities include market making-related activities, risk-mitigating hedging, underwriting, and trading on behalf of customers, among others. These are not "loopholes" as some would argue, but deliberate choices made by Congress to preserve liquidity in U.S. financial markets. Congress appreciated the impact that freezing up markets in many asset classes would have on the real economy. These

important trading activities are crucial to U.S. corporations, asset managers and their Main Street investors, capital formation, and employment and job creation. Unfortunately, in drafting the proposed regulations the Agencies have proposed a compliance and enforcement regime that would ultimately restrict these permitted activities in a manner that exceeds their statutory authority and conflicts with congressional intent. By adopting an overly rigid, prescriptive and burdensome construct, the proposed regulations will have a severe chilling effect on these traditional and economically beneficial trading activities that Congress explicitly identified as necessary to the proper functioning of U.S. markets. The proposed regulations will severely impair U.S. markets in many asset classes, up to now the deepest and most liquid capital markets in the world. As a result of the unnecessarily rigid restrictions on trading activity in these markets, U.S. issuers and investors would suffer from less liquid markets resulting in greater costs of issuance and transaction costs, and ultimately cost of capital, creating dislocation at a sensitive time for the economy.

For instance, the proposed rules are unclear regarding whether the entire municipal securities market is subject to the provisions for permitted trading in state and local government obligations. Subjecting portions of the municipal market to the proposed Rule's restrictions will lead to immense confusion, result in less liquidity,

and less access for municipal issuers to low cost financing for essential government projects.

[The proposed regulations request comments on whether permitted trading activities in obligations of any State or political subdivision thereof should be extended to State or municipal agency obligations. The municipal market is made up of over 50,000 different issuing entities and one million CUSIPS outstanding. Depending on the law of a particular state, an affordable housing or transportation bond in one state may be issued by a state or county, whereas in a different state a bond for the same purpose might be issued by a state or county agency or authority. Unless all municipal securities (as defined by Section 3(a)(29) of the Securities Exchange Act of 1934) are subject to the provision for permitted trading in state and local government obligations, there will be no consistency as to the types of municipal securities that are exempt from the Volcker Rule. This disparate result will lead to immense confusion in the municipal securities market and affect the safety and soundness of the municipal market – by some estimates at least 30% of municipal bond issuances may fall outside the permitted trading in government obligations.]

Another fundamental problem with the proposed regulations is their strong bias toward agency, as opposed to principal, markets. Market makers provide liquidity by acting as a principal, not an agent, in most asset classes. In serving as a market maker for a customer in the U.S. corporate bond market, for example, a banking entity buys a

bond from or sells a bond to a customer with the knowledge that there may be little chance of rapidly reselling the bond and a high likelihood they will have to hold onto that bond for a significant period of time. The market maker thus becomes exposed, as principal, to the risk of the market value of the bond in a way that a market maker in liquid equity securities, who may be able to buy and sell nearly contemporaneously and generate revenue off of the spread, is not. This model of taking principal positions as part of market making operates in most other markets as well. Most markets have low liquidity, few participants and no centralized exchanges. The markets for commodities, derivatives, municipal securities, securitized products and emerging market securities, among many others, are characterized by even less liquidity and less frequent trading than U.S. corporate bonds. As just one of many possible examples, the Agencies' proposal so restricts market making activities as to seriously impair the ability of market makers to make markets in illiquid products by effectively removing the discretion of market makers to enter into transactions to build inventory, which is one of the most important elements of market making. An overly restrictive market making-related permitted activity will significantly decrease liquidity and increase price volatility in these markets, making it more difficult for market participants to use the financial markets to invest or hedge commercial exposures. In addition, a narrow market making-related permitted activity will impair capital formation, which is dependent upon the liquidity of secondary markets. A study that explains potential

impacts on that liquidity was released last month by SIFMA in conjunction with Oliver Wyman.[2]

The statutory text also contains an explicit provision permitting risk-mitigating hedging activity, which is crucial to the safety and soundness of financial institutions. Unfortunately, the proposed regulations impinge upon legitimate hedging activities, which must be protected for the health of banking institutions and the financial markets. As just one of many possible examples, the requirement that each hedge be "reasonably correlated" to a particular underlying position is particularly problematic for scenario hedges, where trading units enter into hedges to mitigate the risk of unlikely "tail" events that might otherwise have a devastating impact on the trading unit. Scenario hedging, due to the significant but infrequent risk it is trying to mitigate, requires knowledgeable traders to consider how major yet infrequent events might affect various markets. The instruments used for scenario hedges may not have high correlation with movements in the price of assets in normal times, and as a result may appear to be weakly correlated with the risk and not appropriate for purposes of the permitted activity. Such hedges, however, are critical to ensuring that particularly problematic scenarios do not jeopardize the stability of the financial institution. Indeed, given that the Federal Reserve requires banking entities to perform stress tests

[2] Oliver Wyman – SIFMA, The Volcker Rule Restrictions on Proprietary Trading: Implications for the U.S. Corporate Bond Market (December 2011).

based upon scenarios, it is puzzling that the proposed regulations do not expressly permit such activity.

SIFMA understands the difficult task the Agencies have been given. However, by crafting a compliance regime targeted at the individual trade and trader level, the Agencies have established compliance and enforcement liability for otherwise explicitly permitted activities and thus restricted the ability of banking entities to engage in permitted and economically useful market making and hedging activity. Perhaps one of the most glaring indications of this quest to eradicate each and every potential proprietary trade is the requirement for banking institutions to create and maintain vast amounts of data at the granular trading unit level using seventeen different metrics for market making activity to be captured on a daily basis and reported monthly to the Agencies.

The original purpose for limiting investments in hedge funds and private equity funds has been lost in the Agencies' proposal.

The funds restrictions were intended to serve as a backstop to the proprietary trading prohibition. As Senator Merkley stated, "if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided." Unfortunately, however, these restrictions have taken on a life of their own well beyond the intent of Congress. The statutory text and proposed regulations have swept within the purview of the Volcker Rule any number of entities that no one would

consider to be “hedge funds” or “private equity funds” – a risk that Representative Frank, Senator Dodd and others noted on the record at the time of enactment and urged the Agencies to address. For example, Representative Himes noted that “[b]ecause the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds, [but] I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won’t deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings.” The proposed regulations, however, defined “covered funds” in a manner that appears to make the prohibitions of the Volcker Rule applicable to virtually every affiliate in a banking group, including FDIC-insured depository institutions, SEC-registered broker-dealers, parent holding companies, wholly owned subsidiaries, joint ventures, acquisition vehicles, minority investments in regulated market utilities such as securities exchanges and clearing houses, and various other non-fund subsidiaries and affiliates. This is an absurd result that Congress could not possibly have intended, and is not required by the language of the statute. It is difficult to overstate the time, effort and expense banks will have to commit to identifying, monitoring and conforming thousands of entities in their ownership structures that in no way resemble hedge funds or private equity funds. If the Agencies define the term “covered fund” in a manner

that sweeps in a substantial number of non-fund entities or creates a serious risk of doing so, it would have a devastating effect on the ability of banking entities to fund, guarantee or enter into derivatives with non-fund subsidiaries and affiliates, preventing parent banking entities from acting as a source of strength to thousands of nonbank subsidiaries by prohibiting ordinary course internal financing, liquidity and risk management transactions. Further, because asset-backed securities issuers and insurance-linked securities issues are not hedge funds or private equity funds, the Agencies should, as intended by the Securitization Exclusion in the legislation, exclude such issuers from the Proposed Rules' definition of "covered funds." Another example of a financing structure that has been caught up in the definition of "covered funds" is the repackaging of municipal securities into a structure known as tender obligation bonds (TOBs) which would be restricted under the proposed Volcker Rule, yet these products in no way take the form of hedge funds.

The proposed regulations are more like a concept release than a concrete proposal.

The Agencies' proposal contains 1,347 questions, runs 298 pages, and includes a rule text and 3 appendices. It appears to be the result of committee drafting, contains inconsistencies and doesn't even use the same defined terms throughout. How the different parts of the proposed regulations interrelate, both to each other and to existing law, is unclear.

The proposal published by the Agencies is not sufficiently complete to be a proper notice of proposed rulemaking. The proposal acknowledges that the Agencies are implementing a complex statute, and the number of questions makes clear that there is much more work to be done before the proposal is complete. Depending on how the questions are addressed, there are likely to be changes so fundamental to the nature and characteristics of the rule that a reproposal will be necessary.

The conformance period should be given real meaning, as Congress intended.

The Volcker Rule will become effective on July 21, 2012, whether or not implementing regulations are in place. On its own, the Volcker Rule will bring about meaningful behavioral changes in market structures. Combined with other changes made by the Dodd-Frank Act, it is a paradigm shift.

The Agencies have the power and flexibility to create a workable phase-in to ensure that the implementation of the Volcker Rule will not unduly disrupt financial markets. The statutory Volcker Rule explicitly allows for a two-year transition period after the effective date, ensuring that banks would have sufficient time to prepare for the new restrictions on their activities. The transition period was intended, as Senator Merkley put it, to "minimize market disruption while still steadily moving firms away from the risks of the restricted activities." Underscoring the importance of a smooth transition, the statute permits the Federal Reserve to extend the conformance period,

but does not contemplate any mechanism for shortening or restricting the conformance period.

By contrast, the proposed regulations would require that metrics and compliance systems be in place by July 21, 2012. Moreover, while Congress gave banking entities two years to "bring [their] activities and investments into compliance," the Federal Reserve's conformance rules impermissibly restrict this conformance period, providing that the 2-year transition period applies only to "activities, investments, and relationships . . . that were *commenced, acquired, or entered into* before the Volcker Rule's effective date." Implementation by banks in the time frame provided by the Agencies will be extremely difficult for an institution of any size, particularly in light of the level of granularity at which the compliance program must be implemented. This herculean feat is not only impossible but is not required by the statute. Congress contemplated that final regulations would be in place nine months ahead of effectiveness and provided a two-year transition period; it was not the intent of Congress that banks would be left scrambling to erect massive compliance structures within the span of a few short weeks.

In addition, Congress included in the Volcker Rule an extended transition for investments in illiquid funds, which permits the Federal Reserve to extend the period during which a banking entity may take or retain its interest in an illiquid fund to the extent necessary to fulfill a pre-existing contractual obligation. As the Federal

Reserve has acknowledged, the purpose of this extended transition period is "to minimize disruption of existing investments in illiquid funds and permit banking entities to fulfill existing obligations to illiquid funds." Congress provided the longest potential conformance period for investments in illiquid funds because it understood that the difficulty of divesting or conforming those investments pose the greatest risk of harm to banking entities and other stakeholders. In implementing this transition period, however, the Federal Reserve again placed unnecessary restrictions on the transition period that were not contemplated by Congress, and in fact would largely read the extension out of the statute. The problems arise primarily from the conformance rules' definitions of various terms that are not defined in the statute, including "illiquid fund," "illiquid assets," "principally invested," "invested," "contractually committed," "contractual obligations" and "necessary to fulfill a contractual obligation." SIFMA believes that the current definitions of these terms are inconsistent with congressional intent and would result in the exclusion of many genuinely illiquid funds from the transition periods.

As banks attempt to become fully compliant by July 21, 2012 – a mere six months from now – the result will be extreme dislocations in many markets for financial assets at a sensitive economic time. This problem is exacerbated by the fact that the proposal itself leaves so many open questions. Even if the Agencies were to adopt final regulations immediately after the close of the comment period, without

giving any consideration to the comments received, banks would have only five months to develop significant compliance and reporting structures, new policies and procedures, including individual trader mandates, and ensure that all new trades were fully in compliance with the stringent new regulations. In reality, of course, the Agencies will have received a number of comments addressing hundreds of questions from the release, which will require their careful review. The Agencies will not be able to adopt the final rule for some time, leaving banking entities even less time to prepare for a July 21 effective date. The delay in finalizing regulations makes it even more critical for the Agencies to respect the Congressionally mandated conformance period.

It is not clear who should be regulating and enforcing the Volcker Rule.

The statutory Volcker Rule sets forth the rulemaking responsibilities of each Agency, but is silent as to the division of responsibility for supervision, examination and enforcement of the implementing regulations. Given the structure of the proposed regulations, which contemplate the extensive use of principles, metrics and analysis of explanatory facts and circumstances, the question of which Agency will take the lead on supervision and enforcement across banking entities and trading units is a critical one, but is left unanswered in the proposed regulations.

The proposed regulations specify that each Agency will have supervisory, examination and enforcement authority for the legal entities for which it has

rulemaking authority. It is unclear how the Agencies will coordinate the exercise of their authorities with respect to entities that are subject to supervision by multiple Agencies, particularly at the trading unit level, where a trading unit and its reportable quantitative metrics will almost certainly cut across legal entities. SIFMA is deeply concerned that the Agencies may exercise overlapping jurisdiction, providing inconsistent or contradictory views on the interpretive questions that will inevitably arise. As a result, banking entities could be left with the impossible task of complying with the disparate interpretations of multiple Agencies.

SIFMA believes that one primary regulator should take the lead for any particular banking entity and its subsidiaries. As the Federal Reserve is the Agency responsible for enforcement of the Bank Holding Company Act, in which the Volcker Rule is codified, the Federal Reserve should take primary responsibility for enforcement of the Volcker Rule. Designating the Federal Reserve as primary regulator for all banking entities will eliminate the concern of inconsistent or contradictory enforcement within banking entities as well as the potential for disparate treatment of different types of banking entities. In addition, the designation of one primary regulator for all banking entities would avoid duplicative costs between the Agencies.

The benefits of the Volcker Rule as implemented in the proposed regulations will be dwarfed by the costs.

The U.S. economy will be forced to bear both short-term and long-term costs associated with the reduction in market liquidity that will result from a sudden and overly restrictive interpretation of the Volcker Rule. The negative impact will reverberate on Main Street as well as Wall Street. SIFMA, in conjunction with Oliver Wyman, conducted a study that outlines the potential effect of such regulations on the corporate bond market. We have attached the study as a supplement to our testimony. With nearly $1 trillion raised in each of the last several years, the corporate credit market is a critical source of funding for American businesses. It is also an essential element of a diversified investment strategy for U.S. household investors who hold approximately $3 trillion, or almost half of the overall outstanding corporate debt issuance across direct holdings, pensions, and mutual funds. As proposed, the Volcker Rule regulations could result in the reduction of liquidity across a wide spectrum of asset classes and could ultimately cost investors as much as $90 billion to $315 billion in mark-to-market losses on their existing holdings due to these assets becoming less liquid and therefore less valuable. Corporate issuers could incur $12 billion to $43 billion in additional annual borrowing costs while investors could experience $1 billion to $4 billion in incremental annual transaction costs as the level and depth of liquidity in asset classes are reduced. These costs reflect the far-reaching consequences the

Volcker Rule will have not only on financial firms but average American investors if not appropriately implemented.

Thank you for the opportunity to submit our views. SIFMA appreciates the attention of the Subcommittees to the vitally important issues for the markets, businesses, investors and job creation that the Volcker Rule regulations raise.