April 16, 2012

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (RIN 3038-AD05)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") in response to the request for public comment in connection with the Notice of Proposed Rulemaking ("Proposed Rule") published on February 14, 2012, in connection with the "Volcker Rule" required under §619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Better Markets filed a comprehensive comment letter on February 13, 2012 in response to the rule proposed by other regulators to limit proprietary trading.[2] That letter is attached hereto and incorporated herein as if fully set forth.

In the Better Markets 2/13/12 Comment Letter, we presented historical evidence that demonstrates the need for restrictions on proprietary trading by banks. We showed how bank trading behavior introduced enormous risk into individual banks and into the financial system as a whole.

High leverage and dependence on short term finance made bank trading operations vulnerable to creditor runs. Because there were no constraints on the positions they took, their balance sheets had high concentrations of long maturity illiquid assets. Significant

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1 Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.

2 *See* Better Markets Comment Letter, February 13, 2012 ("Better Markets 2/13/12 Comment Letter") *available at* http://www.bettermarkets.com/sites/default/files/SEC-%20CL-%20Volcker%20Rule-%202-13-12.pdf

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proportions of these assets were rarely traded or "marked to model" and had no real market price – making it impossible for anyone to determine, even in calm markets, whether the trading operations were solvent or in compliance with capital and other regulatory requirements.

When the house price bubble burst, bank trading operations were early victims, taking huge losses and grievously wounding their firms. Creditor runs on individual firms, and on assets that their traders financed through the repo and other wholesale markets, fed the developing financial panic.

We detailed our support for the efforts of federal regulators to constrain risk-taking by bank traders in the Better Markets 2/13/12 Comment Letter. However, we also emphasized that the implementing regulations must, among other things:

- break the link between proprietary trading and banker bonuses by limiting market making revenue and compensation to the bid-ask spread, or fees and commissions;
- impose leverage limits on all permitted trading activity to reduce the possibility of destablizing creditor runs during periods of market stress;
- carefully restrict hedging activity, also permitted under the statute, to effectively prevent disguised risk taking; and
- create an effective enforcement mechanism to deter all forms of evasion.[3]

In this letter we explain in more detail the benefits of defining market making activity in terms of permissible revenue sources. A principal effect is to eliminate the incentive to hold unhedged trading inventories, because by definition significant income from price appreciation will be a signal that traders are not engaged in market making.

In addition, requiring the existence of an observable bid-ask spread will prevent traders from taking positions in assets that must be "marked to model" or which "trade by appointment." It also will allow market participants and regulators to more effectively calculate the solvency and capital adequacy of trading operations, subjecting traders to more effective market discipline and regulatory oversight.

Perhaps most importantly, such a metric is simple to monitor and will give market participants an unambiguous safe harbor for genuine market making activity.

We also respond to recent claims made by the banks and their advocates about the purported impact of implementing the Volcker Rule. We point out that:

- many bank claims about the impact on market making lack empirical support, even though bank broker dealers have privileged access to relevant data and the highest incentive to disclose it **if** it supports their claims;

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[3] For further information, *see* Better Markets 2/13/12 Comment Letter

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- independent academic research contradicts bank claims that the corporate bond market is liquid because market makers hold significant inventories of infrequently traded bonds; and

- the assertion that implementation of the rule will raise energy prices relies on the untenable assumption that only banks can and will trade energy-related assets.

(1) Limiting market making income to an observable bid-ask spread will effectively reduce high-risk bank trading behavior

To eliminate trader incentives to take large, high-risk positions in hopes of large bonuses, revenue for permitted market making activity must be strictly limited to an observable and meaningful bid-ask spread or fees and commissions.

An observable and meaningful bid-ask spread will exist only where traders continuously offer to buy or sell a well-defined asset and actively do so, allowing the calculation of the spread from contemporaneous, executed purchases and sales with non-dealer customers. The existence of such a bid-ask spread shows that market making services – the provision of immediacy to customers who desire to buy or sell – are actually being provided.

This limitation will have the effect of eliminating trader incentives to hold unhedged asset inventories. Because by definition significant income from the price appreciation of positions will be a signal that the traders are not engaged in market making, they will have a strong incentive to carefully hedge the inventories that they do hold to meet client demand.[4] It will also assure that market makers meet the statutory requirement that their activities be "...designed not to exceed the reasonably expected near term demands of clients, customers and counterparties."

In addition, requiring observable and meaningful bid-ask spreads will prevent banks from using the market making exemption to take positions in assets that are:

- traded so infrequently that bid-ask spreads cannot be calculated from contemporaneous purchases and sales; or

- so-called Level 3 assets that are "marked to model", such as "structured" securities or complex bespoke derivatives.

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[4] The importance of changing dealer incentives and limiting unhedged inventory accumulation has been emphasized in several non-industry comments on the proposed rule. See the Comment Letter from John Reed, February 13, 2012, 3-4 ("Reed Comment Letter"); Comment Letter from Rob Johnson and Joseph Stiglitz, Februrary 13, 2012, 7 ("Johnson/Stiglitz Comment Letter").

During the crisis, trader inventories of these assets proved to be worth far less than their reported values indicated. Firms such as Citigroup and Merrill Lynch were forced to write down their positions and recognize losses that severely weakened them.[5] Eliminating the accumulation of positions in these highly risky assets in the banks will in itself make them more stable. Moreover, it will meet the requirement of Section 619(d)(2) of the Dodd-Frank Act, which prohibits trading activity that exposes a banking entity to high risk assets and high risk trading strategies or threatens financial stability.[6]

In addition, by eliminating impossible-to-value assets from trader balance sheets, market participants will be better able to assess the risk of transacting with bank dealers. This should increase market discipline of the market makers. Moreover, regulators will have a more accurate idea of the solvency of the traders they oversee.

Finally, an obvious but nonetheless important benefit of limiting permissible market making income is that it provides an easily monitored, market generated metric that will give bank traders clear guidance on what they may do. This will clearly satisfy any demand for bright lines or safe harbors for trading activity.

Inexplicably, the quantitative measures of the bid-ask spread in the proposed rule do not require that spread measures are observed and contemporaneous. They must be strengthened.

In the Proposed Rule, banks are directed to use observable bid-ask spreads to calculate spread profit and loss when they exist. But, the rule goes on to say because "...bid-ask or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable...", the trading unit may choose between three proxy measures of the spread.

These alternatives allow banks to invent measures of the bid-ask spread that are useless for distinguishing between market making and proprietary trading.

For example, the "End of Day Spread Proxy" is defined as "[a] proxy based on the bid-ask or similar spread that is used to estimate, or is otherwise implied by, the market price at which the trading entity marks (or in the case of a sale, would have marked) the position for accounting purposes at the close of the day it executes the purchase or sale." This would allow the fiction of "mark to model" pricing, used for Level 3 and some Level 2 assets under accounting rules.

Another example is the "Historical Data Spread Proxy," which is defined as "[a] proxy based on historical bid-ask or similar spreads in similar market conditions." Banks

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5 The effects of impossible to value CDO securities on Citigroup are discussed in the Better Markets 2/13/12 Comment Letter. The damage done to Merrill Lynch is discussed in the Comment Letter from Matthew Richardson, February 13, 2012, 13 ("Richardson Comment Letter").

6 Other commenters have emphasized the importance of limiting positions in highly illiquid, impossible-to-value assets. *See* Johnson/Stiglitz Comment Letter, 6; Reed Comment Letter, 2; Richardson Comment Letter, 11.

will undoubtedly be highly creative in finding "similar" conditions that optimize the spread outcome.

And, finally, banks are allowed to use "[a]ny other proxy that the banking entity can demonstrate accurately reflects prevailing bid-ask or similar spreads for transactions in the specific asset class." This is so broad as to give the banks nearly unlimited latitude in determining this measure.

Under the definitions in the Proposed Rule, banks could post bid and ask prices sufficient to produce any desired level of "market making" income. Realized gains that derive from holding risky positions can be attributed to income earned from these fictional spreads. This will provide **no** constraint on trading behavior, and in fact will allow traders to disguise trading and evade the letter and intent of Section 619.

(2) Banks have failed to offer empirical evidence – to which they have privileged access – to support their claims about market making

In previously submitted comment letters on the Volcker Rule, banks have claimed that when they act as market makers they must hold substantial inventories of infrequently traded assets. Because these assets trade rarely, they say, continuous observable bid-ask spreads do not exist. In practice, they claim, market making in these assets is only possible because they can earn revenues from the price changes on the positions they hold. Therefore, using the existence of a bid-ask spread or revenue from the bid-ask spread as indices of market making will drive them from their market making role.

For example, Morgan Stanley claims that because market makers must hold inventories of large or illiquid assets for "days, weeks or months," they must necessarily have "substantial revenues from market movements in their principal positions." [7] Citigroup Inc. says that in "all but the most liquid portions of the equity, rate and foreign exchange markets, profitability from bona fide market-making-related activity is significantly derived from price appreciation of inventory positions."

If Morgan Stanley or other banks really wanted to inform us about how market making works, they would have presented verifiable data to answer some basic questions about their business. For example, with respect to corporate bonds, for which bonds are they market markers? Which of these bonds are infrequently traded, and which are frequently traded in the market as a whole? For which of these bonds do they typically hold inventories, and for which of them do they meet client demand by acting as agents or brokers? For those bonds in which they maintain positions, how large are their inventories? For which of the bonds in their inventory is there an observable bid-ask?

[7] Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – Proprietary Trading, from C. Kelleher, Co-President, Institutional Securities Group, and J. Rosenthal, Chief Operating Officer, Morgan Stanley. February 13, 2012, 4 ("Morgan Stanley Comment Letter"); Comment Letter on the Joint Notice of Proposed Rulemaking Implementing the Volcker Rule, from Brian Leach, Chief Risk Office, Citigroup. February 13, 2012, 4 ("Citigroup Comment Letter").

How much of their trading revenue comes from frequently traded bonds for which there is an observable bid-ask? These and other relevant data are not forthcoming from the banks.

When data are offered, they are often beside the point. Morgan Stanley, for example, in an appendix to its February 13, 2012 comment letter on the proposed rule, provides descriptive statistics on the frequency of bond trades during 2009. However, these data are derived from TRACE, a publicly available source. Such data tell us nothing about the actual market making activity of Morgan Stanley or any other large bond trader.

These data provide **no** evidence that Morgan Stanley actually holds inventories of any of the infrequently traded bonds identified in the appendix, nor do they tell us anything about the availability of bids and asks for frequently traded bonds. The failure of the banks to provide meaningful data in their exclusive possession, and their focus on data that are irrelevant to the issues being discussed, leaves regulators with **no** data supporting their assertions.

Given that they are self-interested market participants with the unique ability to support their claims with data, but chose not to, there is no defensible conclusion other than such data does not exist or, more likely, is not supportive. After all, if their claims were correct, it obviously would be in their interest to support their case empirically. They chose not to. Regulators have no choice but to disregard their unsupported assertions and claims.

(3) Independent evidence contradicts bank claims about market making for corporate bonds

Claims made about the market for U.S. corporate bonds – a market which banks have cited in their arguments that large scale asset inventories and revenue from price appreciation are essential to market making [8] – are contradicted by independent academic research.

A recent scholarly article, for example, suggests that dealers hold only small inventories of bonds that are frequently traded and no inventories of bonds that trade infrequently:

> "One argument against proposals to increase transparency in a dealer market is that dealers will become reluctant to enter trades as principals – that is, by themselves, purchasing bonds from customers or selling customers bonds owned by the dealer – and instead will only be willing to work orders on an "agency basis" – that is, they will search for potential counter parties (Genmill, 1996). In interviews, numerous corporate bond market participants voiced similar concerns. **We were told that, post-TRACE, bond dealers no longer**

[8] Comment Letter on Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds, from J. F. W. Rodgers, Chief of Staff, Goldman Sachs Group, Inc., February 13, 2012, 12; Morgan Stanley Comment Letter, op. cit.,4, appended Discussion Materials; Citigroup Comment Letter, op. cit.

> **hold large inventories of bonds for some of the most active issues; for less active bonds, they now serve only as brokers.** As noted, individual corporate bond issues trade on average only two or three times per day, and for illiquid issues even less often. With trade reporting, it may be possible to ascertain when a dealer may have taken a large position into inventory, and the price paid. Knowledge of the dealer's inventory may allow market participants to forecast upcoming trades the dealer will undertake to rebalance inventories, and these forecasts may in turn cause price movements adverse to the dealer." [9] [emphasis added]

A second empirical study, using data from a sample of traded corporate bonds, also indicates that dealers avoid holding inventories of infrequently traded bonds.[10] Sample data show that when infrequently traded bonds are added to dealer inventory, they are held for shorter periods than frequently traded bonds, and the entire position is more frequently sold off to buyers. The authors conclude that for infrequently traded bonds "... **dealers may serve more of a search role, matching buyers and sellers, and not assuming the risk of holding bonds in their inventory**." [emphasis added] [11]

It is important to emphasize that even after TRACE was introduced, post-trade bond prices became widely available, and bond traders reduced their inventories of infrequently traded bonds, the market for corporate bonds did not vanish. Between 2002, when TRACE was introduced, and 2006, the average daily trading volume for corporate debt increased from $18.9 billion to $22.7 billion.[12] Market makers continued to flourish, although their ability to extract rents from their counterparties was reduced.[13]

So contrary to the claims made by banks, the operation of the corporate bond market actually demonstrates that market making does not require that dealers hold significant inventories of infrequently traded assets. Effective implementation of the Volcker Rule, which requires tying permitted trading revenue and compensation to observable bid-ask spreads, will not bring an end to genuine market making by banks. Instead it will limit the ability of banks to take proprietary positions in opaque markets in pursuit of large speculative profits. While banks may object, the banking system will become more stable as a result.

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9 H. Bessembinder and W. Maxwell (2008). Transparency and the Corporate Bond Market. Journal of Economic Perspectives, Volume 22, Number 2, 217-234, 228.

10 M. Goldstein et al. (2007). Transparency and Liquidity: A Controlled Experiment on Corporate Bonds. The Review of Financial Studies. Volume 20, Number 2, 235-273. In the sample used in this study frequently traded bonds are defined as those that trade at least once per week. Infrequently traded bonds trade less than once every two days, but at least once every two weeks.

11 *Ibid*, 267.

12 Bessembinder, op. cit., 222.

13 After the implementation of TRACE, transactions costs for corporate bond trades declined. *See* Bessemer and Maxwell, op. cit.; Goldstein et al., op. cit.; A. Edwards et al. (2007). Corporate Bond Market Transparency and Transactions Costs. Journal of Finance, Volume 19, Number 1, 69-90.

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(4) Claims that market making restrictions will raise energy prices rely on the assumption that only banks can trade energy related assets

A recent industry-sponsored paper claims that a narrow definition of market making will raise U.S. energy prices by billions of dollars annually. The reason is that "[r]educed bank transaction activity could reduce liquidity in commodity exchanges and over the counter (OTC) markets, and even availability of commodities risk management, financing and other intermediation services." [14]

The weakness of this argument is that it ignores what every college freshman learns in Econ. 1: in competitive markets profit opportunities attract new entrants.

If banks completely cease trading energy assets, and if that trading does not require the taxpayer-provided subsidies provided to too big to fail bank holding companies, nonbank firms will step into their shoes to make their trading profits. And if bank trading activity only exists because the taxpayer put allows them to avoid reserving adequate capital to cover losses, then their supply of liquidity to energy asset markets is an inefficient allocation of resources.

Better Markets has made these points with respect to previous industry-sponsored attacks that also assume that entry will not happen.[15] Professor John Parsons of MIT has come to similar conclusions about the IHS report: [16]

> "There are 2 essential fallacies at the heart of the IHS report. And many other ones, too, but let's focus on the essential ones.
>
> First, the report assumes its conclusion. The Volcker Rule bans banks from proprietary trading. But the Volcker Rule does not ban anyone else from proprietary trading. The IHS report assumes that when banks stop proprietary trading, no one else will step in and do so.
>
> That's a ridiculous assumption. Let's look at other industries where governments sometimes regulate which institutions may and may not operate – take alcohol sales, for example. Suppose a state were to ban grocery stores from selling alcohol. Does that mean alcohol would not be sold? Obviously not.
>
> So why does IHS assume that if bankers stop providing this service, no one else would step in to do so. The report never explains...
>
> Second, the report ignores taxpayer subsidies to bank risk taking. If banks are better at providing this intermediation, then by all means,

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14 IHS Global Insight (2012). The Volcker Rule, Impact Assessment on the U.S. Energy Industry and Economy, ES-3. ("IHS report")

15 Better Markets 2/13/12 Comment Letter.

16 Professor Parsons' comments on the IHS report are available at http://bettingthebusiness.com/2012/03/28/the-quickest-way-to-a-conclusion-jump/.

> let's do it through banks. But that is not the reason this activity moved onto bank balance sheets. It happened because banks do not pay the full cost of the risks they fund – taxpayers do. Ignore the taxpayer subsidy, and, of course, it looks wise to allow the banks to keep doing the business. But accounting for the subsidy, it makes no sense."

In short, there is no reason to take the IHS report and predictions of grave economic harm seriously. The claims are baseless.

We hope these comments are helpful in your consideration of the Proposed Rule.

Sincerely,

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