AFR Americans for Financial Reform
Education Fund

October 17, 2018

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Docket ID OCC-2018-0010, RIN 1557-AE27; Docket No. R-1608, RIN 7100-AF06; RIN 3064-AE67; File No S7-14-18, RIN 3235-AM10; RIN 3038-AE72

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge and Private Equity Funds

To Whom It May Concern:

On behalf of the Americans for Financial Reform Education Fund ("AFR Education Fund"), thank you for the opportunity to comment to the five above-listed agencies (the "Agencies") on these proposed revisions to the current prohibitions and limitations on proprietary trading and relationships with covered funds (the "Proposal").[1]

The Volcker Rule (Section 13 of the Bank Holding Company Act, added by Section 619 of the Dodd-Frank Act) is a central response to the 2008 financial crisis. In a recent report by the AFR Education Fund, we describe the origins of the Volcker Rule as a direct response to the events of the 2008 financial crisis, the crafting of the current implementing regulation for the Volcker Rule, and the effect of that rule on financial markets. Conclusions of the report include:

- Proprietary trading losses were highly significant in the 2008 financial crisis. Major banks like Citibank and Bank of America / Merrill Lynch lost almost half their tangible equity capital to trading losses. After the crisis regulators found that the greatest bank losses were centered in trading accounts, which were systematically undercapitalized.

[1] The Americans for Financial Reform Education Fund brings together an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

- The Volcker Rule also directly addresses the "toxic" loan securitizations at the heart of the 2008 crisis. These securitizations were "covered funds" that are restricted by the statutory Volcker Rule. Bank underwriting and trading in these securitizations was central to the business model that drove the crisis.

- Although the goal of the drafters of the Volcker Rule was fundamental systemic reform, the current rule as implemented has apparently had very limited effects. Almost no enforcement actions have been taken and there has been almost no public disclosure as to the effectiveness of the rule. At the largest U.S. trading banks, trading revenue as a share of total revenue has not declined since the final Volcker Rule began to be implemented.

A copy of the report, which documents these and other claims, is attached to this comment.

Unfortunately, this Proposal only adds to the shortcomings of the current implementation of the Volcker Rule. In assessing the original Volcker Rule regulatory proposal in 2012, Senators Merkley and Levin, the two key drafters of the statute, stated that[2]:

> "The Proposed Rule puts forth principles and then directs banks to figure out for themselves what is, and what is not, proprietary trading. This approach essentially puts the fox in charge of designing the hen house."

This new Proposal doubles down on the already self-regulatory nature of the current Volcker Rule. It strips away key parts of the rule's compliance program and documentation requirements and replaces them with what is effectively bank self-certification. It further strips away important parts of the current Volcker Rule limitations on bank ownership of covered funds, and suggests that regulators are also considering sweeping many more of these vital limitations.

Many of these changes are justified by the claim that the current Volcker Rule is excessively complex and needs simplification. However, this Proposal is marked by a persistent confusion between making the Volcker Rule easier for banks to comply with and actually simplifying the rule. There are indeed numerous elements in this Proposal that make it easier for banks to comply with Volcker Rule limitations on proprietary trading and relationships with covered funds. Many new exemptions to statutory limits are introduced, and the proposal allows banks to essentially self-certify their compliance with the market-making and underwriting exemptions by using their own internal risk limits. But these changes do not make the Volcker Rule conceptually simpler. Instead, they make it more complicated and difficult to understand what the rule is actually doing. The already tangled web of regulator-created exemptions to the rule will grow even thicker, and there will be less consistency in the implementation of Volcker Rule limitations across banks (or even across trading desks within the same bank).

It is particularly frustrating to see the numerous references in the Proposal to the Agencies' intent to provide banks with greater "clarity" and "certainty" about what is and is not permitted under the Volcker Rule. It is true that permitting banks more latitude to set their own standards for

[2] https://www.sec.gov/comments/s7-41-11/s74111-362.pdf

what constitutes underwriting and market-making, dispensing with a wide variety of compliance requirements for the rule, and introducing multiple new exemptions will provide more certainty to banks. However, the initial lack of clarity in the current rule was a deliberate choice by regulators. The 2014 Final Rule explicitly rejected drawing "bright lines" that would have provided more clarity as to the boundaries of permitted market-making and other exemptions, in order to preserve bank flexibility in trading approaches.[3]

The assumption of AFR and other public interest groups was that regulators would work with banks to use the data gathered under the rule's compliance regime, including extensive trading metrics data and documentation, to arrive at a clearer and more precise understanding of what the parameters of permitted trading were. This assumption was based on, for example, the statement in the Final Rule that as part of the design of their compliance regime banks would be required to set their own numerical thresholds for trading metrics in order to determine when activities were prohibited under the Volcker Rule.[4] Supervisory manuals for the implementation of the rule instructed supervisors to assist banks in setting detailed trading desk-level inventory limits for key permitted activities under the rule, based on measurement of customer demand.[5]

This Proposal does not reflect success in using the data collected to clarify the limits and boundaries of the Volcker Rule. It offers no additional detail or clarity to the public regarding the permissible boundaries of trading, but instead proposes to dispense with a variety of important compliance requirements in order to give banks still more latitude to define those boundaries for themselves. The Proposal raises the question of whether and how regulators have used the past four years to make the effort necessary to a proper implementation of the Volcker Rule, namely understand bank trading practices well enough to arrive at a clearer and sharper definition of market making.

The lack of public disclosures concerning supervisory choices and bank practices under the Volcker Rule also raises this question. As AFR and others have previously discussed in detail, the public has been given no clear explanation of how the metrics and data currently being gathered are being used by supervisors, or what those metrics and data show about bank trading practices and whether Volcker Rule implementation has led to any change in such practices.[6] The absence of disclosure makes it difficult to assess this Proposal, which contains numerous references to regulatory experience or findings without any concrete information or data provided in support.[7] Without more disclosure, it is essentially impossible to judge the accuracy of the numerous claims made in this Proposal concerning the ability of supervisors to improve the implementation of the Volcker Rule by dispensing with various compliance requirements.

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[3] See CFR 5582 Final Rule Federal Register January 31, 2014

[4] CFR 5765 Final Rule Federal Register January 31 2014.

[5] See e,g. p. 11 in the OCC Interim Supervisory Manual https://www.occ.treas.gov/news-issuances/bulletins/2014/bulletin-2014-27a.pdf

[6] See Americans for Financial Reform, "Letter to Regulators on Volcker Rule Disclosure", December 17, 2015. http://ourfinancialsecurity.org/wp-content/uploads/2015/12/AFR-Volcker-Joint-Letter-12.17.15-1.pdf

[7] The only hard evidence offered is are cites to claims of bank lobbyists concerning their own compliance costs, e.g. in footnote 18 of the Proposal and other places.

More disclosure would also have allowed better assessment of the significant weakening in the Volcker Rule restrictions on covered funds contemplated in this Proposal. While banks claim to have reviewed vast numbers of covered funds for Volcker Rule compliance, continued extensions of the Volcker Rule deadlines for compliance with covered funds restrictions have meant that they may not have divested all of these funds. There has been no release of data concerning the volume and nature of covered funds still held by banks. Nor is there data in this proposal as to the increase in the volume of covered funds (or the nature of such funds) that banks could own if the recommendations in this Proposal are finalized or the further exemptions hinted at in questions are pursued by the Agencies. The covered funds at issue include precisely the types of complex securitized products that were at the center of the 2008 financial crisis.

The general impression created by this Proposal is that the Agencies simply have no appetite for the kind of assertive regulatory limitations on bank practices that are required by the Volcker statute. Instead of an honest assessment of the current state of bank trading and a thoughtful attempt to use the information gathered since 2010 to clarify and strengthen Volcker Rule restrictions, this Proposal makes Volcker Rule enforcement even more passive and loophole-ridden than it already is.

Rather than take this approach, we urge the Agencies to reject the weakening of the Volcker Rule in this Proposal and instead undertake a comprehensive re-evaluation of how they have implemented the rule that is aimed at both strengthening the rule and simplifying it. The issue here is not simplicity vs complexity. There are many ways in which the Volcker Rule could be both clarified and simplified, and also strengthened. To take a few examples, bright-line limits could be set on trading inventories based on quantified and automated forecasts of customer demand, with limited and specified exemptions for periods of market disruption. Restrictions on trader compensation methods that encourage proprietary trading could be made far more specific and powerful than they are in the current rule, without being excessively complex. The set of exemptions to the statutory definition of covered funds, which are currently very numerous and complex, could be cut back and simplified. However, such actions would also require placing stronger limits on bank trading practices and greater restrictions on bank business models.

To be fair, not all of the recommendations in this Proposal are so misguided. Some appear to represent a good faith effort to grapple with legitimate complexities that have arisen in implementation. For example, it is reasonable to try to align Volcker Rule trading desk definitions with the trading desk definitions used for general business purposes in the bank. The switch to an accounting-based presumption for the definition of a covered trading account also appears to be a reasonable effort to grapple with the complexities of offering more certainty around Volcker Rule coverage. Certain other recommendations concerning error accounts and liquidity management also address genuine issues.

Below, we offer a more detailed discussion of some of the recommendations in this Proposal. Rather than proceed in the same order as the Proposal, we discuss the issues in order of significance, addressing first reductions in compliance requirements, then requirements regarding covered funds, and then delve into a number of other issues. As will be seen, this comment letter does not address all of the recommendations and questions in this lengthy Proposal. We may supply additional comments after further review of the Proposal.

Detailed Discussion: Reductions in Compliance Requirements that Shift to a More "Self-Regulatory" Approach to Volcker Enforcement

This proposal cuts back on current Volcker Rule compliance requirements at the largest banks in a number of important ways.[8] Some of the most prominent of these are:

- Changes in Section _4 of the rule to introduce a rebuttable presumption of compliance with the underwriting exemption based on bank-set risk limits.
- Changes in Section _4 of the rule to introduce a rebuttable presumption of compliance with the market-making exemption based on bank-set risk limits, and an elimination of the requirement to perform a "demonstrable analysis" of historical customer demand and compare it to current inventories in order to support market-making.
- Changes in Section _5 of the rule to remove the requirement that hedges "demonstrably" reduce a specified risk and that banks conduct a quantitative correlation analysis of a proposed hedge to demonstrate that the hedge reduces the specific risk being hedged. Other changes in Section _5 eliminate documentation requirements for aggregated hedges (hedges of risks aggregated across desks).
- The elimination of almost all of Appendix B of the current rule, which lays out specific requirements for a Volcker compliance program. The requirement for CEO attestation for is preserved for larger banks, but other key requirements are removed.

While these changes may appear somewhat technical on the surface, they in fact go to the heart of the rule. Their general tendency is to loosen requirements for banks to document and review their compliance with core Volcker Rule requirements, and to allow banks to collapse Volcker compliance into their routine structure for risk oversight, which serves very different purposes.

Changes in Section _4 concerning market-making and underwriting: The Proposal introduces a new presumption that banks are complying with the underwriting or market-making exemptions to the Volcker Rule ban on proprietary trading so long as their trading is within internal, bank-set risk limits that are designed not to exceed the reasonably expected near-term demand of customers and counterparties (RENTD). The Proposal specifically states that this presumption of compliance means that banks will no longer be required to tie their trading compliance to "any specific or mandated analysis" of RENTD customer demand, as they must currently do (CFR 33456). For example, the Proposal removes requirements in _4(b)(ii)(2)(B) of the current rule that market-making be tied to a "demonstrable analysis of historical customer demand" as compared to "the current inventory of financial instruments".

The entire point of the market-making and underwriting exemptions to the proprietary trading ban is that this such permitted activities must be closely linked to expected customer demand. In other words, banks are intended to follow markets and accommodate customers, not play an aggressive role leading markets. This is of course a statutory requirement, as Section 13(d)(1)(B) of the Bank Holding Company Act only permits underwriting and market-making to the extent

[8] This section focuses on cuts in compliance requirements that affect all banks, even the largest. There are further cuts in compliance requirements for banks with moderate and small amounts of trading assets.

that such activities are designed not to exceed RENTD. It is also highly economically significant, since we saw that prior to the financial crisis inflated proprietary trading inventories and supposed market-making activities unrelated to customer demand played a crucial role in inflating the bubble for securitized assets.[9]

Given how central the RENTD requirement is to the trading limitations in the rule, it is entirely unclear why the Agencies would remove any requirement that banks actually measure and analyze real customer demand and compare it to their inventories. Such activity is essential to the role of an actual market-maker, since for an actual market-maker excess inventory presents an unnecessary carrying cost. However, a failure to perform such analysis can easily allow market-making and underwriting to slide into proprietary trading.

The Agencies justify removing this requirement by citing bank lobbyist claims that RENTD analysis is excessively costly and complex. But since RENTD compliance is core to the intent of the rule a simple claim by regulated entities that they find such analysis burdensome should not be dispositive.

The RENTD analysis cannot be effectively replaced by the other quantitative metrics in the Proposal. In Footnote 115 of the Proposal the Agencies suggest that the Risk and Position Limits metric that banks are still required to report will help them monitor market-making activities even in the absence of a RENTD analysis. However, this metric is a risk metric (as are most of the other required metrics such as Value at Risk) and does not provide information on customer demand relative to trading inventories. The Volcker Rule is not intended simply to be a limitation on bank *risks*, but on bank *activities.* Regulators cannot effectively determine whether or not the bank is truly engaged in the activity of market-making without directly comparing trading inventories to reasonable estimates of near-term customer demand. Metrics showing that measured market risk is currently low, or within bank limits, do not demonstrate whether or not the bank is holding large inventories relative to customer demand. Again, prior to the 2008 financial crisis measured risk in bank trading inventories were low, but these inventories were much larger than would be necessary to satisfy customer demand. When the market became turbulent risk in these positions expanded rapidly and significantly.

The Proposal does retain language specifying that risk limits must be designed not to exceed RENTD. Such language is required by the statute. The Proposal also reassures us that bank-set risk limits will be subject to supervision and that supervisors will provide oversight of whether such internal risk limits are truly designed to remain within RENTD. But it is difficult to see how the regulators will obtain data needed to do such oversight. Regulators do not have the capacity to directly analyze customer demand and inventory data themselves, but must rely on banks to do so. Yet this Proposal eliminates any requirement for banks to perform the kind of RENTD analysis that would be needed to understand the relationship of market-making trading to customer demand. Presumably regulators would not eliminate this requirement if they intended banks to continue to perform RENTD analyses as part of the supervisory process. It is hard to avoid the impression that any supervision of bank-set risk limits in this crucial area will be a pro forma exercise, and will lack the necessary analytic base to be effective.

[9] See the attached report

Changes in Section _5 Concerning Risk Mitigating Hedging: As with the market-making and underwriting changes, the proposed changes in risk-mitigating hedging eliminate requirements for banks to perform the kind of tangible and concrete analyses which would confirm that hedging activities are actually working as intended to reduce risks. The Proposal maintains current language requiring that hedges be designed to reduce or mitigate specific, identified risks. But it removes the current requirement that hedges should "demonstrably" reduce such identified risks, as well as requirements that the claim of such demonstrable reduction be supported by a correlation analysis. Once again, these changes keep in place a relatively vague and general directive to banks, namely that they design their hedges to reduce specific risks. But the rule would no longer require banks to provide the more detailed analysis necessary to properly assess the risks of the hedge.

We would note that, as in many other cases in this Proposal, the provisions to be weakened here were already weakened in the 2014 Final Rule, when the requirement that there be a "reasonable correlation" between the hedge and the identified specific risk was weakened to a requirement of a simple correlation analysis.[10] The 2014 Final Rule also rejected the recommendation of Senators Merkley and Levin that the bank actually have to affirmatively demonstrate that the hedge was risk reducing. Instead, the current rule requires an "expectation" that the hedge "demonstrably reduce" risks and some type of analysis of correlation, with no requirement that such correlation conclusively demonstrate that the hedge is risk-reducing.

Now, this Proposal would weaken the requirement still further by removing any requirement for the hedge to "demonstrably" reduce risk, as well as requirements for any correlation analysis at all. If this Proposal is finalized, all that would be left would be a requirement that the hedge be "designed" to reduce risk or that it "may be expected" to reduce risk. Once again, we would question how regulators will provide proper oversight of these vague terms without concrete data and analyses of the hedge performance, including correlation analyses, provided by the banks.

These changes are justified by the claim that the current requirements for hedge documentation are so onerous that banks may not engage in needed hedging because of their concern that they may inadvertently violate the Volcker Rule. We are aware of only one disclosed case in the entire history of the Volcker Rule's implementation in which a bank was found to have violated the rule, so the chance of inadvertently violating the rule does not seem high. We would also question how onerous a correlation analysis is given the possibility of automating such an analysis, including on a pre-trade basis. The Proposal also raises the possibility that correlations may change over time or across trades, rendering new information relevant, or that a bank may not have enough time to undertake a complete correlation analysis before it needs to... hedge against the risks as they arise" (CFR 33465). But such rushed or rapidly changing situations might actually be situations in which it is particularly valuable to hedge risks carefully and to understand the risks being taken, even if such a procedure creates some delay. Traders have traditionally had a great deal of on-the-spot discretion and the need for careful risk management may interfere with such short-term discretion. But it should not be the Agencies goal to preserve instantaneous discretion for traders at major banks that must comply with the Volcker Rule.

[10] CFR 5636 of 2014 Final Rule, Federal Register, January 31, 2014.

Eliminating Most of Appendix B of the Current Rule: The current rule contains two Appendices which describe specific and detailed requirements for the Volcker Rule compliance program at large banks. Appendix A describes the metrics each bank must collect at the trading desk level. Appendix B sets forth minimum standards with respect to the establishment, oversight, maintenance, and enforcement of an internal compliance program for ensuring and monitoring compliance with Volcker Rule restrictions on proprietary trading and covered fund activities. While it does retain the requirement for the CEO to attest to the bank's compliance with the Volcker Rule – which we strongly support -- the Proposal would effectively eliminate most of the Appendix B compliance requirements. These compliance requirements would be eliminated for all banks, even the largest trading banks.

The effect of this change would be to remove a range of highly significant compliance requirements at major banks. These include, for example, requirements that a large bank must perform robust analysis and quantitative measurement of its trading activities to ensure that the trading activity of each individual trading desk is consistent with the bank's Volcker compliance program, and prevent the occurrence of prohibited proprietary trading.[11] Removing Appendix B will also eliminate the requirement that a major bank describe how it monitors for and prohibits potential exposure to high-risk assets or high-risk trading strategies due to otherwise permitted trading activities. Under this requirement, banks are required to take into account exposure to products that are difficult to value, novel products that do not have a market history, highly volatile products, or products with significant embedded leverage.[12] (This compliance requirement enforces Section 13(d)(2) of the BHC, the so-called "prudential backstop to the Volcker Rule). Section II.b of Appendix B, requiring banks to create a process and internal controls for the identification and limitation / divestment of Volcker covered funds, would also be eliminated. These are all absolutely vital areas of the Volcker Rule.

It is true that even though the detailed Appendix B compliance requirements covering these areas of the Volcker Rule would be eliminated, the Volcker Rule restrictions themselves would remain in place. It is also true that the Proposal retains the broad requirements for a compliance program at _20(b) 1 through 6 of the current rule, including a general requirement for written policies and procedures and internal controls.

However, many of these Volcker Rule restrictions are stated in a very broad and general manner in the existing rule. For example, the prohibition on material exposures to a high-risk asset or trading strategy in Section _7 of the current rule is non-specific and simply reiterates the general prohibition in the statute. It is only in the Appendix B compliance requirements that high-risk assets are defined with greater specificity.

The broad compliance program requirements at _20(b) are also written in a very brief and general manner. For example, monitoring compliance with trading requirements is not mandated at the individual trading desk level, as it is in the enhanced compliance standards in Appendix B, and the specific requirements listed in Appendix B for enforcement of the 13(d)(2) prudential backstop are completely lacking . Without being backed up by specific and detailed requirements

[11] Section II.a.5 of the current Appendix B.
[12] Section II.a.6(ii) of the current Appendix B.

for internal compliance we are concerned that broad and general requirements such as the prudential backstop will not be effectively enforced. In cases where requirements are more detailed, such as in the covered fund provisions in the rule, we are concerned that regulators will lack the capacity to properly supervise the details of implementation without the support of a detailed a robust bank compliance program.

These concerns are heightened by the justification given in the Proposal for the elimination of Appendix B. At CFR 33490-33491 the Agencies state:

> "While recognizing the need to establish and maintain an appropriate compliance program, the Agencies also believe that banking entities should be provided discretion to tailor their compliance programs to the structure and activities of their organizations. The flexibility to build on compliance regimes that already exist at banking entities, including risk limits, risk management systems, board-level governance protocols, and the level at which compliance is monitored, may reduce the costs and complexity of compliance…The Agencies believe that many of the compliance requirements of the current enhanced compliance program could be implemented effectively if incorporated into a risk management framework already developed and designed to fit a banking entity's organizational and reporting structure. The prescribed six pillar compliance requirements in §ll.20 are consistent with general standards of safety and soundness as well as diligent supervision, the implementation of which conforms with the traditional risk management processes of ensuring governance, controls, and records appropriately tailored to the risks and activities of each banking entity. Accordingly, the Agencies propose to eliminate the requirements of Appendix B (other than the CEO attestation)."

This seems to indicate the intent of the Agencies to merge the Volcker Rule compliance structure with pre-existing compliance regimes at major banks, such as for example the Federal Reserve consolidated supervisory framework for large financial institutions.[13]

This would be highly inappropriate. The Volcker Rule is fundamentally different from other supervisory compliance structures intended to enforce "general standards of safety and soundness". The Volcker Rule is a limitation on activities which is intended to change bank business models, not simply control risks to enhance bank soundness. For example Section 13(d)(2) of the BHC does not simply require banks to control the risk involved in high-risk trading strategies, it outright bans bank involvement in high-risk trading strategies, even within otherwise permitted trading activities. The Volcker Rule does not simply require control of the risks in ownership of covered funds, it bans ownership of such funds. Likewise, the Volcker Rule does not require control of aggregated trading risks, it outright bans all trading activities that do not fit into specified permitted activities.

Other supervisory compliance structures designed to enforce safety and soundness are instead oriented at top-down control of aggregated risks rather than banning activities. This is very different than the Volcker Rule approach. It is inappropriate to merge compliance structures intended to control aggregated risks and compliance structures intended to ban activities at the

[13] See Federal Reserve Supervisory Letters at https://www.federalreserve.gov/supervisionreg/srletters/sr1217.htm

detailed trading desk level. Such a merger is likely to render the Volcker Rule substantially or ineffective.

The Agencies Should Withdraw the Weakening of Compliance Activities in the Proposal that Are Outlined Above: The various elements of the Proposal described above that weaken Volcker Rule compliance requirements should all be rejected. They appear unsupported by data or evidence, despite the vast amounts of data the Agencies have collected (or should have collected) on Volcker Rule implementation over the past four years. Their justifications are subjective and based on highly questionable assumptions. They strike at the heart of the system of Volcker Rule oversight put in place in the 2014 Final Rule.

Detailed Discussion: Weakening of Covered Fund Restrictions in the Proposal

The Proposal proposes to weaken covered fund restrictions in several significant and unjustified ways. Even more disturbingly, the Proposal includes numerous questions that appear to contemplate narrowing the covered fund restrictions in even more dramatic ways, specifically by eliminating most or all restrictions on any covered funds that do not meet the definition of a hedge or private equity fund under the Form PF issued by the Securities and Exchange Commission (see CFR 33545 and following).

Several Proposed Changes to the Covered Fund Definition are Unjustified: The Proposal suggests at least two specific expansions in covered fund activities permitted under the Volcker Rule that are unjustified.

First, the Agencies propose to modify Section _11(c) of the current rule to eliminate the aggregate limits and capital deductions for covered fund ownership for the purposes of underwriting and market-making in "unrelated" or "third party" covered funds. The proposal also expands the scope of these third party covered funds by permitting banks to directly or indirectly guarantee or insure covered funds without triggering the requirement to treat a fund as "related". It would appear that guaranteeing or insuring a fund would certainly create a relationship with bank that guarantees the fund – this is the assumption under the current rule – but that assumption would be eliminated by this Proposal.

These changes alone represent a potentially vast expansion in the practical ability of banks to take ownership interests in covered funds. Yet it is not supported by quantitative estimates of the potential expansion in bank covered fund inventories that would result from this new exemption. Nor is there any estimate of potential bank losses on these funds, or any assessment of the expansion in fund holdings on potential conflicts of interest with customers that should be banned under the Volcker Rule.

The type of bank underwriting and market-making in securitizations that would be expanded by this part of the Proposal was a major contributor to the 2008 financial crisis. As documented in the attached report, these securitized assets were enormously overleveraged before the financial crisis, as banks were permitted to hold them with inadequate capital, and were also tied to significant conflicts of interests with customers.

Second, the Agencies also propose to modify Section _11 of the rule to add a new exemption for ownership interests in a covered fund that are related to hedging a fund-linked product offered to customers. This exemption was specifically rejected in the 2014 Final Rule as posing excessive risks to the banking entity.[14] The purpose and justification of this exemption is unclear. The Proposal does not offer specific examples of fund-linked products that would require banks to hedge their exposure through ownership interests in the covered fund, explain why such products are necessary to the banking system, or explain why the economic equivalent of such products could not be offered by simply selling shares of a covered fund to customers, with no need for the bank to offer indirect exposure that would then need to be hedged.

The Proposal Also Hints at Radically Expanding Exemptions to the Statutory Volcker Rule Restrictions on Covered Funds: The statutory definition in Section 13(h)(2) of the BHC Act of "hedge and private equity funds" covered under the Volcker Rule -- namely an issuer that would be an investment company under the Investment Company Act of 1940 but for Sections 3(c)(1) and 3(c)(7) of that Act – is enormously broader than the definition of "hedge and private equity fund" used in Form PF, and completely unrelated to that definition. As we point out in the report attached to this comment, that broad definition is highly economically and substantively significant, since it includes all of the "toxic" securitizations, special purpose vehicles, asset backed conduits, and other vehicles that were at the center of the 2008 financial crisis. The Form PF definition of "hedge and private equity fund" would include none of these entities, but only a far more limited set of unregistered funds. It would be completely inappropriate for the Agencies to seize upon the phrase "hedge and private equity fund" in the statute while ignoring the specific statutory definition of that term, and substitute a Form PF definition of covered funds that would radically narrow the coverage of the Volcker Rule and strike directly at the intent of the statute in limiting the bank practices that led to the financial crisis.

The existing Volcker Rule already contains almost a dozen specified exemptions from the statutory definition of "hedge and private equity fund". However, those exemptions were outlined in advance and in detail in the 2012 proposed rule, and also justified in some detail under the exemptive authority in the Dodd-Frank statute. While we frankly disagree with the scope of these existing exemptions, at least they were proposed and justified in compliance with the Administrative Procedures Act (APA). If they Agencies were to issue a Final Rule that radically expanded exemptions from Volcker Rule covered fund restrictions based on the extremely broad, speculative, and unjustified suggestions hinted at in various questions within this Proposal, it would certainly not be justified under the APA. The same goes for other significant expansions in existing covered fund exemptions, such as an expansion of the loan securitization exemption to include synthetic securitizations, which were the types of securitized funds that showed the largest losses during the financial crisis.

Any broad expansion in the exemptions to the statutory Volcker Rule limitations on covered fund investments should instead be proposed in a separate rulemaking, described in detail, and justified with far more data and analysis than are provided in this Proposal.

Some Other Issues Raised in the Proposal

[14] See CFR 5736 of the 2014 Final Rule.

As noted above, this letter does not address many of the recommendations and questions in this lengthy Proposal. We may offer further comment on the Proposal's recommendations in the future. However, below we offer brief comment on several other major elements of the Proposal.

Changes in the definition of "trading account": The definition of "Trading Account" is one of the most critical elements of the rule, as it determines the scope of coverage for the core Volcker Rule prohibitions on proprietary trading. Thus, an under inclusive definition of the trading account will render the Volcker Rule ineffective.

The current Volcker Rule defines the trading account to include all positions subject to the Market Risk Capital Rule and all positions held by registered dealers. It also includes a third prong of the definition that establishes a rebuttable presumption that all positions held for less than 60 days are assumed to be held for short-term trading intent, as specified in the statutory definition of the trading account in Section 13(h)(6) of the Bank Holding Company Act.

This Proposal would retain the Market Risk Capital Rule and the registered dealer elements of the current trading account definition. However, it would eliminate the rebuttable presumption based on the 60 day holding period and replace it with an accounting-based definition under which all positions that are marked to market under accounting rules are presumed to be trading account positions. However, positions qualifying solely under the accounting based definition would be granted a presumption of compliance with proprietary trading requirements that would be available **unless** the rolling 90 day sum of absolute profit and loss (P&L) at the relevant trading desk exceeds $25 million.

We strongly support retaining the Market Risk and registered dealer elements of the trading account definition. We also believe it is sensible to base a trading account definition on mark to market or fair value accounting treatment. Although accounting treatment is not designed as an indicator of proprietary trading, fair value accounting treatment would generally be necessary to manage trading risk and mark to market valuation would generally be indicative of a desire to use an asset to profit by changes in market prices. In addition, the current 60 day rebuttable presumption of proprietary trading is likely under inclusive, since many positions could be held in order to profit through short-term price movements that might not be disposed of within 60 days. Derivatives positions or available for trade securities that are held in anticipation of price changes might be examples.

However, we are concerned about the presumption of compliance granted to positions that qualify as proprietary trading through the accounting prong. Positions intended for trading purposes might avoid Volcker Rule coverage during periods of extremely low volatility. A large number of such positions might suddenly convert to trading account coverage when volatility increases during periods of market stress. The Agencies should in general seek to avoid such radical shifts in Volcker Rule coverage due to changes in market conditions. This risk is reduced if the threshold of absolute P&L necessary to benefit from the presumption of compliance is kept at an extremely low level. At the very least, this level should not be raised from the level of $25 million recommended in the Proposal, and the P&L threshold should continue to be defined through the sum of absolute values over at least a rolling 90 day period.

In addition, we would note that the statutory definition of Trading Account in Section 13(h)(6) of the BHC refers to the intent to benefit from short-term price movements, and we do not believe that the Agencies can entirely eliminate this "intent" prong from the rule. That is, the Agencies will always have the statutory authority to classify positions as within the trading account based on an assessment of trading intent. The Agencies should not automatically grant the presumption of compliance to positions that qualify through the profit and loss threshold if it appears that such positions are held with trading intent.

Changes in the definition of "trading desk": The Agencies request comment on the current definition of "trading desk". This definition is also critical to the rule, as the trading desk is the level at which various metrics for monitoring proprietary trading are aggregated and defined. This includes the P&L threshold metric for inclusion in the trading account. Since this P&L threshold becomes far less meaningful if the trading desk is defined at an excessively granular level of aggregation, it is particularly important to maintain a meaningful trading desk definition if the P&L threshold for exemption from the trading account definition is adopted.

Under the current rule, the trading desk is defined with reference to the "smallest discrete unit" engaged in trading activity. According to the Proposal, banks have found this definition confusing and also unrelated to the ways in which trading desks are defined for other business purposes. Accordingly, the Agencies request comment on an alternative definition. This definition appears to have a greater reliance on the way in which the trading desk is defined within the administrative and personnel structure of the bank.

We agree that an alternative definition of trading desk would be sensible. We also agree with many of the factors set out in the trading desk definition on CFR 33453 of the Proposal. In general, the trading desk should refer to a discrete and clearly defined unit of personnel that engages in coordinated trading, books its trades together, reports to the same managers and superiors (including risk managers), and is managed under the same risk limit structure. However, the trading desk definition is so important that supervisors should retain control over its definition. Specifically, supervisors should be required to approve the initial trading desk designations and also any changes in such definitions and designations. In addition, supervisors should seek to prevent excessive aggregation of trading desks, so as to maintain visibility into discrete trading activities.

Public disclosures of Volcker Rule data: As stated in the introduction to this comment, AFR believes that public disclosures regarding the implementation of the Volcker Rule and its impact on bank trading practices have been gravely inadequate.[15] Question 300 of this Proposal requests comment on whether some or all of the reported quantitative trading metrics under the Volcker Rule should be made available to the public. We strongly believe that they should be. These metrics are already aggregated at the trading desk level when they are reported to the Agencies. They do not represent individual trades or positions, but the sum or aggregation of specific metrics derived from many positions. If the metrics were released on a time-delayed basis (e.g. several months after they were reported to the Agencies), we believe that it would be effectively

[15] Americans for Financial Reform, "Letter to Regulators on Volcker Rule Disclosure", December 17, 2015. http://ourfinancialsecurity.org/wp-content/uploads/2015/12/AFR-Volcker-Joint-Letter-12.17.15-1.pdf

impossible to infer current positions from these aggregated metrics. They would thus not create costs for reporting banks. However, they would lead to substantial public benefits as academics, analysts, and public interest organizations could use them to better understand the impact the Volcker Rule was having on banks and markets.

However, the metrics alone would be an incomplete level of public reporting. For example, the metrics do not include any assessment of near-term customer demand (RENTD) relative to inventory. We believe such an assessment is necessary in order to determine whether the Volcker Rule is actually permitting proprietary trading. As discussed above, we are concerned that the Agencies are effectively eliminating requirements to do a quantitative assessment of RENTD from the rule. At a minimum, the Agencies should and must describe to the public the specific methodologies and practices being used by banks and supervisors to ensure that trading desk level risk limits are set in a manner designed not to exceed RENTD. Without such disclosures it will be impossible to tell if the statute is being effectively implemented. The number of risk limit breaches and supervisory action in response to such breaches should also be made public. This kind of reporting becomes even more important given the deregulatory changes in this Proposal.

In addition to RENTD procedures and risk limit breaches, other information that should be reported to the public includes:

- The trading desk structure of major banks.
- Inventory at each trading desk, perhaps on a delayed basis.
- The type, nature, and amount of Volcker-covered funds owned by the bank, and which exemption from the Volcker Rule permits such ownership.

We would also suggest the Agencies consult the Pillar 3 disclosures for market risk positions recommended in the 2013 iteration of the Basel rule on the Fundamental Review of the Trading Book.[16] These disclosures, which have unfortunately not been finalized and implemented, provide an excellent guide to reasonable disclosures of bank trading practices.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact the AFR Education Fund's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform Education Fund

[16] See pages 114-115 in BCBS Consultative Document 265 from 2013, available at https://www.bis.org/publ/bcbs265.pdf