Occupy the SEC

http://www.occupythesec.org

September 20, 2017

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218
Washington, DC 20219

Re: Notice Seeking Public Input on the Volcker Rule (Docket No. OCC-2017-0014)

Dear Sir or Madam:

Occupy the SEC[1] ("OSEC") submits this comment letter in response to the Office of the Comptroller of the Currency's ("OCC") notice seeking public input on the Volcker Rule ("Notice").

I. Introduction

In December 2013, the Treasury and other concerned regulatory agencies ("the Agencies") issued a Final Rule implementing Section 619 of the Dodd-Frank Act ("Volcker Rule").[2] The Volcker Rule has been a codified, well-established regulation for almost four years now, and we object to the OCC's recent attempts to upend it at this late stage.

Even if the Agencies plan to reconsider the Volcker regulations, we fully expect them to give due consideration to proposals to *strengthen*, and not just weaken, the Rule. In February 2012,

[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.
[2] Press Release, Board of Governors of the Federal Reserve System, Agencies Issue Final Rules Implementing the Volcker Rule (Dec. 10, 2013).

OSEC had submitted a 325-page comment letter in response to the proposed version of the rule.[3] In that letter, we detailed our concerns with the proposal and provided extensive recommendations to strengthen the Volcker Rule. We would request the Agencies to reconsider the various proposals suggested in our February 2012 letter as part of any new attempt to redefine the Rule's contours.

It is clear that the OCC's Notice has been issued as the result of the inordinate influence of the financial services lobby on regulatory initiatives at the agency. In the Notice, the OCC takes cognizance of numerous industry comments proclaiming that the Volcker Rule will harm the financial markets and suffocate market "liquidity." (Notice at 14.) These commentators suffer from what Keynes referred to as the "fetish of liquidity," that most "anti-social maxim of orthodox finance."[4] Instead of considering the Volcker Rule's impact on levels of employment, output or growth in all markets, such commentators primarily focus their analysis on the potential impacts of the Rule on short-term bank profitability. In doing so, they gloss over the numerous benefits to be reaped from vigorous implementation of the Volcker Rule.

Many of the Volcker Rule's liquidity costs occur in the form a zero-sum game, wherein a banking entity's "cost" serves as a benefit to depositors and the public in general. While the Volcker Rule may reduce banking profits resulting from proprietary trading, such lost profits are not unanticipated "costs," but rather benefits that form the crux of Dodd-Frank Section 619's intended regulatory effect.

Proprietary trading by a government-backstopped bank involves the distinct possibility of the bank needing to be bailed out, whether through depositors' funds, Federal Reserve financing, or taxpayer subsidies. The costs associated with these forms of bailout must be included in the equation when considering the economic impact of the Volcker Rule. Thus, to the extent that banks face costs from their compliance obligations or from lost proprietary trading profits, depositors and the public are concomitantly saved the externality costs of potential bailouts.

An undiluted version of the Volcker Rule's ban on "proprietary trading" by banking entities would reduce the risk of bank failure, as only the most basic, customer-focused trades could make it through the Rule's gauntlet. This outcome would increase both depositor and investor confidence in banking entities, which in turn would increase *real* liquidity in the banking industry, and as a consequence, the overall market for credit. Increases in real liquidity would drive down real interest rates, improve consumption and help the global economy enjoy a sustained recovery.

II. The Scope of the Definition of Banking Entity

The Notice suggests that certain activities of small banks have been caught up in the proprietary trading prohibition, and that exempting such entities from the definition of "banking entity" in the Volcker regulations would reduce compliance costs. (Notice at 11.)

---

[3] Occupy the SEC, Comment Letter to SEC, FRB, OCC and FDIC on Section 619 of the Dodd Frank Act of 2010 (Feb. 13, 2012), *available at* http://www.occupythesec.org/letter/OSEC%20-%20OCC-2011-14%20-%20Comment%20Letter.pdf.

[4] John Maynard Keynes, *The General Theory of Employment, Interest and Money* 155 (1936).

Community banks are obviously less equipped to deal with large-scale regulatory requirements than are relatively large banks. But it should be noted that the existing Volcker Final Rule already imposes a relaxed regulatory regime on small banks.

Eliminating community banks outright from the scope of the Volcker Rule is not warranted. While community banks have not generally engaged in risky trading activities, completely exempting them from the scope of the Volcker Rule would permit a larger bank to evade proprietary trading by routing such activities through small, ostensibly separate community banks. The example of Long Term Capital Management (LTCM) will demonstrate that even small, seemingly-sophisticated financial institutions can engage in risky activities that can threaten the broader markets.[5] While LTCM was not a bank, much of its trading bore a remarkable similarity to the kind of derivatives activities that troubled banks like Citigroup and Wachovia.

In any case, the OCC has no authority to exempt small banks from the scope of the Volcker Rule. Under Section 619, a "banking entity shall not engage in proprietary trading."[6] A "banking entity" is defined as "any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)."[7] The Federal Deposit Insurance Act defines "insured depository institution" as "any bank or savings association the deposits of which are insured by the Corporation pursuant to this Act."[8] *Thus, any bank that benefits from FDIC insurance must be covered by the Volcker Rule, regardless of size.* Neither the Department of Treasury generally nor the OCC specifically has the authority to change that statutory requirement.

III. The Volcker Rule Has Not Hampered Useful Market Liquidity

The Volcker Rule's proprietary trading prohibition has been effective in limiting banking entities' risk-taking and reducing the likelihood of taxpayer bailouts. Perhaps the best evidence of this is the fact that since the Rule's passage no major financial institution has foundered or required government liquidation under Dodd Frank Title II.

Industry claims that the Volcker Rule has hampered market liquidity are motivated more by political ideology (and the appetite for risky profiteering) than fact. The Securities and Exchange Commission had found that total primary market security issuance has not been lowered by the enactment of the Dodd-Frank Act (or the Volcker Rule in particular).[9] The SEC found "no empirical evidence consistent with the hypothesis that liquidity has deteriorated after regulatory reforms. More specifically, there is no support for a causal link between the Volcker

---

[5] *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001).
[6] 12 U.S.C. § 1851(a).
[7] *Id*. at § 1851(h)(1).
[8] 12 U.S.C. § 1813(c)(2).
[9] SEC Report to Congress on Access to Capital and Market Liquidity 4, 5
(August 2017) [hereinafter SEC Report], *available at* https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

Rule and U.S. Treasury market liquidity conditions."[10] The absence of any such causal link is not surprising, given that the Volcker Rule specifically exempts proprietary trading in U.S. Treasury securities, which largely drive overall bond liquidity.

In fact, the Volcker Rule statute already contains an outright exemption for municipal, treasury and federal agency securities. According to data from the Securities Industry and Financial Markets Association, these government securities exceed **50% of the bond market**.[11] Participants in the remaining 50% of the bond market can also avail of numerous additional exemptions built into Section 619, including market-making, underwriting and customer-facing transactions.

While dealers in particularly esoteric corporate bond markets have, in aggregate, reduced their capital commitment since the 2007 peak, that result is by design. The Volcker Rule was passed to protect banks and the public, and not to safeguard liquidity in esoteric niche markets. Even if major banks undergo significant costs in changing their business models to offload certain prohibited asset classes, those costs are required by Section 619 and are justified by the benefits to be enjoyed by the overall economy. Those benefits include, for instance, more prudent risk management that will make the job-creating functions of banks more viable.

Moreover, banks have had ample opportunity to offload offending assets from their proprietary trading books. The Volcker Rule was passed as statute over 7 years ago, and implementing regulations were promulgated almost 4 years ago. Thus, industry claims of unexpected "fire sales" of assets must be taken with a grain of salt. Indeed, even if the application of the Volcker Rule has forced banks to take write-downs on certain assets then that is likely the appropriate result of a fully effective rule. Such write-downs better reflect true market conditions and offer bank examiners greater transparency into bank health. Moreover, it is disingenuous for industry participants to proclaim that the Volcker Rule is creating new losses by operation of mark-to-market accounting requirements. The fact is that any such "realized" losses are in fact losses that the banks always knew they had on their books — such losses were simply camouflaged for the purpose of artificially upholding valuations. These duplicitous accounting practices only contribute to the proliferation of liquidity-based crises. The markets and the public can only benefit from the increased transparency produced by a strongly enforced Volcker Rule.

IV. Revisions to the Definition of Proprietary Trading

Section 619 stipulates that any position that is principally taken "for the purpose of selling in the near term" would qualify as a proprietary trade.[12] The OCC is correct in suggesting that the Volcker Final Rule's presumption, whereby a sale within 60 days will be presumed to be a proprietary trade, is flawed. Illiquid securities, for example, often have a long duration between purchase and sale, so the functional meaning of "near term" in illiquid markets is much different

---

[10] *Id*. at 7.
[11] *See* SIFMA, US Bond Market Issuance and Outstanding (September 2017), *available at* https://www.sifma.org/wp-content/uploads/2017/06/cm-us-bond-market-sifma.xls (demonstrating that municipal, treasury and federal agency securities comprised 50.4% of bond market issuance in August 2017).
[12] *See* 12 U.S.C. § 1851(h)(4), (6) (defining "trading account" and "proprietary trading").

than for securities in more liquid markets. A very illiquid security should still fall within a proprietary "trading account" even if it is meant for a "short term" resale that is more than 60 days from purchase.

For this reason, we recommend that the definition of "short-term" be deemed to vary by asset class. The 60 day presumption should continue to exist for moderately liquid securities, such as equities traded on minor exchanges. Relatively illiquid securities such as bonds, and especially derivatives, should be assigned a longer window of presumption, such as 90 or 120 days. Further, the resale of highly liquid securities, such as equities traded on major exchanges, within a 60 day timeframe should be considered proprietary trading, *per se*, with no possibility of rebuttal. The Agencies should eschew a one-size-fits-all approach in favor of a definition of proprietary trading that reflects market realities.

V. Revisions to the Definition of Covered Funds

Section 619 prohibits a banking entity from owning any hedge fund or private equity, defined as an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act. The Notice laments that the statutory definition referencing sections 3(c)(1) and 3(c)(7) of the Investment Company Act covers a broad range of issuers. The Notice also implies that this broad definition of covered funds has hampered fund liquidity. To address the issue, the Notice asks what specific characteristics could be used to narrow the covered fund definition.

As a principal matter, it should be noted that the SEC has found that any link between the Volcker Rule and reduced fund liquidity is tenuous. Various factors such as macroeconomic conditions or even the "the trading activity of funds that participate in the bond market may affect bond market liquidity in ways that confound [the agency's] ability to identify the impacts of regulatory action on bond market liquidity."[13]

In any case, *the plain language* of Section 619 dictates that the agencies can only *expand*, not narrow the existing definition of covered funds. Section (h)(2) states the following:

> The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, **or such similar funds** as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.
> (emphasis added).

Under this language, any fund that would be an investment company but for section 3(c)(1) or 3(c)(7) the Investment Company Act of 1940 must necessarily be a covered fund, *irrespective of its characteristics*. In addition, the clause after "or" in the above passage allows the Agencies to expand the purview of the Volcker Rule to include additional funds, such as investment companies or non-investment companies that fall outside the purview of the Investment

[13] SEC Report at 264.

Company Act because of exemptions other than section 3(c)(1) or 3(c)(7). But any attempt to deviate from the statutory reference to 3(c)(1) or 3(c)(7) would be an *ultra vires* derogation of rulemaking authority.

Particular galling is the question in the Notice asking whether the Agencies should consider "adjusted implementation of the existing covered fund provisions." (Notice at 18.) A similar question asks "which compliance program requirements should be reduced or eliminated."[14] Again, any "adjusted implementation" or reduced compliance that falls short of the plain language of the statute would be an illegal derogation of the Agencies' responsibilities, not to mention a troubling threat to the hallowed separation of powers principles ensuring administrative accountability to the legislature.

VI. The OCC Should Accept the Fact that the Volcker Rule is Law

We believe that the current Final Rule already contains sufficient exclusions and exemptions from the proprietary trading prohibition. We commend the OCC for its solicitude in assuring that the existing proprietary trading provisions clearly delineate the line between permissible and impermissible activities. However, it should be noted that the OCC and the other Volcker regulators were given ample opportunity to define the contours of the regulations implementing Section 619. The rule finalization process took over three years, well in excess of the deadline established by Congress.

Millions of lobbying dollars were spent by industry participants to cajole the Agencies into favorable interpretations. Thousands of commentators, comprised of individuals, groups, companies and governments opined on various aspects of the Volcker Rule, including exemptions, market realities, and trends. The Agencies expended considerable manpower and government resources to consider these comments. In short, the Volcker Rule was finalized after much deliberation. The OCC's issuance of the instant notice for comment is akin to reopening Pandora's box.

The OCC and the other Volcker-enforcing agencies should now focus on enforcing the Rule rather than on constantly seeking new opportunities to refine and complicate an already-complex law. Many years after it became law (technically going into effect on July 21, 2012 by virtue of 12 U.S.C. § 1851(c)(1)(B)), the Volcker Rule remains a largely unenforced one. Only one major bank, Deutsche Bank, has been penalized for Volcker non-compliance. And even in that case, the assessment was a paltry **$19.7 million**.[15] Rather than habitually kow-towing to industry efforts to gut the Volcker Rule, the OCC should set its sight on actual enforcement of what is now a well-established law.

---

[14] *Id*. at 19.

[15] Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Announces Two Enforcement Actions Against Deutsche Bank AG That Will Require Bank To Pay A Combined $156.6 Million In Civil Money Penalties (Apr. 20, 2017).

VII. Conclusion

We urge the OCC and the other Agencies to retain a vigorous version of the Volcker Rule, and reject any deregulatory recommendations from financial industry lobbyists.

Thank you for your attention to this matter of great public interest.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Neil Taylor
et al.