Intended and Unintended Results of the Proposed Volcker Rule

Skold, Alida S.

International School of Management

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Regulation is written with the intent of protecting the vulnerable. However, it can cause an undesirable result if written without understanding how the positive intent can have a negative impact. In its present form, the proposed Volcker Rule has the potential of expanding the liquidity crisis that devastated the housing market into the capital markets. Risk will be transferred to less regulated entities. Banks conducting business in the U.S. or with U.S. "residents" will be at a competitive disadvantage.

By Alida Skold

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ABSTRACT

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INTRODUCTION

The unintended results of the rule are what can either partially or completely derail the intended results of the Volcker Rule. In the first section, the prohibited practice of proprietary trading and the allowed practice of market making will be discussed. The proposed rule will have the effect of decreasing revenue while simultaneously increasing costs for compliance. The capacity to compete in the global markets for covered banking entities as well as for U.S. businesses will also decline.

Relationships with hedge funds and private equity funds are discussed in the second section. Risk is transferring from the more regulated banking entities to the less regulated asset managers and insurance companies. The transfer will place many, including vulnerable retirees at increased risk. Pension funds are underfunded and are investing in hedge funds for absolute returns.

IMPACT ON PROPRIETARY TRADING AND MARKET MAKING

Market making activity is vital to market efficiency. If banks are not assured their market making activity will be perceived as legal under the Volcker Rule, the opposite effect of the rule's purpose will occur. Liquidity will leave the markets and costs to investors will rise.

In his video produced by Kantola (2008), Jay Conger quoted a person he identified as a private banking executive for a large Swiss bank. The executive positioned the division's attitude to competition with the statement, "You are about to lose every second customer." His words how essential it is to compete to gain every new client that has an interest in investment and private banking, and to maintain a secure relationship with every one of the division's established clients.

In response to the Volcker Rule, Private banking divisions may consider that statement to be more than

a positioning of attitude. It may become reality, especially regarding their high net worth clients that provide a large percentage of a bank's private investment capital. Rather than invest their wealth with private banking, they may move it to a private hedge fund or they may open a family office. Families with $100 million or more have been increasingly trending toward opening independent offices. The first family office was opened by John D. Rockefeller in 1882 to manage his family's assets. With the advent of the Volcker Rule, a lesser known method for managing wealth is becoming more widely implemented.

The proposed Volcker Rule is 298 pages long. A complete copy of the draft of the rule released by the Federal Reserve can be located online. The rule's official name is "Prohibitions And Restrictions On Proprietary Trading And Certain Interests In, And Relationships With, Hedge Funds And Private Equity Funds" (Federal Reserve, 2011). It has been named the Volcker Rule after the former Federal Reserve Chairman, Paul Volcker (Mehta, 2011).

A debate is forming in the public sector regarding the unintended results of the rule. The draft released on October 11, 2011 is open for public comment on the Federal Reserve's web site until January 13, 2012 (Board of Governors of the Federal Reserve System, 2011). Whether or not the regulation is finalized, the statutory Volcker Rule prohibitions will go into effect on July 21, 2012 (Davis Polk & Wardwell LLP, 2011).

The Volcker Rule draft that was released on October 11, 2011 has two main prohibitions. First, the rule "prohibits [federally] insured depository institutions, bank holding companies, and their subsidiaries or affiliates (banking entities)from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for a banking entity's own account, subject to certain exemptions. Second, it prohibits owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund, subject to certain exemptions." (Board of Governors of the Federal Reserve System, 2011).

The first purpose of the proposed Volcker Rule is to protect the customers from losing their deposits through trading that involves risk for the firm's own benefit. This type of trading is known as proprietary trading. The second purpose is to lessen systemic risk within the financial system. The intended results of the proposed rule follow Newton's well-known third law, "For every action there is an equal and opposite reaction." Integrated into the rule, without specific comment, are the unintended results of decreasing revenue while simultaneously increasing costs.

Decreased Revenues

An unintended result is a large calculation on the revenue side of the equation. The loss in annual revenues by covered financial institutions will be substantial. Patterson and Zibel (2011) quote analyst estimates of $2 billion in lost revenue. The removal of the source of revenue is occurring at a time when banks are already under pressure from substantial costs and weak growth.

Frank Keating, president and chief executive of the American Bankers Association (ABA) is quoted in the

following statement; “Only in today's regulatory climate could such a simple idea become so complex, generating a rule whose preamble alone is 215 pages, with 381 footnotes to boot. How can banks comply with a rule that complicated, and how can regulators effectively administer it in a way that doesn't make it harder for banks to serve their customers and further weaken the broader economy?"

Touryalai (2011, Oct 7) provides partial details of revenues at risk. Goldman Sachs’ has 48 percent principal trading revenue at risk, although the Nomura analyst Glenn Schorr is quoted as saying the rule will impact 20 percent, which is still a substantial loss of revenue. Morgan Stanley will also feel the effect of the rule with up to 27 percent of its principal trading revenue at risk. Bank of America has 9 percent at risk, JPMorgan Chase has 8 percent at risk, and Citigroup has 5 percent at risk.

Nomura’s analyst, Schorr sounds the alarm when he provides clarity to unintended results of the rule in his following statement, “A draconian form of the Volcker Rule will likely have unintended consequences, such as reduced liquidity, higher funding costs for U.S. companies, less credit for small businesses, higher trading costs and lower investor returns, less ability to transfer risk, and competitive disadvantages for U.S. banks relative to foreign banks. We are hopeful regulators are mindful of these risks and doing their best to write fair, yet effective, rules.” (Touryalai, 2011 October 7).

Increased Costs

As has been discussed, the proposed rule will decrease revenue. At the same time it will increase costs, pushing the revenue and cost equation further out of balance during a weak economy.

Tourlyalai (2011, Oct 12) quotes Frank Keating, president of The American Banker Association (ABA):

> “Only in today’s regulatory climate could such a simple idea become so complex, generating a rule whose preamble alone is 215 pages, with 381 footnotes to boot. How can banks comply with a rule that complicated, and how can regulators effectively administer it in a way that doesn’t make it harder for banks to serve their customers and further weaken the broader economy?
>
> It’s clear from the proposal that many important details remain unresolved**.** More questions are asked than answered, with requests for public comment on 394 specific issues. The exceedingly high number of unanswered questions betrays the frustration regulators are having as they come to grips with the complexity of the concepts behind the Volcker Rule when applied to reality. Regulators will be working on these practical questions for a long time to come…Regulators’ own estimates indicate banks will have to spend nearly 6.6 million hours to implement the rule, of which more than 1.8 million hours would be required every year in perpetuity. That translates into 3,292 years, or more than 3,000 bank employees whose sole job will be complying with this rule. They will be transferred to a role that provides no customer service, generates zero revenue and does nothing for the economy.”

Brush (2011) writes that the government estimates the cost for compliance and capital to banking entities covered by the rule could reach $1 billion. The office of the Comptroller of the Currency (OCC) estimates the cost of capital alone will reach $917 million.

Many consider these estimates to be low. Brush continues by quoting Donald N. Lamson who once worked for the OCC as assistant director and is now a Washington-based counsel at Shearman &

Sterling; "There are a number of costs associated with this and I think the rulemaking and official government assessments understate the costs."

After withdrawing the revenues generated by the prohibited proprietary trading, the next cost forced upon banks will be the cost of compliance with the rule. Regulators estimate more than six million hours will be required in the first year of implementation for documenting, record keeping, and reporting (Basar, 2011). Schorr estimates the cost to the industry for compliance and monitoring will reach $2.1 billion each year (Mehta, 2011). When added to the $2 billion in lost revenues, the annual impact of the rule is estimated at $4.1 billion – during a weak economy.

Regulatory agencies suggest using 17 metrics in the process for determining if a bank has engaged in market making or in the prohibited practice of proprietary trading (Mehta, 2011, Oct 16). Davis Polk & Wardwell LLP Law Firm (Davis, Polk & Wardwell, 2011) created a series of flowcharts to explain the Volcker rule. The flowchart demonstrating the complexity of the metrics used to determine the difference between market making and proprietary trading can be found in Appendix A.

Mehta (2011) writes in her article about the additional costs that will be incurred by the need to hire new compliance employees. Daily calculations running the 17 metrics will be required of firms with more than $5 billion in trading assets and liabilities. The results are to be reported to regulators monthly. Thirteen firms fall into this category and account for 98.4 percent of the trading assets and liabilities of the 1,020 bank holding companies that are to be regulated by the rule. One compliance person will be required in each subsidiary and trading unit to meet the required monitoring for the rule. Each bank may have a multiple of a dozen trading units. To comply with the rule, a multiple of a dozen additional jobs in the compliance division would be required.

Middle sized banks will be required to measure eight of the seventeen metrics, and the small sized banks will be exempt. The smaller scale would make the costs prohibitive for the added monitoring.

The result of the required monitoring is to add jobs that will add to costs without generating any revenue. The added costs, estimated at $2 billion, will be incurred at a time when banks are striving to improve their financial condition during a weak economy.

Proprietary Trading or Market Making?

Proprietary trading is done for a financial firm's own benefit and is prohibited in the proposed rule. However, market making, which is the buying or selling of equities or securities for the benefit of customers, is allowed. The impact of the Volcker Rule will not be limited to banking entities. Investors will be impacted with a meaningfully unintended result if the rule is applied too restrictively regarding proprietary trading and market making due to its lack of clarity.

Market making provides liquidity in the markets and increases market efficiency. The definition of market making in the Financial Dictionary by Farlex (2011) provides insight into how difficult it can be to identify the difference between proprietary trading and market making. A market maker is, "a dealer available to trade a stated security on its own account at any time at the quoted price. The job of a dealer is to be a market maker in

order to promote liquidity for a security. When a broker-dealer makes a market, it trades from its own inventory, which is easier and less expensive for an investor than looking for other brokerages willing to trade. Many exchanges designate a market maker for each of its listed securities to promote ease of trade. Market makers improve the efficiency of markets by quoting both bid and ask prices of an asset."

Thomas Gira, Executive Vice President of the Financial Industry Regulatory Authority (FINRA) is quoted by Mehta (2011) as saying the Volcker Rule has the "potential to impact legitimate activity." FINRA is the largest independent regulator for all securities firms doing business in the United States. It oversees nearly 4,495 brokerage firms, 163,450 branch offices, and 635,515 registered securities representatives. Some of its purposes range from registering and educating brokerage industry participants, to writing rules, to resolving disputes, to informing and educating the public. FINRA defines itself as an advocate for investors that maintains fair markets and, most importantly regarding the Volcker Rule, it proactively addresses "emerging regulatory issues before they harm investors or the markets," (FINRA, 2011). Gira continues by pointing out that what constitutes market making is a "difficult question to get your arms around. From a surveillance standpoint, this is a pretty challenging rule," (Mehta, 2011).

Jamie Dimon, Chairman and Chief Executive Officer of JPMorgan Chase made a public statement on October 13th saying that banning proprietary trading was "fine." In the statement made during the conference call, Dimon described the importance of banks acting as market makers for investors; "The United States has the best, deepest, widest, and the most transparent capital markets in the world, which give you, the investor, the ability to buy and sell large amounts at very cheap prices. That's a good thing. I wish Paul Volcker understood that." (Mehta, 2011).

David A. Viniar, Chief Financial Officer of Goldman Sachs, and James Gorman, Chief Executive Officer of Morgan Stanley, both of whom are in the process of implementing the rule, are shutting down their proprietary trading divisions. They too, are concerned about losing capacity for market making. They warn that if the Volcker Rule is interpreted too strictly, banking entities will see their capacity for market making hindered. The investor will ultimately feel the impact when market liquidity is reduced (Brush, Harper, & Moore, 2011).

Lost Capacity for Banks and Businesses to Compete

An unintended result of the proposed rule is how it will decrease competitiveness by all that are affected by its reach. To begin with, it will give the advantage to all foreign banks that will not have any involvement with U.S. financial services covered by the rule.

Peter Nerby, a Moody's Investors Service analyst, observes that, "The rule disadvantages the important core market-making franchises of the big U.S. banks and creates opportunities for unregulated competitors, such as high-frequency trading firms, and the non-U.S. operations of foreign banks," (Panchuk, 2011).

While speaking on a panel hosted by New York University's Stern School of Business in September, the chief executive of JPMorgan's investment bank, James (Jes) Staley commented on the regulators' observance when the Volcker Rule was first introduced. He said assurances were made that other

countries “would fall in line but we haven’t seen that. Germany, France, China, Brazil. They didn’t follow us.” (Touryalai, Oct 12).

The rule covers all banking entities that fit the guidelines, whether they are U.S. owned or foreign owned. Landy (2011) summarizes how the rule expands its jurisdiction beyond the U.S. shores. First, no party to a trade may be a U.S. resident, which includes U.S. companies. Second, no person in the U.S. may be directly involved in the trade, including employees of non-American banks that are operating in the U.S. These restrictions will cause jobs to leave the country as foreign owned banks move their offices and branches out of the United States.

The third part of Landy’s summary states that a trade must be “executed wholly” outside of the United States. No part of a trade may be executed by any banking entity, clearinghouse, stock exchange, or any other entity that is a part of the U.S. financial system. The last point of Landy’s summary has to do with compliance. Every trade must be proven to comply through documenting, reporting, internal controls, and certifications.

Not only will jobs leave the U.S., but it can be inferred that given the high costs associated with compliance with the Volcker Rule, rather than adding new jobs to enforce the U.S. rule, foreign banks may decide to avoid working with U.S. customers. For example, it would be difficult to grasp how European banks could absorb the lost revenues and increased costs during the current financial crisis taking place in the European Union.

The competition in the global markets will shift away from U.S. banking entities and customers. The revenues generated from the transactions may not cover the higher costs, and the U.S. customers – including businesses – will have to pay higher fees. If enforced, the proposed rule will place our banks as well as our U.S. companies at a disadvantage while competing in the global markets.

Prop Traders Exiting Investment Banks

A result of the proposed Volcker Rule is that proprietary traders are leaving the regulated institutions and either going independent or moving to private asset managers or insurance companies, all of which are relatively unregulated entities by comparison, to open new hedge funds (Major Trends, 2011). This transfer of risk from a regulated entity to a far less regulated entity does not accomplish the goal of the rule. The new hedge funds are not subject to the regulations to which the covered financial entities must adhere. Instead of investing their wealth in a regulated environment, albeit not perfect regulation, investors are placing their wealth at greater risk of loss in an environment that is not subject to the same regulations.

Another destination for exiting prop traders and hedge fund managers is offshore, in particular, Asia. With them go their talents and skills in creating wealth, which will be encountered in competition with those still working to create wealth in the United States. The investment opportunities will be lost in the U.S., as well as the jobs of those that left and all the support jobs. Tax revenues generated through capital gains taxes are lost for the country, too.

What is the difference between a prop trader and hedge fund manager? While both are experienced with managing large amounts of capital, a bank prop trader has a different focus regarding capital and risk. Prop traders do not view capital as a tightly fixed amount (Analysis, 2011). They have an investment "credit line" financed through the bank's balance sheet. By contrast, private asset managers and independent hedge fund managers are not in a division of a larger entity with a larger balance sheet. Their capital is limited to a balance sheet of the assets they manage from day-to-day that is more finite than the balance sheet of a banking entity.

The second difference between prop trading and managing a hedge fund is the amount of cash maintained (Analysis). Again, prop traders can take more risk while working with minimal cash. Hedge fund managers maintain a certain amount of cash in preparation for customer redemptions. The higher percentage of cash balance reduces the amount of risk in the fund.

The third difference between prop trading and managing a hedge fund is diversification (Analysis). An individual prop trader can specialize in a single type of asset. Diversification is not a focus for an individual prop trader. It is established through the combination of the trading activities of the many prop traders in the banking entity who each specialize their area of asset classes. In contrast, a hedge fund manager is required to provide diversification within the fund. Diversification within a fund can decrease the amount of investible capital that can be used to manage risk while unwinding a position.

The differences between prop trading and hedge fund management lead to different risk management structures. An example of a broker-dealer that was overwhelmed with too much risk was MF Global Holdings Ltd., which would not be covered under the Volcker Rule.

Carney (2011) describes events that lead to MF Global's filing for bankruptcy. After constructing what is traditionally viewed as a low risk "repo-to-maturity" trade of European debt with capital owned by the firm, the risk suddenly increased as the value of the bonds decreased. The result was a circle of events.

Regulators required more capital in preparation for probable margin calls, as well as the disclosure of the size of position. After learning the size of position and the higher risk due to the lower value of the bonds, ratings agencies issued downgrades of MF Global's credit, which in turn led to further creditor calls for additional collateral. Circumstances surrounding MF Global's demise were not new to the financial sector. Its situation was similar to the crisis experienced by American Insurance Group (AIG) during the financial crisis.

At first, even though MF Global is not covered by the Volcker Rule, its implosion seems to support the purpose of the rule in that its demise has not led the entire financial system to the precipice of implosion. However, the important phenomenon of herding has not been considered. When herding occurs, the sum of the parts adds up to a systemically meaningful whole, potentially leading to a systemic risk of failure.

HEDGE FUNDS

Herding

To effectively manage or regulate systemic risk, it is essential to first understand the two channels through which the risk can occur. King and Maier (2007) provide the following analysis of the two channels:

> "A **direct channel** occurs when a collapse of a hedge fund (or group of hedge funds) holding large positions leads to forced liquidations of those positions at fire-sale prices. The impact on asset prices may be amplified through the use of leverage – whether created directly through the use of margin or indirectly through the embedded leverage of derivative positions. Such a disorderly unwinding, it is feared, could generate heavy losses to counterparties and ultimately contribute to severe financial distress at one or more systematically important financial institutions.
>
> In the **indirect channel**, a forced hedge fund liquidation exacerbates market volatility and reduces liquidity in key markets. Systemic risk can occur when correlations in asset classes increase during times of stress, or when the potential for herding amplifies market movements."

King and Maier (2007) caution that systemic risk increases when economies and markets experience increased stress. The correlation between asset classes increases, and hedge fund trades herd together, amplifying market movements. If enough hedge funds unknowingly herd together with a trade that makes sense given market conditions, market volatility increases as does the potential for systemic risk with increased price movement. Tail risk events are occurring more frequently, again increasing the potential for systemic risk through herding. The Volcker Rule does not address the potential for systemic risk from the domino effect of hedge funds and broker-dealers.

The financial system has been actively working to reduce the amount of systemic risk in the system since 2007. Tim Ryan, President and Chief Executive Officer of Securities Industry and Financial Markets Association (SIFMA) included the following quote in his opening remarks for the annual SIFMA meeting held November 7, 2011:

> "Since the end of 2007, U.S. financial firms have raised more than $300 billion of common equity. The largest U.S. banks have reduced their average leverage ratio from 16:1 to 11:1 and increased loan loss reserves by about 200%. Off-balance sheet activity has also been reduced dramatically. Many have already undergone stress tests with both the Treasury and Fed. Over 90 percent of the TARP capital infusion funds into banks have already been repaid, with interest, dividend and warrant sales for a profit of $19 billion to the taxpayers to date."
>
> "At SIFMA, we have been focused from the very early days of regulatory reform on being productive participants in the process. Through our committees, on

> which almost 6,000 members from the industry participate, we provide information and analysis to help the regulators craft rules that work and create certainty. We support measures to restore faith and confidence in our financial system, such as establishing a systemic risk regulator and the designation of bank and non-bank firms as systemically important. We believe there should be a uniform fiduciary standard of care. We support risk retention and other improvements in the securitization space to help jumpstart recovery of the housing market. But we cannot support measures which disrupt market functions or increase systemic risk, ultimately failing to achieve what Congress and the Administration sought to accomplish with this legislation."

Capitalism is fortified by competition and sustainability. If a business practice does not support the company's sustainability, the company will take action to correct the practice. The financial system is implementing the changed practices as noted in Tim Ryan's statement to decrease systemic risk, which in turn will increase the sustainability of a company and ultimately of the financial system.

Risk Transferred to the Vulnerable

One of the effects of the Volcker Rule prohibiting banking entities from owning more than three percent in a hedge fund or private equity fund is to transfer the risk from the financial sector to an already vulnerable segment of the population, the current and future retirees.

There is a large dislocation in funding of pension funds that is driving the funds to increase investment in hedge funds to capture the absolute returns. In the White Paper, "Major Trends Occurring in 2011: Implications for Hedge Funds / Funds of Funds," Infovest 21 (2011) writes about the increasing demand by pensions that are underfunded. At year-end 2010, Standard & Poor's estimated the amount of combined underfunding to be $315 billion for 1500 of the largest United States pension funds. In 2010, corporate pension funds were funded at average to 81 percent, and state and local funds were funded at average to only 79 percent. Infovest21 further defined the lack of performance in pension funds that invested in the S&P 500, which had a return of only 0.4 during the ten years from 2000 to 2010.

With the Volcker Rule prohibiting prop trading and more than three percent ownership in hedge funds, the best and the brightest traders and managers are exiting the banks to manage hedge funds independently or within financial entities not covered by the rule. They will not be met with the regulatory concerns arising from the Volcker Rule, including limits on compensation (Major Trends, 2011). There are two issues that arise from the relocation of talent.

The first issue is that many of the skilled and talented prop traders do not have experience with running a business. The business activities that were segregated into separate departments of the bank suddenly become a part of the traders' daily schedule when running a hedge fund outside of the banking entity (Major Trends). Higher costs are associated with the administrative duties of a hedge fund office. Commentary from a law firm in the "Major Trends Occurring in 2011" White Paper by Infovest21 provides perspective on the different requirements of a hedge fund that is managed outside

of a banking entity. The law firm recommends:

> "that managers adopt articulate FCPA (Foreign Corrupt Practices Act of 1977) compliance policies and procedures, establish oversight by senior executives with responsibility for compliance policy implementation and review, require annual certification and regular training, establish procedures for entering into a third party business relationship, create a reporting system to ensure that violations can be promptly detected and remedied, set up accounting procedures and controls to ensure accurate accounting and books and records, and have independent audits conducted."

The broker-dealer MF Global provides an example of what can happen when accounting books and records are not accurate. Inaccurate accounting methods brought negotiations for a merger with other broker-dealers to a halt. MF Global was rapidly searching for a buyer with a larger balance sheet that could absorb the risk; however, each broker-dealer considering the merger stated they backed away after analyzing the books. The statement was made by one broker-dealer that it could not "get a good sense of what was on the balance sheet," (Lucchetti & Patterson, 2011).

MF Global was forced into filing for bankruptcy. The events support the statement made by Pirrong, a finance professor specializing in risk management at the University of Houston. Mehta (2011) quotes Pirrong; "You think you're reducing risk but you're shifting it around in ways that can come back and bite you. Customers will go to other financial entities. (The Volcker Rule) doesn't make the problems go away. It just changes the location." Add herding to the mix, and Pirrong's statement becomes even more concerning.

At the time of the writing of this paper, $600 million of MF Global's customer money cannot be found. In the article written by Lucchetti and Patterson (2011), a regulator with the Commodity Futures Trading Commission (CFTC) made a statement regarding the condition of the accounting books ten days out from the initial bankruptcy filing. To date, the numbers are not leading the regulators to the customers' money.

Prior to the Volcker Rule, the concern over customer money is what has prompted some to construct a "fund of one," (Major Trends, 2011). In response to the fraud from Madoff, private wealth divisions were increasing their due diligence teams and creating new products. The fund of one was a new product in which the fund was constructed with investment from a single customer. The customer might be an individual, a pension fund, or another type of investor. A feature is that it eliminates the opportunity for the Ponzi scheme fraud committed by Madoff. A fund of one can be cost prohibitive with the extra accounting, compliance and administration required, which makes it less attractive to hedge fund managers outside of investment banks.

The second issue concerns the management of risk within the fund. The prop traders and fund managers are talented and skilled in their areas of specialization; however, their risk management skills

were sharpened with a balance sheet that could absorb a greater amount of risk.

MF Global, with its ties to Goldman Sachs talent, is an example of the difference in risk management techniques of a more constrained, broker-dealer balance sheet as compared to the larger investment bank balance sheet of Goldman Sachs. The relatively sedate risk management technique that matched the smaller balance sheet was ratcheted up by the investment bank talent. A higher tolerance for risk had been learned while working with a much larger balance sheet (Brush, Harper & Moore, 2011). The trade that had been thought to involve low risk suddenly altered into a trade that involved too much risk for the smaller balance sheet of the broker-dealer.

MF Global had to declare bankruptcy; however, Goldman Sachs would have had the capacity to manage the risk through additional hedging while unwinding the position, leaving the fund intact. The events of MF Global's demise point to the transfer of risk from investment banks to other venues that can be more vulnerable. Smaller banking entities with smaller balance sheets and retirees are more susceptible to risk. The Oregon public pension fund was invested in a fund that had been built to $7 billion and then used to invest in MF Global. The fund is down 60 percent (Erman, 2011).

When pension funds could invest in funds managed by banks, they had the additional assurance of the bank performing due diligence to decrease the likelihood of fraud. With the prohibition in the Volcker Rule, pension funds along with all other investors in hedge funds, will have to rely solely on their independent due diligence while researching the fund manager's competency and legitimacy. With the trading strategies that are unique to hedge funds, the funds are not readily transparent, causing both competency and legitimacy to be difficult to determine.

Conclusion

Rather than remove the capability of banks to continue competing in their areas of expertise, the financial system could be strengthened rather than pieced apart by placing stricter limits on the amount of risk taken and the amount of leverage used. The lack of clarity between prop trading and market making could be resolved through the use of tier one capital. Ultimately, the investor is benefitted through a more competitive investment environment that will maintain market liquidity.

Jobs will leave the U.S. if the current proposed rule is enforced. The increase in required bureaucracy and the high costs associated with compliance with the Volcker Rule may cause foreign banks to end conducting business within the U.S. and to avoid working with U.S. customers. Either the revenues generated from the transactions will not cover the costs and the associated bureaucracy, or the U.S. customer will pay substantially higher costs for the financial service. If enforced, the proposed rule will place our banks as well as our U.S. companies at a disadvantage while competing in the global markets.

The intention of the proposed Volcker Rule is to reduce risk of lost investor capital and to reduce systemic risk in the financial system. Further transformation of the rule is needed to reach the intended results.

If the Volcker Rule is enforced, further effects of the rule will be to decrease revenue and to markedly

increase costs of compliance for banks at a time when the entities are recovering from the recent financial crisis, and when economic growth has been slow.

In its current form, the proposed rule lacks clarity between prohibited proprietary trading and allowed market making activities. As covered banking entities end prop trading, they may also decrease market making out of lack of clear definition. The result will be less liquidity in the markets, causing less efficiency and increasing costs for investors.

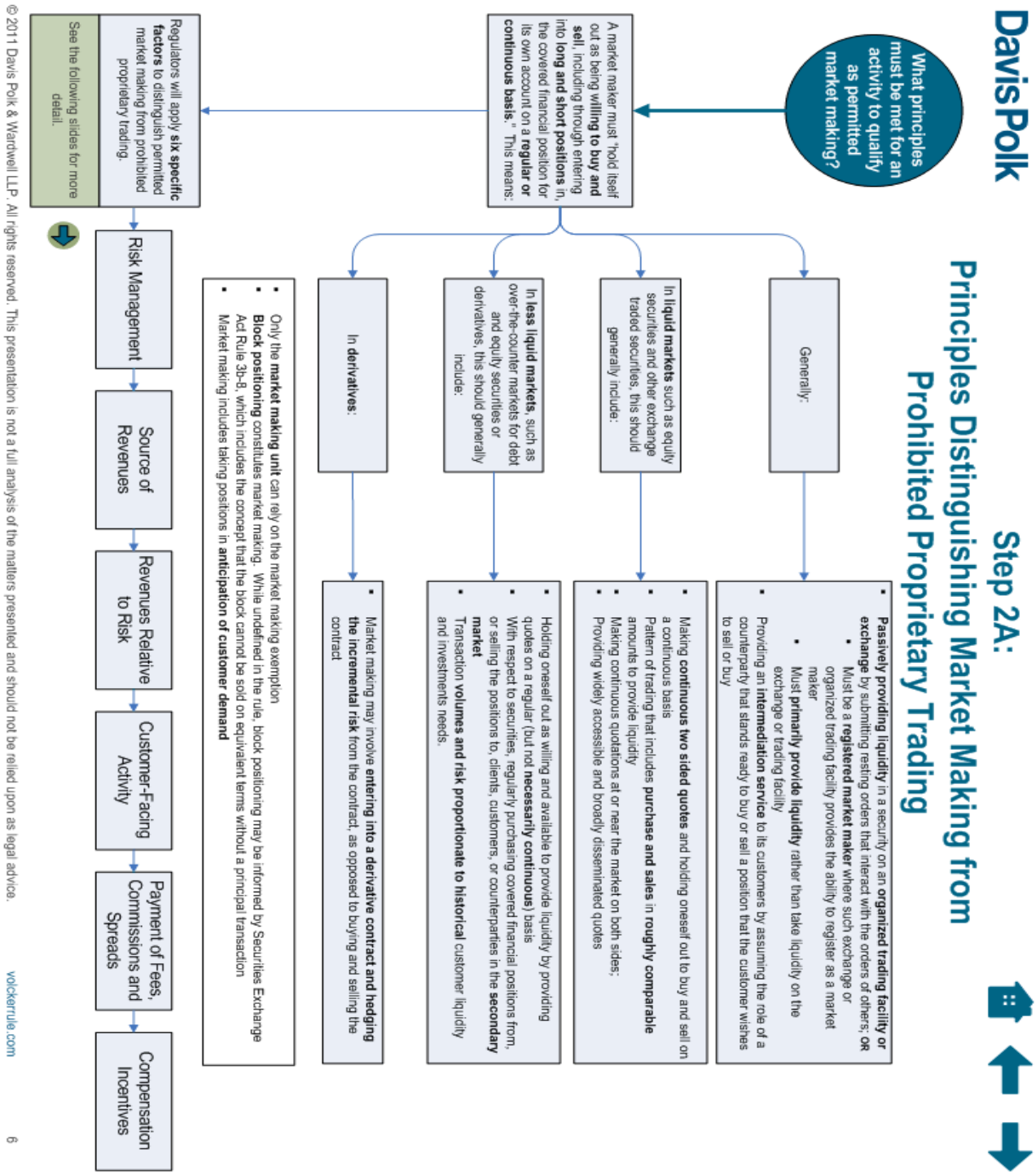
Rather than prohibit prop trading, banks should be regulated to limit prop trading to tier one capital. Two objectives would be met with implementation of this type of regulation. Customer deposits would be protected from prop trading activities, and banks would not be concerned about how the regulatory agencies would interpret their market making activities. Market liquidity would not be negatively impacted by regulation.

Investment by banking entities, covered by the proposed Volcker Rule, in hedge funds and private equity funds is limited to 3%. Risk is transferring from regulated banking entities to less regulated asset managers and insurance companies as prop traders exit investment banks to open new hedge funds, and banking entities are exiting their prohibited ownership or relationships with the funds.

Pension funds that are underfunded are increasingly searching for absolute returns generated by hedge funds and returns from private equity funds. The unintended result of reducing systemic risk in banking entities will be the transfer of risk to relatively unregulated financial asset management entities and the vulnerable current and future retirees.

In divergence from the proposed Volcker Rule, rather than severely limit regulated banking entity ownership or relationships with hedge funds and private equity funds, systemic risk can be reduced by lowering the amount of leverage allowed to generate the absolute return. The future and current retirees depending on pension funds will benefit from the increased competition between banking entities within an investment environment that is regulated.

Appendix A



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