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[redacted]

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Ms. Jennifer Johnson
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Ms. Elizabeth M. Murphy
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David A. Stawick, Secretary of the
Commission
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Care of Email: comments@fdic.gov

***RE: Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds***

Dear Sirs and Madams:

I write to reaffirm my support for the Volcker Rule's strong and sweeping efforts to establish a modernized Glass-Steagall wall between traditional client-oriented banking and the high-risk trading activities that helped cause the collapse of the world's financial system. To achieve that goal, I urge you to strengthen the proposed rule as I outline below.

As I have said before, the recent financial crisis demonstrated all too clearly the twenty year deregulatory experiment in combining commercial banking with risky trading activities frequently found in investment banking, failed. In 2007 and 2008, losses in the major financial firms from trading positions and off-balance sheet funds quickly decimated the availability of credit and seriously damaged the U.S. and global economy. Indeed, today's continuing slow recover in the U.S. and the credit crisis in Europe is a direct aftermath of the collapse of 2008.

Sadly, recent cases in the media, including UBS and MF Global, demonstrate that risk management and conflicts of interest systems are not alone sufficient to deal with the threat of high risk trading. When a firm is focused on market gain, it will employ every available device to achieve those gains – including taking advantages of clients and putting the firm at risk. And, when it is large enough to be a threat to systemic stability, it is able to avoid the constraints of market discipline which apply to smaller actors. In short, little will stand in the way of it becoming a threat to systemic stability.

The Volcker Rule is a critical response to this problem, and the proposed rule takes an important step forward in putting into place the prohibition on proprietary trading and positions in private funds. However, I am concerned it does not offer bright enough lines or provide strong enough penalties for violation. I offer specific suggestions below.

**Sign Off**

Accountability is crucial to success in business, and I believe that accountability starts at the top, with tone set by the board of directors and the chief executive officer. Far too many senior executives believed their duties to their shareholders were simply to maximize short-term profitability, and ignored their fiduciary duties to provide for long-term stability and success. The results were catastrophic for those shareholders, and for our financial system.

The Proposed Rule directs that boards and senior management should take an active role in designing internal controls and compliance guidelines. This is important, but it does not go far enough in requiring accountability for results. I propose that chief executive officer, the senior officer responsible for trading, his equivalent responsible for risk management, and his equivalent responsible for accounting within the trading unit sign a statement each quarter stating that to the best of their individual knowledge the operations of the trading unit were conducted within the letter and spirit of the Volcker Rule.

**Market-Making and Hedging**

At present, the proposed rule appears to enforce the separation between hedge fund-like proprietary trading from market-making by collection of certain metrics and then application of certain presumptions to the metrics. Unfortunately, the proposed rule leaves it entirely to the discretion of the supervisors to determine when a presumption actually has been violated and includes no discussion of enforcement or penalties. As such, it is entirely unclear whether this rule will actually be enforced. At the same time, banking organizations are fearful that without bright lines to clarify what they can and cannot do, they will not be able to structure their businesses. I believe that businesses have a legitimate interest in clarity as to what is permitted, although the most likely result of this situation is that supervisors over time will not end up meaningfully enforcing the provision at all, and industry will continue to do everything they were able to do that caused the crisis.

Accordingly, I urge the regulators to provide clear bright lines regarding what types of market-making are *permitted*. This should be accomplished through bright line numerical presumptions, most likely set by revenue-to-risk metrics and inventory turnover metrics on an asset-by-asset basis. Positions should also be fully hedged. This type of approach would permit distinctions to be drawn between assets that turn over in minutes and hours from those that turn over in days. Anything beyond this permitted space should be presumed to be impermissible proprietary trading. Also, the presumption could be negated if high volatility or other metrics suggest that activity within the presumed space is not market-making. Although industry and reform advocates might argue about how loose or tight the presumed compliance space is, at least everyone would know what it is.

I am also concerned that the proposed rule continues to permit market-making in some assets where there is no real market. Customized, structured products, OTC derivatives, and any other asset that "trades by appointment" cannot be said to be part of any market. There does not appear to be any evidence that the rapid expansion of these products in the last fifteen years has produced any important benefits to the real economy. Instead, we all know the costs. The Volcker Rule supports the efforts to Title VII derivatives reform by limiting derivatives in banks' trading accounts to products that have true trading markets, and which are exchange traded and centrally cleared. If customized derivatives and structured products are truly client-serving, they should be treated like the loan they truly are and be subject to the capital charges applied to bespoke loans, along with additional charges to cover any risks of margin calls. They should not be subsidized through treatment as a "trading" asset that is only as risky as the latest value-at-risk calculation.

**Compensation**

I urge much stronger tools be deployed to align incentives between those engaged in trading activities permitted following the Volcker Rule – market-making and hedging – with meaningful Volcker Rule compliance. In recent years, the incentives of management and traders at today's massive, publicly-traded banks are geared towards short term profits – both the firm's and their own – and not towards the long-term well-being of their employer or their clients. Boards of directors have obligations to maximize shareholder value, and no matter how much they and management attest to the contrary, they too naturally focus on short term performance. As one competitor's risky trading boosts its earnings and relative short term performance, others will be pressured—by the markets, and their own economic self-interest—to follow suit.

Do not get me wrong – market-making is profitable · but its profitability is a moderate and steady profitability, analogous to the kind present in commercial banking that supports clients. Done properly, it does not allow for the outsized returns of high-risk proprietary bets or for the risky leveraged carry trades that arbitrage different assets and funding markets. Without strong rules that align interests, we will see another race to the bottom, as traders, management, directors, and even shareholders will seek to game even the best written rules governing permitted trading in the hope that they can attain the supersized rewards made possible by high risk investments.

To minimize this possibility, I urge that traders be paid based on the *results* of their market-making and hedging activities *after* those positions are fully unwound. Properly crafted, such a rule would discourage them from carrying inventory and encourage them to get out of positions as soon as possible, which is a characteristic of market-making and responsible hedging. It will also limit the practice of collecting bonuses based on the price appreciation of assets in the short-term, when the long-term performance of the asset is highly questionable.

In addition, compensation should be adjusted by risk or based on performance relative to an outside object indicator – for example, an index reflecting the relevant market being traded. Anyone truly engaged in market-making cannot outperform the index since it is not possible to obtain "alpha" through market-making. No one is suggesting that those engaged in trading cannot be paid appropriately for the complicated services they provide; but, that compensation should be designed to encourage the accomplishment of the goals of client service and reduction of risk to the financial institution serving as an intermediary.

**<u>Severe Penalties</u>**

Finally, the alignment of interests must be buttressed by clear penalties and vigorous enforcement. Routine examinations and analyses of trading results will be sufficient to ensure that the firms are complying. Failure to comply should be severely punished. The proposed rule should set out specific and vigorous penalties for individual traders, management, and firms for failure to comply.

Compliance should also be buttressed through disclosure. The Basel Committee has long recognized the role of disclosure in enforcing meaningful competition and risk management. Metrics should also be disclosed to the markets, permitting counterparties, depositors (including corporate treasurers), and investors to be able to know whether a bank is in compliance with the Volcker Rule. Shareholders should not be the only ones who pay the price for trading failures, as was the case in 2008 and continues to be exemplified in the case of UBS and MF Global, and they can play a role enforcing firm policies. Indeed, institutional investors would prefer the stable profits of market-making to the high-risk boom and bust of proprietary trading. Let them enforce their interests through disclosure.

**<u>Conclusion</u>**

In conclusion, I urge you to remember that the Volcker Rule is designed to return financial institutions that benefit from the support of deposit insurance and access to the discount window, and which manage our nation's payment system, to the traditional banking business of providing services to consumers, small businesses, and rated companies.

I strongly supported the efforts of Chairman Volcker, as well as Senators Jeff Merkley and Carl Levin, to see a strong version of the Volcker Rule become law. The statute as adopted provides reasonable exceptions for client-oriented services while including the necessary safeguards to protect against the dangers of high-risk assets and high-risk trading strategies. Implementing these restrictions will be good for our economy and good for our financial services industry – even though they may now argue to the contrary. Refocusing our financial firms on client services will help them restore the global leadership position that has been seriously undermined by the recent crisis.

Certainly, we need to fully implement many other important reforms currently before the regulators, including reestablishing a well-regulated market for derivatives. But a strong Volcker Rule is one of the most important provisions to prevent "too big to fail" financial institutions, stop conflicts of interest, and support credit in our economy.

I urge you to strengthen your efforts and proceed quickly.

Sincerely,

John S. Reed