United States Senate

WASHINGTON, DC 20510

November 4, 2010

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Re: **Implementing the Merkley-Levin Provisions on Proprietary Trading and Conflcits of Interest, Docket Number FSOC-2010-0002**

Dear Members of the Financial Stability Oversight Council:

Now that Congress has passed and the President has signed into law the strongest protections for our financial system in 75 years, we look to you to follow the statutory intent to eliminate high risk and conflict-ridden activities at banks, and limit them at systemically significant non-bank financial firms.

The Merkley-Levin provisions on proprietary trading and conflicts of interest, often called the Volcker Rule, offer key measures to address these issues. The Financial Stability Oversight Council (FSOC) study will hopefully recommend vigorous enforcement of them and provide guidance to agencies on how to ensure their effective implementation.

Financial firms must not be allowed to rely on implicit or explicit government support, through access to the Federal Reserve discount window, FDIC deposit insurance, or other taxpayer- financed mechanisms, to place bets where heads they win, tails taxpayers lose.

As the primary co-authors of these provisions, we write in response to the FSOC request for comments on how our provisions should be implemented.

BALANCING PROHIBITED AND PERMITTED ACTIVITIES

Effectively balancing the proprietary trading restrictions against the statute's "permitted activities" to facilitate client transactions, including "market-making," "risk-mitigating hedging," and limited ownership interests in private funds, will be essential to achieve the statutory objective of protecting our financial system. Ensuring that the permitted activities are not used to circumvent the proprietary trading restrictions will require clearly defining the terms, as well as implementing an effective strategy to monitor for compliance, and take enforcement action against violations.

The first task that the FSOC study should undertake is to provide guidance on implementation language for key statutory terms, including the following.

"Market-making-related" activities are those in which a firm acts to provide liquidity to clients, customers, or counterparties, while simultaneously seeking to avoid any long or short exposures to the instruments it is trading. The goal of a true market-maker is to provide clients with buy and sell opportunities without incurring substantial risk. They seek to profit from the fees charged to clients to perform this function. Proprietary traders, by contrast, seek to profit from changes in the values of the held financial instruments. In essence, market-makers and proprietary traders act pursuant to opposite goals, with the former seeking to minimize risk and the latter consciously incurring risk.

Some firms seem to assert that entering into any transaction with a client or counterparty is somehow market-making. That view, however, would expand the definition of market-making to include all proprietary trading—because every trade has at least two parties—and would thus render the statutory protections against high-risk proprietary trading meaningless.

Distinguishing between trades that are part of market-making activities versus proprietary transactions may be challenging, but it lies at the center of effective implementation of our provisions. Distinguishing between them by focusing on the intent of the traders involved would be a time-consuming, complex, and subjective effort, so more objective measures need to be identified, monitored, and evaluated.

One key objective measure involves timing. If a firm allows a position on its books for more than a brief period of time, the activity loses its character as a market-making activity aimed at facilitating client trades, and instead becomes a proprietary investment. A firm is clearly acting as a market-maker only when it takes a long or short position for a relatively brief period of time and, during the holding period, takes appropriate steps to limit its exposure to price changes in the instrument, both up and down. The statute explicitly provides that positions should be allowed only to the extent that they "**are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties**." While this language allows firms to build modest inventories in some circumstances, the FSOC study should make it clear that this language does not justify longer term holdings or any holdings in liquid instruments for which such demand could be readily met by other parties in the markets. The FSOC study should provide guidance to regulators on using timing factors to distinguish between short-term market making trades and longer-term proprietary investments.

The primary objective of the Merkley-Levin provisions is to reduce risks to individual financial firms and to the financial system as a whole. Accordingly, firms are allowed to engage in "**risk-mitigating hedging**" activities. These activities are those in which a firm takes a position in order to reduce a specific financial exposure created by another position or holding. Again, the goal of "risk-mitigating hedging" is to reduce risk rather than profit from the change in the value of a financial instrument. The difficulty here is that some hedges ostensibly taken to reduce risk may, in fact, be disguised investments. Regulators must monitor and evaluate the hedging activities that firms claim to have undertaken as risk mitigating measures to ensure that they are not used as vehicles for hidden proprietary trades. The FSOC study should provide guidance to regulators on how to determine when an alleged hedge actually offsets a specific position and mitigates rather than increases the risk incurred by the financial institution. Many firms already engage in this analysis for their own risk management, and regulators may want to take advantage of that internal analysis.

A third key statutory term that should be addressed in the FSOC study involves **"trading accounts,"** which are central to the scope of the Volcker Rule itself and should be interpreted broadly to cover all types of trading activities. Firms may seek to hide proprietary trades in various types of accounts, and regulators will need clear authority to examine a wide variety of accounts at an institution to determine whether it is engaging, on its own behalf, in trades based on price appreciation or depreciation. The statute refers to "**short term**" in the definition to confine the application of the term to trades made to profit from price changes, as opposed to the longer-term investments of the firm that are more comparable to the extension of credit. The FSOC study should advocate making it clear that all accounts where financial instruments are traded are presumed to be trading accounts until proven otherwise. It should also advise regulators to periodically examine a variety of accounts in which trades take place to ensure compliance with the provisions.

TWO-TIERED SUPERVISION AND ENFORCEMENT STRUCTURE

In order to identify, monitor and evaluate market-making, risk-mitigating hedging, and other trading activities, regulators will need detailed trading data and positions. At a minimum, regulators will need to know in real-time, or close to it, objective information such as the parties to a trade, the size of the trade, pricing information, the size of the parties' positions, how long those positions are held, and whether and how they are hedged. Regulators will need to collect and analyze this data across multiple asset classes and should seek to utilize automated systems to the greatest extent possible.

The FSOC study should detail the trading information needed for regulators to evaluate a firm's trading activities, positions, and hedges, and enforce the proprietary trading restrictions. The study should also examine the extent to which this information could be gathered from data warehouses already being established under the law, from existing or new SEC and CFTC filings, and from data to be gathered and analyzed by the Office of Financial Research. Further, to the extent that firms already have policies and procedures and engage in complex analyses of their risk exposures across asset classes, regulators should take advantage of that expertise and those internal evaluations.

Effective enforcement of the proprietary trading restrictions will need to occur on two levels. On one level, perhaps overseen by the SEC and CFTC, regulators should establish systems to monitor in real time the trade-by-trade and position-by-position activities of covered banks and firms. These monitoring efforts can build upon already existing systems for real time monitoring of insider trading and position limits (including those systems at individual firms), as well as new data collection mandates under the Dodd-Frank Act. On the other level, perhaps overseen by the Federal Reserve Board, Federal Deposit Insurance Corporation, and the Comptroller of the Currency, regulators should assess policies and procedures and engage in portfolio level reviews to ensure that financial institutions have set up the infrastructure and investment strategies needed to put an end to proprietary trading and conflicts of interest, and provide effective oversight of their trading operations. In addition to this two-tier regulatory approach to enforcement, to ensure that permitted activities are undertaken in a safe and sound manner at banking entities, banking regulators should take the lead in establishing that appropriate capital charges are applied uniformly throughout a financial institution and its affiliates and across the banking community.

The FSOC study should advocate establishing this two-tier regulatory structure, provide guidance on which agencies should take the lead in specific tasks, and suggest a timeline and deadlines for building the needed oversight and enforcement infrastructures. The study should also provide guidance to regulators on how to establish a system for imposing capital charges.

REDUCING HIGH-RISK PROPRIETARY TRADING AT NON-BANK FINANCIAL COMPANIES SUPERVISED BY THE BOARD

The Merkley-Levin provisions impose an outright prohibition on proprietary trading by banking entities, while providing capital charges and quantitative limits on non-bank financial companies supervised by the Board. As we saw during the crisis, high-risk proprietary trading at systemically significant nonbank financial companies can be just as dangerous to our economy and financial system as when engaged in by banking entities, especially when the linkages between firms through derivatives and other means are complex and opaque. While other provisions in the Dodd-Frank Act begin to remedy many of those challenges, such improvements must be complemented by establishing strong protections against high-risk proprietary trading activities at systemically significant non-bank financial companies, as was provided for in the Merkley-Levin provisions.

The restrictions on the systemically significant non-bank financial companies should parallel similar restrictions on the banking entities. Capital charges and quantitative limits provide regulators with flexible tools to limit high-risk activities at the various types of financial entities that may be designated as systemically significant non-bank financial companies. These capital charges and quantitative limits should be strenuous enough to deter high-risk activities, while also providing a generous capital buffer for the firms for whom proprietary trading may be their primary business (such as a systemically significant investment firm). In addition, capital charges should be assessed at levels designed to deter these firms from acquiring "high-risk assets," or engaging in "high-risk trading strategies" or "material conflicts of interest." The statute also imposes limits on their relationships with private funds, in particular bailouts of them (see below). The FSOC study should provide guidance to regulators on appropriate capital charges and quantitative limits for systemically significant financial firms to discourage risky activities and provide the necessary capital buffer for potentially severe losses.

Capital charges and quantitative limits are intended to give regulators the flexibility to limit risk across the range of nonbank financial companies that may come under Board supervision. They should, in general, be stepped up as firms become increasingly large and complex. In particular, quantitative limits should become stricter with size, as capital charges may not be able to capture all the risks. The FSOC study should provide guidance to regulators on the mechanics and policies that should be used to identify increasingly large and complex financial firms and impose increasingly tough limits on their higher risk activities.

ENFORCING THE BACKSTOP ON "PERMITTED ACTIVITIES" TO PREVENT HIGH RISK AND CONFLICTS OF INTEREST

The Merkley-Levin provisions impose additional limits on even permitted activities, to prevent conflicts of interest and high-risk activities. The FSOC study should provide guidance on the nature and scope of these prohibitions, and how regulators should monitor for compliance and enforce them.

The statute prohibits banks and systemically significant non-bank financial firms from engaging in any activities that would "**involve or result in a material conflict of interest**" with a customer or client. The FSOC study should clarify this prohibition and the term "material conflict of interest," including by recommending regulations that prohibit certain practices that took place during the financial crisis. For example, regulations could prohibit firms from taking advantage of order flow information for their own profit, sometimes called front-running, and from designing financial products to fail and selling them to unsuspecting customers. In addition to recommending that these and other specific practices be stopped, the study could provide guidance on establishing more general principles that prohibit the design of financial products or activities where the firm acts against the best interests of its clients. This broad prohibition against conflicts of interest has the potential to bar a host of the most troubling practices on Wall Street today, and the FSOC study should advise regulators to establish broad authority under this provision to do just that.

The statute also prohibits banking entities from engaging in any activities involving "**high-risk assets**" or "**high-risk trading strategies**," and requires other systemically significant financial companies to set aside significantly more capital to engage in those activities. The FSOC study should provide guidance to regulators on how to identify high-risk assets and trading strategies, considering both the risk to an individual firm and to the U.S. financial system as a whole.

To carry out this statutory prohibition, the study could provide both a list of prohibited assets and strategies, as well as a set of principles to identify others. For example, the study could urge regulators to prohibit banks from offering products – even if for true market-making purposes – that cannot be quickly and accurately hedged or reliably priced, and impose substantial capital charges for such products when offered by systemically significant non-banks. In another example, the FSOC study could advocate prohibiting trading strategies that rely too heavily on financing from the "repo" or other short-term funding markets. Further, the FSOC study should advise the prohibition of hedging activities that effectively result in a high-risk trading strategy – even if it reduces risk from another long-term position. One such activity recently brought to our attention are systemically dangerous hedging strategies deployed for so-called "catastrophe funds."

To identify high-risk assets and trading strategies, the FSOC study should closely examine the banks, firms, and individual funds that failed during or prior to the financial crisis and develop criteria to help regulators identify such activities in the future. Given the challenging nature of this assignment, the FSOC study will also hopefully set out strategies for further investigation and analysis, and direct the Office of Financial Research to conduct that research and to keep regulators apprised of risky activities to ensure that the statutory prohibition against high-risk activities evolves with market developments.

PROTECTING FIRMS FROM THEIR FUNDS

The Merkley-Levin provisions impose a host of statutory protections to ensure an appropriate relationship between financial firms and the funds they manage or sponsor, and the FSOC study should provide guidance to regulators to ensure the effective implementation of those safeguards.

The financial crisis showed that, even if a firm does not have a significant amount of its own capital invested in a fund, competitive pressures and business relationships with investors may pressure it to bail out funds in times of stress, even if those bailouts threaten the safety and soundness of the banking entity. In one example, a prominent custodial bank bought securities for nearly $2.5 billion from one of its ailing funds, and then relied on TARP and several other taxpayer-backed programs to stay afloat during the crisis. In another, a prominent investment bank bailed out two of its funds for over $3 billion, despite having only about $35 million invested in them. Ultimately, that firm collapsed.

The Merkley-Levin provisions permit "**de minimis**" investments in funds to facilitate asset management by firms whose clients demand "skin in the game" as part of asset management services. While allowing those "de minimis" investments, regulators are expected nevertheless to impose high capital charges on such investments to provide a disincentive and additional capital buffer against those risky activities. The law also requires regulators to further increase those capital charges as the leverage of those funds increases, both to reflect the increased risk to the individual firm and to further discourage high-risk activities that may have systemic impact.

The law covers "**hedge funds**," "**private equity funds**," and "**such similar funds**" to ensure that its protections apply to all types of funds managed or sponsored by banks or systemically significant non-banks. Merchant banking activities are not exempt from the restrictions.

To reestablish market integrity and promote financial stability, the Merkley-Levin provisions do not permit banking entities to bail out or otherwise guarantee the performance of their funds. To effectuate that prohibition, it establishes strict limits on the lending and asset purchase relationships that firms have used to facilitate such bailouts and requires officer certifications against such bailouts. Firms cannot engage in lending, writing derivatives, or engaging in asset purchases with sponsored or managed funds, among other restrictions. Prime brokerage relationships with underlying funds in fund-of-funds scenarios are permitted, but are also subject to limits.

The FSOC study should provide guidance to regulators on the broad range of funds and fund investments covered by the law, appropriate capital charges, and how to escalate those charges for leveraged funds. In addition, the study should provide guidance on how regulators can effectively monitor for compliance, detect violations, and enforce the statutory restrictions on bailouts and guarantees, including in prime brokerage relationships with underlying funds in fund-of-funds.

<u>ANTI-EVASION AUTHORITY</u>

Press reports suggest that some firms are already beginning to comply with the Merkley-Levin protections by spinning off their stand-alone proprietary trading desks. However, we are concerned that some firms will attempt to continue to engage in proprietary trading through their "market-making" desks or "de minimis" investments in private funds. Congress has provided regulators with strong anti-evasion authority to prevent circumventions of the law. The FSOC study should provide guidance to regulators about possible evasive tactics that could occur, and on how to make it clear that they have broad authority to prevent such tactics.

For example, some firms may seek to evade the restrictions on proprietary trading by abusing the private fund exception. Specifically, firms are allowed to "seed" a new fund and establish a track record to market the fund to investors, as well as maintain a "skin in the game" investment to align the firm's interests with its customers. At the same time, the law requires firms that seed funds to bring their ownership interest from the initial 100 percent down to 3 percent within a year, or seek an extension of up to an additional two years. Yet, some firms may seek to engage in proprietary trading through a "seed" fund for a year, and then simply roll those assets into a new "seed" fund. That type of conduct would be a clear evasion of the law's prohibitions.

The FSOC study should provide guidance to regulators about how to evaluate whether funds are being used to circumvent the proprietary trading restrictions. For example, the study may advise regulators to scrutinize all seed funds over a certain threshold, such as $25 million. The study should consider advising regulators that repeated instances of a bank's funds failing to attract the requisite amount of client investment to comply with the "3 percent in 1 year" restriction give rise to a presumption of evasion that will trigger enforcement action.

The FSOC study should also advise regulators on methods for detecting other evasive tactics such as the use of client desks, novel financial products, or complex hedges to make disguised proprietary investments or engaging in high-risk or conflict-ridden practices.

PROTECTING U.S. ECONOMY AND FINANCIAL SYSTEM FROM INTERNATIONAL PROPRIETARY TRADING

The Merkley-Levin provisions apply to U.S. firms globally and to foreign firms operating in the United States. The FSOC study should provide guidance to regulators about how to apply both aspects of the statute's provisions – to foreign affiliates of U.S. firms and to foreign banks that conduct proprietary trades outside of the United States. The provisions do not apply to proprietary trading or sponsoring a private fund (not sold to U.S. persons) by a foreign bank outside of the United States. However, the FSOC study should advise regulators to protect U.S. entities and taxpayers from foreign firms with significant proprietary trading activities, including through recommending that the Federal Reserve Board reject applications for bank acquisitions where U.S. depositors and taxpayers would become subject to significant foreign proprietary trading exposures. The FSOC study should also advise regulators on the need to negotiate with other countries to impose similar restrictions on their financial firms to stop high risk proprietary trading and conflicts of interest.

Thank you for this opportunity to make recommendations relative to the design of the FSOC study. For additional detail on some of the implementation issues, we enclose copies of our Senate colloquy entered into during consideration of the Dodd-Frank Act. If you have any questions or would like our further insight into any matter, please do not hesitate to contact us.

Sincerely,

Jeffrey A. Merkley Carl Levin

Jeff Merkley Carl Levin

Street and in our financial sector have a direct impact on Main Street and the lives of every American. We need to ensure that taxpayers are never again asked to bail out Wall Street.

This financial reform legislation will prevent another financial sector collapse, or at least will help prevent it. I do not think any of us can say this will prevent any future collapse, but it is critically important to helping us prevent another collapse. It will allow the government to shut down firms that threaten to crater our economy and ensure that the financial industry, not taxpayers, is on the hook for any costs. It will rein in risky derivatives and other risky trading practices that undermined some of our largest financial institutions. It will help level the playing field for smaller banks and credit unions by cracking down on the risky practices of Wall Street and nonbank financial institutions that caused the financial crisis.

I am grateful to Senator DODD, the Banking Committee, and members of the conference for working with me to make certain that the final bill recognizes the special circumstances of community banks and credit unions in rural States such as mine. In particular, I appreciate the committee's modification to the lending limit standards. This is very important to farming communities across the country.

The final bill also provides added flexibility for rural lenders in the new mortgage standards as well as provisions to improve interchange reform for smaller financial institutions. Finally, I am pleased the committee included a risk-focused deposit insurance fund assessment formula and modified risk retention requirements for high quality loans.

Especially I thank Senator DODD for his extraordinary leadership. What a final year in the Senate. What a remarkable legacy he is leaving. I think the annals of the Senate will show very few Senators have had a record of accomplishment that matches what Senator DODD will have done in this year.

With respect to the budget point of order that has been raised against the conference report, let me make a couple of general points. First, this budget violation is not significant enough to merit derailing this important legislation. Second, we must bear in mind the risks of failing to act. If we fail to protect against a future collapse and create an orderly process for dealing with giant insolvent financial institutions, it is inevitable that taxpayers will again at some future point be asked to bail out the financial sector and prevent a catastrophic financial collapse. If one measures on any scale the differences between the technical violation in this budget point of order against what would happen if this legislation fails, they cannot even be compared. I mean, it is a gnat against an elephant. So let's keep things in mind here.

Second, we must bear in mind the risk of failing to act because that would burden taxpayers in a way far beyond anything we see with this budget point of order. None of us wants that. This bill is an insurance policy against an expensive future taxpayer bailout.

The point of order that has been raised is the long-term deficit point of order, a point of order I established in the budget resolution of 2008. This point of order prohibits legislation that worsens the deficit by more than $5 billion in any of the four 10-year periods following 2019.

CBO has determined that at least in one of those four 10-year periods, the conference report would exceed this threshold. But this is really just a timing issue caused by the new bipartisan resolution authority created by the bill. This is the new authority given to the government to wind down failing financial firms. Under the resolution authority, if a financial firm is about to collapse, the government will use the firm's assets to wind it down and put it out of business. If the firm's assets are insufficient, the government will temporarily borrow funds from the Treasury. The financial industry will then reimburse the government and the taxpayers for 100 percent of the cost. Again, 100 percent of the money will be paid back by the banks. So the net impact on the deficit is zero.

Overall, the bill saves $3.2 billion over the first 10 years, according to the Congressional Budget Office. So while technically this budget point of order lies, if you pierce the veil and look at what really happens, this bill reduces the deficit, according to the Congressional Budget Office, which is the nonpartisan scorekeeper here in the Senate. Because there is a lag time for the government to collect this money from the financial industry, CBO scores the bill as increasing the deficit in some of the later decades. But all of that money will be paid back in ensuing years, and that is what matters most in this case.

So although this bill does technically violate the long-term deficit point of order, it is insignificant. The fact is, this bill reduces the deficit, according to the Congressional Budget Office. So I urge my colleagues to waive the point of order, to support passage of this financial reform legislation, which is clearly a significant step in the right direction in preventing the kind of risk to our Nation's economy that is so apparent with the current structure.

Again, I thank the chairman for his extraordinary work not only on this bill but throughout the year and, I think all of us know, throughout his career.

I yield the floor.

The PRESIDING OFFICER. The Senator from Connecticut

Mr. DODD. Mr. President, before my friend, the chairman of the Budget Committee, leaves, let me thank him immensely for his analysis of this issue. He has it, as we saw as well, exactly right. In fact, it is not only repaying 100 percent but with interest. There is an interest requirement, that if we borrow from the taxpayers in order to wind down substantially risky firms, then not only do you get paid back, but the interest on the cost of that money is also part of the deal. So it is 100 percent-plus coming back to the Treasury.

But his analysis and that of his committee—and there is no one who has been more disciplined or guarded about the budgetary process over the years we have served together, and so I appreciate the Senator's analysis of this particular point on the long-term deficit.

I commend the Senator for including the provisions he has and trying to build some discipline into the process of how we expend taxpayer moneys, collect taxes in the first place to pay for the needed expenditures of our government. So I thank the Senator for that.

I thank him for his comments as well about the bill and his support and also the substantive contributions the Senator from North Dakota has made, because one of the things we tried to be very careful about—JON TESTER of Montana, who sits on the committee with me, has been very careful and been tremendously active in seeing to it that rural America is going to be well served by this legislation. And there are differences. It is not all Wall Street, New York, and major financial centers. The importance of the availability of credit in rural communities is critical, as my colleague from North Dakota has informed me over the years we have served together. That ability of a local farmer to borrow that money in the spring, to be able to pay back in the fall, at harvest time, has been essential, and knowing how difficult it has been throughout the country to have access to credit is essential.

So his contributions to the legislation make sure that what we do here is going to enhance the capability of rural America to not only come out of this crisis we are in but to prosper in the years ahead with this legislation. So beyond the budgetary considerations and the points of order before us, I thank him for his contributions to the substance of the bill, which has made it a far better bill to begin with.

I see my colleague from Oregon is here. I yield the floor.

The PRESIDING OFFICER. The Senator from Oregon is recognized.

Mr. MERKLEY. Mr. President, I thank Chairman DODD for yielding to me and for his leadership on financial reform.

I yield to Senator LEVIN.

Mr. LEVIN. Mr. President, Senator MERKLEY and I, as the principal authors of sections 619, 620, and 621 of the Dodd-Frank Act, thought it might be helpful to explain in some detail those sections, which are based on our bill, S. 3098, called the Protect Our Recovery

Through Oversight of Proprietary, PROP, Trading Act of 2010, and the subsequently filed Merkley-Levin Amendment, No. 4101, to the Dodd-Lincoln substitute, which was the basis of the provision adopted by the Conference Committee.

I yield the floor to my colleague, Senator MERKLEY.

Mr. MERKLEY. I thank Senator LEVIN and will be setting forth here our joint explanation of the Merkley-Levin provisions of the Dodd-Frank Act. Sections 619, 620 and 621 do three things: prohibit high-risk proprietary trading at banks, limit the systemic risk of such activities at systemically significant nonbank financial companies, and prohibit material conflicts of interest in asset-backed securitizations.

Sections 619 and 620 amend the Bank Holding Company Act of 1956 to broadly prohibit proprietary trading, while nevertheless permitting certain activities that may technically fall within the definition of proprietary trading but which are, in fact, safer, client-oriented financial services. To account for the additional risk of proprietary trading among systemically critical financial firms that are not banks, bank holding companies, or the like, the sections require nonbank financial companies supervised by the Federal Reserve Board, the "Board", to keep additional capital for their proprietary trading activities and subject them to quantitative limits on those activities. In addition, given the unique control that firms who package and sell asset-backed securities (including synthetic asset-backed securities) have over transactions involving those securities, section 621 protects purchasers by prohibiting those firms from engaging in transactions that involve or result in material conflicts of interest.

First, it is important to remind our colleagues how the financial crisis of the past several years came to pass. Beginning in the 1980's, new financial products and significant amounts of deregulation undermined the Glass-Steagall Act's separation of commercial banking from securities brokerage or "investment banking" that had kept our banking system relatively safe since 1933.

Over time, commercial and investment banks increasingly relied on precarious short term funding sources, while at the same time significantly increasing their leverage. It was as if our banks and securities firms, in competing against one another, were race car drivers taking the curves ever more tightly and at ever faster speeds. Meanwhile, to match their short-term funding sources, commercial and investment banks drove into increasingly risky, short-term, and sometimes theoretically hedged, proprietary trading. When markets took unexpected turns, such as when Russia defaulted on its debt and when the U.S. mortgage-backed securities market collapsed, liquidity evaporated, and financial firms became insolvent very rapidly. No amount of capital could provide a sufficient buffer in such situations.

In the face of the worst financial crisis in 60 years, the January 2009 report by the Group of 30, an international group of financial experts, placed blame squarely on proprietary trading. This report, largely authored by former Federal Reserve System Chairman Paul Volcker, recommended prohibiting systemically critical banking institutions from trading in securities and other products for their own accounts. In January 2010, President Barack Obama gave his full support to common-sense restrictions on proprietary trading and fund investing, which he coined the "Volcker Rule."

The "Volcker Rule," which Senator LEVIN and I drafted and have championed in the Senate, and which is embodied in section 619, embraces the spirit of the Glass-Steagall Act's separation of "commercial" from "investment" banking by restoring a protective barrier around our critical financial infrastructure. It covers not simply securities, but also derivatives and other financial products. It applies not only to banks, but also to nonbank financial firms whose size and function render them systemically significant.

While the intent of section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world and permit a broad array of low-risk, client-oriented financial services. As a result, the barrier constructed in section 619 will not restrict most financial firms.

Section 619 is intended to limit proprietary trading by banking entities and systemically significant nonbank financial companies. Properly implemented, section 619's limits will tamp down on the risk to the system arising from firms competing to obtain greater and greater returns by increasing the size, leverage, and riskiness of their trades. This is a critical part of ending too big to fail financial firms. In addition, section 619 seeks to reorient the U.S. banking system away from leveraged, short-term speculation and instead towards the safe and sound provision of long-term credit to families and business enterprises.

We recognize that regulators are essential partners in the legislative process. Because regulatory interpretation is so critical to the success of the rule, we will now set forth, as the principal authors of Sections 619 to 621, our explanations of how these provisions work.

Section 619's prohibitions and restrictions on proprietary trading are set forth in a new section 13 to the Bank Holding Company Act of 1956, and subsection (a), paragraph (1) establishes the basic principle clearly: a banking entity shall not "engage in proprietary trading" or "acquire or retain . . . ownership interest[s] in or sponsor a hedge fund or private equity fund", unless otherwise provided in the section. Paragraph (2) establishes the principle for nonbank financial companies supervised by the Board by subjecting their proprietary trading activities to quantitative restrictions and additional capital charges. Such quantitative limits and capital charges are to be set by the regulators to address risks similar to those which lead to the flat prohibition for banking entities.

Subsection (h), paragraph (1) defines "banking entity" to be any insured depository institution (as otherwise defined under the Bank Holding Company Act), any entity that controls an insured depository institution, any entity that is treated as a bank holding company under section 8 of the International Banking Act of 1978, and any affiliates or subsidiaries of such entities. We and the Congress specifically rejected proposals to exclude the affiliates and subsidiaries of bank holding companies and insured depository institutions, because it was obvious that restricting a bank, but not its affiliates and subsidiaries, would ultimately be ineffective in restraining the type of high-risk proprietary trading that can undermine an insured depository institution.

The provision recognizes the modern reality that it is difficult to separate the fate of a bank and its bank holding company, and that for the bank holding company to be a source of strength to the bank, its activities, and those of its other subsidiaries and affiliates, cannot be at such great risk as to imperil the bank. We also note that not all banks pose the same risks. Accordingly, the paragraph provides a narrow exception for insured depository institutions that function principally for trust purposes and do not hold public depositor money, make loans, or access Federal Reserve lending or payment services. These specialized entities that offer very limited trust services are elsewhere carved out of the definition of "bank," so we do not treat them as banks for the purposes of the restriction on proprietary trading. However, such institutions are covered by the restriction if they qualify under the provisions covering systemically important nonbank financial companies.

Subsection (h), paragraph (3) defines nonbank financial companies supervised by the Board to be those financial companies whose size, interconnectedness, or core functions are of sufficiently systemic significance as to warrant additional supervision, as directed by the Financial Stability Oversight Council pursuant to Title I of the Dodd-Frank Act. Given the varied nature of such nonbank financial companies, for some of which proprietary trading is effectively their business, an outright statutory prohibition on such trading was not warranted. Instead, the risks posed by their proprietary trading is addressed through robust capital charges and quantitative limits that increase with the size, interconnectedness, and systemic importance of the business functions of the nonbank financial firm. These restrictions should become stricter as size, leverage, and other factors increase. As with banking entities, these restrictions should also help reduce the size and risk of these financial firms.

Naturally, the definition of "proprietary trading" is critical to the provision. For the purposes of section 13, proprietary trading means "engaging as a principal for the trading account" in transactions to "purchase or sell, or otherwise acquire or dispose of" a wide range of traded financial products, including securities, derivatives, futures, and options. There are essentially three key elements to the definition: (1) the firm must be acting "as a principal," (2) the trading must be in its "trading account" or another similar account, and (3) the restrictions apply to the full range of its financial instruments.

Purchasing or selling "as a principal" refers to when the firm purchases or sells the relevant financial instrument for its own account. The prohibition on proprietary trading does not cover trading engaged with exclusively client funds.

The term "trading account" is intended to cover an account used by a firm to make profits from relatively short-term trading positions, as opposed to long-term, multi-year investments. The administration's proposed Volcker Rule focused on short-term trading, using the phrase "trading book" to capture that concept. That phrase, which is currently used by some bank regulators was rejected, however, and the ultimate conference report language uses the term "trading account" rather than "trading book" to ensure that all types of accounts used for proprietary trading are covered by the section.

To ensure broad coverage of the prohibition on proprietary trading, paragraph (3) of subsection (h) defines "trading account" as any account used "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)" and such other accounts as the regulators determine are properly covered by the provision to fulfill the purposes of the section. In designing this definition, we were aware of bank regulatory capital rules that distinguish between short-term trading and long-term investments, and our overall focus was to restrict high-risk proprietary trading. For banking entity subsidiaries that do not maintain a distinction between a trading account and an investment account, all accounts should be presumed to be trading accounts and covered by the restriction.

Linking the prohibition on proprietary trading to trading accounts permits banking entities to hold debt securities and other financial instruments in long-term investment portfolios. Such investments should be maintained with the appropriate capital charges and held for longer periods.

The definition of proprietary trading in paragraph (4) covers a wide range of financial instruments, including securities, commodities, futures, options, derivatives, and any similar financial instruments. Pursuant to the rule of construction in subsection (g), paragraph (2), the definition should not generally include loans sold in the process of securitizing; however, it could include such loans if such loans become financial instruments traded to capture the change in their market value.

Limiting the definition of proprietary trading to near-term holdings has the advantage of permitting banking entities to continue to deploy credit via long-term capital market debt instruments. However, it has the disadvantage of failing to prevent the problems created by longer-term holdings in riskier financial instruments, for example, highly complex collateralized debt obligations and other opaque instruments that are not readily marketable. To address the risks to the banking system arising from those longer-term instruments and related trading, section 620 directs Federal banking regulators to sift through the assets, trading strategies, and other investments of banking entities to identify assets or activities that pose unacceptable risks to banks, even when held in longer-term accounts. Regulators are expected to apply the lessons of that analysis to tighten the range of investments and activities permissible for banking entities, whether they are at the insured depository institution or at an affiliate or subsidiary, and whether they are short or long term in nature.

The new Bank Holding Company Act section 13 also restricts investing in or sponsoring hedge funds and private equity funds. Clearly, if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue. A financial institution that sponsors or manages a hedge fund or private equity fund also incurs significant risk even when it does not invest in the fund it manages or sponsors. Although piercing the corporate veil between a fund and its sponsoring entity may be difficult, recent history demonstrates that a financial firm will often feel compelled by reputational demands and relationship preservation concerns to bail out clients in a failed fund that it managed or sponsored, rather than risk litigation or lost business. Knowledge of such concerns creates a moral hazard among clients, attracting investment into managed or sponsored funds on the assumption that the sponsoring bank or systemically significant firm will rescue them if markets turn south, as was done by a number of firms during the 2008 crisis. That is why setting limits on involvement in hedge funds and private equity funds is critical to protecting against risks arising from asset management services.

Subsection (h), paragraph (2) sets forth a broad definition of hedge fund and private equity fund, not distinguishing between the two. The definition includes any company that would be an investment company under the Investment Company Act of 1940, but is excluded from such coverage by the provisions of sections 3(c)(1) or 3(c)(7). Although market practice in many cases distinguishes between hedge funds, which tend to be trading vehicles, and private equity funds, which tend to own entire companies, both types of funds can engage in high risk activities and it is exceedingly difficult to limit those risks by focusing on only one type of entity.

Despite the broad prohibition on proprietary trading set forth in subsection (a), the legislation recognizes that there are a number of low-risk proprietary activities that do not pose unreasonable risks and explicitly permits those activities to occur. Those low-risk proprietary trading activities are identified in subsection (d), paragraph (1), subject to certain limitations set forth in paragraph (2), and additional capital charges required in paragraph (3).

While paragraph (1) authorizes several permitted activities, it simultaneously grants regulators broad authority to set further restrictions on any of those activities and to supplement the additional capital charges provided for by paragraph (3).

Subparagraph (d)(1)(A) authorizes the purchase or sale of government obligations, including government-sponsored enterprise, GSE, obligations, on the grounds that such products are used as low-risk, short-term liquidity positions and as low-risk collateral in a wide range of transactions, and so are appropriately retained in a trading account. Allowing trading in a broad range of GSE obligations is also meant to recognize a market reality that removing the use of these securities as liquidity and collateral positions would have significant market implications, including negative implications for the housing and farm credit markets. By authorizing trading in GSE obligations, the language is not meant to imply a view as to GSE operations or structure over the long-term, and permits regulators to add restrictions on this permitted activity as necessary to prevent high-risk proprietary trading activities under paragraph (2). When GSE reform occurs, we expect these provisions to be adjusted accordingly. Moreover, as is the case with all permitted activities under paragraph (1), regulators are expected to apply additional capital restrictions under paragraph (3) as necessary to account for the risks of the trading activities.

Subparagraph (d)(1)(B) permits underwriting and market-making-related transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services. Market-making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments. Done properly, it is not a speculative enterprise, and revenues for the firm should largely arise from the provision of credit provided, and not from the capital gain earned on the change in the price of instruments held in the firm's accounts. Academic literature sets out the distinctions between making markets for customers and holding speculative positions in assets, but in general, the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open, and the volatility of profits and losses, among other factors. Regulations implementing this permitted activity should focus on these types of factors to assist regulators in distinguishing between financial firms assisting their clients versus those engaged in proprietary trading. Vigorous and robust regulatory oversight of this issue will be essential to the prevent "market-making" from being used as a loophole in the ban on proprietary trading.

The administration's draft language, the original section 619 contemplated by the Senate Banking Committee, and amendment 4101 each included the term "in facilitation of customer relations" as a permitted activity. The term was removed in the final version of the Dodd-Frank Act out of concern that this phrase was too subjective, ambiguous, and susceptible to abuse. At the same time, we recognize that the term was previously included to permit certain legitimate client-oriented services, such pre-market-making accumulation of small positions that might not rise to the level of fully "market-making" in a security or financial instrument, but are intended to nonetheless meet expected near-term client liquidity needs. Accordingly, while previous versions of the legislation referenced "market-making", the final version references "market-making-related" to provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs, without unduly warping the common understanding of market-making.

We note, however, that "market-making-related" is not a term whose definition is without limits. It does not implicitly cover every time a firm buys an existing financial instrument with the intent to later sell it, nor does it cover situations in which a firm creates or underwrites a new security with the intent to market it to a client. Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that any time the firm created a new mortgage related security and began soliciting clients to buy it, the firm was "making a market" for the security. But one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling existing securities. The reality was that Goldman Sachs was creating new securities for sale to clients and building large speculative positions in high-risk instruments, including credit default swaps. Such speculative activities are the essence of proprietary trading and cannot be properly considered within the coverage of the terms "market-making" or "market-making-related."

The subparagraph also specifically limits such underwriting and market-making-related activities to "reasonably expected near term demands of clients, customers, and counterparties." Essentially, the subparagraph creates two restrictions, one on the expected holding period and one on the intent of the holding. These two restrictions greatly limit the types of risks and returns for market-makers. Generally, the revenues for market-making by the covered firms should be made from the fees charged for providing a ready, two-sided market for financial instruments, and not from the changes in prices acquired and sold by the financial institution. The "near term" requirement connects to the provision in the definition of trading account whereby the account is defined as trading assets that are acquired "principally for the purpose of selling in the near term." The intent is to focus firms on genuinely making markets for clients, and not taking speculative positions with the firm's capital. Put simply, a firm will not satisfy this requirement by acquiring a position on the hope that the position will be able to be sold at some unknown future date for a trading profit.

Subparagraph (d)(1)(C) permits a banking entity to engage in "risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings." This activity is permitted because its sole purpose is to lower risk.

While this subparagraph is intended to permit banking entities to utilize their trading accounts to hedge, the phrase "in connection with and related to individual or aggregated positions . . ." was added between amendment 4101 and the final version in the conference report in order to ensure that the hedge applied to specific, identifiable assets, whether it be on an individual or aggregate basis. Moreover, hedges must be to reduce "specific risks" to the banking entity arising from these positions. This formulation is meant to focus banking entities on traditional hedges and prevent proprietary speculation under the guise of general "hedging." For example, for a bank with a significant set of loans to a foreign country, a foreign exchange swap may be an appropriate hedging strategy. On the other hand, purchasing commodity futures to "hedge" inflation risks that may generally impact the banking entity may be nothing more than proprietary trading under another name. Distinguishing between true hedges and covert proprietary trades may be one of the more challenging areas for regulators, and will require clear identification by financial firms of the specific assets and risks being hedged, research and analysis of market best practices, and reasonable regulatory judgment calls. Vigorous and robust regulatory oversight of this issue will be essential to the prevent "hedging" from being used as a loophole in the ban on proprietary trading.

Subparagraph (d)(1)(D) permits the acquisition of the securities and other affected financial instruments "on behalf of customers." This permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves. This subparagraph is intended, in particular, to provide reassurance that trading in "street name" for customers or in trust for customers is permitted.

In general, subparagraph (d)(1)(E) provides exceptions to the prohibition on investing in hedge funds or private equity funds, if such investments advance a "public welfare" purpose. It permits investments in small business investment companies, which are a form of regulated venture capital fund in which banks have a long history of successful participation. The subparagraph also permits investments "of the type" permitted under the paragraph of the National Bank Act enabling banks to invest in a range of low-income community development and other projects. The subparagraph also specifically mentions tax credits for historical building rehabilitation administered by the National Park Service, but is flexible enough to permit the regulators to include other similar low-risk investments with a public welfare purpose.

Subparagraph (d)(1)(F) is meant to accommodate the normal business of insurance at regulated insurance companies that are affiliated with banks. The Volcker Rule was never meant to affect the ordinary business of insurance: the collection and investment of premiums, which are then used to satisfy claims of the insured. These activities, while definitionally proprietary trading, are heavily regulated by State insurance regulators, and in most cases do not pose the same level of risk as other proprietary trading.

However, to prevent abuse, firms seeking to rely on this insurance-related exception must meet two essential qualifications. First, only trading for the general account of the insurance firm would qualify. Second, the trading must be subject to adequate State-level insurance regulation. Trading by insurance companies or their affiliates that is not subject to insurance company investment regulations will not qualify for protection here.

Further, where State laws and regulations do not exist or otherwise fail to appropriately connect the insurance company investments to the actual business of insurance or are found to inadequately protect the firm, the subparagraph's conditions will not be met.

Subparagraph (d)(1)(G) permits firms to organize and offer hedge funds or private equity funds as an asset management service to clients. It is important to remember that nothing in section 619 otherwise prohibits a bank from serving as an investment adviser to an independent hedge fund or private equity fund. Yet, to serve in that capacity, a number of criteria must be met.

First, the firm must be doing so pursuant to its provision of bona fide trust, fiduciary, or investment advisory services to customers. Given the fiduciary obligations that come with such services, these requirements ensure that banking entities are properly engaged in responsible forms of asset management, which should tamp down on the risks taken by the relevant fund.

Second, subparagraph (d)(1)(G) provides strong protections against a firm bailing out its funds. Clause (iv) prohibits banking entities, as provided under paragraph (1) and (2) of subsection (f), from entering into lending or similar transactions with related funds, and clause (v) prohibits banking entities from "directly or indirectly, guarantee[ing], assum[ing], or otherwise insur[ing] the obligations or performance of the hedge fund or private equity fund." To prevent banking entities from engaging in backdoor bailouts of their invested funds, clause (v) extends to the hedge funds and private equity funds in which such subparagraph (G) hedge funds and private equity funds invest.

Third, to prevent a banking entity from having an incentive to bailout its funds and also to limit conflicts of interest, clause (vii) of subparagraph (G) restricts directors and employees of a banking entity from being invested in hedge funds and private equity funds organized and offered by the banking entity, except for directors or employees "directly engaged" in offering investment advisory or other services to the hedge fund or private equity fund. Fund managers can have "skin in the game" for the hedge fund or private equity fund they run, but to prevent the bank from running its general employee compensation through the hedge fund or private equity fund, other management and employees may not.

Fourth, by stating that a firm may not organize and offer a hedge fund or private equity fund with the firm's name on it, clause (vi) of subparagraph (G) further restores market discipline and supports the restriction on firms bailing out funds on the grounds of reputational risk. Similarly, clause (viii) ensures that investors recognize that the funds are subject to market discipline by requiring that funds provide prominent disclosure that any losses of a hedge fund or private equity fund are borne by investors and not by the firm, and the firm must also comply with any other restrictions to ensure that investors do not rely on the firm, including any of its affiliates or subsidiaries, for a bailout.

Fifth, the firm or its affiliates cannot make or maintain an investment interest in the fund, except in compliance with the limited fund seeding and alignment of interest provisions provided in paragraph (4) of subsection (d). This paragraph allows a firm, for the limited purpose of maintaining an investment management business, to seed a new fund or make and maintain a "de minimis" co-investment in a hedge fund or private equity fund to align the interests of the fund managers and the clients, subject to several conditions. As a general rule, firms taking advantage of this provision should maintain only small seed funds, likely to be $5 to $10 million or less. Large funds or funds that are not effectively marketed to investors would be evasions of the restrictions of this section. Similarly, co-investments designed to align the firm with its clients must not be excessive, and should not allow for firms to evade the intent of the restrictions of this section.

These "de minimis" investments are to be greatly disfavored, and subject to several significant restrictions. First, a firm may only have, in the aggregate, an immaterial amount of capital in such funds, but in no circumstance may such positions aggregate to more than 3 percent of the firm's Tier 1 capital. Second, by one year after the date of establishment for any fund, the firm must have not more than a 3 percent ownership interest. Third, investments in hedge funds and private equity funds shall be deducted on, at a minimum, a one-to-one basis from capital. As the leverage of a fund increases, the capital charges shall be increased to reflect the greater risk of loss. This is specifically intended to discourage these high-risk investments, and should be used to limit these investments to the size only necessary to facilitate asset management businesses for clients.

Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs seek to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.

Subparagraph (J) permits the regulators to add additional exceptions as necessary to "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." This general exception power is intended to ensure that some unforeseen, low-risk activity is not inadvertently swept in by the prohibition on proprietary trading. However, the subparagraph sets an extremely high bar: the activity must be necessary to promote and protect the safety and soundness of the banking entity and the financial stability of the United States, and not simply pose a competitive disadvantage or a threat to firms' profitability.

Paragraph (2) of section (d) adds explicit statutory limits to the permitted activities under paragraph (1). Specifically, it prevents an activity from qualifying as a permitted activity if it would "involve or result in a material conflict of interest," "result directly or indirectly in a material exposure . . . to high-risk assets or high-risk trading strategies" or otherwise pose a threat to the safety and soundness of the firm or the financial stability of the United States. Regulators are directed to define the key terms in the paragraph and implement the restrictions as part of the rulemaking process. Regulators should pay particular attention to the hedge funds and private equity funds organized and offered under subparagraph (G) to ensure that such activities have sufficient distance from other parts of the firm, especially those with windows into the trading flow of other clients. Hedging activities should also be particularly scrutinized to ensure that information about client trading is not improperly utilized.

The limitation on proprietary trading activities that "involve or result in a material conflict of interest" is a companion to the conflicts of interest prohibition in section 621, but applies to all types of activities rather than just asset-backed securitizations.

With respect to the definition of high-risk assets and high-risk trading strategies, regulators should pay close attention to the characteristics of assets and trading strategies that have contributed to substantial financial loss, bank failures, bankruptcies, or the collapse of financial firms or financial markets in the past, including but not limited to the crisis of 2008 and the financial crisis of 1998. In assessing high-risk assets and high-risk trading strategies, particular attention should be paid to the transparency of the markets, the availability of consistent pricing information, the depth of the markets, and the risk characteristics of the assets and strategies themselves, including any embedded leverage. Further, these characteristics should be evaluated in times of extreme market stress, such as those experienced recently. With respect to trading strategies, attention should be paid to the role that certain types of trading strategies play in times of relative market calm, as well as times of extreme market stress. While investment advisors may freely deploy high-risk strategies for their clients, attention should be paid to ensure that firms do not utilize them for their own proprietary activities. Barring high risk strategies may be particularly critical when policing market-making-related and hedging activities, as well as trading otherwise permitted under subparagraph (d)(1)(A). In this context, however, it is irrelevant whether or not a firm provides market liquidity: high-risk assets and high-risk trading strategies are never permitted.

Subsection (d), paragraph (3) directs the regulators to set appropriate additional capital charges and quantitative limits for permitted activities. These restrictions apply to both banking entities and nonbank financial companies supervised by the Board. It is left to regulators to determine if those restrictions should apply equally to both, or whether there may appropriately be a distinction between banking entities and non-bank financial companies supervised by the Board. The paragraph also mandates diversification requirements where appropriate, for example, to ensure that banking entities do not deploy their entire permitted amount of de minimis investments into a small number of hedge funds or private equity funds, or that they dangerously over-concentrate in specific products or types of financial products.

Subsection (e) provides vigorous anti-evasion authority, including record-keeping requirements. This authority is designed to allow regulators to appropriately assess the trading of firms, and aggressively enforce the text and intent of section 619.

The restrictions on proprietary trading and relationships with private funds seek to break the internal connection between a bank's balance sheet and taking risk in the markets, with a view towards reestablishing market discipline and refocusing the bank on its credit extension function and client services. In the recent financial crisis, when funds advised by banks suffered significant losses, those off-balance sheet funds came back onto the banks' balance sheets. At times, the banks bailed out the funds because the investors in the funds had other important business with the banks. In some cases, the investors were also key personnel at the banks. Regardless of the motivations, in far too many cases, the banks that bailed out their funds ultimately relied on taxpayers to bail them out. It is precisely for this reason that the permitted activities under subparagraph (d)(1)(G) are so narrowly defined.

Indeed, a large part of protecting firms from bailing out their affiliated funds is by limiting the lending, asset purchases and sales, derivatives trading, and other relationships that a banking entity or nonbank financial company supervised by the Board may maintain with the hedge funds and private equity funds it advises. The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition, or through writing a derivative. Further, providing advisory services to a hedge fund or private equity fund creates a conflict of interest and risk because when a banking entity is itself determining the investment strategy of a fund, it no longer can make a fully independent credit evaluation of the hedge fund or private equity fund borrower. These bailout protections will significantly benefit independent hedge funds and private equity funds, and also improve U.S. financial stability.

Accordingly, subsection (f), paragraph (1) sets forth the broad prohibition on a banking entity entering into any "covered transactions" as such term is defined in the Federal Reserve Act's section 23A, as if such banking entity were a member bank and the fund were an affiliate thereof. "Covered transactions" under section 23A includes loans, asset purchases, and, following the Dodd-Frank bill adoption, derivatives between the member bank and the affiliate. In general, section 23A sets limits on the extension of credit between such entities, but paragraph (1) of subsection (f) prohibits all such transactions. It also prohibits transactions with funds that are controlled by the advised or sponsored fund. In short, if a banking entity organizes and offers a hedge fund or private equity fund or serves as investment advisor, manager, or sponsor of a fund, the fund must seek credit, including from asset purchases and derivatives, from an independent third party.

Subsection (f), paragraph (2) applies section 23B of the Federal Reserve Act to a banking entity and its advised or sponsored hedge fund or private equity fund. This provides, inter alia, that transactions between a banking entity and its fund be conducted at arms length. The fact that section 23B also includes the provision of covered transactions under section 23A as part of its arms-length requirement should not be interpreted to undermine the strict prohibition on such transactions in paragraph (1).

Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of "prime brokerage" between the banking entity and a third-party-advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest. Essentially, it was argued that a banking entity should not be prohibited, under proper restrictions, from providing limited services to unaffiliated funds, but in which its own advised fund may invest. Accordingly, paragraph (3) is intended to only cover third-party funds, and should not be used as a means of evading the general prohibition provided in paragraph (1). Put simply, a firm may not create tiered structures and rely upon paragraph (3) to provide these types of services to funds for which it serves as investment advisor.

Further, in recognition of the risks that are created by allowing for these services to unaffiliated funds, several additional criteria must also be met for the banking entity to take advantage of this exception. Most notably, on top of the flat prohibitions on bailouts, the statute requires the chief executive officer of firms taking advantage of this paragraph to also certify that these services are not used directly or indirectly to bail out a fund advised by the firm.

Subsection (f), paragraph (4) requires the regulatory agencies to apply additional capital charges and other restrictions to systemically significant nonbank financial institutions to account for the risks and conflicts of interest that are addressed by the prohibitions for banking entities. Such capital charges and other restrictions should be sufficiently rigorous to account for the significant amount of risks associated with these activities.

To give markets and firms an opportunity to adjust, implementation of section 620 will proceed over a period of several years. First, pursuant to subsection (b), paragraph (1), the Financial Stability Oversight Council will conduct a study to examine the most effective means of implementing the rule. Then, under paragraph (b)(2), the Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall each engage in rulemakings for their regulated entities, with the rulemaking coordinated for consistency through the Financial Stability Oversight Council. In coordinating the rulemaking, the Council should strive to avoid a "lowest common denominator" framework, and instead apply the best, most rigorous practice from each regulatory agency.

Pursuant to subsection (c), paragraph (1), most provisions of section 619 become effective 12 months after the issuance of final rules pursuant to subsection (b), but in no case later than 2 years after the enactment of the Dodd-Frank Act. Paragraph (c)(2) provides a 2-year period following effective date of the provision during which entities must bring their activities into conformity with the law, which may be extended for up to 3 more years. Special illiquid funds may, if necessary, receive one 5-year extension and may also continue to honor certain contractual commitments during the transition period. The purpose of this extended wind-down period is to minimize market disruption while still steadily moving firms away from the risks of the restricted activities.

The definition of "illiquid funds" set forth in subsection (h) paragraph (7) is meant to cover, in general, very illiquid private equity funds that have deployed capital to illiquid assets such as portfolio companies and real estate with a projected investment holding period of several years. The Board, in consultation with the SEC, should therefore adopt rules to define the contours of an illiquid fund as appropriate to capture the intent of the provision. To facilitate certainty in the market with respect to divestiture, the Board is to conduct a special expedited rulemaking regarding these conformance and wind-down periods. The Board is also to set capital rules and any additional restrictions to protect the banking entities and the U.S. financial system during this wind-down period.

We noted above that the purpose of section 620 is to review the long-term investments and other activities of banks. The concerns reflected in this section arise out of losses that have appeared in the long-term investment portfolios in traditional depository institutions.

Over time, various banking regulators have displayed expansive views and conflicting judgments about permissible investments for banking entities. Some of these activities, including particular trading strategies and investment assets, pose significant risks. While section 619 provides numerous restrictions to proprietary trading and relationships to hedge funds and private equity funds, it does not seek to significantly alter the traditional business of banking.

Section 620 is an attempt to reevaluate banking assets and strategies and see what types of restrictions are most appropriate. The Federal banking agencies should closely review the risks contained in the types of assets retained in the investment portfolio of depository institutions, as well as risks in affiliates' activities such as merchant banking. The review should dovetail with the determination of what constitutes "high-risk assets" and "high risk trading strategies" under paragraph (d)(2).

At this point, I yield to Senator LEVIN to discuss an issue that is of particular interest to him involving section 621's conflict of interest provisions.

Mr. LEVIN. I thank my colleague for the detailed explanation he has provided of sections 619 and 620, and fully concur in it. I would like to add our joint explanation of section 621, which addresses the blatant conflicts of interest in the underwriting of asset-backed securities highlighted in a hearing with Goldman Sachs before the Permanent Subcommittee on Investigations, which I chair.

The intent of section 621 is to prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures. This practice has been likened to selling someone a car with no brakes and then taking out a life insurance policy on the purchaser. In the asset-backed securities context, the sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. They, like the mechanic servicing a car, would know if the vehicle has been designed to fail. And so they must be prevented from securing handsome rewards for designing and selling malfunctioning vehicles that undermine the asset-backed securities markets. It is for that reason that we prohibit those entities from engaging in transactions that would involve or result in material conflicts of interest with the purchasers of their products.

Section 621 is not intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it. Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position. But a firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.

We believe that the Securities and Exchange Commission has sufficient authority to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets.

In conclusion, we would like to acknowledge all our supporters, co-sponsors, and advisers who assisted us greatly in bringing this legislation to fruition. From the time President Obama announced his support for the Volcker Rule, a diverse and collaborative effort has emerged, uniting community bankers to old school financiers to reformers. Senator MERKLEY and I further extend special thanks to the original cosponsors of the PROP Trading Act, Senators TED KAUFMAN, SHERROD BROWN, and JEANNE SHAHEEN, who have been with us since the beginning.

Senator JACK REED and his staff did yeoman's work in advancing this cause. We further tip our hat to our tireless and vocal colleague, Senator BYRON DORGAN, who opposed the repeal of Glass-Steagall and has been speaking about the risks from proprietary trading for a number of years. Above all, we pay tribute to the tremendous labors of Chairman CHRIS DODD and his entire team and staff on the Senate Banking Committee, as well as the support of Chairman BARNEY FRANK and Representative PAUL KANJORSKI. We extend our deep gratitude to our staffs, including the entire team and staff at the Permanent Subcommittee on Investigations, for their outstanding work. And last but not least, we highlight the visionary leadership of Paul Volcker and his staff. Without the support of all of them and many others, the Merkley-Levin language would not have been included in the Conference Report.

We believe this provision will stand the test of time. We hope that our regulators have learned with Congress that tearing down regulatory walls without erecting new ones undermines our financial stability and threatens economic growth. We have legislated to the best of our ability. It is now up to our regulators to fully and faithfully implement these strong provisions.

I yield the floor to Senator MERKLEY.

Mr. MERKLEY. I thank my colleague for his remarks and concur in all respects.

Mr. DODD. Mr. President, I said so yesterday, and I will say it again: I thank Senator MERKLEY. I guess there are four new Members of the Senate serving on the Banking Committee. Senator MERKLEY, Senator WARNER, Senator TESTER, and Senator BENNET are all new Members of the Senate from their respective States of Oregon, Virginia, Montana, and Colorado. To be thrown into what has been the largest undertaking of the Banking Committee, certainly in my three decades here—and many have argued going back almost 100 years—was certainly an awful lot to ask.

I have already pointed out the contribution Senator WARNER has made to this bill. But I must say as well that Senator BENNET of Colorado has been invaluable in his contributions. I just mentioned Senator TESTER a moment ago for his contribution on talking about rural America and the importance of those issues. And Senator MERKLEY, as a member of the committee, on matters we included here dealing particularly with the mortgage reforms, the underwriting standards, the protections people have to go through, and credit cards as well—we passed the credit card bill—again, it was Senator JEFF MERKLEY of Oregon who played a critical role in that whole debate not to mention, of course, working with CARL LEVIN, one of the more senior Members here, having served for many years in the Senate. But the Merkley-Levin, Levin-Merkley provisions in this bill have added substantial contributions to this effort. So I thank him for his contribution.

I see my colleague from North Dakota is here. I suggest the absence of a