

**Davis Polk**

**Volcker Rule Materials  
Proprietary Trading**

**November 5, 2010**

**SIFMA FSOC Study  
Comment Letter**



November 5, 2010

*By electronic submission to [www.regulations.gov](http://www.regulations.gov)*

Financial Stability Oversight Council  
c/o United States Department of the Treasury  
Office of Domestic Finance  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds

Docket Number FSOC-2010-0002

**Comment Letter on the Proprietary Trading Portion of Study**

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> thanks the Financial Stability Oversight Council (the “FSOC”) for the opportunity to provide our views in connection with the FSOC’s Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (the “Study”) required by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). This letter is submitted in response to the FSOC’s solicitation for comments dated October 1, 2010 and deals only with questions relating to proprietary trading. SIFMA is submitting a separate letter relating to the hedge fund and private equity fund portion of the Study.

SIFMA believes that the issues arising out of the proprietary trading portion of Section 619 are very different from those arising out of the funds portion. The proprietary trading provisions contain many vague definitions. These definitions require the agencies to exercise considerable discretion and judgment in implementation, and this discretion should be exercised

---

<sup>1</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit [www.sifma.org](http://www.sifma.org).

in a manner that preserves the effective functioning of the markets and access to capital while achieving the objectives of the statute. As a result, SIFMA urges the FSOC to adopt a careful, staged approach to implementation of the proprietary trading restrictions with a firm grounding in market realities. The reasons for this recommended approach, and the recommendations for carrying it out, are discussed further in this letter.

Our companion letter addresses the hedge fund and private equity fund portions of Section 619. In contrast to the proprietary trading provisions, the provisions relating to hedge funds and private equity funds do not generally suffer from excessive vagueness. Instead of lacking specificity, the key definitions in this portion of Section 619 are generally overbroad: they sweep in entities and vehicles that Congress did not intend to be treated as hedge funds or private equity funds and which Congress expected the implementing agencies to exclude from the general definition through the exercise of their regulatory discretion. In addition, the interaction of defined terms and other provisions in this portion of Section 619 contain internal contradictions or generate unintended consequences that the implementing agencies will need to correct through use of the Supreme Court's canons of statutory construction. Therefore, in our companion letter, SIFMA asks the FSOC to recommend that the implementing agencies act promptly to provide legal certainty on these issues relating to the hedge fund and private equity fund provisions of Section 619.

## **I. Executive Summary**

The FSOC faces a difficult task under a challenging deadline. Congress acknowledged the difficult issues presented by Section 619 by deliberately leaving a number of terms in the proprietary trading restrictions vaguely defined, requiring the FSOC to conduct the Study to guide the interpretation of these terms and the scope of the prohibition.

Important economic and policy considerations underlie Congress's design of a multi-step approach to the implementation of the Section 619 proprietary trading restrictions. Implementation should be undertaken with a firm grounding in market realities in order to avoid serious negative implications for the cost of capital to U.S. businesses, liquidity in the U.S. financial markets and U.S. economic recovery and growth. Implementation should also be examined in the context of the global financial markets, recognizing the risk that financial activity may migrate to the unregulated shadow banking system or to foreign financial centers such as Hong Kong, Singapore, London, Frankfurt, Paris or Zurich, and the resulting effects on the strength and competitiveness of the United States as a global financial center.

We respectfully request that the FSOC and the regulators use the Study to develop principles to guide rulemaking relating to the proprietary trading restrictions and to develop a staged work plan for the remaining phases of implementation.

The Study should set forth principles to encourage regulators to approach the permitted activities—particularly market making and hedging—with sensitivity to the functioning of U.S. and global markets. With respect to market making-related activities, the Study should emphasize the importance of a wide range of market making-related activities and should recognize expressly that market making necessarily involves taking risk. With respect to hedging, the Study should highlight the importance of hedging to the safety and soundness of banking entities,<sup>2</sup> the full range of risks to which banking entities are subject, the manner in which banking entities assess those risks, and the range of risk management techniques that banking entities currently use to mitigate those risks.

The Study should recognize that the variety of asset classes, market practices, markets and market conditions make it impractical to develop prescriptive regulations that delineate precise boundaries for permitted activities. SIFMA believes that the regulatory framework should be based on broad principles and use a compliance approach that requires banking entities to establish and maintain policies and procedures reasonably designed to ensure compliance with the prohibitions in Section 619, subject to ongoing supervision by the regulators.

While we do not address in this letter whether the activities prohibited by Section 619 caused the financial crisis, we believe there are cogent arguments that they did not. We ask that the FSOC and regulators consider these arguments when implementing Section 619.

## **II. Careful Review Is Needed**

Section 619 of the Dodd-Frank Act generally prohibits any “banking entity” from engaging in “proprietary trading,” subject to certain exceptions.<sup>3</sup> The statute adopts a multi-step implementation process. First, the FSOC must conduct the Study and make recommendations on implementation by January 21, 2011, six months after the date of enactment of the Dodd-Frank Act. Within nine months after the completion of the Study, the agencies responsible for implementing Section 619 are required to adopt final rules implementing Section 619 that consider the FSOC’s Study and recommendations.<sup>4</sup>

---

<sup>2</sup> In this letter, we use the term “banking entity” consistently with its definition in Section 619, which includes any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act), any company that controls an insured depository institution, any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such an entity.

<sup>3</sup> See discussion of the definition of “banking entity” in the companion letter for funds from SIFMA.

<sup>4</sup> See the companion letter for funds from SIFMA for a list of which regulators cover which type of entity. Although the Board of Governors of the Federal Reserve System (the “**Board**”) is generally the exclusive agency responsible for implementing the Bank Holding Company Act, new Section 13 added by Section 619 of the Dodd-Frank Act is required to be implemented by the Board, the Office of the Comptroller of the Currency (the “**OCC**”), the Federal Deposit Insurance Corporation (the “**FDIC**”), the Securities and Exchange

The Study marks only the first stage of the Section 619 implementation process. SIFMA respectfully requests the FSOC to use the Study to recommend principles relating to the proprietary trading restrictions and to develop a staged work plan for the remaining phases of implementation. As a second stage, regulators should be encouraged to conduct an in-depth review during the first six months of 2011 that focuses on the function of hedging and the role of market making within markets on an asset-class-by-asset-class basis. The regulators' review should include consultation with market participants from both the buy and sell sides. SIFMA members stand ready, through working groups of senior business and risk experts and other means, to work constructively with the regulators during this second stage. Only after completing this second stage review should the regulators enter the rule-writing process, aiming to issue proposed regulations by early summer for notice and comment and to issue final regulations by October 21, 2011.<sup>5</sup>

### **III. Section 619 Will Result in Meaningful Changes**

SIFMA and its members understand that the new restrictions on proprietary trading will result in meaningful changes to the way that banking entities do business. The statute defines "proprietary trading" as "engaging as principal for the 'trading account,'" defined as "any account used for acquiring or taking positions... 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 any such other accounts" as determined by the regulators.<sup>6</sup>

Before the passage of the Dodd-Frank Act, many U.S. banking entities had discrete proprietary trading operations. SIFMA and its members understand that banking entities will have to discontinue these operations. A number of SIFMA members have already announced plans to close or sell their segregated proprietary trading businesses, and we understand that others are planning to do so even before Section 619's prohibitions become effective. By

---

Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and together with the Board, the OCC, the FDIC and the SEC, the "regulators") with respect to the companies for which they are the primary financial regulatory agencies. The Treasury Secretary, as chairperson of the FSOC, is responsible for coordination of the regulations issued under Section 619.

<sup>5</sup> SIFMA encourages regulators to propose regulations for proprietary trading by June 30, 2011 at the latest, and in any case, respectfully requests at least a 60-day comment period to respond.

<sup>6</sup> Section 619 uses the words "near term" in the definition of "trading account" and in describing the "market making-related" permitted activity. The FSOC should encourage regulators when writing regulations to apply a meaning to the words "near term" that is appropriate to the context in which they appear. In the definition of "trading account," the phrase defines the nature of the seller's selling activity, and when used to describe a "market making-related" permitted activity, the phrase defines the nature of the demand of clients, customers and counterparties. The FSOC should encourage regulators to view the phrase in its defining context. The FSOC also should recognize that any definitions in this area should be sufficiently flexible to account for differences among asset classes and markets.

proactively taking steps to wind down these prohibited proprietary trading activities, banking entities are already fulfilling one of the primary objectives of Section 619.

We also understand the concerns of some that these discrete proprietary trading operations will simply migrate to customer facing desks, but we believe that the regulatory structure and compliance framework proposed in this letter and the spirit of cooperation that the industry is bringing to this process will help ensure that this does not occur. As noted above, SIFMA and its members stand ready to work with the FSOC and the regulators to develop the proposed regulatory and compliance framework.

#### **IV. Section 619 Expressly Permits Certain Key Market Activities**

Section 619 expressly permits activities that are critical to the functioning of the U.S. and global markets. The permitted activities allow banking entities to continue to service clients, customers and counterparty relationships. In this letter, we focus on market making-related, underwriting and hedging activities, and on activities conducted on behalf of customers.

##### **A. Market Making**

SIFMA views the market making-related permitted activity as a crucial component of Section 619. Market making is a core function of banking entities and provides liquidity needed by all market participants, resulting in better pricing. The Study should support the design of a sensible framework of regulations and policies and procedures that preserve the effective functioning of markets and the current role of market making within those markets, and at the same time achieve the objectives of the statute.

SIFMA supports a robust discussion of this topic, especially in light of possible confusion regarding the activities involved in market making.

##### **1. *A Range of Market Making-Related Permitted Activities Should Be Recognized***

The FSOC should encourage regulators to conduct an in-depth review of the roles of market making across all markets, and ultimately to adopt rules that address market making-related activities in a way that preserves this essential function.

Market making provides essential liquidity to clients, customers and counterparties.<sup>7</sup> A banking entity engaged in market making-related activities in securities,

---

<sup>7</sup> In this letter, SIFMA uses the term “customer” interchangeably with the term “clients, customers or counterparties.”

derivatives and futures stands ready to buy, sell or otherwise transact with customers under a variety of market conditions, and typically provides firm or indicative prices in response to customer requests. In order to provide market making-related services, a banking entity must be permitted to conduct activities that include, but are not limited to:

- taking positions in anticipation of, and in response to, customer demand to buy or sell, and—depending on the liquidity of the relevant market and the size of the position—holding those positions for minutes or weeks (or longer depending on the market);
- managing and assuming basis risk between customized customer risks and the standardized products available in the market to hedge those risks;
- building, maintaining, and re-balancing inventory, through trades with other market participants, and engaging in accumulation activities to accommodate anticipated customer demand;<sup>8</sup>
- trading in the market to remain current on pricing and trends; and
- engaging in arbitrage activities to provide efficiency and liquidity for markets.

Market making-related activities vary widely by asset class because of differences in trade size, liquidity, market infrastructure, market interdependencies and geography. In highly liquid markets, risk assumed in the course of market making-related activities can often be laid off in short time frames, measured in minutes or hours.<sup>9</sup> However, in less liquid markets, banking entities conducting market making-related activities often assume positions from or for customers in instruments that trade infrequently and, in those markets, banking entities may have to hold the risk for much longer periods, measured in weeks or even months.

If regulators were to define market making-related activities solely by reference to market practice in highly liquid instruments such as U.S. cash equities or on-the-run government bonds, banking entities would be unable to provide liquidity for less liquid instruments, such as corporate debt.

---

<sup>8</sup> In the market for structured products, such as ETFs and asset-backed securities, market makers are involved in creating the “units” that represent rights to underlying pools of assets. Acting as a market maker in this capacity requires banking entities to accumulate the underlying components of these assets in order to create units, which are then used to cover customer demand for the units. The creation of units is crucial for these activities and is an essential part of market making.

<sup>9</sup> Yet even in such markets, for example, a block positioner that has taken on a large position from a customer (an activity defined as market making in the Securities Exchange Act of 1934) may need to hold the position for some extended period of time to avoid selling the block at a large loss or causing severe movements in the price of the asset.

The liquidity provided by market making-related activities is vital to the U.S. economy. Corporate debt is a good example. Corporate bonds are an essential means by which U.S. companies access capital. In no small part, investors, both retail and institutional, are willing to buy those bonds because they know that market-makers stand ready to buy the bonds from them if the investors subsequently want to sell the bonds. A definition of market making-related activities that prevents banking entities from providing that committed source of liquidity would seriously and immediately reduce demand for U.S. corporate debt, thereby increasing costs for U.S. corporations and potentially restricting the U.S. economy's access to capital.

The statute, by framing the permitted activity as "market making-related," rather than just "market making," recognizes a need for a broad range of permitted market making activities. In the colloquy between Senator Bayh (D-IN) and Chairman Dodd (D-CT), Chairman Dodd affirmed Senator Bayh's clarification that the market making-related permitted activity "would allow banking entities to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets."<sup>10</sup> The FSOC should recommend that regulators effect Congress's intent to permit a broad range of market making-related activities.

## ***2. Market Making Necessarily Involves Taking and Managing Risk***

The Study should also acknowledge the fundamental role of risk-taking in market making and the fact that market making cannot be undertaken without exposure to the possibility of price appreciation and depreciation.

It is useful to contrast a market maker's role with that of an agency or riskless principal trader, where the trader matches buyers and sellers without taking risk. In an agency trade, if a client wishes to sell a position, the trader will execute that trade only if the trader has lined up a buyer on the other side. Similarly, in a riskless principal trade, a trader will nearly simultaneously buy and sell a position only after the counterparty on the other side has been identified. In both situations, the trader has virtually no market risk and accordingly, its fees are limited to commission equivalents. As such, agency or riskless principal traders can properly be said to profit without changes in the value of the underlying instrument.

By contrast, banking entities engaging in market making-related activities trade as principals directly with customers, putting their own capital at risk to price changes. The size of positions and the length of time those positions are held is a function of asset class, liquidity and market conditions. In all but the most liquid markets, it is not possible for banking entities engaged in market making-related activities to undertake only trades where the bid-ask spread can

---

<sup>10</sup> 156 CONG. REC. S5902 (daily ed. July 15, 2010).



immediately be captured for “intermediating” a trade between a buyer and a seller. Rather, market makers must take principal positions—either in anticipation of customer demand or in response to customer demand.

For example, if a banking entity purchases a debt position from a customer seeking to sell the position, it is often the case that the banking entity will not be able to immediately identify another customer or dealer ready to purchase that identical position from the banking entity at a price higher than, or even equal to, the price paid by the banking entity. To realize the bid-offer spread in that example, through which the banking entity is compensated for the risk of providing liquidity to the markets, the entity will have to manage the acquired position actively over time. Because they hold positions, banking entities engaged in market making-related activities are at risk of changes in the market price of such positions. Part of the market making function is to manage this inherent price risk and to position an overall portfolio in a prudent way and within risk limits established by independent risk managers.

From the language of the statute, it is clear that Congress did not intend for “market making-related” permitted activities to be limited to what essentially amounts to agency trading, albeit on a principal basis. The statute separately permits activities “on behalf of customers,” which, as described below, would include riskless principal trading, among others.<sup>11</sup> The fact that the statute separately permits “market making-related” activities and activities “on behalf of customers” is a clear indication that Congress intended to distinguish between banking entities engaged in market making-related activities and traders engaging in agency or riskless principal activities. The Study should recommend that the regulators give effect to that Congressional intent by ensuring that market makers remain permitted to engage in activities that are essential to their role and to maintaining an orderly, functioning market.

## **B. Underwriting**

Underwriting activities are also designated as permitted activities under Section 619<sup>12</sup> and are essential for raising capital needed by corporate and sovereign entities of all sizes. Issuers need the certainty of knowing that banking entities will continue to serve in this very important role of assisting issuers with gaining access to a broad range of potential investors. The FSOC should recommend that the regulators interpret “underwriting” to include all traditional underwriting activities including, at a minimum: registered transactions in which the banking entity would be an “underwriter”; registration-exempt transactions conducted outside the U.S. in accordance with local regulations and customs; Rule 144A and other private placements; any other distribution of securities or other financial instruments distinguishable from ordinary

---

<sup>11</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, Bank Holding Company Act § 13(d)(1)(D) (2010).

<sup>12</sup> *Id.* § 13(d)(1)(B) (2010).

transactions on the secondary market by magnitude and selling practices; and related stabilization, overallotment and other underwriting activities.

### **C. Hedging**

Risk-mitigating hedging activities are expressly permitted by Section 619. The Study should recommend that the regulators recognize the full range of risks to which banking entities are subject, the manner in which banking entities currently assess those risks, and the range of risk management techniques that banking entities currently employ to mitigate those risks.

The Study should take account of the manner in which banking entities actually measure and mitigate risk. Few transactions present only a single risk; most present a series of risks that may include, among others, market risk, interest rate risk, credit risk and currency risk. Transactions are rarely hedged on a transaction-by-transaction or “one-for-one” basis. Rather, individual transactions contribute to the overall risk profile of a portfolio and banking entities typically assess, manage and hedge the aggregated risks on a portfolio basis. We believe that the reference to “individual or aggregated positions, contracts or other holdings” in the hedging permitted activity gives regulators a clear mandate to implement regulations that allow banking entities to hedge their risks at a portfolio, business or entity level. Banking entities also take on basis risks—the difference between the client’s risk and what can be simply hedged immediately in the market from their clients. This basis risk must be actively managed over time using a variety of techniques, including hedges that are expected to reduce the risk being hedged but may not completely eliminate the risk. In addition, the regulations should recognize that banking entities actively assess and manage their portfolios in anticipation of possible future risks and should clearly permit the use of anticipatory hedges. The regulations should clearly permit the continued use of these, and not inhibit the development of new, hedging techniques.

### **D. On Behalf of Customers**

Section 619 also treats trading “on behalf of customers” as a permitted activity.<sup>13</sup> As an initial matter, the Study should recommend that regulators clarify that trades in a customer discretionary account, riskless principal activities and trust and fiduciary activities are permitted. The Study should further encourage regulators to review the full range of transactions that banking entities enter into on behalf of customers and to craft the permitted activity in light of the broad range of customer transactions that banking entities have traditionally provided. The Study

---

<sup>13</sup> This exception is unrelated to agency or brokerage activities, because such activities are not conducted as a principal and thus not subject to the proprietary trading restrictions in the first place.

should encourage the regulators to review longstanding regulatory guidance in this area, including the OCC's interpretive letters on the determination of whether a trade is "customer-driven."<sup>14</sup>

#### **E. Other Permitted Activities**

The permitted activities that this section has discussed—market making-related activities, underwriting, hedging and transactions on behalf of customers—are only four of the several permitted activities relating to the proprietary trading restrictions. When approaching the full scope of permitted activities, the FSOC should encourage regulators to structure the permitted activities so that in aggregate, they result in sensible parameters and do not create arbitrary distinctions between permitted and prohibited activities.

#### **V. Other Principal Activities Should Not Be Affected By Section 619; The Study Should Confirm the Intended Scope of the Ban on "Proprietary Trading"**

Congress did not intend that every activity engaged in by a banking entity as a principal would fall within Section 619's definition of banned "proprietary trading." The Study should confirm that there are principal activities in securities, derivatives and other defined instruments engaged in by banking entities that are not "proprietary trading" because they are not principally for the purpose of selling in the near term or to profit from short-term price movements.<sup>15</sup> Among the activities that the Study should confirm fall outside the scope of Section 619 are asset-liability, liquidity, interest-rate and treasury management activities and investing activities. None of these activities is engaged in 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). Further, we do not believe these activities were intended to be barred by Section 619.

Asset-liability, liquidity, interest-rate and treasury management activities are engaged in by consumer and commercial banks of all sizes to control the risks arising from their traditional banking activities. Traditional banking activities, such as making loans and taking deposits, give rise to interest rate, credit and market risks that regulators have long required to be properly managed and controlled by the banking entity to assure the safety and soundness of their operations. Likewise, liquidity management indisputably is core to safety and soundness, and the

---

<sup>14</sup> See OCC Interpretive Letter No. 892 (September 13, 2000). See also OCC Interpretive Letter No. 1090 (October 25, 2007); OCC Interpretive Letter No. 1018 (February 10, 2005).

<sup>15</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, Bank Holding Company Act § 13(h)(6)(2010). Regulators should give careful consideration before broadening the definition of "proprietary trading" to include trading activities in financial instruments not specifically enumerated in the statute.

recent financial crisis has only served to reinforce the importance of maintaining liquidity under current, anticipated and stressed scenarios. In order for banking entities to respond appropriately when risks to capital, income or liquidity are identified, they must be able to manage their assets and liabilities freely, and on a real-time basis, including by purchasing and selling assets as principal. These securities or other assets may be different than those that gave rise to the underlying risk, and such trades often must be executed in anticipation of the expected effects of the identified risks.

Regulators have long viewed these asset-liability, interest rate, liquidity and other treasury management activities to be at the heart of managing a bank's safety and soundness. Regulators require that prudent risk management be undertaken and establish parameters for its execution. These activities must, among other things, be documented in written policies and procedures, coordinated at an enterprise level within appropriate limits approved by the firm's board of directors, executed using assets, securities and other instruments, as well as strategies, deemed permissible by the regulators, and be correlated with the sophisticated models that each bank is required to develop to measure and monitor the risks attendant to its individual mix of business. Regulatory oversight of asset-liability and liquidity management activities is rigorous. Regulatory supervisors regularly examine the policies and procedures established by the banking entity for risk and liquidity management and review the firm's adherence to them. We believe it is appropriate for bank supervisors to continue to examine this function intensively as they currently do, and this supervisory approach is consistent with the policies and procedures-based approach discussed below.

We do not believe Section 619 was intended to disrupt essential asset-liability, interest rate, liquidity or other appropriate treasury functions or include them within its definition of "proprietary trading." We believe the clear intent of Congress was to allow these crucial risk and liquidity management functions to continue, subject to ongoing appropriate regulatory oversight.

#### **VI. The Regulatory Framework Should Rely on Robust and Carefully Examined Policies and Procedures**

The regulations should not attempt to hard-code detailed distinctions between permitted activities and prohibited proprietary trading. This is particularly true in light of the variety of asset classes, market practices, markets and market conditions that the regulations must take into account. SIFMA believes that, instead, the regulatory framework should be a principles-based framework that requires banking entities to establish and maintain policies and procedures reasonably designed to ensure compliance with the prohibitions of Section 619.

Those policies and procedures should build on the policies and procedures currently used by banking entities to monitor their customer-facing desks. In developing policies

and procedures, banking entities should consider employing metrics that are designed and calibrated to distinguish permitted market making-related and hedging activities from prohibited proprietary trading. Such metrics would be available for review by examiners. Any metrics should be tailored based on factors such as asset class, market liquidity, the capital base of the business or portfolio, trade type, presence of active market participants and market makers, and trading volumes and frequencies. Compliance with agreed metrics should create a presumption of compliance with Section 619's proprietary trading restrictions.

The regulations should establish criteria for satisfactory policies, including monitoring requirements, escalation procedures, recordkeeping and disclosure requirements.

As with policies and procedures-based regimes generally, identified variances from established policies and procedures and related metrics should not give rise to a presumption of prohibited proprietary trading. Rather, such variances should be considered "flags" that require the banking entity to conduct a qualitative review of the relevant variance. The policies and procedures would require the banking entity to take appropriate corrective or other action in response to such flags (including permitting the activity if it is determined not to be prohibited proprietary trading). Examiners would be able to review these variances and the banking entity's response. The policies and procedures will need to be designed to maximize their practical effectiveness. As with any warning system, there will be a trade-off between sensitivity and accuracy.

The policies and procedures should not be assessed on an individual trade basis at first instance. Market making is a portfolio concept, and hedging is conducted on an aggregate basis. As such, routinely reviewing every trade in isolation for compliance with Section 619 will not result in an accurate assessment of the character of the trading activity. Moreover, this review is not practicable given the sheer volume of trading.

The policies and procedures approach should acknowledge that each financial institution should bear the responsibility of continuing or implementing disclosure requirements and other internal compliance policies and procedures designed to prevent the occurrence of a material conflict of interest. Mitigation of exposure to high-risk assets and high-risk trading strategies and activities that pose a threat to safety and soundness or financial stability should be encompassed within the policies, procedures and metrics to be used by firms in conducting their market making and hedging activities.

In approaching the regulations and compliance framework, the regulators should engage in joint rulemaking to the extent possible, and should also impose the same processes for examination and review in order to prevent unnecessary confusion, complexity and inefficiencies. The regulations should establish a notice and process procedure that would be required with regard to a determination that an otherwise permitted activity should be limited. Any such

procedure should provide for appropriate conformance periods in order to avoid the destabilizing effects of market uncertainty.

\* \* \* \* \*

## **VII. Conclusion: Need for Careful Implementation**

As discussed above, the implementation of the Dodd-Frank Act proprietary trading restrictions could have serious negative effects on economic recovery. Banking entities are important sources of strength in U.S. financial markets and strong capital markets are critical to restoration of a strong economy. If the prohibitions in Section 619 are implemented in an overly restrictive way, they could adversely impact the ability of markets to function, and impede access to capital by U.S. corporations.

Recognizing the potential consequences of Section 619, Congress gave the FSOC and regulators discretion in the implementation of the provision. For this reason, SIFMA encourages the FSOC to use the Study to recommend principles relating to the proprietary trading restrictions and to develop a staged work plan for the remaining phases of implementation. This letter sets forth SIFMA's suggestions on those principles, and does not provide recommendations on the definitions underlying the proprietary trading restrictions, which we believe should be informed by the regulatory review and public comment in the second stage. SIFMA and its members stand ready, through working groups of senior business and risk experts and other means, to work constructively with the regulators during the second stage. In connection with this collaboration, we look forward to providing detailed comments to the FSOC and the regulators on the definitions and metrics.

\* \* \* \* \*

Financial Stability Oversight Council  
November 5, 2010  
Page 14

SIFMA thanks the FSOC for the opportunity to comment on the Study. If you have any questions, please do not hesitate to call me at 212-313-1114, or SIFMA's counsel, Margaret E. Tahyar at 212-450-4379 or Robert L.D. Colby at 202-762-7121, of Davis Polk & Wardwell LLP.

Sincerely,

A handwritten signature in black ink, appearing to read "R. C. Snook". The signature is fluid and cursive, with a large initial "R" and a distinct "C" and "S".

Randolph C. Snook  
Executive Vice President  
Securities Industry and Financial Markets Association