Public Statement

Statement on Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

Commissioner Kara M. Stein

June 5, 2018

I also would like to thank the staff for all of their hard work on this proposal. I'd like to begin my statement this morning with a quote about today's proposed amendment to the Volker Rule:

> [W]e recognize that the proposed amendment could increase moral hazard risks related to proprietary trading by allowing dealers to take positions that are economically equivalent to positions they could have taken in the absence of the 2013 final rule.[1]

More on this later. Let's start first with a little history.

October 19, 1987: Black Monday

On October 19, 1987, or Black Monday, the stock market plunged over 20% in one day—the largest single day drop in market history.[2] Black Monday's drop was partially caused by rapid-fire trading related to a newly popularized financial product—portfolio insurance. Portfolio insurance, or so-called "dynamic hedging," was sold as a mechanism for mutual funds, insurance companies, pension funds, and others to protect their market gains from future declines.[3] This hedging strategy compounded selling into a declining market and accelerated the pace of the crash.[4]

As one trader recalled:

> You had leveraged risk arbitrage investors who were "forced" to sell to meet margin calls. You had mutual fund[s] who were "forced" to sell to meet mutual fund redemptions. Finally, you had holders of portfolio insurance who were contractually "forced" to sell to protect (or "insure") their portfolios.[5]

The Federal Reserve had to intervene to avoid a major financial crisis by bolstering market liquidity and investor confidence.[6] The Federal Reserve, among other things, reduced the short-term borrowing rate, expanded open market operations, issued calming statements affirming its commitment to providing future liquidity support, and

expanded lending of its Treasury securities. The Federal Reserve also assured a continuing supply of credit for financial institutions to support funding needs of broker-dealers and securities firms.

September 1998: Long Term Capital Management

Eleven years later, the Federal Reserve had to intervene once again to protect the financial system from the risk of financial contagion.

In September 1998, a $126 billion hedge fund's risky trades suddenly went south, bringing the fund to the brink of collapse.[7] The hedge fund—called Long Term Capital Management—employed a variety of risky trading strategies. However, incorrect assumptions in their arbitrage positions combined with significant leverage led to a quick erosion of their capital base and extensive losses.[8]

The Federal Reserve intervened again and rescued the firm to protect the financial system from the damage that would have occurred upon the firm's collapse. The potentially catastrophic impact this one hedge fund could have had on the entire financial system raised red flags about aggressive trading strategies. Unfortunately, the Federal Reserve's bailout of Long Term Capital Management may have had the unintentional effect of assuring the financial services industry that the government would stand ready to intervene if faulty trading strategies once again threatened the economy.

2007–2008: The Great Recession

Ten years after the collapse of Long Term Capital Management, the Federal Reserve yet again had to intervene to protect the financial system. In late 2007 and early 2008, a tidal wave of financial problems cascaded through our financial system. These problems ultimately required the largest and most significant government intervention in the financial markets since the Great Depression. The Federal Reserve launched a number of programs designed to support the liquidity of financial institutions and to improve conditions in the financial markets.[9] The federal government took over the housing giants Freddie Mac and Fannie Mae.[10] And, critically, the government created a number of programs to lend, guarantee, and stave off the failure of large and small banks.[11] Ultimately, the U.S. Treasury pumped nearly $440 billion in taxpayer funds into the market to bail out private financial institutions. This is in addition to the Federal Reserve's multi-billion dollar programs designed to support the liquidity of financial institutions and foster improved conditions in the financial markets.[12]

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I present this abridged history not for the sake of hyperbole, but because I believe it is important that we remember why the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed and signed into law.[13] More specifically, as the Commission is poised to act on today's recommendation, it is imperative that we understand what happened in recent decades, and what drove such historic government intervention in the financial system. We also need to remember the reasons behind the passage of Section 619 of the Dodd-Frank Act, which became known as the Volcker Rule.

Why? Because, as George Santayana once said, "Those who cannot remember the past are condemned to repeat it."[14]

The Commission and other federal financial regulators adopted the final version of the Volcker Rule in December 2013.[15] Named after former Federal Reserve Chairman Paul Volcker, the Rule limited the ability of banks to place risky bets with customer deposits, whether directly or indirectly. In particular, the Rule restricted the ability of banks to engage in proprietary trading and limited their ability to make investments in, and have certain relationships with, hedge and private equity funds.

The Rule did this by focusing first and foremost on prevention. It was designed to help prevent yet another bailout of the financial system by the Federal Reserve and the federal government. It also aimed to reduce conflicts of interest between banks and their customers and to promote competition.[16]

However, today's proposal to amend the Volcker Rule runs in the opposite direction. It appears that the proposed amendment is actually aimed at making it easier for banks to take on greater leverage and risk. And, if adopted, I believe that today's proposal would help undo the framework that has helped avoid another financial crisis. I recognize that some of the items being proposed today are changes at the margin,[17] and that there are several requests for comment related to issues that may not be at the heart of the Rule's purpose. But I believe that, overall, this proposal cleverly and carefully euthanizes the Volcker Rule.

While I have innumerable concerns about the proposal, I would like to discuss three major concerns here, with the hope that commenters will study these issues and write in with their thoughts and insights.

First, it appears that the proposed amendment is opening the door for banks to engage in risky trading strategies by expanding the hedging-related exemptions. Let's talk about hedging for a moment. At the end of the day, a hedge is not a hedge if it doesn't reduce risk. The Volcker Rule allows banks to engage in risk-mitigating hedging, but only if they can demonstrate, through documentation and ongoing correlation analysis, among other things, that the trade was actually a hedge. That should go without saying.

Part of the business model of today's banks is to come up with creative products and figure out a way to sell them to their customers. Banks do this a lot—it's how they make money. But if they are on the other end of the exposure to these products, they also tend to want to hedge that exposure. Among other things, today's proposal would allow banks to more easily classify any trade as a hedge, regardless of whether it effectively and demonstrably offsets risk. For example, the proposal allows banks to invest directly in hedge funds and private equity funds if they are purportedly doing so to hedge a customer's exposure.

In addition, larger banks no longer have to show that their hedging activity "demonstrably reduces or otherwise significantly mitigates" the risk.[18] This goes to the very meaning of hedging. Hedging is fundamentally an attempt to reduce risk.[19] If you aren't at least attempting to demonstrate reduced risk, are you hedging? Or are you proprietary trading?

What's more, under the proposal, some of the requirements related to documentation and ongoing correlation analysis would no longer be required for certain hedges. One might say, the more relaxed the hedging requirement the more incentive the bank has to engage in speculative trading while classifying the trading as "hedging". As the release acknowledges, this change could increase moral hazard and conflicts of interest to the extent that banking entities engage in more risky trading.[20]

Accordingly, today's proposal runs counter to the most basic objectives of the Volcker Rule by increasing proprietary trading, moral hazards, and conflicts of interest. When the health of our financial markets is at stake, shouldn't a bank be required to prove, with documentation and ongoing analyses, that its hedge demonstrably reduces or otherwise significantly mitigates the risk? In other words, why are we opening the door to more speculative trading by banks?

Second, I'm concerned about competition. It is important to remember that only certain financial institutions have access to money that is federally insured or have the ability to borrow from the Federal Reserve. Banks with this type of access to cheap money should be required to follow certain protocols for how they use that money. That is precisely what the Volcker Rule sought to do—to limit proprietary trading for banks with this type of access. If these banks can do more risky trading under the proposed rules, then it would seem to me that they would have an easier time competing against the financial entities that do not have the same level of access. How does this affect concentration in the marketplace? For example, are fewer and fewer market participants going to be able to provide counterparty services? I hope commenters weigh in on these points.

Third, and arguably most important, it appears to me that today's amendment proposes a "just trust me" paradigm. Under this paradigm, a bank can set various internal limits and, so long as they aren't exceeded, the bank will be "presumed" to be in compliance. There is also a presumption of compliance generally for banks with limited trading assets and liabilities. This novel approach of "presumed compliance" for banks with limited trading assets and liabilities significantly reduces accountability. It may also incentivize evasion. What if the federal government presumed that all taxpayers paid the right amount of taxes, or that all drivers with small cars obey the speed limits?

Differential regulation can be useful at times, but it must be done carefully. I don't think this is an effective way to do this. I would urge commenters to write in on this point.

Conclusion

Many will claim that this proposal does not do all that much—that it "tailors" and "streamlines." But when I look at this proposal, I think of the old adage "you give an inch and they'll take a mile." When it comes down to it, I believe that we should be preventing acceleration of risks, conflicts of interest, and concentration in our markets, not encouraging them. In short, I believe this proposal is antithetical to what the law was written to accomplish. And I am not alone. I started my remarks today with a quote, which I will repeat:

> [W]e recognize that the proposed amendment could increase moral hazard risks related to proprietary trading by allowing dealers to take positions that are economically equivalent to positions they could have taken in the absence of the 2013 final rule.[21]

This sentence was taken from the Commission's own economic analysis, and I agree.[22] As a result, I cannot support today's proposed amendment to dismember the Volcker Rule.

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[1] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, at 430 (June 5, 2018) ("Proposal").

[2] A 22% decline in today's Dow Jones Industrial Average would represent an approximate 4,800 point one-day drop.

[3] Portfolio insurance was invented by Hayne Leland, John O'Brien and Mark Rubinstein in the 1970s. Originally, portfolio insurance essentially meant hedging a portfolio by adjusting the ratio of stocks to money market instruments as stock prices rise and fall. Andrew Kupfer, Leland, O'Brien, and Rubenstien, *The Guys Who Gave Us Portfolio Insurance*, Fortune Magazine (Jan. 4, 1988), *available at* http://archive.fortune.com/magazines/fortune/fortune_archive/1988/01/04/70047/index.htm .*See also* Robin Wigglesworth, *Rise in New Form of 'Portfolio Insurance' Sparks Fears*, Financial Times (Mar. 21, 2017), *available at* https://www.ft.com/content/3eba3f56-08c6-11e7-97d1-5e720a26771b .

[4] This hedging strategy entailed automatically selling index futures when markets were falling. Mark Carlson, Office of the Fed. Res., Board of Governors, *A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response* (Nov. 2006), *available at* https://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf (hereinafter "1987 History").

[5] Matt Maley, The Real Reason for the 1987 Crash, as Told by a Salomon Brothers Veteran, CNBC (Nov. 3, 2017), *available at* https://www.cnbc.com/2017/10/16/cause-of-black-monday-in-1987-as-told-by-a-trader-who-lived-through-it.html .

[6] "The first contemporary global financial crisis unfolded in the autumn of 1987 on a day known infamously as 'Black Monday.' A chain reaction of market distress sent global stock exchanges plummeting in a matter of hours. In the United States, the Dow Jones Industrial Average (DJIA) dropped 22.6 percent in a single trading session, a loss that remains the largest one-day stock market decline in history. At the time, it also marked the sharpest market downturn in the United States since theGreat Depression." Donald Bernhardt & Marshall Eckblad, Fed. Res. Bank of Chicago, *Stock Market Crash of 1987,* Federal Reserve History (Nov. 22, 2013), *available at* https://www.federalreservehistory.org/essays/stock_market_crash_of_1987 .

"The Federal Reserve was active in providing highly visible liquidity support in an effort to bolster market functioning. In particular, the Federal Reserve eased short-term credit conditions by conducting more expansive open market operations at earlier-than-usual times, issuing public statements affirming its commitment to providing liquidity, and temporarily liberalizing the rules governing the lending of Treasury securities from its portfolio. The liquidity support was important by itself, but the public nature of the activities likely helped support market

confidence. The Federal Reserve also encouraged the commercial banking system to extend liquidity support to other financial market participants. The response of the Federal Reserve was well received and was seen as important in helping financial markets return to more normal functioning." *See* 1987 History, *supra* note 4.

[7] "[Long-Term Capital Management L.P.] is an institutional investment manager which acts as a general partner and investment adviser to Long Term Capital Partners, L.P., a Delaware limited partnership. Substantially all of this partnership's assets are invested through a master fund/feeder fund structure in Long Term Capital Portfolio, L.P. a Cayman Islands limited partnership. Other non-U.S. investment vehicles managed by LTCM also invest substantially all of their assets in Long-Term Capital Portfolio. (These entities are collectively referred to as 'LTCM.')" Testimony of Richard R. Lindsey, Director, Division of Market Regulation, Before the House Committee on Banking and Financial Services, Concerning Hedge Fund Activities in the U.S. Financial Markets (October 1, 1998), *available at* https://www.sec.gov/news/testimony/testarchive/1998/tsty1498.htm (hereinafter "Lindsey Testimony"). *See also* Kimberly Amadeo, Long Term Capital Management Hedge Fund Crisis: How a 1998 Bailout Led to the 2008 Financial Crisis, The Balance (Apr. 9, 2018), *available at* https://www.thebalance.com/long-term-capital-crisis-3306240 .

[8] *See* Lindsey Testimony, *supra* note 7.

[9] Board of Governors of the Fed. Res. Sys., *Credit and Liquidity Programs and the Balance Sheet* (last updated Feb. 23, 2017), *available at* https://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm.

[10] FHFA 2017 Rep. to Congress (2017), *available at* https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2017_Report-to-Congress.pdf.

[11] Neil Irwin & Zachary A. Goldfarb, *U.S. Seizes Control of Mortgage Giants*, Wash. Post (Sep. 8. 2008), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/09/07/AR2008090700259.html?noredirect=on .

[12] Department of the Treasury, *Citizens' Report*, Office of Financial Stability – Troubled Asset Relief Program, Fiscal Year 2017, *available at* https://www.treasury.gov/initiatives/financial-stability/reports/Documents/FY2017%20OFS%20Citizens%20Report.pdf.

[13] Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203).

[14] George Santayana, The Life of Reason: The Phases of Human Progress (pub. 1905-06).

[15] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, SEC Release No. BHCA-1 (April 1, 2014), *available at* https://www.sec.gov/rules/final/2013/bhca-1.pdf.

[16] Volcker Rule, 17 C.F.R. § 255 (2018).

[17] The argument put forth by the banks is that the current rule is simply too complicated and difficult for our modern banks to comply with. These are the same banks, by the way, that can create complicated financial instruments in short order at the demand of a client. Financial complexity has been steadily increasing and has been shown to increase when competition intensifies. Clare Célérier & Boris Vallée, *What Drives Financial Complexity? A Look into the Retail Market for Structured Products*, Working Paper, University of Zurich and HEC Paris (2013),*available at* http://www.hbs.edu/faculty/conferences/2013-household-behavior-risky-asset-mkts/Documents/What-Drives-Financial-Complexity_Celerier-Vallee.pdf .

[18] We also must remember that hedging can have significant collateral consequences and cause large gains or losses. For instance, the "London Whale" was a portfolio hedge that rapidly increased to over $157 billion in trades that eventually caused at least $6.2 billion of losses for the bank. The Volcker Rule prohibited such "portfolio hedges," however it appears that under the new amendments they would be allowed. Another example, of collateral consequences of a hedge is the swift and dramatic decline of inverse volatility products on February 5, 2018. Many believe that the steep decline was caused by hedging activity and that the hedger may have made a sizeable profit on the trade. See, e.g., Kid Dynamite's World, "$XIV Volpocalypse—A Sea of Disinformation and

Misunderstanding, Feb. 7, 2018, available at http://kiddynamitesworld.com/xiv-volpocalypse-sea-disinformation-ignorance/ .

[19] “A hedge is an investment to reduce the risk of adverse price movements in an asset.” *Hedge*, Investopedia, https://www.investopedia.com/terms/h/hedge.asp#ixzz5HV6QDH1O (last visited June 4, 2018).

[21] Proposal, at 430.

[22] The moral hazard arises because banks have access to low-interest financing and deposit insurance that may be viewed as a backstop, allowing them to engage in excessive risk taking. If the bet pays off, the bank pockets the money. And if the bet goes sour, the government, with taxpayer money, has bailed them out to help soften the blow.