United States Senate

WASHINGTON, DC 20510

August 3, 2010

Hon. Ben Bernanke, Chairman, and
Hon. Daniel Tarullo, Governor
Federal Reserve Board
20th Street and Constitution Avenue NW
Washington, DC 20551

Hon. Mary Shapiro, Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Hon. Gary Gensler, Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Hon. Sheila Bair, Chairman
Federal Deposit Insurance Commission
550 17th Street, NW
Washington, DC 20429

Hon. John Dugan, Comptroller, and
Mr. John Walsh, Acting Comptroller-designate
Office of the Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

RE: Implementation of Merkley-Levin Provisions

Dear Sir or Madam:

Two weeks ago, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The law is clear: the risky and abusive financial practices that drove our country into an economic ditch must end. Now, as you set out to implement this legislation, the American people are counting on you to fully and faithfully follow that directive. For reform to work, Wall Street cannot simply be allowed to return to business-as-usual.

As essential components of the Wall Street reform effort, the Merkley-Levin provisions on proprietary trading and conflicts of interest, sections 619-621 of the Dodd-Frank Act, are designed to achieve five main objectives:

1) Protect our economy from high-risk, conflict-ridden financial activities by barring depository banks and their affiliates from engaging in proprietary trading and making large investments in hedge funds and private equity funds.
2) Rein in dangerous risk-taking by subjecting critical nonbank financial institutions to strict capital charges and quantitative limits on any proprietary trading and investments in hedge funds and private equity funds.
3) Reestablish market discipline and integrity by restricting the ability of banks and critical nonbank financial institutions to bail out sponsored or advised hedge funds and private equity funds.
4) Rehabilitate the traditional business of banking by conducting a significant review of the long-term investment activities currently permitted to banks and their affiliates.
5) End the conflicts of interest that arise when a financial firm designs an asset-backed security, sells it to customers, and then bets on its failure.

If properly implemented, the impact of these provisions will be profound.

We do not expect Wall Street to give up its risky and conflict-ridden trading operations without a fight. But the Merkley-Levin provisions, which we drafted, are intended to give you strong tools to protect our nation's families and small businesses from the vagaries of the Wall Street casino.

We wish to help you use these tools to their fullest potential, and we write now with our recommendations for drafting the rules and regulations to fully and faithfully implement these provisions. Enclosed please find the detailed explanation that we provided during the debate on the Senate floor, which will hopefully be helpful to you as regulators tasked with the difficult but necessary job of making these provisions come to life.

Naturally, there are many complex areas that will need to be carefully analyzed, rules thoughtfully written, and enforcement rigorously conducted – including robust use of the strong anti-evasion authority. At this time, we would like to briefly address three issues that have already received attention: (1) what types of activities are "market-making-related", (2) what are allowable relationships with hedge funds and private equity funds, and (3) what do the conflicts of interest provisions of sections 619(d)(2) and 621 intend to address.

Market-Making-Related

We have recently seen press reports suggesting that firms are responding to some of these new restrictions by taking what amounts to two approaches: (1) burying their proprietary trading in their market-making accounts, and (2) reassigning their proprietary traders into asset management units managing client money.

The fact of these developments on their own suggests that the statutory provisions have the teeth that Congress intended. However, they also highlight the need for meaningful and faithful implementation. For example, banks seeking to bury their proprietary trading desks in their "market-making" operations are likely attempting to evade these restrictions, while banks who move traders to separate asset management businesses to manage clients' funds are likely taking laudable steps towards compliance.

Done properly, market-making is not a speculative enterprise, and firms' revenues should largely arise from bid-ask spreads and associated fees, rather than from changes in the prices of the financial instruments being traded. Regulations seeking to distinguish market-making from proprietary trading activities will require routine data from banks on the volume of trading being conducted, the size of the accumulated positions, the length of time positions remain open, average bid-ask spreads, and the volatility of profits and losses, among other information.

It is also important to note that the term "in facilitation of customer relations" was removed from the final version of the Merkley-Levin provisions out of the concern that the phrase was too subjective, ambiguous, and susceptible to abuse. This means banks will have to establish that their market-making-related purchases and sales are not designed merely to facilitate customer relationships, but are intended to meet the reasonably expected near term demands of clients for specific financial instruments.

Relationships with Hedge Funds and Private Equity Funds

Some of the most intense negotiation over the Merkley-Levin provisions concerned the extent to which banks that provide client asset management services would be permitted to invest in hedge and private equity funds. The final language includes strong protections to ensure that the limited exceptions intended to preserve asset management functions do not become backdoor proprietary trading operations. Preventing these exceptions from becoming such a loophole will require careful implementation and vigorous enforcement.

The Merkley-Levin provisions limit banks to a "de minimis" amount of money that can be invested in any given fund (at most, 3% in each fund) and in all funds in the aggregate (at most, 3% of Tier 1 capital). This de minimis allowance is permitted only to enable banks or their affiliates to provide asset management services to clients, and not to open the door to proprietary trading. However, these investments, and the banks' relationships with them, cannot be allowed to jeopardize the banks. Accordingly, regulations implementing these provisions should only allow for a bank investment as necessary to seed a fund or align the interests of the bank with the fund investors. Seeding funds should be limited to the minimum amount necessary to attract investors to the investment strategy of the fund and must not serve principally as a proprietary investment. Regulators should issue rules treating hedge and private equity funds with large initial investments from the sponsoring bank and funds that are not effectively marketed to investors as evasions of the Merkley-Levin restrictions. 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.

Further, the Merkley-Levin provisions prohibit banks from bailing out their sponsored or advised funds or investors in those funds, or from having relationships or engaging in transactions that make such bailouts more likely. For example, investments by officers and directors could create inappropriate incentives to bail out funds. Similarly, maintaining lending and derivatives relationships with sponsored funds would make such bailouts possible. Both are generally prohibited. Regulations implementing these restrictions should be strict, and the penalties for violations, severe.

Another critical factor to minimize bank risk from hedge funds and private equity funds is to require the bank to deduct investments in hedge funds and private equity funds on, at a minimum, a one-to-one basis from capital. As the leverage of a fund increases, the capital charges should be increased to reflect the greater risk of loss. Regulations implementing these capital charges should discourage these high-risk investments and limit them to the size necessary to facilitate management of clients' assets.

During the crisis, banks jeopardized their financial stability, and ultimately needed taxpayer bailouts, because they bailed out the funds they managed. Our banking system, and our taxpayers, must never again be left holding the bag when a bank's hedge funds or private equity funds collapse.

Conflicts of Interest

Section 619(d)(2) prohibits what might otherwise be permitted activities, if such activities would involve or result in material conflicts of interest with clients, customers, or counterparties. This conflicts of interest prohibition seeks to restore integrity and stability to the financial marketplace, making it safe for clients to place their investments with firms that are required to work on their behalf instead of betting against their interests. Unlike section 621, section 619(d)(2) is not limited to asset-back securities, but applies to all types of permitted trading activities.

Regulations implementing section 619(d)(2) should pay particular attention not only to the financial activities of a bank's own traders, but also to the hedge funds and private equity funds organized and offered under subparagraph (G) to ensure that that they are not taking unfair advantage of information on the trading flow of the banks' other clients. Hedging activities should also be particularly scrutinized to ensure that information about client trading is not improperly utilized.

Section 621 in the Merkley-Levin provisions also addresses conflicts of interest, but only in the context of asset-backed securities. This section prohibits firms from packaging and selling asset-backed securities to their clients and then engaging in transactions that create conflicts of interest between them and their clients. The Permanent Subcommittee on Investigations' hearing on Goldman Sachs highlighted a blatant example of this practice: the firm assembled asset-backed securities, sold those securities to clients, bet against them, and then profited from the failures. Regulations implementing section 621 should put an end to those conflict-ridden practices.

The conflict of interest prohibition in section 621 is not intended to prevent firms from supporting an asset-backed security in the after-market. But this activity must be designed to support the value of the security, not undermine it. Further, the utility of disclosures must be carefully examined, and not be seen as a cure for the conflicts. We provided the Securities and Exchange Commission with sufficient authority to define the contours of the rule in such a way as to remove conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets.

Implemented properly, the Merkley-Levin provisions on proprietary trading and conflicts of interest are critical elements in Congress's mandate to reestablish a financial system that provides capital to grow the economy while serving clients with integrity. We are ready to assist you during the rulemaking process in any way we can, and encourage you to consult us and our staffs with any questions about how the rules were designed to function.

Sincerely,

Jeffrey A. Merkley

Jeffrey Merkley

Carl Levin

Carl Levin

cc: Hon. Timothy Geithner, Secretary of the Treasury
Hon. Paul Volcker, Chairman, President's Economic Recovery Advisory Board