BDA Bond Dealers of America

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STATEMENT OF WILLIAM DALY
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SUBMITTED FOR THE RECORD TO
THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
AND
THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
HOUSE FINANCIAL SERVICES COMMITTEE

EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION

JANUARY 18, 2012
2128 RAYBURN HOUSE OFFICE BUILDING

Chairman Garrett, Chairman Capito, Ranking Member Waters, Ranking Member Maloney and members of the Subcommittees:

Thank you for the opportunity to submit for the record this statement from the Bond Dealers of America.

The Bond Dealers of America (”the BDA”) is the only trade association exclusively focused on U.S. fixed income markets and represents middle-market brokers and dealers who are headquartered in cities all over the country, doing business throughout the United States coast to coast. Our members are the “Main Street” firms, not the Wall Street firms. They help communities around the country finance their schools, roads and bridges. They help businesses raise the funds they need to grow. They provide individuals and institutions with fixed income investment opportunities in municipal, corporate and agency-backed securities. They also provide liquidity for the investors in those securities. Many of our members are affiliated with banks and will be subject to the restrictions on proprietary trading and investments under the Dodd-Frank Act even though they do not represent any systemic risk to the financial system and did not cause the financial crisis that led to the enactment of Dodd-Frank.

We have very serious concerns with the proposed Volcker Rule. As proposed, the rule will increase the costs to issuers of fixed-income securities, reduce investor liquidity, bifurcate the market in state and local bonds and increase the business challenges of middle market broker-dealers.

By way of background, the market in fixed-income securities is not like the equity markets or the market in Treasury obligations. Most bonds do not trade very frequently and they do not trade on exchanges. In the municipal market alone there are over 50,000 issuers most of which do not issue often and each of which is unique. In such a market, broker-dealers play an important role by being familiar with the issuers and their credit, by selling bonds from their inventories to investors and by purchasing bonds from investors to hold in their inventory for later resale – at a profit governed by the markup and markdown rules of the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB). An investor goes to his or her broker-dealer in search of a suitable investment. The broker searches what is available – including what is in the broker’s own inventory – and proposes an investment. Or, on the other side, an investor seeks to liquidate an investment and unless his or her broker can find an immediate buyer, the broker purchases the bonds. As you can tell from that description, that looks a lot like proprietary trading but it in fact is crucial to the operation of these markets. The proposed Volcker Rule would disrupt these markets.

The Volcker Rule is supposed to have several exceptions that we believe Congress intended to preserve the businesses and market functions of broker-dealers. Those include statutory exceptions for market making and for state and local obligations. The proposed rule, however, is too narrow, complex and ultimately unworkable for the exceptions to be meaningful.

The exemption for market makers is very complex. It is also particularly troubling when it comes to fixed-income securities. The proposed rule states that it is based on the definition of market making under the Securities Act because that definition is "generally well-understood by market participants."

The simple fact is that the SEC has never put forward a definition of market making for fixed-income securities. There is, therefore, no reference point for market participants, nothing for them to "generally well understand." The Bond Dealers of America has repeatedly urged the SEC to establish a definition of market making for fixed-income securities. To date, the SEC has not done so.

Moreover, the seven criteria in the proposed rule are very complicated and rely heavily on commentary in appendices. A firm simply will not know with certainty when it engages in a trade whether a regulator will, at some later point in time, judge whether or not the trade met the seven criteria and the commentary in the appendices. Consequently, firms will err on the side of caution and liquidity will be lost.

The proposed Volcker Rule would also exempt only part of the market in state and local bonds. Under the proposal, only bonds that were issued by units of general government – such as a state, a county or a city – would be exempt from the Volcker Rule. Bonds issued by agencies or authorities – such as turnpike authorities, water and sewer districts, school districts, levee districts, housing authorities – would not be exempt. These latter bonds would face a much diminished market as bank-affiliated broker dealers would not be able to purchase or sell them from their inventory. The result would be that the issuers of these bonds would face higher costs because there would be fewer investors and those investors would demand higher returns to compensate them for the lower liquidity. The investors would have lower liquidity because this rule, combined with the unworkable market maker provision, means that bank-affiliated broker dealers would not be able to buy the bonds into their inventory.

We believe that the proposed rule should be amended to allow all state and local government bonds, including those of agencies and instrumentalities to be exempt from the Volcker Rule. The provision in the proposed rule derives from a comparison of language in the Bank Holding Company Act with that of the Securities Exchange Act, which is broader. This technical reading should give way to the intent of Dodd-Frank and the agencies should use the authority granted to them by Dodd-Frank to expand the definition.

The proposed rule would also capture a common municipal financing vehicle called the Tender Option Bonds (TOB) because the trust arrangement integral to the TOB would be included in the definition of a "covered fund" just as a hedge fund. TOBs are common financing vehicles that allow state and local governments to issue debt at a reasonable interest rate. The bond is deposited in a trust and serves to provide the underlying credit for variable rate bonds which are sold to investors. Investors can, at specified intervals, put or tender the bonds. Because these trusts that hold the underlying bonds would be considered covered funds under the proposed rule, banks could no longer set up these trusts and would have to divest themselves of their existing interests. Because the underlying asset in the trust is a state or local bond, we believe that the TOB arrangement should be exempted from the definition of covered fund. TOB

arrangements are transparent, the trusts generally have bonds of a single issuer and there is no "tranching."

The result of these provisions in the proposed rule will be that investors will have less liquidity, issuers will have higher costs and the current network of middle market broker-dealers who have served those investors and issuers will face greater stress.

Finally, we note that the purpose of the Volcker Rule was to prevent banks from using Federally-insured deposits to engage in proprietary trading. However, the SEC has capitalization rules that apply to broker-dealers. Further, as mentioned above, the SEC, FINRA and the MSRB regulate how much can be earned on a trade. Consequently, in the case of broker-dealers, the risks that the Volcker Rule was meant to address are very small. On the other side, that small benefit is coupled with large costs, not only administrative costs to broker-dealers, but also harm to investors and issuers. A fair cost-benefit analysis of the proposed rule, especially as applied to fixed-income broker-dealers, would show that this proposed regulation is simply not worth the cost.