BDA Bond Dealers of America

21 Dupont Circle, NW • Suite 750
Washington, DC 20036
202.204.7900
www.bdamerica.org

September 7, 2012

The Honorable Spencer Bachus
Chairman, House Financial Services Committee
2129 RHOB
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Bachus,

Thank you for the opportunity to provide input regarding the potential impact of the proposed Volcker Rule ("Rule"). I am writing on behalf of the Bond Dealers of America ("BDA"), the only organization representing the unique interests of middle-market, fixed income dealers nationwide. BDA members are concerned that unless the final Volcker rule draws a bright line that (1) exempts municipal revenue bonds in addition to governmental bonds and (2) permits bank-affiliated broker-dealers to continue their essential role facilitating trading for their customers, fixed-income securities will decline in value and become less liquid. This will increase costs to issuers financing critical public infrastructure and harm retail investors seeking low-risk investments.

Municipal Securities Should Be Appropriately Defined and Exempted

The Volcker Rule, as currently proposed, recognizes that municipal securities are not the root cause of systemic risk and aims to exempt them from the prohibition on proprietary trading. The proposal, however, fails to exempt all state and local government securities – namely, those issued by agencies and authorities such as turnpike authorities and water and sewer districts. These issuances of municipal revenue bonds represent about 60% of the municipal securities market. They are indistinguishable from the 40% of municipal securities exempted from the proposed rule in that they do not present any more credit or systemic risk. The arbitrary distinction subjecting 60% of municipal securities to the Rule would interfere with the ability of broker-dealers to bridge gaps between buyers and sellers, immediately removing liquidity from the market needed to keep issuance costs low and valuations stable. As the Securities and Exchange Commission ("SEC") and other agencies finalize the Volcker Rule, BDA urges them to exempt all state and local government securities from the proprietary trading prohibitions.

The Market-Maker Exemptions Must Recognize the Unique Nature of Fixed Income Principal Trading

The Volcker proposal exempts market making activities, but only if the "trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell…the covered financial position for its own account on a regular or continuous basis" (emphasis added). This exemption is too narrow. A broker-dealer must be permitted under the Rule to purchase a position for his own account until the broker is able to sell that position so that issuers have the assurance of a ready market for their bonds. A broker-dealer cannot hold himself out as continuously or regularly supporting specific positions; rather, the broker-dealer acts as a steady presence in the fixed-income market to facilitate the customer trading by bridging buyers and sellers of bonds. Moreover, dealers support the market by purchasing from other dealers, cooperating with each other to provide liquidity to the market as a whole. If the market-maker exemption is too narrow and these activities are treated as proprietary trading, then an essential source of liquidity will be eliminated from the fixed-income market, harming both issuers and investors.

The cure is to broaden the market-maker exemption to recognize the critical practice of "principal trading," in which broker-dealers serve the role of facilitating trades for their customers. Because fixed income securities trade less frequently than equity securities, there may not be a buyer for a particular fixed income security at the precise point in time when a seller wants to sell it. Further, buyers tend not to target one specific security but will instead opt to purchase from a selection of bonds with characteristics meeting their investment objectives. Therefore, the only way the fixed income securities market works properly to match buyers and sellers is if broker-dealers are willing to purchase a bond into inventory with a view to re-sell that bond later to another customer.

In essence, principal trading is substantially different from the risk taking of proprietary trading. Since the purpose of principal trading is to facilitate customer trades, banks are incentivized to limit the risks of principal trading and therefore, institute policies and procedures that mitigate potential risks. At the same time, principal trading adds enormous value to ordinary investors by providing them a place to sell their bonds. This provides the liquidity and stability that makes the market function.

The Underwriting Activities Exception Should Be Clarified

While underwriting activities are exempt from the Volcker Rule, more clarity is needed around the proposed exception. Regional bond dealers can serve as underwriters for municipal issuers in which the dealer purchases the bond from the issuer in order to distribute and sell the bonds to investors. In the fixed-income market, underwriters frequently underwrite bonds knowing that at the sale of the bonds, they may need to temporarily retain unsold allotments within their inventories -- particularly since liquidity in the fixed income market is not as deep as other markets. The rule should clarify that just because bonds temporarily remain within a bank-affiliated broker-dealer's inventory, this does not change the regulator's perception that the purchase or sale was performed in connection with a view to distribute the securities.

<u>Tender Option Bond Trusts Should be Excluded from the Definition of a Covered Fund</u>

As now drafted, the proposed Volcker Rule would treat tender option bond trusts ("TOB Trusts") as "covered funds," the same as hedge funds and private equity funds, thereby prohibiting banks from using them as investments. TOB Trusts, however, should be excluded from the definition of a covered fund because they usually hold municipal securities. They operate as a more efficient way for state and local governments to access the capital markets and for banks to participate in the issuance and financing of tax-exempt bonds. Banks frequently sponsor TOB Trusts, may own residual and other ownership rights in TOB Trusts and may provide credit and liquidity enhancements that support securities issued by TOB Trusts. If banks were required to divest their holdings in TOB Trusts, this could lead to a massive sell-off of municipal securities holdings that could destabilize the municipal securities markets.

The remedy is for the covered fund rules to borrow some of the principles of the proprietary trading rules of the proposed Volcker Rule. That is, if an asset is considered safe enough for a bank to purchase that asset directly under the proprietary trading rules, such as is the case with municipal securities, then there is no reason to prohibit a bank from creating a fund or trust to hold that asset indirectly.

Thank you for the opportunity to present our views on the proposed Volcker Rule. Middle-market, fixed-income dealers across the country want to ensure that liquidity and ultimately, stability is preserved in municipal bond markets under the final Rule so that issuers and retail investors are protected. Towards that end, we believe it is urgent for the SEC and Congress to consider these items. Feel free to contact me or my staff, Susan Collet, with any questions or if you would like a briefing.

Sincerely,

M Nicholas

Michael Nicholas
Chief Executive Officer