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Submitted for the Record Before the
Committee on Financial Services
United States House of Representatives

Hearing Entitled, “Examining the Impact of the
Volcker Rule on Markets, Business, Investors and
Job Creation, Part II”

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On behalf of the Bond Dealers of America (“BDA”), thank you for the opportunity to submit testimony for this hearing to examine the impact of the Volcker Rule on market participants. BDA represents middle market and regional banks and securities dealers focused on the US fixed income markets.

The BDA would like to underscore that the Volcker Rule implementation, if not carefully crafted, could harm liquidity in the fixed income markets. This testimony sets forth recommended solutions to avoid this outcome. Any final Volcker rule must permit bank-affiliated broker-dealers to continue their essential role of facilitating fixed income trading for their customers. If the Volcker Rule does not appropriately consider the uniqueness of fixed income markets and principal trading, costs to issuers financing critical public infrastructure will increase; and retail investors seeking low-risk investments will be harmed. Equally urgent and more fundamentally, the rule must exempt municipal revenue bonds in addition to governmental bonds. Finally, the Rule should clarify the underwriting activities exception and Tender Option Bond Trusts should be excluded from the definition of a covered fund.

The Volcker Rule Should Include An Exception for 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 and precludes the ability of bank-affiliated broker-dealers in the fixed income markets to facilitate trading among its customers. In order to support customer trading, a bank-affiliated broker-dealer must be permitted under the Rule to purchase a position for his or her 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 bank-affiliated broker-dealer cannot meet the test in the current proposal that requires it to hold itself out as continuously or regularly supporting specific positions; rather, the broker-dealer acts as a steady presence in the fixed-income markets to facilitate the customer trading by bridging buyers and sellers of bonds. Moreover, dealers support the markets by purchasing from other dealers, cooperating with each other to provide liquidity to the markets 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 markets, harming both issuers and investors.

The cure is to broaden the market-maker exemption to recognize the critical practice of “principal trading,” in which bank-affiliated 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 markets work 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.

Such 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, to 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 markets function.

BDA's recommendation is that the final Volcker Rule include in the market making exemption an additional exception that includes the purchases and sales of a "principal trading desk." A "principal trading desk" should be defined as having the purpose of facilitating trading among the bank's customers and clients. A safe harbor should be included in the definition based upon the presence of sales representatives in the desk's transactions. Essentially, BDA proposes that the Rule use the percentage of transactions a trading desk effects through sales representatives to determine when a trading desk clearly is -- and clearly is not -- a principal trading desk.

This approach would provide a method to prove that a bank's trading desk exists for the purpose of facilitating trading among customers that provides certainty to banks and regulators alike. Sales representatives trade with the customers and clients of the bank. Their presence largely implies the substantial involvement of the trading desk with customers. Sales representatives eliminate the incentive for banks to maintain "proprietary books" because trades involving sales representatives require the trading desk to pay a commission. Further, the involvement of sales representatives is easily provable since the trade tickets need to record the involvement of the sales representative in order to properly credit the sales representative for sales commissions.

Based on this certainty, BDA believes that the Agencies could create a safe harbor under which a trading desk would be deemed to be a principal trading desk if it effects more than 50% of its transactions through sales representatives. Conversely, the Agencies could deem a trading desk to "not be" a principal trading desk if it effects less than 25% of its transactions through sales representatives. While a principal trading operation with no "proprietary book" should ordinarily not experience trading activity with other broker-dealers that exceeds a majority of its trading activity, practices do vary. BDA recommends retaining the ability of a bank to establish that its principal trading desk is customer facing even if less than 50% (but more than 25%) of trades are through sales representatives, if other evidence can be produced to prove the customer-facing nature of the principal trading operations.

Providing more certainty to regulators, a trading desk (except for hedging transactions) could be required to make any covered financial position available for purchase to sales representatives through an electronic trading system if it is available to registered broker-dealers for purchase through an electronic trading system. The essence of a “proprietary book” is that its sales and trading inventory are not available for purchase by sales representatives. By making these covered financial positions available to both registered broker-dealers and sales representatives alike, it renders difficult any effort to maintain a “proprietary book” that effectively navigates the quantitative categories above.

These suggestions, if incorporated, would provide regulators and fixed-income dealers more of the certainty they need so that issuers and investors are not damaged by the issuance of a Volcker Rule that destroys the important role of principal trading within the fixed-income markets.

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 that is necessary to keep issuance costs low and valuations stable. As the Securities and Exchange Commission (“SEC”) and other agencies finalize the Volcker Rule, BDA urges the Agencies to exempt all state and local government securities from the proprietary trading prohibitions.

The Underwriting Activities Exception Should Be Clarified

While underwriting activities are exempt from the Volcker Rule, more clarity is needed around this 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 markets, 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 markets 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.

Tender Option Bond Trusts Should Be Excluded from the Definition of a Covered Fund

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. The Volcker Rule as proposed must be modified to better accommodate the nature of fixed income markets. Developing a definition of and exception around principal trading is a critical component of these modifications. BDA stands ready to assist the Committee as you continue your important review of the Rule.