June 19, 2012

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Prohibition on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds; File Number S7-41-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the time that members of the Commission's staff have spent meeting with us to discuss the Commission's Proposed Rule on the prohibition on proprietary trading and certain relationships with hedge funds and private equity funds. This letter is a follow-up to our meeting and to our comment letters submitted on February 13, 2012 and April 16, 2012.[2] We respond here to points discussed in the meeting on which additional comment was requested.

Entry of market makers

Among other things, the law prohibiting proprietary trading is intended to reduce the scope of high risk trading activity by broker dealers located inside large U.S. bank holding companies ("LBHCs"). If the prohibition required by the law reduces the supply of valuable market making services, then it will simultaneously create an unfilled demand for those services. This profit opportunity will attract entry and innovation by others, as has frequently happened in the financial markets over time.

For example, developments in the secondary market for corporate bonds illustrate the ability of competitive entry and innovation to supply unmet demand for trading services. As explained in our earlier comment letter, the 2002 introduction of the TRACE bond price reporting system prompted LBHC dealers and others to reduce inventories of corporate bonds.[3] Bond trading volumes have increased significantly over 2002 levels and the

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

[2] *See* Comment Letter from Better Markets, Inc. to the Commission, "Prohibition on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds"; File Number S7-41-11 (February 13, 2012), *available at* http://www.sec.gov/comments/s7-41-11/s74111-341.pdf, and Comment Letter from Better Markets to the CFTC, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds" (RIN 3038-AD05)(April 16, 2012), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=kelleher.

[3] *Id.*

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secondary market has remained liquid. However, since the financial crisis began in 2007, dealers have further reduced their inventories relative to the size of the secondary market. This has left some large asset managers, accustomed to executing large trades over the counter with a preferred counterparty, reportedly unsatisfied.

However, this unmet demand is prompting new entry, innovation and market adaptation. For example, both BlackRock and Goldman Sachs are planning new electronic bond trading networks, according to a recent Wall Street Journal report. The report notes that "[s]ome traders hope the outlines of a new electronic-trading network will begin to take shape within a year and over time could evolve into an open and active marketplace resembling the stock market. That would be a first for the corporate bond market."[4]

There are other recent examples, not directly related to market making, that illustrate how profit opportunities prompt rapid entry and adaptation in financial markets. When regulation NMS reduced regulatory barriers to entry for electronic market centers, there was rapid entry of new trading platforms and an increase in competition. As a recent academic study notes:

> Regulation NMS freed electronic trading platforms to compete with the NYSE. Subsequently, new entrants gained significant market share. The NYSE market share of volume in its listed stocks fell from 80% at the beginning of 2003 to 25% by the end of 2009. NASDAQ matched share volume also increased, but later fell as volume traded through new entrants such as BATS and DirectEdge increased.[5]

Entry of new trading firms has been facilitated by technological and conceptual developments that have fostered the creation of high frequency trading ("HFT"). One of the distinguishing features of HFT is that is can be executed with relatively small amounts of capital. Positions are held for very short time periods, and the books of HFT firms are typically flat at the end of the day.[6] Because this overcomes the cost advantage of the established dealers, including those located in the LBHCs, numerous HFT firms have entered an activity in which bank dealers once played a more prominent role.[7]

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4 "Large Institutions Discuss New Marketplace for Bonds", Wall Street Journal online, June 13, 2012, *available at* http://online.wsj.com/article/SB10001424052702303410404577464580218513456.html?mod=WSJ_hp_LEFTWhatsNewsCollection#printMode.

5 J. Angel et al. (2010). Equity Trading in the 21st Century, USC Marshall Research Paper FBE 09-10, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584026.

6 Technical Committee of the International Organization of Securities Commissions (2011). Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency, Consultation Report CR0211, July, 21, *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf.

7 This example is an illustration of market entry when a profit opportunity presents itself. We do not here make a judgment regarding whether this particular entry, HFT, was good or bad for the markets, in whole or in part. See, e.g., S. Arnuk, and J. Saluzzi (2012). Broken Markets, Pearson Education LTD: FT Press. *See also*, Comment Letters of Better Markets: "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest" (November 15, 2010), 9,18, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26475&SearchText=, "Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 3, 2011), 2, 4, 7, 9-14, *available at*

Another classic example of competitive entry in response to newly created profit opportunities is the events following the passage of the Glass-Steagall Banking Act, passed in 1933 during the Great Depression. The Banking Act required commercial banks to exit from investment banking (including underwriting and trading) one year after enactment. Commercial banks divested their investment banking operations, thereby creating profit opportunities for new entrants. New investment banks were quickly formed, often employing the experienced personnel formerly located in the commercial banks.

As Vincent Carosso notes in his historical study of investment banking:

> A major reorganization of the investment banking industry immediately resulted from the Banking Act. Affiliations were eliminated; the bond departments of commercial banks were cut in size and their activities greatly reduced; and private bankers were forced to choose between deposit and investment banking....
>
> Implementation of the Banking Act also led to the organization of new investment firms. Most of these were officered and staffed by the individuals formerly associated either with security affiliates or with private banks that had decided to give up the security business. The First Boston Corporation, one of the largest and leading underwriting and bond-trading houses since its establishment, is a case in point. Organized on June 16, 1934, as a publicly owned corporation, it was a rare phenomenon among investment banking firms. The First Boston grew out of the securities affiliate of the First National Bank of Boston, with some key personnel also coming from the old Harris, Forbes organization....
>
> In September 1934 three Morgan partners and two from Drexel resigned and organized Morgan Stanley & Co., Inc., an investment banking corporation. **They moved just at the time the securities business was starting to revive**...

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http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26928&SearchText=, "Reporting, Recordkeeping and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants" (February 7, 2011), 1-2, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27630&SearchText=, "Core Principles and other Requirements for Designated Contract Markets" (February 22, 2011), 3-10, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=, "Core Principles and Other Requirement for Swap Execution Facilities" (March 8, 2011), 12-18, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31238&SearchText= , "Antidisruptive Practices" (May 17, 2011), 2-3, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42710&SearchText= , "Reopening and Extension of Comment periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act" (June 3, 2011), 7-8, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44711&SearchText=, "Clearing Member Risk Management" (September 30, 2011), 5, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48477&SearchText=.

> Numerous other similar changes occurred in 1934 and 1935, as former officials and associates of security affiliates and partners in private banking houses organized new firms or joined existing ones....[8]

Despite these rapid changes required by the change in regulation, which allowed just one year for total divestiture, the newly configured investment banking industry was able to handle a large increase in underwriting volume that occurred in 1935.[9]

Precisely these types of entry and market adaptions have been happening routinely since the passage of the financial reform law. For example, the Financial Times reported recently that "the former head of proprietary trading at Citigroup," who is also the "former head of proprietary trading at Morgan Stanley," is launching "one of the largest hedge fund start-ups of 2012."[10] This is similar to what has already happened when proprietary traders left JP Morgan Chase and Goldman Sachs, which "has spawned the largest number of hedge fund start-ups in recent years."[11]

Given these examples, there is little reason to believe that there will be a shortage of market making services, even if the Volcker Rule caused the LBHC dealers to cease providing them completely. That outcome, however, is unlikely given that the law specifically permits genuine "market making ... designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."

Thus, the market can be expected to adapt and that LBHCs will provide many of the same services they do now, but in compliance with the law, and new market entrants will provide the services that the LBHCs choose not to provide.

Using tests for randomness as a metric to test for permitted activity of risk-mitigating hedging

As discussed in our recent meeting on the proposed Volcker Rule, we believe that it would be useful to include tests for randomness of the returns on claimed hedged positions as a metric for determining whether the positions are in fact hedged. As the statute clearly states, the Permitted Activity is solely for "Risk-mitigating hedging activities," and, therefore, compliance requires ensuring that the trading activity is not disguised proprietary trading.

Bone fide risk-mitigating hedging is a strategy to insure against an adverse change in value of a position. It is accomplished by holding a second position, the value of which is negatively correlated with the price of the first. If the two values are perfectly correlated, and the value of the hedge is appropriately chosen, then changes in the value of one position will be offset by an opposite change in the value of the other. The rate of return on the initial position and its hedge taken together will be zero.

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8 V. Carosso (1970). Investment Banking in America: A History. Cambridge: Harvard University Press, 372-374. (emphasis added)

9 R. Chernow (1990). The House of Morgan. New York: Atlantic Monthly Press, 390.

10 "Sharma to launch $500m London Hedge Fund," *available at* http://www.ft.com/intl/cms/s/0/94e28e48-b870-11e1-82c8-00144feabdc0.html#axzz1y6Ui5ash .

11 *Id.*

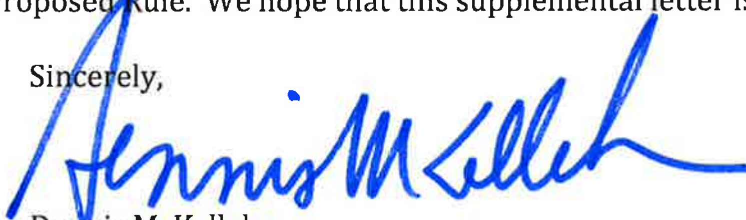
In practice, it may be at times difficult to hedge some positions perfectly. As a consequence, the combined rate of return on the position and its hedge may at times be non-zero: sometimes positive and sometimes negative. If, however, the deviations from zero are actually the result of an economic environment that is unpredictable, then the deviations themselves should also be unpredictable. That is, returns on hedged positions should vary randomly around zero.

To ensure that this is the case -- and that the permitted activity of risk-mitigating hedging is not used to disguise illegal proprietary trading -- one or more of the well-known statistical tests for randomness should be applied to the observed returns on claimed hedged positions. A number of operational versions of many such tests are described in a recent publication of the National Institute of Standards and Technology.[12]

CONCLUSION

We again thank the Commission's staff for their time and attention to our comments on the Proposed Rule. We hope that this supplemental letter is helpful.

Sincerely,



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[12] National Institute of Standards and Technology (2010). A Statistical Test Suite for Random Number Generators and Pseudorandom Number Generators for Cryptographic Applications, April, *available at* http://csrc.nist.gov/groups/ST/toolkit/rng/documentation_software.html.