Occupy the SEC

http://www.occupythesec.org

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Secretary of the Commission
Commodity Futures Trading Commission
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Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC
20549-1090

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (RIN 1557-AD79; RIN 7100 AE-11; RIN 3064-AE11; RIN 3235-AL52; RIN 3038-AD05)

Dear Sirs and Mesdames:

Occupy the SEC[1] submits this comment letter in response to the above-mentioned regulatory agencies' ("Agencies") Interim Final Rule modifying regulations implementing Section 619 of the Dodd-Frank Act ("Volcker Rule").

[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.

The recently-implemented Volcker Rule regulations generally prohibit a covered banking entity from sponsoring or having an ownership interest in a covered fund, subject to certain exceptions. The Interim Final Rule ("IFR") creates a novel exemption for ownership interests in issuers of collateralized debt obligations ("CDOs") backed up trust-preferred securities ("TruPS"), even though the legislative template for the Volcker regulations, Section 619, contains no mention whatsoever of any such exemption.

For the reasons stated below, OSEC believes that the TruPS exemption is flawed, and should be eliminated.

The Interim Final Rule Ignores the Grave Risks Attendant to TruPS and TruPS CDOS

Under the IFR, the Volcker Rule will no longer restrict a bank holding company from owning collateralized debt obligations backed by trust-preferred securities ("TruPS CDOs") fitting certain conditions. If left unchanged, this amendment to the Volcker Rule would serve as a conduit for the systemic proliferation of toxic credit risks throughout the economy.

TruPS CDOs are securitized debts that use trust preferred securities as collateral. Trust preferred securities are hybrid instruments that have been issued primarily by small, unrated banks that themselves have vast exposures to localized commercial real estate loans. Thus, purchasers of TruPS CDOs in effect take on risk associated with real estate loans having uncertain credit-worthiness and hailing from all parts of the country. Purchasers of TruPS CDOs typically have very little transparency into the actual risk profile of these instruments (which relate to local real estate loans).

Most TruPS were issued by community banks between 2003 to 2007, which was the peak period for the origination of risky real estate loans offered under poor underwriting standards. Thus, the creditworthiness of TruPS (and consequently TruPS CDOs) is inextricably tied to the performance of these banks' pre-crisis commercial loan books. Many of the dangers associated with these pre-crisis loans have yet to reveal themselves, and so TruPS present a veritable ticking timebomb of risk.

Whereas a single TruP security implicates the credit risk associated with one issuing bank, TruPS CDOs pool and concentrate the risk associated with many issuing banks. To make matters worse, community banks have also been the primary purchasers of TruPS CDOs (in addition to being TruPS issuers). The high level of interconnectedness between TruPS CDO issuers and purchasers exacerbates the already-troubling risk of contagion that these products present. As a result, a single default by a TruPS-issuing community bank has the potential to enmesh a wide swathe of firms in the banking industry.

It comes as no surprise, then, that researchers at the Federal Reserve Bank of Philadelphia have singled out TruPS CDOs as particularly risky products that, across the board, "are likely to perform poorly."[2] These experts "estimate that large numbers of the subordinated bonds and

[2] Larry Cordell, Michael Hopkins & Yilin Huang, *The Trust Preferred CDO Market: From Start to (Expected) Finish*, Working Paper No. 11-22 (Federal Reserve Bank of Philadelphia), June 2011.

some senior bonds will be either fully or partially written down, **even if no further defaults occur going forward**."[3]

By inscribing an exemption for TruPS CDOs into the Volcker Rule, the IFR undermines the central purpose of the Volcker Rule by permitting risk associated with subordinated real estate loans to spread like wildfire through the banking sector. Under this amendment, *all* bank holding companies, and not just community banks, would be permitted to speculate in the commercial real estate market using money loaned to them by depositors and the Federal Reserve. This outcome flies in the face of the basic premise of the Volcker Rule.

Further, the Interim Final Rule, as drafted, would facilitate broader evasion of the Volcker Rule's restriction on proprietary trading by bank holding companies. The amendment permits the purchase of a CDO interest provided that the "banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in Qualifying TruPS Collateral." (emphases added) Thus, a banking entity could speculate on *virtually any asset type*, *no matter how risky*, so long as that asset is placed in a CDO vehicle comprised at least 50.1% of qualifying TruPS. The dangers attendant to this outcome should be clear to the Agencies. Moreover, as the Agencies well know, establishing the bona fide intent or "reasonable belief" of a multi-billion dollar banking corporation is likely to be exceedingly difficult to prove. By defining this exemption using a subjective reasonableness standard, the Agencies have paved the way for weak enforcement of the restriction.

The Agencies Must Eschew Crafting Volcker Exemptions Based on Hackneyed Claims of Lost Liquidity in Asset Classes

The IFR sets a dangerous precedent for the crafting of additional "bespoke" exemptions from the Volcker Rule regulations. TruPS are but one of hundreds of asset classes that could fall under the purview of the Volcker Rule. The Agencies should be aware that granting a specific exemption here will only lead to increased clamor for exemptions for other assets classes. We are already witnessing such a clamor arising in the wake of the IFR, which constitutes an appallingly brazen concession to the financial lobby.

For instance, the financial lobbying organization SIFMA has been recently exhorting regulators to broaden the exemptions in the Volcker regulations to include assets like senior debt issued by CLOs.[4] More alarming than requests by SIFMA are requests by individuals members of Congress for the Agencies to dilute the Volcker Rule by granting additional exemptions for, *inter alia*, CLOs. For instance, during a recent hearing held by the House Financial Services Committee, several members expressed opposition to the Volcker Rule, even though many of them had not been in office when Section 619 was passed. We urge the regulators not to confuse the inklings and desires of particular congressional members with the overall intent of Congress as it was constituted when Dodd-Frank was passed in 2010.

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[3] *Id*. (emphasis added).

[4] *See, e.g.*, Cheyenne Hopkins &Jesse Hamilton, *Banks Push for More Changes to Volcker Rule Following CDO Fix,* BUSINESSWEEK, Jan. 16, 2014, *at http://www.businessweek.com/news/2014-01-15/banks-push-for-further-changes-to-volcker-rule-following-cdo-fix.*

Each additional exemption that the industry can gain would further erode the basic protections of the Volcker Rule, which are absolutely essential to re-orient banks back towards conservative, customer-focused transactions. A skeptical observer can only surmise what asset class will be the next to be exempted from the Volcker Rule by dint of Agency fiat (aka "interim final rule").

The Agencies will continue to be bombarded with arguments that the Volcker Rule will desiccate liquidity in various asset classes. On a larger scale, such arguments are nothing new, and have been thoroughly rebutted in OSEC's February 2012 comment letter to the Agencies. Still, it bears reiterating that **the Volcker Rule was passed to protect banks, and not to safeguard liquidity in esoteric niche markets**. Even if major banks undergo significant costs in changing their business models to offload certain prohibited asset classes, those costs are required by Section 619 and are justified by the benefits to be enjoyed by the overall economy. Those benefits include, for instance, more prudent risk management that will make the job-creating functions of banks more viable.

Banks have had ample opportunity to offload offending assets from their proprietary trading books. The Volcker Rule was passed as statute almost 4 years ago, and implementing regulations will not be in effect for at least another year. Thus, industry claims of unexpected "fire sales" of assets must be taken with a grain of salt. Indeed, even if the application of the Volcker Rule forced banks to take write-downs on certain assets then that would be the appropriate result of a fully effective rule. Such write-downs would better reflect true market conditions and would offer bank examiners greater transparency into bank health. Moreover, it is disingenuous for industry participants to proclaim that the Volcker Rule is creating new losses by operation of mark-to-market accounting requirements. The fact is that any such "realized" losses are in fact losses that the banks always knew they had on their books — such losses were simply camouflaged for the purpose of artificially upholding valuations. These duplicitous accounting practices only contribute to the proliferation of liquidity-based crisis. The markets and the public can only benefit from the increased transparency produced by the Volcker Rule.

Importantly, one must remain ever-cognizant of the fact that the Volcker Rule only applies to banking entities, and that pure investment banks, broker dealers and hedge funds are free to step into any market vacuums created by the departure of government-supported banks. Even before the issuance of the IFR, these other financial actors were free to buttress the TruPS CDO market, and would have done so if that market were indeed worthy of support. That fact severely calls into question the Agencies' decision to grant the novel exemption contained in the IFR.

Section 171 of the Dodd Frank Act Provides No Justification for the IFR's Exemption

The IFR bases the exemption for TruPS CDOs on the language of Section 171 of the Dodd Frank Act. However, Section 171 lends no support for such an exemption. The grandfathering of TruPS under Section 171 was only intended to preserve the usage of TruPS by small banks for capital adequacy purposes.[5] The Agencies take an untenable leap of faith to suggest that the Congressional intent behind Section 171 was to preserve liquidity in the TruPS CDO market. Congress intended no such thing. Simply put, Section 171 grandfathers TruPS. It does not grandfather TruPS CDOs.

[5] *See* 12 U.S.C. § 5371(b)(4)(C) (2014).

Indeed, Congress was well aware of the pernicious role that CDOs played in the run-up to the Great Recession of 2008. Only a highly strained interpretation of Section 171 would lead to the conclusion that Congress intended to preserve the ability of *any bank of any size* to purchase interests in TruPS CDOs despite the plain prohibition of Section 619 (the Volcker Rule). In fact, if Congress intended to grandfather TruPS CDOs, it could have crafted an express exemption among the numerous loopholes contained in Section 619. The fact that it declined to do so speaks volumes about Congress's real intent.

Moreover, the Agencies have heedlessly accepted the contention that preserving the TruPS CDO market is the only possible means by which the TruPS market can be preserved. TruPS can still be purchased by market participants without the risk agglomeration that occurs with collateralization.

The purpose of the Section 171 of Dodd Frank was to protect community banks' usage of a small segment of TruPS. It was not meant to allow *all* banks to take on risks associated with TruPS, which is exactly what the IFR allows. In fact, the IFR's TruPS exemption flies in the face of the basic premise of the Volcker Rule, which is to forbid government-backstopped banks from speculating in esoteric financial instruments.

Repealing the IFR's TruPS CDO Exemption Would Promote Economic Growth

The grandfathering provisions of Section 171 are limited only to the usage of certain TruPS for capital adequacy purposes. Those provisions do not change the economic reality that the Agencies must consider: that TruPS CDOs are fundamentally risky instruments.

As noted above, TruPS CDOs have introduced high levels of inter-connected risk into the community banking sector. Community banks are often the lifeline for small business growth on Main Street USA, and so the solvency of such banks is a matter of grave concern for the overall economy.

The Agencies should repeal the IFR's exemption for TruPS CDOs, as doing so would influence local and community banks to cease relying on TruPS instruments for fundraising purposes. Such banks would instead pursue fundraising through safer and sounder alternatives. In turn, increased bank solvency would promote stable job growth in local communities.

Conclusion

Both Section 619 of the Dodd-Frank Act and its implementing regulations have already been passed. The Agencies are wasting valuable time and resources in considering amendments that would dilute the Volcker Rule's effect. We urge the Agencies to move on to other pressing matters relating to much-needed financial reform, and allow the Rule to have its full effect as *originally* intended by Congress, so that the economy might actually realize the intended long-term benefits of the rule.

The Volcker Rule provides the Agencies a unique opportunity to help fix a core problem that led

to the 2008 crisis: unfettered proprietary trading at the nation's largest financial institutions. As noted by a July 2011 report from the Government Accountability Office ("GAO"), proprietary trading was the source of substantial losses at the major bank holding companies from 2006 through 2010.[6] In February 2012, Tim Geithner noted that: "If these [Dodd-Frank] protections had been in place, then we would not have faced the risk of this severe a crisis with this much basic damage."[7] We ask that you vigorously implement the considerable responsibilities that have been discharged to you by Congress, remain faithful to Section 619's intent and consider the comments contained in this letter.

Thank you.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
Eric Taylor
George Bailey
et al

[6] U.S. Government Accountability Office, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented*, GAO-11-529 (Washington, D.C.: July 2011), *available at* http://www.gao.gov/new.items/d11529.pdf.
[7] Ian Katz, *Committee to Save World Repudiated by Successors*, Bloomberg Businessweek, Mar. 23, 2012, *available at* http://www.businessweek.com/printer/articles/25452?type=bloomberg.