UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

VOLCKER RULE ROUNDTABLE

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P R O C E E D I N G S

(9:34 a.m.)

MR. BERKOVITZ: Good morning, everyone. I'm Dan Berkovitz, General Counsel at the CFTC. I'd like to thank all of our panelists for taking time out of their busy schedule to participate in today's CFTC roundtable on the Volcker Rule. We are fortunate to have a wide range of panelists with extensive expertise in financial markets and financial market regulation. We look forward to a very productive discussion today.

I have the pleasure of introducing Chairman Gensler, who will provide a few introductory remarks today.

CHAIRMAN GENSLER: Thank you, and welcome to the Commodity Futures Trading Commission Roundtable on the Volcker Rule. Thank you, Dan, for that briefest of introductions.

But no, thank you for working with Steven Seitz and Steve Kane -- Steven Seitz is with the Office of General Counsel, Steve Kane is with our Chief Economist Office -- in putting this together. And I want to thank everybody from the Treasury Department and other financial regulators who are here as well. This task of implementing the Volcker Rule is a five agency, and with Treasury, a six agency effort and I think everybody's been working enormously well together in coordinating this effort.

I also want to thank Sheila Bair, former chair of the Federal Deposit Insurance Corporation for participating here today. Sheila, it's so good to see you. Marty is doing a terrific job. We do miss you over at the FDIC. It's good to see you, Bob, too, as a former regulator as well.

Former Federal Reserve chairman, Paul Volcker, was unfortunately not able to join us because he's on international travel, but I want to just acknowledge his many years of public service as we talk about a rule named for him I guess.

In 2008, the financial system and the financial regulatory system failed; and the crisis, caused in part by the unregulated swaps market, plunged the United States into the worst recession since the Great Depression. We know the results. Eight million jobs were lost, millions of families losing their homes, and thousands of small businesses closing their doors. And the financial storms continue to reverberate with the debt crisis in Europe. I think when history is told they'll look back and see these connections between the two. And the prospects of people around the globe are still very much at risk.

In 2010, Congress and the president came together on the Dodd-Frank Act to promote transparency in the markets, but also to lower risk to the public from large, complex financial institutions, and part of that, not the only part, but part of it, was protection from the Volcker Rule which prohibits banking entities from proprietary trading and activity that may put taxpayers at risk.

Now, this is our 17th roundtable at the CFTC. We do these on important topics. They add to the over 30,000 comments that we've received and 1,600 meetings with the public we've held. And we'll have an 18th roundtable next week on promoting the price discovery function on the designated contract markets and some related issues on swap execution facilities. That's June 5th for those who want to come. I don't know that it will be as well attended as today's.

But in adopting the Volcker Rule, Congress prohibited banking entities from proprietary trading while at the same time permitting a number of other functions, importantly, risk mitigating hedging and also market making. So one of the challenges in finalizing the rules for the five regulators is somehow achieving these multiple objectives. Prohibiting one thing on one hand and then permitting at least these two: market making and hedging on the other.

I'm looking forward to the lively discussion. I just wanted to take this opportunity to highlight three issues that I think will be very helpful, and then I'm going to step away from this desk and sit with Commissioner Wetjen and Mark, if you want to say a few words, too. I don't know if I see other commissioners here, but certainly welcome to do so.

So I'm going to just mention three things. First, as prescribed by Congress, the Volcker Rule prohibits proprietary trading while permitting risk mitigating hedging. These two provisions I think are consistent with each other in that they both are meant to lower risk in the banking entities. Prohibiting one thing and permitting the other might sound like they're in conflict, but they actually both go the same direction to lower risk.

But the question is how we as regulators balance these two risk-lowering provisions. Some commenters have said that we're too prohibitive in one area and we may be limiting the banking entity's ability to engage in risk- mitigating hedging. On the other hand, if we were to follow comments of some of the banking entities, then the rule's allowances for permitted hedging might actually swallow up Congress's intent to limit the risk of proprietary trading. So it's how we, you know, do both of these.

Specifically, under the statute, banking entities may engage in "risk-mitigating hedging activities in connection with -- and the words are important -- and related to individual or aggregated positions, contracts, or holdings. So individual or aggregated positions, but it's risk-mitigating hedging. And to qualify as one of these hedges it has to be designed to reduce the specific risks to the banking entity in connection with such positions or contracts or holdings. So these are Congress's words. They're not our rule's words; they're Congress's words.

So the criteria for the hedging exemption as included in the proposed Volcker Rule are basically as follows: Hedges must mitigate one or more specific risks on either individual or aggregate positions. They cannot generate significant new exposures. These are what we included in our proposed rules. They must be subject to continuous monitoring and management. Compensation for the hedging cannot reward proprietary trading. And the hedges must be reasonably correlated to specific risk of the positions. And we're looking for comments on those types of criteria. Did we get it right? Should we change it? Should the final rule be different?

I think a further question about hedging activity, and it was actually highlighted by all of the agencies --it happened to be question 109 if anybody wants to look at it in our proposal. But everybody asks this, is whether "certain hedging strategies or techniques that involve hedging the risk of aggregated positions, e.g., portfolio hedging, create the potential for abuse of the hedging exemption." That was written in October but that was a question that was out there in our proposal stage.

A related question on which I think it would be helpful to hear: Is it possible, and if so, if it were possible, could a separate trading desk with its own profit and loss statement engage in risk mitigating hedging? Is it possible to have somebody over here, you know, motivated by profits, solely by profits, actually still be a hedging desk? The further removed a hedging activity is from a specific position of a banking entity, isn't it more likely that such trading activity is prone to express something other than the hedging itself?

As Dan will explain in a moment, we're not going to be speaking about the specifics of the credit derivative products trading at JP Morgan Chase's Chief Investment Office. I have to read that specifically as Dan wrote it. But I do think that it may be instructive for regulators as we finalize the key reforms, these lessons from this. Second, and shorter question, is it related to hedging.

In addition to hedging is market making. Dodd- Frank permits market-making. That's key to well-functioning capital markets. It's also key to the economy. So the question is for the regulators, once again finding balance. How on the one hand to prohibit proprietary trading and on the other hand permit market-making and finding that balance. Congress didn't give us an easy job I think on either of these.

The agencies also asked a question. In this case it was our question number 89 that was very specific to this. In essence, would it be possible to permit market making without somehow overwhelming the proprietary trading ban? I mean, I'm paraphrasing question number 89. But we all asked it. It was the same question of how do we find the balance.

The criteria for market-making in the proposed rule included seven requirements. I'm not going to list them, but a number of commenters suggested that these requirements may be more applicable to listed securities than they are to swaps. So I'll be listening closely today if there are suggestions how we at the CFTC should do this in the context of swaps. I think that some commenters have raised some very good points about that.

And then the third area that I'm particularly interested in hearing about is how this prohibition on proprietary trading should be applied to banking entities transacting in futures and swaps. And so this is a little bit narrow but this is the CFTC. And our goal, with regard to the Volcker Rule, is really within banking entities their futures commission merchants, their swap dealers. And so we're an agency that oversees derivatives. And we're interested in the rest of the rule, but that's our keen focus.

And in particular, a banking entity's market-making in swaps is likely to leave them with significant open positions over many years. It's the nature of the business.

And particularly in customized swaps. It's important to the economy. It's important that people can hedge particularized risk over many years. So then the question is when would a banking entity's decision not to hedge -- and I'm using the word "not to hedge" a swaps position or only partially hedge an open swaps position. When would that be considered prohibited proprietary trading? That would be very helpful to the CFTC and I think all five agencies as we move forward.

So I thank you. I sort of laid out three questions. I'm going to relax and remove myself but I don't know if Commissioner Wetjen or any other commissioners -- Mark, did you -- nope? I see no. You've saved a seat for me though. Right? All right. Dan.

MR. BERKOVITZ: Thank you, Mr. Chairman. Before we begin the discussion into -- get some views on the questions that Chairman Gensler has asked and others, I just want to take care of a few housekeeping matters and a few notes.

As the Chairman noted, the discussion today is a staff roundtable. Anything that is said today by the members of the CFTC staff, Steve or Steven or myself or any other staff participants, reflects only the views of the staff and not the views of the Commission. Additionally, because of the ongoing nature of the rule-making process, the staff is not in a position to be able to answer questions about the rule itself or of the commission's decision-making process. The purpose of the roundtable here today is to help compile a record for the rule-making, both for the staff and the Commission as it formulates the final Volcker Rule.

We encourage each of you to respond to the views of the other panelists. We want to have a very interactive discussion. And that will help us as we compile the record. If you would like to speak, just please hold up the name card and place it vertically. I also encourage everybody to use the microphone so everybody can hear. And also, for the first couple of times that you speak, to identify yourself so everybody in the audience can know who is speaking. And also for the court reporter so the court reporter can be familiar with everybody.

As the Chairman noted, the CFTC a couple weeks ago announced that it is investigating certain recent events involving JP Morgan Chase's

Chief Investment Office. Therefore, we request that today's discussion not focus on the particulars, on the particular factual circumstances surrounding that event.

Lastly, the transcript of today's roundtable will be included in our rule-making file. We invite the panelists and the attendees to submit written comments on the topics discussed today. We request that any further comments to be included as part of the record of this roundtable be submitted within two weeks of this date.

Any other questions before we begin? At this point then I'd like to turn the first question over to Ms. Sheila Bair, the former chair of the FDIC who we are greatly honored to have here today. And ask for your views on the hedging exemption to the Volcker Rule.

MS. BAIR: Well, thank you. And I guess I'm bringing the perspective of a former bank regulator but I should also note I am also I'm a former Commissioner of the CFTC and once served as the acting Chairman of this agency. So it's nice to be back.

If you could indulge me for a few minutes, I wanted to talk, perhaps provide just some general observations about the Volcker Rule again from a bank regulator perspective. You know, I don't think it's understood so much. Safety and soundness principles have always applied to insured banks, as well as bank holding companies. And so banks (inaudible) prior to Dodd-Frank and maybe those authorities weren't used as well as they should have been by bank regulators, but banks and bank holding companies are subject to standards of prudential supervision already. So I think some of this activity that we talk about, it may or may not have violated the Volcker Rule, probably should have violated the Volcker Rule, but it was not safe and sound to begin with so I think you really don't even need to get that far in the discussion because of that.

The Volcker Rule really goes farther than basic prudential regulation, and I think it really says that there are certain types of activities that we just don't think are appropriate inside banking organizations. Right? Whether they're prudential or not, we just don't think they belong in banking organizations. And the main challenge that I see with Volcker is that obviously when we repealed Glass-Steagall, banking organizations became legally entitled to engage in a full range of investment banking market-making, as Gary mentioned, and other activities that were traditionally conducted by securities firms that were outside of the safety net, and now they're back in the safety net and with the crisis with the major investment banks becoming bank holding companies, we particularly have this challenge.

I think there are certain activities like market making where it is extremely difficult to distinguish between legitimate market-making and proprietary trading. And I fear if you try to fine tune this too much you are going to either allow too much or not allow enough. And as Gary indicated, market-making clearly is a legitimate function for financial organizations. So what I have argued in the past and what I would argue again is that I think really part of the solution here needs to be for the regulators to use their powers not only on the Volcker Rule but their safety and soundness authorities, as well as their resolution planning authorities, to move gray areas, inevitably gray areas, like market-making, outside of the insured bank. Don't let insured deposits fund that activity. Because we don't know. It's very, very difficult to tell when it goes from legitimate market- making to other proprietary activities that would not be appropriate for insured deposits to support.

I think a lot of people -- it's not generally understood that banking organizations are made up of a lot of different subsidiaries, and some are funded by insured deposits and some are not funded by insured deposits. But I think part of the solution here, to get to the problems that we're trying to tackle, is to move securities and derivatives activities outside into separate subsidiaries that are firewalled off from the insured bank. My ideal world would be insured banks would be restricted to traditional commercial banking. They should take deposits, they should make loans, payments processing, wealth management. Those are the kinds of activities traditionally that have been conducted inside insured banks. There's a public policy interest in having insured deposits support them longstanding. That's not to say that those activities, certainly lending, cannot be subject to excess risk taking; they can be. But generally they're straightforward activities. There's a long experience with the bank managers, investors, and examiners. And I think those risks are much better understood by the market and the regulators than some of these other more complex, higher risk activities.

Obviously, and this is what we saw, the troubles with JP Morgan Chase, is you're going to have excess deposits from time to time. You know, it's a particular problem now because there's been a flight to safety. People don't know where to put their money so they're putting their money in insured deposits. And so there's a lot of excess deposits. There's not enough lending or loan demand to use all those deposits, and that's traditionally been the case. There's usually some level of excess deposits, so they had to be invested somewhere. But I would like to go back to the time where they really just invested in government-backed securities or very high grade liquid corporate debt. Derivatives: I would only allow an insured bank to hedge risk, specific risk. They should be plain vanilla derivatives products that are centrally cleared. I would ban inter-affiliate transactions with the insured banks and securities and derivatives affiliates where I'd like to push most of the activity that we'll be discussing today in terms of trying to fine tune where the Volcker line should be drawn.

So I think there are ways to make sure that money is not upstreamed from banks to support other subsidiaries. You can use firewalls for that. And that's what I would like to see longer term, just a general restructuring of these banking organizations, which I think can be done through regulatory authority. I don't think you need statutory authority to do that. Move this activity outside the insured banks, have the FDIC insured banks stick to those traditional activities that again we know have social and economic value and are well understood by management investors, as well as regulators.

So that said, I understand that that would be a major restricting that would change certainly a big change from how megabanks currently operate. So we do need a robust application of the Volcker Rule to the entire banking organization, I think, until we can try to get some of this activity away from the insured deposit functions.

So to your specific question, the way I would approach hedging is I would tighten the rule. I think a hedge should not be allowed unless you identify when you put the position on that it is a hedge. You identify the specific risk that you are hedging. I think the banking organization, they should be required to show to regulators that there's a reasonable correlation between the hedge and the underlying risks that they are trying to hedge. I think the identification of the hedge and the underlying risk should be publicly disclosed. You don't have to disclose specific reference names, but I think the fact that these are hedges and these are the types of underlying risks that these are hedging should be publicly disclosed. I think the methodology that the holding company uses to determine that there's going to be a correlation to be disclosed when the position is put on, and I think there should be continuous disclosure of how that hedge is performing and the degree of correlation and whether it's panned out.

I think, you know, if you could have a macro hedge that met those requirements, I'm kind of skeptical that you could, fine. If you can have a hedge that you can show is going to correlate to your entire financial institution, I'm skeptical that could happen. But you would need to disclose that. You would need to show how the hedge performed over time and whether there was a variation.

Again, I think also where I would really tighten the rule is in how it deal with compensation. I would ban any compensation based on hedging profits. If it's a good hedge, you probably should lose money. Right? You know, you do not want anybody in the banking organization, especially the risk managers, having their compensation in any way influenced by hedging profits.

So I think with those two -- those would be the two basic principles I would apply, and I think by removing employees' financial incentives to make market bets to the guise of hedging, you're going to get rid of a lot of the problems that you're seeing right now. And similarly, a transparency and investor scrutiny of these banking organizations' hedging strategies and whether they actually perform according to the methodology that they use I think will do probably a lot more than any very detailed prescriptive rules.

So that is the basic approach I would take, and I do think the rule needs to be tightened in certain areas to get to that result.

MR. STANLEY: I'm Marcus Stanley from Americans for Financial Reform.

Just to follow up on some of the things Sheila said, I think that the Lincoln Amendment or the swaps pushout provision which is also coming down the pike and will be implemented before the Volcker Rule or before the compliance period for the Volcker Rule has ended actually, clearly shows that the Dodd-Frank Act and intention in the Dodd-Frank Act to push, as she said, non-hedging swaps out of the depository subsidiary. And there's also a hedge amendment in the Lincoln Amendment. And I think that needs to be aligned with the hedge exemption here.

Just a few other things that Sheila pointed out, that hedging should not be a profit center, essentially. And I know we're not going to discuss the specifics of the Chief Investment Office at JP Morgan, but it was clearly a profit center, a major profit center for the bank for years. And that should have sort of made oversight of it or the determination of whether it was engaged in hedging fairly straightforward for regulators, even though it doesn't seem to have done that.

And in terms of the compensation, I think one specific change that needs to be made in the rule is right now the rule states that compensation arrangements of persons performing risk mitigating hedging exemptions are designed not to reward proprietary risk taking. And I think that word "designed" has to be changed to "do not." So do not reward proprietary risk taking, because otherwise you're in for a sort of endless legal fight over, well, it did, in fact, reward proprietary profits but it wasn't designed to do that.

And just the final thing, I think the

list of things that Sheila listed there is actually fairly close to the conceptual list that's already in the rule. You just have to make sure that those conceptual things of not adding additional risk, being associated with a specific risk that's being hedged and so on, which are already conceptually in the rule, are enforced on a very tight basis. And the administrative requirements are in there and documentation requirements are in there to ensure that that is there for every single hedge.

MS. BAIR: I would just -- I think the rule -- thank you. I really like those comments.

This rule doesn't require any public disclosure as I can tell, but I want this disclosed. You require a correlation. You require that we disclose to regulators. But I think financial analysts and investors need to know what the methodology is and whether these correlations are actually performing. You also restrict, and you're right, the language on the compensation is very fuzzy, and I would say betting on hedging profits, not proprietary profits, then you're going to get into a debate about whether this hedge was proprietary or not. You don't want compensation based on hedging profits period. Hedges are not supposed to be there to generate profits. They're supposed to be hedging being -- they're supposed to be there to hedge underlying risks that you already have.

MR. BERKOVITZ: A couple questions on those points. One is the second point actually is what I was going to ask. If we -- if the rule would say prohibit compensation based on hedging profits, are we essentially saying, or were you essentially saying, that if it's a true hedge it shouldn't be a profit center at all, let alone whether traders are making compensation from it?

MS. BAIR: You don't want people in risk management having their decisions influenced on whether the hedge is going to make money. Their focus should be on whether the hedge is going to reduce the risk. That's what the statute says; that's what good bank management says.

MR. BERKOVITZ: Lynn.

MS. STOUT: Thank you. My name is Lynn Stout. I'm a professor at Cornell University, and I also have the qualification that I wrote an article in 1995 called "Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Erodes Returns and Increased Risks in Financial Markets." So I'm very pleased to be here today, although unhappy about the circumstances that have led us all here.

I want to talk a little bit about the cost and benefits of the rule, and particularly put it in a broader context. Essentially, the reality of derivatives is that they are literally wagers between people. And it's been recognized by the law for some hundreds, perhaps thousands of years, that while wagers can be used for insurance, wagers can also be used to attempt to speculate, to earn profits by predicting the future better than other people do. The problem with speculation is that it is a zero sum game. When I am hoping to buy low and sell high and I'm dealing with a counterparty who also hopes to profit from buying low and selling high, the sad truth is one of us must inevitably be wrong. This is not an Adam Smith market in which both parties have a benefit. And therefore, it is not also a socially beneficial market. So I think it's important to bear in mind in addressing regulation of derivatives that the focus of your agency should be on social costs and benefits and not on private costs and benefits. And I think that's very important to bear in mind.

Now, focusing on the social costs and benefits of derivatives, when they are used primarily for speculation, there's a lot of evidence that, in fact, over-the-counter derivatives were used primarily for speculation -- we've seen a lot of increase in risk and very little increase in return -- when they're used for speculation, that is clearly a dramatic social cost. And indeed, I've seen estimates of the social costs of the risk that was added to the system by deregulating over-the-counter derivatives that are as high as $13 trillion. It would take a heck of a large hedging benefit to offset those social costs. And what I simply want to point out is that in looking at the so-called economic benefits of hedging, it is very easy for them to be exaggerated. Even if we focus on hedging by commercial end-users, I think it's worth bearing in mind that many of these end-users are publicly traded corporations, and hedging against specific risks does not provide any benefit to their diversified shareholders at all.

But quite apart from that problem, if you have hedging, it is actually likely that that could lead to at least three kinds of problems. The first problem is that frequently hedges are likely to prove to be mistaken hedges. And indeed, we've seen several very large and expensive examples of that. People think they are adequately hedging when, in fact, unbeknownst to them, they're actually taking on more risk. This occurs because derivatives are, in economic terms, fundamentally common value assets and they are being auctioned off to the highest bidder, meaning that the person who wins and ends up owning a particular derivative or hedge is likely to be afflicted by what we call the "winner's curse." In layman's terms, what that means is that hedging may not be moving risk to the person who can bear it most easily, but in fact, is moving to the person who perceives it most poorly.

A second problem is that when you are hedging with someone who is not, in fact, a regulated sale of insurance, you are often trading price risk for counterparty risk because you don't know if your counterparty will be able to make good on the supposed hedge. So when you take these considerations into -- when you take account of these considerations, I think the bottom-line is we come out with recognizing that anything like a portfolio hedging exemption makes it extremely difficult to police the line between what is fundamentally speculative activity and what is true hedging. It is in the social interest, clearly, even if not in necessarily the interest of all the trading parties, that the CFTC adopt rules that are very strict and err on the side of precluding activities that are described as hedging in the interest of preventing extremely socially-costly speculation. Thank you.

MR. ROBERTSON: Hi. My name is Dave Robertson, and I'm a partner with Treasury Strategies. And I'm here to represent the voice of corporate treasurers. We're a consultancy that assists corporate treasurers and CFOs in managing risk and operations on a global basis. And I wanted to take issue with the concept of the social good of hedging. When it comes to an individual company, there might be a theoretical diversification of risks for a holder of equities, but for an individual company to ensure that it has adequate liquidity, that can have a stable array of profits that it can use to make capital investing decisions, these entities do need access to risk hedging instruments. And I think the biggest concern that corporate treasurers with whom we work have around the Volcker Rule is that currently corporate treasurers enjoy a highly liquid, very transparent, lots of price information around hedging. And to the extent that they get better and better at getting visibility into their cash flows as they expand globally, as they take on capital projects with mismatched maturity cash flows, they are relying upon hedges to invest and create opportunities for the economy.

And I think it's notable to compare the U.S. with its robust capital markets to other economies, like the European economy where there is more of a concentration of activities in the banking sector and a less robust capital markets sector. What we find is that the actual level of cash held on the balance sheets of European firms is 33 percent greater proportionally than a U.S. Firm. And in essence, while there's cash accumulating on balance sheets due to economic uncertainty and risk, what corporations do when they can't hedge risk is they hold cash on the balance sheet as a natural hedge against risk.

You can see where the pharmaceutical company that has massive R&D swings, all you have to do is look at the cash balances. And the biggest concern that corporate treasurers and CFOs have about the Volcker Rule is that it may impair their ability to do legitimate hedging activities. This would require them to hold greater cash on their balance sheets, and in essence, that would further contract the economy. Thank you.

MR. BERKOVITZ: Wally.

MR. TURBEVILLE: Thanks. Wally Turbeville, Demos.

I've accumulated a couple of comments. I'll try to do them quickly.

On the issue of hedging and conceptually discussing hedging, I think it's really important that the rules, as in their final form address more clearly the interplay between the concept of correlation and the concept that the chairman laid out earlier that's explicitly in the rules which says that the inception of a hedge, no significant risk that's not immediately reduced, be put on.

So the fact of the matter is that what purports to be a hedge can be correlated but can add risk to the entity. And a correlated position that adds risk over and above what the entity had going in, that's simply taking a position that wasn't permitted in the first place by the Volcker Rule, which is a new risk position that has to be addressed.

I had the experience in the energy sector of watching trading desks -- gas, electricity, and oil products -- when their board said no more proprietary trading, just hedging, which just induced the desk to take on risks through purported hedges. And again, not going into great detail about what happened in London, that's the perfect example, just conceptually, assuming that what happened happened.

So the whole notion that what purports to be a hedge is truly a hedge is truly risk-reducing and is not simply a way to take on a risk position is very, very important to weave together with a concept of correlation of other things that are in the rules. And then the language now, I read it as being very effective that there's no new risk but others perhaps don't in the conversation. So obviously, clarification is needed.

Just quickly, Mr. Robertson's discussion was analytically sound in that a derivative is designed to offset a risk. The tradeoff is between a derivative and cash. But it's fundamentally unsound, with all due respect, because the way I look at a derivative is it's a synthetic form of borrowing money. And so the tradeoff between cash reserve and hedging a risk by the derivative, and the literature, in the academic literature basically it's a push, although I looked at the leading article on it and found five different valuation issues associated with the derivatives that the leading academics in the field missed. So that valuation tradeoff is very important and very ill understood by corporate treasurers throughout the United States and by even the leading academics. So I think we should not be shy about addressing the fact that derivatives are not necessarily the be all and end all.

MR. BERKOVITZ: We had Jeff first.

MR. AGOSTA: This is Jeff Agosta. I'm the CFO of Devon Energy, and we are a North American oil and natural gas producer. And I take exception to Mr. Turbeville's characterization of derivatives as a form of borrowing money. I think that they are, in fact, an instrument that we implement and use to ensure a base level of cash flow for our firm. Contrary to public opinion, we don't get to pick the price of oil and natural gas that we produce and sell, and so to have the ability to lock in a certain level of cash flows is very important for our firm to be able to make capital allocation decisions.

And I agree with Mr. Robertson's characterization that if we don't have that ability, then we are going to be more conservative in our capital allocation decisions and our budgeting decisions, and therefore, we're going to be less willing to expose and expand our activity.

MR. BERKOVITZ: I think we had Simon next.

MR. SIMON JOHNSON: Thanks. I wanted to ask David Robertson to clarify the remarks he made just now because I found that somewhat puzzling. First of all, perhaps you could share with us the study, the details with regard to the European firms having excess cash, and particularly how that's related to the lack of hedging availability or restrictions on the activities of, I guess, European banks, or perhaps there's some segmentation between those banks and the other global megabanks.

Certainly, what we know about the European banks -- some of whom are represented here today, they can speak for themselves -- what we know is they have a very large integrated banking and securities operation. And they have some of the biggest exposures to over-the-counter derivatives in the world, and many of these banks are quite frankly in serious jeopardy now, partly through their own mismanagement and partly through circumstances beyond their control.

Now, to Sheila Bair's point about the need for a firewall, I completely agree. If Morgan Stanley, for example, moves derivatives from its trading operation to its insured bank, which it reportedly has done and under circumstances that have not been explained by the Federal Reserve or any other responsible regulator, I don't see how that makes the economy safer. If you were putting a subsidy -- these are insured deposits -- you're subsidizing these trading activities. You are building up danger. The worst thing that can happen to your companies is another financial crisis. That's what's debilitated the economy. That's what Chairman Gensler talked about. That's eight million jobs lost. That's thousands of companies smashed. You don't want that. You want a safe market-based trading system, not the ability of the megabanks to blow themselves up with excessive subsidies. Thank you.

MS. BAIR: Yeah, just to build on that. I think we do need to distinguish between constraining activity that is supported by insured deposits and constraining activity generally. What I'm suggesting is market-making derivatives and securities be moved and firewalled away from the insured bank. They can still -- and I don't think anybody's taking about restricting in any major way legitimate hedging by non-financial commercial entities-- but I would like to see that. I don't think insured deposits should support that. I think they should go to the private market and raise capital, get market participants to support, to provide the funding they need for that service. I don't think insured deposits should support that. That is not to say we don't think it should happen at all, but the insured deposits skew economic allocation. And if they're using borrowed money that's backed by the government, you know, I've had -- without mentioning any names -- I started making some inquiries about whether a certain bank their very large positions and CDS indices whether those were centrally cleared. And I was told, well, for (inaudible) CDS indices, clearing houses won't take them. They don't know how to manage the risk. So I'm thinking to myself, why is that going on inside an insured bank? If a clearinghouse cannot figure out how to manage the risk, why in the world are we allowing that to happen inside an insured bank supported by insured deposits? I think that's really the issue.

MR. BERKOVITZ: Kurt.

MR. BARROW: I just wanted to -- sorry, Kurt Barrow with IHS. I just wanted to reiterate and build on something Jeff said, and that is I think there is a lot of negativity, you know, around the word "derivative." But the reality is what we found is that energy companies, both producers and energy consumers, including, you know, major industries like airlines, trucking companies, railroads, actually use these hedging instruments in a very professional and very useful way. And I don't think I have to explain to everybody the volatility in energy prices that we have in our world today. And what we found really is that a lot of the activities that we take for granted, in particular, the very low price of natural gas, it's really stimulating manufacturing activity in this country. You know, a lot of that wouldn't have come about. It would be a lot more difficult for companies to do that. And we would have higher energy prices really without some of the risk management services that these banking entities provide. And I guess in our discussions with some very smart people in the industries, primarily I'm speaking to the energy industries, it's not clear to us, you know, exactly, you know, what would happen if the banks exited this space. And really, the way the exemptions are written now, they're really so narrow that a lot of that activity, you know, would likely get curtailed. So, thanks.

MR. BERKOVITZ: I'd like to recognize Dan, and also thank Dan and Credit Suisse for participating in the panel discussion today.

MR. RODRIGUEZ: Thank you, Dan. I appreciate the opportunity to come here and speak to you on this very important topic and also to meet a lot of the principals involved in developing these new rules.

To give you guys a flavor of kind of where we've been moving, I tend to agree. I mean, I think Simon Johnson just made a, you know, pretty passionate point for making the system safer.

By way of background, I'm the chief risk officer for America's Equities. So I am involved in making sure that we do have correct hedges and I'd have to agree with a lot of the points that Ms. Bair just made. Correlation is important. The methodology for evaluating those hedges is important. Those should be examined by the regulators. I would support that. And I think anybody who is involved in those hedging activities should be able to answer those questions with a fair degree of confidence. I will say though that hedging in general, correlations are very idiosyncratic. They can be fairly challenging of how to do that and implement that in reality.

So, you know, how do you measure correlation? Should it be daily, weekly, monthly, over what time period should you measure that correlation? So a lot of, you know, challenges are involved in doing effective hedging. But because something is challenging, you know, having a business, operating a major oil and gas producer is challenging. You know, being a power generation company is challenging. We have to deal with challenges every day that we go to work. What I'd say is that derivatives and hedging activities help us meet a lot of those challenges.

So I vehemently disagree with the comment made earlier that the derivatives -- you know, two comments, I guess. One comment, the derivatives are a way of borrowing money. For a lot of our clients, we actually provide derivatives, especially now in the recent environment, for protection on their portfolio.

We're providing risk- mitigating instruments for clients and we are reducing the risk. In addition to that, we're reducing the risk -- have been reducing the risk in our own portfolio by an emphasis more -- not necessarily more on the spirit of the Volcker Rule, which is to make the system safer. And I would just emphasize the whole Basel III approach. And there's a very good paper by Darrell Duffie on the Volcker Rule, which emphasizes, you know, three alternatives for making things much safer. One, there's much more capital for the banks. Two is better liquidity, funding liquidity for the banks. And three is just increase supervision of the banks. So those three items I think are difficult.

I'm from a bank. I'm a banker and I'm saying that yes, we need more capital. Yes, we need better funding liquidity. Yes, supervise us, come in and ask us more questions about what we're doing and how we're doing it. We need all those things. Why? Because of what Simon just said, is that, you know, the world, the global financial system now has to continue to become safer. I think that the Volcker Rule is an opportunity to move in that direction. I think Basel III and those requirements are a better way potentially of doing that or a complementary way with the Volcker Rule.

So to answer the questions earlier that the chairman had posed -- can you have a hedging desk that focuses on idiosyncratic risk and aggregated portfolio risk? Can that been an effective desk? And I would say yes. It has to be managed very carefully and it should be monitored and supervised very carefully by the regulators. So I would say there are challenges in there and I'm happy, you know, to go into more detail separately. But there are challenges involved in hedging both a portfolio and idiosyncratic risk.

Two examples of idiosyncratic risk I think that might be relevant for this panel, we have a number of energy folks here. You know, the major airlines have to hedge out their jet fuel exposure. Right? If they are effective at hedging out their jet fuel through jet fuel swaps and derivatives, you know, puts and calls on jet fuel, that actually smoothes out their earnings stream and actually reduces ticket prices.

I was able to fly down this morning from New York to D.C., you know, a relatively inexpensive flight, coach, of course, on Delta. And I think about that and I look at the energy guys here. Why is that? Why was that flight so cheap? Part of the reason is because of derivatives. Derivatives are not, you know, an evil instrument. They're an instrument for good. They can be used as an instrument for evil as well. You know, so when you're cutting fruit with a knife, that knife can be a very effective tool for cutting fruit, but it can also be used incorrectly and cause problems. So in order to mitigate the problems that can be caused by derivatives, you need better supervision, better understanding of how those instruments are used. And I agree, in the past the industry has tended to misuse those instruments and we have to be more, you know, cognizant of the potential problems that can arise from that. And how do you mitigate the problems that can arise from bad hedging? More capital, better liquidity, more supervision.

MR. BERKOVITZ: What I'm going to try to do is get everybody in the first round before we go to second round. Shawn, I think.

MR. SHAWN JOHNSON: Thank you. And thank you for having me today. My name is Shawn Johnson. I'm the chairman of the Investment Committee for State Street Global Advisors, and I'm here today representing the Association of Institutional Investors, a collection of the largest and oldest buy-side shops. And I thought I would give a slightly different perspective than what you've heard today.

We collectively manage money for retirement funds, 401(k) plans, individuals throughout the United States, certainly more than 100 million people across all of our association members. At SSGA, just to give you some perspective, we manage approximately $400 billion in cash, about $260 billion in other fixed income instruments, and about $900 billion in equities. So as you're starting to restructure how the financial markets work, we have a vested interest in that on behalf of our clients.

And I've been trying to think about the best way to explain what worries us. And the best perhaps way to do that is through an example. And that would be if we had a client call us and say we need a billion dollars today because we're making an asset allocation change and we want to pay some retirees; our traders will get a list of 150 CUSIPs. We'll send it over to maybe a Credit Suisse and Barclays who I think is here as well. They'll give us a bid. They'll give us a billion dollars and we'll make our client happy.

In this proposed regulation I'll give them both the list but first, they're going to see who they can sell it to immediately. So maybe they can move a half a billion dollars, and the other half a billion they're going to have to take down themselves, which means they have to put principal capital at risk to take that trade in a market- making activity.

Now, it was my understanding of the way this is going to impact them, the next thing he'll do is he'll call me back and say, okay, I've got 500 placed. Give me a minute. I've got to figure out how to hedge the other 500. And the bid on the other 500 is going to involve the cost of all of his required hedging and compliance and everything else. So I'm going to turn around and those costs will be borne by the retirees as they (inaudible) spreads in the marketplace, assuming he can even find adequate hedges for what I'm asking him to hedge. So it may be that I have to call the client back and say, sorry, I can only do 500 today. You're going to have to wait until I can get the rest of the 500 placed. So the practical implications of what you're trying to do falls on a very interesting population set that I don't think has had a voice yet in the debate.

I also think wearing a different hat, we are one of the largest shareholders. In fact, we're a top 10 shareholder of every large bank in the United States. As a shareholder, I have an interest in how banks mitigate their risk, not the first of which is to define what risk is. I think regulators and folks in Washington have a short memory. The last time banks were simply -- or bank-like entities were simply taking deposits and making loans, we had the savings and loan crisis. The fact is, a diversified bank is a safer bank. It is safer as an investor and it is safer as a regulator. So I'm concerned if banks go backwards to be concentrated as only deposit institutions and lending institutions. I think we'll just have another savings and loan-like crisis. It'll just be 15 years from now.

So I wanted to give two different perspectives -- one as an investor and one as making trades for our clients, which I don't think has been articulated in the debate yet.

MR. BERKOVITZ: John, I think you've had

your card up.

MR. PARSONS: Yeah, John Parsons from MIT. And thank you very much for the opportunity to be here and participate.

I'm a little taken aback. We were talking about the Volcker Rule and now we're talking briefly about corporations being able to hedge. And I frankly didn't really see exactly how that's related. The United States pioneered the derivatives markets and made them a major institution in American in the 20th century before that, but also in the 20th century. Pre-repeal of Glass-Steagall when financial institutions were not doing the kind of -- the depository financial institutions that Sheila Bair was talking about -- were not doing the kind of proprietary trading that we're talking about here. Non-financial corporations were able to find financial intermediaries to assist them in hedging without needing to put taxpayer funds at risk. I don't see any conflict between those two things at all. As Simon pointed out, trying to create a safe financial system serves the interests of non-financial corporations.

In September 2008, one energy company, Constellation, was in a financial crisis because it needed an injection of cash. But September 2008 was a tough time to go looking for cash. If we could avoid a financial crisis, we could serve the interests of non-financial corporations hedging and doing all of the other things that they do much more successfully.

So I think the issue at hand is how to make a safe financial system precisely so that we can serve the interests of companies in all of the various different financial services that they need.

I want to then just make a couple more technical points in response to some of the questions that have been raised. Mr. Robertson mentioned a study, and I'd be very interested in seeing it. It's not a study I'm familiar with. It sounds very odd. I'm not sure what distinction I'm talking about between European and U.S.

Corporations. Is BP a European corporation? If so, it does a vast majority of its trading in derivatives inside the United States. Shell does the same thing. Statoil is a state-owned oil corporation and one of the leading risk managers in the energy markets. So I'm just not sure where we're coming from in trying to blame the distinction between European and U.S. corporations on the availability of depository institutions providing taxpayer backstop to derivative transactions.

And then the last point I'd like to just touch on is one of the very specific questions that introduced this discussion about portfolio trading -- portfolio hedging and the statutory language about single or aggregate positions. Technically, it seems to me you certainly can hedge an aggregate position and there's no conflict between the terminology of hedging and hedging being portfolio hedging. They're not necessarily a conflict. As long as we do the type of things that Sheila Bair was describing about placing requirements on what defines a hedge, something that can be specified, something where the correlation is quantified, something where it's monitored, you can do that on a single or an aggregate position. The public needs to be aware, however, that it is true that the industry tends to utilize the term "portfolio hedging" in an entirely different way. The industry uses that term to describe trading and transactions that it can't quite quantify, specify, and prove are hedges. And it's important that the regulators who are writing these rules, write them in a way so that portfolio hedging is truly hedging, it satisfies the type of criteria that were being described, and not allow in a term which basically allows anything to go under the label of hedging. Thank you.

MR. BERKOVITZ: Josh.

MR. COHN: I'm Josh Cohn for Mayer Brown here today on behalf of the International Swaps and Derivatives Association.

This has been thus far a very

interesting and wide-ranging conversation. I'd like to try to bring it back to a specific statute because we do have a specific statute. And the specific statute, of course, protects the swaps intermediation business in banks in covered banking entities. Let's just say covered entities. It also protects the hedging function in those entities. That's specific in the statute. We also have, of course, in the statute a specific reference to hedging aggregate risk. Aggregate has a plain meaning. I think that Mr. Parsons just spoke to the plain meaning and the ability of that plain meeting to encompass portfolio hedging. And portfolio hedging is, in fact, practiced and for the most part practiced effectively in many financial institutions right now. In fact, I would refer us all to the CFTC final rule on swap dealer recordkeeping and reporting at 77 Federal Register 20136, which specifically recognizes the virtues in some institutions of consolidated hedging and provides for consolidated risk management programs.

Moving along to hedging as a function, I think it's important to remember there are no perfect hedges. There is no hedge that you can put in place that doesn't create another risk unless you sell exactly the same transaction that you bought or vice versa. You're always creating a new risk. The question is: what is the risk? How risky is it? Fundamentally, what is the cost benefit of that risk in a hedging analysis? That is, has it made things safer? Has it not made things safer?

Now, hedge needs and values change. There's recognition in the preamble to the release accompanying the proposed regulation that's quite clear on the ability, in fact, the need of an institution to dynamically hedge, to be changing its hedge positions over time. Each time a hedge position is changed there's P&L. There's profit and loss. We can't be saying -- we can't really be saying that we want derivatives dealers to lose money each time.

Which brings me to a third point about

the derivatives market, and that is that derivatives markets are low liquidity markets. We're not talking about markets where there is a regular pair in bid ask or revenue from customers. We're talking about relatively infrequent trades. If we're expecting dealers to run their businesses on a fundamentally economically efficient inefficient basis, we're going to find ourselves with far fewer dealers and far higher prices.

Lastly, where does that leave us? We have a statute. We have a statute that says no proprietary trading on the one hand. On the other hand it says yes to hedging and it says yes to intermediation in derivatives. Where I think it leaves us is with a regulatory conversation that each swap dealer, each swap market maker as it were, needs to have. The market maker has to be discussing what its activities are in connection with its market making. It has to be discussing what its hedging is. It has to be describing reasonable correlation. It has to be describing specific risks. And our regulators have to be involved in the process of overseeing how a covered entity deals with these challenges, and there has to be a process of accord going forward. I think perhaps along the lines, Dan, that you were describing.

So I've probably taken enough time for first round.

MR. BERKOVITZ: Marc.

MR. JARSULIC: Just a couple of points. First of all, I think one of the things that is sometimes lost in the discussion of the Volcker Rule and the motivation for it is the historically demonstrated risk that this poses to large bank holding companies. And I think one really good index of the risk that it poses is the amount of funding that had to go out the door from the Federal Reserve to preserve the dealer banks. So if you add up the funding from the term securities' lending facility, primary dealer credit facility, and the repo lending that the Fed did, at its peak there was about $433 billion outstanding. So there's pretty good evidence that, in times of stress, the trading operations, the big trading operations in dealer banks are highly unstable and pose a real source of systemic risk. So there's not just a risk to firms, there's a risk to the financial system as a whole. So there's a very strong motivation for trying to limit the risk that the dealer functions inside banks shift onto the public and onto the financial system.

I would say that in terms of the specific thing we're addressing this morning, which is the permitted hedging inside the banks that will be done by these dealers, the two points that were raised by Sheila Bair were extraordinarily important. The incentives for people to make large gains from trading, of course, extend to hedging behavior. And so the notion that compensation for the people who are executing the hedging function can't come from gains and losses in hedging, is extraordinarily important. But I think it's also important that the hedging function not be a long-term profit source for the bank as a whole and that the regulations explicitly say that.

Secondly, the notion of reasonable correlation is something that truly needs to be spelled out. In common law, you know, there's a well defined legacy of what a reasonable man is. Right? You can look to a long history of case law and say, you know, this person acted reasonably, this person didn't. In terms of reasonable correlation or reasonable risk reduction that a hedging position exhibits, I think there is no history here. So since we're starting de novo, we really need to say what's a reasonable reduction in risk that a hedging position needs to take in order for it to qualify for this exemption. And I know that's very difficult, but it seems to me that if it's not possible for the firms that are putting on hedges to initially demonstrate what the hedge is related to and how risk is being reduced, then it doesn't qualify.

So one of the things that you might do when you're looking at the regulations as their written is to go beyond saying you must document the hedge and what it's related to, but you must document how the risk is being reduced. And if I may, the notion that this could all be handled by capital in the bank, I would say, yeah, if you can get the leverage ratio for big bank holding companies down to five, then I think that you're going a long way to controlling the risk posed by broker-dealers. If Basel III does that, that would be great. It doesn't look like it's going to come anywhere near that. But there is an option inside the statute that would allow you to impose leverage limitations on the dealer function.

If you look at 619(d)(2), I think, or 2(d), there are provisions which say that no permitted activity can threaten the safety and soundness of the bank or financial stability. So if you look back at the history of the instability of the dealers inside bank holding companies, they have historically posed a real threat so you might consider say margin -- sorry, leverage requirements for the dealers in order to reduce the risk that they pose to the holding companies in the financial system as a whole. Thank you.

MR. BERKOVITZ: Okay, why don't we go Wally, then Simon, then David, and Dan.

MR. TURBEVILLE: Yeah, thanks. The point was raised about dynamic hedging and the language that's in the regulations concerning dynamic hedging. Again, I think there's correlation and then there's different types of correlation. Correlation isn't all one kind of thing. So the challenge is to take a very explicit part of the proposed regulation that says this must be risk reducing, meaning at the inception of the hedge, no additional risk should be introduced into the bank by virtue of doing the hedge. And then you have to look at the other discussion of dynamic hedging and what that means. I think it's a bit of a "strawman" to articulate that there's no perfect hedge. There are perfect hedges. Not every hedge is going to be perfect and there's going to be residual risk associated in the underlying position once a hedge is put on from time to time for sure.

But the real question is whether you're going to put on a position, a risk position, and thereby avoid and evade the Volcker Rule just because you've said, oh, no hedges are perfect, which is not true actually and is very dangerous if you let that sort-of intellectually migrate out to the circumstance where you allow a purported hedge to create a great new risk. Again, that large financial institution operating out of London, that's the kind of thing that's really, really problematic. So I think that we need to get past a simple sort-of talking point that no hedges are perfect and really talk about how this should work in the real world so that no significant risk is introduced at the inception of the hedge when it occurs. That does beg the question of what dynamic hedging means in the rules. We can go into great detail about that because dynamic hedging is supposed to manage risks that were laid on at the time the purported hedge existed. That contravenes the other language that talks about no new risk. But dynamic hedging can mean other things, too, because actual, real-world correlations might change from time to time as opposed to risks introduced at the time the purported hedge was laid on. I think this is a very important point and one that shouldn't be just glossed over by generalized statements.

MR. SIMON JOHNSON: Thanks. I would just like to reinforce the point made by Marc just a moment ago about leverage limitations. I think we're actually agreeing that these are very risky operations. In fact, Josh laid out the reasons why hedging can create volatility in earnings. And we know from recent historical experience that this volatility can be big relative to the macro economy. So the most sensible way to deal with this is to require -- is to have tough leverage limitations, to require more equity and less debt.

And if Sheila Bair was still here I think she would also make these points about overall balance sheet. We should be looking more at leverage ratios and less at risk-weighted assets.

Just to, also for the record, perhaps Mr. Chairman, Dan mentioned the paper by Darrell Duffie. I think we should recognize that there was a paper commissioned by SIFMA, even though Darrell Duffie is an independent academic. He does, and I have the same issue actually with the IHS paper which I understand was commissioned by Morgan Stanley. Kurt can correct me. In both of these papers, I don't find any explanation or analysis of why markets won't evolve to, as John Parsons said, draw on this deep tradition of strong, independent markets as opposed to having so much of the derivatives business concentrated over-the-counter in banking entities or bank-related entities.

And to Shawn's point, I'm sure you're right that we'll always have banking crises, and perhaps in the future there will be another version of the savings and loans crisis. But the savings and loans crisis did not threaten to bring down the world economy. The crisis of 2008 centered around large diversified banks, almost brought this financial system to its knees. And as Chairman Gensler said at the beginning, still threatens a third of the world's economy in Europe. So I don't understand how taking these risks onto the balance sheet, these dealer-intense repeated, clearly demonstrated, dealer risks onto the balance sheets of banks and bank-related entities with a great deal of leverage, leverage at current levels, or leverage even close to Basel III. We should be talking more about the capital requirements of Switzerland, which has moved far ahead of Basel III. I would go even further than what's currently required for Credit Suisse and UBS in the U.S. context. Thank you.

MR. ROBERTSON: Thank you. I just wanted to address two points. One was just to provide some background on the study around the corporate cash since there have been a couple questions about that. Each quarter Treasury

Strategies monitors the level of corporate cash. We also go out, and we interview and survey corporations in Europe and the U.S. as to what's going on with their cash, how is it composed, where are they getting the uses of it, what do they plan to do with it? And we've been tracking this before the crisis and following the crisis and it's quite fascinating because as you might expect, cash is accumulating on balance sheets. It's doing that obviously for economic uncertainty, lack of prospects, but also due to higher risk in the environment. And if you were to look today, the U.S. corporations hold about 14 percent of their GDP on the balance sheets of the legal entities in the U.S. as compared to Europe where it's 21 percent of the legal entities of GDP. So in essence, proportionally there's a third greater holding in Europe.

Now, you could analyze all kinds of reasons for that. We've really dug into this, and as far as we can tell, there are several aspects to the U.S. economy that make it a more liquid market and enables corporations to do their business and conduct their business with less cash on the balance sheet. Some of this is actually due to very robust secondary markets. To the extent that the Volcker Rule impairs the ability of banks to underwrite or others to underwrite securities and hold them in inventory, that would reduce the access to liquidity. And as well, to the extent that financial risk cannot be hedged, we do see companies put cash on their balance sheet to hedge risks. And all you have to do is actually look at the proportion of cash to revenues by industry segment and correlate that to the level of operating risk and cash flow volatility of those firms and you'll see a very clear correlation between the level of cash on the balance sheet and the level of un-hedgeable risk flowing through that firm's cash flows.

So that's the primary point that we're most concerned about. I think we don't want to conflate the idea that because corporate treasury wants access to robust financial markets, that means that they don't want prudent regulation and that they want to see another financial crisis. Clearly, that's not the case. However, I think corporate treasurers and CFOs do want access to these instruments and I think as many of the practitioners in this room have pointed out, there's quite a bit of activity that goes into the liquidity of these markets, the accessibility, the speed of executing the transactions. Keep in mind that a corporation that's going to engage in a hedge needs to figure out the accounting for it under FAS133. And they need to be able to do that quickly, so they can't wait for prices to come around and be created. They need the pricing in a very liquid market.

So our concern again is not that this market should not be regulated, but that it be regulated in a manner that preserves the liquidity, the speed, the transparency, and the price robustness of the market. Thank you.

MR. CASTILLO: David Castillo from California State Teachers Retirement System.

As an end-user, we just want to encourage better disclosure in the derivatives market. I mean, we're all talking about significant changes. We don't know yet whether it's going to make a better market, a worse market. We do know there's not very good disclosure and information in derivatives, especially OTC markets. We were talking about banks and balance sheets. A lot of this stuff doesn't start off on the balance sheet. It's only when it comes out of the shadows that it's on the balance sheet. And I think we need to have regulators in a marketplace that has much better information about what all the participants are doing, but especially banking institutions and institutions that stretch globally. And the markets do stretch globally and we want to encourage disclosure and getting better information flow about what's out there. And then we can evaluate whether or not these participants are adding value or detracting value, adding risk, taking away from risk. But our position is to get better disclosure out there. Thank you.

MR. BERKOVITZ: Curtis, you had yours up.

MR. ISHII: I'm Curtis Ishii. I run the fixed income operation at CalPERS.

I want to just make sure and pretty much restate some of the things that have been said before. I think we're very supportive of what Sheila was talking about. We think it's very important for alignment of interests to be properly done and I think her thought of not making or making sure that compensation is not tied to profitability of hedges but to what they're supposed to be doing, which is risk reduction, is important. And I think David had some really good points. We would argue that transparency and the development of quantifiable measures, some ways in which you can monitor from multiple viewpoints of what is going on in this area, we find that disclosure in this area is very minimal. We would recommend that institutions disclose more and not just -- this will help you as regulators because if you allow the investment community to know more, there's more eyes on what's going on and you'll have greater scrutiny and then you need to probably have some sort of group that begins to have a discussion early on what people are beginning to see in the markets.

MR. BERKOVITZ: When you're talking of disclosure, are you talking about disclosure to regulators or public disclosure or both types of disclosure?

MR. ISHII: We are -- I think we're both, but what I was speaking to more is public disclosure. We find that the current disclosure by various financial institutions to be tremendously wide. If you look at the disclosure document by Bank of America, it's very extensive because they're under a lot of scrutiny. You compare that to someone like Goldman or something like that and it's very nebulous. We find that there aren't a lot of quantifiable measures being disclosed to investors and we would encourage an establishment of much more standardization across the industry so that we can understand or at least begin to quantify some of the risks that are going on and we would, you know, it would help, I think, this entity monitor. And then we're talking about volume discussions. We're talking about net exposures. We're talking about it could be even something about counterparty, their counterparty exposures. The more quantifiable measures that you have and the greater scrutiny, the greater transparency we find in a number of markets, it helps bring more eyes to bear and it exposes more of the potential risks that are in various markets.

MR. CASTILLO: Yeah, I just back exactly what Curtis said. We've gone from a market that has none of the above when it comes to disclosure, and we want to go to all of the above. And let's move that paradigm from disclosing nothing to maybe we'll get too much disclosure, but that would be a welcome change from where we are today.

MR. STANLEY: A bunch of points have been made, and I just want to start out by saying a lot of the things I'm about to say are also in Americans for Financial Reform's written comment on the Volcker Rule.

But the first thing I wanted to say is very connected to what David and Curtis -- the point David and Curtis just made, which is the issue of liquid markets, especially in customized and over-the-counter derivatives. And I was sort of concerned to hear various comments that seemed to imply that continued activity in highly illiquid markets would be permitted under the Volcker Rule. It's sort of a general thrust of the Dodd-Frank Act, all of Title 7 of the Dodd-Frank Act, that we want to move derivatives onto exchange-trade markets where possible. Deep liquid markets with good transparency because they occur through exchanges with transparency of counterparty risk because they are cleared. So you just need to know about the exposure to the clearing house and not necessarily the entire web of counterparty risk that happens when you get uncleared derivatives.

And I think that's a risk reduction focus in Title 7, and that focus needs to also be picked up in the Volcker Rule by trying to limit bank activities to exchange-traded standardized transparent types of derivatives with deep liquid markets. And I think I'm not going to be able to be here for the market-making discussion, but I think it gets very difficult to enforce the various market-making metrics if you don't do that because there isn't good pricing information. I mean, as we sit here there is a big international bank whose London office cannot get out of its derivatives positions because it's in an illiquid market. It can't find anyone to take the other side of the trade. So that, you know, if we needed any illustration, that's, you know, the issue.

And I was kind of concerned to hear Chairman Gensler in the opening discussions say that it's necessary for swaps dealers to hold large, unhedged positions as dealers. In other words, not to maintain a balanced book for long periods of time. And I suppose that might be connected to dealing in over-the-counter kinds of markets. But that to me, it becomes very difficult to tell the difference between dealing and market-making and proprietary speculative trading when you do not have a balanced book.

And just some of the other points I wanted to make quickly. Correlation. A couple of people have touched on this. I think an over-emphasis on correlation alone instead of a real economic connection between what's the instrument that's being hedged, the position being hedged and the hedge would be a real problem. There's all kinds of software out there right now that just sort of searches through all the assets and instruments on the market to see what's the cheapest instrument that has a correlation that's over a certain level, even if there is no economic connection whatsoever. You know, if, so I think it would be a big mistake to just rely on some kind of mechanical correlation number and not have some kind of requirement for a real underlying economic connection because the primary worry of the regulator needs to be about stressed markets. And in stressed markets, correlations that aren't based on fundamental economic connections disappear and they disappear quickly.

And one thing, when we talk to traders about this, and it's kind of unfortunate Occupy the SEC isn't here because they've got some really good ex-traders on their staff, but when we talk to traders, one thing they say, including hedge fund traders, is that we know when there's a hedge. We know when a position is a hedge and when it's not a hedge. There are very standardized kinds of hedges for different asset classes, and I think one thing that should be considered is just building up a database of what those standardized hedges are based on real underlying economic connection and providing a safe harbor for really trustworthy, reliable hedges that are just on their face, hedges.

MR. BERKOVITZ: Shawn.

MR. SHAWN JOHNSON: I just wanted to

give an example of sometimes hedging isn't a good idea and also very hard to do. For example, if we try to sell a $500 million five-year CD in a French bank, I need to get liquid in that. And I have somebody on the other side trying to take it down, somebody at Credit Suisse perhaps. Under the current proposal, they'll look at that. They'll either try to sell it or they're going to have to hedge the fact that they've got a five-year CD position against a French bank.

Now, I can think of some things that might be correlated, to your point, but there isn't a good one. I mean, but his risk department and his regulatory department is going to force him to hedge. So what's he going to do? Buy a five-year credit default swap against SocGen? You know, I don't -- which is about 100 times more volatile than the security of asking him to take on a principal basis.

So what we wrote in our comment letter is that there needs to be a distinguishing definitional issue between what is proprietary trading and what is principal-based market-making activities. And perhaps it's under that definition of "you know it when you see it." But the regulators could very easily distinguish those types of activities so that he can take a principal-based position in certain types of securities and maybe you have to limit leverage and these other things. I have no problems with that. But the idea is there needs to be principal capital being placed into the market. They need to be able to make a reasonable economic return for having placed that capital in the market. If they don't, over time they will exit those markets, find some other place to make money, and the liquidity that's provided into the marketplace, both in the form of derivatives or in the form of cash-based securities will wane. There may eventually be other market participants that come in to provide that liquidity. It may be hedge funds. It may be other types of capital. And maybe at very, very different prices. But they need to be able to on that bank side, be able to take principal-based activities.

MR. BERKOVITZ: Lynn, you had your card up.

MS. STOUT: I want to make just a few short points. One thing is that I've been looking at this issue for a good decade, and one thing that has struck me as extremely odd is the absence of any dollar figures that are attached to the supposed value of allowing derivatives trading generally for hedging and particularly by deposit-taking banks. So it's not because the industry has not spent money or is not willing to spend money generating studies. So I think that when you're looking and weighing the costs and benefits of a rather strong regulation that takes a very restrictive view of what is hedging as opposed to a more lax regulation, I think it's certainly within your rights to consider the fact that the industry has had a decade and lots of money to generate some sort of evidence that would allow you to attach an actual dollar figure to the cost side.

I will just repeat, once I was testifying for the Senate Agriculture Committee on very much this issue and I was astonished to hear someone from Cargill get up and testify that the absence or restricting their ability to use derivatives to hedge would require them to maintain a larger cash amount. And this would cost them $7 million a year. And to hear someone complaining about $7 million a year increased cost at a time when we were in the middle of a $1 trillion bailout was somewhat shocking to me. So I'd really like, and I invite the industry to produce some studies that attach an actual dollar figure to the supposed economic benefits of hedging, particularly hedging that is done through deposit-taking banks.

As a second point, I just want to second what John Parsons and Simon Johnson have both side. History teaches us that it's not as if there are people who are going to disappear and be unwilling to offer hedging services if deposit-taking banks are not allowed to do it.

Let me just point out that we've had two longstanding industries that have performed the function of offering hedging opportunities. One is called the Commodities Futures Exchanges and the other one is called the insurance industry. So it's not as if there's any shortage of private actors who would be willing to perform these services if taxpayer subsidized banks were not willing to perform them. There might be a temporary period of adjustment until competitors arise, but I am quite confident based on business history that competitors will arise.

Number three, I want to reinforce Sheila Bair's point that the best way to judge whether a division in a bank is truly hedging or, to the contrary, indulging in speculative proprietary trading is to look ex ante at whether that division is generating profits. If they are generating profits, I think that's prima facie evidence that they are not, in fact, hedging. Hedging is buying insurance; insurance costs money.

And my last point is I just want to simply respond to the suggestion people have made that there is no such thing as a perfect hedge. We call it insurance. The hedging/trading distinction is one that has been dealt with by insurance law, again, for centuries. Insurance law takes a very restrictive view, will not treat something as a hedge that is an enforceable insurance contract unless you actually own the underlying that you have essentially bet against. So there are more restrictive definitions available to the Commission should it want to adopt them. Thank you.

MR. RODRIGUEZ: I just want to give a couple of examples. I'm sorry, yeah. I want to give a couple of specific examples on the perfect hedge. I've just been writing down a bunch of notes. First, on the perfect hedge argument brought up by several of the participants here, two specific examples that Credit Suisse has been involved in this year. I think it's out there in the public record. We took on I think about $6 billion of the mortgage-backed securities that the Federal Reserve wanted to get out into the marketplace. I think it's an example where the Volcker Rule is already working. I mean, we were already kind of under the guise that we were going to go ahead and try to lay off as much of that as possible. And as Shawn has illustrated in several very good examples of how the real market works. I know there's a lot of faculty here. You know, I respect the faculty. I used to be a faculty member myself in a former life, and I think it's very important to have outstanding research when you're actually conducting transactions and doing these in the marketplace on a day in, day out basis. You know, it's a little bit different than I think what's being suggested here.

If there is -- I'll give an example, that $6 billion of mortgage-based securities. At that point in time, very difficult to hedge out that entire risk other than to lay it off. So our goal is to get rid of as much as possible as quickly as possible. And whatever little residual there is, to hedge that out as effectively as possible. Our goal is not to take on a lot of risk onto our book. Our goal in that case is to be a true market maker, to facilitate the transaction, and help taxpayers get their money back.

The second transaction was with AIG. There was a large block trade. Credit Suisse, Morgan Stanley, Citibank, the first round. Each of us took $1 billion of AIG stock. That's a matter of public record. So what do you do with a billion dollars of AIG stock? How do you hedge that? Where's the perfect hedge for that? The perfect hedge is to sell a lot of the AIG stock. The other hedges are, you know, there are some correlations. A number of instruments, as mentioned here earlier, you know, and we're going to use those instruments to the best of our ability to manage our risk, and to keep that risk profile as tight as possible, which we have been doing.

And to Shawn's other point here which I

like, measuring risk, how do you measure risk? It is something that I'm involved in on a daily basis. There are a number of different ways to measure risk. I like the approach. We've been talking to the Fed on a number of Volcker metrics. How do you measure these various risk metrics across a portfolio? And doing that on an interactive basis, you know, iterative basis. So what's a good risk measure for this type of activity? There's going to be multiple risk measures and I think -- and the optimal risk measures evolve over time and it is, in fact, dynamic. And the problem is some of these correlations in a stress environment do disappear or appear. So you may actually have a hedge on that doesn't look like it has a correlation now but if you have a stress event, all of a sudden you do get a correlation. So these things have to be looked at on an interactive basis, dynamic ongoing basis. And I do believe there has to be a continuous dialogue between the supervised entities and the supervisors.

And I would say on the deposit, you know, I hear the phrase "taxpayers subsidize deposit-taking banks." Now, at Credit Suisse, we're here and I guess we'd come under the Volcker Rule not because we're FDIC -- we have FDIC-backed deposits, but because we're interested in -- we do have access, I guess, to the Fed window, the discount window. And in that case there is some indirect subsidy through that channel. We don't have any FDIC-backed deposits. However, we are very much in favor of a safer, you know, financial system. But I think supporting these activities and supporting banks to continue to provide those markets is going to be very important. If you ask a lot of our clients -- I would say go to our clients -- you know, CalPERS, State Street, a lot of the energy companies that are conducting this hedging -- ask them if they want to not have access to these activities. And I will say, as has already been indicated, that that's not the case.

Now, to address Simon's point about

Darrell Duffie, I just wanted to make sure for the record here, you know, this paper, it was commissioned by SIFMA. However, the commission for that was donated to the Michael J. Fox Foundation for Parkinson's Research. And he made that very clear when he came to present that paper, you know, for risk managers across the industry a few months back. And the title of that paper, "Market Making under the Proposed Volcker Rule." I know in the morning session we were talking about hedging. He does address that. And I just wanted to read his section. He's a Dean Witter distinguished professor of finance at the Graduate School of Business at Stanford University. And his statements on this, the agency's proposed implementation of the Volcker Rule in the most stringent case would reduce the quality and capacity of market-making services that banks provide to U.S. investors. Investors and issuers of securities would find it more costly to borrow, raise capital, invest, which is -- to Shawn's point about the retirees being impacted and basically every corner of the capital market is being impacted -- hedge risk and obtain liquidity for their existing positions. Eventually, nonbank providers of market-making service would fill somewhere all of this lost market-banking capacity but with an unpredictable and potentially adverse impact on the safety and soundness of the financial system.

Basically, pushing a lot of that risk-taking into the unregulated, unsupervised segments of the marketplace. Now, you know, that could lead to a lot of other problems that we're not aware of. So the issue is: do you want to have good visibility of the risk taking that's going on on the system? Or do you want to push it out to the corners and dark reaches of the financial system and have random blowups that we're not going to be aware of? You know, we're here today -- I know Barclays did show up but the other banks have not shown up -- we're here today because we're here to engage. Right? We want to have a dialogue, and I think this is pretty constructive. And from my seat here it seems that we're a lot closer than people think. We, more than anyone, want a solid financial system. We're trying to do things to move that.

And to refer back to 2008, you know, the system is very different. Yes, in 2008, there was far too much risk-taking. In 2012, you know, who knows the optimal level of risk taking for the global capital markets? I don't think that's a very tall order to know what that level is. We know they were too high in 2008. We don't know where we are. We need to get lower. We are moving lower.

And just one last comment on this. Consistent profits. The one comment was made that if you have a hedge desk and it makes profit, then it's not a hedge desk. It so happens to be the case that the hedge, you know, a lot of hedge desks right now have been making profits over the last four to five weeks. Now, why is that? Because there's been a pretty dramatic sell-off in the marketplace. So just because a hedge desk happens to make money for one month or one quarter, when the market was selling off very sharply, it does not necessarily mean that's a profit center. It means it's a hedge. Hedges sometimes make money and sometimes they lose money. Now, if you have a hedge desk that is consistently generating outsize profits, then that's something on an ongoing basis over an extended period of time, then that's something that probably should be investigated further by the regulators. Thank you.

MR. BERKOVITZ: Now we have Kurt and Jeff and Josh.

MR. BARROW: Thanks. Yeah, I just want to respond to a couple points. I guess first on our study. It was commissioned by Morgan Stanley. It was an independent piece of work, and we completely stand behind all its findings. And I guess Professor Stout, I'd point you to our study. It's one where we did actually try to quantify with real numbers, 200,000 jobs in just a subsector of the energy space. So this is not the total commodity space, certainly not any of the activities that the bank, the Volcker Rule would impact outside of the commodity space. It really looked at just the subsector of the energy space, and we came up with an impact around 200,000 jobs if the current regulations were to curtail the bank's activity in the risk management space.

So I think, you know, one key point to bring up is a lot of discussion about should the banks be in this business. Right? Should banks be doing hedging and market making? The reality is Congress's intent, firmly stated intent, was to maintain market making and hedging services by the banks. The client-facing businesses they provide. They're very important and they have real world consequences in the real world to real companies, real consumers in terms of energy prices is the area we looked, but I'm sure that extends beyond energy markets.

And to the point of illiquid markets and whether banks, you know, should not be writing OTC contracts in illiquid markets, the reality is that's where the customers need it. That's where the customers need the help. It's pretty easy to write, you know, to get a hedge on WTI. I can go out and get one of those. Big deal. Right? If you're a producer or a power producer in Wyoming or you're drilling for natural gas in Colorado, those futures markets, listed exchanges don't do you a lot of good. And if you do use them, all you're doing is adding basis risk. And so that's a key function of the OTC markets and the banks in their client-facing business.

I guess finally, you know, the idea of markets will evolve, that's certainly a nice hypothetical academic approach. And it certainly might be true over time. The reality is if you talk to the people in the industry, the users, is that nobody else has that client-facing model. It's in the markets that we can really step in. And so I think even outside of the fact that Congress wants them to stay there, even if you were to write regulations as they are currently written, would largely impact those markets in a dramatic way. You know, the reality is there is nobody there, and so I think you're taking a leap of faith, a large leap of faith as the regulations are written today. Thanks.

MR. AGOSTA: Again, Jeff Agosta with Devon. Just to build on Kurt's point and to address Mr. Stanley's point about exchange traded derivatives. If they exist in large liquid quantities and it actually does facilitate hedging one of our risks. That's great. But in many instances they don't. They're not plain vanilla to Kurt's point exactly. You know, we do have oil and gas operations in Wyoming and that's not a deep liquid market. And we do use our financial institutions to help facilitate hedging those risks. And I could give you a number of other examples where we do not use plain vanilla type derivatives that are not going to be traded in an exchange traded firm. And it allows us to better plan our business.

Second point, I'd like to build upon Mr. Johnson from State Street's example about the importance of having financial institutions to take securities into inventory. We are a very large issuer in the commercial paper market as are most large corporations. That's how we fund our day-to-day liquidity needs. And it's often times our commercial paper dealers, one of which is Credit Suisse, cannot find a buyer for that security immediately and they take it into inventory. And that gives us the cash that we need to fund our operations that day. And they hold it on their balance sheet. And if they're not allowed to do that, they're unable to do that, it's going to push up the cost of borrowing for all of corporate America and slow things down frankly.

MR. COHN: Thank you again. Josh Cohn for International Swaps and Derivatives Association.

The suggestion was made, I think, that Dodd-Frank is pushing derivatives out of illiquid markets into the liquidity of clearing. I think that's wrong. Dodd-Frank provides for clearing of adequately liquid derivatives and it provides for a remaining OTC market.

The phrase has been used by people on -- let's call it both sides of the room -- real world. And I'd just like to mention a couple of points that I see as real world. One, we have a statutory mandate as others have mentioned and that statutory mandate is to protect certain functions within banks. Two, real world economic concerns. I think that we've heard from David, Kurt, Jeff, and Dan Rodriguez about what are actual real world concerns. And I think we need to take heed of those.

What I think we, as a derivatives industry, need to see in the Volcker context in the way of rules are reasonable and not chilling rules. And I'll give you an example of a particular statement in the draft preamble that I think resounds in the context of the conversation that we've just had. It is: regardless of the price degree of correlation, if the predicted performance of the hedge position would result in a banking entity earning appreciably more profits on the hedge position than it stood to lose on the related position, the hedge would appear like to be a proprietary trade rather than an exempt hedge. Now, I question whether that proposition, the proposition stated in that passage, is actually possible. But assuming it is possible, we have a hedge that is perfectly correlated and contains risks and yields profits. It's absolutely a magical transaction. We should want that. We should actually want that. We have fulfilled our risk reduction obligation and yet we are providing for profit in the institution.

What we're looking for is a rule that does not establish impossible cases and unnecessary and chilling admonitions. We need reasonable and not chilling rules that will lead to real continuing regulatory dialogues between covered banking entities and their regulators, between experts on the regulatory side and within the institutions, that will have an obligation of tracing reasonably correlated hedging on either a portfolio or on an individual basis according to a mix of business judgment and cost benefit analysis. I think that's really what we're looking for and very much hoping the regulators will produce.

MR. BERKOVITZ: Okay. I think we'll do Simon, and Wally, and Lynn, and Marcus, and then we'll take a break.

MR. SIMON JOHNSON: Thanks. Dan said that he sees a lot of faculty here and it sounded like a bad thing the way he said it. I see special interest represented here, a powerful special interest that receives a government subsidy. And it is natural. In fact, I think you have a fiduciary responsibility to your shareholders to seek to maintain that subsidy. I think you would probably be remiss and they would reprimand you if you didn't see it. I think it is in the interests more broadly of society to assess whether or not providing you with that subsidy is worth it. There are costs and there are benefits. And the representatives of the non-financial sector here, I think I'd put IHS in the financial camp given who paid for the study, but representatives of the non-financial sector here I think have highly relevant evidence. And there I would take up the point made by Lynn Stout, which is, how much exactly is being saved here? How do we weigh that against the catastrophic costs of allowing excessive risk to be concentrated in and around banks?

Now, Dan, when I have more time we can review my resume and my qualifications and my real world experience in a little more detail. Let me just mention that, among other things, I am the former chief economist of the International Monetary Fund. I don't see other IMF representatives here. Let me tell you their perspective and how they see the crisis and saw the crisis.

This is about banks. This is about allowing these risks to be unduly concentrated generating a massive negative social cost. The increase -- Chairman Gentler talked about many of the costs at the beginning. The increase in the government debt, federal government debt held by the public -- oh, I'm also a member of the Panel of Economic Advisors of the Congressional Budget Office but these are not my numbers; these are their numbers. The CBO estimates that the cost to us as American taxpayers of this financial crisis when all is said and done will be about 50 percent of GDP. Call that $7.5 trillion in today's money.

So we have to look at the cost. We have to go through David's study and we have to take up Jeff's very important interesting point, and we have to look at how big those costs are and how much you're sharing in a subsidy from the banks. I understand that. And we have to weight that against the measurable, repeatedly demonstrated social costs of these arrangements and having excessive risk in this way.

And to Josh's point that allowing some of these risks to continue is congressional intent, that's fine. But the question is how much risk and how are you going to manage that and what are the leverage requirements you're going to have and what will be the overall supervisory and regulatory position on how much you trust the banks to manage their own risk, particularly in the light of their repeated and even apparently recently demonstrated inability to manage, understand, and control these risks.

MR. TURBEVILLE: Thanks. I think one of the things that's important to take away from the discussion is that when you do a swap, you don't destroy risk, you shift consequences from one party to another. And what you're really doing is shifting the consequences of some price movement from the balance sheet of one company to another company. The other company being a bank. And so what's happening is that that risk is being transferred onto the bank balance sheet.

So not only are the banks being subsidized, their customers are being subsidized because when they shift the cost of shorting onto the bank balance sheet, it ends up being a subsidized cost. And I think that's what the

Volcker Rule is really -- is an important feature of the Volcker Rule, which is that shifting these things onto the bank balance sheets is something that's a very risky proposition because of the consequences if things go bad.

Now, whether it's a rule -- whether the rules say you can't do that activity or whether with capital rules and with leverage rules you say the consequences of doing that activity are very expensive, you tend to get to sort of the same place. But the point here is that yes, there will be a chilling effect. I think the Volcker Rule by definition says there will be a chilling effect on activities and one way or the other, whether it's activity prohibitions or whether it's increased capital it will have that consequence. And both the banks will have to address that and actually customers who have big positions to lay off or highly illiquid risks that they want to address.

MR. STANLEY: I just wanted to take up this issue of illiquid assets again since it seems to have created interest among the panel. I thought Dan's example of an un-hedgeable asset was actually really telling and interesting. I don't question that the Maiden Lane assets may well be un-hedgeable, but we need to remember what those assets were. Those Maiden Lane assets were precisely the assets that created the last financial crisis. They were the assets that brought down Bear Stearns and AIG. And in the case of the Bear Stearns Maiden Lane assets, they were the assets that were so illiquid, so opaque, and so risky that JP Morgan refused to take them on in the Bear Stearns bailout.

So, you know, it's entirely true. Assets like that can be very hard to hedge. But the question is do you want a bank making markets in those kinds of assets or is that a more appropriate business for a hedge fund? Because as soon as you're invested in those assets, you know, there's no two-sided market. So inherently there's a proprietary risk.

And going to some of the points made by the energy companies here, it's perfect, or actually let me mention this real world issue which is related. The point of the Volcker Rule is to change the real world. If you get done with the Volcker Rule and banks are not required to get out of at least some of their current businesses, lines of business, then you will have failed. The Congressional intent of the Volcker Rule, they're not putting you to all this trouble just so banks can maintain all their current lines of business. And one thing that I really saw in the bank comments and I'm hearing a little bit again today is that if a bank currently does something for a customer, then they have to be permitted to continue doing that thing for the customer under the Volcker Rule. And that's just not congressional intent and that's not the point of the Volcker Rule. The point of the Volcker Rule is to change the financial system.

So the question that you should be asking yourself is that if a bank gets out of this line of business, is somebody else who is a non-bank who is smaller, who can fail, who doesn't have either an explicit or implicit subsidy, can they pick up this business? So I think it's perfectly natural that an energy company might want to sell forward some of its production for a field that's developing in Northeast Dakota or something or, you know, in South Dakota or something like that or North Dakota. And that selling that production forward might not be doable on a deep liquid exchange trading market where there's a two-sided market in energy derivates. But there are many non-banks who are going to pick up the challenge, I believe, of buying that production from that specific field. And that may not be something, a business that we want banks to be in because it is inherently very difficult to hedge and very difficult to risk manage.

MS. STOUT: I'm always glad to focus on the real world. I actually view that as my specialty, not just as an academic, but also as the director of a mutual fund family where I represent hundreds of thousands of individual investors who have not been doing too well lately sadly.

So while we're on the real world and while we're on numbers, I think it's certainly within the commission's realm of acceptable evidence to consider that weighed against the study of the hypothetical loss of 200,000 jobs that Kurt mentioned, I believe, in 2008, the U.S. Economy lost 2.6 million jobs. So when we're weighing costs and benefits, I certainly think if we're going to measure them in terms of jobs rather than dollars, that is also a number worthy of considering. Thank you.

MR. COHN: Two quick comments. It goes to several prior comments but focused on the Maiden Lane assets. I think it's important for purposes of this conversation to remember what we're talking about and the fact that the Maiden Lane assets were not hedging assets. They were not part of any bank's hedging business, nor were they part of any bank's derivatives market-making activity.

MR. RODRIGUEZ: Just two quick points. The banks have responded to the Volcker Rule already. A lot of proprietary trading desks are shut down completely. We're out of that business. We've been focusing on market making. We're focused on client flow. And just to read this, you know, this is from the Volcker Rule. Permitted trading on behalf of customers. Supervision on proprietary trading does not apply to the purchase or sale of covered financial positions by a covered banking entity on behalf of customers. So the notion is that we're doing transactions on behalf of customers and trying to conduct those transactions in the most risk-efficient way possible.

So the Volcker Rule has already had a tremendous impact on the industry. I'll cite two quick examples. Thirty percent reduction in trading volumes across cash equities. Okay. Big reductions already as I would say part of that is due to the Volcker Rule. So they've already reduced liquidity across the industry. So these deep liquid markets that we thought we had have become a lot less liquid over the last 18 months.

Now, it's difficult. We would have to do a very detailed academic study to determine what the proportion is due to Volcker versus other factors out there. There's a lot of other factors. I'm very familiar with those. You know, I do know from operating in the markets that a portion of that is definitely due to Volcker. Volcker has had a non-zero impact. How big that impact is is difficult to estimate. But I think on the illiquid structured products, we do continue to do those on behalf of customers. And so I think linking the comments made by Josh and some of the other panelists here is that, you know, that's an activity that the Volcker Rule wants us to continue to do on behalf of customers in the most risk-efficient way possible and the regulators need to continue to supervise that activity. And then to understand where there's any excessive buildup of risk. And they need to measure those risks in a number of different ways.

And then the final comment. I think this notion of there's all this destruction in the financial markets in 2008. That was not due to proprietary trading on Apple stock or Google stock. Okay. So when people say there's millions of jobs lost because of some trading activity, that connection I think -- that connection is, I think, very difficult to make here. There were some specific trading activities that exacerbated more deep-seated structural problems that go back to the overinvestment or over allocation of capital into the U.S. housing markets. So that's a very different discussion of what caused the financial crisis. So to say that the Volcker Rule is going to fix the financial crisis or prevent a new financial crisis from happening, that's not the case. It suggests that trading equities or corporate bonds from bank trading desks caused the crisis and caused the loss of eight million jobs as Simon, you know, insinuated and Lynn over here insinuated, I think we need to make sure that we take those comments with a huge grain of salt and acknowledge that the connection there is stretched at best.

MR. BERKOVITZ: Okay. Why don't we take a 15-minute break until about a quarter til and we'll start off with Bob after the break. Thank you.

(Recess)

MR. BERKOVITZ: Okay. Why don't we get everybody to resume. If everybody wants to come back, please. I think we had a couple of participants who have comments. We'll go to those, and then we have a few questions related to the hedging that we'd like to pose to the panel which we'll get to after the next couple of comments.

MR. PARSONS: Yeah, thank you. John Parsons from MIT.

I wanted to address one point that has been made a couple of times having to do with whether or not if certain kinds of banks can't do certain types of activities, will anybody else do it? One comment was made that some of us perhaps have too much faith in the market. Since I am an economist, it's in my union card that we're supposed to have faith in the market so I'm not exactly upset about being charged with that. But it's not an unfounded faith, and I think it's sensible to worry about whether or not new institutions, new businesses will move in because sometimes there are obstacles to that. Sometimes there are barriers to entry. Sometimes there are special subsidies. There was a long list of possible reasons why other companies might not take up the slack. And it's worthwhile to ask that. But I haven't heard any explanations of such things.

So just to be concrete, let me give you two examples. So one of the studies that was discussed here where big numbers were thrown out, like 200,000 jobs by Mr. Barrows's company, IHS CERA, which analyzed the impact of the Volcker Rule on the energy industry, if you get beyond the 200,000 headline number and open up the study and look at it, it has as one of its premises that if the Volcker Rule stops the banks from doing all these things -- 1, 2, 3, 4, 5, 6, 7, 8, 9, 10 -- and here's the big one -- and if nobody else does it, then the world collapses.

But there is no explanation at all of any reason why nobody else might do that. And that's what we need in order to get a handle on this issue. Give us something. Certainly, the CFTC needs to be provided with some substantive foundation before you can take numbers like that seriously. Now, the IHS CERA study was financed by Morgan Stanley. And Morgan Stanley provided a comment letter to the CFTC focusing on some of these issues related to the Volcker Rule. And I'll just, for the sake of time, pick out one specific example. Morgan Stanley provides an example about how Morgan Stanley serves the interests of certain airlines by acting as a supplier of jet fuel. Managing the logistics of the jet fuel, managing the price risk and so on and so forth.

Well, that's all well and good. It's a

perfect example of something that could easily be provided by somebody else. There's absolutely no imagination why a bank holding company needs to be the supplier of jet fuel oil logistic services to an airline. Shell Oil can do the same thing. BP can do the same thing. Exxon can do the same thing. Or some new company can do the same thing. There are historical reasons why it happened to be that banks chose to provide that service of late, having to do both with some expertise in price risk management but also with various subsidies. And we're talking about taxpayer subsidies for the credit risk. But there's no substantive business reason why that has to be done there.

So I think as the CFTC is analyzing these supposed costs and analyzing these suggestions about particular activities that might be damaged because of the Volcker Rule, it would be wise to scrutinize and ask for is there a real barrier? So far as I've been going through the studies, like the IHS study, the barriers are assumed; they're not explained, exposited, and demonstrated. And similarly, when I looked at comment letters like Morgan Stanley's comment letter, the situation is the same. There are no substantive economic barriers provided. So I think there's no reason to have unfounded fear. Excuse me, there's no reason to have unfounded trust in the market, but there's also no reason to have unfounded fear. We need to have substantive evidence-based discussions of this thing, and the ones I've seen for the particular activities like Morgan Stanley providing the jet fuel oil logistics are just the type of thing that easily can be provided outside of the taxpayer subsidized banking system.

MR. BERKOVITZ: Dan.

MR. RODRIGUEZ: I guess not to necessarily defend Morgan Stanley in that particular study, I haven't read that. I have read excerpts of it. And I guess the issue is that if the market has decided to -- well, first of all, the Volcker Rule is designed not necessarily to prevent banks from engaging in market-making activities, customer trades, and hedging activities. So first of all, you'd have to rewrite the law if you don't want these things to occur anymore in banks. Secondly, if the marketplace has already decided to go ahead and execute these transactions in the way they're executing them right now, that is prima facie evidence that the market has decided that this is the best way that they wish to do it. No one is forcing United Airlines to hedge out their jet fuel risk with Morgan Stanley right now. They've chosen to do that. So the notion is, not to say that they couldn't do it with someone else, but right now they've chosen to remain with Morgan Stanley.

MR. BERKOVITZ: Kurt.

MR. BARROW: Yeah, I guess I just come back to the point of why are we talking at all about taking the banks -- taking these services away from the banks? Congress said that banks -- the Volcker Rule says banks shall not participate in proprietary trading. Fine. That's clear but it allowed exemptions for market making and hedging. Our understanding of how those rules, proposed rules have been set is that it's nearly impossible to do your day-to-day commodity trading business, you know, for the banks to do that and provide those services. So de facto, they're out. And so that's really -- that was really the crux of our study and the basis on which we developed our numbers. Granted, we assume the banks completely curtained their activity. At the same time we looked really just at a subset of the energy industry.

So, you know, back to the point of 200,000 jobs compared with millions and millions of jobs lost during the economic meltdown, completely unrelated. Completely apples and oranges. You know, we looked at a very narrow part of one specific industry, not the economy wide. And that's it. Thanks.

MR. ROBERTSON: Thank you. I'd like to address the issue of who provides the services from really two perspectives. One is who might step in if a bank were not to provide these financial risk mitigation products because the regulation is either too onerous or just practically they can't offer them due to restrictions. And I think we all have short memories because if there was probably one most critical point in the crisis, it was not a bank. It was AIG. And it was AIG with its credit default swaps that brought down tremendous systemic risk to the point where the government went in and subsidized it as a bailout. And so what we're talking about is taking potentially significant financial risk activity out of the banking industry and putting it into other industries that are not as transparent, are not as regulated, and in fact, intensifying the systemic risk of the industry. So my concern is not a lack of trust in the market, but it's a concern that this risk activity doesn't go away but, in fact, it does get supported outside of any prudent regulation. So that's the first point I'd like to make.

And then the second point I'd like to make is really from the standpoint of the social good that banks provide to corporate treasurers and CFOs. When banks have a full array of financial products and solutions they can deliver to corporations, they can work collaboratively with those corporations to structure the best approach for that particular corporation. It might be an underwritten debt instrument that might even have an embedded option in it. It might be something placed on the bank's balance sheet with some kind of a swap attached to it. So they're able to take myriad products and tailor them specifically to the needs of corporate treasurers and CFOs. And so to the extent we're talking about significantly restricting the ability of the banks to offer products that can be prudently managed, we are actually restricting the ability of the banks to deliver products that enhance the financial operations of companies.

And just one final point on the jet fuel logistics, which I hope jet fuel logistics did not cause the crisis -- I'm pretty sure they didn't -- but one reason why you see some operating products linked with financial products is that corporate treasurers and CFOs gain great benefits from banks integrating the financial and physical supply chains together. So as an industry, the CFO chain of command spends roughly $1.8 trillion on its financial operations. Banks today provide fee-based services that are just under 10 percent of that. And by actually knitting together cash management products that help with the flow of money across borders, and pooling of cash with physical logistics and data around actual trade settlements, they're able to deliver great value to CFOs and treasurers. Thank you.

MR. BERKOVITZ: Actually, while I've got you at the microphone, or any of the other energy market participants on the buy side, I was interested, in light of some of the comments on the previous discussion, in terms of whether the standards, for example, in the proposed rule is to whether compensation should be based on profits from hedging, whether hedging operations should make profits, what is the practice, say, in the corporate world or in the energy companies, the companies who are actually hedging risk, not the banks, but energy companies, to what extent are the operations in the companies themselves, to what extent do they see profits from hedging? Or to an extent is it viewed as something if you're even, you're doing well as compensation of the traders or the people who put on the hedges? Does that depend upon how successful or how profitable those hedges are? So how is it done on that side of the equation?

MR. AGOSTA: Well, speaking -- this is Jeff Agosta with Devon. Speaking, as far as our company goes, there is no remuneration associated with hedging profits or losses. We put in place natural gas and oil hedges in order to ensure a baseload of cash flow. It's actually in our best interest if those hedges are out of the money because that means that prices have risen above the price that we've hedged them at. And the rest of our unhedged business is actually doing much better.

So but, you know, we go about our hedging operations, like I said, to ensure our baseload of cash flow so that we can make investment decisions. I had a question at the break about, you know, why we do what we do. And it's because the nature of oil and gas operations -- and I'm sure it's the case with other commodity producers -- that the decisions that you make in a current year often have impacts for years in advance. And so we're making commitments today for drilling activity that we won't conduct until next year. We need to know that we have some base level of cash flow available to us to fund those operations. If we don't have that ability to do that, then what it's going to cause us to do is be much more conservative in our capital allocation decisions. And it's not just our company but every other oil and gas operator in North America. We would not be where we are today -- I forget who mentioned it before, but we would not be where we are today in the growth in oil and natural gas in North America had it not been for the ability of our companies to lock in that base level of cash flow for 2008, 2009, 2010, and 2011, because commodity prices absolutely collapsed in 2009.

Our company was actually unhedged in that environment. Okay, in 2009. We went into that unhedged. We took our drilling rig activity from a peak of, I think, about 124 rigs in 2008. We took it down to 24 in 2009 because we were unhedged. We didn't have that baseload of cash flow. There were other companies, our competitors, that were hedged. They were hedged at very robust prices, and their rig activity maybe declined a little bit, but it didn't decline by 100 rigs. And so you could see the dramatic effect. If our industry was unable to lock in that base level of cash flow, it would just introduce more volatility into the activity.

CHAIRMAN GENSLER: Can I just follow up because I'm listening to this and you caught my attention. You went from 124 rigs to 24 rigs, which I would note was probably somewhat related to the risk of Wall Street spilling out to Main Street. And I would call Devon -- you're not Wall Street, right?

MR. AGOSTA: Right.

CHAIRMAN GENSLER: So if I can use the vernacular, you're Main Street.

MR. AGOSTA: Right.

CHAIRMAN GENSLER: So Wall Street comes crashing down. We've got the financial crisis and you go from 124 rigs to 24 rigs. That's the risk or its one part of the risk that Congress was addressing of let's lower some of the risk of these very large complex financial institutions posed to the rest of society. I would note 94 percent of private sector jobs are non-finance. It's only 6 percent in finance. And even of that 6 percent, it's probably less than one of those six percent that is really kind of Wall Street because there's the community banking system, there's the pension fund system, the asset managers, insurance companies, et cetera. So probably less than 1 percent of our jobs in America.

Now, it's an enormous part of our economy, but it came crashing down when you came from 124 to 24 rigs. So I'm just noting that. That's what Congress, and that's then ultimately what we regulators are trying to accomplish. And at the same time I think there is a complete, not only acceptance, but support amongst the regulators and the administration that swaps and futures be used both in standard form and customized form to help end-users lock in a price. It could be a former rancher that's locking in a price at harvest time, and then they focus on that which they do best. They focus -- it can be an oil company or a natural gas company that's focusing on what they do best -- exploration and production and milling and conforming. And lock in a price and then focus on job creation and economic growth but when you lock in a price that the party on the other side is well regulated and isn't concentrating so much risk that might just spill out so that your rig count comes down. And the Volcker Rule is one small piece of that. But I sort of wonder and it's a question, why an end-user like yourself would be, in essence, advocating for the Wall Street firms to keep so much risk on their balance sheets?

MR. ACOSTA: Well, I absolutely --

CHAIRMAN GENSLER: I mean, because that hurts you in your rig count in '09.

MR. ACOSTA: Well, specifically to that point, to the rig count, our drilling activity, it was reduced because commodity prices dropped so dramatically. Our cash flows -- our cash flows probably were cut in half.

CHAIRMAN GENSLER: It was only because --

MR. ACOSTA: Right.

CHAIRMAN GENSLER: But the crisis took energy prices.

MR. ACOSTA: Sure.

CHAIRMAN GENSLER: I mean, there was an asset bubble and the energy prices were high. But then it went cascading the other way, too.

MR. ACOSTA: Right. And I would argue that hedging and derivatives had almost nothing to do with the financial crisis and it was just a massive amount of leverage in the financial system overall.

CHAIRMAN GENSLER: We might have a different view. Credit default swaps in AIG might be Exhibit A on the other side.

MR. ACOSTA: Exhibit A, I agree with that completely. Exhibit A. And unregulated insurance, a financial products branch of an insurance company.

CHAIRMAN GENSLER: It was headquartered in London.

MR. ACOSTA: In London, right.

CHAIRMAN GENSLER: I just want to make sure.

MR. ACOSTA: Make that point. But I am absolutely all for strong regulation of the financial institutions. Please don't misunderstand me in any way, shape, or form. I am absolutely for that. What we are a bit concerned with in the Volcker Rule is just the potential for hindsight 20/20 second guessing what a firm is doing. A firm may be legitimately providing us with a financial product.

CHAIRMAN GENSLER: Which should be -- that's at the core of making sure that the economy works, that you can hedge your risks.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: I'll call it the 94 percent.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: And plus the insurance companies.

MR. ACOSTA: I'm a bit skeptical of the fact that there would be other parties stepping in to fill a void if the banks got out of this business all-together because we saw a firm, a hedge fund by the name of Amaranth that came to visit our company in the middle part of Alaska, holding itself out to be a top five dealer.

CHAIRMAN GENSLER: But, see, I think the

challenge for us regulators, and then I'm going to hand it back, I think the challenge for us regulators is to permit that market making to the end-user community. The end-user community can lock in a price and using swaps and futures, but not have the banking entities retain so much risk that's proprietary that it's just, well, I think, you know, I'll keep $10 billion of oil risk because I think oil is going up or down. That they properly hedge themselves as you hedge yourselves. That they run something closer to a matched book.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: It's never going to be exactly a match but I think that's the challenge. And where we can get help from the banks and from the market participants and the investor advocates on how to do that, but I'm just sort of intrigued and it came up to the table because end-users are out of central clearing.

MR. ACOSTA: Thank you.

CHAIRMAN GENSLER: I believe that

Congress was clear in the intent that they not be caught up in any mandatory way into margin on non-cleared swaps. And we're doing everything on the international stage and with international regulators. You know where the CFTC is on that.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: And we've given a lot of deference and thought -- hopefully thoughtfulness on the end-user issue-- when we came to the swap dealer definition and so forth. If this Volcker Rule becomes a debate about end-users, something seems to be, with all respect, a little upside down.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: Because I think Wall Street and the financial community is why your rig count went from 124 to 24 in part. And we should be trying to get this balanced so that you can hedge, that they can market make, but they not retain what is in essence proprietary risk.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: But absolutely that

they market make and that you can hedge.

I'll hand it back. Sorry. Simon, do you have any view on this? (Laughter)

MR. SIMON JOHNSON: Yes, I do. I think, Chairman Gensler, you asked one of the big fascinating questions of this whole debate, which is why do so many non-financial companies come out and speak in favor of pretty much the Wall Street position? And I think with all due respect to people here today that the answer goes back to the subsidies.

Now, Dan, I'm also on the Systemic Resolution Advisory Panel committee of the FDIC, and I do have a lot of respect for what they're trying to do implementing Dodd-Frank in terms of resolution for the global megabanks. But honestly, it's a very tough technical problem, particularly for cross-border operations. And it's not clear to anybody that it's going to work. So there's still a potential -- there's substantial support there more than just the taxpayer support on the deposit insurance. So I think that the non-financial companies are getting a piece of the subsidies.

CHAIRMAN GENSLER: So you're -- I can't believe I'm having a conversation with an MIT esteemed professor because I couldn't quite go there. But you're suggesting that the non-financial participants in the market are being rational in their advocacy because they may be transacting with parties who have a subsidy, the banking entities? And that somehow these rules might be costing them because the subsidy might go down?

MR. SIMON JOHNSON: That is my rational -- that is a rational explanation for what we're observing here. The end-user --

CHAIRMAN GENSLER: I was just trying to explain what you were saying. I was trying to make sure -- it's your point, not my point.

MR. SIMON JOHNSON: That is my point. And the End-User Coalition, so-called during the Dodd-Frank financial reform legislation, was very closely aligned with Wall Street interests. And as you said though, very clear (inaudible) in Congress was adamant that you should protect exactly, as you said, the legitimate hedging needs of the non-financial corporate sector. And yet we're still finding them aligned.

CHAIRMAN GENSLER: We've protected that and we'll continue to protect that.

MR. ACOSTA: It's very much appreciated.

CHAIRMAN GENSLER: Yeah. Yeah. I've taken the blood oath. But Simon's raising an interesting point that it might be a broader economic about subsidies.

MR. SIMON JOHNSON: Yes. I'm with John Parsons and with Lynn Stout on this point that if there's value in the transaction, then somebody will be providing that. And the idea that only the big banks can provide this kind of hedging service to you just seems at odds with everything we know about economics and economic history. From an academic point of view, Dan, and from a real world point of view. But perhaps there is a subsidy that's being shared through these markets.

That's entirely possible. And then for a subsidy you should be assessing, as Lynn said, the costs and the benefits. And there are absolutely big social -- it's like a form of pollution. There are big social cost scores when you generate systemic risk. And the complexity and nature of derivatives, when you concentrate the risk on the balance sheet of the global megabanks it's definitely a significant systemic risk.

Oh, and to your point about AIG and to Chairman Gensler's point, of course that's important. Dodd-Frank also addressed that by creating this category of systematically important financial institutions. So we can -- it is correct to worry about what goes on in the shadows. Everything should be regulated. Everything should be covered in the same way. And Dodd-Frank does that. And the regulators are absolutely on that case as well.

MR. ACOSTA: And maybe I could just address the question of why we care about the banks staying in this business and why we advocate similar positions. You know, it's because they're the parties that are making the market. They see oil and gas producers. They see oil and gas consumers. And I don't want to leave out all the other commodity producers because they're also very relevant. But, for example, Morgan Stanley providing jet fuel to an airline, well, they're buying oil from companies like us. And they've got some logistics, pipelines, and other infrastructure that facilities that transaction. And I don't want to necessarily get into the subsidy debate because I am a taxpaying American citizen as well and I'm not fond of bailouts either. So I'm just trying to provide maybe a rational explanation as to why they're a logical party because they deal with us, they deal with utilities, they deal with airlines. They deal with every industry in America. And we don't necessarily deal with all those.

MR. SIMON JOHNSON: Can I ask a question? What is it? This is to John's point, what is it that the banks have in terms of innate ability, physical capital, human capital it can't move, that makes them uniquely capable of providing those services as opposed to somebody else in the marketplace. Then they have an advantage, I think you're conceding, I think it's obvious that they have an advantage because of the backing from the taxpayer. So they get a pricing advantage. We get that. What advantage do they have other than that? If you remove the pricing advantage, why can't other people provide the same integrated bundle of services? Or you buy the services in a less integrated fashion.

MR. ACOSTA: They're, in theory, far more credit worthy. I mean, I was going to give the example of Amaranth.

MR. SIMON JOHNSON: Because they're backed by the U.S. taxpayer. That's the credit subsidies.

MR. ACOSTA: I'm not going to debate. I don't want to debate that with you, but I want to just give you a real life example of why we prefer to transact with these firms. We also transact with BP and Shell and others, but these parties, they have the technical capability, so the intellectual capacity to do these types of things, the creativity. Okay, for example, I can go out. We can all go hedge a barrel of oil at NYMEX. Okay, the WTI that we all see quoted on CNBC every day. That is for physical delivery of a barrel of oil in Cushing, Oklahoma. Okay? Not everybody produces crude oil proximate to Cushing, Oklahoma. So these firms facilitate the transactions at different delivery points throughout North America. And then they provide -- they may be buying product from us in Central Texas and they may be delivering it to a utility customer in Atlanta, for example. They just facilitate that movement of vital energy resources across our economy. And it's just that they have that -- they face every industry in America. Right? They deal with everybody. And so they have a unique role that they're playing within our economy that allows them to see a need on our part to get product to market, and a need on another customer's part to own it somewhere else. And they have the ability to link those two up.

MR. SIMON JOHNSON: There are no measurable economies of scale in scope and banking over $100 billion in total assets. A lot of people have looked at this, including people hired by the banks. You can't find those economies of scale and scope. This country was not built on big banks, Jeff. You know this. Fifteen years ago the top six banks in the United States had total assets around 15 percent of GDP. Now they're over 60 percent of GDP. The energy sector was not built around services provided by big banks. There's 15 years of those banks becoming bigger. It's actually been associated not with the boom in the non-financial sector, not with unprecedented productivity growth. Quite the contrary. And with the buildup of these very large risks that came, unfortunately, to fruition in 2008 in you, the taxpayer, and all of us as taxpayers, massively.

CHAIRMAN GENSLER: I was just going to

say one thing and then I'm going to step away from the table. There are costs and benefits. A lot of people focus on cost and benefits. There may be, and I think Jeff is highlighting it in Simon's discussion, there may be some costs that large complex financial institutions will do less proprietary trading. And Jeff is possibly contending by extension that if they do less proprietary trading they might do less facilitating of the market making you would like. But Congress has been pretty clear. They've weighed and balanced and they said there should be less proprietary trading. Prohibited, in fact.

So, and why? It's because there were benefits. Benefits of not having eight million people, you know, out of work and your rig count going from 124 to 24, et cetera. Now, there were a lot of reasons other than proprietary trading. So Congress is sort of, you know, so our job as regulators is not to, you know, sort of re-litigate that question or re-legislate that question but to try to find the balance allowing market making but prohibiting proprietary trading. And permitting risk mitigating hedging at banks that, again, lowers risk to the taxpayers rather than increasing risk. And hopefully that's when I leave the table what it'll go back to.

MR. BERKOVITZ: Dan, go ahead.

MR. RODRIGUEZ: Yeah, just to echo the Commissioner's words there, I mean, this exactly -- proprietary trading has been reduced dramatically across the industry by any measure, whether you look at gross book sizes, net exposures, you know, scenario exposures, valued risk measures, by any metric. And I would, you know, suggest and Credit Suisse supports a metrics-based approach. You want to reduce risk. Let's measure it, you know, every which way that we know. Continue to evolve those risk measures over time.

So, yes, we in a banking institution, want to reduce systemic risk. It's very important for us not to have dramatic systemic risk cross the industry. Banks do much better when the economy is growing. 2011 was a challenging year for financial services, for banks in particular. 2012 is going to be an even more challenging year. Why? There's still a lot of systemic risk right now emanating mostly out of the sovereign debt issues in Europe. I would point that by any metric, proprietary trading has been significantly reduced, and I would say in some institutions by most measures, eliminated. And I would put Credit Suisse in that category by, you know, whatever metric, you know, by an agreed-upon series of metrics that we could put out there. And I think this notion of cost and benefits is very important. So yes, we've achieved less proprietary trading.

Two, there is this issue of a subsidy. We were fortunate throughout the crisis not to be, you know, participate explicitly in the TARP program. However, we understand that there is this notion of a subsidy out there. I think that the FDIC's effort to have resolution authority and, you know, the bail-in concept I think to a degree can address that problem. It says, hey, let's be very explicit about mitigating that subsidy and the potential, as Simon says appropriately, there's potential negative externalities associated with excessive risk taking. So if we have negative externalities associated with that excessive risk taking, then we want to go ahead and reduce that in some efficient way, you know, without killing the positive benefits of hedging activities.

So I think that we're actually much closer on this issue. The banker wants less systemic risk. We've accepted that yes, there's going to be a lot less or completely eliminate proprietary trading. However, as the law suggests, we do want to continue to support, you know, market making activities and hedging activities for our clients to the extent possible within the risk metrics and the capital requirements established under, you know, rules like Basel III.

MR. BERKOVITZ: Okay, Bob.

MR. COLBY:: : I want to speak to a technical point but it's not very interesting so I'm happy to wait until after this conversation plays out.

MR. BERKOVITZ: I think actually it may be helpful to -- we've got a couple technical points, questions to ask, too. So why don't you go ahead.

MR. COLBY:: : Well, I just want to say as Chairman Gensler said, you have a difficult task because the statute puts in an express risk mitigating provision exception. And it expressly applies that to aggregate positions. So it picks up a properly construed portfolio margining as part of that. But the task is how do you then apply this in a way that's faithful to the statute but doesn't -- but also permits hedging? And it seems like Congress meant to permit hedging but do it in a way that doesn't overly constrict it but it's faithful to the purposes.

I mean, this is difficult in part because a number of the hedges I think that firms would have wouldn't even technically be within the rulebook but for the status test under the trading account. But because of the status test, if your bank that's a swap dealer in your world, they will be under the trading account and therefore, they have to have an exception for the hedges.

I'm Bob Colby from Davis Polk speaking for SIFMA and FIA. Sorry about that.

So you have to -- so the rule as expressed takes the general exception and then says there are a number of factors that you have to satisfy. And the concern as other people have said with some of the factors is that it does not introduce any significant new risks. But in your world new risks will be introduced. And sometimes they'll be significant because either you're going to have a clearinghouse that's your counterparty or you're going to be in an over-the-counter swap and you're going to have someone that has a riskiness to it as your counterparty. And that's a new risk. And sometimes, depending on the nature of the counterparty, it can be significant. And it has to be reasonably correlated but correlation is not always easy to judge. And it can change. And it certainly should -- that's certainly an important part of assessing when you have a risk mitigating position. And you're going to have --

And then another factor is that you have a compliance structure that's designed. And it's quite an extensive Appendix C compliance structure built up with governance and with audit responsibilities in management. And this compliance structure, if you have it work right, is going to be checking all these things and they're going to be putting on constraints based on the factors. And also, these entities are going to be intensely supervised. So if they're banks, they have bank regulators watching them. You're going to be intensely supervising them when they're swap dealers. And so the SIFMA members' point of view is that just as a technical matter the rules should be written, drafted differently.

It should retain the general statement about that there's risk mitigation hedging. And then the factors should be changed from something that loses the exemption for you, to guidance that's then applied by the supervisors as part of their intensive supervision.

I told you it wasn't interesting.

MR. BERKOVITZ: Let me also ask a technical question on the issue of portfolio hedging. The statute says that the risk mitigating hedging activities need to be designed to reduce the specific risks arising from individual or aggregate positions. And that's permitted. Some commenters have urged that it would actually be the specific desk that incurs a risk, be the one that would have to put on the hedge. If you're hedging a specific risk it should be the particular desk that puts on the risk or those aggregate risks. That's where the hedge would have to originate in order to qualify for that because some firms may have a whole separate office designed for portfolio -- to hedge portfolio risks and the concern that has been raised with that is that that can just be used for virtually anything. It's not tied to specific risks. So I was wondering if there are comments on whether -- how many different levels up in an organization should these -- can these risk mitigating activities occur? Should it be at the particular office where the desk where the risks are incurred or can it be several levels up in an organization? Can you have a different office for the hedging than actually incurring the risks? Interested in any comments on that.

MR. RODRIGUEZ: I mean, it really depends on the structure of the desk or the trading activity that you're supervising. If it's, you know, a fixed income desk you may have a lot of different bonds here across a number of different countries. If you have enough liquidity to hedge that effectively you may have country-specific hedges or you may want to have more generic hedges. So there are different levels. I think you need to have as much flexibility as you can to allow degrees of freedom but while measuring very closely and supervising very closely the overall level of risk. So these hedging activities as people have mentioned here have to reduce the overall level of risk.

And so what you really need to look at is you need to have a number of these different metrics. And I think, you know, something that we have to continually focus in on is one: how are we defining risk for these activities? Are we looking at a valued risk measure, different correlation metrics, economic relationships between different positions? You know, volatility over time. Forward-looking volatility, backward looking volatility. I mean, a lot of these different metrics that I think that we have to continually evaluate. And for just certain hedges you will do it at a lower level. Other hedges you may have to do it at a higher level. And the risk mitigation of those different hedges. But the risk mitigation of those two different hedges should be visible. It should be measurable and quantifiable. And I would say that there are a number of standard, you know, industry metrics. You know, we know a lot of those -- VAR, scenario, net, delta, gross book size -- that would be helpful in supervising that. And working with the supervised entities in establishing that. I think something that we have to continuously evaluate. But you'll need to do the hedging at a number of different levels. And ideally, you should be able to see that at the, you know, say at the division level or regional level.

MR. ROBERTSON: Hi. Thank you. I just wanted to switch gears a little bit and talk about how a bank treasury department has to look at risk. And if you think about it, I think we tend to think about the financial instruments being hedged where you may have a very clear instrument and the hedge is much simpler, but in fact, banks are intermediating all kinds of liquidity, credit, basis, other risk on their balance sheets. They may be putting on deposits which look to be an indeterminate maturity. They can have mortgages.

And what you're looking at are instruments with tremendous convexity. There are threshold impacts of how they behave under different macroeconomic scenarios. And to some extent this is a very challenging financial risk to model at a portfolio level but given the flexibility to model that at a more aggregate level can actually diversify risks better. And at some point you can't literally hedge each deposit. So a bank can't hedge the risk of a deposit from Shell or a mortgage from a very specific consumer. They do have to look at some of these things at an aggregate portfolio level. And for that reason, the more flexibility that's provided in looking at the structure of the hedge, it's going to make for better economic decisions.

MR. SIMON JOHNSON: My specific suggestion is not to allow this to take place in another country, including London, for example. So we don't, I agree, know exactly yet what happened with JP Morgan Chase but we do know that the so-called hedging operation, if it was a hedging operation, was in London. And we know that AIG Financial Products was in London. And I think being able to move or again "hedge" risks across jurisdictions is very problematic. Cross-border resolution is the biggest problem that the FDIC and others have to deal with when thinking about how to liquidate in an orderly fashion any of these global megabanks. And if you're allowing them to move more complicated operations across borders, that makes the whole process of anything too big to fail much more difficult and perhaps makes it impossible actually. That by itself may make it impossible depending on how big the risks are relative to that total balance sheet.

MR. ACOSTA: Just to show my ignorance, if it's a hedging operation for the financial institution, it's done outside of the United States. So it's done in their London office. Do you all not have regulatory oversight over that if it's a U.S.-based financial institution?

MR. BERKOVITZ: Dodd-Frank has a

specific extra cross-border provision specifying under what circumstances it applies to activities outside the United States. Basically, if there's a direct and significant connection. We're actually working on guidance. We want to put out guidance for comment on that in the very near future as to how the provisions would apply in that context. And so some of these are very timely issues.

MR. SIMON JOHNSON: But in addition to the point of the legal jurisdiction, there is the issue of organizational span. To what extent any organization can manage and let's say they're aspiring to legitimately hedge but they're doing it across a much larger distance. Again, the anecdotal evidence that we have, which is not complete, suggests that this was part of what happened to AIG Financial Products and JP Morgan Chase. There's not lots of control within the organization for risks that are very big relative to the total balance sheet, in part because of the distance involved.

CHAIRMAN GENSLER: And I would note just three or four other examples. You might remember that Citicorp had something called structured investment vehicles. They were launched in London in 1988, incorporated in the Cayman Islands, and they had to be pulled back onto their balance sheet because they gave a guarantee through something called a liquidity put.

MR. ACOSTA: Right.

CHAIRMAN GENSLER: Though you could argue they maybe didn't have to. Bear Stearns' hedge funds, you might remember that little calamity. They were incorporated in the Cayman Islands. And Long Term Capital Management, that earlier distressed situation operating out of Connecticut but they, once again, it was the Cayman Islands. So this cross-border thing is very real. And so this recent event is just a reminder.

But I'm intrigued. I'm hoping Dan would have just answered your question yes.

MR. BERKOVITZ: It was yes.

CHAIRMAN GENSLER: Thank you. I just needed to hear him say it on the record.

MR. ACOSTA: So if you all have the regulatory oversight authority to look into --

CHAIRMAN GENSLER: If it has a direct and significant effect on the commerce or activities here in the U.S.

MR. ACOSTA: Right. I mean, it would seem to me that the banks would need the flexibility to be able to hedge at different levels. I mean, for example, the London office may know a lot better about their aggregate exposure to Europe, for example.

CHAIRMAN GENSLER: Right. But Simon's raised -- I don't know if it's in comment letters, but Simon's raising a point that if you put the hedge in one jurisdiction and you put the aggregate positions you're hedging in another jurisdiction, it might be a mismatch and get caught up in a bankruptcy regime or something like that. So it's helpful, I mean, for me to take away -- it might still be a hedge on an aggregate position but you want to align it in a similar jurisdiction that the underlying positions are in.

MR. SIMON JOHNSON: MF Global, now you mention other examples, would be a very good example where apparently, again, this is anecdotal and we don't have the full definitive record yet, but there is competing claims from U.K.-based customers and U.S.-based customers. And at least the payout -- the proposed payout is quite different between the U.S. and the U.K., in part because of the way that the liquidation has been handled. So that would be -- I think it's 30 cents on the dollar in the U.K. and 90 some cents on the dollar in the U.S. -- dramatically different. So the hedge in that case could fall under exactly this sort of differential treatment and fail for that reason.

MR. BERKOVITZ: Lynn.

MS. STOUT: I think the good news is we all seem to have reached a consensus that it's not in anyone's interests for banks, especially deposit-taking banks to suddenly experience enormous losses that lead them to fall. So that leads us to the question of why do banks have banks and other financial entities suddenly experience large losses that lead them to fail. And a lot of it, as we've seen, has been with bad derivatives bets. So what the Volcker Rule is designed to do is to reduce the chances that banks will suddenly experience enormous and unanticipated losses and fail. And it does this primarily by recognizing that when banks use derivatives to try and make profits, to speculate that is, they are inevitably taking on risks they weren't exposed to, thereby increasing the risk of a sudden unanticipated failure, which is why the Volcker Rule tries to prohibit proprietary trading but still protect hedging.

And by the way, you know, when I raised the possibility that the benefits of hedging are easily exaggerated, I didn't mean to suggest that hedging is not beneficial, just that the magnitude of the benefits are easily exaggerated. But now when we look at the possibility of banks losing money when they are doing what they say is hedging, we've got to ask ourselves how can that happen? It's understandable that you would lose a little bit of money hedging. Indeed, as Sheila points out, that's what you would expect to see; you're buying insurance. But what could have happened when a bank suddenly loses an enormous amount of money hedging? One possibility is that they were not hedging at all but in fact speculating. And that's one of the reasons why. And this is basic, but I think it's worth someone saying it. The problem with allowing banks to do portfolio hedging is that it makes it so easy for a bank to actually undertake proprietary trading for speculative profit and then after the fact claim to have been hedging. And that's why I will applaud the way the rule has gone to great lengths to try and make that more difficult by requiring banks that are doing portfolio hedging to discuss and to put in written plans for the sorts of hedging that they're attempting to do, to have compliance departments that make sure they're following their plans, to make sure they identify the specific risks that they're hedging against.

But even with that, the other reason why a bank that could truly be intending to hedge could suddenly find itself experiencing enormous and unexpected losses is that they just did a bad job hedging. Maybe there was a risk that they didn't appreciate and understand. Maybe circumstances changed, so something that wasn't a risk became a risk.

Sorry for that long introduction but it leads to a point. If you want to prevent banks from failing due to bad hedging, as well as to what's essentially proprietary trading dressed up as hedging, then you want to have monitoring at as many levels as possible. You want to have it be done in as many levels as possible within the institution, and you want to have as much information generated and provided to regulators so it can be monitored by the regulator as well. And the reason has to do with the complexity of information theory,but basically it's much easier for one person to make a mistake in judgment about a future risk than it is for a lot of different people coming with different baskets of information to collectively make the same mistake about the nature and the degree of a risk.

So that's just a general point for the agency. But if you're worried not only about proprietary trading dressed up as risk -- sorry, dressed up as hedging, but also against mistaken hedging, and I don't think you need to, you know, work too hard to think of all the cases we've seen where people have suddenly lost enormous amounts of money and then said it was basically a botched hedge, what you want to do is have as much information generated as possible. You want to have it reviewed at as many levels as possible within the institution and within the agency.

MR. BERKOVITZ: Wally.

MR. TURBEVILLE: It might be helpful to be clear about what aggregation is. It seems to me that as you aggregate going up a food chain, what you're really doing is taking positions and using them as internal hedges, one against another, so that it would be a bizarre result to allow hedging according to certain standards but then allow netting in the process of aggregation that's based on different standards. So it would seem to me helpful, especially since there's so much confusion about what does portfolio hedging mean, which was mentioned only in a footnote in the entire proposed rulemaking, but to be very explicit that in the aggregation process, that which is netted against one against the other has to comply with the same kind of standards that would be used if it were being used as a hedge in qualifying as a hedge under the rule. I think that would address some of the issues and concerns that people have.

MR. BERKOVITZ: Josh.

MR. COHN: We canvassed some of our members before coming down to ask about portfolio hedging to see if we could establish some principles. And what we found was that actually we couldn't; that each institution that we spoke to was managing its hedging differently at different levels of the institution according to its particular views of best risk management practice and cost efficiency in its hedging function.

And so what I think that says, both about the question of portfolio hedging, is that it's a varied activity and I think it has to be assessed on its merits and the context of the institution that says that it is carrying on portfolio hedging. The people we spoke to were reasonably confident that they could show the reasonable correlation that I think we all agree is required. The reasonable correlation with specific risk. But again, to come back to fundamentals, hedging is a varied activity. It's carried out in different ways in different banks. And that variety needs to be protected I think as Dan was saying. We hope to see flexible regulations out of the Volcker Rule writing effort that will fulfill the statutory mandate and also create a reasonable and a positive basis for hedging in banks subject to regulatory oversight. And we see that oversight as essentially a continuing conversational process between skilled risk managers on the side of the bank and equally skilled risk analysts within the regulators who understand that hedging is a dynamic process, that risk changes over time, and that there's a constant series of judgments that need to be made.

MR. BERKOVITZ: John.

MR. PARSONS: Yes. Directly to your question about the level, I think most of the trouble, excepting things like international, but most of the trouble with whether it's acceptable at higher levels would be resolved if one applies a consistent principle that these things need to be hedging specifically identifiable risks, measurable, all of the things that, for example, Sheila Bair was describing earlier this morning, continuing monitoring, and so on. That -- if that principle is applied consistently no matter which level you're analyzing the hedging, I don't think there'd be as much dispute. I think what you find is sometimes at these supposedly higher levels of operation, people want to be able to describe something as a hedge that doesn't satisfy these kinds of criteria. And so that's in a sense why people like to use something like portfolio hedging.

Just as a minor anecdote, I do note that JP Morgan's CDSs, at least if you look at the financial statements, do not qualify as hedges under the accounting rules. They don't satisfy the various restrictions. Whatever rules one wants to implement, my point is merely that if you measure that performance independent of the level, I think you will resolve a lot of the question here.

MR. BERKOVITZ: Jeff.

MR. ACOSTA: Two quick points. One is just because a hedge doesn't qualify under accounting standards doesn't mean that it's not a hedge or an effective hedge. I'm a CPA so I'm allowed to say this: sometimes the accounting rules are kind of screwy.

So, but another point about the whole hedging and proprietary trade. I think the big task for you all is in how you define these things because you have -- the way the proposed rule is written now, there's a lot of room for 20/20 hindsight, kind of gotcha kind of events to happen whereas several of the gentlemen have indicated hedging is a dynamic thing. Risk changes every minute of every day. And so having the ability to track that and having a risk management team at a financial institution that's diligent and vigilant and is closely at work monitoring that risk and working closely with you all to monitor that and report that accurately, I think that's the critical part of this. And it's a very, very difficult balancing act that you all have here to properly define these things so as to not quell the activity but actually continue to encourage it in a prudent manner.

MR. BERKOVITZ: Josh, and then I've got another follow up.

MR. COHN: I don't --

MR. BERKOVITZ: Okay. In regard to that point, in terms of what the expectation of the regulators would be and a couple points have been made regarding 20/20 hindsight and are regulators going to come in and judge everything retrospectively, I guess first just as a factual matter, CFTC, we don't have onsite examiners and we're not in the banks. We're just not set up that way. That's not how we're structured. It's not our mission. We're not certainly funded that way. And the resources that we do have, we're a small agency. We're around 700 people right now and significant new responsibilities under Dodd-Frank to monitor these types of activities on top of our additional responsibilities is certainly a challenge.

In terms of what the expectation of the regulator would be and what we could be, the proposed rule sets forth a program. Firms would have compliance plans. Hedging program, how they plan to conduct their hedging. And presumably, if the firm conducts -- under the proposed rule the firm conducts its hedging activities in accordance with the rule, there's flexibility in the proposed rule, the hedge recognizes, for example, what might start out reasonably correlated may evolve over time and there's accommodation made for that. But a number of panelists have expressed the concern that regulators are going to come in hindsight and that may be a deterrent to activities, entering into the activities in the first place. But given our limited resources, our inability to actually approve everything beforehand, that would be a virtual impossibility. I'm wondering is there -- what other way could this be done to address that concern given the fact that there's a program, presumably if a firm is conducting the hedging activities according to the compliance program and it's conducted in compliance, is that not a reasonable way to proceed or what suggestions -- how can we address this concern?

MR. ROBERTSON: Yeah. I think that's kind of the key point which is at the end of the day, within the jurisdiction of the CFTC, you're going to be much more about guidelines and frameworks and interpreting the rule. And I think this is a classic Type I, Type 2 error. Do you have very prescriptive guidelines that constrain the ability to have activities? Or are they so flexible that you allow, you know, unacceptable levels of risk into the market?

And I think from a corporate treasury perspective, obviously corporate treasurers want a very robust system that's prudently regulated. They don't want to crash, but I think the major issue is with these guidelines, is that going to slow down the ability of a provider to a "risk mitigation instrument" and to make a market in it? And so if we end up with something where the banks have to document, okay, I'm doing this as a hedge and I need to stop and actually do this, the market doesn't stop; it keeps moving. So I think the concern would be something that was so onerous that there had to be a documentation of intent. There had to be all these steps to go through to really almost barter each hedge one off of the other versus having a very fluid market where the market-making activities and the hedge activities are all within a trading flow that provides robust pricing. So I think the concern isn't so much somebody coming in and inspecting each individual hedge, but complying with a set of guidelines. Will those guidelines allow the market to remain fluid and dynamic?

MR. BERKOVITZ: Wally?

MR. TURBEVILLE: Yeah. The proposed rules are very wisely set up, I believe, to establish a set of metrics that to the extent activities deviate in terms of revenues or profit or loss, that's suggestive of activity, permitted activity that is, in fact, proprietary trading. And it's not a bright line. The results are intended to be suggestive of some activity that might be deviant. That all works great as long as the Chairman's description of taking risks and moving them off the bank book makes sense.

One of the great concerns is if a bank

tasks a risk where there's no reasonable expectation of what the outcome might be, in other words there's no market for it and there's no hedge for it and it becomes simply a risk-taking activity and in the energy area you end up getting into Morgan Stanley running line businesses to offset the risk, as opposed to moving it off your book, then those metrics may be difficult to implement. And the reason they're difficult to implement is because permitting that kind of a transaction, a flyer kind of a transaction where there's really no reasonable expectation of what the financial outcome is going to be to the bank, is actually not market making and is, in fact, taking a proprietary risk of the greatest kind, that which you can't actually offset very well except perhaps by getting into the oil business.

So the metrics are really good because they don't -- they're not intrusive, they're self-reported, and they suggest the possibility of being outside of the Volcker Rule but aren't determinative and will then simply yield to the discussion after the fact to see why either profits or losses, for instance, are greater than they should be; why risks on your book are disproportionate to the kind of business you're going to be looking at.

MR. BERKOVITZ: Simon.

MR. SIMON JOHNSON: So perhaps there is guidance or maybe even rules you can provide to the points made by Jeff and Josh with regard to the board-level supervision or monitoring. The corporate board. The board of the bank. Now, I know you don't want to talk about JP Morgan Chase and I'm reluctant to talk about them in their absence, but I guess I have no alternative, that there are -- concerns have been raised about the composition of their risk committee and the frequency with which it met, the people who were on it, their background in risk, the flow of information to the board level. And to the point that you need to hedge, and hedging is dynamic and the world is changing rapidly, presumably there should be an expectation, and you can help set that expectation, of who should be on the risk committee of a global megabank, what should be their competence, what should be the flow of information both directly to them and through ordinary managerial channels. That seems to be critical.

And also in this regard, there has to be oversight, I would think, over both the de jure and de facto compensation of the people who are running these hedging schemes. Again, I have no idea what the arrangement was at JP Morgan Chase, but if the people running this CIO, the entity supposedly doing the hedging, if they were being compensated on profit and loss in that unit, they're doing proprietary trading. If they're being compensated based on the overall returns of the firm, then I think it's hedging. It's a very simple test. And it's a test that can be applied by any board. It's a test that can also be applied in real time because obviously people can shift their personal holdings and you can have your own derivative transactions if you're a trader. And that needs to be watched as well with regard to determining whether or not this is prohibited proprietary trading.

MR. BERKOVITZ: We'll take Jeff and then we'll break.

MR. ACOSTA: Just one last point to build on Simon's point about who's involved in the risk oversight. I'm in the fortunate position that I get to deal with every financial institution on Wall Street. And I see certain institutions where the risk oversight people have also worked in the trading operations and vice versa. So there's a constant flow and so they know that at some point the traders are going to have to work in risk oversight so they treat each other with more respect, whereas others, the risk oversight committee is viewed like an internal audit or a policeman who's out to prevent the traders from making profits. And the traders will often go over their heads and get something approved outside of that risk oversight committee. So I think having the ability to move people into the risk oversight and into the trading operations is pretty critical.

MR. SIMON JOHNSON: And I don't want to put you on the spot, Jeff, or ask you anything uncomfortable, but at least by general reputation, JP Morgan Chase's risk control management operation was regarded as being very good until recently. So perhaps we should change a little bit the benchmark for where these organizations need to be. If a company like JP Morgan Chase could go from thinking all they had was 10 percent [inaudible] to recognize that they had -- I don't know what it is, two, three, four, but whatever the loss is, within a very short period of time, something is not going well on the frontier of technology with regard to risk management on Wall Street.

MR. COHN: I'm reluctant to take any lessons from JP Morgan Chase just being reluctant to speculate and I hope other people feel the same way.

MR. SIMON JOHNSON: I was hedging, not

speculating.

MR. BERKOVITZ: Before we break, I want to clarify one point. The question I think you raised about application overseas. The response that I gave was the general CFTC's -- the application of the swaps provisions of Dodd-Frank, which is Title 7 of Dodd-Frank, our swaps regulatory authority overseas to activities outside the United States. That's a direct and significant connection. There's a separate provision, the Volcker provision, is section 619 of the Dodd-Frank Act, that has its own provision talking about how it would apply to activities outside the United States. And there's a provision in the proposed rule regarding to which activities it applies. So I want to just make sure that there's two separate extraterritoriality provisions. There's one generally in the Commodity Exchange Act for the CFTC's jurisdiction; there's one specifically that states how the Volcker Rule applies. My previous answer went to the Title 7 and there's also this one in the Volcker provision itself.

MR. RODRIGUEZ: Before we break, I guess the notion about having split hedges, there is the definition of legal entities and where hedges that reside in different legal entities do not offset or net for capital purposes. So that split hedging issues does address the concern that Simon raised. And it's important maybe to just reinforce that as you go about your supervisory responsibilities. Split hedging is not allowed across different legal entities.

MR. BERKOVITZ: Okay, with that I'd like to thank the morning panel. This has been a really lively and excellent discussion. We've touched on a lot of topics. We'll take an hour break for lunch. We'll come back at 2:00 and the afternoon panel will talk about market making. I'm looking forward to an equally lively discussion. So thank you, everybody.

(Recess)

MR. BERKOVITZ: Welcome back. Welcome to our afternoon session of the CFTC Volcker

Roundtable. The afternoon session will be talking about market making activities and some of this morning's discussion talked in this area as well. So some of this will be a continuation of this morning's discussion, but we hope to get into specifics. We have the proposed rule and how to determine whether an activity is market making or not. And I'll ask if anybody wants to start off the discussion generally, but if anyone has any general comments on the market making?

David.

MR. SIMMONS: I'm Dave Simmons of Loomis Sayles. My remarks will be on behalf of the Association of Institutional Investors, an organization of some of the oldest, largest, and most trusted investment advisors in the world. All our firms have a fiduciary duty to put our clients' interests first. So put simply, it's not our money. We manage pensions, 401(k), mutual funds, personal investments on behalf of more than 100 million workers and retirees. Our clients include companies and labor unions, public and private pension plans, mutual funds, and individuals and families who depend on us to help them provide for their retirements.

So with that being said, we're really here to make sure that, you know, what I'm really here for anyway is to make sure that market making by the Street, is there's clarity for the Street for market making. Okay? I'm on the Corporate Bond Trading Desk. I have a different perspective I guess than everybody else. I'm a regular, everyday trader. I trade corporate bonds every day. So I'm on the frontlines. A significant part of the day-to-day trading that we do is dealers making markets a significant part. There's no way to put a number on that unless you actually calculate it on a day-to-day basis. We don't do that but it is more than 50 percent of the daily trades that we do are dealers making markets.

Lately, agency trading versus principle trading, or principle trading being dealers making markets has gone up. There is more agency trading that we've witnessed. The Street is taking less risk. We've talked about that. Dan has mentioned that. And the fact that they're taking more risk means they're doing more agency-type trading. That's been adequate. It's working. It's still nowhere near capable of facilitating the amount of trades that need to be done in the system. For example, you know, if I have 20 million of a company -- I won't say any names -- and I need to sell it to -- because we have an account -- we have a client that wants to take money and I go to the Street, excuse me, the banks and try to sell that bond, if they don't have -- they can't bid it. If they don't feel comfortable with the clarity of the rules in market making, they won't bid the bond. So I'll say, okay, well, see if you can find an end-buyer. If they can't find an end-buyer, take two, three days, four days, a trade can take a lot longer. I get the bonds back because they couldn't find an end-buyer. I have to cheapen the bonds up. So all of a sudden this company's funding costs have now gone wider -- 20, 30, 40 basis points potentially. And that's obviously going to be a problem for someone like Jeff over here at Devon. It's going to be a problem for us. It's going to be a problem for everybody. It's a problem all the way down through the economy. Funding costs go higher. I think we all know that.

So therefore, we get the association that is concerned with not only the relative value of day-to-day trading that's going on out there, but also the funding of redemptions, the funding of capital additions. If we have mutual fund redemptions and we need to pay those out, how are we going to do that if the Street's not clear on market making? We know market making is permitted through the Volcker Rule. We understand that, but I guess the clarity of it is the big concern in the markets right now. And so we're really here to make sure that there's clarity on the rules for market making.

If the rules aren't clear, the banks are going to avoid making markets and the clients, corporations, are going to struggle. And the bid ask is going to go wider. So the cost to buy a bond is going to go up and the cost to sell it is going to go down, and the differential is going to be huge. That's our take anyways. Thank you.

MR. BERKOVITZ: Curtis.

MR. ISHII: So, I also belong to the group that was just speaking, except we have a slight different take. We agree that spreads will move wider. There will be less liquidity, although I think that if you look at a number of the charts, liquidity within the Street has been dropping for the last five to 10 years. It's just less profitable. They were making 40 percent return on equity in the '90s. It's dropped to 20 and most estimates now are based on what is expected to happen is the expected returns are going to be in single digits. So capital is probably going to be less in this area.

And so we as fixed income players will need to adjust. And so our take is that this is a cost. There is no doubt there's a cost that's going to be born. We, CalPERS is not a high turnover account. Our belief is that as spreads widen and so there will be more costs, whether it's 25 or 50 basis points, to various entities, CalPERS will profit from that over time and we're talking long periods of time. Those that need what I call instant liquidity -- those that need to sell because there's redemptions and this could be a hedge fund, this could be a mutual fund, this could be a client who wants it and needs it quickly -- will not have that liquidity and will have to probably create some sort of buffer within their portfolio and it will affect them.

So our take is it's a cost, we think, where it's an acceptable cost for CalPERS given what the goals of what you're trying to do. And we will, as we see it going forward, the market's evolving to a different model. And it's involving -- I kind of look at the equity markets and see how it's evolved in which that's the total agent market or mostly agent market. And a lot of our securities are moving towards that. The days in which we can transact 50 million in a various name corporate entity are probably gone. Those were the '80s and '90s. And our desk is adjusting. We will do it over time. Either way you just adjust the way you approach it in terms of how much market impact you will have and we'll make the adjustments.

So we are supportive of what you are doing. We think if you want to accomplish the separation, or you think that there's a subsidy per se going on and you want to break that, then this is the cost to the markets.

MR. BERKOVITZ: Keith, I would also like to thank Barclays for participating in the afternoon panel.

MR. BAILEY: Good afternoon. My name is Keith Bailey. I'm at Barclays in New York. I'm part of the Fixed Income Currencies and Commodities Group with a focus on market structure. Thank you for the opportunity to be here today.

We are here because we support strong

regulation and well functioning markets and the ability to best serve our clients. The statute protects bona fide market making by exempting it from being a proprietary trading activity. And the purpose of this panel, which we welcome, is to explore where those lines need to be drawn between what is permitted and what is not permitted. And we read the statute as neither limiting the asset classes in which a market-making activity can be engaged, nor limiting it to particularly highly liquid products, subject in each case to appropriate risk management and supervisory oversight. We think that the statute and the rules should support a model that permits the retention of principal risk when it's assumed appropriately in a market-making capacity. And this includes holding inventory. If the store is empty, we have nothing to sell. And it involves holding that inventory over very varying degrees of time depending on the nature of the instrument in the marketplace.

We don't think that one size fits all

for each market and we think there is a risk of that being a challenge. We also agree that clarity is terribly important. Our trading desks are very concerned about certainty, but we understand that that obviously has to be married with some degree of flexibility because of the varying asset classes involved and the liquidity spectrums so that it makes the challenge particularly difficult to articulate either linguistically within the qualitative framework or metrically within the numerical framework where to draw those lines.

And we think of ourselves as making markets in products, particularly, I suppose, on the bond space. But more accurately I think we think of ourselves as making markets and risks. And clearly, in the case of derivatives, we don't see a secondary market in swaps. Every swap is treated as a risk element that's composed of an aggregate set of risks that we marry with the balance of our portfolio. And so we hedge it as a risk set and that's really what we think of ourselves as transacting.

So the challenge is going to be how do we marry the seven requirements that are set out in the statute in part in the rules to calibrate those in a way that will appropriately put the line between what's permitted and not permitted in a way that is both faithful to the statute and preserves the bona fide elements of the market-making activity that we believe is so important to the marketplace. Thank you.

MR. BERKOVITZ: Larry.

MR. MAKOVICH: Thanks. I'm Larry Makovich of IHS, a colleague of Kurt Barrow. And I want to provide some of the oversight into what we came up with as we looked into this with the study we did. And I think the bottom-line was that these market-making activities that are done within the energy sector are very, very important. And this morning's discussion tried to suggest, for example, that, you know, you could do without them and just rely on deep liquid exchange traded standardized products with continuously posted prices. And those exist, those are used in the energy sector but they're only liquid, you know, for a few years out and they can do some of the risk management job but not all of it. And in our study we pointed out that this market-making activity is one of a number of things that are done in the energy sector. And in fact, in the power area we pointed out that by far the most effective risk management tool has been a diversified portfolio of generating fuel-based assets.

But the problem is that the energy sector is inherently risky, and it is complex, and it's capital intensive. And so as Jeff Agosta pointed out, you've got to manage the risk on those future cash flows in order to get adequate capital deployed in this business. And so you need all of these risk management tools, including what the banks have been doing. And what they've been doing is when you've got a gas project, it's got a very frontend loaded output. You know, you drill a gas drill -- a gas project. You get a lot of gas and then it starts to deplete rapidly. It's frontend loaded cash flow. If you've got a power plant, you need gas for the next 20 or 30 years and year-to-year it's quite unpredictable.

A market maker can get between these two players. The gas player that's long on gas, the power player that's short on gas. And it can create a transaction as an intermediary that uses those offsetting risks and can reduce risk for both parties. But the market maker ends up with some of the residual risk from the mismatch. And so if you do that once you've got an exposure, if you do that more than once, now you've got a set of positions from having enabled these transactions in the marketplace that together create an aggregate risk exposure.

And so a market making bank, if Dodd-Frank works the way it was intended, banks continue to provide this function. As a result, they take on the risk associated with the residuals from making these transactions possible. And what our study also pointed out is that a market maker would then have the opportunity to hedge the risk that they face in aggregate from all this. But the economics of efficient and cost effective risk management are that hedging has a cost and a benefit. And if you do it efficiently, you're going to be doing as much until you get the marginal benefits just equal to the marginal costs, which means efficient risk management by the market maker will not reduce risk to zero and create an aggregate position that has no potential for gains or losses when prices play out differently than expected.

And so the rules as proposed -- and I think that Sheila Bair hit the nail on the head when we started off saying if you get the kind of market making that Dodd-Frank was intended to allow, it's going to be extremely difficult to differentiate that end state. The bank has got a risk exposure from all these transactions to commodity prices. You can't differentiate that from -- it's going to be very difficult, extremely difficult to use her term, to differentiate that from proprietary trading where somebody takes a position betting that the price is going to move one way or the other.

And so the proposed rules are so narrow in trying to create this differentiation that our conclusion was they will effectively eliminate banks from doing the market making. And as a result, the proposed rules don't seem likely to deliver the intended result of Dodd-Frank. Our study was actually trying to support the implementation of Dodd-Frank in a way that it would deliver the intended result.

Now, the criticism that our shortcoming is that we didn't consider. So what. If you just eliminate the banks from this, somebody else will come in and do it. That's not the issue we were focused on. It is not clear that people are going to be able to come in, do it as well, as efficiently, as transparent. And what we said was we quantified how important this market making activity is, and we said in the study if other people do it and it becomes more expensive as a result, naturally, the energy businesses will use less risk management and you can proportionately scale the numbers we came up with. If they do half as much risk management, the cost will be half as much as if they did none.

So it isn't so much a criticism of Dodd-Frank as realization that the current definitions are too narrow. What could you do? I think you ought to consider options that don't try to tightly differentiate between how much market making is too much and spills over to proprietary trading. You obviously have stopped blatant proprietary trading. If you allow the market-making activity and quantify risk and total, something like the value at risk as a percentage and center reg as a percentage of the equity that the bank has, shareholder equity, so that the backstop is not the insured deposits that are on the balance sheet. There are other things on the balance sheet, including shareholder equity. And let that be the backstop for the positions that get created by doing efficient market making on behalf of clients.

MR. BERKOVITZ: Lynn.

MS. STOUT: Yes. I'd like to talk a little bit about the proposed attempt to make the admittedly difficult distinction between proprietary trading and market making. And in particular, I'd like to point out some elements that the proposed rule relies on that I think will probably not be very effective, primarily because they seem to be drawn from securities law and from prior rules that attempted to find market making in secondary securities markets. And for a variety of reasons I think they're not going to be very effective at separating out market making from proprietary trading in derivatives markets.

So, for example, and this is under section 2, bona fide market making. One element that is in the proposed rule is that you're more likely to be a market maker if you hold yourself out as willing and available to provide liquidity by providing quotes on a regular but not necessarily continuous basis. That's probably not going to be a very effective way of distinguishing between proprietary trading and market making in derivatives because if someone is a proprietary trader in derivatives, yes, you're always going to be willing to provide a price at which you buy or sell, presumably one that would be favorable to you. Similarly, when it says that with respect to securities regularly purchasing covered financial positions from or selling the positions to clients, customers, or counterparties in the secondary market, I say that doesn't apply to derivatives but it's a good thing because, again, in derivatives, if you have what's essentially a hedge fund that's trading in derivatives, you would also regularly purchase and sell positions.

Transactions, volumes, and risks proportionate to historical customer liquidity and investment needs, that's not going to be very effective in the bespoke market because, of course, since the customer is on the other side of the transaction, your volume is going to be proportionate to what appears to be customer demand because on every transaction where you're on one side, it's going to be a customer on the other.

So I just want to suggest that these three traditional distinctions used in the securities field may not be so apt in the case of derivatives markets. That does get to the question of what might be more effective. Certainly, I think that -- I'm looking at your own criteria -- the criteria I really like are the fifth criterion, revenues from fees, commissions, bid ask spreads, rather similar income, essentially at a functional level what distinguishes a proprietary trader from someone who is essentially a dealer or market maker that makes a living providing liquidity, is that if you're providing liquidity you can expect to make a certain return but it's not going to be particularly spectacular. So if you see very unusually large revenues coming in from what purports to be market-making activity, it's probably not market-making activity. So I like that criterion.

I also like the sixth criterion for similar reasons, focusing on the incentives that are created for the people who are supposedly making the markets. But I just want to say generally I think my point is that in derivatives markets, if you're going to be distinguishing proprietary trading from market making, you're going to have to be making much more of what I would describe as a functional analysis, which emphasizes what kinds of revenues are being generated by the so-called market maker. And do they look comparable to and consistent with the revenues that are typically earned by securities dealers who truly do just provide liquidity? And we know from looking at securities markets, those are actually pretty thin. Or does it look like -- as our resident economist would put is -- rents that are being generated within a particular so-called market making division? Thank you.

MR. BERKOVITZ: Simon.

MR. SIMON JOHNSON: Thanks. I detect a

potential moment of agreement across the differing views here. And tell me if I'm wrong, Larry, if I misunderstood what you said. I thought I heard you say at the end that trading operations should be backed by shareholder equity, not by insured bank deposits. And if that's the basic idea, I'm in favor. In fact, that's exactly what Sheila Bair said at the beginning, that you should firewall off completely trading operations from insured banks and not allow any cross usage of capital or cross guarantees, implicit or explicit, that would enhance the credit worthiness of the trading operation.

Now, I would caution or I do have a caveat which is, of course, as was mentioned before, Morgan Stanley itself recently moved a significant part of its trading operation into the insured bank. So I wonder if we really have converged on this point as fully we might. But perhaps Larry can speak to that.

More generally, I would like to respond to previous comments on three points. First of all, with regard to the first point made by David, perhaps we should agree or at least discuss whether liquidity per se really is the goal here. I don't think that just lowering spreads is necessarily the outcome that you want in your markets. We can think of plenty of financial products that have had great liquidity, very tight spreads during boom phases. Greek sovereign debt pops into my mind, somewhat topical. Also, I thought it wouldn't offend anyone in the room if I mentioned that. CDOs would be another one. We could mention some more modern instruments that would offend people.

So I think I'm skeptical of the view that just having more liquidity, just having more trading, and I think this is to Curtis's point also which is that investors will adapt. The market will move on once you remove the subsidies. You shouldn't be subsidizing liquidity for the sake of liquidity.

And building on points made by Curtis and his colleagues this morning on disclosure, I would also, on picking up what Lynn just said, I testified on the Volcker Rule to the Senate Banking Committee in early 2010. John Reed, the former head of Citigroup was also on the panel. The point he made was that bank management knows when trading is proprietary versus market making, but it's very hard for anyone on the outside to know because of the complexity. And I have specific recommendations for you and we can go through the details now or later if you want regarding the disclosure information that you should require from banks on an ex post basis, not in real time. Ex post, as them to disclose the profits they made, the positions they had on all trading positions relative to derivatives, including what they label as market making and what they label as hedging or anything else.

And to Lynn's point, if you are seeing very large profits coming from particular operations that are not driven by the rise and fall of the flow of business, that indicates somebody is taking a proprietary risk. Hopefully, management is aware of that. If it isn't aware, that's an interesting conversation. If it is aware, of course, that's a different conversation under the Volcker Rule. So disclosure -- and I think to the corporate treasurers in the room, and the people who represent CFOs, it should be very helpful to you if you can see exactly what kinds of risks these major counterparties are taking in the financial market. So it's not just you, Jeff, talking to people and having sort of a sense of who's got a grip on their risk but actually being able to see a lot more data and having third-party independent analysis of that data. What kind of positions did they have? How did these move with the market? Again, incredibly useful for market participation. You should want it and we should regard it as a reasonable quid pro quo for the subsidies that these megabanks continue to get.

Compensation can also be linked. And I think Marc Jarsulic has very good proposals on this and hopefully he will speak to them now from Better Markets.

And just finally, the most rewarding thing I heard today was actually the points made by Robert Colby in the morning. It did take me a while, Robert, I had to read my notes carefully, to understand, but what I think you said, and again, you can correct me, but if the idea is to move, either with regard to hedging or market making, away from having rules, and as David said you need to have rules. You need to have clarity. Moving to a situation where it's all about discretion, it's all about being able to negotiate deal by deal with the supervisor, the primary regulator, all the CFTC, I think that's really not helpful. I don't think that brings clarity to the market. I think that it actually is going to confuse people a great deal. And I think the way that the regulation is currently written in terms of these are the following activities that are allowed, and if it's not specified here it's prohibited, that is the right approach for the market clarity point of view.

MR. BERKOVITZ: We have Marc next.

MR. JARSULIC: Marc Jarsulic from Better Markets. Yeah, let me just address the issue of distinguishing between market making and proprietary trading. I think it's probably not as difficult as is being made out and I think the solution is embedded in the proposed rules with some minor amendment.

I think certainly when the academic literature thinks about market making when other people with experience in markets think about market making. Think of the market maker as someone who provides immediacy to clients. You want to buy it. You want to sell it. I'll do it. The market maker, however, is earning his return, not so much from hauling inventories but from holding whatever inventories are necessary to do the business and hedging those. And the income from market making, from a pure point of view, is from fees, commissions, and from observable bid ask spreads where they exist. So if you take that view of what market making is, then it seems perfectly reasonable to say that you want to align the incentives of the people inside the bank with market making by tying their compensation and by tying the acceptable revenue from market making to the kinds of revenue that come from that activity from providing immediacy so that if you say that people who are market makers in your bank can be compensated from fees, commissions, observable spreads, if you say that the revenue that accrues to your market making activity comes from those same sources and that you will look at deviations from those rules, except for random deviations as evidence that non-market making activities going in, you are a long way toward making sure that what's going on is market making and the incentives of the people who are supposed to be engaged in market making are aligned with that mission.

I think that given the way the proposed rule is structured, a couple of changes would make this -- would embed this in the rule. So as the rule is currently stated it says revenue from the trading related to market making has to come primarily from fees, commissions, bid ask spreads, strike primarily saying that's where it has to come from except for some random variation. It says compensation should be designed not to reward people for proprietary trading. Say compensation should not reward people for proprietary trading. Therefore, they shouldn't be paid out of large temporary gains from the positions they've taken. I think if you make those kinds of changes it becomes very clear inside the organizations. You don't have to micromanage the behavior of people. You don't have to have really complex rules governing the behavior of individuals. And you achieve the goal of moving unacceptable risk out of the bank dealers and moving it someplace else.

MR. BERKOVITZ: Josh.

MR. COHN: Thank you. A few points. First, I think we agree with the need to revise the proposed rule to properly define market making in the swaps market. And we think that the CFTC has taken a pretty good shot at that actually in the entities definitions rulemaking and that's probably a more appropriate starting point for discussion in any case than the section 3(a)(38) Exchange Act definition that is essentially the fundamental source of definition of market making in the proposed rule. We think it's also important that as people consider the exemption that is in the statute, that people focus on the full breadth of the language in the statute and that is the exemption protects positions taken in connection with market making related activity. That is, it is not just the act of market making and facing a customer, and it can't simply be relying on compensation from the bid offer, and it can't be relying on compensation from the bid offer because there's simply not enough of that.

And another thing that the -- another thing that the rule as ultimately published should take account of is, in fact, the relative illiquidity of the derivatives markets as compared to the securities markets. And it may be helpful if I give you just a couple of examples. The most popular interest rate swap in the world, the U.S.

Dollar 10-year swap, there are 200 trades in that swap a day distributed over how many dealers? Unclear. But let's say there are at least 14 significant dealers. And so there's appropriate distribution. All interest rate swaps globally, there are 6,800 trades a day in all currencies, and that's in caps, floors, collars, swaps, and swaptions, not just interest rate swaps. So these are in different things. All CDS. You had 6,400 trades daily globally.

Let's compare the London Stock Exchange, if we may. U.K. Equity books 685,000 trades a day. There's a lot more bid offer potential even at thin margins in that flow on the London Stock Exchange than one can think of with respect to derivatives trades globally. The most liquid single name CDS contract trades only 20 times per day, distributed over, again, a number of dealers. So the opportunities for dealers to make money from the bid offer are highly limited, yet dealers have to maintain their books. If they have to maintain their books, they have to be hedging, which we discussed this morning. They have to be positioning and repositioning the book to try to take account of anticipated needs, anticipated market circumstances. They may engage in limited arbitrage activities for liquidity. They will provide liquidity. Where they don't necessarily get the full bid offer to other dealers at times, they will need liquidity and they will pay the bid offer to other dealers.

So I don't think -- to step back and look at the proposal as the proposal stands now, I don't think the proposal takes full account of these factors. I don't think a proposal that market makers just live on bid offer alone actually has any practicality. And being mindful of the breadth of the exemption that is in connection with market-making related activities, I think there needs to be some sympathy for the fact that the dealer maintaining its book has to be undertaking different sorts of transactions as it positions, as it hedges, and that it needs to make money on these things. It can't run these things as money-losing propositions. The only way to compensate for that is to jack up the price to go out of business. A dealer can, of course, make less but if a dealer makes less, ultimately, it will face those problems anyway.

A word about the structure of the proposal. One of the problems with the proposal is that although the statute provides an exemption for market making, the proposal starts by saying all swap dealing is proprietary trading unless it is market making. So it creates an adverse presumption more than a presumption, a certainty against swap dealing. The release goes on to say that that presumption is based on the -- well, it's based on the assertion that swap dealer positions have short-term trading intent and are held for resale on that short-term basis. And I think we've already heard in the course of our discussion that that, in fact, is not necessarily the case.

Now, there's an Appendix B to the proposed rule, and the Appendix B discussion of market making is actually helpful in many respects. It better treats the illiquidity that I've already addressed. It is, however, still stated very much in the negative with presumptions against the activity. Relatively little discussion of what the activity is that is welcome and that it is, in fact, exempted from the proprietary trading bar. So it's a good start but it should be written in concert with revisions to the rule and the preamble to endorse what is appropriate market making activity to help set a metrics base. And I think that there was a helpful discussion about reflecting on how much risk can and should be allowed in a market-making business. Perhaps reflecting on the amount of compensation overall of how much extraordinary compensation can come into a market-making business. But all at the same time with the understanding that these have to be money-making businesses. Thanks.

MR. BERKOVITZ: Larry.

MR. MAKOVICH: When you think about some

of the proposed rules that Lynn and Marc discussed here about if this market-making activity produces too much profit you've got a problem, that it's prima facie evidence of proprietary trading. And that really doesn't sound right. If you've got somebody that made a market by combining two people with a short and a long position and, for example, the bank gets a residual short position and as happened, you know, in 2010, in the middle of the winter, gas was $5.32 per million BTU. This year it was 2.50. So it was half as much in just two years time. And it's because of something that most people have no ability to predict accurately. We had a terrible warm winter. So that's the kind of risk here.

If a bank ends up with a short position and makes money as a result, that really isn't a problem. We've got a profitable bank. The problem, and Lynn, I think you had mentioned this earlier, is if there's a flip side to this, that if you can make that much money, you can also lose that much money, which goes to the point that

Simon and I seem to be agreeing on, that if you analyze this risk in aggregate and set limits so that if you stress test it and everything goes against the position the market maker has, that you're not going to be threatening the insured depositors assets, that it is limited so that the bank can survive this. But what it means is if we set those kinds of limits, I think most banks can handle some pretty substantial swings there so that we will get periods where most of the money is made because the position matured and it worked out. There will be other times when it doesn't, but I think the presumption that if you make some profits in a bank this way that there's something wrong is just a metric here that's not going to get the job done properly if we want efficient, cost-effective risk management from banks.

MR. BERKOVITZ: Simon.

MR. SIMON JOHNSON: I want to respond to a couple of points. On the residual short position, Larry, I think we are agreeing that what matters, certainly from a financial stability point of view -- fresh stability point of view, what matters is the size of the potential downside risks relative to your balance sheet and relative to how this bill would affect the rest of the economy.

The easiest way to deal with this is to completely separate those activities from the balance sheet of the bank with the insured deposits. No contamination, now or at any point during the cycle. And I guess my question to you is do you agree with that? Why not, given the logic of your position, exactly, allow these trading operations but in completely separate subsidiaries, firewalled off totally with no recourse at all to the insured deposits? I leave that as a question if you come back to me.

Josh, I didn't quite understand some of the economic reasoning behind what you were saying. So if -- and David can check me on this -- if a market is less liquid, I expect the spreads, the bid offer spreads to be higher. I don't understand why just the lack of liquidity in the CDS means this is an inherently less profitable activity. I do take your point that in making markets there are a variety of activities, including the buying and the selling and other activities related to that. And that's exactly why I think Marc's proposal to monitor -- well, to guide compensation and to my point about data, to report on exactly how the banks made their money.

And so, I guess my question to you, Josh, would be with your perspective that this is -- there's a rich new set of activities that fall under the heading of market making. Would you agree that it is entirely reasonable for the CFTC to require on an ex post basis after the fact, with a reasonable time lag but presumably somewhat actionable data from point of view of market participants, to require the disclosure of how exactly the bank made its money, on exactly which parts of these activities, which we can -- which the bank certainly -- this is self-reporting presumably -- the bank can observe and the bank can report on to the CFTC and to the market.

MR. BERKOVITZ: We have Dan.

MR. RODRIGUEZ: Yeah, we've heard from a couple other institutions and traders here. I think we have a fixed income person also from Credit Suisse. I'm Dan Rodriguez and in my role with equities we deal in block trading, underwriting. We also trade convertible bonds on a pretty active basis globally and definitely here in the United States. And just to give a couple of examples, it seems that we haven't talked about specific market making activities, and I want to introduce just a couple of examples of how that happens and where it can become difficult as Sheila Bair said this morning, to differentiate between proprietary trading risk and market-making activity. I mentioned the block trade that we did on behalf of the Fed, which was the AIG transaction.

So in that, if we break that transaction down to make the discussion here a little more concrete, there was $6 billion that the federal government needed to put out. Okay, that's a fairly large size transaction. Three billion was purchased by AIG. One billion was taken on by Credit Suisse, one billion by Citigroup and one billion by Morgan Stanley. When you took that one billion down, so the activities -- we're making a market. We're doing a block trade. We take that position onto our book and obviously, as soon as we take it on we're trying to get that out to a number of other potential customers, but there's a position there and we have to manage that position. So we're making a market now in an AIG block. It's going to be a billion less the portion that we were able to sell out of. And then the question is how long do you keep that position on?

Now, there's stability requirements, right? As we're making that market, the agreement is not to blow out of the position immediately. And so you're going to have that position on the book for a period of time. Now, the question is how long do you keep that position on the book? How quickly do you sell it out? What bid ask spreads are you willing to take on that position? If that position is on the books for three or four weeks, is that a proprietary position or is that a market-making position? If it's on the books for 25 seconds, if you keep the position on and you have to pay a dramatic, you know, you may have to pay out $25 million as the market maker to get out of that position that quickly.

And that's the issue with the immediacy part and the market making. And in reality it is incredibly difficult. I would argue, as some of the Fed chairmen have said, or Fed governors have indicated, it is impossible to differentiate between bona fide market-making activities often and what is a true, you know, say a position that you're taking on by choice. You can argue that you're holding the position on for five extra days. Why? Because you think the price was overdone. To the downside, people were putting too much pressure on the price and you made a decision to wait a few days for that position to come back and to have a more liquid market to put the position out in.

Now, these are all decisions that happen every day when you're underwriting and when you're doing block trades. And if you're doing five or six block trades at the same time in one sector, let's say for financial firms, then the catalyst becomes even more complicated. But these are decisions and actions that have to be taken by an active market maker that's supporting block trading or market making activities.

Now, how do you measure it? As Simon said, I think Credit Suisse is in that group that agrees we do not have FDIC-backed deposits. We agree that that should be segregated. So this activity is, in fact, segregated from any FDIC-backed deposits at our institution. And it is based on the equity capital of our firm as per Basel III right now and how that's measured under that regulation.

So we talked about block trades. We talked about underwriting. You know, the other example we make is when we do an IPO we do a convertible bond underwriting. We've done a number this year. A recent example, Annaly Capital. We go out and do that transaction and, you know, we're able to lay off some of that but some of the risk we have to retain on our books. Beforehand, we may do pre-hedging because we know we're getting ready to take on the transaction. These are all standard actions that market makers have to undertake. And it may show up on the books as, oh, this looks like a proprietary trading position. No, this is a position, a risk position taking on to support bona fide market-making activities.

So I want to make sure that gets out there because there seems to be some confusion as to the fact that market making is absent any risk. No, market making entails risk, risk taking. And I think the big question for this forum and the CFTC is to ensure that that level of risk taking, monitor the level of risk-taking very closely, ensure that we have good, accurate metrics around that risk-taking activity. And if that risk-taking activity appears to be excessive, the regulators should, you know, step in and say this is excessive and it needs to be reduced. And that has to be the ongoing dialogue between the supervisors and those that are being supervised in these very important market-making activities.

And I just want to mention one point earlier from the gentleman from State Street who indicated that at the end of the day, the Volcker Rule has had some impacts. We've already talked about it reducing, you know, other proprietary trading, you know, not necessarily associated with market-making activities. So I think that type of trading has been for the most part eliminated. In conjunction with that we had some reduced liquidity. Bid ask spreads have gone out on certain names and it has, you know, as the gentleman from CalPERS said, it has imposed additional costs. And how are the folks, you know, how are the different pension funds, how are the insurance companies dealing with that? They're paying higher costs. The investors are getting a lower return. And then retirement funds are shrinking and our pension fund deficit is increasing across the country. So I'd say we have to be careful on how strict we're going to go ahead and apply this rule and just be aware of all the dimensions around risk taking that are associated with true bona fide market- making activity.

MR. MAKOVICH: David.

MR. ROBERTSON: Thank you. I want to address sort of a thread that's been emerging in this afternoon's discussion which is somehow making the markets less liquid and less robust. And let's face it, over the years the markets have developed quite a bit of liquidity and price depth that that would not be a bad thing. And at the risk of being pedantic, I want to take a step back and just kind of walk through how a corporation would hedge a risk. And so if I'm a company with a global exposure and interest rate exposure, I'm actually forecasting out my balance sheet and my income statement and my cash flows over time. And

I'm developing a hedge horizon going out, you know, potentially two years, maybe more. And I have a hedge ratio that over time I'm hedging that risk and then each month I'm selling down the balance sheet and the income statement exposure and I'm replacing and replenishing those hedges.

And part of the reason why I'm in that regular periodic management of my balance sheet and my income statement is I know there's a liquid market where I can go and get financial risk instruments at a decent price with a good bid ask spread. And I think if we go too far in restricting the ability of the market makers to make a market, what we're going to end up with is companies choosing not to hedge because why would I put on a hedge position if I think I can't manage that and adjust it over time? And so while it might be fine for a large institution like CalPERS to be able to exploit less liquidity in the market and make a profit out of it, there are hundreds of middle market corporations that are relying upon foreign contracts, options, and other methods of hedging their balance sheet and income statement exposures. What happens if we take that away is we're going to end up with companies going naked, either holding more cash on their balance sheet, choosing not to expand globally, or trying to find some way of doing natural hedges. It's going to be a significant impairment to the efficiency of the economy.

So we're all for the transparency of non-owners reporting. We're all for making sure that banks are taking risks that are appropriate and compensatory to their capital base, but let's not pretend that making markets less liquid and less reliable is a social good. We're actually impairing the economy when we talk about making these decisions.

MR. BERKOVITZ: Bob.

MR. COLBY:: : Well, as Lynn very ably said, there are difficulties in the definition of market maker when they get applied to swaps and futures markets where a number of these different factors really don't work well for you. And so --

and there is an active discussion in the preamble. There's a less active discussion and most swaps don't fit in either category. And then as you work your way through the preamble and the metrics, there are discussions that are really apropos of swaps but they're not very extensive. So I wanted to focus on those.

So one problem you have is the swaps, as Josh said, are not very liquid. And so when you're trying to calculate a spread, many times you're not going to actually be thinking of a spread in the same way that the equity markets do or the fixed income markets do. You're really going to be looking at some swap that's hedging a swap that's put on, and the revenues are between the difference in what you get paid on the hedge and what you get paid on the initial swap. Someplace in there is your revenues and you're going to have to figure out if those are hedge returns, if they're market making spreads, or if they're something else. And partly because of that difficulty, SIMFA would recommend that you take the factor, the revenue factor, and you take it down to guidance as I said earlier.

So in essence, to make this work, you're going to have to have supervisors. The bank supervisors with respect to a bank affiliate or the CFTC. And let's be frank, the CFTC needs more staff. They're going to have to know these entities and learn what they're doing and what the nature of their business is so they can look at the particular business where there is principal trading and try to figure out is this supportive market making or is it not?

And then the last point I'd make is I agree with Josh. I think that your definition of swap dealer captures the right concepts of what a market maker is. It's someone that's accommodating customer demand, not necessarily quoting because that's not the way this business is done, but is there across market cycles trying to accommodate customer demand. And that should be your central focus. And then you use the other things that are now factors as other indicators about whether this entity is operating as a market maker.

MR. BERKOVITZ: Marc.

MR. JARSULIC: Yeah. I think it's important to remember that the Volcker Rule is a statute and it attempts to do something. It attempts to move high risk activity out of the banks. It doesn't intend to keep it there. And market making is permitted because market making is viewed from the point of view of the statute as a not high risk activity. So if you, you know, if you can run market making in the way that I've described, one which the risks are essentially hedged and revenues comes from the service fees that you charge, that's not a high risk activity. If the response is there are certain kinds of market making which can't be accommodated by this model, we don't do it this way, you should therefore somehow ignore the intent of the statute and widen the rulemaking so this activity can be permissible, it just flies in the face of the statute. And in fact, what the Volcker Rule ultimately wants to do is to move this high risk behavior off the bank balance sheet.

Now, one way to do it is the way I suggested. Simon is suggesting that this activity be walled off someplace. But I have yet to hear, you know, proposals from the banking community for doing that or for say imposing leverage limitations on a trading subsidiary that would essentially insulate both the holding company and the banking community and financial markets generally from the kinds of failures which can happen very rapidly in these kinds of trading operations.

MR. BERKOVITZ: Keith.

MR. BAILEY: Thanks. I have a number of points to make so I'm going to make them quite quickly.

First of all, to the extent that these are non-continuous e-traded markets, we do stream prices in regular interest rate swaps and Index CDS, but they're at the other end of the spectrum. There are many prices, markets that trade very occasionally. And to that extent, we absolutely support Dan Rodriguez's points about market making involves risk. And there is a discretion, a choice made by traders in the exercise of that market-making function every day, every minute of every day, in some instances as to hedge selection and timeliness of hedge selection. Do you hedge with treasuries? Do you hedge with futures? Do you hedge with bond futures? Do you -- there's a whole string of varieties you could use even in the more liquid markets.

And so I respect the point about compensating, not compensating being designed for, traders that take proprietary risk. But it's important that within the tolerances that are permitted for the exercise of the limited discretion that is permitted in order to substantiate market making you need to be able to compensate traders who are good at it differently than traders who are bad at it. So I would just make that point.

Secondly, we also agree that because of

the whole spectrum of liquidity differentials across these products, a market-making definition that contemplates some obligation to make two-way prices on a continuous basis is not as appropriate. We think the definition that you looked at in the context of the swap dealer is closer where you speak more in terms of routine market making. There are thousands of CUSIPs. There are infinite numbers of swaps. And I hope the customers that we have in the audience would recognize that we stand ready to make prices on a whole variety of products that we're not streaming prices on each and every day, especially in those less liquid markets. So I think those are points.

As to certainty, I think that it's important not to lose sight of the fact that there are many other controls other than Volcker particularly in the context of market making. We have strenuous risk limits around the amount of risks that our trading desk can take. And naturally, in the less liquid risks those risks measured by VAR are proportionately smaller than they would be in markets which have much more stable volatility profiles. So it is not as if there is an indifference between the character of the risk that's being take by a trading desk. And so whilst I respect the point in principle, we don't treat the measurements and the tolerance for illiquid risk at the same measure as we do for liquid risk. Thank you.

MR. RODRIGUEZ: I want to respond to that comment about the banks. So the comment that the Volcker Rule is designed to eliminate risk from banks -- maybe I'm paraphrasing or misquoting -- high risk activities. So now the question becomes, so the Volcker Rule is designed to take high risk activities from banks. Market-making activities and hedging activities were both specifically included in the Volcker Rule to be preserved for banking institutions. I want to make sure that that's on the record and that's very clear.

And then the next question is what's a high risk activity? And I would agree with Simon

Johnson on that. That a high risk activity would be any combination of activities that would put a bank at risk and would basically potentially result in losses exceeding the capital available to that institution or the equity capital. And you know, that's pretty clear. So we know what a big risk is. We measure it daily in a number of different ways. And, you know, in the front office in the equity division we have a concept called deep downside loss, which is far larger in excess of VAR. We take the VAR number and multiply it by 7, 8, 10 times, which is the worst thing that we can conceive of happening on this particular transaction, and we actually add up those numbers.

And so, you know, we have processes in place that we've talked to the regulators about pretty frequently of how we manage the risk on these positions. But I want to make sure that I take exception with the notion that the Volcker Rule is designed to take, you know, risky activities away from banks. Banks continue to, you know, they have to take risks in the marketplace. When you do a transaction, any transaction you do you're taking risk. And that's just something. You're not eliminating risk from the system and people need to understand that there is an optimal level of risk taking out there and that level is definitely greater than zero. If we had zero risk taking, then economic growth would basically, you know, come to a standstill.

I know Simon is very familiar with the solo growth model. You know, the A there, the entrepreneurship, that technology innovation factor, that includes risk taking. You want to make sure that we preserve risk taking and risk is not something that -- an excessive risk, yes, we don't want excessive risk but we want proportionate risk. And I think the Volcker Rule needs to focus on the metrics that attempt to measure and monitor risk over time to ensure that banks are taking proportionate risk commensurate with supporting effective and efficient market-making activities. And from this morning's discussion, effective hedging activities for our clients and for institutions that are operating in the capital markets.

MR. BERKOVITZ: David.

MR. SIMMONS: From the institutional side we'd, of course, like all our client trades to be considered market making. Of course, right? Knowing that market making involves risk, we do recognize a lot of the views that are around the table here that risk measures by banks need to be followed. You know, we agree with that. Measures that leave banks comfortable with making markets though. We need traders comfortable with what they're doing knowing that, I'll say it again, that they have clarity in what they're doing and they're not going to get penalized after the fact.

We've seen evidence of the banks, just to reiterate what the banks have already said here. Evidence of the banks, reducing risk dramatically. Dealer balance sheets, inventories, DV01, VAR, all the things that have been mentioned, we've been polling the banks for the last three years on this and we've seen a significant decline. We go to each dealer. We ask each dealer about all these different parameters because we like to track liquidity based on what we're seeing for dealer DV01s and balance sheets. We've seen a decline in that. That's happened. And we've been able to still trade bonds in that environment. The environment has been adequate enough to trade bonds.

So holding period, fine, you know, the P&L tracking, I think that's -- knowing the guys I deal with, the traders I deal with, that's going to create confusion for them. P&L tracking, if they make a lot of money in the trade, all of a sudden that's considered proprietary. I think we're going to have traders out there that are going to be very concerned with taking the trade on at all. And that's just going to hurt, especially the more liquid bonds out there, smaller companies that don't have, you know, not AT&Ts of the world but a smaller company with maybe a 250 million bond deal outstanding. It's going to hurt them more than anybody.

So I think it's important to recognize that money needs to be made at the banks. We think that anyways. If they're not making money, there's no -- if they feel like they're allowed to make any money, then why are they going to trade these products at all? And if they don't trade these products at all, then we all have a problem. And our clients have a problem.

MR. BERKOVITZ: As the discussion continues, I'll ask one question. Maybe a panelist can answer along with other remarks. One of the concerns in the comments about the Volcker Rule in general is it's level of complexity and detail. On the other hand, we've heard some discussion today about particular asset classes, illiquid markets need to be -- not all markets are the same. Certain aspects of the rule were written to more aptly describe equity market making rather than what the CFTC would be dealing with in commodity markets. We obviously are faced with writing our Volcker Rule but we're looking to what the other regulators working with other regulators as well, should the CFTC -- should our rule differ and have special considerations for our type of markets? Or will that add a level of complexity that people are trying to avoid? Obviously, the more we target our rule to specific asset classes and to our specific type markets, then it becomes more complex. So do people favor addressing different asset classes with different sets of metrics and maybe different criteria? Or would you prefer a more consistent general higher level approach?

Larry.

MR. MAKOVICH: Based on the discussion today I think it points to a higher level approach. I think that, you know, there's general agreement. It's extremely difficult to differentiate this market-making activity from the results of proprietary trading. But there's also general agreement that this is a very valuable service that's provided. As Chairman Gensler said this morning, that market making is important to the economy. I think that's kind of come up and that if you try to get too detailed and prescribe, it's too complicated. It's just not going to work well and it's going to be very, very inefficient and the 20/20 hindsight that people talked about. But I think we kind of got to the root of the problem here which is it's a valuable service that fills a unique position in the risk management job, but that market making is not risk free.

And to Marc's point, we don't want high and unacceptable risk exposures, but Dodd-Frank seems to want to be able to allow the market making with acceptable risk. And that really gets to the question that Simon had posed. I think no one is advocating backstopping the risk associated with market making with insured deposits. I don't think anybody's saying that ought to be how it works but it does seem to appear with some general broad specifications that limit the exposure in aggregate from this activity. We can keep the risk at a level that is acceptable and that this doesn't seem to require that the banks exit this activity or that they have to spin off this activity. It looks like rules could be developed that would sufficiently separate this activity and the intent of Dodd-Frank could be accomplished.

MR. BERKOVITZ: Lynn.

MS. STOUT: It seems to me, I agree that generally complexity is not good. Excessive involvement in detail is not good. But I do want to emphasize that in formulating rules, I think it's important to bear in mind that in many ways the social consequences, the costs and benefits of derivative markets are very different from the social consequences, the costs and benefits of secondary securities markets and that that is a distinction that's worth bearing in mind as you're trying to calculate the costs and benefits of adopting a relatively more restrictive rule that makes it harder to claim that activity is market making as opposed to a less restrictive rule.

So to get specific, it's important again to bear in mind that neither derivatives markets, nor secondary securities markets, directly allocate capital to what we're going to call the real economy. They're not Adam Smith's markets. And to the extent they are socially beneficial at all, and people have questioned whether either is socially beneficial, it's agreed that they're socially beneficial only indirectly.

So the secondary securities markets is socially beneficial for two reasons. Number one, the existence of a secondary market makes investors interested in investing in the primary market, and it's the primary market in which real businesses raise real capital. And then to a lesser extent, a secondary securities market performs a price discovery function. By the time we get to derivatives markets, and again, just as an aside, it's very easy for people who are here who are representing industries, when they're talking about the costs and benefits to the rules, to be thinking about the costs and the benefits of the rule to their particular company or their particular firm or even their particular industry. But I think your brief is to think about the costs and benefits of the rule to society as a whole.

So focusing on derivatives in particular, to the extent derivatives are beneficial, they are beneficial only because they reduce risk. They obviously don't raise capital for anybody. They can't provide positive returns on the whole because they're wagers and they're by definition zero sum gains. You know, you can't have an economy that runs on a casino. It's not going to generate income. So what derivatives do is simply, if they are regulated properly, move risk to the party who can hopefully bear it most cheaply, or we have to worry is the person simply the one who is the least informed about the risk they're taking on.

So that being said, we have to also look at this question of the importance of liquidity. So I'm going to disagree with Larry. I don't think everyone here actually agrees, and I'm going to agree with Simon, shockingly enough, that liquidity is always a wonderful thing and always essentially for our economy. In fact, it's not.

And famous economists from Keynes, through Tobin, through Jack Hirshleifer, have argued why it's not. There are plenty of situations where liquidity is either not socially beneficial, although I will concede that it's always perceived as privately beneficial to the person who wants to sell something, but it's not always socially beneficial. Sometimes it's socially harmful. And I mention this simply because, again, I think that as an agency weighing the costs and benefits from a social perspective, you can take with a grain of salt the claim that liquidity is always socially beneficial.

So I'll just give you a couple of examples. One example, classic example drawn from the stock market. The fact is that it's been long established that actively managed mutual funds on average underperform the market. Why? Because they think they can beat the market and they've been statistically proven as an industry to fail to do so. If lowering the transactions costs of trading in the secondary stock market leads actively-managed mutual funds to trade still more because the demand for trading is highly elastic and the data suggests it is highly elastic, the irony is the lower the trading costs, the more liquid the stock market, the more money actively managed mutual funds will lose for their investors trying to beat the market. I'm not saying that this is happening overall or in the case of any particular firm, but I'm saying that it is a logical problem that cuts against the claim that liquidity is always beneficial.

And similar arguments can be made in the derivatives market. To the extent that some people who are going to those who make markets in OTC derivatives are doing so not to hedge risks but are doing so because they hope to profit from speculating on their future predictions. That again becomes a similar sort of zero sum game where greater liquidity could lead to even greater trading that actually increases the net social losses. Certainly, greater liquidity is not a benefit when many of the people who go to the market, who actually think they are hedging, prove to be mistaken and to have made a hedge that didn't work. And I really don't think that we can discount the possibility, which is very, very well supported by the last 15 years of experience, that a lot of people who use derivatives to hedge are falling prey to a version of the winner's curse in that they think they're buying a more complete hedge than in fact they are. And the reality is that leads them to take on greater risk in the underlying market that turns out to be incompletely protected against leading to more institutional failures.

So I'm sorry for the long-winded discussion, but the basic point is I think that it's time to stop saying that liquidity is always beneficial and is always highly valuable in markets. That may be true in spot markets for commodities being traded in the real economy. It's not always true in the secondary market for equities or bonds or in derivatives markets.

MR. BERKOVITZ: Curtis.

MR. ISHII: So I have four points. One is that I agree with the premise that it's difficult to separate prop trading and market making. Even if you allow hedging, many of the -- even a simple -- something as simple as a corporate bond, it depends on what you're going to be hedging. Are you hedging the interest rate risk? Are you hedging the equity exposure and how you go about doing it? So I think it's difficult. My last point will be a new way to kind of look at this possibly, too, is the effects on the pension fund, someone said that this would cause pension funds to not be able to make their nut. I would not worry about that. Financial repression is causing low returns and markets in general are really focusing or causing that. So I don't think this, whether you enact this will cause pension funds to either make it or not. Three is you talked about whether the rule should be differentiated between asset classes. I would argue yes. Don't treat bonds like stocks. I mean, they aren't. There are the differences and

I think it's been made that a corporation has one typical stock and typically in a bond it may have, you know, 10, 20 different issues. And so the issues are different.

Lastly, due to the complexity, potentially, and we put this in our letter, you might want to think about a different way to handle this. And one is what I've seen some of the desks on the street do who handle risk fairly well is think about vintaging. So it allows trades to occur without immediately hedging them for a certain amount of time. But you look at the positions and begin to start to potentially raise capital unless you can define it as hedging of some sort as it stays on their books over time. And the reason I say this is many of the mistakes and many of the things that have cost many of these financial institutions quite a bit of money have been bad trades or trades that were done to make -- short-term trades became long-term trades and they get hidden in the books for quite some time and then they become proprietary and eventually they blow up. But it takes quite some time. And so if you begin to sit there and can find out let's say that it's maybe a non-hedging activity but a kind of market transaction that's been on the books for a month or two, it may then require more capital and then you can begin to address it. It's just another different way to address it and it's a potential.

MR. BERKOVITZ: Josh, I think you were next.

MR. COHN: You asked about one rule or different rules by different regulators. And I think the way we would see it is one rule as much as possible, but ultimately there needs to be product nuance. And it can be that to the extent that different products are in fact supervised by multiple regulators as may be the case, then perhaps one regulator gets to write the first draft and the others mark it up. And ultimately, you have one rule for the product embedded in one Volcker Rule that has different product facets.

There has been the point made about

derivatives market making being a high risk business. And I don't think that many of us on the industry side of it are thinking of it as a high risk business or of maintaining a high risk business. I think we're looking at maintaining prudent market-making businesses subject to policies and metrics that make sure these are prudent market-making businesses. I think Larry's ideas for founding the risk that can be in these businesses are good and fundamentally important ideas.

MR. BERKOVITZ: Simon.

MR. SIMON JOHNSON: To your question about whether you should have different requirements across different markets, I certainly think that around derivatives we need to have a lot more data and disclosure, both with regards to some of the issues we've touched on today and also more broadly about trading positions, exposures, and compensation for traders, compensation schemes and natural compensation outcomes.

Let me put it to you like this, and I

apologize if this upsets anyone or causes them to close their positions before the trading day is over. But the European sovereign debt is currently about 8.5 trillion Euros, $11 trillion, 2 trillion Euros outstanding Italian debt. I think there's a [inaudible] of a major sovereign debt restructuring coming in Europe, including default perhaps. Perhaps disorderly events around very big markets. Now, the European banks are undercapitalized, whatever with I'm sure present company excepted. The Euro zone banks, Euro zone banks, I correct myself, are notoriously undercapitalized and are likely to be severely damaged by whatever is coming. Now, how do we know? How do you know? How do we know? How does the non-financial sector of the United States know who's safe and who's not safe in this kind of coming storm? It is relatively easy to look at balance sheets and look at balance sheet exposures. Not perfect, but relatively easy.

Derivative exposures, off balance sheet transactions of all kinds, it's extremely difficult, I would say impossible. From where I sit I listen to the corporate treasurer's perspective and I'm happy to be contradicted by our banking colleagues. This is huge. This is a huge systemic risk. And, you know, VAR may well be a component in your decision-making. It's obviously got a pretty mixed reputation. I think Dan's term is deep downside loss. I'm going to start calling it double deep downside loss. It will be my perspective. Whatever you think the losses are out there, we have to worry about this much bigger impact coming through derivatives. And, you know, I understand you don't want your businesses to get swept away. And to Josh's point and to Larry's point, you believe legitimately, honestly on the basis of available information to you and your perspective of the world, that these activities you're involved in are not very high risk. Unfortunately, the financial sector has established a very robust track record of consistently getting it wrong, including some of the best names in risk management until a month ago. I guess I did read in the New York Times that JP Morgan was going to attend this hearing or perhaps was interested in attending this hearing and unfortunately couldn't make it under the circumstances.

This is not an isolated incident. This is a pattern of repeated large scale accidents. Or maybe it's worse than accidents. Maybe it's compensation schemes and incentive schemes. And David Robertson, to come back to you, it's a subsidy. We're providing subsidies to the bank through the taxpayer guarantees, both insured deposits and more broadly through being too big to fail.

So the issue on liquidity, to build on Lynn's point, is what are you paying for it? How much additional liquidity are you getting, which I understand you like, in return for this subsidy? Do you want to subsidize liquidity at this level? And I think the intent of the Volcker Rule is clear, to back away from those subsidies, not to remove them completely, not to eliminate risk from the world. There's risk in everything, including crossing the road. We get that. The question is do you want to concentrate these risks on the balance sheets or off the balance sheet of these global megabanks that pose a real and present danger to this economy and other economies with which we have very close trading and financial relationships?

MR. BERKOVITZ: Dan.

MR. RODRIGUEZ: A quick response on that. I think it sounds like we're all in agreement that we don't want excessive risk concentrated on the bank's balance sheet. I think we all agree on that. Us, I mean, if you work at a bank, you don't want your bank to have too much risk so it blows up and everyone becomes unemployed. So our centers are completely aligned in that regard.

The issue, I think the difference in opinion regarding, you know, I think about the comment made earlier that liquidity may be bad is like saying, you know, having highways could be bad because there's car accidents. And so that was the metaphor that popped in my mind when I heard that statement. And I've heard it now several times that allowing people to trade is bad because sometimes people lose money when they trade. And I think that's similar to saying, hey, driving is bad because sometimes people have car accidents. And I think we have to get out of that mindset and really think about what we're doing here. The CFTC is trying to preserve important economic capital market activities that need to be preserved in a prudent way. And I think we are all saying the same thing here at this table in a little bit different manner, and it sounds like a matter of degree, although I think, you know, parts of the table are a little bit more skewed one way or the other.

We all want a safer system. We don't want taxpayer subsidies to support excessive and disproportionate risk taking. I think we're all in agreement on that. And I think the way to do that is how are you going to figure that out? I agree wholly with Simon on that. It is difficult to figure it out.

You know, I think I always like to say in some of my seminars on risk management is, you know, only Stephen King has enough imagination to be able to determine all the bad things that can potentially happen to you out in the marketplace. And so it is a difficult -- it's difficult to operate and function effectively out there. We do need help for the regulators. We need to continually improve our processes and continue to improve our risk management effectiveness. And you know, I think we've gotten a little bit better. We've become more prudent. Are we prudent enough? Are we good enough now? I would say we're still improving in that regard and the regulators need to continue to take a look at us. They need to continue to monitor us and continue to have these dialogues about, you know, when I say deep downside, I mean, it is a seven times or a 10 times VAR multiple. I mean, I have three different ways to measure that. And I always think more metrics are better than less, although it is sometimes costly to produce these metrics. You need to have multiple dimensional views on the activities that you're taking, like having, you know, you're driving down the road, and you want to have as many mirrors as you can to see where all the potential risks can be coming from, but we don't want to do away with cars and we don't want to do away with the highways that we need and the liquidity that is very helpful and critical to capital markets.

MR. SIMON JOHNSON: No one is proposing to do away with highways. The question is speed limits. If you want to drive without any speed limit at all you can go to Germany and drive on the Autobahn. That option is available. And that's also a country it turns out with a massively undercapitalized, overly leveraged banking system that's been consistently badly run. So good luck sorting that out, too.

MR. BERKOVITZ: Paul.

MR. SHANTIC: Paul Shantic, California

State Teachers. I run a credit portfolio and we've talked a lot about liquidity. As a portfolio manager, I always like liquidity. What that pretty much tells me is I can get out. Get out of a bond, get out of a position. Sometimes I want to get into a position. But for the most part I usually want to get out. And if you're levered 25 or 30 times like the investment banks were earlier on, there's plenty of liquidity. And now that we've seen that they're less leveraged, we have much less liquidity to deal with.

The perfect portfolio for me would be something I could set up and walk away from for six months and not have to trade a bond in. Unfortunately, that's not the markets that we're in. What can occur and what is a little bit of a concern to me going forward, though I think it's probably been addressed, is there will be events and markets in which people will want liquidity either to get out or to get in to take advantage of a situation. I would be concerned that whoever is involved the other side, be it the investment bankers or the banks themselves, would be afraid to take on risk if we have volatility in either particular names or sectors of the market and walk away from those sorts of things. I get concerned about large price drops that may not necessarily reflect reality but granted, I understand it's a market.

Prop desk. Part of the reasons prop desks must have been created was the knowledge that you can see., first of all, what your clients are doing, but also must have made good money in a number of different positions along the way, whether that be Enron, WorldCom, or what have you, Time Warner, that have occurred along the way. I would be concerned that we're trying to move away from that with some of these rules. And I'm much more comfortable after hearing the discussion today that that's not where we're going.

I'm also concerned a little bit in terms of swaps transactions that might be necessarily off the rack but slightly more customized. We run a pension fund. We have a number of different indices. We also have occurring within those indices certain exemptions. For example, smoke-free, Sudan-free, things like that that might be slightly more difficult to hedge. I'm sure bankers will be able to figure that out and hedge those products appropriately, but that is a concern in terms of some of the customization that we might want to do either on the equity side or, for example, on the bond side. It seems that we've addressed a lot of those things here but I just wanted to reflect those positions.

MR. BERKOVITZ: Keith.

MR. BAILEY: This is not necessarily an official Barclays' position but my instincts on your question are that we really don't want five different rules. We think that the principles around what is proprietary trading and what is not proprietary trading should be common across markets. But I do think that the parameterization and the calibration of the metric set that you may attach to the determination of the presumption or the justification for further investigation will be very different depending on the asset class and indeed within an asset class perhaps. But I think at the foundational level it seems to me that this is a tough enough issue without trying to fragment different solutions. And I think it would add certainty to know that there's any one kind of foundational rules.

And I do have to say that I don't think Barclays -- this is the official rule. I don't think we're undercapitalized. I don't think we're going to do harm anybody.

MR. BERKOVITZ: David.

MR. SIMMONS: And back to the same topic on asset classes, just going over some statistics we have on the corporate bond market, you know, we feel that asset classes that are less liquid should be potentially treated differently from a risk metric standpoint. You know, in 2011, in the corporate bond market, 35 issuers out of over 600 issuers in the corporate bond market, the actual Barclays Corporate Index, 50 percent -- so the 35 issuers made up 50 percent of the overall volumes in our market. The other 50 percent being the other 550 some-odd plus. It shows the difference in liquidity in our market where you've got the banks are trading a lot, the big companies, the AT&Ts, the GEs, they're trading a lot, but a lot of smaller companies aren't trading that much and they're very illiquid.

It also takes about 250 to 270 days to turn over the corporate bond market, whereas in the S&P I've seen anywhere from 3 to 10 days to turn over the S&P. It's completely different markets. I think that's important to recognize when you're deciding to make your rules and figuring out how markets -- how different markets should be regulated.

MR. BERKOVITZ: Larry.

MR. MAKOVICH: I just wanted to try to tie together these two ideas. I think that the different asset classes are very fundamentally different in the way risk appears, its characteristics. So bonds and equities and energy commodities are all very, very different. And I think that ties into Simon's point that there's I think some very clear evidence that people have had a difficult time properly assessing risk and it's not for lack of education or intelligence. We've had very smart and well educated people make huge blunders in risk management, but I think that really says we need to focus on getting the set of metrics that are properly differentiated by asset class that with some oversight here can create effective limits on what is the root cause of the problem here that banks can or, you know, anybody can -- market makers, banks, anybody -- can get over exposed on risk.

And if the focus is on these metrics, I think it'll be a much more productive implementation than if the focus is trying to draw the line between when somebody's market making has crossed some gray area distinction into proprietary trading.

MR. BERKOVITZ: Lynn.

MS. STOUT: I just want to point out that we've been working on these metrics for some

20-odd years, just as we've been working on coming up with the ideal executive compensation contract for 20-some odd years. And both ventures I think it's fair to say have failed pretty dramatically, in part because it's simply -- the assumption that you can come up with a perfect metric assumes a world in which there's risk, but absolutely no uncertainty of the kind originally described by Frank Knight in 1923 and highlighted by Nassim Taleb in "The Black Swan." In a world where there is uncertainty as well as risk, it is simply impossible to come up with metrics that allow you in any way to be sure that you are perfectly hedged. The world just won't permit it.

So I'm not a big fan of relying on metrics of human omniscience as a means of ensuring we will not have any future disasters. I'm much more a fan of Marc's argument. And I just wanted to get the response from some of the people in the room. I'm not sure that this is something that would be permissible within the purview of Dodd-Frank, but it would be interesting to ask yourselves the following experiment. Would it be an appropriate way to distinguish proprietary trading from market making to set a limit on the amount of profit that a bank can make from its allegedly market-making activities? So you would say in essence that if you make more than a certain amount on a particular transaction, some portion of that would have to be paid out, I don't know, to the SEC or the CFTC or in the form of a confiscatory tax.

I'm just looking for your reaction. I'm not proposing it, obviously. But does that arise any problems from your perspective? I would think as an end-user it might actually be attractive to have some reassurance that the bid ask spreads you're paying have a limit to them.

MR. BERKOVITZ: Go ahead.

MR. ACOSTA: Maybe I'll respond. This is Jeff Agosta with Devon.

Let me just give you a specific example of something that we just did with a pair of financial institutions. We were going to hedge --

we were going to issue bonds before May 15th. So we entered into some forward starting swaps because our bonds are principally going to be priced off of underlying U.S. treasuries and we wanted to hedge our interest rate risk. Right? Because if rates went up before we issued, it's going to cost us a lot more. So we wanted to lock on those interest rates.

What happened was the opposite. Okay? Treasury rates went down and we had to write a check for $15 million to get out of those trades. Were we happy to do that? Sure. Because we got a much lower rate on the bonds that we issued. So we were fine with that. They made a profit off of that trade. It was a short-term trade but it was to our benefit. I don't have a problem with them making money. I think that that's a good thing. Banks should make money.

MR. BERKOVITZ: Bob.

MR. COLBY:: : I don't want to change the tenor of the conversation. I have a few more technical points to make at some point in the discussion.

MR. BERKOVITZ: Larry, did you want to respond on Lynn's point?

MR. MAKOVICH: Yeah. You know, the point here that it is possible to put together some workable metrics that would effectively limit risk. Will they be perfect? No. But we shouldn't let perfect get in the way of the good. You know, this is possible. It's not easy but it's possible to do. And I think if we do these simplistic solutions of limiting profitability we'll create these perverse incentives that if the bank on the other side of this interest hedge figures it's going to make too much money, they're going to have to find some losing proposition to offset it which just doesn't make sense. And you know, Frank Knight was the cornerstone of the Chicago school that very much believed that the profit motive was one of the primary drivers for economic efficiency. So it's just kind of a nutty idea to think that we've got a problem if we've got profitable banks. The problem here is to protect ourselves against banks that lose too much.

MS. STOUT: My point, I just want to emphasize, is that the large profits and the large losses are not utterly unrelated. I obviously also am not against banks making profits. The question is are they making it through proprietary trading which adds risk to the banks along with occasional individual profits?

So let me, one more time, Jeff. So let's say we're not doing it on a transaction by transaction basis, which I concede probably wouldn't work. But suppose there were limits set on the amount of profit that a bank could make market making over some lengthy period of time. We could make it 12 months. We could make it a rolling 12 months. In other words, I'm asking you generally, at some point, if a bank is making 30 percent margin or something, just amazing profits, are you as an end-user not concerned about that?

MR. ACOSTA: If it's done legitimately, transparently, I have no problem with them making money. There's nothing wrong with a bank being ultra profitable. That's fine.

MR. BERKOVITZ: Simon.

MR. SIMON JOHNSON: Lynn, I think the end-users are splitting the subsidies so that's why they're not too bothered. The issue is not the end-user. The issue is the social cost. There's an asymmetry in the payoffs for banks. When they get to keep the topside and the downside comes onto the taxpayer, either through the FDIC insured deposits or more broadly because the largest banks in this country are too big to fail despite the best intentions of the people who wrote Dodd-Frank and the regulators who tried to implement it. Too big to fail is a reality in this economy and around the world. And if you want to deny it, if you want to tell me that global megabanks can't actually fail today, right now, let's have that discussion. I think it's a fascinating discussion to walk through exactly how that failure would happen unimpeded. It doesn't exist.

I would commend to the staff and to anyone else who at all doesn't get this the work of Anat R. Admati and her colleagues at Stanford University who go through in great detail from the perspective of both corporate finance from an academic point of view and from a real world point of view and lay out for you the social costs of this asymmetric payoffs.

While we're putting ideas on the table for addressing the asymmetric payoffs, not that you can move on this one by yourself, but limiting the tax deductibility of interest for highly leveraged, very big financial institutions is a good idea whose time will come.

MR. BERKOVITZ: David.

MR. ROBERTSON: Yeah. I just wanted to address a couple points from the standpoint of corporate treasurers. I do think that there's a difference between wanting banks to be healthy and strong and wanting access to liquid markets doesn't necessarily make the corporate treasurers a shell for the banking industry or somehow enjoying subsidies. Right now in the market we have an extreme credit condition, and I think if there is a subsidy in the market it's the fact that basically everything shifted to sovereign risk. And so as you said, there are banks that are too big to fail and, in fact, those banks aren't just getting all of the deposits. They're getting larger and larger.

And what we're dealing with here is a perfect example of why we have banks too big to fail, and that is we put through regulation that has one perspective. We think we're going to restrict something and in point in fact, we have unintended consequences. And I think that's probably the biggest concern of corporate treasurers is that we are laying regulation upon regulation and regulation and we've seen banks like Wachovia and National City fail, but what have we seen as a result? We've seen more concentration of financial risks in the market. So adding yet another restriction on what can happen with a smaller number of counterparties with which corporate treasurers can truly do business, that's not going to help the financial markets. And I don't perceive that there is any subsidy when a bank is selling a derivative or a forward contract to a company. They're making an open market transaction. There's multiple corollary price points. There's an informed buyer and an informed seller. So I'm not buying the subsidy argument.

MR. SIMON JOHNSON: The cost to capital, David, the cost to capital, sure you would agree, is lower for a financial institution that is backed implicitly by the full faith and credit of the U.S. Treasury than it is for another institution that is small enough, simple enough to fail.

MR. ROBERTSON: Actually, if we see the subsidies in the banking industry, they're across the board for banks of all sizes through unlimited insurance given to the banks. If you really are managing trading risks properly, and I agree that's a big if that the industry has to address, you have banks that have to set aside capital internally, even from prudent risk management, but the exposures that these trades generate.

Now, we can have an argument whether they're doing it properly or not but the bank is attempting during a ROE on that swap. It has trading risk, it has credit risk embedded in that capital that's set aside for that instrument. And the corporate treasury is paying for that exposure as well. So there's no sense of a subsidy unless you believe that all the risk-based capital allocations that are going into these products are incorrect.

MR. SIMON JOHNSON: The estimates of the funding cost advantage for too big to fail banks within the financial sector vary between 25 and 75 basis points. I would put it around 50 basis points. That's a huge funding advantage in today's market from being too big to fail.

MR. ROBERTSON: For deposits. It's a funding of mandatory deposits.

MR. SIMON JOHNSON: It's being too big

-- it's having a balance sheet that's large enough relative to the size of the economy.

MR. JARSULIC: Yeah, that's not a funding advantage to deposits. This is a funding advantage to bank holding companies and the advantage to the bank holding companies derives from the fact that there's a put option on the taxpayer that will prevent that bank from failing. And as a consequence, their cost of funds is remarkably lower. It's not just because there's an insurance on the deposits.

MR. ROBERTSON: Right, but again we're talking about funding the bank; we're not talking about the balance sheet exposures.

MR. RODRIGUEZ: I just want to respond to that. I think that there may be a funding advantage. I'd be interested to look into that study or follow up with you Simon afterwards. The issue here -- that's a separate discussion from the Volcker Rule. Right. I think that is, you know, too big to fail, two points or comments I would make at least from the Credit Suisse perspective. I think Basel III has addressed this. Once again where you have significantly increased the capital requirements, improved the funding liquidity requirements, and also encouraged significantly greater oversight of these banking institutions, you know, the risk to weighed assets as measured by Basel II have come down from about 450 billion down to about 150 billion.

So if we were too big to fail before, we're not as too big to fail now for sure by any measure. And I'd also say that the balance sheet has shrunk down from about a trillion dollars to -- and this is all public information -- down to, I think, maybe south of 400 billion. I think this is about the numbers. So significant shrinkage in terms of balance sheet exposure. The size of the institution has become a lot tighter. And I think this too big to fail problem is being addressed. People in this room may not be aware of it but institutions are getting smaller. You always hear the statistic out there cited that, oh, a bigger proportion of banking is being addressed or being concentrated in a fewer number of banks. But the overall size of the balance sheets and the risk associated with those banks is actually much smaller than it's been in the past.

MR. SIMON JOHNSON: That may be true in Switzerland; it's not true in the United States. JP Morgan Chase, the largest bank in the country, has a balance sheet now around $2.3 trillion if you measure under U.S. GAAP. That allows a very generous definition of netting. If you put them under IFRS, it would be a $4 trillion bank, which would be larger than Citigroup was, which was the largest bank at the time in 2008. So our biggest banks are actually getting bigger. I agree that the Swiss are moving in the right direction. I wish that we had Swiss level capital and capital requirements which are much stronger than Basel III across all our banks. That would put us in a better position, although I would argue not a strong enough position with regard to capital going forward.

MR. RODRIGUEZ: I agree with that statement from Simon.

MR. BERKOVITZ: Bob, I think you had some technical --

MR. COLBY:: : Well, I don't want to bore people here.

MR. BERKOVITZ: I think we've probably got about 15 minutes left.

MR. COLBY:: Yeah. I won't take all that. I wanted to say three more things about the issues that you face in the market maker definition and just remind you of two other major points that you need to focus on in the Volcker Rule context. And none of this will be startling to you.

The three points with respect to the swaps. The first is that because people don't, as Keith said, don't hold themselves out with a quote in a particular -- they may do a swap but you really have to think about it as being willing to accommodate customer demand in positions, a type of position as opposed to any sort of particular instrument because they're too diffuse in number.

The second is that I think you're going to have a higher number of interdealer trades than you would in other markets because oftentimes a market maker facilitates a customer with a swap then they may do a similar or a hedge swap with a dealer. And, you know, the customer-facing ratio counts against you but that's something that you have to pay attention to particularly. Then a topic that's very familiar to you, inter-affiliate swaps. The release doesn't discuss them. They complicate the analysis. You're going to have to look at it probably across the full range of swaps to see the full market making relationship. So those are the three things specifically here.

And then I just wanted to, before we lose time all together, point out that there's a great deal of concern about including forwards in the derivative definition. And most people thought that commodities were excluded and that included commodity forwards and not just spot -- when they're physically settled.

And then last of all you really need to pay attention to commodity pools. I think you know but it's vastly over extensive and it needs to be brought down to what I think the original purpose was.

MR. SIMON JOHNSON: Just Robert's point reminds me that on the issue of inter-affiliate swaps I presume and hope that you're talking in a very deep way with the FDIC, particularly with regard to Title 2 resolution where inter-affiliate transactions are a huge part of the problem that they've identified, but also with regard to living wills. If we have a large amount of these swaps and the ability, these organizations continue to have the ability to change whether the risk is recognized or would ultimately fall or will fall in the event of a severe stress scenario, that makes the living will process much harder to implement. Makes it much harder for that to have real value to supervisors. And presumably, at least the swaps part of that is something that you should be involved in.

MR. BERKOVITZ: Paul.

MR. SHANTIC: I would like to try to stay out of the Simon, David back and forth here. And a point I had earlier in terms of Lynn's comment about profits in terms of limiting profits, it's incumbent upon me as a portfolio manager always to try to find the best price. And it's also important that we remember that during the 2009-2010 period when most of the big banks were paralyzed for large periods of time, other banks came in, other firms were formed that took care of some of that liquidity during that period and became pretty crucial until I suspect the funding for the banks got better and took advantage of the funding advantage to restart and to take more risks for their clients. So there was a period of time, six to nine months, where the difficulty of getting a trade done was pretty substantial. And the only liquidity in many instances was, in some cases, some foreign banks and newly formed firms that were split off from some of the larger firms. That then turned around as liquidity came back into the markets.

MR. BERKOVITZ: Lynn.

MS. STOUT: I'm just going to say how relieved I am at least to hear that Paul Shantic is concerned about the profitability of banks when he's the counterparty to the banks. But I also wanted to respond, simple point out that each of the concerns that Robert Colby brought up and that suggested your agency you should focus on, your Commission should focus on, to the extent that you take those concerns into account in your standards, I'm having a hard time seeing how you can do that without simultaneously loosening the standards in a way that would make it much easier for banks to be essentially proprietary trading while claiming to be market making.

I'm not saying that you're not right to raise those concerns, Robert, but I'd be interested in hearing any suggestions from you or anyone else on how those concerns can be addressed without simultaneously making it more likely that deposit accepting banks will indeed resort to proprietary trading.

MR. COLBY:: : Well, so what I'm trying to address here is the disqualifying factors that will knock you out of the exception. But generally speaking, I think that because of the complexity of the whole topic that the only way it can be effectively administered is by having existing rule, having guidance about how you should be thinking about this, both for the banks and for the supervisors, and then having the supervisors having a very intense discussion looking at metrics and trying to understand what the actual activities of a particular swap dealer or FCM if they're doing business, what their particular characteristics are and trying to understand their business because the concern I'm trying to express is that the way that the rule itself has been structured now with factors that if you don't -- if any one of them -- if there's some question about whether you comply, that you'll be knocked out and you won't be in a permitted activity, then that's going to result in overly restrictive compliance requirements on the part of people that are actually trying to comply with the statute. And it will ratchet up or restrict the activities more than the regulators actually intend when they try to adopt the rule.

MS. STOUT: So just to make sure I understand what you're suggesting, you're suggesting that rather than try and put in place prophylactic rules that might have the admittedly undesirable consequence of discouraging or chilling transactions that perhaps were not intended to originally be covered by the statute, you would favor a system in which a combination of the industry and regulators would on a case-by-case basis try to identify potentially risk-creating dangerous situations in advance?

MR. COLBY:: : I wouldn't express it that way. What we'd say is that the prophylactic rule would be that you do not -- the exception is just for market making. But after that I think the entire discussion where it's been focused on details has shown the extreme complexity of trying to identify ahead of time what the difference is between market making and proprietary trading. And that, I think, says to the people that are going to have to live with the rule, that what it's going to have to be is an iterative process. And this is not one that they take lightly because it means extensive involvement with their supervisors on the details of how they engage in hedging and in market making. But that's what it's going to take and they're going to have to walk -- set up a compliance program that's going to have to identify what the mandates are and what they're allowed to do and what the risk requirements are and what the policies and procedures that control this is, and they're going to have to go through it desk by desk with their supervisors so that the supervisors understand what they do. And I don't think that most -- other people can comment on this -- there's no other effective way to ensure that this is being applied in some sort of a workable but constraining manner.

MR. BERKOVITZ: Steven or Stephen, do you have any further questions? Any further comments? I think we've had an excellent discussion today. If there are no further comments I'd just like to thank everybody. We have a task given us by Congress which is to implement section 619 of the Dodd-Frank act, the Volcker Rule, and this discussion has been very helpful as we try to carry out Congress's intent to prohibit proprietary trading yet permit market making and risk mitigating hedging activities, and this discussion will be very helpful. It really builds upon our record and I again thank all the participants for taking time out of your busy schedules to come here and engage in a lively debate. It's been very, very informative and we again thank you very much.

(Applause)

(Whereupon, at 4:11 p.m., the PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

DISTRICT OF COLUMBIA

I, Christine Allen, notary public in and for the District of Columbia, do hereby certify that the forgoing PROCEEDING was duly recorded and thereafter reduced to print under my direction; that the witnesses were sworn to tell the truth under penalty of perjury; that said transcript is a true record of the testimony given by witnesses; that I am neither counsel for, related to, nor employed by any of the parties to the action in which this proceeding was called; and, furthermore, that I am not a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

(Signature and Seal on File)

Notary Public, in and for the District of Columbia

My Commission Expires: January 14, 2013