United States Senate
WASHINGTON, DC 20510

June 23, 2011

Hon. Gene L. Dodaro, Comptroller General
Government Accountability Office
441 G St., NW
Washington, DC 20548

Re: Study of Proprietary Trading

Dear Mr. Dodaro:

We write to express our concerns and disappointment with the failure of the Government Accountability Office (GAO) to complete the study required pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). While the GAO has conducted a study into some issues related to proprietary trading—which our offices and others are reviewing in draft form—that study bears little relation to the statutory mandate requiring the GAO to look into the risks and conflicts of interest in proprietary trading.

The GAO Study has failed to:

(1) accurately capture the scope of proprietary trading required by the mandate;
(2) analyze such proprietary trading in the places where it occurs; or
(3) explain how proprietary trading losses can—and did during the financial crisis—contribute to significant losses in bank capital.

Accordingly, we urge the GAO to re-examine its statutory mandate and use its authority to collect and analyze data necessary to fulfill that mandate. Failure to do so will result in an incomplete and potentially highly misleading report that not only fails to follow its statutory mandate but also fails to provide meaningful guidance to policy makers and regulators on these issues.

Section 989—Mandate for the GAO Study

Section 989 of the Dodd-Frank Act, which was included in the Conference Committee Report at Senator Merkley's request,[1] directed you to

> conduct a study regarding the risks and conflicts of interest associated with proprietary trading … including an evaluation of—
> (A) whether proprietary trading presents a material systemic risk to the stability of the United States financial system …;

[1] S. Rep. No. 111-176, at 157 (2010).

(B) whether proprietary trading presents material risks to the safety and soundness of covered entities …;
(C) whether proprietary trading presents material conflicts of interest between covered entities that engage in proprietary trading and [their customers] …;
(D) whether adequate disclosure regarding the risks and conflicts of proprietary trading is provided to the depositors, trading and asset management clients, and investors of covered entities …;
(E) whether the banking, securities, and commodities regulators of institutions that engage in proprietary trading have in place adequate systems and controls to monitor and contain any risk and conflicts of interest related to proprietary trading…[2]

The study, which is due in October, was included to provide additional guidance to regulators and policy makers tasked with implementing the Merkley-Levin restrictions on proprietary trading and conflicts of interest, included as Sections 619-621 of the Dodd-Frank Act.

GAO Failed to Use the Mandated Definition of Proprietary Trading

Proprietary trading is a term that, prior to the Dodd-Frank Act, was not defined in law, and it colloquially has come to have many different and sometimes inconsistent meanings. That is why Sections 989 and 619, which we drafted, were precisely worded.

For the purposes of the GAO Study, Section 989 defined proprietary trading as "investing as a principal in securities, commodities, derivatives, hedge funds, private equity firms, or other such financial products or entities as the Comptroller General may determine."[3] This is a very broad definition: there are no distinctions regarding the period of time for which such investments are held, or where within a firm such trading may occur. Further, there is no legislative history to suggest that Section 989's approach to studying proprietary trading was or should be narrowed.

Section 619—which is the substantive provision that makes significant restrictions on proprietary trading—uses its own, different definition of proprietary trading. That definition is much more complex, and, depending on regulatory interpretation, more narrow. Section 619 defines proprietary trading for the purposes of its regulatory restrictions as "engaging as a principal *for the trading account* of the banking entity or [systemically significant non-bank] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract for the sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that [the appropriate regulators] may, by rule … determine" (emphasis added). The term "trading account," in turn, is defined to be "any account used for acquiring or taking positions in the securities and instruments [described in the proprietary trading definition] principally for the purpose of selling in the *near term* …, and any *such other accounts* as the [appropriate regulators] may, by rule … determine" (emphasis added). Thus, Section 619 covers principal trading in the "trading account," but provides regulators with authority to expand the coverage to include other accounts, including those that are not limited to sales that may occur in the "near term."

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[2] Section 989(b)(1).
[4] *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS, 15-22 (2011).

The difference between these two definitions is essential for understanding the purpose of the GAO Study. In the first iteration of the Merkley-Levin provisions, the PROP Trading Act (S.3098), proprietary trading was defined very broadly, much like it is for the GAO Study. However, during the course of the legislative process, the substantive restrictions in the Merkley-Levin provisions in Section 619 came to use the much more complex and narrow definition of proprietary trading, but one that could be expanded at regulators' discretion.

Because the application of Section 619's restrictions could be expanded by regulators, the GAO Study remained in the bill as a means to inform regulators' decisions on whether to broaden the scope of the activities covered by the substantive restrictions. The GAO Study was included in the Conference Committee Report to shed light on areas where regulators could exercise their discretion to make the provisions more or less restrictive. For example, one issue that we had hoped the GAO Study would examine would be whether regulators should consider, as a potential exercise of their discretion under Section 619, restricting trading outside of the "trading account."

Unfortunately, rather than study proprietary trading as that term is defined in its mandate, the GAO appears to have created its own definition of the term, which relies neither on the definition of Section 619 nor on the statutory mandate of Section 989. Instead, it appears to have selectively focused on only short term principal trading, and its numerical analysis appears constricted to only the limited data that was most readily ascertainable—that related to "stand-alone proprietary trading," which is the subset of proprietary trading that occurs on distinct proprietary trading desks.

Distinct proprietary trading desks are dedicated units within a firm whose sole function is to engage in proprietary trading for the account of the firm, and as noted by the Financial Stability Oversight Council (Oversight Council) study released in January,[4] comprise only a small subset of overall proprietary trading targeted by Section 619. Thus, the GAO's operating definition of proprietary trading is significantly narrower even than that of Section 619, much less than that of its mandate.

GAO Failed to Collect Data and Analyze Proprietary Trading Occurring in All Parts of a Firm, as Required by its Mandate

The Oversight Council's study, and common sense, make clear that proprietary trading may occur in many locations at the firm, in particular on trading desks engaged in market-making, underwriting, hedging, and other long-term principal investments. Again, policy makers and regulators knew—before the GAO Study and before the passage of the Dodd-Frank Act—that distinct ***proprietary trading desks*** were only one small portion of the activities that posed significant risks and conflicts of interest to the firms. And the GAO was not asked to examine whether that was the case. Rather, the GAO was tasked with identifying and assessing the risks and conflicts of interest associated with ***proprietary trading, wherever it occurs***.

This is critical, in part, because so many investigators, experts, and regulators, including the Financial Crisis Inquiry Commission, have pointed to the deterioration of firms' principal trading positions as the cause of the collapse of many of the nation's largest financial firms.[5] Indeed, the structured

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[4] *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS, 15-22 (2011).

[5] See FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY COMMISSION REPORT, 196-97, 202-04, 223, 226-28, 256-57, 260-61, 280-81 (Jan. 2011); Report of Exam'r Anton R. Valukas at 59-

products, including collateralized debt obligations and other instruments that were the "toxic assets", were largely retained in the trading books of the firms as a result of their market-making and underwriting activities. Unfortunately, the GAO did not collect or analyze any data regarding proprietary trading occurring within the market-making, underwriting, or hedging desks, or in units dedicated to principal investments such as merchant banking, all of which is required by the mandate under Section 989. Failure to collect data directly regarding the principal investments in these instruments – as is plainly required by Section 989 – is a significant oversight.

While the GAO Study may provide some limited information regarding total trading activities (which includes market making, hedging, and activities on distinct proprietary trading desks), that data is of limited utility absent an analysis that breaks out which of those activities may properly be considered proprietary trading. Indeed, any comparison between distinct proprietary trading desks (which are facially prohibited under Section 619) and all trading is inapposite because it is unclear how much of "all trading" in fact includes prohibited proprietary trading under Section 619. Even if the GAO concluded that the small subset of proprietary trading on distinct proprietary trading desks was riskier than all trading, it surely cannot conclude that all other trading activities are somehow low-risk unless, at a minimum, it specifically breaks out the rest of the trading activities into specific categories of trading that are either permitted or not, and then analyze those categories for assessments of risk.

GAO Failed to Explore How Proprietary Trading Losses Pose Risk to the Safety and Soundness of Financial Institutions, as Required by the Mandate

In order to fulfill its mandate, the GAO needed to explore exactly how proprietary trading losses could affect the safety and soundness of a financial institution. In the financial crisis, when firms took write-downs on their principal trading positions (which, under Section 989 were proprietary trading positions), those firms had to record significant losses to their capital positions. Their depleted capital positions left the firms in need of unprecedented government support, which led directly to our desire to remove the need for taxpayers to provide that support ever again.

Unfortunately, the GAO Study fails to explore any of the causal links between deteriorating trading positions and declining capital, including the impact of mark-to-market accounting on the timing of capital write-downs. Such an examination is essential to understanding the impact on the financial institutions of proprietary trading losses. By failing to explore this essential link between proprietary

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60, In re Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. 2010), available at http://lehmanreport.jenner.com/; Fed. Deposit Ins. Corp. ("FDIC"), *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, 5 FDIC QUARTERLY, no. 2, 2011 at 1, available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf; JANE D'ARISTA, POLITICAL ECON. RESEARCH INST., LEVERAGE, PROPRIETARY TRADING AND FUNDING ACTIVITIES 1 (2009), available at http://www.peri.umass.edu/fileadmin/pdf/other_publication_types/SAFERbriefs/SAFER_issue_brief1.pdf; Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 199-204 (2009); Wilmarth, Jr., at 1032-34=; John Cassidy, *Subprime Suspect: The Rise and Fall of Wall Street's First Black C.E.O.*, NEW YORKER, Mar. 31, 2008, at 78, 86-88; Jake Bernstein & Jesse Eisinger, *Banks' Self-Dealing Super-Charged Financial Crisis*, PROPUBLICA, Aug. 26, 2010, available at http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis; Jake Bernstein & Jesse Eisinger, *The 'Subsidy': How a Handful of Merrill Lynch Bankers Helped Blow Up Their Own Firm*, PROPUBLICA, Dec. 22, 2010, available at http://www.propublica.org/article/the-subsidy-how-merrill-lynch-traders-helped-blow-up-their-own-firm.

trading losses and impact on bank capital positions, the GAO has left out a critical piece of the picture: one of the main reasons the restrictions on proprietary trading were put into place was to protect banks from the types of losses to their capital that nearly destroyed them. Yet, despite a mandate directing it to do so, the GAO sheds no light on this important issue.

Any GAO Conclusions and Recommendations Will be of Extremely Limited Value

Congress has concluded that proprietary trading gave rise to significant risks and conflicts of interest, and it directed the GAO to provide guidance to regulators tasked with addressing those concerns. Yet, by failing to use the statutorily-mandated definition of proprietary trading and failing to identify and analyze proprietary trading occurring in other areas of the firms, the GAO's conclusions and recommendations will necessarily be of limited utility.

As a practical matter, distinct proprietary trading desks will be prohibited at banking entities once the Merkley-Levin provisions become effective—so any analysis of them is of limited value. While the GAO Study may reflect some risks and conflicts analysis, that analysis is only useful to the extent that characteristics of the trading can be used to help firms and regulators identify, analyze, and restrict proprietary trading occurring in other parts of a firm. However, by failing to identify the size, scope, and nature of proprietary trading occurring elsewhere, extrapolating the characteristics of proprietary trading occurring on the distinct proprietary trading desks to all proprietary trading at a firm will be difficult.

Indeed, we and others, including the financial regulators, have long recognized that one of the key challenges for regulators seeking to implement the Merkley-Levin restrictions on proprietary trading is delineating between permitted and prohibited proprietary trading under Section 619.[6] Although the GAO notes that broader proprietary trading may be occurring elsewhere within the firm and urges regulators to collect additional data to analyze and monitor those risks, the GAO Study itself is unable to offer any analysis of these types of proprietary trading, other than to note of their potential existence. It was precisely the desire to seek GAO's assistance in answering this question that is a principal basis for the study. However, the GAO's answer so far, is to simply beg the question.

Similarly, by not using the statutorily-mandated definition of proprietary trading and not collecting and analyzing data related to all proprietary trading occurring in various business units, the GAO cannot accurately identify and assess the full range of conflicts of interest associated with proprietary trading. For instance, the U.S. Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, has identified several examples wherein a firm engaged in abusive practices for its own proprietary trading profits.[7] In those instances, the conflicted proprietary trading occurred as the firm claimed to be acting as a "market maker" or "underwriter," and did not occur on a distinct proprietary trading desk. However, by focusing only on distinct proprietary trading desks and not proprietary trading occurring at, for example, market-making desks or underwriting desks, the GAO is unable to fully appreciate these conflicts of interest or recommend mechanisms for regulators and firms to appropriately address the conflicts.

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[6] *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS, 22 (2011).

[7] U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011).

Conclusion

Section 989 was intended to provide guidance to regulators and policy makers on the scope, risks, and conflicts of interest associated with proprietary trading. Indeed, its greatest utility is to shine light on areas where regulators are able to exercise discretion under Section 619. Yet, as drafted, the GAO Study adopts an exceedingly narrow approach to the problem, fails to collect and analyze the relevant data, and, as a result, is unable to fulfill its mandate or meaningfully aid policy makers and regulators in implementing the Merkley-Levin restrictions on proprietary trading and conflicts of interest. Accordingly, we urge you to re-examine the statutory mandate and use its authorities to complete its study pursuant to its mandate.

Sincerely,

Jeffrey A. Merkley

Jeff Merkley
U.S. Senator

Carl Levin

Carl Levin
U.S. Senator