



Felix Salmon

Occupy's amazing Volcker Rule letter

By Felix Salmon | FEBRUARY 14, 2012

banking

One of the saddest aspects of the financialization of the US economy is the way in which America's best and brightest found themselves working on Wall Street, rather than in jobs which improved the state of the world. Proof of this comes from the absolutely astonishing 325-page comment letter on the Volcker Rule which has been put together by Occupy the SEC; it's pretty clear, from reading the letter, that the people who wrote it are whip-smart and extremely talented.

Occupy the SEC is the wonky finreg arm of Occupy Wall Street, and its main authors are worth naming and celebrating: Akshat Tewary, Alexis Goldstein, Corley Miller, George Bailey, Caitlin Kline, Elizabeth Friedrich, and Eric Taylor. If you can't read the whole thing, at least read the introductory comments, on pages 3-6, both for their substance and for the panache of their delivery. A taster:

During the legislative process, the Volcker Rule was woefully enfeebled by the addition of numerous loopholes and exceptions. The banking lobby exerted inordinate influence on Congress and succeeded in diluting the statute, despite the catastrophic failures that bank policies have produced and continue to produce...

The Proposed Rule also evinces a remarkable solicitude for the interests of banking corporations over those of investors, consumers, taxpayers and other human beings. In their Overview of the Proposed Rule, "the Agencies request comment on the potential impacts the proposed approach may have on banking entities and the businesses in which they engage," but curiously fail to solicit comment on the potential impact on consumers, depositors, or taxpayers. The Administrative Procedure Act requires that, prior to the enactment of a substantive regulation, an agency must give "interested persons" an opportunity to comment. The Agencies seem to have lost sight of the fact that "interested persons" could include human beings, and not just banking corporations.

There's lots more where that comes from, including the indelible vision of how "the Volcker Rule simply removes the government's all-too-visible hand from underneath the pampered haunches of banking conglomerates". But the real substance is in the following hundreds of pages, where the authors go through the Volcker Rule line by line, explaining where it's useless and where it can and should be improved.

For instance, there's a massive repo loophole in the proposed rule, which basically allows banks to move all their prop trading to their repo desks.

And then there's the even bigger market-making loophole, which, unlike the repo loophole, actually exists in the original statute. Still, Occupy the SEC does a great job in glossing why it's a bad idea:

Market making is an indispensable component of liquid, efficient markets. This service, however, simply does not belong in banks...

The bank lobbying effort is certainly understandable: market making is a profitable business and one that banking entities certainly do not want to lose. It is well-known that the major dealers have always fiercely guarded their dominance of market making, particularly in the less regulated OTC markets. Firms that attempt to enter this business are regularly strong-armed through anti-competitive arrangements with inter-broker dealers... Despite the banks' desire to continue reaping such profits, their contention—that banking entities alone are able and willing to provide this valuable service to the market, and that regulation will cause irreparable damage to the financial system at large—is unfounded and nonsensical.

In the proposed rule, banks can claim to be “making a market” in illiquid instruments when they're only on one side: buying and not selling, or selling and not buying. They're even allowed to claim to be making a market when they're unwilling to provide executable bids or offers *at all*. (After all, if such situations never occurred, then the market wouldn't be illiquid in the first place.) It's pretty easy to see how a market-maker's inventory can morph into a proprietary trade, under such circumstances.

As the letter says, “an unfortunate consequence of the generalized language throughout the Proposed Rule may be the shift of risky practices out of liquid and transparent markets into the less regulated illiquid and OTC products” — there's a real risk, here, that the Volcker rule could actually make bank trading *more* risky, rather than less.

The letter also picks up on the Volcker Rule's proposed treatment of carried interest. As we all know from following the Romney campaign, carried interest is treated as capital gains for income tax purposes. But in the Volcker Rule, it's treated as fee earnings. As the letter says, “carried interest should not provide loopholes to banking entities and to covered funds in both the realm of taxation and the realm of regulation”. Carried interest is income, yes, but it's also an ownership stake — but under the proposed rule, it's exempt from the definition of “ownership interest”. Which seems silly.

Very well done, then, to Occupy the SEC — a clear example of how the Occupy movement is making incredibly detailed and substantive demands of our legislators and regulators. This letter is many things, but inchoate it is not. Let's hope that the SEC gives it the full attention it deserves.