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GAO Report on Proprietary Trading

[25358]

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TO: SEC RULES MEMBERS No. 93-11
EQUITY MARKETS ADVISORY COMMITTEE No. 47-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 60-11
ETF ADVISORY COMMITTEE No. 52-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 33-11 RE: GAO REPORT ON PROPRIETARY TRADING

The U.S. Government Accountability Office ("GAO") has issued a report, as required by Section 989 of the Dodd-Frank Act, reviewing the risks and conflicts associated with proprietary trading. [1] The Report responds to several issues surrounding the implementation of Section 619 of the Dodd-Frank Act (the "Volcker Rule"), which prohibits banking entities from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds. The Report specifically examined: (1) what is known about the risks associated with the prohibited activities and the potential effects of the restrictions and (2) how regulators oversee the prohibited activities and what challenges they might face in implementing the restrictions going forward. The most significant aspects of the Report are summarized below.

The Report states that GAO found that proprietary trading and investments in hedge funds and private equity funds, like other trading and investment activities, provide banking entities with revenue but also create the potential for losses. The Report notes that banking entities conduct proprietary trading at stand-alone proprietary-trading desks as well as elsewhere within their firms. GAO determined that collecting information on activities other than at stand-alone proprietary trading desks was not feasible because firms did not separately maintain records on such activities. The Report therefore did not analyze data on broader proprietary trading activity but only analyzed data on stand-alone proprietary-trading desks at the six largest U.S. bank holding companies from June 2006 through December 2010. The Report found that compared to these firms' overall revenues, their stand-alone proprietary trading and their hedge fund and private equity fund investments generally produced small revenues in most quarters and some larger losses during the financial crisis.

The Report notes that some financial institutions, policymakers, and researchers expressed concerns about potential negative consequences of the Volcker Rule's restrictions on proprietary trading and hedge fund and private equity fund investments, e.g., that the restrictions could reduce the ability of banks to offset risks in other areas, potentially reduce the competitiveness of U.S. firms by restricting their activities compared to their international competitors, and reduce the amount of liquidity in the financial markets. The Report found that there with little evidence existing on these effects and therefore the likelihood of these potential outcomes was unclear.

The Report found that while the Volcker Rule's restrictions reduce the scope of activities regulators must monitor, implementing the restrictions, and in particular clarifying and requiring monitoring to better ensure that only permissible activities occur, will be difficult. The Report also found that effective data collection will be critical to oversight by regulators. The Report states that completing a more in-depth review of activities that may be covered by the restrictions could provide information on the potential impact of the restrictions, how firms are preparing for them, whether there are efforts to evade the restrictions, and how to improve monitoring and enforcement. Because regulators have yet to collect more complete information on the number and nature of trading desks where proprietary trading could be occurring, or firms' hedge fund and private equity fund investment activities, the Report states that regulators risk not being able to most effectively implement the restrictions.

Based on its findings, GAO recommended that as part of implementing the new restrictions, regulators should collect and review more comprehensive information on the nature and volume of activities potentially covered by the Volcker Rule. [2]

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endnotes

[1] See United States Government Accountability Office Report to Congressional Committees: Proprietary Trading, Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented (July 2011), available at http://gao.gov/mobile/products/GAO-11-529 ("Report").

[2] Regulators are required to adopt implementing regulations for the Volcker Rule by October 2011.