Postscript: Toward a New Regulatory Environment

The Volcker Rule was advanced as a means of protecting the public from the risks of negative externalities and the effect of distorted incentives (or "moral hazard") arising from proprietary trading activities by financial institutions that have access to funding through insured deposits or access to the Federal Reserve's discount window. Proponents of the ban on proprietary trading offered this description of the rationale: "After taxpayers were forced to bail out banks and other systemically significant financial companies whose proprietary trades went awry, we determined that the economy and taxpayers need strong protections against an increasingly casino-like financial system."[1] Paul Volcker observed that "adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense … when those risks arise from more speculative activities far better suited for other areas of the financial markets"[2] and that, accordingly, a robust financial system requires regulatory limitations on the proprietary activities of banks to balance the moral hazard implied by the public safety net.[3] The utility of the regulations proposed to implement the Volcker Rule will depend upon the effectiveness of the protections that they provide against these risks, balanced against the costs and unintended consequences that they generate.

Objectives of the Rule and Potential Unintended Consequences

The perception that proprietary trading by banks could cause catastrophic losses was an important impetus to the enactment of the Volcker Rule. Proprietary trading was seen as inherently risky[4] and a significant contributor to the financial crisis.[5] Moreover, it was viewed as a source of distraction from the provision by banks of credit and other core services, and a source of unacceptable conflicts of interest between banks and their customers.[6] The rule's architects objected to the use of federal support[7] by banks to enable their trading desks to speculate in financial assets. The prohibition against sponsoring and investing in private funds was viewed as necessary to counteract incentives that may impel banks to "bail out" a sponsored private fund and to prevent banks from using such investments to circumvent the proprietary trading ban.[8]

These views are not universally held. Some observers have questioned whether long-term investments (in, for example, collateralized debt obligations, mortgage-backed securities and leveraged loans), which

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[1] Letter from Jeff Merkley *et al.*, Senator, U.S. Senate, to FSOC, 2 (Oct. 28, 2010), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-0822. *See also* Fin. Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds* 15 (Jan. 18, 2011) (FSOC Study), *available at* http://www.sifma.org/uploadedfiles/issues/regulatory_reform/volcker_rules/fsoc%20volcker%20section%20619%20dodd-frank%20study%20final%201%2018%2011%20rg.pdf (indicating that a purpose of the Volcker Rule is to "[s]eparate federal support for the banking system from speculative trading activity with the banking entity's own capital").

[2] Paul Volcker, Op-Ed, *How to Reform Our Financial System*, N.Y. Times, Jan. 31, 2010, at WK11. The Volcker Rule is named for former Federal Reserve Chairman Paul Volcker.

[3] *See id.*

[4] *See* U.S. Gov't Accountability Office, GAO-11-529, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (2011) (GAO Report), *available at* http://www.gao.gov/new.items/d11529.pdf.

[5] *Id.* at 6, 43.

[6] *Id.* at 10.

[7] The FSOC Study, in describing the prohibitions mandated by the Volcker Rule, observes that banking entities "benefit from federal insurance on customer deposits or access to the discount window." FSOC Study at 1.

[8] *Id.* at 6.

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the rules would allow, present banks with a greater risk of destabilizing losses than the short-term trading that the rules prohibit.[9] Others have observed that the rules allow short-term proprietary trading in debt issued by the Treasury or government-sponsored enterprises.[10] Opponents of the Volcker Rule have questioned whether proprietary trading played any part in a financial crisis "caused by the erosion of lending standards and the federal government's poorly-conceived efforts to subsidize mortgage lending."[11] In addition, some have questioned whether the risk of loss arising from proprietary trading could be addressed more effectively by other means, such as improvements to the risk-based capital rules or requirements for elevated levels of margin in interbank transactions.[12]

Even if the Volcker Rule is an appropriate legislative response to the financial crisis, its utility will depend on whether the regulations issued to implement it will give regulators the tools they need to satisfy its objectives. The introduction to the proposed regulations evinces an overriding concern with trades that may appear (at least superficially) to be permitted market making or hedging activities but, in some more genuine sense, constitute a proscribed form of proprietary trading.[13] In one important dimension, the effectiveness of the regulations will depend on whether they provide sufficient means to detect such covert forms of proprietary trading.

The regulations will function effectively in the complex arena of modern trading only to the extent that they prove to be sufficiently dynamic and flexible to keep pace with rapid market innovation. There is a danger that the rules represent the regulatory equivalent of "fighting the last war." Even if they leave no risk that the conditions that caused the financial crisis will recur, the more relevant question is whether the rules can prevent the next crisis.

The proposed regulations will tilt the playing field toward financial firms — within and outside of the U.S. — that compete with the covered banking entities but are not subject to the same regulations. Banks outside the reach of U.S. regulation will gain a competitive advantage if, as expected, foreign regulatory authorities do not adopt the Volcker Rule's regulatory approach.[14] Non-U.S. banks and U.S. nonbanks that are not subject to the regulations can be expected to assume more of the risk attending the proprietary trading activities prohibited by the regulations. Given the uncertainty, complexity and cost that regulated banking entities will face in attempting to comply with the conditions that the regulations impose upon activities — such as market making — that the regulations are intended to allow, unregulated non-U.S. banks and U.S. nonbanks may assume an increasing share of those functions as well.

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[9] GAO Report at 24-26 (showing that between June 2006 and December 2010, the six largest bank holding companies "usually experienced larger revenues and losses from activities other than stand-alone proprietary trading … including writedowns on the values of these firms' positions in CDOs and leveraged loans"). *See also* Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 Harv. Bus. L. Rev. 39, 41 n.10 (2011).

[10] *See, e.g.*, Editorial, *So Much for the Volcker Rule*, *Wall St. J.*, Oct. 24, 2011, at A14.

[11] Letter from Spencer Bachus, Ranking Member, Committee on Financial Services, U.S. House of Representatives, to FSOC 1 (Nov. 3, 2010), *available at* http://www.ft.com/intl/cms/d983eaa6-e793-11df-8ade-00144feab49a.pdf.

[12] *See, e.g.*, Editorial, *So Much for the Volcker Rule*, *Wall St. J.*, *supra* note 10.

[13] Notice at 10, 13-14, 47-71.

[14] *See* J.P.Morgan Cazenove, *Global Investment Banks: Regulatory Arbitrage Series: OW European Over US IBs* 24 (2011), *available at* https://mm.jpmorgan.com/stp/t/c.do?i=5930E-12&u=a_p*d_558208.pdf*h_-2igf3ms. In the United Kingdom, for example, regulators propose to permit any bank to continue proprietary trading activities if those activities are separated by a "ring-fence" from that bank's retail banking activities. *See* Independent Commission on Banking, Final Report Recommendations (2011) 35, *available at* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/201%7/ICB-Final-Report.pdf.

By restricting proprietary trading and altering the competitive landscape, the proposed regulations may channel risk to financial intermediaries that are not subject to prudential regulation, without reducing the overall level of risk in the financial system. This prospect may not appear to be inconsistent with the Volcker Rule's objectives, because those entities do not receive governmental support. Any such realignment, however, may cause regulated banks to depend increasingly on those other intermediaries to absorb risk,[15] increase the proportion of risk that lies beyond the reach of any prudential regulation and elevate systemic leverage. The soundness of the entities that assume additional risk in this shift, particularly if that risk is accompanied by greater leverage, could be highly inter-correlated, and any disruption ultimately may cause risk to flow back to the banks that the proposed regulations are designed to insulate.

Essential Financial Intermediation Services as 'Permitted Activities'

In the introduction to the proposed regulations, the agencies recognize that the provision by banking entities of "client-oriented financial services, which include underwriting, market making, and traditional asset management services, is important to the U.S. financial markets and the participants in those markets."[16] A fundamental challenge presented to the governmental agencies called upon to give regulatory substance to the Volcker Rule is to arrive at a wise balance between satisfying the goals of the rule and permitting banking entities to continue to perform functions that benefit the financial markets and the global economy.

The regulations attempt to accommodate this need by excluding certain "permitted activities" from the prohibition against proprietary trading. The permitted activities are designed to "preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 [of the Bank Holding Company Act] expressly protects and permits."[17] Thus the permitted activities are viewed as a means to "ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation."[18]

If the new regulations are to permit banks to continue to provide core financial intermediation services, such as market making, and to mitigate risk through hedging, the permitted activities (as expressed in the regulations and applied by the regulators) must function as intended. Moreover, if banks are to create necessary solutions to financial intermediation problems in complex and novel transactions, the permitted activities must provide adequate exceptions from the restrictions imposed by the regulations. The effectiveness of these provisions may be undermined by uncertainty in their meaning and consequences; insufficiency in their breadth and scope; and the costs that regulated institutions will be required to bear to comply with them.

The permitted activities must be sufficiently clear and definite to allow banks to continue to provide essential financial services. The agencies recognize that "the delineation of what constitutes a prohibited or permitted activity under section 13 of the BHC Act often involves subtle distinctions that are difficult

[15] *See* Whitehead, *supra note 9*, at 44-46.

[16] Notice at 9.

[17] *Id. See also* FSOC Study at 1 (Permitted activities are intended "to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation.").

[18] FSOC Study at 1.

both to describe comprehensively within regulation and to evaluate in practice."[19] With respect to the distinction between proprietary trading and market making, for example, the agencies observe that "[a]lthough the purpose and function of these two activities are markedly different — market making-related activities provide intermediation and liquidity services to customers, while proprietary trading involves the generation of profit through speculative risk-taking — clearly distinguishing these activities may be difficult in practice."[20]

Several key provisions attempt to distinguish permitted activities from prohibited proprietary trading based on the purpose, design and intention of the trading unit entering into the transaction in question.[21] Any attempt by an outside observer to ascertain the mental state of even a single individual, in performing even one action, is difficult. In the case of the proprietary trading restrictions, the actor is a business organization comprised of numerous individuals, and the proposed regulations would require the agencies to determine the intention or purpose of that actor in a multitude of trading transactions, many of which may be executed simultaneously.

From the perspective of a banking entity attempting to comply with the rules, the uncertainty of these provisions, the difficulty of their application and the risk of being second-guessed may have a chilling effect on its provision of financial services. The rules on hedging, for example, require that a hedge be entered into "to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings."[22] If that hedge fails, however, its failure may appear, in hindsight, to have been inevitable and to suggest that the relevant transaction was pursued for purposes of speculation, rather than risk reduction. Similarly, a banking entity would be required to rebut the presumption that a position violated the prohibition against positions acquired principally for the purpose of short-term resale[23] if, contrary to plan, unanticipated circumstances require disposition of that position in the short term. The presumption may be overcome "by reference to all facts and circumstances surrounding the acquisition,"[24] but the banking entity would bear the burden of producing evidence of those facts and circumstances and persuading the regulators that the acquisition should be permitted. This dynamic may lead a banking entity to conclude that the potential benefits of a contemplated activity do not justify the time, effort and resources that would be required to pursue it under the regulations. Thus the regulations may inhibit the process of innovation that creates solutions to financial intermediation problems.

The regulations also are unclear as to how they would treat actions that are undertaken for multiple purposes. A "trading account," for example, is used to "[a]cquire or take financial positions *principally* for the purpose" of specified categories of short-term trading activities.[25] The need to ascertain whether short-term trading is a "principal" purpose (as opposed, presumably, to a secondary or incidental purpose or another purpose of a lesser rank), adds a further dimension to the practical difficulty of assigning determinative significance to the banking entity's purpose or objective in pursuing the relevant transaction. Accordingly, if a banking entity wishes to market separately managed accounts and acquires positions in

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[19]Notice at 9. *See also* Notice at 27, 53, 64, 177, 179; Proposed Regulations app. B.III.C.

[20]Notice at 53.

[21]Proposed Regulations app. B. *See also* Notice at 82.

[22]*Id.* § __.5(a).

[23]*Id.* § __.3(b)(2)(ii).

[24]Notice at 34.

[25]Proposed Regulations § __.3(b)(2)(emphasis added).

its own account to establish a track record for use in its marketing efforts, would the "principal" purpose of those positions be the creation of a track record, when they will only serve that purpose if the institution is successful in executing short-term trades in the account?[26] Where the regulations would restrict an activity of a banking entity based on the purpose of that activity, but include no express reference to the ranking of that purpose in relation to others,[27] will regulators find the restriction to apply if the specified purpose is not a "principal" purpose — or even a significant purpose?

The proposed regulations prescribe factors, based on quantitative metrics, for use by regulators to determine the intention or purpose of trading activity.[28] However, the factors draw no bright lines. The regulations provide many criteria, but no guidance on how to apply them and no indication of what specific level of a measured quantity should be viewed as the boundary between what is permitted and what is prohibited. These conceptual gaps include the level of risk "required" for conducting market making activities,[29] the level of "Portfolio Profit and Loss" in proportion to "Comprehensive Profit and Loss" that will indicate that a trading unit's revenues are derived from movements in the price of retained principal positions (and thus indicative of proprietary trading)[30] and the means to determine "reasonably expected near term customer demands" that would justify a trading unit in retaining a principal position for market making (as opposed to proprietary trading).[31] Thus, the rules leave broad discretion to the regulators and place enormous pressure on the resources and insight they will bring to bear on these determinations. Banking entities, in turn, are left with little guidance or certainty as to where the boundaries lie.

Individual institutions and the broader financial system may benefit if the agencies, in applying the regulations, either establish bright lines or allow regulated firms to lead the process of determining whether the requirements for permitted activities have been satisfied. The rules provide a framework for banking entities to establish their own criteria and processes for making the relevant determinations;[32] and the agencies may be justified in deferring to them in light of their resources, experience and understanding of the facts and circumstances relevant to the specified criteria in the context of their particular trading operations. Alternatively, the regulators may attempt to establish clearly delineated safe harbors, based on the quantitative metrics contained in the regulations, for permitted activities. If the regulators neither establish bright lines nor allow a degree of self-regulation by the banking entities, we would anticipate that the uncertainty, unpredictability of outcomes and increased transaction costs engendered by the regulations will work against the efficient provision by banking entities of liquidity and other financial intermediation services.

Even apart from the absence of bright-line standards, however, regulated entities may find it challenging to interpret and apply many of the criteria that the proposed regulations would prescribe to identify

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[26] The regulations allow banking entities to provide seed capital in the private fund context (*see* Proposed Regulations § __.12(a)(1)) but do not expressly authorize seeding activity outside of the private fund context.

[27] *See, e.g.*, Proposed Regulations §§ __.3(b)(2)(i)-(iii), __12.(a)(i) & __.14(2).

[28] "The quantitative measurements that must be furnished under the proposed rule are generally designed to reflect, and provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful to help differentiate permitted market making-related activities from prohibited proprietary trading and to identify whether certain trading activities result in a material exposure to high-risk assets or high-risk trading strategies." Notice at 14.

[29] Proposed Regulations app. B.III.C.1.

[30] *Id.* app. B.III.C.2.

[31] *Id.* app. B.III.C.4.

[32] *Id.* app. C. *See also* Notice at 10, 13, 14, 54, 84, 163-164.

permitted activities. The regulations, for example, attempt to identify a conceptual link between "customer"-oriented services and market making. The regulations would deem a purchase or sale of a covered financial position to be made in connection with market making-related activities only if (among other things) "the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of *clients, customers, or counterparties*."[33] Separately, the regulations provide that activities of a trading unit will be prohibited as proprietary trading, rather than permitted as market making-related activities, if that trading unit "retains principal … risks in excess of reasonably expected near term *customer* demands."[34] The omission of "clients" and "counterparties" in the second provision is not explained. In addition, the criteria indicate that the agencies will use the "Customer Facing Trade Ratio" metric to help them assess the extent to which a trading unit's transactions are with "customers versus non-customers."[35] The Customer Facing Trade Ratio relies on a distinction between a "*counterparty* that is a *customer*" and a "*counterparty* that is not a *customer*."[36] The clarity of the market making exception may be improved to the extent that the final regulations can harmonize these provisions.

The distinction between a "customer" and a "non-customer" thus appears to be essential to the determination of whether trading will be considered permitted market making activity.[37] A clear concept of "customer" is elusive, however, and the regulations provide little illumination.[38] An appendix to the regulations provides that a transaction counterparty is not a customer if the transaction is executed on a national securities exchange,[39] but a separate appendix provides that a customer is a person on behalf of whom a broker-dealer or other market participant submits a buy or sell order on an exchange.[40] Appendix B indicates that a customer in an OTC market makes use of the market maker's intermediation services either by requesting those services or by entering into a continuing relationship with the market maker with respect to those services.[41] No guidance is offered to identify a "continuing relationship." Moreover, no definition or explanation of the term "intermediation services" is offered. Indeed, the entire process of distinguishing market making from proprietary trading can be viewed as an exercise in identifying "intermediation."

The introduction to the proposed regulations indicates that "for a banking entity's expectations regarding near-term demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally be based on the unique customer base of the banking entity's specific market making business lines and the near term demands of those customers based on particular factors beyond a general expectation of price

[33] Proposed Regulations § __.4(b)(2)(iii) (emphasis added).

[34] *Id.* app. B.III.C.4 (emphasis added).

[35] *Id.* app. B.III.C.4.

[36] *Id.* app. A.IV.D (emphasis added).

[37] *Id.* app. B.III.C.4. *See also* Notice at 92-95, 262-263.

[38] The agencies may add definitions of "client," "customer" and "counterparty" to the final regulations. The agencies seek public comment as to whether and how such terms should be defined. Notice at 64.

[39] Proposed Regulation app. A.IV.D.3.

[40] Proposed Regulation app. B.III.A.

[41] *Id.*

appreciation."[42] To benefit from this guidance, a trading unit considering whether a position would be commensurate with near-term demand of its customers (or, in the alternative formulation, its clients, customers and counterparties) would appear to be required to infer the underlying motivation for projected demand. The agencies offer no suggestion of what factor "beyond" an expectation of price appreciation may drive such demand.

In addition to the foregoing issues concerning the interpretation and application of the proposed criteria for the permitted activities, banking entities should consider the scope and breadth of those permitted activities. The Dodd-Frank Act invited the agencies to establish exemptions to the proprietary trading restrictions beyond those that the Act enumerated specifically,[43] but the agencies have not proposed any such discretionary exemptions. If the permitted activities as set forth in the final rules are not sufficiently broad and comprehensive, the regulations may inhibit banking entities from providing innovative solutions to financial intermediation problems in an evolving financial system. During the public comment period, financial industry participants will have an opportunity to identify and communicate to the agencies any needs for additional exemptions.

Jurisdictional Reach of the Proposed Regulations

Market participants within and outside the U.S. may be surprised by the jurisdictional reach of the regulations. The permitted activity in respect of trading effected "solely outside of the United States" is narrowly circumscribed. An entity may be subject to the proposed regulations as a "banking entity" if it is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, even if that bank holding company has only a minimal presence (such as a single branch or agency) in the U.S. Such a banking entity would not be permitted to enter into a proprietary trading transaction with a non-U.S. subsidiary of a U.S. corporation (even if that corporation is in no respect subject to banking regulation) if that subsidiary was formed for the purpose of entering into such transactions.[44] A foreign banking entity would not be permitted to enter into a proprietary trading transaction with a non-U.S. counterparty if any employee of the banking entity "directly involved" in the transaction is located in the U.S.[45] or if the transaction is not "executed wholly outside of the United States."[46] The proposed regulations provide no guidance as to what it means for an employee to be "directly involved" or where a transaction would be deemed "executed" for these purposes.

The proposed regulations would appear to require a foreign banking entity with a minimal U.S. presence to comply with the recordkeeping and reporting provisions of the regulations to establish that it is permitted to effect any transaction that qualifies for the permitted activity in respect of trading effected "solely outside of the United States."[47] Even if such a banking entity is otherwise permitted to pursue a transaction "solely outside of the United States," the regulations would appear to prohibit that transaction if it would give rise to a material conflict of interest between the non-U.S. banking entity and its clients or counterparties; expose the banking entity to a high-risk asset or high-risk trading strategy (*i.e.*, an asset or strategy that would significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail); or pose a threat to the safety and soundness of the banking entity.[48]

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[42] Notice at 58.

[43] Dodd-Frank Act § 619(d)(1)(J), 12 U.S.C. § 1851(d)(1)(J).

[44] Proposed Regulations §§ __.2(t)(8) & __.6(d)(3)(ii).

[45] *Id.* § __.6(d)(3)(iii).

[46] *Id.* § __.6(d)(3)(iv).

[47] *Id.* § __.7.

[48] *Id.* § __.8.

Costs of Compliance With the Proposed Regulations

Each time that any trading unit of a banking entity even considers a transaction that may be within the scope of the proposed regulations, that entity will incur the cost of interpreting the applicable provisions of the regulations and analyzing whether, and in what form, the regulations may permit the proposed transaction to be effected. The trading unit will be required to ascertain, in real time, the impact upon any applicable quantitative metrics of the contemplated trade, together with any other trades being executed or considered within the applicable period by that trading unit and the larger institution. If it enters into such a transaction, the banking entity will bear additional costs, including costs arising from monitoring and reporting on trading data as required to establish that transactions qualify as permitted activities under the regulations.

The rules would require banking entities to monitor and report on a range of metrics[49] for trades that are often executed in high volumes and at high velocities. The rules would require each trading unit within a regulated institution to monitor and report this information separately.[50] Governmental agencies, in turn, will incur costs to respond to interpretive requests of regulated entities, analyze the information provided in periodic reports and take any necessary regulatory action. In the introduction to the proposed regulations, the agencies request public comment concerning the potential economic impact of the proposed regulations, including the costs and benefits of compliance and the potential for the requirements and costs of complying with the proposed regulations to cause banking entities to alter their business practices and trading systems.[51]

The cost of complying with the regulations' requirements for interpretation, monitoring and reporting may distort the market for financial services and thus reduce economic efficiency in the financial sector as a whole. These transaction costs, along with the uncertainty and other risks described in this analysis, have the potential to create disincentives for regulated firms to continue to provide financial intermediation services such as market making. As a result, entities that are not subject to similar regulation may come to provide a larger share of these services even if, apart from their advantage in being free of the costs associated with complying with the rules, they are less efficient providers of the services.

[49] *Id.* § __.8, app. A.

[50] *Id.* app. A.III.A(i)(a).

[51] Notice at 192-193.