GreenPoint Financial
www.greenpoint.financial

REGULATORY PERSPECTIVES

June 27th, 2017

Volume - 10

Series - 1

WILL THE VOLCKER RULE SURVIVE UNDER THE TRUMP ADMINISTRATION?

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The "Volcker Rule"[1], a ban on proprietary trading activities by banks included in Dodd-Frank at the last minute, has long been one of the least popular parts of the landmark financial services reform law. Opponents of the Volcker Rule contended that it was a solution in search of a problem: there is scant evidence that proprietary trading played any role in the financial crisis that prompted Dodd-Frank. More importantly, the drafters of this provision soon confronted the reality that it would not be possible to draft a law that simply banned proprietary trading. There were certain trading activities, including treasury management functions, securities underwriting and market-making, that banks were either required to conduct or that lawmakers wanted banks to continue. Opponents of the Volcker Rule argued vociferously that the subsequent efforts to distinguish between prohibited and permitted trading activities made the rule overly complicated and burdensome. On balance, they argued that the harms to the financial markets caused by the Volcker Rule outweighed any supposed benefits in reducing the risks of proprietary trading.

For their part, proponents of the Volcker Rule did not join the debate over the role of bank proprietary trading in the financial crisis. Rather, they contended that the federal banking safety net should not be extended to allow banks to be in the business of engaging in risky trading activities. They noted that the Volcker Rule, and its implementing regulations, carefully separate out this risky trading activity and preserve the ability of banks to engage in trading that promotes risk management and market liquidity. To the extent the rule caused some banks to reduce their permitted trading activities, other non-bank affiliated dealers, hedge funds and others could step in to maintain liquidity.

During the final years of the Obama Administration, backers of Dodd-Frank successfully fended off virtually every effort to peel back even minor provisions of the law, not to mention one of its centerpiece provisions like the Volcker Rule. However, as the implementation of the Volcker Rule has moved forward, opposition has not eased. It has become one of the most frequently mentioned targets for relaxation or outright appeal as the new Trump Administration begins to govern.

In this article, we argue that reform of the Volcker Rule is both appropriate from a policy perspective and likely as a political matter. Further, we believe that, once lawmakers travel down the road of reform, it will be difficult for them to stop short of outright appeal. We also believe that there are other financial controls, particularly capital rules, that can and will be relied on to address the potentially risky behavior the Volcker Rule was intended to address.

Promulgation of the "Volcker Rule"

As adopted, the Volcker Rule provision of Dodd-Frank is far more complicated than a simple bar on proprietary trading. It was recognized from the outset that certain trading activities are integral to the conduct of conventional banking activities, and others, while perhaps not essential, are nevertheless desirable. Hence, the law contains a laundry list of "permitted" trading activities, including trading in government securities, trading "in connection with underwriting and market making-related activities," risk mitigating hedging activities, trading for the general account of an insurance subsidiary or affiliate, and trading that occurs "solely outside of the United States."[2] It also allows the bank regulatory agencies, SEC and CFTC, to permit other activities they determine would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.[3]

The law then imposes limits on the permitted activities, restricting activity that would give rise to conflicts of interest, result in exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banks or the financial stability of the United States.[4] For further measure, the law also included a broad "anti-evasion" provision that permits the regulatory agencies either to adopt rules or take action in particular instances where they believe trading that was nominally permitted nevertheless functioned as an evasion or otherwise violated the Volcker Rule trading ban.[5]

In addition to these broad provisions related to trading activity, the promulgators of the Volcker Rule recognized that bank formation of, or investment in, hedge funds or private equity funds could indirectly circumvent the proprietary trading ban. As a result, additional provisions were added that prohibit banks from serving directly or indirectly as managers, advisers or sponsors of hedge funds or private equity funds.[6] Parallel to the proprietary trading ban, the Volcker Rule goes on to include a list of permitted private fund investments[7] and bank activities related to private funds,[8] and in turn imposes certain restrictions related to those permitted fund-related activities.[9]

Challenges and Costs to Volcker Compliance: Two Examples

This entire structure did not take effect upon the enactment of Dodd-Frank. Even though the statute contained detailed definitions of a number of key terms,[10] its drafters recognized that many concepts incorporated into the law required further clarification, and the various prohibitions and permissions required further definition. Drawing the lines between prohibited and permitted proprietary trading—and prohibited and permitted fund formation, sponsorship, investment and management activities—proved challenging.

Distinguishing Market-Making from Proprietary Trading

Even before adoption of the Volcker Rule, the SEC struggled with the distinction between permissible market-making and improper trading activity. Even if performed in a market-making account, trading was not necessarily considered to be *bona fide* market-making.[11] As a consequence , the final implementing rule included a number of restrictions on the market-making activities it would permit. Among other things, it required that the amount, types and risks of the financial instruments in the trading desk's inventories be designed not to exceed the "reasonably expected near term demand" of customers and counterparties, based on the characteristics of the particular securities involved, as well as a "demonstrable analysis" of historical demand and other factors. It also directed banks to establish and implement compliance programs in which their market-making activity would be assessed based on a variety of metrics, to take actions to demonstrably reduce or promptly mitigate risks taken in connection with their market-making, and to establish limits on the risks taken, the instruments used for risk management, and the length of time positions may be held. The adopting release devotes over 200 pages to a discussion of permitted market-making related activities, with 40 pages alone devoted to a detailed discussion of the expected metrics firms are required to adopt in their compliance program.

The steps required by a bank seeking to rely on the exemption for permitted market-making related activity are truly daunting. To prevent a bank's market-making activities from giving rise to excessive risks, the implementing rules require that the bank's trading inventories not exceed the "reasonably expected near-term demand" (nicknamed "RENTD") of customers, clients and counterparties. The determination of what level is appropriate will vary from one class of securities to the next, and indeed among individual securities within the class, and can vary over time and based on market conditions.[12] While the regulatory agencies administering the Volcker Rule have issued FAQs on a number of questions, unfortunately they have not provided guidance on how RENTD should be determined, leaving confusion and disparities in approaches among banks.[13] To assist the regulatory agencies in enforcing compliance with the rule, banking entities and their affiliates are required to maintain metrics related to their market-making activity on a daily basis, and provide submissions regarding those metrics to the appropriate regulator monthly or quarterly. The required metrics include: (i) risk and position limits and usage; (ii) risk factor sensitivities; (iii) value-at-risk and stress VaR; (iv) comprehensive profit and loss attribution; (v) inventory turnover; (vi) inventory aging; and (vii) customer-facing trade ratio.[14] While banks have indicated that they view the more quantitative metrics, such as risk limits and sensitivities, to be relatively straightforward, they have found some of the other metrics, particularly inventory turnover, customer-facing trade ratio and PnL attribution, to be much more challenging, for reasons such as an absence of internal data and established analytical processes.[15]

Defining Risk Mitigating Hedging

The exception for "risk-mitigating hedging activities," while less lengthy in its exposition, posed perhaps even greater analytical and compliance challenges. The final implementing rules recognize that a hedge need not eliminate all risks related to a position. For example, a hedge may extend only to part of a position (e.g., to bring it below defined risk limits), be for a limited duration (e.g., through use of a swap, future or option), or only address certain risk elements of a market making position (e.g., reduce the currency or interest exposure of a bond, but not the credit risks posed by the particular issuer). The implementing rules permitted an area other than the trading desk that established a risk position to engage in hedging activity (e.g., a risk management group). They also recognized that hedges may not even relate to financial instruments (e.g., a bank might use securities of derivatives to hedge currency, interest rate or credit risks associated with a commercial loan). On the other hand, the implementing rules also recognized that financial instruments used for hedges may give rise to risks of their own (e.g., if they are imperfect hedges, or if they are retained after the underlying market making position is liquidated), giving rise to esoteric questions such as whether to permit hedging of hedge positions.

Other Challenges

Other examples include the challenges in determining when trading activity or private fund activity occurs "solely" outside the United States,[16] delineating the securities/instruments eligible for the U.S., foreign government and municipal securities eligible for exemption, defining which private funds, hedge funds and similar entities are deemed "covered funds" under the Rule, and discerning permissible activities and time frames associated with "seeding" newly launched public funds and divesting seed positions.

Changing Perspectives on Volker

During the 2016 presidential campaign, Dodd-Frank was a frequent target of criticism by presidential candidate Donald Trump. Almost immediately after his election, Trump's transition team pledged to dismantle Dodd-Frank.[17] Subsequent press reports stated that both Trump and his nominee for Treasury Secretary, Steven Mnuchin, were targeting Dodd-Frank, with Mr. Mnuchin declaring reform of Dodd-Frank to be the Trump Administration's "#1 priority."[18] As to the Volcker Rule, Mnuchin stated: "It's unlikely the Volcker Rule is completely eliminated. But certain provisions may be reversed that give banks more discretion. The number one problem with it is that it's too complicated."[19]

These remarks from the incoming Presidential administration coincide with strong opposition among many Republican Congressional leaders. Rep. Jeb Hensarling, Chairman of the House Financial Services Committee, introduced the Financial Choice Act in mid-2016, which would pare back significant parts of Dodd-Frank. Rep. Hensarling would go further than Mnuchin, as the Financial Choice Act calls for complete elimination of the Volcker Rule.[20] The Financial Choice Act passed the House Financial Services Committee, although further action on it stalled before the election. Following Trump's election victory, Rep. Hensarling reiterated his support for radical revamping of financial services regulation and continues to champion the Financial Choice Act and its dismantling of Dodd-Frank.[21]

Significant support for a possible dismantling of the Volcker Rule came from a seemingly unlikely source: the regulator with the primary mandate for enforcing the rule. On December 22, 2016, a paper was released by the Federal Reserve Board staff documenting that market liquidity had suffered as a result of the Volcker Rule.[22] The paper found that illiquidity of stressed bonds had increased after the Volcker Rule. It further found that dealers subject to the Volcker Rule had decreased their market-making activities while non-Volcker-affected (i.e., non-bank) dealers had stepped in to provide some additional liquidity, but not enough to offset the reduction by bank dealers. The Fed researchers were able to isolate this impact of the Volcker Rule from other changes in financial regulation, such as Basel III and new bank capital regulations (CCAR). The authors of the paper asserted that market maker liquidity is most needed in times of market stress. In perhaps its most damning conclusion, the paper stated: "[W]e find that the relative deterioration in liquidity around these stress events is as high during the post-Volcker period as during the Financial Crisis. Given how badly liquidity deteriorated during the financial crisis, this finding suggests that the Volcker Rule may have serious consequences for corporate bond market functioning in stress times."[23]

Following the release of the paper, the Federal Reserve Governor in charge of regulation, Daniel Tarullo, retired and his responsibilities were assumed by another Federal Reserve Governor, Jerome Powell. Recently, Mr. Powell urged Congress to revisit the Volcker Rule.[24] In a speech before the American Finance Association, Powell stated: "What the current law and rule do is effectively force you to look into the mind and heart of every trader on every trade to see what the intent is. Is it proprietary trading or something else? If that is the test you set yourself, you are going to wind up with tremendous expense and burden. . . . We don't want the largest financial institutions to be seriously engaged in proprietary trading. We do want them to be able to hedge their positions and create markets. . . . I feel the Congress should take another look at it."[25] On the other hand, Fed Chair Janet Yellen, in recent testimony before Rep. Hensarling's House Financial Services Committee, defended the Volcker Rule, stated that the Fed staff paper did not represent the views of the Federal Reserve Board as a whole, and described evidence on its impact as "conflicting."

There is reason to believe that the Volcker Rule, in some form, may well survive. During his Senate confirmation hearings, Mnuchin backtracked somewhat on his earlier remarks, stating that he supported the Volcker Rule, but he felt it would be appropriate to review how it was being enforced by regulators.[26] For their part, many industry leaders, despite strong opposition to the Volcker Rule during its proposal and implementation, have remained guarded in their remarks, despite the opening provided by the Fed paper and comments from the incoming Administration and Congressional leaders. For example, in an article discussing the "cover" provided by the Fed paper for political leaders to change the Volcker Rule, the CEO of JP Morgan's Corporate and Investment Bank, Daniel Pinto, was quoted as saying: "We will not do anything differently if the rule is eliminated." The CFO of Citi, John Gerspach, stated: "We don't want to do proprietary trading, but I also would love to work with regulators to lessen the burden of proving that we are not engaging in proprietary trading."[27] These cautious remarks by the senior management of major banks may merely reflect "smart" politics during an uncertain transition period. But this hesitancy is striking when contrasted, for example, with unabashed calls to unwind the DOL's fiduciary rule.[28]

The future of the Volcker Rule under the Trump Administration

So what does this portend for the Volcker Rule? At the very least, the regulations adopted to implement the Volcker Rule will clearly be up for review, if not the statutory Volcker Rule itself. The initial focus will clearly be on trying to devise ways in which compliance with the Volcker Rule, particularly the exception for market-making related trading, can be made simpler. But I predict that this effort will fairly quickly evolve into a rethinking of the

Volcker Rule itself, and a search for alternative approaches to addressing the "evils" of proprietary trading that the Volcker Rule was intended to address.

The regulators clearly did not intentionally create an administrative nightmare that was burdensome to comply with and required them to "look into the mind and heart of every trader on every trade." However, they were faced with a statutory framework that required them to distinguish "risky" proprietary trading from beneficial proprietary trading, when such a dichotomy simply doesn't exist. Virtually all "beneficial" market-making and underwriting requires a trader to assume risk—that's a big part of why it is beneficial.

But it is naïve to believe that the Volcker Rule will be fixed by re-drawing the lines more simply or to allow more trading. If it were easy to draw lines distinguishing good proprietary trading from the bad, the regulators who labored for three years to craft the implementing rules would have done so. It was undoubtedly an ominous portent of the challenges they faced that, when asked to define the bright line that would identify harmful proprietary trading, Paul Volcker himself, in testimony before Congress, was forced to resort to the quip: "It's like pornography. You know it when you see it."[29] Attempting to undo the illiquidity consequences of the Volcker Rule by drawing the lines so as to allow more trading will simply be substituting a different, and possibly even more difficult, set of metaphysical judgments for the rules' current ones—it's no easier to define "soft" pornography than the "hard" sort.

What is needed is a different approach. There is a ready tool that is already in the regulators' arsenal and renders the Volcker Rule largely superfluous: bank and broker-dealer capital regulation. The Volcker Rule has long been derided by its critics as a blunt instrument.[30] If a market maker puts on a trade, it is either a permitted trade or, if it exceeds RENTD or isn't offset by a risk mitigating transaction quickly enough, it becomes an illegal trade that violates the Volcker Rule. If a hedge is imperfect, or is left on after the underlying position is unwound, it becomes an unlawful proprietary trade. Rather than take such an all-or-none approach, capital regulations impose capital charges on riskier activity. Capital regulations, at both the bank and broker-dealer level, are complex, but they are well-established and well understood. They do involve some judgment calls, but for the most part they are objective and mechanical, and do not rely on discerning a trader's motivation or intent. They also have the advantage of being very flexible, for traders and regulators alike. If a trader decides to assume, maintain, or fail to hedge or offset a large risk position in a market-making account, he or she can do so, recognizing that increased capital charges will result from those decisions. In managing its overall activities, a bank can rationally determine where it wants to allocate its capital, and is incentivized to carry out its activities in the most capital-efficient (and thereby in the least risky) manner possible. For their part, if the regulators determine that existing capital rules either underweigh or overweigh the risks of certain activities or positions, they can recalibrate their capital treatment accordingly. House Speaker Ryan's legislative blueprint, while not explicitly calling for a repeal of the Volcker Rule, recognizes these key elements in endorsing reliance on capital regulation as the centerpiece of bank financial regulation.[31]

Conclusion

Unfortunately, that brings us full circle. Ultimately the fate of the Volcker Rule will be determined not by economic research studies or rational regulatory calculus, but in the political arena. And there, its fate will be tied to considerations such as the need to obtain 60 votes in an almost evenly divided Senate in order to overturn existing laws or enact new ones. That Donald Trump's nominee for Treasury Secretary has testified that he now supports the Volcker Rule, and senior officials at leading banks say they aren't interested in proprietary trading (even though trading profits are up substantially across Wall Street), suggests that the path to the Rule's repeal will not be an easy one. While repeal makes the most sense, a more likely result, at least in the near term, is that the Volcker Rule remains on the books, while the implementing rules, and enforcement measures associated with them, are relaxed.

1. https://www.sec.gov/rules/final/2013/bhca-1.pdf
2. See Section 13(d)(1) of the Bank Holding Company Act.
3. See Section 13(d)(1)(J) of the Bank Holding Company Act.
4. See Section 13(d)(2) of the Bank Holding Company Act.
5. See Section 13(e) of the Bank Holding Company Act.
6. See Section 13(a)(1)(B) of the Bank Holding Company Act.
7. See Sections 13(d)(1)(E) and (I), and Section 13(d)(4) of the Bank Holding Company Act.
8. See Sections 13(d)(1)(G) and 13(f)(3) of the Bank Holding Company Act.
9. See Sections 13(d)(2) and 13(d)(4)(B) of the Bank Holding Company Act.
10. See Section 13(h) of the Bank Holding Company Act.
11. Various SEC rules, such as Regulation SHO governing short sales, provide relief for activities that are deemed to be bona fide market making.
12. See Section IV.A.3.c.2. of the Preamble to the final implementing rules. 79 FR 5536 (Jan 31, 2014).
13. See "RMA Survey Reveals Insights into How Banks are Complying with the Rule's Permitted Trading Activity Requirement," The RMA Journal, April 2016.
14. The market-making metrics and other aspects of a bank's compliance program with respect to the market-making related activity exemption are set out in Appendix A to Volcker implementing rules.
15. See RMA Survey, supra note 22.
16. Several law firms have penned lengthy articles and provided detailed guidance on these topics, which have given rise to new acronyms ("TOTUS" for trading outside the U.S. and "SOTUS" for fund investments and activities that are solely outside the U.S.).
17. Bloomberg News, Nov. 10, 2016.
18. USA Today, November 30, 2016.
19. Ibid.
20. See www.financialservices.house.gov/choice/, and www.financialservices.house.gov/uploadedfiles/financial_choice_act-_executive_summary.pdf.
21. "This Congressman Could Turn the Dodd-Frank Financial Reforms Upside Down," Fortune, Nov. 15, 2016.
22. Bao, Jack, Maureen O'Hara, and Alex Zhou (2016), "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2016.102.
23. Ibid., at page 3.
24. "Fed's Powell Urges Congres to Take Another Look at Volcker Rule," by Steve Matthews, Bloomberg News, Jan. 7, 2017.
25. Ibid.
26. "Treasury Nominee Pressed on Views," Wall Street Journal, Jan. 20, 2017.
27. "The Fed Has Given Trump Cover to Unwind Key Wall Street Rule," by Matt Turner, Business Insider, Dec. 27, 2016.
28. "Labor Proposes Easing Fiduciary Rule on Fees for Some Annuities Sellers," by Lisa Belfuss, Wall Street Journal, Jan. 19. 2017.
29. "The Volcker Rule is Fatally Flawed," by Peter J. Wallison, Wall Street Journal, Apr. 10, 2012.
30. Ibid.
31. http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Economy-PolicyPaper.pdf. See the discussion on page 41 of the paper, under the headings: "Smarter Regulations for Financial Institutions that Choose to Invest in their Safety," and "Task Force Solution: A new regulatory paradigm offers highly-capitalized, well-managed financial institutions an option for relief from excessive regulatory complexity."