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The "Volcker Rule": Barring Banking Organizations from Proprietary Trading, Fund Investment, and Sponsorship

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The "Volcker Rule" is a new federal statute proposed by the President at the instance of former Federal Reserve Chairman Paul Volcker that would ban proprietary trading, i.e., trading for a bank's own account, as opposed to that of a customer, in a bank's trading book. The trading book is an accounting concept and distinguishes the way an asset is held based on the holder's intent to trade the asset as opposed to holding it to maturity, the carrying value of the former being marked to market daily. The Volcker Rule exempts both market-making and hedging activity from the prohibition and would also exclude securities that banks have long been permitted to underwrite and deal in, such as bonds issued by the U.S. government and its agencies and state and local bonds, as well as Government National Mortgage Associations ("GNMAs"), Federal National Mortgage Associations ("FNMAs"), and Federal Home Loan Mortgage Corporations ("FHLMCs"). It appears that trading foreign exchange and interest rate swaps, traditional devices used by banks to mitigate the risk of changes in currency values and interest rates, are covered and thus would be prohibited. Underwriting is expressly permitted, as is securitization of loans.

The Rule would also generally prohibit a banking organization's investing in or sponsoring hedge funds and private equity funds, but not other types of mutual funds. Bank-holding companies have been a major source of funds invested in private equity funds. The final bill does permit a banking entity to invest in up to three percent (3%) of the ownership interests in a fund it organizes and offers, capping the aggregate amount of such investments at three percent (3%) of the banking entity's Tier 1 capital.

In many ways, this appears to be the functional equivalent of reinstating the Glass-Steagall Act, which was repealed in large part by the Gramm-Leach-Bliley Act in 1999. The Glass-Steagall Act prohibited commercial banks and their affiliates from underwriting and dealing in corporate securities. Andrew Haldane, the Bank of England's executive director for financial stability, recently reminisced about the simplicity of the Glass-Steagall Act's separation of commercial and investment banking over its sixty-six years as contrasted with the enormous complexity of international capital regulations adopted after its repeal in order to require the largest banking organizations to maintain amounts of capital related to the risk of the assets held by such firms.[1]

Ironically, proprietary traders do not have large bank affiliates[2] and might be expected to divest their banks ("debank") if the Volcker Rule became law.[3] Conversely, most banking organizations are not significant proprietary traders; except for Goldman Sachs and Citicorp,[4] proprietary trading has represented less than one percent of the revenues of most banks.

I. Background

On June 17, 2009, the Administration issued an eighty-nine-page "White Paper," "Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation," ("June White Paper") containing a comprehensive set of proposals for financial regulatory reform that included creating a new Financial Services Oversight Council to identify emerging risks and advise the Federal Reserve Board on the identification of firms whose failure could pose a threat to financial stability; implementing heightened consolidated supervision and regulation of all large, interconnected firms; strengthening capital and other prudential standards for all banks and bank holding companies (including executive compensation practice standards); creating a new National Bank Supervisor; providing for the conversion of depository institutions that have been historically dedicated to financing home ownership to commercial bank status; requiring advisers to hedge funds and other private pools of capital above a "modest threshold" to register with the Securities and Exchange Commission under the Investment Advisers Act; establishing an Office of National Insurance; requiring promulgation of regulations requiring originators or sponsors of credit securitizations to retain an economic interest in a material portion of the credit risk; regulating all over-the-counter derivatives markets, including credit default swap markets; providing oversight of payment, clearing, and settlement systems; creating a new consumer financial protection agency and eliminating National Bank Act preemption of state consumer finance protection laws; establishing a special resolution framework for failing systemically important financial firms; restricting the ability of the Federal Reserve to lend to nonbank firms in unusual and exigent circumstances; and tightening oversight of credit rating agencies.

The June White Paper served as the basis of H.R. 4173, a bill introduced in the House of Representatives by House Financial Services Committee Chairman Barney Frank in August 2009. The paper also served as the basis of a discussion draft bill offered by the Senate Banking, Housing, and Urban Affairs Committee ("Senate Banking Committee") Chairman Christopher Dodd. The draft bill was not introduced because it initially received a hostile reception at a meeting of the Senate Banking Committee.

The June White Paper did not mention bank proprietary trading[5] or bank investment or sponsorship of hedge funds or private equity funds other than to suggest in the discussion of strengthening prudential safeguards that bank regulators

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"should tighten the supervision and regulation of potential conflicts of interest generated by the affiliation of banks and other firms, such as proprietary trading units and hedge funds."[6] After many hearings, mark-ups, and much work, the House of Representatives passed H.R. 4173, codifying much of the June White Paper, on December 11, 2009. It authorized the bank regulators to bar proprietary trading by banking organizations but did not prohibit such trading, and it was silent as to bank investment and sponsorship[7] of hedge funds.

On January 21, 2010, the President, with former Federal Reserve Chairman Paul Volcker standing by his side,[8] announced that the two agreed on the notion that banks should be barred from proprietary trading and from investing and sponsoring hedge funds and private equity funds (the "Volcker Rule"); details were to follow.

The Administration had not discussed this idea with foreign regulators, despite its well-known aversion to unilateral action in the foreign policy arena, and foreign banking regulators were not supportive of the concept. The head of the International Monetary Fund, Dominique Strauss-Kahn, was quoted, shortly after the President's announcement of the Volcker Rule, as saying that "the question of coordinating financial reform is key and we are not going in that direction."[9] The Deputy Director-General of the European Commission's Internal Market and Services Division, David Wright, expressed surprise in late January that the U.S. had taken this position without consulting leaders in Europe.[10] Ironically, the June White Paper expressly represented that the United States is playing a strong leadership role in efforts to coordinate international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision and recommended raising international regulatory standards and improving international cooperation. This is very important in the financial area, as there appears to be a growing consensus that unilateral action by any one country may well drive financial firms to other countries with friendlier regulatory environments, and, thus, a premium should be placed on international cooperation in the area of financial regulatory reform.

On February 4, 2010, the Senate Banking Committee held a hearing on the Volcker Rule at which a handful of witnesses, including former Federal Reserve Bank of New York President E. Gerald Corrigan (now a Managing Director of Goldman, Sachs & Co.), former Chief Executive Officer of Citibank John Reed, and Chief Risk Officer of JP Morgan Chase & Co. Barry Zubrow, testified.

On February 22, 2010, a letter to the editor of *The Wall Street Journal* appeared supporting the Volcker Rule; it was notable because it was signed by five former Secretaries of the Treasury from both Republican and Democratic Administrations: W. Michael Blumenthal, Nicholas Brady, Paul O'Neill, George Schultz, and John Snow. It was also notable that the letter had not been signed by former Goldman Sachs executives who had served as Secretaries of the Treasury, Robert Rubin and Henry Paulson. The basis of the concern was simply stated: "Banks benefiting from public support . . . should not engage in essentially speculative activities unrelated to essential banking services." Hedge funds, private equity funds, and firms trading for speculative gains should, like other private businesses, be free to fail without explicit or implicit taxpayer support.

On March 3, 2010, the Treasury Department released five pages of legislative language that would add new Sections 13 and 13a to the Bank Holding Company Act to implement these prohibitions as well as another prohibition proposed by the President and Chairman Volcker in January against acquisitions by financial companies that would result in the acquiror holding more than ten percent of the aggregate consolidated liabilities of all financial firms. The Volcker Rule language would apply the prohibitions to insured depository institutions and to companies that control them or that are treated as bank holding companies,[11] but would except trading in obligations of the U.S., its agencies, GNMAs, FNMAs, FHLMCs, and obligations of state and local governments. The language would also prohibit such firms sponsoring or investing in hedge funds or private equity funds, but would except investments in small business investment companies and investments designed primarily to promote public welfare. In addition, the language would prohibit a bank's or its parent's loans to, investments in, purchases of assets from, acceptance of securities of (as collateral), and issuances of letters of credit on behalf of, any hedge fund or private equity fund if the bank or parent serves directly or indirectly as investment manager or adviser of such fund. Finally, the language would prohibit any insured depository institution or holding company that serves as investment manager or adviser to a hedge fund or private equity fund from providing custody securities lending or other prime brokerage services to the fund.

A week later, on March 10, 2010, Senators Jeffrey Merkley and Carl Levin introduced the "Protect Our Recovery through Oversight of Proprietary Trading Act" (the "PROP Trading Act"), S. 3098. Its prohibitions and exceptions track those set forth in the Treasury language, but the exceptions would only apply where it would not result in a material conflict of interest or in exposure to high risk assets or trading strategies as to be defined by the Federal Reserve Board and FDIC or pose a threat to safety and soundness or to the financial stability of the U.S. The bill would also add a new Section 27A to the Securities Act of 1933[12] that would prohibit an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security from engaging in any transaction that would either give rise to a material conflict of interest "with respect to any investor in a transaction arising out of such activity" or undermine the value, risk, or performance of the asset-backed security.

Senator Christopher Dodd, the Chairman of the Senate Banking Committee, introduced his own comprehensive financial regulatory reform bill, the Restoring American Financial Stability Act of 2010, on March 15. Section 619 of the bill was a modified version of the Volcker Rule. It clarified that the prohibitions would not only apply to banks and their parents, but also to subsidiaries of either, which was not clear in the Treasury or Merkley language. However, rather than being a self-executing prohibition, the bill provided that, subject to the recommendations and modifications of a newly-established council of regulators created in order to reduce systemic risk, the bank regulatory agencies, through a rulemaking, are jointly to prohibit proprietary trading by banking organizations and also prohibit their sponsoring and investing in hedge funds. In addition, the Federal Reserve, subject to the council's recommendations and modifications, would be required to adopt rules imposing additional capital requirements and specifying quantitative limits for systemically important nonbank firms that engage in proprietary trading or sponsor and invest in hedge funds. The council would undertake a six-month study of whether the prohibition would promote safety and soundness, enhance financial stability, limit the "inappropriate transfer of Federal subsidies," reduce inappropriate conflicts of interest, raise the costs of credit, and limit activities that might reasonably be expected to create undue risk. The regulators were to adopt final regulations within nine months after completion of this study, effective in two years, subject to three one-year additional extensions.

On May 20, 2010, the Dodd bill passed the Senate. After amending Section 619 to permit the aforesaid three percent (3%) investments, the House-Senate Conference Committee reported the bill out, and the President signed it on July 21, 2010.

II. Rationale

When the President proposed the Volcker Rule, he alluded to existing rules "that allowed firms to act contrary to the interests of customers;[13] to conceal their exposure to debt through complex financial dealings;[14] to benefit from taxpayer-insured deposits while making speculative investments; and to take on risks so vast that they posed threats to the entire system." He explained government benefits that banks receive (deposit insurance, a safety net (presumably the Federal Reserve discount window) which reduces bank capital costs) and concluded it was "not appropriate" to "use that cheap money to trade for profit," especially when this trading conflicts with the interests of a bank's customers. He then suggested that this kind of trading can create enormous and costly risks. Thus, the proposed ban would appear to have three bases: (1) inappropriateness of using government support to trade, (2) conflicts between trading and loyalty to customers, and (3) risk.

III. Analysis

The Volcker Rule may be analyzed by breaking it first down into its two components: proprietary trading and activities related to pools of capital, i.e., hedge funds and private equity funds.

However, first, it is important to note that, while there may have arguably been many causes of the financial crisis, neither proprietary trading nor investing in or sponsoring funds has conventionally been considered to be among them. Chairman Volcker himself has acknowledged this,[15] though recently he has suggested it might cause the next financial crisis.[16] Failures of Washington Mutual and IndyMac and problems at Wachovia and Countrywide were attributable to defaulting subprime mortgage loans, not proprietary trading or investing in, or sponsorship of, funds. Similarly, the failure of Lehman Brothers and the problems at Bear Stearns and Merrill Lynch are usually attributed to excessive real estate credit risk, not to trading, investing in, nor sponsoring funds. Of course, the Volcker Rule would only apply to banking organizations; however, some of the biggest problems in the financial crisis occurred at nonbank firms, such as FNMA, FHLMC, Bear Stearns, and Lehman Brothers. Indeed, rather than causing the financial crisis, it has been suggested that proprietary trading, fund sponsorship, and investment activities diversified the revenues of banking organizations and thus stabilized banking organizations.

It also appears that regulators currently have ample authority to control any risks they see in these areas. Capital regulation, currently well within the power of all of the bank regulators, is an obvious existing tool to control any risks regulators see with proprietary trading or investment in, or sponsorship of, funds. (Indeed, under current rules, capital requirements increase as investments increase.) Obviously these activities are also subject to examination authority that bank regulators currently have.

A. Proprietary Trading

Ironically, those banking organizations that have at all significant proprietary trading revenues have very small bank deposit bases, and conversely, most banking organizations with significant deposit bases have insignificant trading revenues. Thus, deposit liabilities represent slightly more than five percent of Goldman Sachs' total liabilities, and Morgan Stanley's bank represents less than nine percent of its total liabilities. Theoretically, therefore, both could debank in order to avoid a proprietary trading ban.[17] Proprietary trading at traditional large banks, such as Wells Fargo and Bank of America, accounts for less than one percent of total revenue. Goldman Sachs, admittedly not disinterested, estimates that cumulative credit losses reported by U.S. banks during the crisis approximated $1.67 trillion, only two percent of which was accounted for by trading and derivatives activity.[18] Thus, it is difficult to see how the Volcker Rule as to proprietary trading would reduce risk significantly.

Initial criticism of the non-detailed original Volcker Rule's ban on proprietary trading by banking organizations was focused on how difficult it would be to define "proprietary trading" without impinging on admittedly legitimate trading for customers, especially market-making and hedging. However, Treasury's language released March 3 simply defined proprietary trading to exclude transactions for customers, market-making, and hedging, and that has been reflected in both bills that have been introduced.

One basis that the President cited for the Volcker Rule was the need to restrain conflicts of interest. The Merkley-Levin bill implementing the Volcker Rule would go so far as to prohibit an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security from engaging in any transaction that would give rise to a material conflict of interest with respect to any investor in that transaction. Former Reserve Bank President Corrigan, testifying at the Senate Banking Committee hearing on the Volcker Rule, rightly noted that there is nothing new about potential conflicts in banking and finance. However, banking firms manage such conflicts with so-called "Chinese Walls," policies and procedures to maintain separation of conflicted business units and to block the flow of information between them, as well as embedding independent lawyers and compliance professionals in revenue-producing business units.

Chairman Volcker, though, has testified that these activities "present virtually insolvable conflicts of interest with customer relationships, conflicts that simply cannot be escaped by an elaboration of so-called Chinese walls between different divisions of an institution."[19] He specifically cited the conflict between a bank's investment management activities and trading for the bank's own account. He urged that an institution should not be able to profit from knowledge of a customer's trades through proprietary trading activity.

Chairman Volcker's concern about conflicts of interest reminds one of the conflicts of interest cited as the reasons for enactment of the Glass-Steagall Act in 1933. The United States Supreme Court reviewed those conflicts in *Investment Company Institute v. Camp*,[20] which featured what a former colleague of mine in the Legal Division of the Federal Reserve Board used to call the "chamber of horrors argument." Besides giving banks an incentive to give interested advice to clients, permitting banking organizations to trade securities for their own account, according to the Court, could jeopardize crucial public confidence in banks if such trading caused losses and even could bias credit decisions as banks might more willingly lend to portfolio companies or persons willing to invest in portfolio companies. Unfortunately—or fortunately, depending on one's perspectives—Congress reconsidered in 1999 and repealed much of the Glass-Steagall Act, enacting the financial modernization in the Gramm-Leach-Bliley Act. Had it not done so, JP Morgan Chase would not have been able to come to the rescue of Bear Stearns, and Bank of America would not have been able to come to the rescue of Merrill Lynch. Nor would Goldman Sachs and Morgan Stanley have been able to save themselves by becoming bank holding companies.

B. Hedge Funds and Private Equity Funds

The Volcker Rule would also prohibit banking organizations from sponsoring or investing in hedge funds and private equity funds.

Deputy Treasury Secretary Neal Wolin, apparently alluding to Bear Stearns' pledge of $3.2 billion to bail out Bear Stearns High-Grade Structured Credit Fund and Bear Stearns High-Grade Structured Enhanced Leverage Fund, has noted that major firms saw their hedge funds suffer large losses in the financial crisis and bailed out their troubled hedge funds, depleting firm capital at precisely the moment that capital was most needed.[21]

Under new Financial Accounting Standards 166 and 167, however, the securitized loans held by any such bank-sponsored hedge fund now remain on the books of the bank if such loans were originated by the bank, and the bank would be required, therefore, to maintain capital against those assets. That arguably is the functional equivalent of setting aside funds for a bailout.

Former New York Federal Reserve Bank President Corrigan suggested, as have others, that financial risks associated with banking organization ownership or sponsorship of hedge funds and private equity funds certainly could be dealt with by means short of outright prohibition. He suggested that bank owners and sponsors of such funds perhaps might be subjected to a prohibition against further investments in such funds unless they first apply for and receive regulatory approval.

Hedge funds and private equity funds are hardly risky gambling operations. To the contrary, they provide equity capital and debt financing to small and medium-sized businesses, which are job-creating enterprises. Limiting investment in, and sponsorship of, such funds would seem to discourage, not encourage, economic growth. Banks are important investors and general partners in private equity funds, and prohibiting those investments would reduce the amount of capital available to such funds and thus impede the flow of capital from such banking organizations to small and medium-sized businesses.

Yet, like proprietary trading, this activity does not represent a significant portion of bank assets, as it represents less than one percent of total assets of traditional banks like Bank of America, Wells Fargo, JP Morgan, and Citigroup and less than two percent of the total assets of non-traditional banking organizations such as Goldman Sachs and Morgan Stanley.

As Mr. Corrigan suggested, the involvement of banking organizations in such funds can improve business practices in the fund industry.

IV. Conclusion

It is not clear that the Volcker Rule would achieve its goals, as most banking organizations are not significantly engaged in proprietary trading or sponsoring and investing in funds. On the other hand, enactment of the Volcker Rule could hurt healthy diversification of income streams of banking organizations and reduce capital flows to small and medium-sized businesses, neither of which is a positive pro-safety and soundness, financial growth-oriented economic outcome.

Though the Volcker Rule may have these problems one cannot lightly dismiss it in light of the respect to which its chief proponent, Chairman Volcker, is entitled, as well as the respect due so many of its other proponents. Whether its adoption was wise public policy, all can agree, needs to be carefully considered and studied. It may have been exceedingly unwise to enact financial reform affecting the very lifeblood of our economy without very carefully and thoroughly considering all of the consequences.

Endnotes

1 Larry Elliott, *Forced Bank Break-up Makes Sense, Says Financial Stability Chief*, Guardian, March 30, 2010.

2 Morgan Stanley's banking liabilities represented 8.7% of its total liabilities at year-end 2009, and Goldman's represented 5.19%.

3 The Dodd bill contains a so-called "Hotel California" provision to the effect that, once a firm becomes a bank holding company, it "can never leave." Section 117 of the bill provides that any bank holding company that had total consolidated assets of $50 billion or more January 1, 2010 and received funds under the U.S. Treasury's Capital Purchase Program under the Troubled Asset Relief Program (TARP) shall be treated as a systemically significant firm subject to Federal Reserve Board supervision and special bank-like prudential standards (subject to an appeal to the new Financial Stability Oversight Council) even if the firm ceases to be a bank holding company. The reference to "Hotel California" is based on the lyrics of the popular 1976 song "Hotel California" recorded by the musical group "The Eagles," which contains the line, "You can check out any time you like, but you can never leave." Some commentators believe that Section 117 is intended to prevent Goldman Sachs and Morgan Stanley from debanking if the Volcker Rule goes into effect

4 Proprietary trading represented approximately ten percent of Goldman's revenues and five percent of Citi's.

5 The Volcker Rule defines "proprietary trading" as:

> engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of 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 regulators] may . . . determine.

6 U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation 32 (2009).

7 The Volcker Rule defines "sponsorship" to mean:

> (A) serving as a general partner, managing member, or trustee of a fund;
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> (B) in any manner selecting or controlling (or having employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or
>
> (C) sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

8 Former SEC Chairman William Donaldson was also present at the announcement.

9 Simon Carswell, *IMF Head Calls for Financial Reform*, Irish Times, Jan. 30, 2010.

10 Joel Clark, *EC Says Obama Prop Trading Plan Would Be "Difficult" to Implement*, Risk Mag., Feb. 1, 2010.

11 Section 8 of the International Banking Act of 1978 (12 U.S.C. 3106) provides that any foreign bank that maintains a branch or agency in a state and any parent of such a bank are subject to the provisions of the Bank Holding Company Act.

12 15 U.S.C. 77a et seq.

13 Subsequently there have been media reports of at least one major securities firm promoting the sale of asset-backed securities to customers and then selling such securities short.

14 Subsequently an examiner in the Lehman bankruptcy has reported that Lehman concealed its exposure to debt using "window-dressing" repurchase agreement transactions known as "Repo 105," a reference to true sale accounting treatment given because "sold" assets were valued at 105% of the sales price received.

15 Reuters, *Volcker: Proprietary Trading Was Not Central to Crisis*, CNBC.com, March 30, 2010, http://www.cnbc.com/id/36101228/Volcker_Proprietary_Trading_Was_Not_Central_to_Crisis; Paul Volcker, Chairman of the Federal Reserve, Speech to the New York Historical Society (April 6, 2010).

16 Speech by Paul Volcker, *supra* note 15.

17 But see note 3 regarding the "Hotel California" provision in the Dodd bill.

18 Goldman Investment Research, United States: Banks 6 (2009).

19 *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (Feb. 2, 2010) (statement of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board).

20 401 U.S. 617 (1971).

21 *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (Feb. 2, 2010) (statement of Neal S. Wolin, Deputy Secretary, U.S. Dep't of Treasury).