IMPLEMENTING FINANCIAL REFORM:

The Ruckus over the Volcker Rule

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Even before President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010, we all knew that the Act would continue to invite controversy. (Appendix A summarizes key provisions of the Dodd-Frank Act.)

Three features of the Dodd-Frank Act—massively long at 2,319 pages—guaranteed a ruckus. First, the financial stakes and global competitive implications for U.S. based financial institutions could be huge. Second, many sections of the act were considered ill-advised and unwarranted by many bankers and members of Congress. (Only 3 Republican senators voted for the House version of the bill.) Third, as a way of ensuring a timely passage of this contested bill, Congress chose to subcontract to federal regulatory agencies the writing of 243 new rules pertaining to key provisions of the Act. This legislative strategy predictably intensified the already heavy lobbying efforts of the banking industry as the Congressionally mandated regulatory rulemaking process geared up.

This current rulemaking process offers the banking industry the possibility of winning battles at the regulatory level that were either lost or never fought during the legislative phase. Bank officials and their representatives have not only tried to gain as much clarity and as many exclusions as possible in the new rules, but also to preserve as maximum flexibility in regulatory compliance going forward. Congressional sponsors of the Act have also been working hard to ensure that the language of the new rules does not water down or otherwise subvert the intent of the legislation. On many important issues, bankers, financial economists, Congressional sponsors, and federal regulators have widely diverging views of what rules are called for and can be effectively implemented. One of the most highly contested rules is known as the “Volcker Rule”, championed by former Federal Reserve Chairman Paul Volcker.

Known formally as section 619 of the Dodd-Frank Act, the Volcker Rule is one of the law’s iconic provisions. It is also one of the law’s most complex provisions. Its intent is to reduce the chances that banks will put federally insured deposits at risk by making risky investments for its own trading account. It also seeks to eliminate potential conflicts of interest between banks and their customers and counterparties. (Appendix B gives a brief legislative history of the Volcker Rule.)

To these ends, the Volcker Rule prohibits federally insured, deposit-taking banks from engaging in proprietary trading, which involves the purchase and near term sale of high-risk investments for banks’ own account. It also limits the amount of money (no more than 3 percent of a bank’s capital) that banks can invest in or use to sponsor hedge funds and private equity funds. The idea behind these investment restrictions is to eliminate the temptation of banking entities to bail out investors in troubled hedge funds and private equity funds, which are typically highly leveraged and can significantly expand a banking entity’s losses during a financial crisis.

In contrast to these prohibited activities, the Volcker Rule also expressly includes exemptions from these prohibitions for certain permitted trading activities, including market making-related activities, trading on behalf of customers, risk-mitigating hedging activities, trading in certain U.S. government obligations, and underwriting. These exemptions may seem
simple enough, but neither the Volcker rule nor the Dodd-Frank Act precisely defines permissible activities.

For example, market making is permitted by section 619 to the extent that it is “designed to not exceed the reasonably expected near term demands of clients, customers, or counterparties,” but this provision neither defines “market making” as a banking activity nor offers a clear meaning of the phrases “reasonably expected” or “near term.” Among many other, unresolved ambiguities, the lack of clarity between prohibited proprietary trading and permitted market making has caused many concerns in the banking industry. For example, many bankers argue that under normal trading conditions, there is often overlap between market making and proprietary trading in securities markets where a simple matching of buyers and sellers is not possible. In such situations, major market makers like Goldman Sachs argue that making a functioning market in equities, credit instruments, or derivatives requires market makers to frequently obtain positions in these securities in anticipation of customer flow. But under these circumstances, the market maker is necessarily exposed to changes in the value of the securities, and market making begins to look very much like proprietary trading. Is this permissible under the Volcker rule?

Authority for developing final definitions necessary to implement the intent of the Volcker Rule is shared by several regulatory agencies under the overall authority of the new Financial Stability Oversight Council (FSOC). These agencies include the Office of the Comptroller of the Currency (Department of the Treasury), the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission. On October 11, 2011 FSOC and its constituent agencies released a highly complex, 298-page report, which proposed a variety of definitions and regulations and posed more than 1,300 questions for comment by industry participants. FSOC asked that comment letters addressing the proposed rules and outstanding questions be submitted by January 13, 2012. FSOC is required by law to issue final rules, ready for implementation, in July 2012.

By the January 13 comment deadline, hundreds of banks, asset managers, business groups, American corporations, members of Congress, U.S. regulators, foreign regulators, and others submitted detailed letters addressing FSOC’s proposed definitions, regulations, and questions. A review of comment letters submitted by leading Wall Street banks, the Securities Industry and Financial Markets Association, members of Congress, and former industry executives reveals many persistent disagreements and concerns about the Volcker Rule. While the banks tended to accept the risk-reduction premise of the rule (namely, that proprietary trading on Wall Street should be placed outside the taxpayer safety net), they argued that the rule, in its current form, is too complex, too burdensome, and inconsistent with preserving the functioning of global trading markets. In the words of JPMorgan Chase, the “extraordinary complexity and large number of laws” in the Volcker Rule makes implementation impossible without imposing “unacceptable costs on our economy and financial system.”

Underlying these broad criticisms are a broad array of more specific concerns. For example, in its 65-page comment letter JPMorgan Chase questioned, among many other matters, (1) the proposed definition of a “trading account,” a seemingly minor matter but one which is absolutely critical to one’s understanding of what constitutes prohibited proprietary trading; (2) proposed criteria for defining and differentiating between proprietary trading and market making; and (3) various proposed rules that inhibit effective asset-liability management, risk-mitigating hedges, and liquidity management—all argued by JPMorgan Chase to be central to safe and sound bank management. The bank also argued that FSOC’s assumption that banking entities will camouflage prohibited trading and work to evade and subvert the intent of the Volcker Rule has contributed to its unnecessary complexity.
The basic thrust of Goldman Sachs’ 63-page comment letter was that FSOC’s definitions of permitted and prohibited trading activities are so narrowly defined that it significantly limits banks’ capacity to help clients raise capital, manage their risks, invest their wealth, and generate liquidity for their holdings. More fundamentally, Goldman criticized regulators and rule-makers for their “totally out-of-date” conception of how financial markets work, one based on an antiquated agency-based, exchange-traded equities paradigm. In the current world of finance, Goldman argued, new illiquid assets abound, thereby invalidating the applicability of the regulators’ implicit, exchange-traded market model. In other words, being a market maker in today’s world requires warehousing an inventory of securities in order to actually make a market—since for many securities there is simply no counterparty currently available, and therefore no price. Goldman claimed that if FSOC stays with the old conception of how financial markets work, the inevitably narrow and restrictive definitions of market making would destroy market liquidity. (The Securities Industry and Financial Markets Association reiterated Goldman’s dire warning about the devastating effects on corporate liquidity in its 175-page comment letter.) According to Goldman, the inevitable result will be massive mark-to-market losses on bank and corporate balance sheets and an escalation of cumulative financial transaction costs into the hundreds of billions of dollars. The most promising way forward, Goldman argued, is to invest in developing quantitative “metrics” that could be helpful for indicating the true character of a trading activity—be it proprietary trading or market making—and avoiding inappropriately restrictive definitions. The design and implementation of such metrics, Goldman argued, will require “robust and on-going dialogue between banking entities and their regulators. It will also require expanding the conformance period beyond the July 2012 start date. Whether this suggestion will be perceived as foot-dragging or gaming the implementation of financial reform remains to be seen.

Chairman Volcker’s comment letter argued that the market liquidity argument put forth by Goldman and others, was way overdrawn: “There should not…be a presumption that evermore market liquidity brings a public benefit. At some point, great liquidity, or the perception of it, may itself encourage more speculative trading…” Volcker also rebutted claims that proprietary trading by commercial banks is not a serious risk factor, that the competitive position of U.S. based banking institutions will be adversely affected as claimed by JPMorgan and Goldman, and that the proposed regulation is simply too complicated and costly. But Volcker did agree with Goldman’s call for meaningful metrics to help discriminate between permitted market making and prohibited (and “deliberatively concealed and recurring”) proprietary trading. Volcker also recognized in his letter “the thorny issue of guidance” with respect to situations where market making for customers takes on characteristics of prohibited proprietary trading. Since only a very few, large banks engage in continuous market making on any significant scale, Volcker was nevertheless sanguine about the possibility of effective regulatory oversight.

Chairman Volcker’s concise letter, while seemingly balanced and non-confrontational, was not seen as such by Jamie Dimon, the chairman and chief executive of JPMorgan Chase. Dimon told Fox Business in a February 13, 2012 interview, “Paul Volcker by his own admission has said he doesn’t understand capital markets. He has proven that to me.” Dimon added, “I understand the goal to make sure these companies don’t take huge bets with their balance sheets. But market making? Just like these stores down the street, when they buy a lot of polka dot dresses, they hope they’re going to sell, they’re making a judgment call. They may be wrong! So protecting the system I agree with, but starting to talk about the ‘intent’…I tell you…for every trader, we’re going to have to have a lawyer, compliance officer, a doctor to see what their testosterone levels are, and a shrink [asking them], “what’s your intent?” No we’re going to make markets for our clients to give them the best products, the best services, the best research and the best prices. That’s a good thing in spite of what Paul Volcker says.”
Compared to Jamie Dimon, the comment letter of Senators Jeff Merkley (D, Oregon) and Carl Levin (D, Michigan), the prime Congressional supporters of the Volcker Rule, sounded mild despite their highly restrictive proposals, which included crafting the definition of a short-term trading account to include positions held as long as a year (to categorize as much short-term trading as possible as proprietary trades), eliminating current exclusions from the FSOC’s definition of proprietary trading, forbidding portfolio hedging (rather than position hedging) that could mask proprietary trading, proposing fine-grained data collection on trading activity down to the level of the individual trader, and strengthening conflict of interest rules, among many other recommendations.

Finally, one of the most remarkable comment letters came from John Reed, who held CEO titles at Citigroup and its predecessor from 1984 to 2000. Reed had helped engineer the merger between Citibank and Sanford Weill’s Travelers Group (owner of the investment firm Salomon Smith Barney) after the repeal of the Glass-Steagall Act, which had separated traditional banks from those involved in capital markets. He has since said that the repeal of Glass-Steagall was a mistake. In his comment letter, Reed recommended that the proposed Volcker Rule be made stronger by requiring regulators to change how traders are paid to prevent future abuse of the activities that the rule still permits, requiring quarterly CEO and top management signoffs on complying with the rule, and the imposition of “severe penalties” for non-compliance.

More specifically, Reed urged that traders be paid on the results of their market making and hedging after those positions are fully unwound, rather than collecting bonuses based on price appreciation of assets in the short-term and, further, that compensation levels should be adjusted by risk or based on performance relative to an outside performance index reflecting the relevant market being traded. With respect to top management sign-off, Reed urged that bank CEOs, the senior officer responsible for trading, equivalent officers responsible for risk management and accounting within the trading unit sign a statement each quarter stating that to the best of their individual knowledge the operations of the of the trading unit were conducted within the letter and spirit of the Volcker Rule. Finally, with respect to penalties, Reed recommended that the Volcker Rule set out specific and vigorous penalties for individual traders, management, and firms for failure to comply.

How such disparate, strongly held views about the final rendering of the Volcker Rule will be reconciled by the July implementation deadline is anyone’s guess. In light of so many detailed criticisms, exhortations, and specific suggestions, and so much uncertainty in future regulations under the rule, some large banks are asking for a push back in the start date of the rule to one year after regulators finish their work. In response to this request, Senators Mike Crapo (R, Idaho) and Mark Warner (D, Virginia) were joined on March 22nd by four additional senators—two Democrats and two Republicans—in introducing legislation that would slow down implementation of the Volcker Rule. All six senators, public records show, are recipients of major campaign contributions from large Wall Street banks.

In response to this proposed legislation, Federal Reserve Governor Daniel Tarullo said that delay was unnecessary because even if the Volcker Rule is not ready for implementation by the July deadline -- which he thought likely -- the government will be able to provide the financial industry direction about how to comply with the coming regulatory changes.

One of the important questions raised by the proposed legislation is whether or not it is the first indication of a “delay and repeal” strategy on the part of the finance industry or, more innocently, a straight-forward attempt to get clarity on new rules of the game before a new regulatory regime takes hold.
Appendix A

Summary of Key Provisions of the Dodd-Frank Act*

1. Established a Financial Stability Oversight Council, made up of federal financial regulators, to identify and respond to emerging financial risks;

2. Established a Consumer Financial Protection Bureau to strengthen protections of American consumers from abusive financial products and practices;

3. Restricted proprietary trading and investments in hedge funds and private equity funds by banks and other large financial institutions;

4. Prohibited sponsors of asset backed securities from engaging in transactions that would involve or result in a material conflict of interest with investors in those securities;

5. Established procedures to require nonbank firms whose failure would threaten U.S. financial stability to divest some holdings or undergo an orderly liquidation;

6. Strengthened regulation of credit rating agencies;

7. Strengthened mortgage regulation, including clamping down on high cost mortgages, requiring securitizers to retain limited liability for securities reliant on high risk mortgages, banning stated income loans, and restricting negative amortization loans;

8. Required better federal regulation of mortgage brokers;

9. Directed regulators to require greater capital and liquidity reserves;

10. Required regulation of derivatives and derivative dealers;

11. Required registration of certain hedge funds and private equity funds;

12. Authorized regulators to impose standards of conduct that are the same as those applicable to investment advisors on broker-dealers who provide personalized investment advice to retail customers; and

13. Abolished the Office of Thrift Supervision.

Appendix B

A Brief Legislative History of the Volcker Rule

In the aftermath of the 2007-2009 financial crisis, former U.S. Federal Reserve Chairman Paul Volcker proposed a plan to curb the kind of speculative activity by banks that he saw as having played a key role in bringing the entire financial system to near collapse. This plan came to be known as the “Volcker Rule.” The central feature of this rule was to bar federally insured, deposit-taking banks from proprietary trading and to limit investments in and sponsorship of hedge funds and private equity funds. Nonbank financial institutions supervised by the Fed also faced new restrictions on proprietary trading and hedge fund and private equity investments, along with additional capital requirements.

The Volcker Rule first got political traction when President Obama publicly endorsed the rule in January 2010. Volcker had been serving as Chairman of the President’s Economic Recovery Advisory Board since February 2009 and had long advocated a de-risking of federally insured banks to limit the damage of recurring financial crises that had accompanied the deregulation of banking.*

The President’s support of the Volcker rule came at an opportune time. The Senate Permanent Subcommittee on Investigations, whose chairman was Senator Carl Levin, D-Michigan, and whose Ranking Republican was Senator Tom Coburn, R-Oklahoma, had conducted 18 months of investigations into the financial crisis. (The House Financial Services Committee also held complementary hearings.) The subcommittee’s major “findings of fact” regarding the controversial role that large banking institutions played in the financial crisis focused on a variety of destructive behaviors and transactions, of which the following four reveal a principal story line of the financial crisis:

- **Securitizing high-risk mortgages**—In exchange for lucrative fees, investment banks securitized high risk, poor quality loans, sought and obtained favorable credit ratings for the resulting residential mortgage backed securities, and sold these securities to investors, thereby pushing billions of dollars of risky mortgages into the financial system.

- **Magnifying risk**—Banks then amplified the risk embedded in these mortgage backed securities by assembling them into ever more risky collateralized debt obligations (CDOs), referencing them to synthetic CDOs, and selling vast quantities of CDO securities to investors. To manage the risk that they themselves clearly saw in the packaging and sale of mortgage backed securities and CDOs, the banks then privately purchased credit default swaps (CDSs) to profit from the increasingly likely failures of the very securities and CDOs it sold to the investing public.

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* The principal deregulation authority was the Financial Services Modernization Act of 1999 (also known as the Gramm-Leach-Bliley Act), which essentially repealed the Glass-Steagall Act of 1933 prohibiting any one institution from acting as any combination of an investment bank, a commercial bank, and an insurance company.
• **Shorting the mortgage market**—Through the 2007-2009, investment banks took increasingly larger net short positions on the mortgage market as high-risk mortgage delinquencies increased. This strategy not only depressed the once booming market for mortgage-related securities, but also ended up generating billions of dollars in gains for the banks when they covered their very large short positions.

• **Tolerating conflicts of interest between client and proprietary trading**—In addition to acting as a market maker for clients seeking to buy or sell mortgage related securities, the banks traded (sold) billions of dollars of mortgage related securities for the benefit of the firm without disclosing its proprietary positions to clients, thereby creating a conflict of interest (especially in the case of Goldman's Abacius transaction) between the firm's proprietary interests and client interests.

The Volcker Rule focused largely on the last finding of the subcommittee, as well as the former Federal Reserve chairman's concern that high-risk proprietary trading and investing by banks created a massive systematic risk for the U.S. economy. Chairman Volcker argued that proprietary trading, its conflict of interest with clients, and the shorting of the mortgage market by banks were important causes of the financial crisis.

It is worth noting that despite the early endorsement of five former Secretaries of the Treasury, the Volcker rule was controversial from the get-go. Many members of the finance community, and like-minded members of Congress, argued that proprietary trading played a very limited role in the financial crisis. They claimed that poor lending and underwriting practices, coupled with excess leverage, were the principal driving forces. Still, a few Wall Street bankers, such as former chairman of Citigroup John Reed and Citigroup's current chief executive Vikram Pandit, begged to differ with their industry colleagues and agreed with the former Treasury Secretaries and a broad array of academic economists supporting the rule. These supporters saw proprietary trading as being at the heart of the financial crisis—pointing specifically to the role that proprietary trading played in creating a market for high-risk CDOs and other instruments that were sold as diversified, low-risk investments in collateralized debt.

As the Dodd-Frank legislation was working its way through the Senate, Senators Jeff Merkley, D-Oregon, and Carl Levin, D-Michigan, took up the cause of the Volcker Rule and introduced its core feature—the limitations on proprietary trading—as an amendment to the bill. As summarized by Acharya, Cooley, Richardson, and Walter in their excellent book on the Dodd-Frank Act, Chairman Volcker originally recommended "that banks be permitted to engage in the full range of commercial banking and investment banking functions as financial intermediaries, but not to be permitted to engage in such nonbanking activities as proprietary trading, principal investing, commodity speculation, and hedge fund and private equity fund management. These activities would be spun off to nonbank asset-management firms and would be subject to whatever regulation is necessary for those types of institutions. The legacy banks would be allowed to have no economic interest in the spun-off entities."*

But that vision did not survive vigorous debate in the House and the Senate. Despite growing congressional support, the Merkley-Levin amendment to the Dodd-Frank Act was never brought to a Senate vote—a direct result of considerable parliamentary maneuvering, vociferous opposition by large banks, and effective lobbying by Wall Street.

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In the end, however, the joint conference committee charged with reconciling the House and Senate versions of the financial reform bill ended up inserting modified rule, which was less clear cut in the separation of activities and included many more exclusions than the original recommendation. The President signed the Dodd-Frank Act, including the contentious Volcker Rule, into law on July 21, 2010.

The act provides 24 months for both studying and the final rule-making pertaining to the act’s major provisions such as Section 619, which embodies the Volcker Rule. The effective date of the act is therefore July 2012. Affected banks and financial institutions will then get two additional years to comply with the new rules, with the possibility of extensions after that.