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The Volcker Rule

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I. Introduction

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Protection Act ("Dodd-Frank or "the Act").[1] Dodd-Frank is intended to strengthen the financial system and constrain risk taking at banking entities.[2] A "key component" of this effort,[3] Section 619 of the Act, is commonly

[1] Dodd-Frank Wall Street Reform and Protection Act, 111 P.L. 203, (2010).

[2] FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 1 (2011), available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[3] *See* id.

known as the Volcker Rule (the "Rule).[4]

Originally proposed by Paul Volcker, former chairman of the Federal Reserve, the Volcker Rule would restrict the ability of banks whose deposits are federally insured from trading for their own benefit. The Rule generally prohibits banking entities[5], including bank holding companies (BHCs), depository institutions, and their affiliates, from engaging in proprietary trading in securities and derivatives,[6] or from investing in, sponsoring, or having certain relationships with hedge funds[7] and private equity firms.[8] The Rule also provides that nonbank financial companies supervised by the Board of Governors[9] which engage in proprietary trading or have such relationships with hedge funds or private equity firms shall be subject to additional capital requirements, quantitative limits, or

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[4] Section 619 amends the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et seq. (to be codified at 12 U.S.C. § 1851), by adding at the end the following: "SEC. 13. PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS. (a) IN GENERAL.— (1) PROHIBITION.—Unless otherwise provided in this section, a banking entity shall not— (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund . . ."

[5] The term "banking entity" means any insured depository institution (other than certain limited-purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity. *See* 12 U.S.C. § 1851(h)(1).

[6] *See* 12 U.S.C. § 1851(a)(1)(A).

[7] The Volcker Rule defines the terms ''hedge fund'' and ''private equity fund'' to mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act [15 U.S.C. 80a–3(c)(1), (7)], or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine. *See* 12 U.S.C. § 1851(h)(2).

[8] *See* 12 U.S.C. § 1851(a)(1)(B).

[9] A "nonbank financial company supervised by the Federal Reserve" is a nonbank financial company or other company that has been designated by the Financial Stability Oversight Council as requiring supervision and regulation by the Federal Reserve on a consolidated basis because of the danger such company may pose to the financial stability of the United States. *See* 12 U.S.C. § 1851(h)(3), 5311(a)(4), and 5323(a).

other restrictions.[10]

II. Proponents

According to its proponents, the Volcker Rule is designed to safeguard the stability of the US banking system by preventing specified categories of financial institutions from engaging in certain risky investment activities. The general principle upon which the Rule is based—the separation of traditional banking activities from other activities—has long been an underlying theme in US banking regulation. However, in decade leading up to the recent financial crisis, banking regulation experienced a marked shift away from this principle, toward a more unified system of banking.[11] This shift has been widely criticized as having contributed to the recent financial crisis.[12]

Prior to its repeal, the Glass-Steagall Act[13] prohibited commercial banks from participating in other financial activities, including insurance and securities activities. In 1999, the Gramm-Leach-Bliley Act[14] lifted such activity restrictions enabling modern banks to engage in many of the financial activities previously prohibited under Glass-Steagall.

The imposition of the Volcker Rule represents a return to the fundamental

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[10] *See* 12 U.S.C. § 1851(a)(2) and (f)(4).
[11] *See* David Skeel, *The New Financial Deal*, 86–87 (2011) (noting that proprietary trading has become crucial to investment banking as the result of technological and market changes).
[12] *See* Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 Harv. Bus. Law Rev. 39, 42 (2011). (noting the populist view that commercial banking should be separated from investment banking, increasingly comprised of proprietary trading and principal investments).
[13] 73 P.L. 66 (1933).
[14] 106 P.L 102 (1999).

regulatory philosophies underlying Glass-Steagall. The Rule, like Glass-Steagall, aims to promote economic stability by separating these basic commercial banking operations from other financial activities with higher perceived risk.

The basic operations of commercial banks are essential to a well-functioning financial system. Both the lending and depository functions of commercial banks are necessary to our country's overall economic stability. As a result, a variety of policies have been established to help ensure the continued availability of such functions. In order to promote the ongoing liquidity of financial institutions, federally subsidized deposit insurance and overnight lending facilities weave a "long-established 'safety net' undergirding the stability of commercial banks."[15]

However, as the financial crisis began to unfold, mounting speculation over the role these subsidies may have played in precipitating the crisis led policymakers to reconsider the extent to which such benefits should be granted. Of particular concern was the moral hazard such federally subsidized financial institutions were exposed to in the pre-crisis regulatory environment. Proprietary trading and other non-banking activities had assumed a much more prominent role among financial institutions in the years preceding the crisis. Many were concerned that the "safety net" designed to protect the commercial banking operations of these institutions may have indirectly subsidized these proprietary trading activities, leading firms to assume more risk than they might otherwise

[15] *See* Paul Volcker, *How to Reform Our Financial System*, The New York Times (January 30, 2010).
http://www.nytimes.com/2010/01/31/opinion/31volcker.html

have.

Adding to these concerns, the U.S. Government made the decision to rescue a number of failing financial institutions in an effort to avoid the potentially catastrophic effects of such failures on the financial system. These actions, unprecedented in both magnitude and scope, cultivated a palpable sense of public outrage over the seemingly unfair treatment of these “too big to fail” institutions.[16] Moreover, the residue of moral hazard resulting from these efforts reinforced the sense that, in the absence of regulatory reforms, financial institutions' risk tolerance would continue to be influenced by explicit subsidies and implicit, taypayer-funded guarantees.

The programs designed to stabilize financial institutions—Federal Deposit Insurance and access to the Fed’s discount window— also provided those financial institutions with a competitive advantage in their financing, in their size and in their ability to take and absorb risks. Arguably, such advantages directly contributed to the evolution of financial institutions which were “too big to fail.”

While there is a need for a “safety net” in the form of deposit insurance through the FDIC and emergency liquidity provisions through the Fed’s lender-of-last-resort facility, the benefit of such taxpayer subsidies should be limited to the traditional lending and depository functions of banking institutions, and should not indirectly subsidize proprietary trading and other speculative activities carried on in other subsidies of a BHC.

By limiting banks' exposure to the risk involved in proprietary trading and

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[16] *See* id.

speculative investment activities, the Volcker Rule seeks to limit future taxpayer exposure to the types of risk that resulted in the bailout of “too big to fail” institutions in the wake of the financial crisis. Particularly in light of the moral hazard problem that arises with the implicit guarantee that the government will prevent bank failures in order to avoid the systemic effects such a failure would cause, it is important for regulations to properly incentivize banks to undertake economically efficient levels of risk. When the full cost of the risk involved in a firm's trading activity is not brought to bear on that entity, the firm is likely to assume excess risk. Limiting banking institutions' proprietary trading activities eliminates one source of such risk.

Furthermore, the prohibitions against proprietary trading embodied in the Volcker Rule also serve to reduce the strong conflict of interest that arises when banks are allowed to conduct investment management activities in a fiduciary capacity for their customers while simultaneously engaging in proprietary trading for their own accounts.

III. Criticisms

The criticisms of the Volcker rule mostly come from the financial services industry. Some critics claim that it is not clear that proprietary trading losses even made a material contribution to causing the financial crisis. Losses suffered by banks tended to result from their mortgage-backed securities holdings themselves, rather than the speculative trading of those securities.[17] Volcker

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[17] *See* Raghuram G. Rajan, *Fault Lines*, 173 (2010).

himself has conceded that "proprietary trading in commercial banks was . . . not central" to the crisis."[18]

Further, opponents argue that the Volcker Rule may simply cause proprietary trading to move to less regulated businesses such as hedge funds. Absent market or regulatory restraint, the result is likely to be an increase in overall risk-taking.[19]

In JPMorgan Chase's comment to the SEC's proposed rule, they claimed that it "would have serious, adverse effects on our ability to manage our risks and address the needs of our clients, and on market liquidity and economic growth."[20]

IV. Analysis of Competing Positions

Anchoring – With the recent financial crisis fresh in the memories of policy-makers and their constituents, the debate over proprietary trading has been heavily influenced by the crisis. Because the financial crisis was, in large part, the result of unsustainable risk-taking by financial institutions, many proponents have anchored their decision-making process to the idea that financial institutions were taking excessive risks during the financial crisis. Thus making the Volcker Rule, which seeks to limit one source of risk, attractive to

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[18] *See* Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, Reuters, (March 30, 2010).
http://www.reuters.com/article/2010/03/30/us-financial-regula tion-volcker-idUSTRE62T56420100330

[19] *See* Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 Harv. Bus. Law Rev. 39, 44-5 (2011). (noting the potential contagion resulting from increasing financial interconnectedness between hedge funds and traditional financial institutions).

[20] See Peter Eavis, Making a Theoretical Case About Volcker, Dealbook, (February 14, 2012). (Quoting JPMorgan Chase's comment in response to the SEC's proposed rule). Available at http://dealbook.nytimes.com/2012/02/14/making-a-theoretical-case-against-volcker/

proponents. However, unless one considers whether proprietary trading was a contributing factor to the financial crisis (rather than simply an acceptable source of risk), this anchor may unduly bias the decision-making process for these proponents, as a (perhaps irrational) fear of another financial crisis and general negative view of financial service firms leads proponents to generally support any regulation aimed at reducing the level of risk taken by financial institutions.

Groupthink - Of the 16,000+ comments filed to the SEC on the proposed Volcker Rule, according to Moshe Silver, about 15,838 were from people who were affected by the recent financial crisis and are therefore in support of a strong Volcker rule in order to protect against another financial crisis.[21] “Groupthink” can occur in situations where cohesiveness, insulation, high stress, and strong directive leadership causes the group “to reach consensus too quickly, often supporting whatever their leader had initially advocated.”[22] It is possible that both individuals and policy-makers who support the Volcker Rule aren’t doing so because of carefully-considered analysis of the issue. Instead, they are simply supporting the rule because of the pressure to avoid another financial crisis.

V. Recommendations

While the Volcker Rule, on its face, appears to represent a dramatic departure from pre-crisis financial services regulation and organization, the philosophy underlying the Rule has long been a tradition in US financial

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[21] *See* Moshe Silver, Volcker Rule Comments: the Good, the Bad, and the Ridiculous, CNN Money, (February 29, 2012). http://finance.fortune.cnn.com/2012/02/29/volcker-rule-comments/

[22] *See* J. Edward Russo and Paul J.H. Schoemaker, Decision Traps: The Ten Barriers to Brilliant DecisionMaking and How to Overcome Them, 39 (1989).

regulation. Statutory firewalls have often been implemented as a backstop to limit the exposure of systemically important commercial banking institutions to securities activities. This is a dramatic contrast to the European philosophy of unified banking, which crept into the US regulatory system over the years in an effort to remain competitive globally. The financial crisis reminded US regulatory authorities of the risks involved in such an undertaking.

In general, I agree with the principle underlying these authorities' efforts to reduce these risks by implementing restrictions on proprietary trading. However, until the rule is implemented and the market has an opportunity to react to the new regulations, the impact that the Volcker rule (and its unintended consequences) will ultimately have on the stability of the financial system remains unclear.

What is clear, however, is that both supporters and critics have largely relied on arguments that are merely theoretical.[23] The lack of numerically supported real-world examples from either supporters or critics of the Volcker Rule makes it difficult to evaluate the rule in the objective, systematic manner required in order to make an well-informed decision. Therefore, I recommend that the SEC require both proponents and critics to support their assertions with such real world examples prior to enacting the Rule.

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[23] See Peter Eavis, Making a Theoretical Case About Volcker, Dealbook, (February 14, 2012). http://dealbook.nytimes.com/2012/02/14/making-a-theoretical-case-against-volcker/