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High Hopes: Measuring the Volcker Rule Proprietary Trading Provisions Against FSOC and Other Recommendations

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The Volcker Rule contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Statute) generally prohibits banking entities from engaging in proprietary trading and investing in private equity and hedge funds. The Statute called on the Financial Stability Oversight Council (FSOC) to conduct a study and make recommendations on implementing the statutory limits on proprietary trading (Study).[1] Within nine months of the release of the Study, the Statute required five agencies - the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC) (Agencies) - to have issued regulations implementing the proprietary trading restrictions. During that time, industry representatives, advocacy groups, and other interested parties provided numerous comment letters. Individuals at the Agencies worked extremely hard to produce the final rule (Final Rule) reflecting the FSOC recommendations and consideration of the comment letters. But ultimately we believe the Final Rule could follow the FSOC recommendations more carefully in several respects for a variety of reasons. This article will focus on discrete issues with the proprietary trading restriction and market making and underwriting exemptions, particularly where we felt the exemption was inconsistent with the FSOC recommendations. Ultimately, these and other shortcomings could have the perverse effect of actually increasing volatility in global financial markets, rather than decreasing overall systemic risks as the drafters of the Final Rule intended.

1. Proprietary Trading Restriction

The prohibition on proprietary trading in the Final Rule is inconsistent in some respects with the recommendations set forth in the Study, particularly with regard to the presumption that financial instruments held for less than 60 days are being used for impermissible purposes and the lack of an exception for asset-liability management activities.

A. 60-Day Presumption

The FSOC recommended that the Final Rule be dynamic and flexible.[2] With respect to the definition of "near term" trading accounts and "short-term price movements," it noted that what constitutes "near term" depends in large part on the nature of the financial instrument.[3] The Study goes on to propose that the definition of trading account might be similar to "(i) language used by FASB accounting standards to determine whether positions are 'held for trading' and (ii) a broader definition of 'covered positions' that are subject to the federal banking agencies' market risk capital rules."[4] Under FASB accounting standards, a security is held for trading if it is acquired with the intent of selling within hours or days.[5] Subject to further limitations, a "covered position" under market risk capital rules is a trading asset or trading liability that is "held by the bank for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits."[6]

The Final Rule provides that where a banking entity holds a covered financial position for fewer than 60 days the transaction is presumptively for the entity's trading account and therefore impermissible.[7] Once the presumption applies, the burden of disproving it falls to the banking entity.[8] This hard and fast rule lacks the flexibility recommended by the FSOC. Further, it disregards the concern that any single time measure will not be appropriate across a range of financial instruments that have varying liquidity levels. And finally, it is inconsistent with the FASB and federal banking agency market risk capital rules language noted in the Study, neither of which includes a strict and specific time measure. The 60-day time period is a far cry from the FASB accounting standards threshold of "hours or days."

The origin of the 60-day presumption has not been clearly spelled out in the Final Rule. The Final Rule only provides that "[b]ased on their supervisory experience, the Agencies find that 60 days is an appropriate cut off for a regulatory presumption."[9] The Agencies reason that the presumption will provide greater clarity, particularly for banking entities not familiar with evaluating short-term trading intent or that are not subject to the market risk capital rules, but provide little else in terms of rationale for this bright-line distinction.[10] However, we believe that a banking entity's lack of familiarity with evaluating short-term trading intent (possibly because such banking entity does not routinely engage in such trading) should not be a primary motivation for adopting a bright line (such as 60-day) restriction. Indeed, there is an element of circularity in an argument that states that a rule should provide a lot of clarity because such clarity would be helpful for someone who is not familiar with the rule and the conduct the rule is attempting to regulate.

The Statute does not suggest that short-term intent should be presumed for positions held for less than a certain period of time.[11] In fact, even the Proposed Rule itself seems to suggest that the 60-day rebuttable presumption is not workable:

> Although neither the Market Risk Capital Rules, the Call Report, nor relevant accounting standards provide a precise definition of what constitutes "near-term" or "short-term" … guidance provided under relevant accounting standards notes that "near term" for purposes of classifying trading activities is "generally measured in hours and days rather than months or years." The Agencies expect that the precise period of time that may be considered near-term or short-term … would depend on a variety of factors. … [12]

Yet despite the uncertainty and complexity surrounding what constitutes "near term" or "short-term" in any given instance, the presumption that short-term intent exists any time positions are held for less than 60 days became a part of the Final Rule.

In order to overcome the presumption, a banking entity must demonstrate, based on all relevant facts and circumstances, that it did not purchase (or sell) the financial instrument principally for an impermissible short-term purpose.[13] The rebuttal process is likely to be costly, time consuming, and fraught with risk, all of which are likely to drive banking entities away from legitimate market making, underwriting, and other activities protected by the statute. Any additional clarity that the presumption might provide is likely to come at an additional price; accordingly, instead of maintaining a rule that is likely to prohibit or deter legitimate conduct, it may be prudent to consider going back to the FSOC recommendations and basing the regulations on the intent and the purposes of the relevant conduct only, without introducing a time period presumption, the length of which does not appear to have any historical, legislative, or business relevance or meaning.

While it is inherently difficult to measure one's "intent to sell" vs. "intent to hold a position" or "the intent to benefit from actual or expected short-term price movements" or "to lock in a profit," intent is an integral part of multiple key federal statutes and, therefore, the Agencies and courts have experience considering "intent" as a factor in determining whether a violation has occurred, for example, in the context of other securities laws violations.[14] Thus, consistent with the FSOC recommendations, we continue to see FASB accounting standards and the federal banking agencies' market risk capital rules as superior to the current format for both consistency with legislative intent and practical implementation purposes.

B. Potential for the Final Rule to Implicate Legitimate Asset-Liability Management

The lack of an express exclusion for asset-liability management (ALM) activities in the Final Rule runs counter to the FSOC recommendations and could create further risks in the banking system. The Study notes that "[a]ll commercial banks, regardless of size, conduct [ALM]" and that, under the Statute, "ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool."[15] Despite this, the Final Rule explicitly declines to carve out ALM from its prohibitions, permitting it only if it falls under another exemption, such as the risk-mitigating hedging exemption.[16] But legitimate ALM activities are often broader than those contemplated by the exemptions under the Final Rule, and, as a result, the 60-day presumption and proprietary trading definition are likely to implicate many ALM activities that might not fall under one of these exemptions. This is problematic because ALM can help banking entities to manage risk and thus fosters stability. Therefore, limitations on legitimate ALM as a result of the Final Rule have the potential to make banking entities more, rather than less, prone to risk.[17]

2. Limitations of the Market Making and Underwriting Exemptions

The Study acknowledges that both underwriting and market making activities are beneficial and should not be prohibited.[18] The Final Rule addresses the challenge of distinguishing between such beneficial activities and the proprietary trading that it is designed to prohibit in a similar fashion with respect to both market making and underwriting activities by placing monitoring and recordkeeping burdens on banks and subjecting them to substantial compliance expenses. In particular, in each case, the Final Rule requires a banking entity to establish and implement, maintain and enforce an internal compliance program meeting a detailed list of significant requirements.[19] Given that market making activities are often difficult to distinguish from proprietary trading and the Study itself noted that "characteristics of underwriting activities are likely to be readily identifiable,"[20] it is unclear why the Agencies utilized similar compliance laden approaches in regulating the two activities. In addition, both activities are already "subject to a prudential 'backstop' that prohibits such activity if it would result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to the financial stability of the United States."[21] Thus, this compliance laden regulation of activities that are readily identifiable as legitimate will do nothing more than unnecessarily inhibit such legitimate activities.

Furthermore, where flexibility is provided with regard to certain of the activities that may constitute underwriting or market making, its benefits are quickly reduced by additional restrictions. For example, the general prohibition on proprietary trading imposed by the Final Rule does not apply where a covered banking entity is acting as underwriter for distribution of securities and the trading desk's underwriting position is related to such distribution.[22] However, in order to engage in such purchases or sales, a covered banking entity has to comply with numerous requirements, including the restriction that underwriting activities be "designed not to exceed the reasonably expected near term demands of clients, customers or counterparties."[23] Comment letters noted that "[t]his restriction limits the inventory holdings of underwriters, which then compromises the ability of underwriters to provide liquidity in a thinly traded market."[24] Given that many markets, such as the municipal bond market, are fairly illiquid, "[t]his means that much of the municipal trading in its current form may fail to qualify for the proprietary-trading exemption from the Volcker Rule"[25] where other securities would. The Final Rule attempted to address these comments and the FSOC recommendations by providing that in determining whether an activity constitutes permitted underwriting or market making, banks may consider the liquidity, maturity and depth of the market for the relevant securities or financial instruments.[26] However, giving banking entities the ability to "consider the liquidity" at the risk of violating the more clearly written portions of the statute if they are wrong provides little comfort as it is far from clear that regulators and entities engaging in these activities will interpret those factors in the same way.

In drafting the market making and underwriting exemptions, the Agencies faced the difficult task of effectively delineating between impermissible proprietary trading and legitimate market making. As the Agencies put it, the exemption needed to achieve two goals. First, the Final Rule should permit market making, which they recognized as "important to well-functioning markets as well as to the economy."[27] And second, it should bar proprietary trading. However, unlike proprietary trading, which is viewed as inherently risky and undesirable, market making generally is viewed as risk reducing and, therefore, desirable. Consistent with this approach, the Statute calls for the Final Rule to permit market making activity to the extent such activity is designed not to exceed reasonably expected near term demand.[28] As a result, if the Final Rule were to essentially prohibit market making activity, it would be inconsistent with the Statute.

The Statute devotes significant attention to the problem of determining whether an activity constitutes proprietary trading rather than permissible market making or underwriting and notes a number of challenges, including discerning market making inventory from inventory held for proprietary trading and distinguishing purchases in anticipation of customer demand from those made with short-term profit intent.[29] The FSOC recommended that the Final Rule identify characteristics that would indicate whether inventory was being purchased and held for permissible or impermissible purposes.[30]

In an effort to further delineate the exemption, the Final Rule provides six requirements for eligibility for the market making exemption that help to differentiate between permissible market making and proprietary trading, but those requirements still include language that could be considered vague in some respects.[31] While inflexible, bright-line distinctions like the 60-day presumption are not helpful, some further guidance in the final rule on certain terms and, possibly, the intent-based approach, would have helped provide greater regulatory certainty.

Like the Statute, the Final Rule requires that market making inventory be designed not to exceed reasonably expected near term demand. The Final Rule adds that this determination should be based on the "liquidity, maturity, and depth of the market for the financial instrument and demonstrable analysis of relevant factors including historical demand and current market and inventory."[32] But even with the inclusion of these factors, questions still linger as to how regulators will define terms such as "reasonably expected" and "near term." Based on the factors listed in the Final Rule, it is still entirely feasible that regulators and banking entities could reach different conclusions with respect to whether market making inventory was designed consistently with applicable restrictions. This is inconsistent with the recommendations of the Study that rules and supervision should allow for predictable evaluation outcomes, wherever possible, as "banking entities may refrain from essential financial intermediation or risk mitigation if they are unable to ascertain what constitutes permitted activities."[33]

Various comment letters from industry participants provided in response to the Proposed Rule set out the potential market consequences of adopting some of the above described provisions that made their way into the Final Rule despite some changes. As a result, the Final Rule has the potential to severely curtail legitimate underwriting and market making activity, which would result in decreased market liquidity and related problems. For example, some comment letters warn that in some asset classes, reductions in liquidity could be particularly acute. For instance, in the corporate bond market, buyers and sellers for the same financial instrument are rarely present in the market at the same time.[34] Other comment letters suggest that the lack of reliable secondary market liquidity would likely cause the risks of bond ownership to rise, which in turn would increase issuers' borrowing costs.[35] This is particularly problematic for smaller issuers because they generally have lower ratings and higher liquidity premiums.[36] Furthermore, some commenters predict that the decreased demand in the bond market would likely result in higher bid-ask spreads.[37] If a bank were forced to sell various assets when it otherwise would not have in order to avoid the appearance of proprietary trading, this could have a destabilizing impact on the market.[38] Finally, commenters note that additionally, although non-bank entities might eventually be able to replace banking entities as primary market makers, this would likely be a lengthy process and would leave the capital markets in disarray in the meantime. What's more, it is not clear that the capital markets would benefit from taking the market making function away from highly regulated and supervised banking entities and turning it over to other, less closely monitored market participants.[39]

In the Final Rule, the Agencies acknowledge all of these risks, but in many ways seem unconcerned by them, writing that "over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated."[40] What the Agencies do not elaborate on is how long this process might take and the significant costs it is likely to incur in the meantime. The Agencies also appear to assume that the Final Rule will only eliminate non-exempt proprietary trading activities, but because of the regulatory uncertainty surrounding the market making exemption, banking entities are likely to limit their market making to a far greater extent than the Final Rule's authors imagined or intended in order to limit regulatory risk. As such, the Final Rule's market impact could be far larger than imagined by the Agencies. The Agencies also seem to give less attention than merited to the potential problems posed by shifting the market making function from highly regulated banking entities to other less regulated entities.

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NOTES

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 619 (2010) (codified at 12 U.S.C. § 1851 (2012)).

2 Financial Stability Oversight Council, *Study and Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, at 26 (January 2011) (hereinafter, *FSOC Study*).

3 *FSOC Study*, at 24-25.

[4] *Id.* at 25.

[5] Financial Accounting Standards Board, Accounting Standards Codification, 320-10-25-1a.

[6] 12 C.F.R. Part 3, Appendix B, § 2a (2010).

[7] 17 C.F.R. § 255.3(b)(2).

[8] *Id.*

[9] Final Volcker Rule, 79 Fed. Reg. 5536, 5550 (January 31, 2014).

[10] *Id.*; Proposed Volcker Rule, 76 Fed. Reg. 68846, 68860 (November 7, 2011).

[11] *See Letter from Barry L. Zubrow*, *JPMorgan Chase & Co.*, (February 13, 2012) at 15-16 (available at *https://www.sec.gov/comments/s7-41-11/s74111-267.pdf*) (hereinafter, *JPMC*); *Letter from Frank Keating, American Bankers Association*, (February 13, 2012) at 23 (available at *https://www.sec.gov/comments/s7-41-11/s74111-280.pdf*).

[12] Proposed Volcker Rule, 76 Fed. Reg. 68846, 68859 (November 7, 2011).

[13] 17 C.F.R. § 255.3(b)(2).

[14] *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007), where the Court considered the intent requirement under the Private Securities Litigation Reform Act; Inst'l Investors Grp. v. Avaya, Inc., 564 F.3d 242 (3d Cir. 2009), where the Third Circuit provided a framework for examining securities fraud claims post-Tellabs, and emphasized that courts must look to the complaint as a whole, not just particular allegations, when assessing claims for securities fraud.

[15] *FSOC Study*, at 47.

[16] Final Volcker Rule, 79 Fed. Reg. 5536, 5555 (January 31, 2014).

[17] *JPMC*, at 52-53.

[18] *FSOC Study*, at 11, 16.

[19] 17 C.F.R. §255.4.

[20] *FSOC Study*, at 31. The Study notes that "[f]or instance, when a firm is acting as an underwriter, its participation in the due diligence process and role as advisor to the issuer will be significant and clearly documented."

[21] *The Study*, at 2.

[22] 17 C.F.R. § 255.4(a)(2)(i).

[23] 17 C.F.R. § 255.4(a)(2)(ii). The market making exemption contains a similar requirement. 17 C.F.R. § 255.4(b)(2)(ii).

[24] *See*, *e.g.*, A.V. Thakor, "The Economic Consequences of the Volcker Rule," *Center for Capital Markets Competitiveness*, Summer 2012, at 8.

[25] *Id.*

[26] 17 C.F.R. § 255.4(a)(2)(ii), (b)((2)(ii)(A).

[27] Final Volcker Rule, 79 Fed. Reg. 5536, 5576 (January 31, 2014).

[28] 12 U.S.C. § 1851(d)(1)(B).

[29] *FSOC Study*, at 18-19, 22-25.

[30] *Id.* at 22.

[31] 17 C.F.R. § 255.4(b)(2)(i)-(vi).

[32] 17 C.F.R. § 255.4(b)(2).

[33] *FSOC Study*, at 26.

[34] *Letter from Oliver Wyman*, (February 13, 2012) at 3 (available at *https://www.sec.gov/comments/s7-41-11/s74111-139.pdf*) (hereinafter, *Wyman*).

[35] *See*, *e.g.*, *JPMC*, at 13.

[36] *Wyman* at 27.

[37] *See*, *e.g.*, *Letter from Hal S. Scott, Committee on Capital Markets Regulation*, (February 13, 2012) at 4 (hereinafter, *CCMR*); *JPMC*, at 15.

[38] *CCMR*, at 6.

[39] *See*, *e.g.*, *Wyman*, at 3. For example, beyond the lack of regulatory oversight, non-banks have less incentive and are less equipped to act as market makers where spreads are narrow or in times of high volatility, which are exactly when market makers' services are most needed. *See also JPMC*, at 14.

[40] Final Volcker Rule, 79 Fed. Reg. 5536, 5584 (January 31, 2014).