Proprietary Trading and Investment Restrictions Under the Volcker Rule

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Business Issues, Competition and Entrepreneurship

Novinka

Library of Congress Cataloging-in-Publication Data

Proprietary trading and investment restrictions under the Volcker Rule /
editors, Bradley S. Duncan and Alicia M. Brenshaw.
p. cm.
Includes index.
ISBN 978-1-61324-066-3 (softcover)
1. Banking law--United States. 2. Bank investments--Law and
legislation--United States. I. Duncan, Bradley S. II. Brenshaw, Alicia M.
III. Title.
KF968.6.P76 2011
346.73'082--dc22
2011007119

Published by Nova Science Publishers, Inc. † New York

BUSINESS ISSUES, COMPETITION AND ENTREPRENEURSHIP

PROPRIETARY TRADING AND INVESTMENT RESTRICTIONS UNDER THE VOLCKER ROLE

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PREFACE

This new book examines the proprietary trading and investment restrictions under the Volcker Rule.

Chapter 1- On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Dodd-Frank Act is intended to strengthen the financial system and constrain risk taking at banking entities. Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is a key component of this effort. The Volcker Rule prohibits banking entities, which benefit from federal insurance on customer deposits or access to the discount window, from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions.[2]

Chapter 2- These remarks were delivered as testimony given by Paul A. Volcker, before the Committee on Banking, Housing, and Urban Affairs.

Chapter 3- These remarks were delivered as testimony given by Neal S. Wolin, before the Committee on Banking, Housing, and Urban Affairs.

CONTENTS

In: Propriety Trading and Investment... ISBN: 978-1-61324-066-3
Editors: B. S. Duncan, A. M. Brenshaw

Chapter 1

STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS

Financial Stability Oversight Council

OVERVIEW OF STUDY AND RECOMMENDATIONS

Introduction

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Dodd-Frank Act is intended to strengthen the financial system and constrain risk taking at banking entities. Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is a key component of this effort. The Volcker Rule prohibits banking entities, which benefit from federal insurance on customer deposits or access to the discount window, from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions.[2]

The proprietary trading provisions prohibit a banking entity[3] from engaging in trading activity in which it acts as a principal in order to profit

from near-term price movements. [4] The hedge fund and private equity fund provisions generally prohibit a banking entity from investing in, or having certain relationships with, any fund that is structured under exclusions commonly used by hedge funds and private equity funds under the Investment Company Act of 1940 (the Investment Company Act").[5]

However, to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation, the Volcker Rule provides for certain "permitted activities" that represent core banking functions such as certain types of market making, asset management, underwriting, and transactions in government securities. These permitted activities – in particular, market making, hedging, underwriting, and other transactions on behalf of customers – often evidence outwardly similar characteristics to proprietary trading, even as they pursue different objectives, and it will be important for Agencies[6] to carefully weigh all characteristics of permitted and prohibited activities as they design the Volcker Rule implementation framework.

These permitted activities are 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.

For nonbank financial companies that are supervised by the Board, the Volcker Rule does not expressly prohibit or limit any activities. Instead, the Volcker Rule requires that the Board adopt rules imposing additional capital charges or other restrictions on such companies to address the risks and conflicts of interest that the Volcker Rule was designed to address.[7]

Since the enactment of the Dodd-Frank Act, a number of banking entities have shut down, or announced plans to shut down, their operationally distinct, dedicated proprietary trading operations ("bright line' proprietary trading") and hedge fund and private equity fund businesses that were a source of losses during the crisis. While these actions have reduced proprietary trading activity, impermissible proprietary trading may continue to occur, including within permitted activities that are not organized solely to conduct impermissible proprietary trading.

As Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System, explained in his testimony to the Senate Banking Committee when he urged adoption of this provision:

What we can do, what we should do, is recognize that curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility and uncertainties are inherent in our market-oriented, profit-seeking financial system. By appropriately defining the business of commercial banks . . . we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.[8]

Recommended Actions to Effectively Implement the Volcker Rule

The Council strongly supports the robust implementation of the Volcker Rule and recommends that Agencies consider taking the following actions:

1) Require banking entities to sell or wind down all impermissible proprietary trading desks.
2) Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness.
3) Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
4) Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
5) Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
6) Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
7) Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers.
8) Prohibit banking entities from engaging in transactions that would allow them to "bail out" a hedge fund or private equity fund.
9) Identify "similar funds" that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
10) Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.

Summary of Conclusions and Recommendations

In this study, the Council sets forth recommendations that seek to identify and eliminate prohibited proprietary trading activities and investments in or sponsorships of hedge funds and private equity funds by banking entities. The proprietary trading section of the study outlines criteria for defining prohibited activities, rigorous tests to identify permitted activities, and grounds to prohibit activities that would involve or result in a material conflict of interest, result in a material exposure to a high-risk asset or high-risk trading strategies, pose a threat to the safety and soundness of such banking entity, or pose a threat to the financial stability of the United States.

The private funds section of the study focuses on key issues raised in the implementation of the Volcker Rules hedge fund and private equity funds provisions, and recommends certain substantive criteria that Agencies should use to guide legal interpretations in the rulemaking. It also recommends a compliance and supervisory framework.

Proprietary Trading

The Volcker Rule mandates that banking entities cease proprietary trading, subject to certain exceptions for permitted activities, such as market making, trading in government securities, hedging, and underwriting. Although bright line proprietary trading desks are readily identifiable, in current practice, significant proprietary trading activity can take place in the context of activities that would otherwise be permitted by the statute. Therefore, an essential part of implementing the statute is the creation of rules and a supervisory framework that effectively prohibit proprietary trading activities throughout a banking entity not just within certain business units and that appropriately distinguish prohibited proprietary trading from permitted activities.

In developing these rules, the study recommends that Agencies rulemaking and implementation efforts be guided by five fundamental principles:

1) The regulations should prohibit improper proprietary trading activity using whatever combination of tools and methods are necessary to monitor and enforce compliance with the Volcker Rule.
2) The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate proprietary trading as new products and business practices emerge.

3) The regulations and supervision should be applied consistently across similar banking entities (e.g., large banks, hedge fund advisers, investment banks) and their affiliates to facilitate comparisons. The regulations and supervision should endeavor to provide banking entities with clarity about criteria for designating trading activity as impermissible proprietary trading.
4) The regulations and supervision should facilitate predictable evaluations of outcomes so Agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity.
5) The regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary, e.g., cash and derivatives markets.

The recommendations also identify indicia of permitted activities that will help prevent banking entities from migrating proprietary trading activities into areas of the banking entity that otherwise conduct permitted activities. Implementing these indicia-based tests would require certain banking entities to change their business practices to bring trading activities into compliance with the statutory definitions of the permitted activities. However, these tests are also designed to preserve banking entities' ability to engage in critical financial intermediation in financial markets.

To effectively apply and monitor these substantive tests, the Council recommends a four-part implementation and supervisory framework that would assist Agencies in identifying proprietary trading activities that must be eliminated, consisting of:

1. ***Programmatic compliance regime***: The Council recommends that banking entities be required to develop robust internal controls and programmatic compliance regimes (that will include strong investment and risk oversight) designed to ensure that proprietary trading does not migrate into permitted activities. The compliance regime may require:

- The establishment of internal policies and procedures to detect and eliminate proprietary trading;
- The development and implementation of a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule

policies and procedures.

- The creation of recordkeeping and reporting systems to enable internal compliance reviews and supervisory examinations;
- The implementation of independent testing of the compliance regime by a banking entity's internal audit department or by outside auditors, consultants or other qualified independent parties; and
- Robust review of permitted activities to ensure that internal policies and procedures are being followed, combined with engagement by the Board of Directors and public attestation of compliance by the Chief Executive Officer ("CEO").

2. ***Analysis and reporting of quantitative metrics***: This study outlines four categories of metrics that banking entities could be required to analyze and report to Agencies to help identify impermissible proprietary trading, including:

- Revenue-based metrics;
- Revenue-to-risk metrics;
- Inventory metrics; and
- Customer-flow metrics.

The use of appropriate metrics to identify possible proprietary trading should be important for management and supervisors to ensure compliance with the Volcker Rule. Although this study puts forth specific metrics that Agencies should consider for these purposes, Agencies may also consider other metrics they identify in the future.

3. Supervisory review and oversight: Agencies can engage in supervisory review and oversight of trading operations to review and test internal controls, monitor for potentially problematic trends or incidents, and investigate specific trading activity, including position-level data, where warranted.

4. Enforcement procedures for violations: If a violation is identified through the examination process, the statute requires that the activity be terminated and that the investment be liquidated. This remedy should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges, or monetary penalties. Also, it should not

insulate proprietary trading from other applicable provisions of law. The statute also provides for an adjudication process, including notice and opportunity for hearing, which supervisors must develop as part of the implementation process.

This section also outlines key issues in the application of the prudential "backstop" provisions that limit the scope of permitted activities. The section closes by outlining other important elements of the U.S. financial regulatory system that will further support the objectives of the Volcker Rule, including more stringent capital standards, comprehensive supervision of derivatives markets and stronger "firewalls" between depository institutions and their affiliates.

Sponsorship of and Investments in Hedge Funds and Private Equity Funds

In addition to the restrictions on proprietary trading, the Volcker Rule generally prohibits banking entities from making investments in or sponsoring hedge funds or private equity funds that are not connected to the provision of bona fide trust, fiduciary, or investment advisory services to its customers. The purpose of this additional prohibition is to:

1) Ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule's restrictions on proprietary trading;
2) Confine the private fund activities of banking entities to customer-related services; and
3) Eliminate incentives and opportunities for banking entities to "bail out" funds that they sponsor, advise, or where they have a significant investment.

The Volcker Rule prohibits hedge fund and private equity fund sponsorship or investment by banking entities except in narrow circumstances. A banking entity is allowed to organize and offer a fund to its bona fide trust, fiduciary, and investment advisory customers. Further, banking entities are not permitted to invest in these types of funds beyond a specified *de minimis* amount in order to establish funds and attract unaffiliated investors in connection with its customer-related business.

The Volcker Rule relies on two commonly-used exclusions from the definition of the term investment company under section 3(c) of the Investment Company Act to define hedge funds and private equity funds.

Although widely used by traditional hedge funds and private equity funds, these statutory exclusions were not designed to apply only to such funds. As such, they do not specifically address or closely relate to the activities or characteristics that are typically associated with hedge funds or private equity funds. In implementing the Volcker Rule, Agencies should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the hedge fund and private equity fund definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute.

The study makes recommendations in three areas below:

1) ***Customer requirement***: The Volcker Rule requires that organized or sponsored funds only be offered to "customers" of a banking entity. The term "customer" is not defined in the statute. The study outlines factors that Agencies should consider in determining who is a customer and the necessary nature of that relationship.
2) ***Calculation of de minimis investment***: The *de minimis* investment calculation applies both to restrict the exposure of a banking entity to 3% of any single fund and to limit the banking entity's aggregate exposure to 3% of Tier 1 capital. Agencies should consider calculating these limits in a manner that will require full accounting of the banking entity's risk and requiring ongoing monitoring of these limits through the life of the fund.
3) ***Monitoring compliance, attestation, and public reporting***: Agencies should consider requiring banking entities to establish internal programmatic compliance regimes that will involve strong investment and risk oversight of permissible hedge fund and private equity fund activities with engagement by the Board of Directors and public attestation of the adequacy of such compliance regime by the CEO. In addition, in the limited instances in which a banking entity is permitted to invest in a hedge fund or private equity fund to facilitate customer-related business, Agencies should consider requirements for banking entities to disclose the nature and amount of any such investment.

THE STATUTORY MANDATE AND OBJECTIVES OF THE STUDY

The Dodd-Frank Act requires the Council to conduct a study and make recommendations on effectively implementing the Volcker Rule not later than six months after the date of enactment:

(1) STUDY.—Not later than 6 months after the date of enactment of this section, the Financial Stability Oversight Council shall study and make recommendations on implementing the provisions of this section so as to—

a) promote and enhance the safety and soundness of banking entities;
b) protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;
c) limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities;
d) reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board,[75] and the interests of the customers of such entities and companies;
e) limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;
f) appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and
g) appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under subsection (a) [of Section 13 of the Bank Holding Company Act of 1956].

Agencies are required, not later than nine months after the completion of this study, to adopt rules to implement the Volcker Rule and must consider the

recommendations of the Council in developing and adopting such regulations. In so doing, Agencies are required to consult and coordinate with each other so that, to the extent possible, these regulations are comparable across Agencies and provide for consistent application and implementation of the Volcker Rule. The Chairperson of the Council is responsible for coordination of the regulations issued under Section 619 of the Dodd-Frank Act.

The recommendations in this study are designed to assist Agencies in effectively implementing the prohibition on proprietary trading in line with the studys statutory objectives. Key objectives of the study are to make recommendations related to reducing risk and promoting safety and soundness of banking entities and nonbank financial companies designated for heightened supervision by the Board.[9] These recommendations directly address the objectives of the study by proposing a framework that would:

- Require a comprehensive compliance and oversight regime focused on monitoring and enforcing (i) the prohibition on impermissible proprietary trading and (ii) impermissible investments in and sponsorship of hedge fund and private equity fund activities, thereby minimizing unsafe and unsound activities;
- Build on existing risk management and supervisory tools by integrating the particular risk characteristics of proprietary trading into Agencies existing framework for safety and soundness, and recommending an oversight and risk monitoring structure for hedge fund and private equity fund activities; and
- Implement the statutory requirement to prohibit proprietary trading and investment in or sponsorship of impermissible hedge funds and private equity funds, so as to limit the transfer of subsidies from the federal support provided to depository institutions to speculative activities.

The study also includes explicit recommendations to address conflicts of interest and accommodations for the insurance industry.

With respect to appropriately timing the divestiture of illiquid assets required by the ban, the Volcker Rule provides for a conformance period during which banking entities and nonbank financial companies supervised by the Board must bring their activities and investments into compliance with the Volcker Rule, and requires the Board to issue rules not later than 6 months after the enactment of the Dodd-Frank Act to implement the conformance period. The Board recently issued a Notice of Proposed Rulemaking in the

Federal Register requesting comment on a proposed rule, which includes the Boards position on the appropriate conformance period for the divestiture of illiquid funds.[10]

PUBLIC OUTREACH AND COMMENTS

To assist the Council in conducting the study and formulating its recommendations, the Council published a Notice and Request for Information in the Federal Register on October 6, 2010.[11] An excerpt from the Notice and Request for Information containing the questions posed is attached as Annex A. At the time the comment period closed on November 5, 2010, the Council had received more than 8,000 comments. Approximately 6,550 of these comments were substantially the same letter arguing for strong implementation of the Volcker Rule. The remaining 1,450 comments each set forth individual perspectives from financial services market participants, Congress, and the public. Further, staff of the Council's member agencies conducted meetings with parties representing a wide range of perspectives on the issues raised by implementation of the Volcker Rule.

In general, many commenters urged Agencies to implement the Volcker Rule so as to:

- Unambiguously prohibit banking entities from engaging in speculative proprietary trading or sponsoring or investing in hedge funds or private equity funds;
- Define terms and eliminate potential loopholes; and
- Provide clear guidance to banking entities as to the definition of permitted and prohibited activities.

Selected written and oral comments are summarized below.

Proprietary Trading

A large number of commenters recommended that the Volcker Rule regulations prescribe clear and predictable rules that distinguish prohibited proprietary trading from permitted activities and noted that ambiguity would hinder compliance and potentially reduce market liquidity. Several commenters drew a distinction between impermissible proprietary trading