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# Financial Reform: Overview of the Volcker Rule

## Background

Legislators and regulators have long grappled with whether restricting the types of activities banks can engage in, or reforming banks' structures, might reduce the risk of large bank failures and the risk of systemic financial instability, such as that seen in the 2008 financial crisis. The Volcker Rule is an example of a means of addressing this issue.

The statutory basis of the Volcker Rule is Section 619 of the Dodd-Frank Act, enacted in 2010 following the crisis. It was conceived of by Paul Volcker, a former Federal Reserve (Fed) chair, and implemented as "the Volcker Rule" in a 2013 joint final rule by five financial regulators: the Fed, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC).

The Volcker Rule generally prohibits a depository bank (or company that owns one) from engaging in proprietary trading or investing in (or sponsoring) a hedge fund or private equity fund. The rule has been subject to debate and was recently amended through legislative action. Regulators have also proposed further changes to the rule.

Prior to the Dodd-Frank Act, no statutory definition of proprietary trading existed, but the concept was generally understood to mean trading by an entity for its own profit and loss, rather than on behalf of a client for commission- or fee-based income. Section 619 defined the term, in part, as "engaging as a principal for the trading account of the banking entity or nonbank financial company…in any transaction to purchase or sell, or otherwise acquire or dispose of" financial instruments, such as securities and derivatives.

A well-known prior example of a restriction on banks is the Glass-Steagall Act, passed in 1933 during the Great Depression. Glass-Steagall generally prohibited certain deposit-taking banks from engaging in various securities markets activities associated with investment banks, such as speculative investment in equity securities. Glass-Steagall also prohibited banks from affiliating with securities firms. Over time, regulators became more permissive in their interpretations of Glass-Steagall, allowing banks to participate in more securities market activities, directly or through affiliations. In 1999, the Gramm-Leach-Bliley Act repealed two provisions of Glass-Steagall, which further expanded permissible activities for certain banks and permitted banks to affiliate with securities firms.

The 2008 financial crisis rekindled the debate over what activities banks should be allowed to engage in. In the run-up to the crisis, banks took on excessive risks, including through proprietary trading in complex derivatives, mortgage-backed securities, and other financial instruments. Excessive risks led to losses that precipitated substantial federal government financial assistance to the financial sector, which proved politically unpopular. These interventions raised concern about taxpayers' exposure to financial crises. The fact that banks were protected from potential losses by taxpayer-backed deposit insurance and other federal assistance, such as short-term lending by the central bank, further aggravated concerns. The Volcker Rule's prohibition of proprietary trading attempts to prevent bank holding companies whose depository banks have access to such government safety nets from speculating in financial markets.

## Issues in Volcker Rule Implementation

The Volcker Rule exempts certain securities, such as Treasuries, from the ban on proprietary trading. It also exempts certain activities such as hedging and market marking. A fundamental challenge in implementing the Volcker Rule has been devising a clear way to distinguish between trading by banks for speculative purposes and other allowable purposes. From the outset, regulators and academics acknowledged that it is difficult to discern whether a financial trade is aimed at profiting from market movements or hedging existing assets against market movements. Market-making entails buying and selling instruments, such as stocks or bonds, for the purpose of fostering a liquid market in them, often for the benefit of a client, such as a company issuing shares. It can be hard to distinguish whether a firm is holding such securities in order to foster a liquid market or to profit from them.

To implement Section 619 of the Dodd-Frank Act, regulators were challenged with creating standards to distinguish between these activities. This inherent challenge may have contributed to the final rule's length and accusations that it is overly complex and cumbersome to follow and for bank supervisors to use. The Volcker Rule has not only faced criticisms from opponents that it is too strict, lengthy, and burdensome, but also from proponents of financial reform and consumer advocates that it does not go far enough to prevent banks from proprietary trading. Some questioned why the 2013 rule presumed short-term trades of less than 60 days to be proprietary unless otherwise proven, whereas longer-term trades were not subject to such a presumption.

In an April 2017 speech, former Fed Governor Daniel Tarullo, who helped implement the rule, flagged several problems with it in practice. He noted that, although the purpose is worthy, the involvement of five different agencies made it complex to supervise and follow. He also noted that the ongoing need for data-driven, contextual guidance from the different regulators took up excessive regulatory and bank supervisors' time and led to increased compliance costs for banks. He stated that the rule might contribute to reduced market-making liquidity in some financial instruments and is unnecessarily costly for small- and medium-sized banks with few trading activities.

## Legislative Changes

On May 24, 2018, President Trump signed into law P.L. 115-174, which made a variety of changes to financial regulation and to the Volcker Rule. First, the new law exempted any bank holding company with less than $10 billion in consolidated assets from having to comply with the Volcker Rule if the firm's total trading assets or liabilities also do not exceed 5% of total consolidated assets.

Second, the law relaxes somewhat the prohibition on bank entities "sponsoring" hedge funds or private equity funds by sharing the bank's name, or variant of it, with the fund – a practice usually used for marketing or promotional purposes. The ban's initial logic was to prevent banks from creating the impression, or the reality, that they would "backstop" such funds in bad times, which could potentially create bank losses, and ultimately, the FDIC and taxpayer losses, if such losses proved severe. Banking associations, however, argued that this restriction hindered banks' role in capital formation and put them at a competitive disadvantage relative to nonbanks when it came to sponsoring such investment funds. The question of whether this disadvantage was intentional and desired, or unfair and undesirable, depends on one's viewpoint. The new law permits banks to share their names with such funds under several circumstances. Regulators announced they will incorporate these legislative changes into a future rulemaking.

## Agencies' Proposal for Reform

On May 30, 2018, the Fed released a new proposed rule that would revise the Volcker Rule. The proposal does not address how to implement P.L. 115-174, which is to occur in a separate rulemaking. The Fed stated in its Board memo that "staff has identified opportunities, consistent with the statute…to incorporate additional tailoring…based on the activities and risks of banking entities and to provide greater clarity about the activities that are prohibited and permitted." The Fed said the proposal would make it easier for bank supervisors to assess compliance with the Volcker Rule. The FDIC, OCC, SEC and CFTC, which had jointly with the Fed issued the original Volcker Rule in 2013, each voted to support the proposal, with dissents at the SEC and CFTC.

A key change is that the new proposal categorizes firms based on their trading activities' size and envisions that only those with the largest trading books will be subject to the most scrutiny. The Fed said this approach would more accurately tailor the regulation to the trading risk profile of a firm rather than to its size by total assets. Firms that have worldwide trading assets and liabilities—including those of their affiliates—which exceed $10 billion when added over the four previous quarters are considered "significant" trading exposures. The Fed estimated this would cover 18 banking organizations.

Firms with more than $1 billion but less than $10 billion in trading assets are to be deemed to have "moderate" trading activities and are to face significantly reduced compliance requirements. An additional 22 banking organizations fall into this category. Firms with "limited trading activity"—those with less than $1 billion of trading assets and liabilities—would be presumed compliant. The Fed estimated that the 40 banking organizations with significant or moderate trading activities account for 98% of total U.S. trading activity by banking entities.

In addition, the proposal modifies what constitutes "proprietary trading" by eliminating the "rebuttable presumption" in the Volcker Rule that trades held for less than 60 days be presumed part of a proprietary trading account unless the bank shows the intent of the trade was not for short-term trading gains. Banks complained this requirement was too ambiguous and time-consuming. The proposal eliminates this rebuttable presumption for short-term trades.

## Analysis of Changes

Although the original Volcker Rule included tailoring for small banks, a broader exemption for smaller banks such as in the law and in the agencies' proposal had been anticipated for some time. Some observers were critical of asset-size thresholds as a regulatory standard for the Volcker Rule, arguing it should be tailored based on the riskiness of the business model instead.

Neither the new law nor the agencies' proposal makes substantial changes to the restriction on banking entities investing in private equity or hedge funds, despite the modification of the naming prohibition on such funds. The proposal potentially relaxes certain requirements for banks' ownership interests in covered funds when they relate to the banks' market making or underwriting activities.

Changes to the Volcker Rule in the agencies' proposal and in P.L. 115-174 garnered significant, and divergent, attention in the press and in Congress. Some Members of Congress, including the ranking members on the Senate Banking and House Financial Services Committees, argued that these changes would make it easier for banks to engage in speculative trading, amplifying risks at these banks. In contrast, proponents of these changes, including the Senate Banking Committee and House Financial Services chairs, said they would streamline regulation and improve clarity and efficiency.

Outside of Congress, assessments of the modifications also diverged. The financial industry welcomed the changes, saying it would reduce compliance burdens and increase regularity clarity. However, certain regulatory leaders opposed the changes. Two SEC commissioners and one CFTC commissioner voted against the proposal. In dissents, they stated that expanding what qualified as risk-mitigating hedging (as opposed to proprietary trading) could potentially enable evasion of the rule. They voiced concern that relaxing the proprietary trading prohibition without finalizing rules restricting compensation for excessive risk taking at banks would likely encourage such risk-taking.

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