Legal Sidebar

Revising the Volcker Rule: Section 203 and Section 204 of the Economic Growth, Regulatory Relief, and Consumer Protection Act

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When Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, Section 619, otherwise known as the "Volcker Rule," proved particularly consequential. Named after former Federal Reserve Chairman Paul Volcker, who had long criticized certain banking practices that he felt were at odds with conventional banking principles, the Volcker Rule prohibits banks and affiliates from, among other things, (1) engaging in proprietary trading, and (2) owning or sponsoring hedge funds and private equity funds. These prohibitions are subject to several exemptions and restrictions, including those relating to underwriting, market making, and risk-mitigating hedging activities. Defenders of the Rule argue that it keeps banks from engaging in risky trading activities. Critics have argued that the Rule is overly complex, ambiguous, and may decrease market liquidity.

In 2018, Congress addressed some of this criticism by amending the Volcker Rule as part of a larger package of financial reforms known as the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). This Legal Sidebar is the first in a series to examine revisions to the Volcker Rule. It discusses rulemaking by five financial regulatory agencies (the Agencies)—the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC)—to implement the EGRRCPA's Volcker Rule revisions. These revisions include Section 203, which exempts so-called "community banks" from Volcker Rule restrictions, and Section 204, which modifies the Volcker Rule's restriction on name sharing among banking entities, hedge funds, and private equity funds.

This Sidebar proceeds in two parts. First, it gives background on the Agencies' rulemakings. Second, it analyzes related legal issues. Specifically, the Agencies' interpretations of Sections 203 and 204 are generally in keeping with the common view regarding the scope of the provisions. Nonetheless, Congress could amend revisit and revise the Volker Rule in the event that it no longer believes the Rule is the best approach or does not believe the Rule is appropriately implemented by the Agencies.

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Background

Section 203: The Community Bank Exemption

Section 203 of the EGRRCPA limits the number of banks and affiliates subject to the Volcker Rule by narrowing the definition of "banking entity." Section 203 provides that the definition of "insured depository institution" for purposes of the Volker Rule's definition of "banking entity"

> does not include an institution . . . (B) that does not have and is not controlled by a company that has (i) more than $10,000,000,000 in total consolidated assets, and (ii) total trading assets and trading liabilities, as reported on the most recent applicable regulatory filing filed by the institution, that are more than 5 percent of total consolidated assets.

At the time of its enactment, some interpreted Section 203 to exempt only community banks—that is, banking entities with fewer than $10 billion in total consolidated assets and total trading assets and liabilities less than 5% of total consolidated assets. The Agencies' proposed rule adopted this position. Others argued, however, that because Section 203 is worded as a double negative, it should be interpreted more broadly to exempt banking entities with *either* $10 billion or less in total consolidated assets *or* trading assets of 5% or less of total consolidated assets.

During the notice-and-comment period, the Agencies received several comments advocating for the broader interpretation of Section 203, under which banks with more than $10 billion in total consolidated assets could be exempted from the Rule's restrictions. These commenters asserted that the Agencies' proposed rule "directly contradict[ed]" the text of the EGRRCPA, and they argued that the Agencies ignored that Congress had modeled the EGRRCPA on a report from the U.S. Department of the Treasury recommending that Congress exempt banks with greater than $10 billion in assets. According to these commenters, "[t]he decision by Congress to implement the Treasury proposal was a compromise position" to keep parts of the Volcker Rule instead of entirely abolishing it, as some members of the House of Representatives had proposed.

The Agencies ultimately rejected this broader interpretation of Section 203, opting instead to exempt banks only if they had fewer than $10 billion in total consolidated assets *and* total trading assets and liabilities less than 5% of total consolidated assets. The Agencies noted that a broader interpretation would exempt "certain global systemically important banks (G-SIBs) with over $250 billion in total consolidated assets," which the Agencies concluded was inconsistent with Congress's intent to carve a narrow exception for smaller community banks. They also noted that Section 203's title—"Community bank relief," floor statements by senators indicating that they understood Section 203 to apply only to smaller banks, and the Senate Banking Committee's summary of Section 203 weighed against exempting larger banks.

Section 204: Modification of Restrictions on Name-Sharing

As originally enacted, the Volcker Rule restricted "banking entities" from sharing their names with hedge funds and private equity funds. Because of the original Rule's broad definition of "banking entity," this prohibition applied not only to insured depository institutions and bank holding companies, but to their subsidiaries and affiliates as well. Section 204 of the EGRRCPA loosened these restrictions for certain investment-advisor subsidiaries and affiliates of insured depository institutions and bank holding companies. Specifically, Section 204 exempts investment advisers—that is, persons or firms that provide investment advice for compensation—from the Rule's name-sharing prohibition as long as:

- The investment adviser is not an insured depository institution, a company that controls an insured depository institution, or a company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978;

- The investment adviser does not share a name, or a variation of the name, with such institutions as listed above;
- The name of the investment adviser does not contain the word "bank." This change codified an existing requirement already implemented by the Agencies through regulation.

During the notice-and-comment period, many commenters expressed general support for the rule. But some trade associations requested that the Agencies grant relief from name-sharing restrictions to banking entities whose affiliated investment advisers are headquartered in foreign jurisdictions that require those entities to share the same name with hedge funds and private equity funds. In opting not to recognize an exception for foreign headquartered entities, the Agencies explained: "Section 204 of EGRRCPA did not provide an exclusion allowing banking entities to share a name with a covered fund if required or expected to by foreign regulators."

Analysis

In 2018 it was reported that some large banks contemplated legal challenges arguing that they are exempt from the Volcker Rule because of Section 203. Given the Agencies' final rule, it is possible that they are still considering legal action. It is also possible, though less likely, that parties may challenge the scope of Section 204, given the Agencies' decision not to grant relief to banks with affiliated advisers that are headquartered in foreign jurisdictions. When the Agencies first implemented the Volcker Rule in 2013, some commenters argued that imposing name-sharing restrictions on foreign entities ran counter to the presumption that U.S. laws should not be applied extraterritorially without a clear expression from Congress. Given Section 204's silence regarding extraterritoriality, this critique may still be relevant. Any legal challenge would face substantial obstacles, however.

Most notably, a court would review any legal challenge to the Agencies' regulatory implementation of Section 203 and Section 204 under the two-step framework established by the Supreme Court in *Chevron U.S.A Inc. v. Natural Resources Defense Council*. *Chevron* instructs courts to first determine "whether Congress has directly spoken to the precise question at issue." If so, "that is the end of the matter," and courts should put into effect the "unambiguously expressed intent of Congress." If a statute is silent or ambiguous, however, per *Chevron*, a court should defer to an agency's reasonable interpretation of the statutory text.

Assuming a court deemed Section 203 to be ambiguous, as explained in an earlier Legal Sidebar, the Agencies' interpretation tracking the interpretation of a majority of commenters and "appears to be at least reasonable." Thus, "a court would likely defer to such an interpretation if it were to conclude that *Chevron* applied." In regard to Section 204, the Agencies' rule largely implements the statutory language of the EGRRCPA, and there does not appear to be much ambiguity regarding congressional intent. Congress may always address any interpretive issues by amending Sections 203 and 204 if they disagree with the Agencies' implementation.

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