The Volcker Rule: Key Implementation Issues

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The so-called "Volcker Rule" is contained in sections 619, 620 and 621 of the Dodd-Frank Act.[a]. According to Senators Merkley and Levin, the Congressional authors of these provisions, these rules are designed to do three main things: 1) Prohibit high risk proprietary trading at banks 2) Limit the systemic risk of such activities at systemically significant nonbank financial companies, and 3) Prohibit material conflicts of interest in asset-backed securitizations. (Merkley and Levin, *Congressional Record*, July 15, 2010, S5894 (Merkley and Levin, (ML, 2010a.)

Appropriate, forceful implementation of these provisions is crucial for helping to avoid future economic crisis. Indeed, risky proprietary investments by investment banks, along with trading for clients whose decisions were influenced by these banks, was one of the main forces that sustained upward pressure on security prices in the bubble (see Crotty, Epstein and Levina, 2010, for a more complete discussion). By limiting high risk proprietary trading and conflicts of interest by banks and systemically significant non-bank financial institutions, the intent of the legislation is to contribute to several broader goals: 1) Reduce government subsidies for socially dangerous, high risk trading by U.S. banks and "systemically significant" non-bank financial companies 2) Reduce the likelihood of government bail-outs of "too big to fail" financial institutions by limiting the risky bets they are allowed to take and 3) Help shift the focus of large banks and non-bank financial firms from shorter term, risky activities, to longer term, productivity enhancing investments and credit extension that will help generate employment and socially productive investments. (ML, 2010, b).

Identifying and preventing highly risky proprietary trading by large, complex financial firms would be challenging under any circumstances because of the complexity of activities undertaken by these institutions, the multiple locations domestically and internationally and within their corporate structures where they are undertaken, and the increasingly complex financial products with which proprietary trading can be conducted and hidden. But the task has been made more difficult and the data requirements much larger because of multiple exemptions from the general prohibitions created by the legislation and the numerous ambiguities in the definitions of key concepts and terms in the Act. For example, allowing banks to own significant *de minimus shares* in hedge and private equity funds could make it easier, all things equal, for banks to hide proprietary trading in the deals struck with hedge funds.

At the same time, there are some very strong provisions in the Volcker Rule, such as the provisions of 619(2)(A)(i-iv) dealing with conflict of interest and high risk trading strategies; the provisions of section 619(3) pertaining to additional capital requirements and quantitative limitations on permitted activity; the provisions of section 619(1)(f) dealing with restrictions on interdependence; and the provisions of section 620 pertaining to broader, longer term high risk investment. If these provisions are high-

[a] The actual language in the Act was drafted by Senators Merkley and Levin and so we will use the terms "Volcker Rules" and "Merkley-Levin provisions" interchangeably.

lighted, defined and implemented properly, they can help ensure that the rules greatly reduce high risk and socially dangerous activities that banks and other systemically important financial firms would otherwise be likely to engage in.

The Tasks Moving Forward

Thus, the tasks moving forward are two-fold:

1) Concretize definitions, identify necessary data, and determine metrics that will minimize the damage created by the many exemptions and possible loopholes potentially present in the provisions in order that the main intent and goals of the Volcker provisions can be effectively implemented; and 2) Ensure that the strong, encompassing provisions discussed above are taken seriously and are given their appropriate place in the hierarchy of rules defined and implemented.

In this regard, the next six to eighteen months -- and especially, the next six to 15 months -- will be crucial in the writing and implementation of these rules. It will be important to properly establish the many key definitions, the multiple data gathering requirements, crucial metrics, and essential enforcement mechanisms.

Much more important than these key technical and procedural details will be to set the right tone by establishing an overall commitment on the part of the regulators to the spirit of the "Merkley-Levin provisions" by establishing rules, data requirements and metrics to strictly limit high-risk trading by financial institutions and their affiliates, to eliminate the possibility that banks will bail out affiliated hedge or private equity funds, to reduce the chances that banks will be tempted though conflicts of interest to exploit their customers, and that, by these means, will undermine the financial stability of the US and require more tax-payer bailouts. Indeed, the language in the Merkley-Levin provisions *requires the regulators to do just that.* So this regulatory commitment right from the outset, must be implemented.

Task 1: Preventing Exemptions from Becoming Evasion Mechanisms

While the Volcker Rules leave plenty of opportunity to define terms and impose procedures that will implement the spirit of the provisions, they also leave opportunities to weaken the rules and enforcement. So it is crucial that the rule making and implementation procedures guard against this danger by insisting on interpretations of rules with a clear intention to eliminate high risk proprietary trading and conflicts of interest with respect to proprietary trading and asset backed securities.

The Merkley-Levin provisions are designed to "broadly prohibit proprietary trading while nevertheless permitting certain activities that may technically fall within the definition of proprietary trading but which are, in fact, safer, client oriented financial services". (ML, 2010A, S5894). Here it will be necessary to: 1) define proprietary trading and gather data appropriate to measuring it, and 2) to determine and define the appropriate capital requirements and quantitative limits for these transactions particularly in the case of non-bank, systemically significant financial firms. A detailed outline of the necessary definitions and clarifications pertaining to the provisions mentioned above is available in SAFER's "The Volker Rule" Policy Brief (Epstein, 2010).

Task 2: Defining and Implementing Limitations on Permitted Activities:

As mentioned earlier, despite the exemptions contained in the Act, section (2) of Section 619 specifies that no "transaction class of transactions or activity may be deemed a permitted activity" if it involves a conflict of interest, would involve a material exposure to high risk assets or strategies, or would threaten the financial stability of the bank or the United States. This section must be placed front and center and all the possible exemptions must be carefully analyzed to make sure that they do not violate this provision.

Other Considerations:

Data Requirements

To properly define and implement these rules, a great deal of data on individual positions, securities and trades will be required. (This is the trade-off paid by those seeking exemptions: in order to make sure the exemptions are not vehicles for evasion, financial institutions will have to provide more information.)

1. Trade details for each principal transaction, including prices, bid/ask spreads, commission information. Note that this could be done in automated fashion for swaps through swap repositories, and through other instruments using similar mechanisms. For example, FINRA automatically screens equities trading for insider trading.

2. The dates and maturities of assets held.

3. Sufficient data to readily connect each hedge to particular risks incurred by the banking entity, i.e., each position that is hedged should be noted and connected to the hedge itself.

4. Extensive data on the hedge funds and private equity funds in which the banking entities invest, and particularly the degree of leverage of those funds, the strategies employed, the ownership interests, and the types of transactions between the funds and the banking entities.

5. Data and analysis of "high-risk" assets and trading strategies and their impact on financial stability of the banking institutions and of the overall economy

Timing and Extensions:

It is critical that the Federal Reserve and relevant regulatory agencies issue transparent rules and transparent mechanisms for determining the timing of compliance and implementation of the Merkley-Levin provisions. This is very important because the provisions allow multiple extensions for compliance with the various rules. In some cases, banks may be able to extend their compliance for twelve years or more (Davis Polk, 2010b). By what criteria will these extensions be granted? Will there be opportunity for public commentary and input before extensions are granted? These decisions should be rule bound and transparent since the financial stability of the economy might be at stake.

Conclusion

There are many other details to be determined in this highly complex set of provisions. The three major points that apply to all the Merkley-Levin provisions and associated rule making are these:

1. The regulators must signal their determination to establish rules, data gathering and monitoring mechanisms that will implement the clear over-riding intention of the act to prohibit high risk proprietary trading, which suggests that, they should "err" on the side of strict interpretations and rigorous monitoring.

2. The multiple exemptions granted to financial firms and resulting complexity of the provisions demand that there be extensive and detailed data gathering from banking entities and funds with banking investments so that the appropriate metrics can be determined and so that compliance with the rules can be enforced. The regulatory agencies must not shy away from the necessity of gathering and utilizing these data.

3. The exemptions and complexity created by them also imply the need for extensive transparency in rule making and enforcement so that the public can be assured that the acts provisions are being appropriately implemented and complied with.

The next six to eighteen months will set the tone for all that follows in the establishment of the Merkley-Levin provisions. We look forward to working with the appropriate regulators to ensure that these provisions are properly implemented to contribute to greater financial stability and fewer tax-payer funded financial rescues.

References

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