THE VOLCKER RULE: HAS ANYTHING CHANGED?

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Abstract: The paper gives an overview of proprietary trading by banking entities leading up to the 2008 financial crisis. Section II describes the Volcker Rule as proposed and implemented. Section III analyzes the broad exceptions to the Volcker Rule. Section IV gives an evaluation of the impact and effectiveness of the Volcker Rule.

I. Introduction

Out of the ashes of a devastated financial system following the 2008 crisis, reform legislation emerged in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act was signed into law on July 21, 2010.[2] To analyze the entirety of the 848 page instrument is not feasible within these online pages, so I limit discussion to what is commonly known as the Volcker Rule. The Volcker Rule was advanced by the Group of Thirty, chaired by the legislation's namesake, Paul Volcker.[3] The Group of Thirty, an international group of financial experts who blamed proprietary trading and conflicts of interest in the financial system for the 2008 financial crisis, advocated for implementation of the Volcker Rule to eliminate such behavior by banking entities.[4]

The elimination of proprietary trading by banking entities is a relatively simple idea, but in application the issue becomes murky. This lack of clarity is

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2 Press Release, Office of the Press Secretary, Background on the President's Bill Signing Ceremony Today (July 21, 2010) *available at* http://www.whitehouse.gov/the-press-office/background-presidents-billsigningceremony-today.

3 Alison K. Gary, *Creating a Future Economic Crisis: Political Failure and the Loopholes of the Volcker Rule*, 90 OR. L. REV. 1339, 1341 (2012).

4 *Id.*

illustrated by the textual expansion (as compared to application expansion) of the Volcker Rule in the first two years after adoption of the Dodd-Frank Act.

Paul Volcker outlined his proposal for proprietary trading restrictions to President Barack Obama in just three pages. This three-page idea translates into a reasonable, ten-page codification found in section 619 of the Dodd-Frank Act.[5] Proposed regulations giving meaning and force to the Volcker Rule make up 298 pages, with that number likely to continue climbing as the regulators continue to define the parameters of the legislation.[6] In fact, to adhere for brevity sake, in this paper, it is not even possible to walk through the 355-step road map developed to assist clients in navigating the Volcker Rule.[7]

II. Background on Proprietary Trading

Proprietary trading is the investing of institutional funds, including depository funds, to augment profit.[8] This activity became particularly popular among larger banks after the effective repeal of the Glass-Steagall Act's restrictions on high-risk speculative investments. Proprietary trading by this sector of financial institutions is of particular concern due to the unique nature of banking entities.[9] Because depository accounts are federally insured, proprietary trading amounts to a government-subsidized risk when engaged in by deposit-taking institutions.[10] This federal assurance gives banking entities an unfair advantage in the marketplace over other financial institutions. In turn, proprietary trading on federally backed depository accounts created a moral hazard. Banking entities were willing to engage in more risky behavior than they would otherwise be willing to undertake because they would not bear the entirety of the costs that could be incurred if their risky investments failed.

Additionally, banks are significant because of their role in the national and global economy.[11] As we have observed over the past five years, when investments by banking entities fail, the effects can be widespread and dire.[12] When the government steps in to back insured deposit accounts or inject funds to

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5 *Id.* at 1376–76.
6 *See id.* at 1376.
7 *See id.*
8 Richard C. Burson, *The Dodd-Frank Act Regulation of Proprietary Trading—The Volcker Rule*, 30 REV. BANKING & FIN. L. 13, 13 (2010).
9 "Banking entities" include any affiliate or subsidiary of an insured depository institution. 12 U.S.C. §1851(h)(1).
10 Burson, *supra* note 7, at 16.
11 Gary, *supra* note 2, at 1345.
12 *See id.*

prevent systemic failure, there are attendant risks from such bailout. Government bailouts create a practical assurance of bailouts in the future.[13] For this reason, governments covering bank losses must oversee the banks and impose regulations to limit the risk of loss in order to prevent the need for future bailouts.[14]

Wall Street lobbyists had a successful campaign in the 1990s, culminating in the repeal of the Glass-Steagall Act's restrictions on high-risk speculative investments in 1999.[15] The lobbyists were able to effectively argue that imposing regulations on the market could have adverse consequences, and trades had become so sophisticated that self-regulation was the only way to handle them.[16] As an illustration of banking behavior in this era of self-regulation, unregulated derivative swaps increased from $28.7 trillion in 1998 to $531.2 trillion during the ten years following the Glass-Steagall Act's repeal.[17] To the surprise of many, including Alan Greenspan, the former Chairman of the Federal Reserve Bank, in 2008, the self-regulated walls came crashing down.

The Group of Thirty places blame for the 2008 financial crisis on proprietary trading and conflicts of interest in the financial system.[18] By implementing the Volcker Rule, these financial experts want to end the "too big to fail" system and reduce moral hazard.[19] The Volcker Rule adheres to ideals President Franklin D. Roosevelt set forth so many years ago in his first inaugural address. In order to prevent this sort of calamity, President Roosevelt pointed to two necessary safeguards: (1) strict supervision of all banking and credit investments and (2) an end to speculation with other people's money.[20] If you are willing to make risky investments, do so at your own peril. As proposed, the Volcker Rule certainly makes an effort to codify these safeguards.

In order to save face, banks operating hedge funds are motivated to bail out failing funds.[21] This is one example of banking entities using depository accounts in a high-risk manner merely to preserve the reputations of the bank and fund managers. The proposed Volcker Rule would have prevented banking entities from doing this. As proposed, banking entities serving as investment

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13 *Id.* at 1346.
14 *Id.* at 1346–47.
15 *See id.* at 1344
16 *Id.*
17 *Id.*
18 *Id.* at 1341.
19 *See id.* at 1342.
20 *Id.* at 1386.
21 *Id.* at 1349.

advisors would be prohibited from entering into a covered transaction with the fund.[22]

Proponents of the Volcker Rule heralded the regulation as a way to reduce systemic risk to the financial system and protect Americans from Wall Street's risky bets.[23] But not everyone was convinced that the Volcker Rule would have a profound impact on the infrastructure of the finance industry. Even Paul Volcker points out proprietary trading was "not central" to the 2008 financial crisis.[24] Although it was a contributing factor, it was not the central factor. Therefore, the systemic risk of the financial system remains subject to risks even with a prohibition on proprietary trading by banking entities.

After the Volcker Rule proposal made its way to Congress, it was met by a dirty word that we are all familiar with: compromise. This swaying period of negotiation was dubbed "Wall Street vs. Main Street," a phrase that was inescapable during 2009 and 2010. In the year leading up to the 2010 adoption of the Dodd-Frank Act, Wall Street spent $600 million and had 13,676 registered lobbyists dedicated to preventing the proposed regulations from becoming law.[25] Roughly 15 percent of all lobbyists in Washington were dedicated to this opposition.[26] As an aside, the leading beneficiaries of Wall Street's political contributions happened to be members of the oversight committees charged with regulating the finance system.[27]

Those familiar with the interest group theory can use the compromise between Wall Street and Main Street as a great example:

> While the Main Street lobby was united in its call for action, which Congress heeded, the lobby was fractured over what steps to take. Wall Street, on the other hand, is a small, well-connected, well-organized, and extremely wealthy interest group that plainly possessed unique expertise in the topics the Dodd-Frank Act addresses. Wall Street was united in its opposition to regulation and many members of the Main Street coalition actually joined Wall Street in opposing increased regulation.[28]

In the end, the unorganized Main Street lobby only united in their desire for some sort of additional restraints on banking entities. Main Street won in this regard;

22 *Id.*
23 Burson, *supra* note 7, at 14.
24 *Id.* at 14–15.
25 Gary, *supra* note 2, at 1351.
26 *Id.*
27 *Id.* at 1355–56.
28 *Id.* at 1355.

the Dodd-Frank Act was adopted. Wall Street, as an organized interest group with much more directly at stake with looming restrictions, won in regard to the specifics of the legislation. As adopted, the Dodd-Frank Act creates additional restraints, but, as we will later see, they are of little consequence.

Perhaps the biggest player in shaping the Volcker Rule was Senator Scott Brown. Senator Brown claimed a surprise victory in the special election to replace the late Senator Ted Kennedy.[29] This election altered the Senate's composition and left Democrats one seat short of the 60-seat majority needed to defeat a filibuster.[30] With Massachusetts banks at the heart of the mutual fund industry, Senator Brown had a vested interest in the intricacies of the Volcker Rule.[31] In turn, Senator Brown had a significant hand in creating the largest exception to the Volcker Rule.[32]

III. Analysis

What does the Volcker Rule do? The answer to this question depends on whom you ask. The vagueness of the Volcker Rule alone creates compliance problems. Banking entities cannot comply with a regulation with which they do not know how to comply. Conversely, regulatory agencies cannot effectively apply the Volcker Rule because they do not know when enforcement is appropriate. Let us begin with what we do know about the Volcker Rule.

It is implemented by section 619 of the Dodd-Frank Act. It amends the Bank Holding Company Act of 1956 to restrict proprietary trading within banking entities.[33] The Volcker Rule is intended to minimize systemic risk in the financial system by limiting the authority of insured depository institutions to manage hedge funds and engage in proprietary trading.[34] Beyond this general idea, it is difficult to give precise definition to the rule, as the final form is not yet set.[35]

Exceptions to the Volcker Rule

One thing we know about the Volcker Rule is that it comes with a multitude of exceptions. Section 619(d)(1) allows general exceptions including the following:

29 Michael Cooper, *G.O.P. Senate Victory Stuns Democrats*, N.Y. TIMES, Jan. 20, 2010, http://www.nytimes.com/2010/01/21/us/politics/21elect.html.
30 *Id.*
31 Gary, *supra* note 2, at 1359.
32 *See id.* at 1362.
33 Burson, *supra* note 7, at 13.
34 Gary, *supra* note 2, at 1340.
35 *Id.* at 1372.

1. Trading undertaken to hedge risks related to other holdings, even if such activity creates a conflict of interest
2. Market-making activities that are not designed to exceed reasonably expected client demand
3. Investments in various government-related securities, small businesses, or those that are qualified rehabilitation expenses under the U.S. Tax Code
4. Certain investments to promote public welfare
5. Trades on behalf of customers
6. Certain foreign activities.[36]

Exceptions to the Exceptions to the Volcker Rule

To make the Volcker Rule more convoluted, there is a failsafe exception to the listed exceptions. This failsafe is found in section 619(d)(2)(A)(i)-(iv). Exceptions to the Volcker Rule are not allowed if:

1. The behavior creates a conflict of interest (unless the banking entity is hedging risks related to other holdings)
2. Unsafely exposes the financial institution to high-risk assets or trading strategies
3. Poses a threat to the soundness of the financial institution
4. Threatens the financial stability of the United States.[37]

These considerations are quite broad and will likely be of minimal consequence until regulatory agencies have an opportunity to elaborate upon application of the failsafe.

Hedge Fund Exception

The biggest exception to the Volcker Rule is found in section 619(d)(4). Under this exception, banking entities are allowed to invest in a hedge fund or private equity fund that the entity organizes and offers, so long as the investment does not constitute more than three percent of total ownership of the fund and the aggregate of all such investments does not exceed more than 3 percent of the banking entity's Tier 1 capital.[38] "Tier 1 capital," as used in this provision, had previously been "tangible common equity."[39] Senator Brown's amendment altered the language of the section 619(d)(4) exception to say "Tier 1 capital."[40]

36 *Id.* at 1348–50; §619, 124 Stat. at 1620–30.
37 S. 3217, 111th Cong. §619, sec. (d)(2)(A)(i)-(iv)
38 §619, 124 Stat. at 1627.
39 Gary, *supra* note 2, at 1362.
40 *Id.*

This change increased the amount of capital that banking entities can place in risky investments by as much as 80 percent compared with the "tangible common equity" language.[41] *With a three-point allowance based on Tier 1 capital, the Volcker Rule loses most of its effect.* Most banking entities were already engaging in proprietary trading around this three-percent cap, so the Volcker Rule doesn't change anything due to the section 619(d)(4) exception.[42] The only institution truly impacted is Goldman Sachs, which was at the forefront of proprietary trading, with 10 percent of its revenue being generated by such activity.[43]

Those searching for complaints and criticism of the Volcker Rule do not have to search far or long. As with any financial regulation, there is the generic argument that the Volcker Rule should not be implemented due to the risk of unintended consequences, *i.e.* reduced liquidity, higher funding costs for U.S. companies, less credit for small businesses, higher trading costs and lower investment returns, less ability to transfer risk, and competitive disadvantages for U.S. banks relative to foreign banks.[44] Many criticize the Volcker Rule for misplacing blame, pointing out that real estate trading should be blamed for the 2008 financial crisis rather than proprietary trading.[45] Even the namesake of the Volcker Rule has indicated proprietary trading by banking entities was not central to the 2008 financial crisis.[46] Reduced diversification of investments is bad for the health of the banking system, and real estate accounted for 55 percent of bank lending shortly before the 2008 financial crisis.[47] Thus, if proponents truly want to decrease systemic risk to the financial industry, then diversification of bank lending should be the focus of regulation rather than proprietary trading.

Additionally, opponents complain the compliance cost of implementing the Volcker Rule for national banks will be almost one billion dollars.[48] An interesting note related to the compliance cost argument, however, is that the market inefficiencies created by the Volcker Rule may unintentionally make trading more profitable, according to the chief financial officer of Goldman Sachs.[49]

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41 *Id.*
42 Burson, *supra* note 7, at 20.
43 *Id.*
44 Gary, *supra* note 2, at 1369–70.
45 *Id.* at 1370.
46 Burson, *supra* note 7, at 14–15.
47 *Id.*
48 Gary, *supra* note 2, at 1370.
49 *Id.* at 1371–72.

IV. Impact of the Volcker Rule

By and large, the risks existing prior to implementation of the Volcker Rule still remain. The three-percent allowance under section 619(d)(4) permits banks to continue with essentially the same level of proprietary trading as before the Dodd-Frank Act was passed.[50] Nothing about the Volcker Rule restricts risky trading.[51] Non-proprietary trading done at the behest of clients exposes banking entities to the same type of market risk as trading on the institution's own accounts, but the Volcker Rule allows this behavior. Often, it is difficult to distinguish when proprietary trading is being done for clients, leaving regulatory agencies to try and define when such high-risk trades are allowed.

When discussing the impact of the Volcker Rule, it is essential to recognize the vast differences between the rule as proposed and the rule as adopted. The original version of the Volcker Rule required a banking entity's interest to be solely outside of the United States; no ownership interest could be offered to U.S. residents in order for the institution to be involved in the hedge fund.[52] The adopted version, with the section 619(d)(4) exception, allows banking entities to operate hedge funds, albeit with certain restrictions: the hedge fund cannot share the bank's name; the bank must provide a bona fide advisory or trust service; the bank may only have de minimis investments; employees cannot have ownership interest in the fund unless they are directly providing services to the fund; and the bank must not guarantee or assume the obligations of the trust.[53] In addition to the Scott Brown section 619(d)(4) exception allowing banking entities to invest up to three percent of Tier 1 capital, amounting to a large sum of money when considering the multi-trillion dollar capital of primary banking entities, banking entities are additionally permitted to provide 100 percent of the fund's capital during the fund's first year.[54]

The power, if there is any, of the Volcker Rule now rests in the hands of regulatory agencies. We are currently in the two-to-five-year rulemaking period, during which more than a dozen agencies are researching and writing 250 new regulations.[55] It is still possible for these regulatory agencies to close the loopholes in the Volcker Rule and give the regulation potency, but how they will proceed remains to be seen. A great deal of the Volcker Rule exists as a general idea and requires regulatory agencies to define terms such as "hedge funds" and

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50 Burson, *supra* note 7, at 20.
51 *Id.* at 21.
52 Gary, *supra* note 2, at 1361.
53 *Id.*
54 *Id.* at 1382.
55 *Id.* at 1365.

draw lines between when a banking entity is acting at the behest of a client vs. engaging in proprietary trading.[56] It has been suggested that regulatory agencies still have the power to reign in the section 619(d)(4) exception by emphasizing the regulation's usage of the word "or" in the three-percent *or* de minimis allowance.[57] By focusing on "or," regulatory agencies would be able to set three percent of Tier 1 capital as the absolute cap after the one-year startup period, with banking entities being restricted to amounts less than three percent when a lower percentage will exceed a de minimis investment.[58]

The Volcker Rule section 619(d)(2)(A)(i)-(iv), the failsafe exception to the exceptions, relies heavily upon a finding of risk. It would make sense, then, for regulatory agencies to require banking entities to disclose the risk levels of their investments. However, risk is almost impossible to calculate and is usually underappreciated.[59] Take Long-Term Capital Management (LTCM) as an illustration of the difficulty in appreciating the true risk of investments. Just one year before the fund collapsed, LTCM received the Nobel Prize in Economics for developing a new method of determining the value of derivatives.[60] The inability to assess risk is core to the very nature and profit potential of speculative investing.

V. Conclusion

Does the Volcker Rule work? *At this time, there is no way to tell.* Too many details remain to be filled in by the regulatory agencies.

Did Congress delegate too large of a task to the regulatory agencies? Although Congress adopted the Dodd-Frank Act to regulate banking entities, they did little to spell out the intricacies of unacceptable behavior. Instead, this job was passed along to regulatory agencies.

What we can conclude with certainty is that we have not heard the last of the Wall Street vs. Main Street debates. The lobbying simply moves down the line from Congress to the regulatory agencies. The result will inevitably be more "compromise," likely resulting in an even weaker version of the Volcker Rule. Without regulatory agencies providing guidance in the definition and application of the Volcker Rule, the financial system is left unregulated and at risk of causing another recession.

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56 *See id.* at 1364–65.
57 *Id.* at 1382–83.
58 *Id.*
59 *Id.* at 1377–78.
60 *Id.*

Does the Volcker Rule really change anything? No, probably not. Banking entities are allowed to account for 100 percent of a fund's capital in the initial startup period and three percent of Tier 1 capital following this first year. Except for Goldman Sachs, which previously operated around 10 percent of Tier 1 capital, the three-percent allowance permits most banking entities to continue engaging in almost the same amount of proprietary trading as they were before the Dodd-Frank Act's Volcker Rule existed.

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