The Volcker Rule: Implementation and Impact

Cornell University
Law School

Charles K. Whitehead
Professor of Law

The Volcker Rule

- Prohibits a banking entity from engaging in (short-term) proprietary trading, or
- Holding an ownership interest in, sponsoring, or engaging in certain transactions with a covered fund
- Prudential backstop: No transaction can involve a material conflict of interest with a client or material exposure to high-risk assets or trading strategies, or pose a threat to a banking entity's safety and soundness or a threat to U.S. financial stability

The Volcker Rule

- Subject to exceptions, e.g., for underwriting, market-making and certain hedging activities.

- A core problem: How to distinguish prohibited from permitted activities?

  Particularly difficult in light of, e.g.:

  Differences among financial markets and instruments

  Differences across firms and, within firms, from desk to desk

  Potential to mask prohibited activities as permitted activities

Cornell University
Law School

Greater Flexibility?

- Flexibility in determining permissible/impermissible trading activities.
  - ✓ E.g., market-making.

Greater Flexibility?

- Trading desk must:

routinely stand ready to purchase and sell financial instruments related to the exposure it manages, and

be willing to quote, purchase and sell those instruments for its own account in commercially reasonable amounts and throughout market cycles

on a basis appropriate for the liquidity, maturity, and depth of the relevant market.

Greater Flexibility?

- "[B]anking entities [may] determine how best to manage the risks of trading desks' market making-related activities through reasonable policies and procedures, internal controls, independent testing, and analysis . . . ." Supp. Info. 283.

- Note: Market-making risks hedged by other trading desks or at a different level of the business must comply with the more detailed risk-mitigating hedging requirements. Supp. Info. 284.

Greater Flexibility?

- Market-making inventory must:

  not exceed the reasonably expected near-term demands of clients, customers, or counterparties

  based on the liquidity, maturity, and depth of the relevant market and

  a demonstrable analysis of historical customer demand.

Greater Flexibility?

- “[T]he Agencies recognize that . . . it may under certain circumstances be appropriate to build inventory in anticipation of a reasonably expected near term event that would likely impact customer demand.” Supp. Info. 257 n. 933.

Greater Flexibility?

- Internal compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule, including:

  ✓ Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities,

  ✓ A system of internal controls reasonably designed to monitor compliance

Greater Flexibility?

- Flexibility in determining permissible/impermissible trading activities.
  - ✓ Market-making.
- Flexibility (so far) in determining quantitative trading metrics.

Greater Flexibility?

- *Risk and Position Limits* must be reported "in the format used by the banking entity for the purposes of risk management of each trading desk." Final Rule App. A § IV.a.1.ii.

- Must report the *Risk Factor Sensitivities* "monitored and managed as part of a trading desk's overall risk management policy." Final Rule App. A § IV.a.2.ii.

- *VaR* and *Stress VaR* must be computed and reported "by employing generally accepted standards and methods of calculation." Final Rule App. A § IV.a.2.ii.

Greater Flexibility?

- A bank may need to develop other quantitative measurements in order to effectively monitor compliance. Their effectiveness "may differ based on the profile of the banking entity's business in general and, more specifically, of the particular trading desk, including the type of instruments traded, trading activities and strategies, and history and experience . . . ." Final Rule App. A § I.e.

Greater Flexibility?

- Not intended to be used as a dispositive tool – not a bright line – to determine compliance with the Volcker Rule, but rather as a way to monitor trends and identify activities for further review. Supp. Info. 828.

- The Agencies will review the metrics-related data collected prior to September 30, 2015 (*i.e.*, data from banking entities with trading assets and liabilities of $50 billion or more) and revise the collection requirement as appropriate. Final Rule App. A § I.d.

Greater Flexibility?

- Will the Agencies and banks agree on what is commercially reasonable and effective?
- How will any differences be reconciled between the Agencies and banks (and among the Agencies)?

Greater Flexibility?Ambiguity?

- Flexibility in determining permissible/impermissible trading activities.
  - ✓ Market-making.
- Flexibility (so far) in determining quantitative trading metrics.
- Prudential backstops

Greater Flexibility?Ambiguity?

- What kinds of transactions would be materially adverse to the interests of a client?

- With one exception, the Agencies have not identified particular high-risk assets or trading strategies, which will depend on the facts and circumstances.

- A trading asset or strategy may be high-risk to one bank but not another, or may be high-risk under some market conditions but not others. Supp. Info. 462.

Too Many Cooks?

The Agencies are directed to:

"provide for consistent application and implementation of the applicable provisions of [the Volcker Rule] to avoid providing advantages or imposing disadvantages to the companies affected."

BHC Act § 13(b)(2)(B)(ii).

Too Many Cooks?

The Agencies:

“plan to coordinate their examination and enforcement proceedings under [the Volcker Rule], to the extent possible and practicable, as to limit duplicative actions and undue costs and burdens for banking entities,” although there may be “overlapping jurisdictional authority.”

Supp. Info. 862.

Too Many Cooks?

- Joint decision-making among the Agencies?
- Who to contact on interpretive questions? Confidentiality?
- Coordination across Agencies in supervision and enforcement?

Unintended Consequences?

- Interaction of the Volcker Rule with other, new requirements? E.g., impact on fixed income liquidity?

Unintended Consequences?

While assets in bond mutual funds and ETFs have grown rapidly in recent years, dealer capacity in the fixed income markets appears to have undergone fundamental changes. . . .

This apparent reduction in market-making capacity may be a persistent change, to the extent it is resulting from broader structural changes such as fewer proprietary trading desks at broker-dealers and increased regulatory capital requirements at the holding company level. A significant reduction in deal market-making capacity has the potential to decrease liquidity and increase volatility in the fixed income markets.

SEC, Division of Investment Management
IM Guidance Update, January 2014

Unintended Consequences?

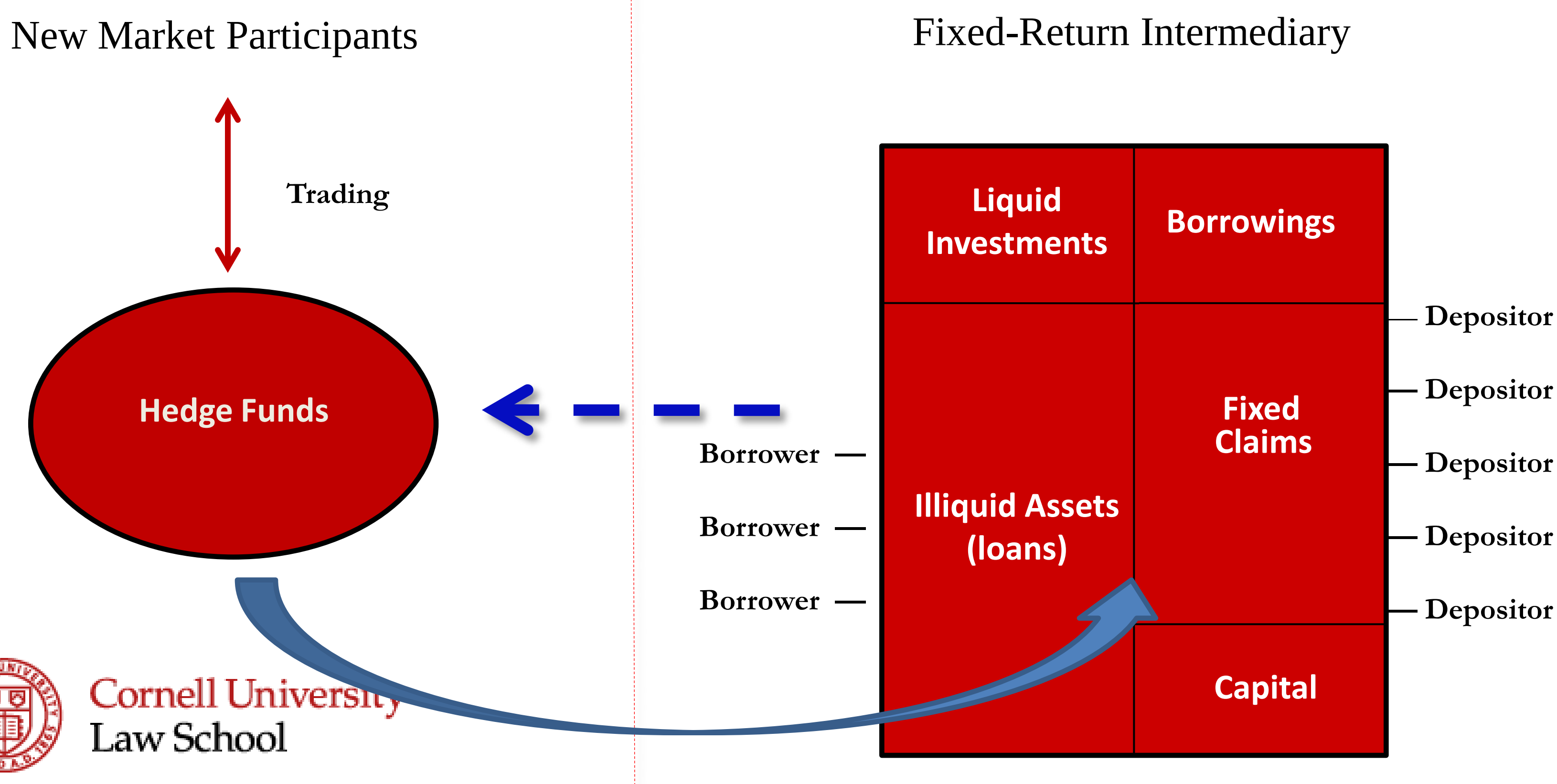
- Interaction of the Volcker Rule with other, new requirements? E.g., impact on fixed income liquidity?

- Impact on systemic risk?

Unintended Consequences?

"[H]edge funds may be the most important transmitters of shocks during crises, more important than commercial banks or investment banks."

How Important Are Hedge Funds in a Crisis?
FRBSF Economic Letter, Apr. 14, 2014, p. 2



Cornell University Law School

The Volcker Rule: Implementation and Impact

Cornell University Law School

Charles K. Whitehead
Professor of Law