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The Comment Period Closes: What's Next for the Volcker Rule?

The Volcker Rule has been only a skeleton in statutory form, but now is beginning to take shape as proposed regulations would flesh out its requirements. Now that the comment period on the proposed regulations has ended, a survey of the substantive suggestions for change displays a variety of approaches, but at least the financial institutions directly affected have made significant, and strident, criticisms of most of the proposal. Surprisingly, many foreign governments have also weighed in because of their concern about the effect on global markets generally and on their own sovereign debt specifically. Many of these topics merit serious consideration.

The financial services industry is closely watching the progress of the federal financial regulatory agencies in adopting rules to implement the Volcker Rule. [1] The rule is at Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and was enacted primarily at the urging of Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System. [2] The Agencies have issued a proposed rule ("Proposal"), the comment period for which ended on February 13. The Agencies will review and analyze the comments, before adopting a final rule that provides guidance on how a banking entity may now conduct market-making and fund activities.

In the interim, the Agencies will continue to be subject to pressure from both supporters and critics of the Volcker Rule, by individual members of Congress, public advocacy groups, and the financial services industry. Many constituents are urging

1 In this note the federal financial regulatory agencies ("Agencies") refer to the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC") and the Securities and Exchange Commission ("SEC"). The Commodity Futures Trading Commission ("CFTC") is separately promulgating its own implementing regulation.

2 The Dodd-Frank Act is at Public Law No. 111-203, 124 Stat. 1376 (2010) and codified throughout the United States Code. The Proposal can be found on the Federal Reserve's website at www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm. If you are interested in reading about the background of the Volcker Rule, you may wish to review our previous client memoranda: "In the Eye of the Beholder: The Volcker Rule Proposal and What it Means" (Oct. 27, 2011); "The Leaked Staff Drafts: New Volcker Rule-Related Concerns for Non-US Banks" (Oct. 10, 2011); "Dodd-Frank: The GAO Struggles with the Volcker Rule" (July 22, 2011); "FSOC Study on Implementing the Volcker Rule — A Series of Missed Opportunities and Some Surprises" (Jan. 2011); "Financial Regulatory Reform Update: The Volcker Rule Continues to Garner Outsized Attention in the Wake of Passage of Financial Reform Legislation" (Oct. 19, 2010).

the Agencies to provide relief while others are calling on them not to weaken the rule, positions that are diametrically opposite and thus, in many cases, simply irreconcilable.

Not surprisingly, most comments submitted by industry participants are critical of the Proposal. It is unusual, however, for one government entity to criticize another's proposed rule in a public comment letter, rather than doing so through informal channels. Yet, this rulemaking has attracted numerous letters from foreign governments, central banks, and regulatory agencies from around the world. While the public awaits a final rule, we can consider what issues the Agencies must address and handicap the chances that portions of the Proposal may change.

We also reviewed a representative sampling of the comments received by the Agencies and can offer the following observations.

I. Proprietary Trading

A. Substantial Costs on Markets

The comment most frequently made by those who object to the Proposal concerns the potential costs that the rule will impose on the public and financial markets and a reduction in market capacity for governments and corporations. One commenter noted that the Agencies have failed to study or adequately consider the economic impacts and costs and benefits associated with the proposed rule, as required by law.

Some provided specific information, arguing that the proposed rule will impose an increase of at least five basis points in bid-ask spreads in the securities markets. One commenter predicted an increase in the bid-ask spreads of 25 to 50 basis points and increased lending costs of between $742 million and $1.483 billion. The impact upon smaller, less frequent borrowers could be an increase in bid-ask spreads of 50 to 100 basis points, and increased lending costs of between $106 million and $211 million.

Outlook: Commenters' efforts to quantify the adverse impact of the rule will force the Agencies to refine significantly their own estimates of costs and benefits. We presume the Agencies will downplay these costs in a final rule, which almost certainly will be challenged in the courts.

B. Exemption for US Government Securities

The Proposal has prompted criticism relating to its extra-territorial effect on the liquidity of global funding markets and non-US sovereign debt markets through proprietary trading restrictions. Commenters were critical that the exception is being interpreted and applied too narrowly.

Foreign Sovereign Debt

The rule would impact foreign sovereigns that borrow funds in US markets. US investors buy billions of dollars of foreign sovereign debt securities annually. Investors from yet other third-party foreign countries that do business in the US also purchase these securities. Foreign banks operating in the US may be prevented from making markets in the debt of their home countries. The rule thus might discourage transactions by these institutions and make it more difficult to float debt in a less liquid market. Pricing of these securities in the secondary market also could suffer from less liquidity as banking entities cease trading in these instruments.

Outlook: The Agencies need to find a way to accommodate the concerns of foreign sovereigns, either through interpreting the Volcker Rule to permit proprietary trading in such debt, or through urging Congress to legislate a fix. The Agencies also will need to take into account the initiatives of foreign countries to address proprietary trading and speculation through alternative approaches, such as the UK Vickers proposal.

Agency Debt

Some commenters complained that the Agencies were too restrictive in their interpretation of the US government securities exception, urging that it be expanded to include securities issued by agencies of states and political subdivisions. A more expansive interpretation would achieve consistency with the treatment of agency securities in other federal statutes and prevent implementation issues as various jurisdictions use the term "agency" inconsistently.

Outlook: The Agencies should easily be able to amend the Proposal to address this concern.

C. Exception for Trading Occurring Solely Outside the US ("SOTUS")

Commenters have argued that the Agencies' interpretation of the SOTUS exception from the proprietary trading restrictions is far more restrictive than required by the statute. This narrow reading could prevent foreign firms that use US exchanges or other market infrastructure from carrying out their business both inside and outside the US and could lead to reduced incentives for foreign firms to engage in transactions with US counterparties. More than one commenter observed that a restrictive reading could lead to subsidiaries and other offices of foreign banks leaving the US or reducing their activities to avoid application of the rule.

Outlook: The Agencies should be able to modify the criteria for satisfying the SOTUS exception to meet many of the commenters' concerns.

D. Exception for Market-Making

A large portion of the comments addressed perceived deficiencies in the Proposal's interpretation of the statute's exception permitting market-making activities.

Definition

The most basic criticism relating to this exception is that the Proposal incorrectly defines the term "market-making."[3] On the one hand, commenters observed that the Proposal does not clearly differentiate proprietary trading from market-making. On the other hand, commenters stated that the Proposal does not recognize that market-making is a form of proprietary trading. The Agencies falsely presume that market-making does not comprehend trades involving the risk of gain or loss, or that market-makers seek to profit from expected changes in market prices, which also are characteristics of proprietary trading. Like a proprietary trader, a market-maker acquires a position from a client at one price and then lays off the position over time at unforeseen market prices, in the expectation that future prices generally will rise. Moreover,

[3] Commenters criticized a number of the rule's definitions. For example, the definition of "proprietary trading," unless revised, would improperly capture the practice of fund sponsors in creating seed accounts for marketing the performance or track record of investment strategies to unaffiliated investors, even though seed accounts are not used "principally for the purpose of selling in the near term" or "with the intent to . . . profit from short-term price movements."

regulators seem ready to ignore the conduct of a market-maker in the aggregate and instead assess compliance at inappropriately detailed levels, e.g., down to a single significant transaction. These weaknesses in the definition of market-making led to other criticisms of the anticipated operation of the rule.

Outlook: The Agencies will focus attention on this exception in particular. The overlap in market-making and proprietary trading probably cannot be reconciled, as Agencies will be reluctant to interpret the market-making exception more broadly to permit increased levels of proprietary trading. The failure to address so many aspects of market-making reveals the depth of the technical issues that the Proposal presents. We hope, but are not confident that the Agencies will be bold and adopt a final rule that permits Agencies discretion to deal with the markets as they continue to evolve, rather than produce an even more detailed, yet inevitably incomplete document.

Effect on Markets

Many commenters agreed that the Proposal, by reducing risk taking by dealers, will also diminish the quality and capacity of market-makers. A reduction in market-making capacity by banking entities would reduce liquidity in foreign and US markets, raise volatility, and make it more difficult, riskier, and costlier for issuers to float debt.

Commenters feared that the Proposal will reduce the resiliency of markets, reduce price discovery, and increase market risk. The rule's constraints will result in wider spreads for asset classes, both the overall spread (the risk premium required versus US Treasuries) and the bid-offer spread (the difference between the highest price a buyer of a security will pay and the lowest price a seller will to offer). Market participants will require a higher risk premium to compensate for the diminished liquidity caused by the Proposal and reduce the allocation of capital to market-making.

The proposed criteria and metrics for market-makers would inhibit market-making. Banks would find that purchasing securities from clients would be unattractive relative to the expected profit. To avoid a violation, dealers would conduct trades as riskless principal, rather than as principal, for example, extending the time for selling a customer's bond by waiting to find an offsetting transaction rather than immediately taking the security directly into inventory.

Outlook: This aspect will be hotly contested by supporters and opponents of the Proposal primarily because it is unknown how any rule would impact the markets. One approach to gain an objective view of the rule's impacts is to study market spreads over the last year for a variety of asset classes in response to the passing of the Volcker Rule and in anticipation of the implementation of Proposal. If one can demonstrate that spreads indeed are widening, the Agencies should act to limit the adverse effects that the Proposal is causing to the financial markets.

Alternative Providers

The Agencies should carefully consider the costs and benefits of the potential migration of market-making activity to non-banks. Non-bank market-makers may fill some of the resulting void in capacity if banks leave the market, but with an unpredictable impact on financial markets. The Proposal seems to assume that the supervisory regimes, liquidity, and capital requirements of non-bank market-makers will be as effective as those for regulated banks.

Outlook: It is difficult to identify a successor class of market-makers. If market-making activity will decrease as a result of the Proposal, it is just as unclear what new firms will step up to fill the breach.

II. Funds

Commenters suggested several ideas for modifying the Proposal's provisions governing investments in hedge funds, primarily by identifying classes of funds and investors that should not be subject to the rule's restrictions.

A. Types of Funds

Commenters identified a lengthy list of funds they believed should not be considered "covered funds" under the Proposal, including real estate investment funds, bank-owned and corporate-owned life insurance, tender option bond programs, insurance company general accounts invested in private equity funds, and insurance company separate accounts.

Fear of the extraterritorial reach of the Volcker Rule prompted a suggestion that the Agencies adopt the approach taken in the federal securities laws and not apply the rule to a fund that is not organized in the US and does not offer its interests in the US, regardless of whether the fund receives investment advice from a US person or whether the fund makes investments in the US.

Outlook: We believe that the Agencies should identify exceptions that the rule was not contemplated to address. Moreover, a final rule should have a mechanism for the Agencies, preferably individually, to create exceptions from the definition of "covered funds" through no-action letters and similar devices. It would be cumbersome and time consuming to obtain a no-action position from five agencies at once.

B. Type of Investors

Foreign banks. A foreign bank doing business in the US and that is not controlled by a US banking entity should be able to invest in a private fund that is organized outside of the US and that does not market its interests to US persons, even if the fund invests and is managed by third party managers in the US.

Canadian Banks. The closer the economic relationship between the US and a foreign country, the more striking is the extraterritorial effect of the Proposal. For example, some complained that the Proposal does not reflect a long-established no-action position taken by the SEC permitting Canadian banks to sell interests in Canadian funds to "snowbirds," Canadians who are temporary residents in the US, without registering the funds under the Investment Company Act of 1940. Without an exclusion for such funds from the Proposal, Canadian banks could be forced to exclude such investors from their funds.

It would be difficult for such banks to determine whether and when fund investors might assume the status of a resident in the US, especially persons who invest through omnibus accounts of third party intermediary brokerage firms. Canadian banks might find it necessary to cease sponsoring and selling interests in such funds entirely to avoid the compliance burden that the Proposal imposes. Those banks also argued that in this respect the Proposal would violate NAFTA.

Outlook: We believe that the Agencies should identify exceptions that the rule was not contemplated to address. Moreover, a final rule should have a mechanism for the Agencies, preferably individually, to except types of investors from the definition of a US resident through no-action letters and similar devices. It would be cumbersome and time consuming to obtain a no-action position from five agencies at once.

C. Other

Commenters identified several areas where regulators may clarify the reach of the rule. For example, some observed that the so-called "Super 23A" provision should not extend prohibitions and restrictions on affiliate transactions to cover business relationships between a banking entity and a third-party fund, a result that is not contemplated by the plain language of the Volcker Rule.

Others suggested that the definition of fund sponsorship should not extend to directed trustee relationships, whereby a banking entity provides trust and custodial services to funds and does not exercise investment authority or discretion over fund assets.

Outlook: We anticipate that industry participants will identify a host of situations that deserve relief from application of the Volcker Rule. A final rule should address as many of these situations as possible, but it will be impossible to foresee all such situations comprehensively. Moreover, it will be difficult for regulators to agree jointly on such exceptions. Thus, the regulators should identify a procedure permitting individual Agencies to create exceptions or recognize that an agency may indicate it will not enforce the rule in situations that warrant relief.

Conclusion

The Agencies face a difficult task as they sift through the public comments on the Proposal. It would be difficult enough for one agency to determine which comments should be followed in amending the Proposal and which to ignore. The task is that much harder since the Agencies must now agree on the form of a joint final rule. Even more complicated is whether the CFTC will agree to join in the final rule at the conclusion of its comment period, which remains open. The Volcker Rule becomes effective at the earlier of July 21, 2012 or the adoption of a final rule. As the clock continues to tick, the industry grows more impatient, seeking time to implement whatever rule is adopted. At this point, we can only wait.

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