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Understanding the Significance of the Obama Administration's Proposed "Volcker Rules"

In a much debated and publicized move, President Obama on January 21, 2010, called for new restrictions on the proprietary trading businesses and size of U.S. banking institutions. If enacted into U.S. law, the restrictions – popularly referred to as the "Volcker Rules" – could potentially reshape the U.S. financial services industry by redrawing existing boundaries on the types of investments and fund-related activities that U.S. depository institution holding companies and non-U.S. banks with U.S. operations may conduct. While U.S. Senate hearings held in early February provided some additional insight into the proposal, questions still abound regarding how the plan would function in practice and its political viability.

In the President's own words, the proposal involves the following two restrictions:[1]

> The "limit on scope" restriction:
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> "*... [b]anks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.*"
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> The "limit on size" restriction:
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> "*... There has long been a deposit cap in place to guard against too much risk being concentrated in a single bank. The same principle should apply to wider forms of funding employed by large financial institutions in today's economy.*"

The President's call for these new restrictions as part of a broader regulatory reform package caught much of the financial world off-guard and very quickly produced a new focal point for the debate on financial reform in the United States, and to a certain degree, in other countries.[2] In addition, the President's speech almost immediately touched off speculation relating to the interpretation, scope and impact of the Volcker Rules.

U.S. Congressional testimony on February 2, 2010, of a senior U.S. Treasury Department official and Paul Volcker – the former Federal Reserve Board chairman and the person whose name has been attached to the President's proposal – provided the public with a more detailed (but still incomplete) picture of the Administration's vision for the "limit on scope" and "limit

[1] While the President dubbed the "limit on scope" (but not the "limit on size") restriction as the "Volcker Rule", the nickname – "Volcker Rules" (or "Volcker Rule") – has since been attached to both of the restrictions.

[2] The President's announcement came as a surprise to the markets as well as to observers of financial regulatory reform developments because the Volcker Rules were not reflected in the Obama Administration's regulatory reform plan submitted to the U.S. Congress last summer or in its "White Paper" on financial reform issued in June 2009.

on size" restrictions.[3] During his testimony, the Deputy Secretary of the U.S. Treasury Department, Neil Wolin, indicated that the Administration is still working on proposed statutory language to implement these restrictions. It is not yet clear when this language will be made available for U.S. Congressional consideration.

This Client Publication lays out what the Obama Administration has, to date, publicly stated about the substance and scope of the Volcker Rules. In addition, it summarizes key aspects of the debate surrounding the Rules and their significance against the backdrop of broader U.S. financial regulatory reform efforts. The principal arguments advanced in support of the Volcker Rules, as well as counter-arguments thereto, are summarized in an Annex to this Client Publication.

The "Limit on Scope" Restriction

According to the Administration, the "limit on scope" restriction would prohibit (i) a U.S. depository institution (including, for this purpose, a U.S. branch or agency of a non-U.S. bank), and (ii) any affiliate of a U.S. depository institution (including, as a general matter, a U.S. affiliate of a non-U.S. bank with a U.S. branch or agency), from conducting the following two broad categories of activities:[4]

- "Proprietary trading", and
- "Sponsoring" and "owning" a hedge fund or private equity fund.

While the moniker "Glass-Steagall lite" (or other similar nicknames referring to the Glass-Steagall Act of 1933) had initially been attached to the "limit on scope" restriction, it would not reenact those Glass-Steagall provisions that for many years (until the enactment of the Gramm-Leach-Bliley Act in 1999) erected a "wall" between U.S. commercial banking and the investment banking businesses of securities underwriting and dealing.

Significantly, if the "limit on scope" restriction is enacted into U.S. law, the Administration has assured banking groups that there would be a "reasonable" transition period for coming into full compliance (e.g., by divesting or winding down impermissible activities or by "de-banking" through surrendering the group's banking license or selling the group's depository institution).

Prohibition on "Proprietary Trading"

For purposes of the "limit on scope" restriction, "proprietary trading" involves trading/investment (whether though a separate trading desk or otherwise) that is:

- for a firm's own balance sheet, and
- unrelated to a customer or intermediation function.

During Congressional testimony in front of the Senate Banking Committee, Mr. Volcker and/or Mr. Wolin used the following activities as (non-exhaustive) illustrations of "proprietary trading":

- speculating on the price of commodities (e.g., oil and gas), and/or equity securities, and
- investing in a hedge fund, private equity fund (which the President identified as a prohibited activity in his speech on January 21st) or real estate fund.

In addition, Mr. Volcker and Mr. Wolin clarified that securities and derivatives-related hedging (in connection with customer-driven trades) and market-making would not be considered "proprietary trading", and thus, would remain permissible.

[3] Mr. Volcker is also the current chairman of the President's Economic Recovery Advisory Board which is an advisory panel of non-governmental experts from business, labor, academia and elsewhere that President Obama created in February 2009 to provide policy recommendations.

[4] The "limit on scope" restriction resembles a recommendation included in a January 2009 report issued by the Group of Thirty (G30), which is led by Mr. Volcker. The report, Financial Reform: A Framework for Financial Stability (Jan. 15, 2009), recommended that nations restrict the proprietary trading activities of, and sponsorship and management of hedge and private equity funds by, large systemically- important banking institutions.

The Administration has not yet indicated whether it intends to provide any carve-outs (e.g., an exemption for trading U.S. Treasury securities) from the general prohibition on proprietary trading.

Potential Interpretive Issues Related to the Meaning of "Proprietary Trading"

Because the difference between proprietary and customer-related trading activities can be nuanced, the dichotomy drawn by the "limit on scope" restriction raises several interpretive issues including those addressed below.[5]

How to separate hedging and market-making activities from proprietary trading?

From one perspective, the "limit on scope" proposal can be seen as an attempt to prohibit a particular underlying motivation (i.e., speculation) for a trade which may, at times, be difficult for U.S. federal banking authorities to discern. For this reason, should the proposal be enacted into law, bank examiners may, at times, have to look to institutions to help explain why trading activities should not be characterized as "proprietary" (and thus, be impermissible).

For example, an examiner may question whether a bank's market-making or foreign currency dealing activities are, in fact, disguised proprietary trading, especially if the business has had little customer activity. Similar questions could arise over the intended function of derivatives-related transactions, which can be used by a financial institution for either speculative or hedging purposes. Indeed, the task of cleanly separating permissible customer-related hedging activity from impermissible proprietary trading could be particularly challenging since banks and bank affiliates may hedge their positions on a portfolio basis (i.e., trades undertaken for hedging purposes may not be directly linked to specific customer-driven trades).[6]

To what extent does "proprietary trading" capture investments in fixed-income instruments?

Purchasing a high-quality bond with an intention to hold it until maturity is not a classic proprietary trading activity (even though such investment may not serve a recognized customer-related function). On the other hand, trading in bonds with an objective to benefit from changes in their market price involves speculative risk-taking. Exactly how and where the line will be drawn for purposes of the "limit on scope" restriction remains uncertain (e.g., under what circumstances would an institution be permitted to sell a long-term instrument prior to maturity?).

Mr. Wolin indicated that "establishing and managing portfolios of short-term, high-quality assets to meet liquidity risk management needs" would remain permissible.[7] It is unclear, however, how the Administration intends to distinguish "liquidity management" from proprietary trading in short-term instruments.

Sponsorship or "Ownership" of an In-House Hedge Fund or Private Equity Fund

During the financial crisis, several institutions "bailed out" troubled fund vehicles with names intimately tied to their own to protect their reputation. Presumably with this type of risk exposure in mind, the Administration has stated that the "limit on scope" restriction would include a prohibition on "sponsoring" and "owning" hedge funds

[5] When asked by a Senator about the practical difficulty involved in drawing a line between proprietary trading and customer-oriented business, Mr. Volcker asserted that "every banker I speak with knows very well what 'proprietary trading' means and implies". He also suggested that regulators should be able to utilize various metrics (e.g., trading volumes vis-à-vis customer relationships) to help identify proprietary trading activity.

[6] U.S. federal banking law currently draws a distinction between proprietary derivatives transactions (which are, in certain cases, impermissible for U.S. banks) and customer-driven derivatives transactions conducted by banks. In general, the current approach of the Office of the Comptroller of the Currency is to permit institutions to hedge the risks associated with customer-driven activities on either a transaction-by-transaction or a portfolio basis.

[7] Presumably the requirement that the bonds be of a "short-term" maturity is intended to reduce the temptation to speculate on interest rate changes and to mitigate interest rate risks.

and private equity funds.[8] The Administration has not yet defined the parameters of "sponsorship" (or "ownership") for these purposes. However, we believe that it could be interpreted to include one or more of the following activities:

- acting as general partner of a private equity/hedge fund vehicle, and/or
- using the institution's name as part of the name of the investment vehicle, and/or
- seeding capital for emerging fund managers and hedge funds/private equity funds.

While the Administration has used the term "owning" when describing those activities that would be impermissible under the Volcker Rules, it is not readily apparent whether this category of impermissible activity would include any activities that would not otherwise fall within the other two categories of impermissible fund activities (i.e., "sponsoring" a fund or "investing" in a fund).

There is a general belief that the type of risk that the "limit on scope" restriction is intended to mitigate is more prevalent in the hedge fund industry than the private equity fund industry in part because hedge fund sponsors offer liquidity to investors in the form of redemption rights while private equity funds typically do not provide redemption rights (generally, private equity fund investors only receive distributions as and when investments of the private equity fund are liquidated). Many private equity funds also do not use leverage (which increases the risk of a fund's collapse) to the same extent as hedge funds. Nonetheless, it appears as though the two types of funds would be treated identically under the "limit on scope" restriction as currently contemplated.

Activities that May Not Be Considered "Sponsorship" or "Ownership" of a Fund

Based on Mr. Volcker's Congressional testimony, it appears that there may be a carve out from the general ban on fund "sponsorship" for bank sponsored "funds of funds" that invest exclusively in underlying independent hedge and/or private equity funds.[9]

In addition, it appears clear that activities provided by banks and bank-affiliates in the capacity of a third-party service provider to hedge funds and/or private equity funds should not be prohibited under the "limit on scope" restriction. For example, prime brokerage activities, which typically involve providing financing and clearing services to funds, would continue to be permissible. In addition, investment advisory services provided to an independent fund should continue to be a permissible activity so long as such services do not include "sponsorship" of a private equity or hedge fund.

Investment advisers frequently invest their own capital in advised funds and/or otherwise receive performance-related compensation through an equity interest in an advised fund (i.e., to align their economic incentives with those of third-party investors). It is not clear whether the "limit on scope" restriction would affect the means by which bank or bank-affiliated advisors currently receive performance-related compensation.

In the days following the President's speech, executives of asset management businesses within banks were quick to focus on the fact that their funds businesses are customer-related. Many initially believed that general asset management activity on behalf of customers, including offerings of private funds sponsored by the bank as part of a full-service investment management lineup, was not the target of the President's proposal.

8 In the Administration's view as articulated by Mr. Wolin, "The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks." Mr. Volcker also noted the risk that "inside" funds may be favored over outside competition in placing funds for clients.

9 From a policy perspective, it is not entirely intuitive why the Administration would distinguish between "funds of funds" and other investment vehicles for these purposes. "Funds of funds" may benefit from additional diversification (i.e., through investments in multiple underlying funds) but potential risks along the lines of those the Administration is seeking to mitigate (e.g., reputational risks and conflict of interest risks) remain a possibility.

Subsequent statements by Mr. Volcker and senior officials within the Administration, however, suggest that the proposal is intended to reach private fund offerings sponsored by a bank or bank affiliate. (As noted above, Mr. Volcker has indicated that banking organizations would still be permitted to provide customers with access to <u>independent</u> hedge funds and private equity funds through funds of funds. Subject to this limited exception, however, he has suggested that a banking organization would no longer be permitted to sponsor an "inside" hedge fund or private equity fund with outside partners.) To the extent banking organizations are required to exit the private equity and hedge fund sponsorship business it is also worth considering whether this would have "spillover effects" on their asset management businesses generally.

Entities Covered by – and the Impact of – the "Limit on Scope" Restriction

During Congressional testimony, Mr. Wolin clarified that the "limit on scope" restriction, as it is currently contemplated, would apply to <u>both</u>:

- the global operations of U.S. FDIC-insured depository institutions <u>and</u> their holding companies, and
- the U.S. operations of non-U.S. banks that have a U.S. branch or agency (or, in U.S. federal banking-law parlance, "foreign banking organizations").

Banking groups that currently conduct in the United States the activities targeted by the "limit on scope" restriction often do so through non-bank entities which generally have broader trading and investment powers than U.S. commercial banks (and other types of U.S. depository institutions such as thrifts).[10] Under current U.S. law, non-bank subsidiaries of a U.S. bank holding company (and U.S. non-bank subsidiaries of a foreign banking organization) may generally engage in these activities so long as they fall within certain parameters established by the U.S. Bank Holding Company Act.[11] Since 1999, U.S. bank holding companies (and foreign banking organizations) with so-called "financial holding company" status have had greater legal authority in these areas than U.S. bank holding companies without such status.[12]

Journalists, bankers and industry experts have attempted to predict how the Volcker Rules would affect the financial services industry and which banking groups would be most impacted. Until key questions concerning the interpretation and scope of the proposal are answered, however, it will not be possible to draw many definitive conclusions beyond general observations, including the following:

- Reports on the topic generally indicate that only a few (<u>e.g.</u>, less than 10) large U.S. banking institutions would be directly affected by the "limit on scope" restriction to any significant degree. Of this group, perhaps Goldman Sachs would be impacted most, as it estimates that it generally derives approximately 10% of its net revenues from activities that would be prohibited.[13]
- Given the capital markets-oriented business model frequently employed by major non-U.S. banks with U.S. operations, the "limit on scope" restriction would appear to have a potentially significant impact on the U.S. trading and funds operations of a number of major banks headquartered outside of the United States.

[10] For example, as a general matter and subject to limited exceptions, FDIC-insured depository institutions are not permitted to make equity investments.

[11] In many cases, investment parameters include a cap of 5% of any class of voting securities of a portfolio company (or fund) being acquired for investment purposes.

[12] U.S. bank holding companies (as well as foreign banking organizations) are eligible for financial holding company status if they satisfy certain capital and management criteria above supervisory minimums.

In general, the powers of a U.S. thrift holding company (without special "grandfathered" status) are broadly comparable to those of a U.S. bank holding company with financial holding company status.

[13] Other major U.S. banking groups are believed to have figures significantly lower than 10%.

- The “limit on scope” restriction would appear to have a particularly large impact on the private funds activities of banking groups and the private fund industry in general. According to the London research firm Preqin, and just by way of example, U.S. banking institutions managing private equity funds and funds of funds have raised a total of 60 funds since 2006, with a total value of over $80 billion.

The “Limit on Size” Restriction

Since 1994, U.S. banks and bank holding companies have been subject to a 10% cap on the accumulation of nationwide deposits through inter-state merger with, or acquisition of, an unaffiliated insured bank. The “limit on size” restriction is intended as a supplement to, and an expansion of, this concentration limit.

Thus far, the Obama Administration has provided few details relating to its proposed “limit on size” restriction. What has been revealed (principally by Mr. Wolin during his Congressional testimony) may be summarized as follows:

- At a minimum, the “limit on size” restriction would cover both (i) large U.S. depository institution holding companies, and (ii) other systemically-important U.S. financial firms (including firms that do not “control” a depository institution).
- The “limit on size” restriction would restrict the ability of these firms (at or near size thresholds expressed in terms of liabilities) to make <u>new</u> acquisitions.
- The new size threshold would not affect the ability of firms to grow organically.[14]

It is unclear at this point whether the “limit on size” would act as a substantial constraint on bank acquisitions since the Obama Administration has yet to define the market share threshold or the type of liabilities that would count towards the threshold. Due in part to the lack of detail that has been provided thus far and the fact that institutions apparently would not be forced to divest units or subsidiaries other than in the context of an acquisition or merger, the “limit on size” restriction has not been the subject of as much attention as the “limit on scope” restriction.

Once additional details are provided, it seems reasonable to expect that there will be a broader debate over this issue.

The Administration’s Case for Adoption of the Volcker Rules

The Administration has advanced a diverse set of arguments in support of the Volcker Rules. The principal arguments advanced in support of the Volcker Rules, as well as counter-arguments thereto, are summarized below and in an Annex to this Client Publication. [15]

The “Limit on Scope” Restriction

The “limit on scope” restriction is most often presented as a proposal designed to eliminate a source of potential risk (<u>i.e.</u>, trading losses) to banks and their affiliates and to prevent banking groups from using the federal “safety net” to subsidize their own trading activities. In this regard, it has been argued that bank affiliates engaged in proprietary trading activities may indirectly benefit from special privileges, such as FDIC insurance and Federal Reserve discount window and payments systems access, granted to banks.[16]

Other rationales offered in favor of the “limit on scope” restriction include the so-called “regulatory capture”

[14] Other reform proposals backed by the Obama Administration, such as heightened capital requirements on systemically-important institutions, may create some financial incentives to restrict organic growth.

[15] There appears to be a split among banking groups on the issue – with some groups (particularly smaller banks or those with limited proprietary trading activities) supporting the proposal and others against it.

[16] The inter-affiliate transaction restrictions imposed under Sections 23A and 23B of the Federal Reserve Act are currently designed to restrict the ability of an FDIC-insured institution to use the “federal safety net” to subsidize the activities of an affiliate. These restrictions may be best thought of as constraints rather than an absolute “fire-wall”.

problem (i.e., regulators may fail to appropriately prohibit or restrict activities that pose serious risks at an influential/important supervised institution), potential conflicts-of-interest (e.g., banks may take proprietary trading positions ahead of, or in conflict with, the interests of their customers as to whom they are acting either implicitly or explicitly in a fiduciary capacity) and a somewhat philosophical argument that proprietary trading is not a proper role of a commercial bank (e.g., because, according to this view, commercial banking is fundamentally a "relationship business").

Some opponents of the "limit on scope" restriction have questioned the need for this type of reform since activities that are the target of the restriction have not been widely considered a major contributing factor to the financial crisis. They have pointed out that the most dramatic financial failures during the crisis involved entities – Bear Stearns, AIG and Lehman Brothers – that did not operate a major U.S. commercial bank. Some legal commentators have also pointed out that as part of its supervisory responsibilities the Federal Reserve already has the legal authority to terminate activities being conducted at a U.S. bank holding company deemed to constitute a "serious risk to the financial safety, soundness, or stability of a U.S. bank subsidiary of the bank holding company".

The "Limit on Size" Restriction

The "limit on size" restriction is intended to reduce concentration in the financial services industry and to mitigate the so-called "too big too fail" problem. Institutions viewed as "too big too fail" (e.g., because of their size and/or links to other financial institutions) may receive financial benefits from such status (e.g., lower cost of capital) and face diminished market discipline against excessive risk-taking if market participants believe that the institution will receive a "bail out" rather than be allowed to fail.

According to the Administration, the "limit on size" restriction would also reduce the "perverse incentive [for the largest U.S. financial firms] to fund themselves through more volatile forms of wholesale funding" created by the existing 10% cap on the accumulation of nationwide deposits (a source of funding with low volatility).

Some opponents of the "limit on size" restriction believe that size caps such as those envisioned by the Administration would (i) be an arbitrary impediment to market-driven bank consolidation, (ii) likely be ineffective in mitigating the "too big to fail" problem, and (iii) hurt the ability of U.S. institutions to compete with institutions headquartered outside of the United States (i.e., assuming other nations do not impose a similar cap).[17]

The Volcker Rules in the Broader Context of U.S. Financial Regulatory Reform

It is still very much an open question as to whether the Volcker Rules – either as proposed or in some modified form – will survive the legislative process. Particularly since the Democrats have lost their filibuster-proof majority in the Senate (and thus, any bill would need to garner at least some Republican support), it seems likely that Democrat supporters of the Volcker Rules will seek to reach a compromise position on the issue if required to facilitate passage of a broader reform bill.[18] For example, compromise approaches relating to the "limit on scope" restriction could conceivably entail:

- placing a cap on proprietary trading revenue of banking groups, and/or
- requiring institutions to receive regulatory approval in order to "bail out" a sponsored fund, and/or
- underscoring the point that U.S. bank regulatory authorities possess the legal authority to restrict or

[17] During a recent Senate Banking Committee hearing, a witness suggested that a cap based on a bank's balance sheet relative to U.S. GDP would be an improvement over a cap based on bank liabilities. A second witness argued that an institution's "inter-connections" with other institutions (rather than size) is central to the "too big to fail" issue.

[18] One possible implication of the recent loss by the Democrats of a Senate seat in Massachusetts is that it could potentially damage the chances of the Volcker Rules being enacted into law.

prohibit activities that would be impermissible under the restriction, and/or

- legally requiring higher capital charges that would make it more expensive for institutions to engage in activities targeted by the restriction.

The House Side of the Equation

The House of Representative passed a comprehensive financial services reform bill in December 2009 (the "House Bill").[19] The bill would authorize U.S. federal banking authorities to curb or prohibit the proprietary trading activities of designated systemically-important financial institutions (whether or not part of a commercial banking group).[20] The House Bill, however, would not go so far as to mandate a general prohibition on proprietary trading or sponsorship of private equity and hedge funds for systemically-important financial institutions. Moreover, since the measure would only cover systemically-important institutions, the House Bill would not cover the vast majority of FDIC-insured institutions and their affiliates, as called for by the "limit on scope" restriction.

The Chairman of the House Financial Services Committee, Barney Frank (D- Mass.), has stated that the Volcker Rules appropriately build on the provisions that are already included in the House Bill. Congressman Frank also has indicated that he would insist that institutions impacted by the Volcker Rules be given three to five years to dispose of impermissible trading positions in order to prevent a "fire sale" of portfolio holdings by these institutions.

The Senate Side of the Equation

The Senate Banking Committee is still at work on companion legislation to the House Bill. The Chairman of the Senate Banking Committee, Senator Chris Dodd (D-Conn.), has stressed that the Volcker Rules deserve serious consideration. However, he has expressed concern that the late introduction of the Volcker Rules into the reform dialogue complicates his efforts to achieve a bi-partisan consensus on the broader reform package. In this regard, on February 5th, Senator Dodd declared that negotiations with Republicans on the Committee are at an "impasse" (reportedly over consumer protection-related issues), and that he intends to introduce a bill later in February without Republican support. On February 11th, however, Senator Dodd announced that he would attempt to finish negotiation of a bi-partisan reform bill with Senator Bob Corker of Tennessee.

The Senate Banking Committee has held two hearings on the Volcker Rules: the first featuring Mr. Volcker and Mr. Wolin, and the second featuring a panel of bank executives and academics.

At the first Senate Banking Committee hearing, Mr. Wolin noted that the Obama Administration intends to submit to the U.S. Congress over the coming days or weeks its proposed legislation to implement the Volcker Rules. In this regard, Mr. Wolin suggested that the Administration's draft language would lay out the Volcker Rules in broad terms and that more specific interpretive issues would be addressed following the enactment of the Rules into law through the issuance of administrative regulations and legal opinions.

Observations

The question of whether the "limit on scope" and "limit on size" restrictions would benefit the economy, the financial services industry and society at large is complex. What we do know is that both proprietary trading and

[19] H.R. 4173 – The Wall Street Reform and Consumer Protection Act of 2009. See our previous Client Publication on H.R. 4173 (dated December 22, 2009) available at http://www.shearman.com/us-house-of-representatives-passes-wall-street-reform-bill-a-preliminary-analysis-12-22-2009/.

[20] The language of the House Bill (added by Rep. Kanjorski) would authorize the U.S. regulatory authorities to take preventative actions – including modifying existing prudential standards, imposing conditions on or terminating activities, limiting mergers and acquisitions, and in the most extreme cases, breaking up the company. Additional language in the House Bill (the so-called Perlmutter-Miller Amendment) would grant the Federal Reserve the specific authority to prohibit systemically-important financial institutions from engaging in proprietary trading.

customer-driven businesses (e.g., including commercial real estate lending and the issuance of mortgage-backed securities) of banking institutions frequently involve considerable risks and potential conflicts of interest (but also may provide economic and social benefits such as increased market liquidity). Moreover, these risks and conflicts of interest are also present outside of the traditional banking sector. Whether the "limit on scope" restriction would alleviate these risks and conflicts in a predictable and socially beneficial manner – without significantly reducing funding levels for investment vehicles, the U.S. government and other important components of the U.S. economy – when viewed from a financial system-wide perspective appears to be open to question and further investigation.

At the core of the case for or against the "limit on scope" restriction also lies philosophical issues (what types of activities do we as a society wish to subsidize or promote?) as well as trust issues (would a bank regulator be sufficiently capable and willing to use its current legal powers, when and as necessary, to restrict a bank (or bank affiliate) from engaging in excessively risky activities?). Policy-makers and the financial industry should give careful and due consideration to these important questions.

Aside from the merits of the Volcker Rules on substance, another legitimate question relates to whether this is the ideal time to push for a change in law of this magnitude. The U.S. economy has yet to regain its footing, and U.S. financial regulatory reform is still very much in a state of flux. Given the financial storm that the world has recently experienced, one may reasonably ask whether this is a matter that can be more fully and conscientiously addressed once the new supervisory architecture intended to control significant systemic risks has been put in place and has been tested.[21]

[21] Under the leading regulatory reform proposals, each systemically-important institution (whether inside or outside of a U.S. bank holding company structure) would be subject to comprehensive supervision, capital requirements, a prompt corrective action regime, and, upon failure, a special resolution regime.

Clearly, in the pre-crisis world, several institutions operating outside of the banking sector (e.g., Long Term Capital Management, Lehman Brothers and Bear Stearns) either posed – or were believed to pose – very serious risks to the financial system as a whole. The Volcker Rules (and, in particular, the "limit on scope") could precipitate spin-offs of capital, personnel and businesses from banking institutions to the less regulated non-banking sector. It is important that policy-makers not lose sight of the fact that the potential for the "limit on scope" restriction to achieve the critical objective of promoting financial stability depends as much (if not more) on the success of other proposed reforms intended to reduce systemic risks arising outside of the banking sector.

Conclusion

Many important questions relating to how the Volcker Rules would function as well as their political viability should be answered once the Administration rolls out its proposed statutory language for Congressional consideration. Whether or not the Volcker Rules are ultimately enacted into law, however, they will likely impact the strategic thinking of major financial institutions as well as the biases of lawmakers, regulators, journalists and the public at large – all with unpredictable effect.

For example, banks (and bank-affiliated) institutions may reassess the importance of their proprietary trading and funds businesses to their overall operations in view of the discussion provoked by the Volcker Rules as well as anticipated changes in global capital standards.[22] Moreover, the attention brought to bank proprietary trading and fund sponsorship will almost certainly lead to closer examination and supervisory scrutiny with respect to these activities (from both "safety and soundness" and "conflicts of interest" perspectives) over the coming months.

[22] See http://www.treas.gov/press/releases/docs/capital-statement_090309.pdf (regarding the U.S. Treasury Department's support of higher capital charges for proprietary trading activities).

The debate over the wisdom of the Volcker Rules will surely continue in the coming weeks as the U.S. financial regulatory reform process unfolds. We will monitor and report on additional developments relating to this important proposal.

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ANNEX

Arguments In Favor of and Against the Volcker Rules

Issue	Arguments For	Arguments Against
<u>"Limit on Scope" Restriction</u>		
Systemic risk/bank failure	· Proprietary trading is volatile and adds another layer of risk to the banking sector · Banking institutions may "bail out" troubled hedge funds and private equity funds that they own and sponsor. The bail outs draw on bank capital which is intended to protect banks against failure · The complexity of owning funds has made it difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks · The "culture" of proprietary trading may lead to excessive risk-taking elsewhere in the organization leading to excessive risk and a greater likelihood of bank failure	· Proprietary trading/fund sponsorship are additional sources of revenue the can help banking organizations diversify their risk (and thus serve as a source of strength to the bank) · Relatively little bank capital is currently at risk in the activities targeted by the restriction (and proprietary trading activities constitute a very small part of the activities of even major U.S. banking institutions) · "Prudential" supervisory tools, such as risk-based capital requirements, may adequately reduce risks of bank failure (an absolute prohibition is not necessary) · The proposed restrictions would simply push trading risks into a less regulated sector of the economy with its own systemic risks. Moreover, faced with this restriction, banking institutions may have to look to even riskier sources of revenue
Conflicts of interest	· Proprietary trading may lead institutions to act at cross purposes to the interests of customers · Banking institutions may favor their own "inside" funds when acting as investment adviser/manager for customers · Firewalls and current conflict of interest constraints have proven ineffective or insufficient to address conflicts of interest	· Firewalls, disclosures to customers, and other conflict of interest constraints can be tightened (if necessary) and have proven sufficient in many areas · Allowing institutions to invest along side of customers (<u>e.g</u>., in private equity and hedge funds) is an important way to align the interests of banks and their customers

Issue	Arguments For	Arguments Against
"Regulatory capture"	· Regulators may not restrict risky activities even if they have the legal authority to do so (they may not be able to identify excess risks and/or act quickly enough to address them and/or have the will to overcome the resistance from supervised institutions)	· Regulators are trusted to monitor and restrict (as necessary) other "risky" activities of banking institutions -- this should be no different · In the post-crisis world, regulators will have the tools, ability and motivation to effectively identify and address excess risks associated with the activities targeted by the restriction
Use of the federal safety net to support proprietary trading/fund activities and related issues	· Banking institutions benefit from FDIC insurance and access to the Federal Reserve's discount window (i.e., the "federal safety net"). The federal safety net is ultimately backed by the U.S. taxpayer. Taxpayers should not be on the hook for speculative activities that do not (unlike lending and other "traditional" bank activities) benefit bank customers · Access to the federal safety-net provides banking institutions with a competitive advantage over other types of firms that engage in proprietary trading/investment/fund activities · Banks "tie up" valuable capital on proprietary trading activities (capital that could be better utilized to make more loans to customers)	· Existing inter-affiliate restrictions (Sections 23A/B of the Federal Reserve Act/Regulation W of the Federal Reserve) limit the ability of banks to transfer the benefits of the federal safety net to their affiliates · Other non-bank institutions have been able to effectively compete against banking institutions in the areas targeted by the restriction · A possible outcome of the restriction – fewer banks and/or lower profits for banks – could mean fewer bank loans available to customers
Timing ("momentum" for regulatory reform)	· This restriction properly belongs as a part of comprehensive financial regulatory reform – it is important that it be enacted while the country is focused on financial regulatory reform	· The debate over the proposed restrictions may hold up adoption of more critical reforms · The economy is still fragile. Requiring banks to exit funds (and proprietary trading) at this time would have an adverse impact on the fund industry/capital markets

Issue	Arguments For	Arguments Against
"Limit on Size" Restriction		
Systemic risk	· Limiting the size (or relative size) of any single financial firm should help reduce systemic risks and the so-called "moral hazard" problem (i.e., "too big to fail" encourages excessive risk-taking) · The restriction should complement other measures (e.g., heightened capital requirements that create financial disincentives to grow in size) that are being proposed as a part of comprehensive financial regulatory reform · A special resolution authority for systemically important institutions may be helpful but it will not alone solve the "too big to fail" problem	· Interconnectedness (scope and complexity of financial relationships) among institutions, and not size, is the most important factor contributing to systemic risk – the proposed restriction will limit the growth of certain large financial institutions without necessarily reducing systemic risk · Providing a special resolution authority, rather than limiting an institution's size, is a better way to address the "too big to fail" problem · The proposed restrictions would not restrict "organic" growth or take into account an institution's asset profile – and thus would be inadequate to meaningfully reduce systemic risks
Market-concentration and competition	· The U.S. financial system is dominated by large institutions - the largest four U.S. banks have half of the market for mortgages and two-thirds of the market for credit cards · Large global institutions rely on syndicates of banks to supply their needs (no single bank supplies all of their needs) · Existing limits on size have not materially impaired the ability of U.S. firms to compete internationally	· None of the five largest banks in the world are headquartered in the United States – other countries have a more concentrated market · Existing anti-trust restrictions and other existing laws should be sufficient to ensure that financial institutions do not exploit market power in anti-competitive ways · Some U.S. institutions must remain large in order to continue to serve the needs of large global companies · U.S. institutions will be at a competitive disadvantage vis-à-vis other banks around the globe unless other nations impose a similar cap
Timing ("momentum" for regulatory reform)	· The restriction properly belongs as a part of comprehensive financial regulatory reform – it is important that it be enacted while the country is focused on financial regulatory reform	· The debate over the proposed restrictions may hold up adoption of more critical reforms · The economy is still fragile. Interrupting market-driven M&A activity particularly at this time may have an adverse impact on the U.S. financial industry