APPLYING THE VOLCKER RULE

CAMBRIDGE, Mass., February 18, 2014—On December 10, 2013, the Federal Reserve, SEC, CFTC, FDIC, and OCC jointly adopted the final version of the Volcker Rule, "generally prohibit[ing] banks from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund . . . subject to certain exemptions."[1] Three years and thousands of comment letters since the Volcker Rule's initial proposal, the devil remains in the details.

The Committee on Capital Markets Regulation considers it imprudent to define "prohibited" and "exempted" activities with precise, bright-line rules. In our comments on the proposed rule, we recommended that the agencies adopt a principles-based approach rather than rely on strict tests or lists of factors. Bank supervisors should retain significant discretion to determine whether particular trades are permissible. This is a delicate task, as an overly narrow and an overly broad definition of prohibited activities each entails significant risks to U.S. capital markets.

The seven quantitative measurements or "metrics" set forth in the final rule are of particular concern. Banking entities with trading assets and liabilities greater than $10 billion must file a report on these metrics if they engage in "significant trading activity"[2] on any trading day. The metrics include measures of risk management, sources of revenue, and the nature of services provided to banking customers.

The stated purpose of these metrics is to provide additional data to regulators engaged in analyzing trades for compliance purposes. Critically, exceeding a metric is not itself a violation of the Volcker Rule. The final rule release emphasizes that such metrics will not be used as "a dispositive tool for differentiating between permitted market making-related activities and prohibited proprietary trading."[3] This is a sensible approach, and we would encourage the agencies to revisit and tailor the metrics so that they are properly calibrated and reflect a uniform view across the bank regulators and agencies.

In assessing compliance and, specifically, in analyzing the output of metric reporting, we urge the agencies to bear in mind the critical nature of the exempted banking activities, namely, hedging, market making, and underwriting. Quantitative measurements are a useful reference point in the assessment of trades, but ultimately, the supervisory agency must determine, based on all the facts and circumstances, whether a failure to comply with a given metric is evidence of impermissible proprietary trading.

[1] Final Preamble to the Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, at 1 (Dec. 10, 2013).
[2] *Id*. at 24.
[3] *Id*. at 317.

Recent litigation challenging the Volcker Rule highlights an issue previously raised by the Committee, namely, the significant logistical issues arising from authorizing five separate agencies to interpret and enforce the rule. Given the extensive reach of the Volcker Rule, there is a high likelihood of disagreement between and among these agencies over a broad range of issues.

The adopting release acknowledges the Committee's suggestion that a single agency (*i.e.*, the Federal Reserve) take the lead in supervising implementation. However, the agencies concluded that such an approach would be inconsistent with the statute and would not effectively make use of the different authorities and expertise of each agency.[4] In the alternative, we suggest that lawmakers adjust the Volcker Rule enforcement framework such that the Secretary of the Treasury, in his role as the Chairman of the Financial Stability Oversight Council, acts as a central contact for all interpretive requests related to the Volcker Rule. The Dodd-Frank Act states that the Chairman "shall be responsible for coordination of the regulations issued under this section;" having the Chairman serve as a central contact for interpretive requests is consistent with the statutory approach. The Secretary could either issue interpretations himself through FSOC or delegate this task to the relevant agency. Such an arrangement would ensure that questions of interpretation are dealt with in a timely, systematic and centralized fashion, and could avoid needless litigation.

During a recent hearing at the House Financial Services Committee, the agencies described their newly-created "interagency working group," formed to help coordinate interpretations and implementations of the rule. We commend the agencies for recognizing that further coordination is necessary, however, a more centralized and formal approach is critical to avoid the uncertainty that will lead to judicial challenge. A document that provides implementation guidance would also be extremely useful.

Finally, we reiterate our concern over the lack of cost-benefit analysis in the Volcker Rule. The OCC explicitly reversed its prior determination that the proposed rule would not impose expenditures of $100 million or more per year and instead concluded that the final rule qualifies as a "significant regulatory action" but without estimating its cost. The adopting release explains that cost-benefit analysis is not required by any agency, because the Volcker Rule was promulgated under the Bank Holding Company Act, which does not specifically require analysis for rules promulgated thereunder. Whether or not this position can withstand legal challenge, the lack of cost-benefit analysis will leave the Volcker Rule susceptible to costly and time-consuming litigation. For a regulation as significant as the Volcker Rule, conducting cost-benefit analysis in accordance with best practices should be an agency priority, even where not required by law.

[4] *Id*. At 801.

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The Committee on Capital Markets Regulation is an independent and nonpartisan 501(c)(3) research organization dedicated to improving the regulation of U.S. capital markets. The Committee's membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Prof. Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School).

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