THE GOOD, THE BAD, AND THE VOLCKER RULE?[1]

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> *"I may not understand modern financial attitudes, but I don't think a bank wants to be conducting financial activities that will be revealed as simply skirting the law."*
> – Paul A. Volcker[2]

I. Introduction

Between 2007 and 2009 occurred what some call "the worst economic episode of financial distress since 1930's."[3] It was the consequence of a large number of banks, among them the so called too big to fail, and intermediaries who shifted risks by exploiting loopholes in the capital regulation framework to invest in highly leveraged investments. The main targets of these investments were real state, commercial real estate and consumer credit instruments. The guarantees offered by the government and the fact that many financial institutions that where too big to fail also contributed to the excessive risk taken by these entities.[4]

As a result of these events, the Congress of the United States of America enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2009 (henceforth "Dodd-Frank Act").[5] This law pretends to regulate and control the activities that conform the financial system of the

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[1] Title adapted from THE GOOD, THE BAD AND THE UGLY (UNITED ARTISTS, 1966).

[2] Floyd Norris, *Volcker Rule May Work, Even if Vague*, N.Y. TIMES, January 21, 2011, at B1.

[3] Matthew Richardson, Roy C. Smith & Ingo Walter, *Large Banks and the Volcker Rule, in* REGULATING WALL STREET. THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 184 (Viral V. Acharya, Thomas F. Cooley, Matthew P. Richardson & Indigo Walter eds., John Wiley & Sons, Inc., 2010).

[4] *Id*.

[5] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376-2223 (2010).

United States and prevent future crises because of certain financial practices which may put in risk the economy of the country. As part of the law, we find the Volcker Rule, which pretends to limit the investing activities, among others, in which some financial and non-financial institutions may participate. This work intends to: (1) describe the Volcker Rule in general terms and (2) mention the possible consequences the Volcker Rule may have in the financial sector of the United States and internationally.

II. The Dodd-Frank Act and the Volcker Rule

The Volcker Rule, named after the former Federal Reserve Chairman Paul Volcker, was not proposed at the original presentation of the Dodd–Frank Act.[6] It was added in January 2010[7] with the objective of providing some restrictions to banks activities, protect consumers and taxpayers, and create conscience of the severe consequences of the law in Wall Street.[8]

Paul A. Volcker, from a long time ago, has advocated that:

> [T]he scope of any implicit federal guarantee be limited to a relatively small number of important banking institutions and to core banking functions, rather than extended across the spectrum of financial intermediaries and risky activities. In exchange for the banking safety net, Volcker recommends that banks be allowed to engage in the full range of commercial and investments banking functions as financial intermediaries, but not permitted to engage in such nonbanking activities as proprietary trading, principal investing, commodity speculation, and hedge fund and private equity fund management.[9]

Simplified, it means that if the government and taxpayers are backing up few important, large, complex financial institutions, why do they will incur in greater risk because of the backup guarantee? Section 619 of the Dodd-

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[6] *Id.*

[7] For the announcement of the addition of the Volcker Rule read Barack Obama, Remarks of the President on Financial Reform, The White House Office of the Press Secretary (Jan. 21, 2010), http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform. See also: Obama's 'Volcker Rule' shifts power away from Geithner, THE WASHINGTON POST (Jan. 22, 2010), http://www.washingtonpost.com/wpdyn/content/article/2010/01/21/AR2010012104935.html.

[8] David Cho & Binyamin Appelbaum, *Obama's 'Volcker Rule' shifts power away from Geithner, The Washington Post (Jan. 22, 2010)*, http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104935.html.

[9] MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER, *supra* note 3, at 198.

Frank Act,[10] deals with this situation and it describes the requirements, prohibitions and exceptions.[11]

A. Prohibitions

The Volcker rule imposes two main prohibitions on banking entities: (1) engage in proprietary trading; and (2) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.[12] Also, the rule imposes a prohibition on the size of financial companies[13] through mergers if the firm's combined liabilities surpass ten percent (10%) of the aggregate consolidated liabilities of all financial companies in the United States at the end of the calendar year preceding the transaction.[14]

B. Requirements, Regulations and Limits

As we noted before, the Volcker rule imposes new limitations to banking and non-banking entities. The rule also seek to impose capital and quantitative limits on the proprietary trading, hedge funds and private equity funds to certain Fed supervised non-financial companies.[15] On the other hand, pertinent banking agencies (ex. SEC, CFTC, among others) are required to:

> [A]dopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, regarding the permitted activities if the agencies determine that additional capital and quantitative limitations are

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[10] Dodd–Frank Act, § 619.

[11] CCH ATTORNEY-EDITOR STAFF, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 228-230 (Wolters Kluwer Law & Business, 2010).

[12] Bank Holding Company Act of 1956 (BHCA), 12 U.S.C. § 13(a)(1) as added by the Dodd-Frank Act, Pub. L. 111-203, § 619, 124 Stat. 1376-2223. *See* CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 229; MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER, *supra* note 3, at 201-205.

[13] A "financial company" according to the Dodd-Frank Act is defined as: "(1) an insured depository institution; (2) a bank holding company; (3) a company that controls an insured depository institution; (4) a nonbank financial company supervised by the Federal Reserve; and a foreign bank or company that is treated as a bank holding company". CCH-EDITOR STAFF, *supra* note 11, at 238; BHCA Act § 14(B).

[14] Bank Holding Company Act of 1956 (BHCA), 12 U.S.C. § 14(b) as added by Dodd-Frank Act § 622. *See* CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 238; American Bankers Association, §6.10, *Nationwide Liability Concentration Limit for Acquisitions,* http://www.aba.com/RegReform/RR6_10.htm.

[15] Bank Holding Company Act of 1956, 12 U.S.C. § 13(a)(2) as added by Dodd-Frank Act § 619. *See* CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 229, 233.

> appropriate to protect the safety and soundness of banking entities engaged in any permitted activity.[16]

Also, according to the American Bankers Association (henceforth "ABA"), the appropriate Federal banking agencies are directed to make bank holding companies (henceforth "BHC's"), as well as security loans holding companies (henceforth "SLHC's"), to meet countercyclical capital requirements. Also, the ABA states a complete new standard for SLHC's. If the Fed determines so, the SLHC's will be required to adhere to a countercyclical capital requirement and to operate, jointly, with section 171 of the Dodd-Frank Act, which imposes a five (5) year term to meet the capital requirements which cannot be:

> (1) less than the generally applicable leverage capital requirements, which must serve as a floor for any capital requirements the agency may require or (2) quantitative lower than the generally applicable leverage capital requirements in effect for the insured depository institutions as of the date of enactment (citations omitted).[17]

In other words, SLHC's leverage standards cannot be lower than any insured banking institution. There are other limitations, which we will discuss in the next section. To conclude this part, is important to mention that the regulations (and studies) directed by the United States Congress to the respective Federal banking agencies in all the scenarios described above have to determine whether the general prohibitions mentioned:

> [(1)] promote safety and soundness of banking entities; [(2)] protect taxpayers; [(3)] limit the inappropriate transfer of federal subsidies, such as deposit insurance and liquidity facilities; [(4)] reduce conflicts of interest between banking entities and nonbank financial companies and their customers; [(5)] limit activities that have caused undue risk or loss in banking entities and nonbank financial companies; [(6)] appropriately accommodate the business of insurance within an insurance company while protecting the safety and

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[16] Bank Holding Company Act of 1956, 12 U.S.C. § 13(d)(4)(B)(iii) as added by Dodd-Frank § 619; CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 233.

[17] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 171(b)(s), 124 Stat. 1376-2223; CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 89-90. *See* American Bankers Association, § 6.17, *Capital Requirements for BHCs and SLHCs and Insured Depository Institutions*, http://www.aba.com/RegReform/RR6_17.htm.

> soundness of a banking entity which is affiliated with that insurance company; [(7)] raise the cost of credit or other financial services; and [(8)] appropriately time the divesture of illiquid assets.[18]

Once the studies are completed, recommendations will be made to agencies in the development of their regulations.[19] It is important to note that the Dodd-Frank Act stresses in the consistency and comparableness of the rules in order to avoid advantages or imposing disadvantages on companies affected by the prohibitions.[20]

C. Permitted Activities

The Dodd-Frank Act has some exceptions for the prohibitions mentioned above. Activities permitted include the acquisition, purchasing, selling, or disposal, by banking and non-banking institutions, of governmental obligations such as:

> (1) obligations of the United States [of America] and its agencies; (2) obligations, participations or other instruments of or issued by the government -sponsored enterprises- Fannie Mae and Freddie Mac, as well the mortgage guarantor Ginnie Mae, the [F]ederal Home Loan Banks, the Federal Agricultural Mortgage Corporation (Farmer Mac) or institutions chartered under the Farm Credit Act of 1971; and obligations of any [S]tate government or one of its political subdivisions. (Citations omitted).[21]

Other activities allowed are: the purchase, sale, acquisition, or disposition of any security, derivative, contract of sale a commodity for future delivery or option on any security, derivative or contract (securities and instruments).[22] These activities must "(1) be conducted in connection with

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[18] Bank Holding Company Act of 1956 (BHCA), 12 U.S.C. § 13(b)(2)(B)(ii) as added by Dodd-Frank Act § 619 (2)(B)(ii). *See* CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 229-30. (Citations omitted).

[19] CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 230.

[20] Bank Holding Company Act of 1956, 12 U.S.C. § 13(b)(1)(A)-(G) as added by Dodd-Frank Act § 619 (1)(A)-(G). *See* CCH ATTORNEY-EDITOR STAFF *supra* note 11, at 229-30.

[21] CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 231. Numeration added by the author. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 13 (d)(1)(D), as added by Dodd-Frank Act §619; MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER *supra* note 3, at 199.

[22] CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 231. *See* MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER *supra* note 3, at 199. (Citations omitted).

underwriting or market making-related activities; and (…) (2) be designed not to exceed the reasonably expected near term demands of clients, costumers or counterparties".[23] The purchase, sale, acquisition or disposition of any security or instrument is also permitted if the activity is on behalf of its customers.[24]

Also, a banking entity may participate in the sale or purchase of securities and instruments by insurance companies and its affiliates if used for the insurance company's general account.[25] Those activities are permitted if they fulfill the following requisites:

> (1) the transaction complies with the laws, regulations and written guidance of the jurisdiction in which the insurance company is domiciled; and (2) the appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners, have not jointly determined, after notice and soundness of the banking entity or the financial stability of the United States [of America].[26]

On the other hand, certain risk mitigating hedging activities are permitted for banking entities if done "in connection with and related to a banking entity's individual or aggregated positions, contracts or other holdings and designed to reduce the specific risks to the banking entity in connection with and related to those positions, contracts or other holdings" (citations omitted).[27] Investments in small business investments companies and those designed to promote the public welfare are also permitted.[28]

Likewise, organizing and offering a private equity or hedge fund is permitted but subject to various limitations.[29] The activity includes "(1) serving as general partner, managing member or trustee of the fund; and (2)

[23] CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 231. Numeration added by the author. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 13(d)(1) (D) as added by Dodd-Frank Act § 619; MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER *supra* note 3, at 199.

[24] CCH ATTORNEY-EDITOR STAFF, *supra* note 11, at 231. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 13(d)(1) (D) as added by Dodd-Frank Act § 619.

[25] C.C.H. ATTORNEY-EDITOR STAFF, *supra* note 11, at 231.

[26] *Id*. (citations omitted). See Bank Holding Company Act of 1956, 12 U.S.C. § 13 (d)(1) (F) as added by Dodd-Frank Act § 619.

[27] *Id*. at 231. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 13(d)(1) (C) as added by Dodd-Frank Act § 619.

[28] *Id*. at 232. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 13(d)(1) (E) as added by Dodd-Frank Act § 619.

[29] 12 U.S.C § 1851 (d) (1) (G) (i)-(viii) as added by Dodd-Frank Act § 619.

selecting and controlling a majority of the directors, trustees or management of the fund" (citations omitted).[30]

III. The Expected Consequences and Some Comments

Many aspects of the Volcker Rule are not in effect because the law has not fully entered in vigor or the respective Federal agencies have not issued the rules yet. So, we cannot properly talk about consequences, but we may talk about possible ones.

Matthew Richardson, Roy C. Smith & Ingo Walter argue that the Dodd-Frank Act fails to limit some activities which, in fact, presents systemic risk. They mention that "activities based solely in revenue such as asset management, advisory roles, or brokerage services"[31] at first sight may not be seen as systemic in nature but if analyzed more in deep, they do. The first example used by the authors is asset management. The authors mention that since the asset management revenues respond to the value of underlying assets management, any market risk of these activities will pass to the system through the value of the asset management business. The other example they use to illustrate this point is the activities that are a combination of capital and fee-based activities.

The authors' mention that the majority of the revenues derived from this model arises from the spread between buying and selling securities. When the seller finds a buyer, the seller is exposed to idiosyncratic and market risks. To mitigate these risks, the seller may hedge the macro or aggregate risk of it. The systemic risk, they explain, emerge from the impact of a systemic crisis on the franchise value of the seller business. In other words, over the counter (O.T.C.) derivatives and other security markets could suffer losses from a systemic event because of the collateral function of hedging.[32] Another point argued by Matthew Richardson, Roy C. Smith & Ingo Walter is that the "one size fits all" idea of the rule may result ineffective, because of the variations, complexities and particularities of the institutions.[33]

Another possibility is the fact that United States based banks could lose some leadership in the international financial markets because of the higher costs compared to foreign banks. Because of this situation, some predict that United States banks will be sold to foreigners as bankers migrate to outside markets. Accordingly, large complex financial institutions (LCFI's) will still be there, but outside of the oversight of the United States' regulatory

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[30] *Id.*
[31] MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER, *supra* note 3, at 193.
[32] *Id.*
[33] *Id.*

scope. The systemic risk will still be there.[34] Matthew Richardson, Roy C. Smith & Ingo Walter argue that, although it may be a possibility, foreign markets are no better positioned than United States markets to serve as lenders of last resort. They add that "[i]t seems doubtful that taxpayers in these countries would be rushing to provide unpriced or underpriced guaranties for their universal banks to gain global market share."[35] Some sectors, such as banking associations and investment firms, argue, on the other hand, that restricting some activities that create value may be detrimental to the financial system. This may be true in the sense that diversifying investments reduce the firm-specific risks but not market-wide risks.[36]

Another interesting consequence may emanate from a gray area created by the definition of "proprietary trading." The Dodd-Frank Act defines proprietary trading as follows:

> [W]hen used with respect to a banking entity or non-bank financial company supervised by the Board, means engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.[37]

This definition suggests an exclusion of customer-related trading and hedging, but due to the nature of the trading business, you cannot trace a hard line between customer related and entity related trading and hedging. Matthew Richardson, Roy C. Smith & Ingo Walter illustrate on this point with the following example:

> [W]hen a LCFI's acts as an intermediary between buyers and sellers, especially for less liquid securities, the firm will often

[34] *Id.* at 94.
[35] *Id.*
[36] *See Id.* at 194-95; Financial Services Forum, "*Volcker Rule is the Wrong Response to the Financial Crisis*" (May 28, 2010), http://www.financialservicesforum.org/index.php/forum-blog/839-volcker-rule-is-the-wrong-response-to-the-financial-crisis.html.
[37] Dodd-Frank Act § 619 (h)(4).

> be exposed to one side of the transaction. In fact, a number of normal market-and client-oriented transactions, such as trading in foreign exchange, fixed-income securities, and derivatives, as well as services like bridge financing[,] prime brokerage, and the like, might result in the firm technically trading on its own account but doing so to serve client needs.[38]

The authors suggest that this situation invites to manipulation. In the first manipulation scheme, we may see a financial entity accumulating a large exposure in a given type of security or derivative because of the expectation of a huge demand.[39] In this case, the company may be exposing to the risk of serving customer needs, true or false, and incurring in risk because of it. Market studies may be used to justify such a demand. We think, in this case, reasonability and proof must be the key to determine the reasonability of the risk exposure. On the other hand, the authors explain that identical trades with different ends are nearly impossible.[40] Also, and related to proprietary trading, the Dodd-Frank Act defines "proprietary trading account" as:

> [A]ny trading account used for acquiring or taking positions in the securities and instruments described in paragraph (4) principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2) determine.[41]

According to Matthew Richardson, Roy C. Smith & Ingo Walter, this description "reads like a green light for continuing carry trades … which result dangerous for financial institutions with government guarantees."[42]

Other problematic definitions are "hedge fund" and "sponsor". The ABA present that those definitions, read broadly, may affect traditional banking activities. This actions goes against the real intention of the law,

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[38] MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER, *supra* note 3, at 201.
[39] *Id.*
[40] *Id.*
[41] Dodd-Frank Act § 619 (h)(6).
[42] MATTHEW RICHARDSON, ROY C. SMITH & INGO WALTER, *supra* note 3, at 203-04.

which is, focus on the significant conflict of interest issues and not to interfere with day to day and traditional banking activities.[43]

Finally, loopholes have been found in the law. According to Paul Salmon, there are two loopholes in the law. The first one is that "the Volcker rule seems to apply only to depositary institutions: if you do not take deposits, then you are exempt."[44] In response, he establishes that as long as the banking entities may fund themselves in the wholesale market and "lend money in things like the syndicated loan market, the entities are banks, and they should be subject to rules like Volcker's which applies to banks".[45] The second loophole is that "it seems that banks might be allowed to continue to own hedge funds, private-equity funds, money-market funds, and the like, just so long as these investments are maintained for clients, with clients' money, rather than being vehicles for the investment of the bank's own capital."[46] In other words, "a bank might say that it has no exposure to such things, and that all the risk lies with its investing clients. But that is never, ever true."[47]

Another loophole is the one reviewed by The Financial Times in which "the Volcker rule does not apply to bank's "principal investments," or longer-term direct purchases of securities, companies and property assets."[48] The before-mentioned loophole may find its genesis on the definition of proprietary trading, which focuses in short-term accounts. This interpretation is incorrect because; (1) the definition does not speak in categorical terms, especially when it says "principally for the purpose of selling in the near term,"[49] so it does not exclude long term trading accounts; and (2) the law provides authority to Federal banking regulators to determine the types of accounts covered.[50]

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[43] Anonymous, *American Bankers Association Urges Regulators Not to Read Volcker Rule Definitions of "Hedge Fund" and "Sponsor" Too Broadly*, HEDGE FUNDS AND PRIVATE EQUITY. New York: Nov 19, 2010. Vol. 4, Issue 9, 8-9(2).

[44] Felix Salmon, The Volcker Rule's Loopholes *in* http://blogs.reuters.com/felix-salmon/2010/02/03/the-volcker-rules-loopholes/February 3 2010 (last visited on March 17, 2011).

[45] *Id.*

[46] *Id.*

[47] *Id.* Emphasis in the original.

[48] *Volcker Rule: Wall Street Reportedly Already Finding Loopholes,* http://www.huffingtonpost.com/2010/11/11/volcker-rule-wall-street-_n_782339.html, November 11, 2010. Updated January 11, 2011 (last visited on March 17, 2011).

[49] Dodd-Frank Act, *supra*, §619 (h)(6). Emphasis supplied.

[50] *Id.*

IV. Conclusion

The Volcker Rule is a good approach to protect the United States financial market and taxpayers, as well as international financial markets and taxpayers. The savage capitalism developed in financial markets, and in the economy in general, needs limitations to balance the leverage between the institutions and the investors, as well as the common taxpayer and the financial markets. Also, institutions that depend on governmental guarantee and/or represent a huge risk for economic stability require to be monitored constantly in order to detect possible sources of and avoid large-scale financial failures, like the ones in the 1930's and the 2007-2009 crisis.

Avoiding all legal and social issues is a high standard for any law. Our legal system is based on a reactive approach, meaning, it regulates things that have already happened. The Dodd-Frank Act is possibly the result of years of development of a broad legislative action. The financial crisis of 2007-2009 is the stimulus of the avalanche. Although not bulletproof, we consider it is a big, good start to protect the stability of the financial system.

We think that the Volcker Rule will be subject to constant revision and changes. At first, financial entities will circumscribe to its content, but loopholes, like the one mentioned above, will start to appear and be exploited. On the other hand, we must consider the rule's impact on the economy, which may require some adjustment on the rule in order to make it fit to current and future economic circumstances.

Another important factor is its universal applicability. We think the rule will have to be a more customized, on a case by case basis, because of the circumstances and particularities of the different types of financial, and banking entities it will regulate, in order to comply with the objective it was enacted: to control, yes, but to create stability and fairness.

Globalization will be a determinant factor in the real implementation of the rule. The fierce competition in the financial markets, as well as the emerging economies, may dictate the extent of the limitations of the rule in the United States. It will be ideal to regulate international financial markets in order to make them more secure for investments, but we must see the disposition of international players to renounce to the competitive advantage, inside and outside the United States that may represent a more regulated and limited United States players. We do not mean that the United States financial industry will fall, but that it will reinvent itself. New breaches will appear, new loopholes will be discovered and new opportunities will be exploited.