VOLCKER RULE Banks engaging in Proprietary Trading

The Volcker Rule is part of the Dodd-Frank Act (The Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010). The act was signed in 2010 by President Barack Obama. The Volcker Rule was proposed by a former Federal Reserve Chairman - Paul Volcker. This rule is based on the argument that the financial crises in the late 2000's were caused by these speculative trading activities of financial institutions, and Volcker's Rule goal is to prohibit the proprietary trading by commercial banks in USA.

The main goal of Dodd-Frank was to bring stability to the economy by protecting consumers, and to improve accountability in the financial sectors, and this Law can be characterized as the most important change in the financial service industry since the Great Depression. The Volcker Rule was first publicly endorsed by the President, and in a February 22, 2010 letter to The Wall Street Journal, five former Secretaries of the Treasury endorsed The Volcker Rule proposals. On October, 2011, the Office of the Comptroller of the Currency, Department of the Treasury (OCC); the Board of Governors of the Federal Reserve System (Federal Reserve); the Federal Deposit Insurance Corporation (FDIC); and the Securities and Exchange Commission (SEC) jointly released a notice of proposed rulemaking (the Notice) pursuant to the authority granted to those agencies by Section 619 of the Act.

The Volcker Rule prohibits an insured depository institution and its affiliates from:

- engaging in "proprietary trading";
- acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and
- Sponsoring a hedge fund or a private equity fund.

In a nutshell, the main intent of the rule is basically to reduce a bank exposition to risky bets that could result in significant losses to the bank and at the same time reduce or eliminate conflict of interest between a bank and its customers.

The Rational behind: Why is the Volcker Rule needed?

"The basic point is that there has been, and remains, a strong public interest in providing a 'safety net' – in particular, deposit insurance and the provision of liquidity in emergencies – for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions." ---- Testimony of Paul Volcker before the Senate Banking Committee, 2/2/10

It is important to mention that the Volcker Rule does not have a geographical limitation; it applies to U.S. banking firms regardless of where the trading activities are conducted. For foreign corporations it applies to the business conducted in the U.S.

The purposes of the Volcker Rule are as below:

1. Separate federal support for the banking system to do speculative trading activity; Banks need own capital;
2. Reduce potential conflicts of interest between a banking entity and its customers; and
3. Reduce risk to banking entities and nonbank financial companies designated for supervision by the Board

Prohibition of engaging in "Proprietary Trading":

Proprietary trading occurs when a firm trades a financial instrument with firm's own money. Typically these strategies are risky in nature, given that the bank is using its own funds and not customer's money, a move of the market in the opposite direction of that anticipated by the bank will generate significant losses at the bank, possibly bringing the bank down. Proprietary trading also results in significant conflicts of interest between the proprietary trading desk vs. the regular trading desk, since the firm is using its own funds it will attempt to maximize profits for itself and not for the customer. Many times an investment bank in the course of its own functions is presented with confidential information, regarding mergers, acquisitions, financial performance of a company etc. This information can be used by the proprietary trading desk in order to maximize profits for the investment bank own capital. Typically massive positions are accumulated in advance of market's knowledge of pending mergers, expected production of commodities etc. If the market moves in the same direction as the bets placed by the proprietary trading desk, it will result in significant gains for the bank. However if the market moves in opposite direction, then the losses are significant and eventually could bring the firm down. Examples of institutions being liquidated as a result of losses due proprietary trading include, Barings Bank and Amaranth Advisors. In 2012, JP Morgan Chase suffered billions in losses.

Acquiring/retaining or sponsoring a hedge fund or private equity fund:

The last two limitations in essence are very similar and are geared towards prohibiting financial institutions not using a legal entity separated from its own business to engage in activities that virtually could be defined as internal proprietary trading. Acquiring a controlling interest in a hedge fund or private equity fund virtually extends the banks reach to a proprietary trading desk at a different legal entity and therefore would allow hiding the gains and losses from its own balance sheets. Sponsoring a hedge fund or a private equity fund also is prohibited since it typically the sponsoring party is allowed to place managers, directors, trustees etc, which essentially gives them control over the day to day operation of the company.

Pros and Cons of the Volcker rule: Positive Aspects:

The Volcker rule is part of the Dodd-Frank act; however it is possible to isolate the contribution of the Volcker rule:

- Will significantly reduce the exposure of banks to risky bets and excesses of proprietary trading. This in turn, along with other provisions in the Dodd-Frank act will reduce the overall risk that investment banks can take when placing bets.
- Will significantly reduce internal conflicts of interest by not allowing banks to benefit first and it benefit customers.
- Will augment transparency by not allowing banks to use accounting tricks (such as "trading accounts") or investing /controlling separate legal entities in order to hide losses or show negative information on its own balance sheet.

- Will promote self regulation world wide by Investment Banks not just within the U.S. geography

Negative Aspects:

- From an economic perspective, the implementation and continuous operation will generate significant costs to companies that are required to implement the Act. This will impact especially small companies and stifle competition.
- The landscape for regulation is already crowded with agencies and regulators, the implementation will add to the amount of reporting and legal activity and create additional burden to comply with the rule.
- As investment banks face increase costs to support additional regulation, those costs will be passed on to customers in the USA. This may cause many financial companies to leave the United States and seek to raise money abroad where regulation is not stringent and costly. U. S. A. could lose its pre-eminence status as the Financial Center of the world.

The following table describes the specific regulations concerning the Volcker Rule within the Dodd-Frank Act.

Action Type	Action	Section (Start)	Sub-Section	Deadline	Category
Study	GAO must conduct a study on the risks and conflicts associated with proprietary trading (including investing as principal in securities, commodities, derivatives, hedge funds and private equity) by and within insured depository institutions and their affiliates, BHCs and financial holding companies and their subsidiaries, and any other person the Comptroller General may determine, and submit a report to Congress	989	(b)	15 months after enactment	Volcker Rule
Study	FSOC must complete study of the Volcker rule and make recommendations of the Volcker rule to FRB, FDIC and OCC (BHCA 213(b)(1))	619		6 months after enactment	Volcker Rule
Rule Making	SEC, CFTC, FRB, FDIC and OCC must jointly issue rules implementing the Volcker rule and reflecting the FSOC's recommendations with respect to the Volcker rule (BHCA Sec 213(b)(2))	619		9 months after completion of FSOC study of Volcker rule	Volcker Rule
Rule Making	SEC, CFTC, FRB, FDIC and OCC shall issue regulations to implement limitations on permitted activities (e.g., those creating a conflict of interest, material exposure to high-risk assets or trading activities, poses a threat to safety and soundness of the banking entity, or a threat to U.S. financial stability (BHCA Sec 213(d)(2)(B))	619		The earlier of 12 months after the issuance of final rules; or 2 years after enactment	Volcker Rule
Rule Making	SEC, CFTC, FRB, FDIC and OCC shall issue rules to impose additional capital requirements, and any quantitative limitations regarding permitted activities of banking entities (BHCA Sec 213(d)(3))	619		The earlier of 12 months after the issuance of final rules; or 2 years after enactment	Volcker Rule
Rule Making	SEC, CFTC, FRB, FDIC and OCC shall implement regulations regarding internal controls and recordkeeping (213(e))	619		The earlier of 12 months after the issuance of final rules; or 2 years after enactment	Volcker Rule
Rule Making	FRB shall issue regulations for bringing activities and investments into compliance with the Volcker Rule for compliance (BHC Act Sec. 213(c)(6))	619		The earlier of 12 months after the issuance of final rules; or 2 years after enactment	Volcker Rule

Implementation:

Volcker Rule as set forth in the Dodd-Frank Act took effect in July 21 of 2012. There is a two years compliance period; in other words the rule will not take effect until July 21, 2014. In the meantime the Agencies in charge of enforcing the regulations will work on its final version. - Five of the most important Agencies in charge of compliance of the rule are The Board of Governors of The Federal Reserve (FED) The Office of the Comptroller of the Currency (OCC), The Federal Deposit Insurance Corporation (FDIC), The Securities and Exchange Commission (SEC) and The Commodity Futures Trading Commission (CFTC) - There is a possibility that the Board of Governors of the Federal Reserve will issue up to three 1 year extensions and also any banking institution can apply for a 5 year extension period. As we can infer from the application of the rule, the rule will be enforced progressively during the following years giving enough time to the financial institutions to prepare for compliance of the rule.

Banks are aware that they have four main duties during this 4 years compliance period:

1. Prepare for full compliance on July 21, 2014.
2. Draft a conformance plan that describes how the entity will achieve this goal.
3. Demonstrate a “good faith” effort to achieve compliance during the conformance period
4. Prepare for possible recordkeeping and reporting requirements that the agencies may impose before July 21, 2014.

Conclusions:

The Volcker Rule was created after the financial crisis to stop Financial Institutions from engaging in proprietary trading activities. There are many opinions in favor and against the rule; the reality is that by July 21, of 2014 all Financial Institutions included in the rule should be prepared to implement the regulations. Whether many argue the merits and demerits of the Volcker Rule, regulators felt that there was a necessity to regulate the activities of the big banks in order to prevent the recurrence of another financial crisis. The Final draft of the rule is not yet known, since many regulatory agencies are still working on the final details. The Implementation of this Rule will be gradual; financial institutions have a choice to ask for more time for compliance if it’s needed. The rule as it is now, is very complicated involved multiple government agencies, a lot of rules and new definitions, also a lot of exceptions that makes it even harder to enforce. According to the American Chamber of Commerce, the Volcker Rule would impact the risk management in financial institutions, lead to a reduction in the value of financial services sold by banks, and an impact the structure of the financial institutions significantly for years to come.