Testimony on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"

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Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees:

Thank you for the opportunity to testify regarding the Commission's joint proposal with the Federal banking agencies to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), commonly referred to as the "Volcker Rule."[1]

The proposal reflects a collective and extensive effort by the four agencies involved — the Board of Governors of the Federal Reserve System ("Board of Governors"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Securities and Exchange Commission ("the Commission" or "SEC") — to design a rule, as mandated by the Dodd-Frank Act, to implement the required prohibitions and restrictions in a way that is consistent with the language and purpose of the statute. To create this proposal, staffs from each of the agencies, along with staff from the Commodity Futures Trading Commission ("CFTC"), engaged in weekly meetings under the leadership of the

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.

Department of the Treasury to discuss issues and share ideas related to effective implementation of the statute.

Section 619 of the Dodd-Frank Act applies to any "banking entity," defined as any insured depository institution, any company that controls an insured depository institution, any company treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliates or subsidiaries of any of the foregoing entities. The Commission has rulewriting authority for banking entities for which the Commission is the primary financial regulatory agency, principally SEC-registered broker-dealers, investment advisers, and security-based swap dealers — collectively defined as "covered banking entities" in the proposed rule.

The statute generally defines the term "proprietary trading" to mean engaging in the purchase or sale of certain financial instruments as principal for the trading account of a banking entity. The trading account concept is a key element of the statutory framework because any position that is not in the banking entity's trading account is outside the scope of the prohibition on proprietary trading. The statute's definition of "trading account" includes any account used by a banking entity to acquire or take a position in certain financial instruments "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)." The proposal establishes three tests for determining whether a position held by a covered banking entity is in the entity's "trading account," including an independent test for registered dealers and security-based swap dealers. Because a registered dealer generally holds positions for sale to customers upon request or to support the firm's trading activities (for example, by hedging its dealing positions), the proposal considers all positions held in connection with a registered dealer's dealing activities to involve the requisite short-term intent and to be captured within the statutory definition of "trading account." Specifically, any position in a security or derivative held by a covered banking entity that is a registered dealer or security-based swap dealer in connection with the activities that require that entity to register would be within the entity's trading account and subject to the prohibition on proprietary trading.

Although the proposed rule broadly captures all securities dealer and security-based swap dealer accounts, consistent with the statute the proposal recognizes the need for these entities to be able to provide essential financial services necessary to provide liquidity to our markets, continued capital raising activities for issuers, and intermediation services to customers. As a result, though the proposal generally prohibits proprietary trading, it allows market making, underwriting, and risk-mitigating hedging, among other permitted activities. In drafting proposed rules, the Commission and its staff focused in particular on these three activities for several reasons. First, the statute specifically identifies underwriting, market making-related activity, and risk-mitigating hedging as "permitted activities." Second, these exemptions involve activities that generally are engaged in by SEC-registered dealers. Third, these activities are integral to the effective operations of the securities markets.

In particular, underwriting activity is important to facilitate capital formation and to promote economic growth. The proposal, like the statute, continues to permit legitimate underwriting and certain trading activities that serve an important role in effective underwriting.

Much like underwriting, the proposal recognizes the important benefits provided by market making activity, including customer intermediation and market liquidity, and would permit market making activities in different markets and asset classes. Permitting legitimate market making in its different forms should facilitate market liquidity and efficiency by allowing covered banking entities to continue to provide customer intermediation and liquidity services in both liquid and illiquid instruments. As acknowledged in the proposal, effective market making also involves hedging of market making positions and some anticipatory market making-related trading activity.

The proposal recognizes that an overly broad interpretation of underwriting, market making, or risk-mitigating hedging could result in these exemptions potentially being used for evasive purposes. Each of the requirements set forth in the proposed exemptions are intended to reflect these considerations and strike an appropriate balance between preserving important market functions and preventing proprietary trading unrelated to such functions. The agencies requested comment on the proposed implementation of the exemptions for market making-related activity, underwriting activity, and hedging. For example, we sought comment on the proposed exemptions' potential impact on the market — including, for example, liquidity, price efficiency, and competition — and whether there are more cost-effective alternatives to implementation that would also be consistent with the purpose and language of the Volcker Rule.

The availability of these exemptions also is limited by the statutory backstop provisions, as implemented in the proposal. Specifically, consistent with the statute, an exemption is not available if the transaction or activity involves a material conflict of interest, high-risk assets or trading strategies, or a threat to a covered banking entity's safety and soundness or to U.S. financial stability. Further, the compliance program requirement contained in the proposal provides that a covered banking entity must establish, maintain, and enforce a program reasonably designed to monitor its permitted activities — including underwriting, market making, and hedging — and to ensure compliance with the specific requirements of the statute and the proposal. We recognize that there are both benefits and costs associated with the compliance program requirement. Although outlined more fully in the proposal, benefits include promoting a covered banking entity's review and assessment of its compliance with the statute and rule, as well as facilitating agency examination and supervision. Costs identified in the proposal include those associated with hiring and training personnel and creating and maintaining appropriate policies and procedures, internal controls, and records. The agencies sought commenters' input on the costs and benefits of the proposed compliance program, particularly seeking quantitative data, where possible. At this time, it appears that covered banking entities are in the best position to provide estimated dollar costs for implementation and ongoing maintenance of the proposed compliance program. Specifically, covered banking entities are familiar with the structure and costs of their current compliance framework pursuant to existing regulatory requirements, which can serve as a baseline for estimating the potential dollar costs associated with the proposed requirements.

As an additional means to monitor market making activities and prevent evasion of the prohibition on proprietary trading, the proposal sets forth specific quantitative measurements that certain covered banking entities would be required to calculate, report, and record for their trading units engaged in market making activities. The proposed quantitative measurements are designed to identify trading activities that warrant further review or examination by the covered banking entity or the Commission to determine compliance with the proposal. As recognized in the proposal, potential benefits related to this requirement include enhanced ability to distinguish permitted market making-related activity from prohibited proprietary trading and identifying trading activity that warrants further analysis or review for compliance. The proposal also identifies certain costs that may arise from this proposed requirement, such as systems, personnel, and recordkeeping costs. Similar to the compliance program requirement, covered banking entities may be in the best position to provide estimates of the dollar costs of this proposed requirement, as they are familiar with the scope of quantitative measurements that are currently utilized by their firm for risk management and other purposes. Overall, I believe that this aspect of the proposal will be informed greatly by public comment regarding the strengths, weaknesses, costs and benefits of each quantitative measurement.

The joint proposal also implements the statute's prohibitions and restrictions on investments in, and relationships with, hedge funds and private equity funds. These provisions are designed to prevent a banking entity from engaging in proprietary trading indirectly through an investment in a hedge fund or a private equity fund or investing in such funds in a manner that may subject bank capital to risk of loss. The proposed rule implements these provisions by adhering closely to the statutory text, while also providing clarifying terms and definitions. As is the case of the proprietary trading restriction, the SEC's proposed rule applies to banking entities for which the SEC is the primary financial regulatory agency.

The statute specifies that a banking entity may not invest in or sponsor a hedge fund or private equity fund, which is defined in the proposed rule as a "covered fund." The proposed rule's definition of covered fund also includes commodity pools and foreign funds, investment funds which trade in a manner similar to typical hedge funds but may be structured differently. The proposed rule, however, recognizes that banks may use investment vehicles to hold assets related to the business of banking. Thus, although these types of investment funds may satisfy the statutory definition, they do not raise the types of concerns that the statute was intended to address. As a result, the proposal would exclude from the statutory prohibition certain investments in, or sponsorship of, bank-owned life insurance separate accounts and common corporate vehicles that hold assets in connection with liquidity management or related to collateral obligations of borrowers. As noted in the preamble, the Commission recognizes that it is important to define "covered fund" in a manner that would implement the purposes of the statute, and therefore the proposal seeks extensive comment on the proposed approach as well as alternative approaches. We expect that commenter input will help inform our understanding of the potential scope and impact of the proposed definition.

By largely mirroring the statutory language, the proposal also implements the statutory exemptions that would enable a banking entity to invest in a hedge fund or private equity fund under specified conditions. These exemptions recognize that these banking entities, often investment advisers, provide important customer-oriented advisory activities, and that, provided certain safeguards are implemented, investments in hedge funds and private equity funds may continue. Thus, for example, a banking entity may own up to 3 percent of a hedge fund that the entity advises and offers to its clients, provided that the entity does not subject bank capital to loss by bailing out that fund. Banking entities may also invest in a hedge fund if the investment is made in connection with effecting a customer transaction, because in these instances, the amount of bank capital subject to loss is mitigated. We recognize a banking entity may incur costs to avail itself of one or more of the proposed exemptions, in particular, costs associated with implementing internal controls reasonably designed to ensure compliance with the elements of an exemption. The proposal seeks commenter views on the scope and effectiveness of each proposed exemption, including each specified exemption element and whether alternative, more cost-effective approaches exist.

These banking entities also would be required to implement a compliance program to ensure that investments in, and relationships with, covered funds comply with the proposed rule. Similar to the proprietary trading provisions, any permitted activity would nonetheless be prohibited if it involved a material conflict of interest, resulted in a material exposure to high-risk assets or high-risk trading strategies, or posed a threat to safety and soundness of the banking entity or the financial stability of the United States.

As in the case of designing a program to ensure compliance with the proprietary trading restrictions, the extent and scope of a banking entity's compliance program in connection with covered fund restrictions would depend on the extent of its activities. A banking entity that does not engage in prohibited covered fund activities would only need to implement a compliance program reasonably designed to ensure it does not engage in these activities, whereas others may incur higher costs if they have more extensive and complex relationships and investments with covered funds. Because of the diversity of covered fund activities, we have sought commenter input on these potential impacts.

The conceptual approach to the Commission's proposed rule regarding a banking entity's covered fund investments is to require a registered investment adviser to comply with the provisions on covered fund activities contained in rules issued by the Federal banking agency that regulates the bank with which the adviser is affiliated. As a consequence, registered investment advisers would look to the appropriate Federal banking agency's rules and related interpretations to comply with the statute's provisions on covered fund activities. This proposed approach ensures that activities conducted by registered investment advisers can be evaluated by their potential impact on the capital levels of the affiliated bank. Moreover, this approach will facilitate compliance by banks and their affiliated registered investment advisers with the requirements of Section 619 of the Dodd-Frank Act and the rules adopted under it.

The proposal includes a joint request for comment on the potential impacts of the proposed implementation of the statute, including, among others, the potential compliance costs, competitive effects, and impacts on market liquidity and efficiency. For example, the proposal recognizes that implementation of the statutory exemption for proprietary trading solely outside of the United States may result in certain competitive advantages for foreign-controlled banking entities over U.S.-controlled banking entities. In addition, the proposal seeks commenters' views on the costs and benefits of all aspects of the proposal, as well as comment on whether alternative approaches to implementing the Volcker Rule would provide greater benefits or involve fewer costs. Further, we encourage commenters to provide quantitative data, to the extent possible, in support of comments regarding the potential economic impact of the proposal. We would also very much welcome receiving studies, in particular those that provide quantitative data and empirical analysis with clearly stated assumptions.

The SEC also proposed certain of the rule's requirements — reporting, recordkeeping, and compliance program requirements — under both the Bank Holding Company Act and the Securities Exchange Act of 1934. The proposal includes a separate SEC-prepared discussion of efficiency, competition, and capital formation addressing those specific requirements.

Moreover, the agencies conducted an initial analysis in the joint proposal pursuant to the Regulatory Flexibility Act, which requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. In analyzing this requirement, we determined that the proposal would not appear to have a significant economic impact on small entities. We encourage public comment on the potential impact on small entities, however, including the nature of the impact and empirical data in support of such comments.

We look forward to robust public comment on all aspects of the joint Volcker proposal. To facilitate comments on the complex issues and questions raised, the Commission and the Federal banking agencies recently extended the comment period for the joint proposal to February 13, 2012. This extended comment period will provide commenters additional time to review, assess, and provide comments on the proposal, and also will help us coordinate our rulemaking with the CFTC's recent proposal to implement Section 619 of the Dodd-Frank Act.

Thank you again for the opportunity to speak about the joint Volcker Rule proposal. I would also like to express my thanks to my colleagues at the Board of Governors, the FDIC, the OCC, the Department of the Treasury, and the CFTC for their efforts related to this proposal. We are committed to continuing to work with them to further refine the rule prior to adoption. I am happy to answer any questions.