Testimony on "The Impact of the Volcker Rule on Job Creators, Part II"

by Mary Jo White, Chair[1]
U.S. Securities and Exchange Commission

Before the House Committee on Financial Services

Wednesday, February 5, 2014

Thank you for the opportunity to testify regarding the final rule 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," adopted under the Bank Holding Company Act on December 10, 2013 by the Federal banking agencies, the Securities and Exchange Commission (the "Commission" or "SEC"), and the Commodity Futures Trading Commission ("CFTC").[2]

Section 619 of the Dodd-Frank Act generally prohibits proprietary trading by insured depository institutions and their affiliates – termed "banking entities"[3] – and imposes limitations on the ability of such entities to sponsor or invest in hedge funds, private equity funds, or similar funds – called "covered funds" in the final rule. The rule implementing these statutory mandates reflects a collective and extensive effort by the five agencies involved – the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the CFTC, and the SEC – to design a regulatory framework that is consistent with the language and purpose of the statute and that preserves the benefits of diverse and competitive markets.

Development of the Final Rule

To create the final rule, staffs from each of the five agencies engaged in a robust, wide-ranging, and extensive process to address issues and develop approaches for

---

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

[2] *See* Bank Holding Company Act Release No. BHCA-1, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds* (December 10, 2013), http://www.sec.gov/rules/final/2013/bhca-1.pdf. Recently the Federal banking agencies, the Commission, and the CFTC approved an interim final rule that permits banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities. *See* Release No. BHCA-2, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds* (Jan. 17, 2014), http://www.sec.gov/rules/interim/2014/bhca-2.pdf.

[3] For purposes of the SEC's responsibility in administering the final rule, the most relevant entities are SEC-registered brokers, dealers, security-based swap dealers, and investment advisers that are banking entities by virtue of their affiliation with an insured depository institution.

effective implementation of the statute. Commission staff played a critical and constructive role from the outset, bringing to bear its expertise as a regulator of markets, market intermediaries, asset managers, and investment funds. Throughout this process, SEC staff worked actively and collaboratively with the staffs of our fellow regulators, engaging in frequent interagency staff conference calls, interagency meetings, and shared drafting throughout the rule's development.

The Commission, like the other agencies, received and reviewed thousands of comment letters on the statutory mandate and the proposed rules that the Federal banking agencies and SEC jointly published to implement the Volcker Rule.[4] Commenters on the proposed rule included, among others, banking entities subject to the rule, financial firms that regularly use the services of banking entities, trade groups representing various parts of the financial services industry, consumer and public interest groups, members of Congress, U.S. state and foreign governments, and individuals. These comments covered a wide spectrum of issues, with many expressing concern about potential negative impacts on market liquidity as well as evasion concerns. The Commission, together with the other agencies, responded to these comments with a well-balanced rule that both reduces the potential impacts on market liquidity and addresses concerns about proprietary trading through robust compliance requirements.

Commissioners and staff met frequently with representatives of the various groups that would be affected by the rule. Throughout this process, these groups not only shared their own perspectives and information, but also responded – through comments and otherwise – to the ideas, data, and perspectives of others.

This enormous volume of public input, diverse in both source and substance, was thoroughly considered and carefully factored into the choices presented by the statutory mandate. Many of the comment letters contained information directly related to the questions posed in the proposal, and, as described in more detail below, helped inform the final version of the rule. These efforts culminated on December 10, 2013, when the five agencies adopted the same final rule under the Bank Holding Company Act.

It was, in my view, very important that the agencies, if possible, adopt the same rule under the Bank Holding Company Act that could be consistently applied and implemented based on continuing consultation among the agencies. Market participants, investor advocates, and others all called for that outcome, which also best achieves the specific – and very critical – statutory objectives of coordination, consistency, and comparability.[5]

---

[4] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf. The CFTC issued a substantially similar proposal. *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 77 FR 8332 (February 14, 2012), http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf.

[5] *See* 12 U.S.C. 1851(b)(2)(B)(ii).

While the final rule is in many respects similar to the proposed rule, there are important differences within the ambit of the Commission's expertise that should be highlighted. Comments on the potential economic effects of the Volcker Rule were particularly useful in shaping revisions in these areas and helped produce a more tailored and more effective final rule. These include:

- The final rule refined the exemptions for market making and underwriting to better enable market intermediaries to provide liquidity and respond to customer and counterparty needs across a diversity of markets, while still appropriately limiting the financial risks that such activities may create.

- The final rule revised the definition of a "covered fund" to provide clearer exclusions for entities that should not present the same risks as the covered funds intended by the statute.

- The final rule revised the exemption for trading by foreign banking entities in a manner designed to help ensure that U.S. investors can continue to benefit from liquidity provided by such entities while limiting the risk to the United States arising from proprietary trading by such entities.

Market Making and Underwriting

Generally, commenters were concerned with the need to preserve the essential functions of market making and underwriting, while not allowing these exemptions to overtake the general prohibition on proprietary trading. For instance, a number of commenters were concerned about potential restrictions on market making in less liquid asset classes, such as corporate bonds. Other commenters, however, expressed concern about permitting market making in illiquid markets because customer trading demand is less frequent, which could potentially lead to risks remaining on a market maker's books for an extended period. Several commenters expressed concern that the proposed underwriting exemption may not have permitted banking entities to underwrite certain types of securities offerings or may have required them to immediately dispose of an unsold allotment in a so-called fire sale.

Consistent with the statute, the final rule generally prohibits banking entities from engaging in proprietary trading – engaging as principal for their own trading accounts by taking positions in various securities and 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.

At the same time, the statute and final rule preserve certain essential financial services such as market making and underwriting, which are necessary for raising capital and the healthy functioning of the U.S. financial system, including our securities markets. Consistent with the statute, the final rule does not, however, allow for these specified permitted activities if they involve material conflicts of interest or the employment of

high-risk assets or trading strategies, or if they threaten the safety and soundness of banking institutions or U.S. financial stability.

The final rule takes a measured but robust approach to implementing the statutory exemptions from the prohibition on proprietary trading for market making and underwriting. This approach benefited from a consideration of commenter views on potential unintended market impacts, particularly with respect to liquidity in off-exchange markets, while preserving an appropriate separation between prohibited proprietary trading and activities permitted by the statute, and taking meaningful steps to prevent evasion.

In general, the market making exemption permits dealers to continue to trade in ways that respond to the needs of clients, customers, and counterparties, provided that they effectively manage the risks associated with that trading. The final rule balances this statutory objective with the goal of prohibiting proprietary trading by implementing a set of strong but flexible risk-reducing requirements to help ensure that the financial exposures of a trading desk are commensurate with the needs of its customers. Among other requirements, the final rule provides that a market-making desk must routinely stand ready to buy and sell an identified set of financial instruments and, importantly, that the desk's inventory in such instruments be designed not to exceed reasonably expected near term customer demand, based on analysis of relevant factors. The rule also requires detailed risk management procedures and comprehensive risk limits for each market-making desk to help ensure risk-taking or position-building is related to customer needs. And the final rule provides that compensation arrangements must be designed not to reward or incentivize prohibited proprietary trading.

Significantly, in establishing these requirements, the final rule takes into account the liquidity, maturity, and depth of the market for the relevant type of financial instrument, allowing banking entities to use the exemption to make markets in a broad range of instruments. To claim the exemption, however, it is not sufficient for a banking entity to demonstrate that a trading desk on occasion creates a customized instrument or provides a price quote in response to a customer request. Instead, the trading desk will need to be able to demonstrate a pattern of taking these actions in response to demand from multiple customers with respect to both long and short risk exposures in identified types of instruments.

With respect to the final rule's implementation of the statutory underwriting exemption, permitted activities include the full range of securities offerings in which underwriters participate, including small offerings. For example, the final rule clarifies that permitted underwriting includes private placements in which resales may be made in reliance on Securities Act Rule 144A or other available exemptions, as well as registered offerings, including bought deals, shelf take downs, at-the-market offerings, continuous offerings, and debt offerings. Ancillary activities that are closely related to underwriting, such as stabilization activities, syndicate shorting, and selling an unsold allotment at a later time, are also permissible under the exemption, subject to certain limitations.

As in the case of market making, the rule requires that the trading desk involved in an underwriting maintain and enforce robust risk limits tied to customer demand. The final rule does not prevent a trading desk from retaining an unsold allotment when it cannot sell all of the securities it is underwriting at the time of distribution. However, a trading desk is required to make reasonable efforts to sell any unsold allotment within a reasonable period, which may differ based on the liquidity, maturity, and depth of the market for the relevant security type.

Together, and in coordination with other elements of the final rule, these specified parameters for permitted activities should allow market makers and underwriters to continue to contribute to the liquidity of the markets and respond to the needs of the marketplace, while limiting the financial risks that may arise from such activities.

Scope of Covered Funds

The final rule also implements the statutory provisions limiting the ability of banking entities to sponsor or invest in hedge funds and private equity funds. The Dodd-Frank Act defined a "hedge fund" and "private equity fund" by reference to the regulatory exemptions under the securities laws commonly used by such funds.[6] The proposal carried forward this definition of a "covered fund," and included in the definition certain commodity pools and foreign funds.

The agencies received a number of comments on the proposed rule's definition of covered fund, with many commenters asserting that the definition was too broad and should not focus exclusively on whether an entity relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act. A number of commenters urged the agencies to tailor the definition, including by excluding from the definition entities used for general corporate purposes and foreign public funds, among various other types of entities, and by taking a less expansive approach with respect to commodity pools and foreign funds.

Responding to these extensive comments, the final rule refines the definition of a "covered fund," making clear that certain entities that should not present the same risks as the covered funds targeted by the statute are excluded, including:

- Entities used for general corporate – rather than investment – purposes, such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles;
- Mutual funds and certain foreign funds publicly offered abroad; and
- Broad-based pension, retirement or similar plans established outside the United States.

[6] Section 619 of the Dodd-Frank Act defines the terms "hedge fund" and "private equity fund" to mean an issuer that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or "such similar funds" as the agencies determine by rule.

The final rule also takes a tailored approach with respect to foreign funds and commodity pools. The final rule includes foreign funds as covered funds only with respect to a U.S. banking entity (or a foreign affiliate of a U.S. banking entity) that sponsors or invests in the foreign fund, and also includes as covered funds those commodity pools that more closely resemble the types of private investment pools that are the focus of the statute. The final rule also provides an exclusion for certain loan securitizations to implement the statutory provision regarding the "sale and securitization of loans" by banking entities.

In addition, as permitted by the Dodd-Frank Act and subject to appropriate conditions, the final rules permits U.S. banking entities to continue to sponsor (and thus exercise control over) or make limited investments in covered funds that the banking entity organizes and offers. In addition, permitted activities include certain underwriting or market-making activities in covered funds; certain types of risk-mitigating hedging activities; activities that occur solely outside of the United States; and insurance company activities. The final rule also clarifies that, provided certain requirements are met, banking entities are not engaging in prohibited covered fund activities or investments when they act on behalf of customers, for example, as agents, brokers, custodians, or trustees.

Trading by Foreign Banking Entities

The cross-border scope of the proposed rule was the subject of a number of comments from market participants, who highlighted the potential competitive impacts and effects on liquidity that could result from applying the rule to foreign banking entities. These issues also attracted attention from governments and regulatory agencies abroad.[7]

Specifically, several commenters expressed concern that the proposal may cause foreign banking entities to withdraw from U.S. markets, avoid using U.S. market infrastructure, and curb trades with U.S. counterparties in foreign markets. Commenters stated that, as a result, the proposed rule would reduce U.S. market liquidity and bifurcate U.S. and foreign markets, leading to increased inefficiencies. At the same time, a few commenters noted that an overly broad approach to this exemption could create a loophole that would increase risk to the U.S. financial system or cause U.S. trading activity to move offshore.

The final rule provides that, if the trading decisions and principal risks associated with the activities of the foreign banking entity are located outside of the United States, a foreign banking entity may trade with U.S. entities subject to certain conditions. In particular, the final rule would permit: (1) transactions strictly with the overseas operations of a U.S. firm, provided no U.S. personnel of the U.S. firm is involved in

[7] Various regulatory bodies in Europe are pursuing banking system reforms, including initiatives to separate deposit-taking from investment banking activities. The European Commission recently proposed restrictions on proprietary trading by certain E.U. banking entities. The European Commission's proposal is subject to review and adoption by the European Parliament and the European Council.

arranging, negotiating, or executing the trade; (2) cleared transactions with a U.S. firm conducted anonymously on an exchange or similar trading facility; and (3) cleared transactions with a U.S. firm that is an unaffiliated market intermediary (such as a market maker) acting as principal.

This approach is designed to limit the risk to the United States arising from proprietary trading by foreign banking entities, while, within statutorily permitted limits, creating a reasonable competitive parity between domestic and foreign banking entities and helping to ensure that U.S. investors can continue to benefit from liquidity provided by foreign banking entities.

Compliance and Enforcement

As with any regulatory initiative of this scope and complexity, the final rule demands close attention to the nature and pace of implementation, particularly with respect to smaller banking entities. The final rule's reporting and compliance program requirements are already focusing both the regulatory agencies and firms on implementation. The staged implementation of the required reporting of quantitative trading data will facilitate reporting that is appropriate for the size of the banking entity's trading activities, and allow the agencies to review the merits of the data collected and revise the data collection as appropriate. The threshold for reporting also has been adjusted to help ensure that it will be focused on the largest trading firms. Similarly, the compliance program requirements in the final rule are tiered, based on the consolidated size of a firm or its trading activities, and the schedule for compliance will be phased in over time, in order to reduce unnecessary burdens and costs without compromising the objectives of the rule.

Consistent with our experience in other rulemakings, we expect a continued need for guidance regarding questions that will arise as market participants seek to comply with the final rule. We must be alert to both unintended impacts and regulatory loopholes as we move forward. The collaborative relationships among the agencies that developed during the rulemaking process are carrying forward and are already supporting joint and coordinated guidance, such as the recent interim final rule issued by the agencies with respect to the treatment of certain collateralized debt obligations backed by trust-preferred securities.

The agencies have formed an interagency working group that plans to meet regularly to discuss implementation of the final rule. This interagency group will be instrumental in coordinating the agencies' interpretations and implementation of the final rule on a going-forward basis. The working group's first meeting occurred on January 23 of this year, and the group plans to convene again later this week. Among other things, the group discussed potential methods of coordinating responses to interpretive questions and approaches to supervising and examining banking entities.

Such collaboration should carry forward not just in implementing the rule, but also in coordinating the compliance and enforcement of the rule. Under the statute, the

agencies have authority to order a banking entity to terminate activities or investments that violate or function as an evasion of the statute. Decisions about whether to issue an order could be made after an examination or otherwise.

Thank you again for providing me the opportunity to testify here today. I also would like to express my gratitude to my colleagues at the other agencies for their efforts to implement the final rule under section 619 of the Dodd-Frank Act. Going forward, I am committed to continued cooperation and collaboration with them in the implementation, compliance, and enforcement of the rule. I look forward to answering your questions.