

## **Daniel K Tarullo: The Volcker Rule**

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, US House of Representatives, Washington DC, 18 January 2012.

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Chairman Capito, Chairman Garrett, Ranking Member Maloney, Ranking Member Waters, and other members of the subcommittees, thank you for the opportunity to testify on the interagency proposal to implement the requirements of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), commonly known as the Volcker Rule. My remarks today will focus on some of the issues faced in developing the interagency proposal. As I have previously noted in Congressional testimony, the goal of the Federal Reserve with respect to this and all other provisions of the Dodd-Frank Act, is to implement the statute in a manner that is faithful to the language of the statute and that maximizes financial stability and other social benefits at the least cost to credit availability and economic growth.

The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) (collectively, the “agencies”) in November sought public comment on a proposal to implement the Volcker Rule. The Commodities Futures Trading Commission (CFTC) recently issued its substantially similar proposal for comment. Because of the importance and complexity of the issues raised by the statutory provisions that make up the Volcker Rule, the agencies initially provided the public a 90-day opportunity to submit comments. We recently extended the comment period for an additional 30 days, until February 13, 2012. The Federal Reserve welcomes comments on Volcker Rule implementation and has had numerous meetings with members of the public on this subject. We continue to post on our website all the comments that we receive and a summary of all the meetings that the Federal Reserve has had with members of the public about the Volcker Rule and all other provisions of the Dodd-Frank Act.

### **Summary of statute and proposal**

The statutory provisions that make up the Volcker Rule generally prohibit banking entities from engaging in two types of activities: 1) proprietary trading and 2) acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (each a covered fund). These statutory provisions apply, in general, to insured depository institutions; companies that control an insured depository institution; and foreign banks with a branch, agency, or subsidiary bank in the United States, as well as to an affiliate of one of these entities.

Under the statute, proprietary trading is defined as taking a position as principal in any security, derivative, option, or contract for sale of a commodity for future delivery for the purpose of selling that position in the near term or otherwise with the intent to resell to profit from short-term price movements. The statute applies only to positions taken by a banking entity as principal for the purpose of making short-term profits; it does not apply to positions taken for long-term or investment purposes. Moreover, the statute contains a number of exemptions, including for underwriting, market making-related activities, and risk-mitigating hedging activities. The implementing rule proposed by the agencies incorporates all of these statutory definitions and exemptions. The statute also authorizes the relevant regulatory

agencies to permit additional activities if they would promote and protect safety and soundness of the banking entity and the financial stability of the United States.

The second major prohibition in the statute forbids any banking entity from acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund. Again, the statute contains a number of exceptions, including for organizing and offering a covered fund, making limited investments in a covered fund, sponsoring and investing in loan securitizations, and risk-mitigating hedging activities. The statutory definition of a fund covered under the Volcker Rule is quite broad. The statute also quite broadly prohibits any banking entity that serves as the investment manager, adviser, or sponsor to a covered fund, or that organizes and offers a covered fund, from engaging in certain transactions with the fund, including lending to, or purchasing assets from, the fund.

The statute also prohibits otherwise permissible trading and investment activities when there is a material conflict of interest with customers, clients, or counterparties, or when the activity results in an exposure to high-risk assets or trading strategies. These are significant provisions and the agencies have specifically solicited comment on disclosure requirements and other approaches to implementing these parts of the statute.

### **Differentiating proprietary trading from market making**

One of the more difficult tasks in implementing the statutory prohibitions is distinguishing between prohibited proprietary trading activities and permissible market-making activities. This distinction is important because of the key role that market makers play in facilitating liquid markets in securities, derivatives, and other assets.

At the ends of the spectrum, the distinction between pure proprietary trading and market making is straightforward. At one end, for instance, trading activities that are organized within a discrete business unit, and that are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation, are not difficult to identify. These “internal hedge fund” operations existed at many bank affiliates for quite some time before the Volcker Rule was enacted. Firms that either are or were engaged in these non-client-oriented, purely proprietary trading businesses can readily identify and wind down these activities. Indeed, some have already done so for a number of reasons, including anticipatory compliance with the Volcker Rule.

At the other end of the spectrum, a textbook example would be a pure agency-based market maker that acts as an intermediary, instantaneously matching a large pool of buyers and sellers of an underlying asset without ever having to take a position in the asset itself. Profits are earned either solely by charging buyers a higher price than is paid to sellers of the asset, or in some cases by charging a commission. Buyers and sellers willingly pay this “spread” fee or commission because the market maker is able to more quickly and efficiently match buyers with sellers than if they were left to find each other on their own.

I refer to this as a textbook example because instances of such riskless market making in our trading markets are rare. In actual markets, buyers and sellers arrive at different times, in staggered numbers and often have demands for similar but not identical assets. Market makers hold inventory and manage exposures to the assets in which they make markets to ensure that they can continuously serve the needs of their customers.

Accordingly, in the broad middle that exists between these two clear examples, the distinction between prohibited proprietary trading and permissible market making can be difficult to draw, because these activities share several important characteristics. In both activities, the banking entity generally acts as principal in trading the underlying position, holds that position for only a relatively short period of time, and enjoys profits (and suffers losses) from any price variation in the position over the period the position is held. Thus, the purchase or sale of a specific block of securities is not obviously permissible or forbidden

based solely on the features of the transaction itself. The statute instead distinguishes between these activities by looking to the purpose of the trade and the intent of the trader. These subjective characteristics can be difficult to discern in practice, particularly in the context of complex global trading markets in which a firm may engage in thousands or more transactions per day. A similar challenge attaches to efforts to distinguish a hedging trade from a proprietary trade.

### **Implementation framework**

The agencies have proposed a framework for implementation of the Volcker Rule that combines: 1) an explanation of the factors the agencies expect to use to differentiate prohibited activities from permitted activities, 2) a requirement that banking entities with significant trading activities implement a program to monitor their activities to ensure compliance with the statute, and 3) data collection and reporting requirements, to facilitate both compliance monitoring and the development of more specific guidance over time. In addition, the agencies will use their supervisory and examination processes to monitor compliance with the statute.

The third element of the interagency proposal bears some additional comment. In order to help differentiate between permitted market-making activities and prohibited proprietary trading activities, the agencies have proposed to collect data from trading firms on a number of quantitative measurements. These metrics are designed to assist both the agencies and banking entities in identifying the risks and characteristics of prohibited proprietary trading and exempt activities. The proposal makes clear that metrics would be used as a tool, but *not* as a dispositive factor for defining permissible activities. The agencies instead propose to use metrics to identify activity that merits special scrutiny by banking entities and examiners in their evaluation of the activities of firms. The proposed rule does not include specific thresholds to trigger further scrutiny for individual metrics, but requests comment on whether thresholds would be useful, and notes that the agencies expect to propose them in the future. The proposal also makes clear that the agencies expect to take a heuristic approach to metrics, revising and refining them over time as greater experience is gained in reviewing, analyzing, and applying these measurements for purposes of identifying prohibited proprietary trading.

Additionally, since some banking entities engage in few or no activities covered by the statute, the proposal also includes a number of elements intended to reduce the burden of the proposed rule on smaller, less-complex banking entities. In particular, the agencies have proposed very limited compliance programs and have reduced or eliminated the data collection requirements for these banking entities.

### **Potential effects of the proposal**

The proprietary trading prohibition in the Volcker Rule statute itself will undoubtedly affect the trading behavior of banking entities. Indeed, that is what Congress intended in enacting these provisions. Congress has itself made the judgment that this prohibition will enhance financial stability and is socially desirable. The task of the agencies is to implement Congressional intentions, as manifest in the statute itself, as efficiently and effectively as possible.

The approach taken in the proposed rulemaking is concededly not a simple one. But, at least to date, it has seemed the most feasible. Two alternative approaches have been suggested, and we considered each prior to issuing the proposed regulation. One considerably simpler approach would be to articulate high-level principles for differentiating prohibited and permitted activities and then leave it to the firms to self-report violations based on internal models or other devices, presumably with compliance and systems monitoring by regulatory agencies. While having the virtue of simplicity at the outset, this approach would provide little

clarity about whether an activity is permitted or prohibited. It seems quite likely that, either formally or informally, the regulatory agencies would regularly be asked to offer guidance or approve specific practices. Otherwise, this approach would essentially rely on self-policing by banking entities.

A second alternative would be to establish definitive bright lines for determining whether an activity is permitted or prohibited. This approach would be very difficult in practice, at least with current information and data, because of the many asset classes, business models, and transaction types covered by the statutory provisions. Hard-and-fast rules would also run the risk of being either too restrictive, and thus inadvertently classifying legitimate, customer-driven market-making or hedging activity as prohibited, or too narrow, and thus failing adequately to capture the full range of activities that are prohibited under the statute.

The more nuanced framework contained in our proposal was designed to realize some of the advantages of both of these approaches while minimizing their potential adverse effects. The Dodd-Frank Act provides a long conformance period for firms that are subject to the Volcker Rule. The agencies have proposed to use that conformance period to study the effects of the statutory prohibitions on the activities of banking entities before the Volcker Rule is fully implemented. To assist in this undertaking, the agencies have proposed to begin collecting and reviewing trading data that should help firms subject to the statutory provisions, as well as the agencies in our efforts, to monitor and understand the contours of the activities that are prohibited, permitted, and affected by the statutory provisions that make up the Volcker Rule. As I mentioned earlier, we are hopeful that the data collection and reporting required in our proposal will eventually facilitate more specific guidance on market-making, hedging, and other exemptions from the general prohibition. After the Volcker Rule becomes fully effective, we would continue to monitor the effects of the rule and look for opportunities to refine it.

Having said all this, the Federal Reserve is more than open to alternatives that would be superior to the approach proposed. Indeed, the agencies requested comment on alternative approaches in the *Federal Register* notice.

Thank you for your attention. I would be pleased to answer any questions you might have.