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Despite Some Easing, Volcker Will Pose Challenges For Banks

By **Evan Weinberger**

Law360, New York (December 10, 2013, 9:25 PM ET) -- Although regulators made some concessions, the final version of the Volcker Rule released Tuesday doesn't give banks much leeway when it comes to compliance, financial reform advocates and attorneys say.

Regulators on Tuesday released a final version of the Volcker Rule that they say should prevent banned proprietary trading without hampering markets — a tough task, given the broad legislative mandate Congress gave them in the 2010 Dodd-Frank Act.

The five regulators — the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission — struggled for more than three years to balance industry concerns that the rule could damage access to needed market liquidity with a need to make sure that banks that benefit from government support, like deposit insurance, are barred from taking unnecessary risks.

After taking criticism following an October 2011 proposal, the five regulators came up with an end product that provides stringent definitions of market making and hedging, aimed at eliminating loopholes, while giving some leeway on the types of international securities and international financial institutions that would be exempt from the rule.

“While the final regulations implementing the Volcker Rule will not please the banking industry, they are somewhat more accommodating to non-US banks than many feared,” said Robin Maxwell, head of Linklaters LLP's New York financial regulatory practice.

The Volcker Rule, named after former Federal Reserve Chairman Paul Volcker, bans bank holding companies and their subsidiaries from short-term proprietary trading of any security, derivative or other financial products intended only to benefit the company. The rule also bars banks from owning or sponsoring a hedge or private equity fund.

Particularly bedeviling for regulators in working out the final rule was finding ways to make sure their definitions of market-making and hedging were strict enough to make it harder for banks to find loopholes while still allowing them to carry out those activities, which are exempted from Dodd-Frank's proprietary trading ban.

To meet their hedging goals, the regulators will require banks to hedge against specific risks rather than a broader economic loss. And banks will have to analyze their hedging transactions to make sure they are protecting against losses on specific financial positions, provide supervisors with a rationale for the transactions, and perform continuous monitoring.

The hedging provisions gained steam after JPMorgan Chase & Co.'s $6 billion 'London Whale' trading loss came to light in the spring of 2012. Federal Reserve Gov. Daniel Tarullo, the central bank's regulatory reform chief, said at a Tuesday open meeting that the London Whale fiasco “allowed staff to test the procedural and substantive requirements of the proposed rule against a real-world example of what should not happen in a banking organization.”

In the end, the regulators came out with a rule that made sense, in that it bars banks from hedging against broad risks, said David Sahr, a partner at Mayer Brown LLP. In fact, they should be doing those things without a formal regulation, he said.

“A lot of this is already done under risk-management processes,” Sahr said. “I'm sure there will be some adjustments here, but good risk management today basically requires that banks have a policy for hedging.”

Still, financial reform advocates spotted a few ways that banks can get around the hedging requirements. The final Volcker Rule allows multi-desk hedging, where risks from multiple bank units can be aggregated and imperfect hedges that do not necessarily correlate with specific risks.

“They can mask prop trading as hedging by creating these imperfect hedges that create more hedging upon hedging,” said Eric Taylor of Occupy the SEC, a pressure group which gave the final Volcker Rule a C-minus in a press release.

The regulators also dialed back some provisions related to international issues. While the original rule allowed an exemption only for U.S. sovereign debt and securities issued by government-sponsored entities, the regulators, facing pressure from Canadian, European and Japanese regulators, added some provisions allowing trade in foreign sovereign debt.

While this has eased relations with foreign regulators, critics warn of the potential risks, pointing to the example of European banks that have been hurt by bad euro-zone sovereign debt in recent years.

“It's not necessarily safe for our banks in the U.S. to take on risks from other countries,” said Occupy the SEC's Akshat Tewary.

U.S. regulators also eased up on the Volcker Rule's international reach, applying it only to U.S. banks and their foreign units and the U.S.-based units of international banks.

U.S. banks are likely to remain at a disadvantage to their foreign counterparts, and some foreign banks may think twice about opening up shop inside the U.S., said Schulte Roth & Zabel LLP partner Joseph Vitale.

“The impact that this will have on foreign banks and their presence in the U.S., as well as the impact that it will have on competition between U.S. and non-U.S. banks — that's going to be an area to watch,” he said.

Regulators also compromised on a provision requiring that CEOs attest that their banks are Volcker Rule-compliant. Rather than having to affirm that each trade complies, they will simply have to confirm in writing that their banks have appropriate “procedures to establish, maintain, enforce, review, test and modify” their compliance with the rule.

“We feel like that provision does set a tone at the top, but it could be stronger,” said Micah Hauptman of Public Citizen.

Although banking trade groups on Tuesday blasted the Volcker Rule as a measure that would hurt the economy and be too complex for banks to successfully navigate, overall there were “a lot of positive things in there,” Sahr said.

In the end, the provisions of the rule will only provide a template for supervisors to follow. The regulatory agencies said Tuesday that it would be up to bank examiners to make sure that the compromises included in the rule allowed for strict compliance and continued market functioning.

“The ultimate effectiveness of the rule will depend importantly on supervisors, who will need to find the appropriate balance while providing feedback to the board on how the rule works in practice,” Fed Chairman Ben Bernanke said.

--Editing by Kat Laskowski and Philip Shea.