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Volcker Rule to Force Banks to Comply With Five Regimes

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U.S. banks that must comply with the proprietary-trading ban known as the Volcker rule are facing inconsistent future demands from the five agencies responsible for enforcing it.

Even before the final version is released next week, current and former regulators and bank lawyers predict an uneven approach on enforcement because of differences in style and jurisdiction between the three U.S. regulators that police banks and the two agencies that monitor markets. For many banks, how enforcement is handled could wind up being more important than the language in the 1,000-page text.

"How supervision and enforcement of the Volcker provisions are handled among the five agencies is one of the most important and potentially complicated practical aspects of implementation," said Julie Williams, who was general counsel for the Office of the Comptroller of the Currency before joining consulting firm Promontory Financial Group LLC. The rule could leave multiple regulators targeting the same activity in a single firm in different ways, she said.

The Volcker rule seeks to prevent banks from making bets with their own money and from holding large stakes in hedge funds and other potentially risky investments that could put their federally insured deposits at risk. The target dates for complying with the measure -- which has taken more than three years to draft -- will be set by the agencies when they adopt it on Dec. 10.

The biggest banks have already shut down proprietary trading units and exited investments. They are awaiting word on how the rule will affect the $44 billion they say comes from market-making -- representing 18 percent of the annual revenue at the five largest Wall Street firms -- and how it will affect trades designed to hedge broad economic risk.

The answers could threaten revenue at banks including JPMorgan Chase & Co., Bank of America Corp. and Morgan Stanley.

Little 'Practicality'

"What we'll find out on Tuesday is what the expectations are in terms of policy," said Kevin Petrasic, a partner at the law firm Paul Hastings Janofsky & Walker LLP. "I don't think that is going to tell us a whole lot in terms of practicality. I think there is going to be a whole drama in the coming weeks and months on what the exemptions mean, how restrictive and what the enforcement posture is."

Enforcement authorities for Volcker violations will rest in the agencies' traditional legal powers -- outlined elsewhere in federal law -- such as shutting down improper activities, hitting firms with cash penalties, collecting restitution for those harmed and banning officials from banking. It's not clear how heavy future penalties may be or if improper profits could be clawed back.

Public, Private

Mark Williams, an executive-in-residence at Boston University who was a former Federal Reserve bank examiner, said a critical distinction is whether banks will be called out in public for any violations.

If Volcker compliance goes awry at a bank, on-site supervisors from the three banking regulators -- the Fed, the OCC and the Federal Deposit Insurance Corp. -- can work things out in private, "one-on-one with the bank," he said.

By contrast, the two agencies that monitor markets -- the Securities and Exchange Commission and the Commodity Futures Trading Commission -- are required to make most violations public. They issue warnings of pending enforcement that companies often include in public filings to inform investors.

"Traditionally, the Fed has been much more of the carrot approach, and the market regulators have been much more of the stick," Williams said.

SEC Commissioner Daniel Gallagher, a Republican who has called for the rule to be re-written, said he foresees his agency being forced to waste resources to issue streams of minor enforcement actions.

'Wiggle Room'

"The banking agencies can employ their discretion," while the SEC won't have the same "wiggle room," Gallagher said in an e-mail. "Our rules are rules, and when our examiners come across a rule violation, whether egregious and intentional or peripheral and accidental, they are required to record such violations."

The initial version of the rule proposed in 2011 said banks would have to set up programs to demonstrate to regulators that they aren't making proprietary trades, and indicated that CEOs and other senior officials would have to personally approve them. The compliance programs,

including written policies, record keeping and independent testing, would be toughest on firms with more than $1 billion in trading assets or that trade 10 percent of their total assets.

More Documentation

The law allows banks to continue hedging and market-making -- where banks take the other side of transactions for clients who want to buy certain securities. The proposed rule would require banks to document the rationale for hedging transactions, specifying how a hedge counters risk. The banks would also keep a running checklist of metrics for each trading day to demonstrate they aren't straying into improper trading, reporting those calculations to the agencies monthly.

Treasury Secretary Jacob J. Lew said in a speech yesterday that the rule "prohibits risky proprietary trading while protecting economically essential activities like market-making, such as when a firm facilitates selling bonds for a mutual fund." It will also block risky bets "masked as risk-mitigating hedges," such as JPMorgan's so-called London Whale trades that led to $6.2 billion in losses, he said.

The New York-based bank was ordered in September to pay $920 million to the OCC, Fed, SEC, CFTC and U.K. regulators over the London Whale trades. Regulators have said that the Volcker rule has been tightened to ensure banks can no longer pursue the same kind of broad, risky hedging strategy.

Inside Banks

"It's hard for me to see how the CFTC and SEC will enforce it, because they are not in the commercial banks regularly, so most of this is going to fall to the Fed," said Mark Calabria, director of financial-regulation studies at the Cato Institute in Washington. Though interpretations might differ from agency to agency, he said, the Fed and OCC will be dealing with it day after day.

Those banking regulators "tend to be more like a social worker, and the securities workers tend to be more like a cop," said Marcus Stanley, policy director for Americans for Financial Reform, a Washington-based group that seeks stronger bank regulation. "But the securities regulators have not always been effective cops, either."

The rule's complexity will make it hard for banks to be sure they're in compliance, said Andrew Olmem, a partner at Venable LLP who was chief counsel for Senate Banking Committee Republicans during the crisis and the writing of Dodd-Frank.

Court Challenges

"If the final rule is materially different from the proposed rule, it is highly likely that the rule will be challenged in court on grounds," Olmem said.

It's not just lawyers who complain that the enforcement regime may be too complex. In a 2012 letter to regulators, Senators Jeff Merkley, a Democrat from Oregon, and Carl Levin, a Michigan Democrat, asked the agencies to establish clearer enforcement structures and penalties.

"Clear and consistent enforcement is going to be essential for the Volcker rule to be a meaningful firewall keeping our banks out of the business of being giant hedge funds," Merkley said in an e-mail. "That means coordination and data-sharing by the regulators, disclosure by the banks, and accountability for both to Congress and the public."