

TESTIMONY OF
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ACTING COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEES ON
CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
And
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

January 18, 2012

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees, I appreciate the opportunity to appear today to provide an update on the work of the Office of the Comptroller of the Currency (OCC) in implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank), also known as the “Volcker Rule.” The letter of invitation requests the agencies to address various aspects of the joint notice of proposed rulemaking implementing the Volcker Rule (the Proposal), including the effect of the Proposal on the financial sector and the economy.

Because we are in the midst of the public comment process on this rulemaking, I must note that there are limitations on the views I should express on the merits of many of the issues raised in the letter of invitation, in order to avoid the appearance of prejudging any of the issues presented by the rulemaking. That said, I can identify areas of the Proposal that present significant issues, and where we have emphasized the importance of input from commenters.

Accordingly, my testimony will describe the Proposal and address the implementation challenges posed by the complexity of section 619, and the questions posed by the Committee. As you are aware, the agencies recently extended the deadline for providing comments on the Proposal from January 13 to February 13, 2012. We are hopeful that this extended comment period will give the public more time to evaluate and provide meaningful comments on the Proposal, and time to evaluate and comment on the proposed rule implementing section 619 that was approved by the Commodity Futures Trading Commission (CFTC) on January 11, 2012.

Implementation of Section 619

The OCC, together with the other banking agencies and the Securities and Exchange Commission, jointly published the Proposal for public comment on November 7, 2011. The Proposal took into consideration the language of section 619 and its legislative history, the Financial Stability Oversight Council's study on implementing section 619 published in January 2011, and the agencies' supervisory experience with the banking entities to which the Volcker Rule is applicable. The Proposal reflects the agencies' rigorous discussions of these elements in a constructive interagency rulemaking process. The CFTC, while not a party to the Proposal, was actively involved in these interagency discussions and in formulating the Proposal.

The Statute. Section 619 prohibits a “banking entity”, which is an insured depository institution,¹ a company that controls an insured depository institution, a foreign banking organization, and an affiliate or subsidiary of any of the above, from engaging in “proprietary trading” and from acquiring or retaining an ownership interest in, or sponsoring, a “hedge fund” or “private equity fund.” The definition of these terms and the structure of section 619 are complex, which results in the complexities of the Proposal. For example, “proprietary trading” is defined as a banking entity engaging as “principal” in acquiring or disposing of securities, derivatives, commodity futures contracts, or options on any of these instruments for an account (the “trading account”) that the entity uses for taking positions “principally for the purpose of selling in the near-term” or “with the intent to resell in order to profit from short-term price movements.” This term and many of the other terms and concepts contained in section 619 are

¹ Section 619 defines “insured depository institution” to exclude certain limited purpose banks that function solely in a trust or fiduciary capacity.

imprecise and at times over- or under-inclusive as applied in practice, and therefore required further refinement in the Proposal.

Section 619 also expressly exempts certain permitted activities from these prohibitions, including:

- Trading in certain government obligations, including U.S. government and agency obligations;
- Trading in connection with underwriting and market-making-related activities designed not to exceed reasonably expected near-term demands of customers;
- Risk-mitigating hedging activities on an individual or portfolio basis;
- Trading on behalf of customers;
- Investments in small business investment companies and investments designed to promote the public welfare;
- Organizing and offering a fund for trust, fiduciary and advisory customers subject to certain investment, ownership and other limits; and
- Trading and fund activities by certain qualifying foreign banking entities solely outside of the United States.

In addition, section 619 generally prohibits a banking entity from entering into any transaction with a fund that it manages, advises or sponsors that would be a “covered transaction” under section 23A of the Federal Reserve Act. A covered transaction includes a loan or extension of credit, a guarantee, and a purchase of securities or assets. This restriction is known as “Super 23A” because it is a flat prohibition on all covered transactions, regardless of the statutory quantitative and qualitative limits otherwise applicable under section 23A or any of the permitted activity exceptions.

Section 619 also imposes statutory “backstops” on all permitted activities. A banking entity may not engage in any activity expressly permitted by section 619 if the activity would involve or result in (1) a material conflict of interest between the banking entity and its customers; (2) a material exposure to a high-risk asset or trading strategy; (3) a threat to the safety and soundness of the banking entity; or (4) a threat to the financial stability of the United States. The statute directs the agencies to define the first two backstops concerning conflicts of interest and high-risk asset and trading strategy. Finally, section 619 directs the agencies to implement internal controls and recordkeeping requirements to ensure compliance with the statute.

Section 619 also contains three rules of construction. First, the prohibitions and restrictions under section 619 apply to all activities of a banking entity even if those activities are authorized under other statutory authorities. In other words, the restrictions and prohibitions of section 619 trump any statutory provision that may permit the activities in question. Second, nothing in section 619 can be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law. This provision presents various issues regarding its scope that were flagged in questions contained in the preamble to the Proposal. Third, nothing in section 619 can be construed to limit the inherent authority of any Federal or state agency under applicable law.

Section 619 becomes effective on July 21, 2012, even without a final rule. In such a case, covered banking entities would be required to comply with the statutory provisions. The statute provides a two year conformance period for banking entities to bring their existing activities and investments into compliance with section 619. Banking entities may request up to

three one-year extensions of this conformance period and another five-year extension to divest of certain illiquid funds as described in the Federal Reserve Board's conformance period rule.

The Proposal. The Proposal implements the complex statutory structure of section 619, including its prohibitions, restrictions, permitted activity exceptions, backstops, and rules of construction. The Proposal establishes requirements for engaging in statutorily permitted activities and interprets many of the exceptions narrowly, including, in particular, the exceptions for underwriting, market-making-related activities, and risk-mitigating hedging. The Proposal's approach for implementing these statutorily-permitted activities introduces a number of operational complexities because of the difficulties of trying to draw precise distinctions between permissible and prohibited activities.

An area that is particularly challenging and that had drawn much attention is how to distinguish permissible market-making-related activities from prohibited proprietary trading -- specifically how to distinguish whether a banking entity is taking principal risk to provide intermediation and liquidity services to customers or as part of a speculative proprietary trading strategy. The Proposal addresses this challenge through a multi-faceted approach consisting of (1) seven criteria that a banking entity's activities must meet to rely on the market-making exception, including establishment of a compliance program, (2) six principles that the agencies will use as a guide in distinguishing bona fide market-making from prohibited proprietary trading, and (3) seventeen quantitative metrics that a banking entity with significant trading activities must report for each of its trading units at every level of the organization.

In addition to the specific prohibitions and exceptions that relate to proprietary trading and covered fund activities, the Proposal also elaborates on two of the four statutory backstops:

the prohibitions on engaging in an activity that would involve or result in either a material conflict of interest between the banking entity and its customers, or in a material exposure by the banking entity to a high-risk asset or trading strategy. Banking entities with significant trading activities are required to report quantitative metrics designed to allow the agencies to evaluate the extent to which these activities expose the institution to high-risk assets or trading strategies.

The Proposal further requires banking entities engaged in any permitted proprietary trading or hedge fund or private equity fund activities or investments to develop and implement a compliance program that must address internal policies and procedures, internal controls, a management framework, independent testing, training, and record-keeping. The extent of these requirements escalates depending on the volume of the activity. Banking entities with significant trading or fund activities or investments must adopt a more detailed compliance program. Banking entities that do not engage in any proprietary trading or hedge or private equity fund activities or investments must put in place policies and procedures that are designed to prevent them from becoming engaged in those activities.

Many have noted that the Proposal contains an unusually large number of questions. This reflects the complexity of the issues involved and the agencies' desire to gain maximum information about the practical operational impact of various implementation alternatives. Without such feedback on the practical impact of the requirements contained in the Proposal, the effects of the Volcker rule on the financial sector and the economy as a whole are difficult to estimate. While the number of questions may seem daunting, they were driven by the agencies' desire to understand what may be quite complex and significant consequences of the Proposal.

As the regulator of many of the banks that will be most affected by the Volcker Rule, the OCC is particularly concerned with how to strike the right balance in identifying and preventing impermissible activities without undermining activities that are safe, sound and profitable and help to reduce a bank's overall risk profile. We also recognize the compliance burdens on banking entities of all sizes arising from the Proposal and therefore will be interested in whether comparably effective compliance results could be achieved through less burdensome approaches.

To date, the OCC has completed an assessment of the impact of the Proposal on OCC-regulated entities under the Unfunded Mandates Reform Act² and the Regulatory Flexibility Act.³ In doing so, OCC economists considered the impact of any mandates imposed by the Proposal on expenditures by the private sector or state, local and tribal governments and its impact on small entities. In particular, we focused on mandates contained in the compliance, recordkeeping, reporting, disclosure, and training requirements of the Proposal. OCC economists ultimately concluded that the Proposal does not contain any mandates, beyond those required by statute, that would result in *expenditures* by *OCC-regulated entities* of over \$100 million in any one year.⁴

Nevertheless, the Proposal solicits extensive comments on the full economic impact of the Proposal, including its impact on market-making and liquidity, costs of borrowing by

² The Unfunded Mandates Reform Act, Pub. L. No. 104-4 (codified at 2 U.S.C. 1532) generally requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in any Federal mandates, beyond those required by statute, that would result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in any one year.

³ The Regulatory Flexibility Act, Pub. L. No. 96-354 (codified at 5 U.S.C. 601) generally requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities. A banking entity is generally considered a small entity for purposes of the Regulatory Flexibility Act if it, together with its domestic and foreign affiliates, has assets less than or equal to \$175 million.

⁴ Consistent with the scope of our obligations under the Unfunded Mandates Act, our impact assessment of the Proposal did not take into account (1) costs of mandates specifically required by statute, (2) costs to the banking industry or to the economy as a whole, or (3) costs to banking entities not regulated by the OCC.

businesses and consumers, and the prices of financial assets. We strongly encourage comments on these issues and hope that the extended comment period will facilitate thoughtful and robust responses from commenters.

The letter of invitation also solicits our views on whether the Proposal places U.S. banking entities at a competitive disadvantage. The Proposal will have a competitive impact but the competitive consequences are the result of provisions of the statute that reflect certain policy choices that differ from approaches that have been adopted in other countries. Section 619 prohibits any banking entity, which includes a U.S. banking entity and a foreign bank with certain U.S. operations,⁵ from engaging in proprietary trading and from making investments in or sponsoring a hedge fund or private equity fund unless an exception applies. Under the statute, these prohibitions apply on a global basis to any covered banking entity. Foreign jurisdictions have not adopted restrictions resembling those in the Volcker Rule. So a foreign bank that is not subject to section 619 because it does not have the requisite U.S. banking operations will remain unaffected by the Volcker Rule. Accordingly, U.S. banks competing with these foreign banks will operate at a competitive disadvantage.

Section 619 creates a limited exception for certain overseas activities of qualifying foreign banking entities that are subject to the Volcker Rule. Specifically, section 619 permits a qualifying foreign banking entity to engage in prohibited proprietary trading and hedge fund and private equity fund activities and investments “solely outside of the United States.” This exception, by its terms, is not available to any banking entity that is controlled by a U.S. banking entity. This means that a qualifying foreign banking entity subject to section 619 may continue

⁵ Section 619 applies to any foreign bank that “is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978.”

to engage in prohibited activities solely outside of the United States, subject to regulation by its respective home country supervisors, while a U.S. banking entity may do so only in reliance on another statutory permitted activity exception, such as in connection with its market-making-related activities, underwriting or risk-mitigating hedging.

I note, however, that while a foreign banking entity that is covered by the Volcker Rule may avail itself of the statutory exception for activities occurring solely outside of the United States, the statutory backstops under section 619 continue to apply to such overseas activities. In addition, the Proposal imposes compliance program and reporting requirements on all banking entities engaging in activities permitted under section 619, including on foreign banking entities covered by the Volcker Rule engaged in activities occurring solely outside of the United States.

We welcome comments on the impact of the Proposal on the competitiveness of U.S. banking entities and how the statutory requirements could be interpreted differently.

Conclusion

I appreciate the opportunity to update the Committee on the work we have done to implement the Volcker Rule. This is a complex rulemaking and very much a work in progress. We appreciate the Committee's concerns and will certainly keep the Committee advised of the status of this rulemaking effort. I am happy to answer your questions.