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STATEMENT OF

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on

"EXAMINING THE IMPACT OF THE VOLCKER RULE ON MARKETS, BUSINESSES, INVESTORS AND JOB CREATION"

before the

SUBCOMMITTEE ON CAPITAL MARKETS AND GSES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS & CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
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Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the Subcommittees, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) on the proposed regulations to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), also known as "the Volcker Rule."

Last November, the FDIC, jointly with the Federal Reserve Board of Governors (FRB), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC), published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the Volcker Rule requirements of the Dodd-Frank Act. On December 23, the four agencies extended the comment period for an additional 30 days until February 13, 2012. The comment period was extended as part of a coordinated interagency effort to allow interested persons more time to analyze the issues and prepare their comments, and to facilitate coordination of the rulemaking among the responsible agencies. In addition, on January 11, 2012, the Commodity Futures Trading Commission (CFTC) approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text as the interagency NPR. We look forward to receiving comments on the NPR.

In recognition of the potential impacts that may arise from the proposed rule and its implementation, the Agencies have requested comments on whether the rule represents a balanced and effective approach in implementing the Volcker Rule or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities

to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets.

My testimony today will include a brief overview of the statutory provisions, a description of the rulemaking process undertaken by the Agencies, an overview of the proposed Volcker Rule, and a discussion of our efforts to identify the potential impact of the proposed rule.

Overview of the Volcker Rule Statutory Provisions

Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, either directly or indirectly, from the federal safety net provided by federal insurance on customer deposits or access to the Federal Reserve's discount window. Specifically, section 619 amends section 13 of the Bank Holding Company Act (BHC Act) to prohibit banking entities from engaging in proprietary trading activities and to limit the ability of banking entities to invest in, or have certain relationships with, hedge funds and private equity funds.

The challenge to regulators in implementing the Volcker Rule is to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets. In general terms, proprietary trading occurs when an entity places its own capital at risk to engage in the short-term buying and selling of securities primarily to profit from short-term price movements, or enters into derivative products for similar purposes.

While section 619 broadly prohibits proprietary trading, it provides several "permitted activities" that allow banking entities to continue to provide important financial intermediation services and to ensure robust and liquid capital markets. Most notably, section 619 allows banking entities to take principal risk, to the extent necessary to engage in bona fide market making and underwriting activities, risk-mitigating hedging, and trading activities on behalf of customers. Other permitted activities include trading in certain domestic government obligations; investments in small business investment companies and those that promote the public welfare; trading for the general account of insurance companies; organizing and offering a covered fund (including limited investments in such funds); foreign markets trading by non-U.S. banking entities; and foreign covered fund activities by non-U.S. banking entities.

To prevent banking organizations from engaging in otherwise prohibited proprietary trading through one or more of the permissible activity exemptions described above, section 619 provides at least three prudential safeguards. First, section 619 requires the federal banking agencies, the SEC, and the CFTC to issue regulations that may include restrictions or limitations on the permitted activities if appropriate. Second, section 619 states that no transaction, class of transactions, or activity may be a permitted activity if it would: involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. Third, section 619 contains anti-evasion provisions that, in part, require the Agencies to include internal controls and recordkeeping requirements as

part of their implementing regulations. In addition, the appropriate federal agency has the authority to order a banking entity to terminate any activity or dispose of any investment, after due notice and opportunity for hearing, if the agency has reasonable cause to believe that a banking entity has engaged in an activity or made an investment in a manner that functions as an evasion of the general prohibitions under section 619.

FSOC Study

Section 619 required the Financial Stability Oversight Council (FSOC) to study and make recommendations for implementation of the Volcker Rule within six months after the effective date of the Dodd-Frank Act. Staff from the FSOC member agencies, including FDIC staff, actively participated in the development of the study.

Prior to developing the study, the FSOC solicited public comment and recommendations on implementation through the issuance on October 6, 2010, in the *Federal Register*, of a notice and request for information (RFI).[1] In response to the RFI, the FSOC received more than 8,000 comments. Of the comments received, approximately 6,550 were substantially identical and supported robust implementation of the Volcker Rule. The remaining 1,450 comments were unique and provided the individual perspectives of banking organizations, trade associations, members of Congress and the general public. In addition, as part of the study, staff from the FSOC member agencies met with representatives from a variety of organizations with a broad spectrum of perspectives on the implementation of the Volcker Rule.

[1] 75 FR 61758 (October 6, 2010).

On January 18, 2011, the FSOC published its Volcker Rule study.[2] The FSOC study recommended that the Agencies' rulemaking and implementation efforts should be guided by five fundamental principles:

1. The regulations should prohibit improper proprietary trading activity using whatever combination of tools and methods are necessary to monitor and enforce compliance with the Volcker Rule.

2. The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate proprietary trading as new products and business practices emerge.

3. The regulations and supervision should be applied consistently across similar banking entities (e.g., large banks, hedge fund advisers, investment banks) and their affiliates. The regulations and supervision should endeavor to provide banking entities with clarity about criteria for designating a trading activity as impermissible proprietary trading.

4. The regulations and supervision should facilitate predictable evaluations of outcomes so Agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity.

5. The regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary, e.g., cash and derivatives markets.[3]

[2] Financial Stability Oversight Council, "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds," January 18, 2011, available at: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%2018%2011rg.pdf.

The FSOC study further recommended that the Agencies adopt a four-part implementation and supervisory framework consisting of (1) a programmatic compliance regime, (2) analysis and reporting of quantitative metrics, (3) supervisory review and oversight, and (4) enforcement procedures for violations.[4] The remainder of the study provided the Agencies with a variety of recommendations and considerations regarding the implementation of each provision contained in section 619 as well as an extensive listing and discussion of various quantitative metrics.

The Rulemaking Process

Consistent with the requirements of section 619 of the Dodd-Frank Act, the FDIC participated in a coordinated interagency rulemaking effort with the FRB, the OCC, the SEC, and the CFTC. This mandated rulemaking effort was coordinated by staff from the Department of the Treasury, representing the Chairperson of the FSOC.

As part of this rulemaking effort, agency staffs carefully considered the recommendations of the FSOC study and separately reviewed and analyzed the public comments received on the study. In addition, agency staffs met with a variety of banking organizations and other interested parties to listen to their views regarding the FSOC study, including concerns and recommendations related to the study's proposed implementation framework and quantitative metrics.

In formulating the proposed rule, the Agencies have tried to carry out the statutory mandate to prevent banking entities from engaging in prohibited proprietary trading and

[3] Id *at* 4.
[4] Id. *at* 5.

the statutory restrictions on the extent to which a banking entity may sponsor or invest in hedge funds or private equity funds. The Agencies have tried to implement the statutory restrictions in a way that ensures that permitted activities, such as providing essential client-oriented financial services and capital markets intermediation, continue in a manner consistent with statutory intent. However, given the complexities and challenges surrounding proprietary trading and hedge fund and private equity fund activities, the Agencies have requested comment on the potential economic impacts that may arise from the proposed rule and its implementation.

As mentioned earlier, on November 7, 2011, the FDIC, together with the FRB, the OCC, and the SEC, published a notice of proposed rulemaking (NPR) to implement the provisions of section 619 with a public comment period ending on January 13, 2012.[5] On January 3, 2012, the Agencies extended the comment period on the NPR until February 13, 2012.[6] Further, on January 11, 2012, the CFTC approved its notice of proposed rulemaking to implement the Volcker Rule, with a substantially identical proposed rule text as the interagency NPR.

In accordance with the statute, the provisions of the Volcker Rule will become effective on July 21, 2012. The statute provides a two-year period for a covered entity to bring its activities and investments into compliance.

Overview of the Proposed Rule

The NPR's proposed rule contains three main elements related to (1) proprietary trading restrictions, (2) covered funds and activities related to hedge funds or private

[5] 76 FR 68846 (November 7, 2011).
[6] 77 FR 23 (January 3, 2012).

equity funds, and (3) compliance and data reporting. Below is a brief description of each element.

Proprietary Trading Restrictions

The proposed rule describes the scope of the prohibition on proprietary trading and defines a number of terms related to proprietary trading, subject to certain exemptions. In general, a banking entity is prohibited from engaging in proprietary trading unless an activity is specifically permitted under the exemptions.

The proposed rule defines a number of key terms, including "proprietary trading" and "trading account" that define activities and financial products subject to the prohibition on proprietary trading. Proprietary trading is defined as engaging as principal for the trading account of a banking entity in any transaction to purchase or sell certain types of financial positions. The term "trading account" then delineates which positions will be considered to have been taken principally for the purpose of short-term resale or benefiting from actual or expected short-term price movements, which ultimately defines the scope of accounts subject to the prohibition on proprietary trading.

As mentioned earlier, the statute includes certain exemptions. For example, the proposed rule articulates a number of requirements that must be met in order for a banking entity to rely on the underwriting and market making-related exemptions. These requirements are designed to ensure that the activities, revenues and other characteristics of the banking entity's trading activities are consistent with underwriting and market making-related activities and not prohibited proprietary trading.

Other key statutory exemptions that are defined in the proposed rule include: (1) risk-mitigating hedging, (2) trading in certain government obligations, (3) trading on

behalf of customers, (4) trading by a regulated insurance company, and (5) trading by certain foreign banking entities outside the United States.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports to the relevant Agency regarding a variety of quantitative measurements related to their covered trading activities and maintain records documenting their preparation and content of these reports. These proposed reporting and recordkeeping requirements vary depending on the scope and size of covered trading activities. For instance, a banking entity must comply with the requirements of Appendix A of the proposed rule only if it has, together with its affiliates and subsidiaries, trading assets and liabilities greater than $1 billion. If its trading assets and liabilities are less than $5 billion, it would only be required to report for trading units that are engaged in market making-related activities. A banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities of $5 billion or more would be required to calculate a more complex series of quantitative measures and would be required to report them for all trading units with activities covered under the proposed rule. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The quantitative measurements required are designed to reflect characteristics of trading activities that appear to be particularly useful in differentiating permitted market-making-related activities from prohibited proprietary trading and in identifying whether trading activities result in a material exposure to high-risk assets and high-risk trading strategies. In addition, the proposed rule contains commentary to help banking entities

identify permitted market making activities and distinguish such activities from prohibited proprietary trading.

Finally, the proposed rule also prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Covered Fund Activities and Investments

Another element of the proposed rule is the statutory prohibition on acquiring and retaining an ownership interest in, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. In general, the proposed rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including "covered fund" and "ownership interest."

The proposed rule also includes several statutory exemptions. Some notable exemptions include:

- *Organizing and offering a covered fund.* This exemption is intended to allow a banking entity to continue to engage in certain traditional asset management and advisory businesses.
- *Investments in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a de minimis investment in the covered fund in compliance with applicable requirements.* Limitations, however,

are imposed regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments.

- *Certain risk-mitigating hedging investments.* These are allowed if the investments represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in the covered fund arising out of that transaction.
- *Investments in certain non-U.S. funds.* This activity is allowed if it occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) or 4(c)(13) of the BHC Act.
- *Any covered fund activity or investment that the Agencies determine promotes and protects the safety and soundness of banking entities and the financial stability of the United States.* The Agencies have proposed to permit three activities at this time under this authority: (i) acquiring and retaining an ownership interest in, or acting as sponsor to, certain bank owned life insurance separate accounts, (ii) investments in and sponsoring of certain asset-backed securitizations, and (iii) investments in and sponsoring of certain entities that rely on the exclusion from the definition of investment company in section 3(c)(1) and/or 3(c)(7) of the Investment Company Act of 1940 that are common corporate organizational vehicles.

Compliance Program Requirements

While most proprietary trading has been conducted by the largest bank holding companies, the FDIC and the other agencies have carefully considered and taken into account the potential impact of the proposed rule on small banking entities and banking

entities that engage in little or no covered trading activities or covered fund activities and investments. Accordingly, the Agencies have proposed to limit the application of certain requirements, such as reporting and recordkeeping requirements and compliance program requirements, for those banking entities that engage in less than $1 billion of covered trading activities or covered fund activities and investments. Further, the Agencies have also requested comment on a number of questions related to the impact associated with particular aspects of the proposal, as well as on any significant alternatives that would minimize the impact of the proposal on smaller banking entities.

For a banking entity with significant covered trading activities or covered fund activities and investments, the compliance program must meet a number of minimum standards that are specified in the proposed rule. The application of detailed minimum standards for these types of banking entities is intended to reflect the heightened compliance risks of large covered trading activities and covered fund activities and investments and to provide clear, specific guidance to such banking entities regarding the compliance measures that would be required for purposes of the proposed rule. These types of banking entities must, at a minimum, establish, maintain, and enforce an effective compliance program, consisting of written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping, that:

- Is designed to clearly document, describe, and monitor the covered trading and covered fund activities or investments and the risks of the covered banking entity related to such activities or investments, identify potential areas of

noncompliance, and prevent activities or investments prohibited by section 13 of the BHC Act as amended by the Volcker Rule;

- Specifically addresses the varying nature of activities or investments conducted by different units of the covered banking entity's organization;
- Subjects the effectiveness of the compliance program to independent review and testing;
- Makes senior management and intermediate managers accountable for the effective implementation of the compliance program, and ensures that the board of directors and CEO review the effectiveness of the program; and
- Facilitates supervision and examination of the covered banking entity's covered trading and covered fund activities or investments by the Agencies.

However, for banking entities with less than $1 billion in covered trading activities or covered fund activities and investments, these minimum standards are not applicable, although the Agencies expect that such entities will consider these minimum standards as guidance in designing an appropriate compliance program.

Regulatory Impact

Overall, the Agencies seek to develop a proposed rule that would impose the lowest cost, while achieving the statutory requirements of section 619. For example, when developing the proposed provision that the sale of securities outside of a banking entity's trading book would be presumed a proprietary trade if the sale occurred within 60 days of the purchase of the security, the Agencies carefully considered instances where

banking entities frequently and legitimately dispose of securities within that timeframe. As a result, the Agencies excluded bona fide liquidity management activities, securities borrowing and lending activities, and repurchase agreements from this "rebuttable presumption" requirement. By doing so, the Agencies greatly reduced the burden associated with the basic definition of "proprietary trading." However, the Agencies did not ignore the potential that prohibited proprietary trading could occur in these activities. Rather, the Agencies chose to impose conditions for purposes of the definition of key terms, such as liquidity management, and to ensure that the banking entities' compliance framework monitored for prohibited proprietary trading. Therefore, banking organizations would not be required to explain on a transaction-by-transaction basis why buying and selling securities to manage their liquidity to meet their near-term funding needs is not prohibited proprietary trading.

In addition, the Agencies have recognized that there are economic impacts that may arise from the proposed rule and its implementation. Therefore, we have requested public comment on several questions on this issue. Some examples of the types of economic impact questions that the Agencies have requested comment on relate to: the services or products that banks offer to clients, customers, or counterparties; operational costs or benefits; benefits and costs associated with the underwriting exemption; material conflicts of interest; costs associated with compliance; and recordkeeping requirements.

The Agencies have also requested comments on whether the proposed rule represents a balanced and effective approach to implementing the Volcker Rule or whether alternative approaches exist that would provide greater benefits or involve fewer costs. Moreover, the Agencies have encouraged commenters to provide quantitative

information with respect to the proposed rule's compliance costs and benefits and effect on competition, and any other economic impact.

In terms of the proposed rule's impact on banking entities, compliance costs are likely to be higher for those banking entities that are significantly engaged in covered trading activities or investments. But as mentioned earlier, the proposed rule takes into consideration the size, scope, and complexity of a banking entity's covered activities and investments in developing the compliance program requirements. Accordingly, entities with less than $1 billion in covered trading activities or covered fund activities and investments would be subjected to greatly reduced compliance requirements.

In accordance with the Paperwork Reduction Act, the Agencies have made initial estimates of the paperwork burden of the proposed rule on entities affected by the rule. In developing the final rule, the Agencies will take into account all comments received on the paperwork burden estimates. Once the final rule is ready for publication, the FRB will submit to the Office of Management and Budget information on the burden for all of the Agencies' supervised institutions, including the FDIC.

The Agencies have also taken an initial look at the potential economic impact on small banking entities as required under the Regulatory Flexibility Act and concluded that the proposed rule will not result in a significant economic impact on small banks. The Agencies based this conclusion on two primary factors: (1) while the proposed rule, per statutory requirements, covers all banking entities, significant reporting and recordkeeping requirements apply only to banking entities with trading assets and liabilities and aggregate covered fund investments greater than $1 billion, respectively; and (2) the compliance program requirements under the proposed rule are established in a

manner that mainly impact entities engaged in covered trading or fund activities – activities that are not typical of small banks. Nevertheless, the Agencies have encouraged public comments on this issue and have asked commenters to include empirical data to illustrate and support the potential impact on small banks.

The FDIC is subject to the Small Business Regulatory Enforcement Fairness Act of 1996, which, among other things, requires agencies to submit to Congress for review rules which have been determined to be "major" under the Act. A rule is considered to be "major" if it results in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment, or innovation. The FDIC will complete this analysis in the final rulemaking in part based on the responses to the questions raised in the NPR.

Conclusion

The proposed rule is intended to carry out the statutory requirements to prohibit proprietary trading and establish prudent limitations on interest in, and relationships with, hedge funds and private equity funds consistent with section 619 of the Dodd-Frank Act. The proposed rule is intended to allow banking entities to continue to engage in permitted activities, including bona fide market making and underwriting activities, risk-mitigating hedging, trading activities on behalf of customers, and investments in covered funds consistent with the statutory mandates. As such, the intended goal of the proposed rule is to allow banking organizations to continue to provide important financial intermediation services and to facilitate robust and liquid capital markets.

Further, the FDIC and its fellow Agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation and therefore, we have specifically requested public comment and information on this issue. The Agencies will analyze the potential impact of the rule based on the comments received through the Notice of Proposed Rulemaking, and work to minimize the burden on the industry and the public while meeting the statutory requirements set by Congress. This approach is consistent with our longstanding policy of ensuring that our regulations will meet the requirements and objectives of the statute while minimizing the costs to the industry and the public.

We look forward to comments on the NPR and will carefully consider them in finalizing the rule.