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Reporting Rules Could Close Volcker Loopholes: Attys

By **Evan Weinberger**

Law360, New York (October 11, 2011, 12:40 PM ET) -- Despite including several exemptions, reporting requirements in the hotly anticipated proposal to restrict banks' proprietary trading activities will make it difficult for banks to fully get around the new rules, attorneys say.

The Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. on Tuesday put out for comment a proposal for the so-called Volcker rule, named after former Fed Chairman Paul A. Volcker, who championed the restriction on proprietary trading by systemically important banks.

The intent of the rule, a key part of the Dodd-Frank Wall Street Reform and Consumer Protection Act passed in July 2010, is to limit the potential damage big banks could do to the broader U.S. economy and global financial system as some trading activities move overseas.

"After two studies, and countless hours of work, regulators have today proposed a rule that is designed to implement these important protections for depositors, taxpayers and the economy," said Sens. Carl Levin, D-Mich., and Jeff Merkley, D-Ore., who put the rule into Dodd-Frank.

Under the proposed rule, bank holding companies and their subsidiaries would be barred 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.

"It is strong enough that it eliminated the proprietary trading desks of most of the big banks," said Michael Greenberger, a former U.S. Commodity Futures Trading Commission division director and advocate of tight financial regulations now teaching at the University of Maryland School of Law. "That is not by any means the be all and end all, but it is not insignificant."

Following the passage of Dodd-Frank, several major investment banks, including Goldman Sachs Group Inc. and Bank of America Corp., sold off hedge funds and prop trading desks.

But some say exemptions built into the proposed Volcker rule could have the effect of watering it down.

In particular, some financial reform advocates wanted the rule to allow banks to justify hedges against risks on individual trades as a way to guard against proprietary trades and potential conflicts of interest. But the proposal unveiled Tuesday allows banks to hedge against risks to a broad portfolio of its investments.

That is a potential loophole that "you could drive a truck through," Greenberger said.

The rule also allows for some exemptions related to market-making activities, where banks will facilitate a trade for a client by arranging for the purchase and sales of securities held by other customers. Market-making has been a traditional part of investment banks' services for customers, but critics say that too often it was used to hide steep conflicts of interest.

But the line between market-making activities, hedging and proprietary trading was blurred prior to the 2008 financial crisis, to the point that they were sometimes indistinguishable, said Marcus Stanley, the policy director at Americans for Financial Reform.

Under the proposed Volcker rule, banks would only have to prove that they faced a "reasonable" risk on a trade to justify a hedging transaction, and could be granted an exemption if they claimed they were "highly likely" to face a risk to their trading books.

Allowing a broad market-making exemption could blunt the regulation's effectiveness, Stanley said.

"Instead of erring toward making the prohibited behavior narrow and the exemptions broad, you have to go in the other direction," Stanley said.

But the rule also comes with hefty reporting requirements, and that could keep banks from taking advantage of the market-making and portfolio trading exemptions, said Satish Kini, co-chair of Debevoise & Plimpton LLP's banking and financial institutions practice.

"There's going to have to be a tremendous amount of effort to meet the required tests to prove they are not engaged in prohibited proprietary trading," he said.

Banks will have to set up robust internal compliance programs and provide regulators with as many as 22 different metrics each day to prove that trades were not done to enhance the bank's short-term gain. Specifically, banks will have to prove that their revenues came from the fees collected for their services, rather than the floating value of its securities, he said.

The American Bankers Association on Tuesday said banks would have to devote 6.6 million hours to comply with the rule, and that more than 3,000 bankers would be transferred over to deal with compliance issues.

In addition, the Volcker rule applies to any trade made by a foreign bank that in some way touches the United States, so it will have sweeping reach, which supporters trumpet and critics fear will reduce the U.S.' role as a financial center.

A Monday report from Moody's Investors Service Inc. analyzing a version of the rule that leaked to the press on Thursday described the proposed Volcker rule, with its complex rules for allowable hedging and market-making, as a negative for U.S. banks and their bondholders.

"The compliance burden appears high, and the risk-reduction achieved is marginal at best, especially in the context of heightened capital and liquidity requirements already mandated by Dodd-Frank," Moody's said.

But the version of the Volcker rule proposed Tuesday was filled with 315 questions regulators posed to industry participants, advocates for financial reform and other potential commenters, so it was far from a finished product.

"This is an art, not a science," said Steve Bloom, a partner with Frandzel Robins Bloom & Csato

LC.

The U.S. Securities and Exchange Commission and the CFTC have yet to vote on the proposal, and could have slightly different versions than the proposed rule introduced Tuesday.

While some proponents of strict financial regulations are concerned that the rule will be watered down once it finally comes into effect, it is just a part of the overall changes to the banking landscape the industry is currently undergoing, both Greenberger and Kini said.

Previously unregulated over-the-counter derivatives will now be regulated, although those details are still being hammered out. That will bring significant transparency and safety to the multitrillion-dollar market, Greenberger said.

The Consumer Financial Protection Bureau is now active, and changing the way banks interact with their customers, Kini said.

The Basel III accords, still being drafted by an international banking panel, will likely hike bank capital requirements significantly and add what advocates hope is a degree of safety to banks, although JPMorgan Chase & Co. Chairman and CEO Jamie Dimon called those particular rules “anti-American.”

“You can see why people like Jamie Dimon are very upset,” Greenberger said. “We’re looking at an entirely new banking structure.”

--Editing by Anne Urda and John Williams.

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