A COUNTERPRODUCTIVE CONSTRAINT: HOW THE VOLCKER RULE UNDERMINES ITS PURPOSE BY DISCOURAGING HEDGING

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I. INTRODUCTION

The Volcker Rule was designed to prevent banks from engaging in proprietary trading, which is investing for their own direct gain as opposed to earning commissions by trading on behalf of clients. The purpose is to insulate banks from the risks of proprietary trading. In theory, proprietary trading is distinct from hedging, a practice that reduces risk. However, there is no clear distinction between proprietary trading and hedging in practice. Classification largely depends on how a bank packages a transaction. Thus, it is unlikely that regulators could enforce the ban on proprietary trading while leaving hedging unscathed. By deterring hedging, regulators undermine the purpose of the Volcker Rule: to reduce banks' exposure to risk. Yet, if regulators under-enforce the ban to encourage hedging, they will essentially fail to deter any proprietary trading. Banks will be able to artfully package their trading activity into compliance, with the Volcker Rule operating like a tax to be collected by bank lawyers.

II. BACKGROUND

The Volcker Rule is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] It prohibits banks from engaging in proprietary trading.[2] The five agencies charged with implementing the Volcker Rule are the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the Securities and Exchange Commission.[3] It was introduced in 2010, went into effect on April 1, 2014, and was fully implemented on July 21, 2015.[4]

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1620 (2010) (codified at 12 U.S.C. § 1851 (2012)); *see also* 12 C.F.R. §§ 44, 248, 351 (2015); 17 C.F.R. §§ 75, 255 (2015).
2. Dodd-Frank § 619; 12 U.S.C. § 1851; 17 C.F.R. § 75.
3. Dodd-Frank § 619; 12 U.S.C. § 1851(b)(2)(B)(i); 12 C.F.R. §§ 44, 248, 351, 255.
4. Vinita Tandon, *The Volcker Rule: Clarifying the Anti-Evasion Provision to Facilitate Compliance*, 20 N.C. BANKING INST. 385, 386 (March 2016) (internal citations omitted).

The Volcker Rule includes limited exceptions to the proprietary trading ban.[5] Proprietary trading is permitted in conjunction with risk-mitigating hedging, underwriting, market making, trading in domestic government debt, trading on behalf of customers, and trading by insurance companies.[6] Yet, these exceptions are harshly circumscribed by overriding limitations known as the "Prudential Backstops."[7] The Prudential Backstops prohibit trading that would otherwise be permitted under the exceptions where it would result in "a material conflict of interest" or "material exposure" to a "high-risk asset or high-risk trading strategy."[8] The Prudential Backstops also prohibit trading that threatens the "safety and soundness" of a bank or the "financial stability of the United States."[9] Therefore, the Prudential Backstops enable regulators to scrutinize trading activity that even they themselves would label as falling into a permitted category.

The Volcker Rule also contains an Anti-Evasion Provision, which authorizes regulators to intervene when there is "reasonable cause to believe" that a bank has engaged in activity that "functions as an evasion of the requirements."[10] Accordingly, regulators may order banks to terminate any activity, or dispose of any assets that functionally violate the Volcker Rule.[11] Reasonable cause is not a high bar for enforcement, and it appears no level of intent is required.[12] Thus, the Volcker Rule gives regulators layers of exceedingly broad discretion in distinguishing prohibited trading from permitted trading.

This broad discretion is concerning particularly in the context of hedging. Hedging is the practice of making an investment to reduce the risk of adverse price movements in an asset.[13] Normally, a hedge consists of taking an offsetting position in a related security. Put simply, hedging is taking out an investment to limit the risk of another investment. But, in practice, there is no principled way to clearly distinguish between permitted hedging and prohibited proprietary trading.[14] For example, some trades may start as hedges, but evolve to

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5. *Id.*; *see also* Dodd-Frank § 619; 12 U.S.C. § 1851(d)(1).
6. Tandon, *supra* note 4 at 386–87.
7. *Id.* (internal citations omitted).
8. *Id.* (citing Dodd-Frank § 619; 12 U.S.C. § 1851(d)(2)(A)).
9. *Id.*
10. Dodd-Frank § 619; 12 U.S.C. § 1851(e)(2).
11. *Id.*
12. *See* Tandon, *supra* note 4, at 389.
13. Carey K. Morewedge et. al, *Betting Your Favorite to Win: Costly Reluctance to Hedge Desired Outcomes*, MGMT. SCI., Oct. 12, 2016, http://dx.doi.org/10.1287/mnsc.2016.2656.
14. *See, e.g.*, Randolph Walerius, *JP Morgan Chase's documentation of hedging may go far in answering Volcker rule question*, CQ ROLL CALL, Mar. 18, 2013 *see also* R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders It*

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look more like proprietary trades.[15] It does not seem that regulators can enforce the ban on proprietary trading while leaving hedging unscathed.[16] Similarly, bank executives, even those at the top banks, may not be able to distinguish when and if a hedging strategy crosses over into proprietary trading.[17] The uncertainty of what constitutes a violation under the Volcker Rule is a serious concern, because engaging in hedging is important for banks to reduce their risk exposure.[18]

III. ANALYSIS

The Volcker Rule does not do what it was designed to do. It was designed to insulate banks from risk, specifically the risks associated with proprietary trading. In theory, proprietary trading is distinct from hedging, which is important because hedging itself insulates banks from risk. Yet, there is no clear distinction between proprietary trading and hedging. Which label applies depends largely on how a bank packages a transaction. Unsurprisingly, bank lawyers have an aptitude for packaging transactions to circumvent regulations.[19]

Regulators can exercise their discretion by enforcing the proprietary trading ban either narrowly or broadly: but this choice is a catch-22. Broadly limiting the transactions is problematic because it would reduce hedging. If hedging might be construed as prohibited proprietary trading, banks will be more hesitant to hedge. If banks hedge less, they are fully exposed to the risks that hedging mitigates. Banks being exposed to more risk undermines the purpose of the Volcker Rule. Yet, narrowly limiting these transactions is not much better. If regulators limit them too narrowly, they will end up prohibiting very little proprietary trading. Banks will incur costs as they pay their lawyers to ensure compliance, but those lawyers will be able to package all of the banks' transactions so they comply with the rules. So banks could continue to make all the risky bets they want, and compliance costs would merely operate like a tax—with the money going to compliance and securities lawyers rather than the government.

Ineffective & A New Solution Is Needed to Adequately Regulate Proprietary Trading, 8 BYU INT'L L. & MGMT. REV. 33, 47 (2011).

15. Walerius, *supra* note 14, *see also* Chatterjee, *supra* note 14, at 47.

16. *See id.*; *see also* Tandon, *supra* note 4, at 387–89.

17. *See* Walerius, *supra* note 14.

18. *See* Hayne E. Leland, *Agency Costs, Risk Management, & Capital Structure*, 53(4) J. OF FIN. 1232–33 (1998).

19. *See* Matthew Goldstein & Ben Protess, *Near a Vote, Volcker Rule Is Weathering New Attacks*, N.Y. TIMES, Dec. 8, 2013.

V. CONCLUSION

The Volcker Rule's purported distinction between prohibited proprietary trading and permitted hedging is unfixed and unworkable. There is simply no overarching, principled way of distinguishing between the two types of activity. This lack of clarity discourages banks from hedging, thereby exposing them to increased risk—which undermines the very purpose of the Volcker Rule.