

September 21, 2017

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219

Re: Proprietary Trading and Certain Interests in and Relationships with Covered Funds
(Volcker Rule); Request for Public Input – OCC Docket ID OCC-2017-0014

Ladies and Gentlemen:

The American Bankers Association¹ (ABA) appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency (OCC) regarding the agency's Request for Information (RFI) on proposals for revising the regulations (Regulation) implementing section 13 of the Bank Holding Company Act (commonly known as the "Volcker Rule") in order to accomplish the statute's purposes better.² The OCC also is soliciting public comments on suggested improvements in the administration of the Regulation since "there is broad recognition that the [Regulation] should be improved both in design and in application."³ The OCC's objective in issuing the RFI is to gather additional and more specific information that could be used to support a re-examination of, and amendments to, the Regulation's requirements.⁴

We commend the OCC for proceeding with this review. For the reasons described in this letter, we are hopeful that the OCC's initiative will facilitate work with the other Agencies involved with Volcker Rule administration to revise the Regulation with respect to (i) the scope of the Regulation; (ii) the excessive vagueness and unfocused approach in the language regarding proprietary trading, covered funds, and affiliate transaction requirements; (iii) compliance obligations; and (iv) examination coordination, all of which we believe would significantly increase the efficacy of the Regulation by aligning it more closely with the objectives of the statute, in the process removing unnecessary obstacles to economic growth.

¹ The American Bankers Association is the voice of the nation's \$17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits, and extend more than \$9 trillion in loans. Learn more at www.aba.com.

² See 12 U.S.C. § 1851. Each of the five federal financial agencies charged with administering the Volcker Rule has incorporated the Regulation into its respective rules. See 12 C.F.R. Part 44 (OCC); 12 C.F.R. Part 248 (Board of Governors of the Federal Reserve System) (Federal Reserve); 12 C.F.R. Part 351 (Federal Deposit Insurance Corporation) (FDIC); 17 C.F.R. Part 75 (Commodity Futures Trading Commission) (CFTC); and 17 C.F.R. Part 255 (Securities and Exchange Commission) (SEC) (collectively, Agencies).

³ Department of the Treasury, Office of the Comptroller of the Currency, Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Input, 82 *Fed. Reg.* 36,692 (2017).

⁴ *Id.*

I. Background: The Compliance Challenge.

Since its enactment, the Volcker Rule has posed an on-going, significant challenge both to regulators and to banking entities (*i.e.*, banks and their affiliates). The Agencies have attempted to implement the Volcker Rule's prohibitions by banning any banking entity's trading and covered fund investment activities that might possibly be considered *proprietary* – regardless of their value to the entity or to its customers or to the economy – rather than specifically defining and prohibiting those trading and fund activities that were clearly the object and intent of the Volcker Rule's systemic risk concerns. Many of the Regulation's requirements beg the question as to why they are applied to the activities to be regulated, providing insufficient operational clarity or policy direction on compliance requirements. Activities which should be permitted, and which therefore should *not* be implicated under the Volcker Rule, instead must be threaded through the complex weave of regulatory constraints and conditions. Not only does this drive up compliance costs for banks, but also it limits their ability to engage in safe and sound asset liability management (ALM) practices and other risk-mitigating activities. It further compels banks to reduce the available products and services upon which their customers have come to rely, in order to avoid triggering possible application of the Regulation.

II. Evidence Shows that the Regulation Is Harming Banks and Their Customers.

Rather than reducing systemic risk, the Volcker Rule has impeded the efficient operation of the financial system, driving banks away from providing services valued by their customers, reducing competition in affected markets, and overall acting as a drag on the economy. We have further described the consequences of the Regulation's overreach to Treasury in our recent white paper on the Volcker Rule (attached to this letter).⁵ Among the mounting evidence of the negative impact on banks of all sizes – including the nation's community and midsize banks to which the Volcker Rule was not intended even to apply – are the following examples of foregone business prospects and opportunities to serve bank customers and communities.

Proprietary Trading

- *Permissible trading activities.* Banks have had to curtail their lawful market-making due to concerns about possibly tripping the subjective line on proprietary trading.
- *Permissible investment securities activities.* Banks have eschewed purchasing for ALM purposes available-for-sale securities that are close to maturity, or purchasing short-term securities, or making risk management-driven adjustments to their available-for-sale securities portfolios, in order to avoid triggering the Rule's 60-day presumption associated with short-term trading.

⁵ See American Bankers Association, *The Volcker Rule: Islands of Permission in a Sea of Prohibition* (April 2017). The ABA white paper's first recommendation is that, "The Volcker Rule should be repealed in its entirety," since "[p]roprietary trading and investment activity did not cause the financial crisis of 2008, and a ban on these activities does not promote bank safety and soundness." *Id.* The white paper, however, states further that "[u]ntil such repeal is enacted, the [Agencies] should mitigate the [Volcker] Rule's adverse effects on the economy and on bank customers by substantially amending the Volcker Rule regulations so that they are consistent with vibrant financial markets, tailored regulation, and with sound banking practices."

- *Permissible interest rate and foreign exchange risk management.* Banks avoid making even minor ministerial adjustments on derivatives hedging of the interest rate and foreign exchange risks of their balance sheet assets and liabilities, since that may trigger Volcker trading account status under the 60-day presumption.

Covered Fund Activity

- *Capital formation.* Banks have had to shutter investment programs and funds that support venture capital across the country, stifling investment in start-up and emerging growth companies, a financial segment that creates an average of three million jobs each year.
- *Banks as custodians.* Banks serving as custodians for covered funds offered to their customers have had to shift custody to outside providers as a result of the Volcker Rule's "Super 23A" provisions. Segregating fund functions and operations with third parties has disrupted customer relationships and increased operational risk and inefficiencies solely because of the potential for intraday or overnight overdrafts which the Volcker Rule prohibits.
- *Foundations and Community Reinvestment Act Investments.* Banks and their affiliates sponsor non-profit private foundations to provide programs for the public welfare, such as disaster relief, health and human services, financial literacy, and support for underserved communities. The covered fund restrictions, because they apply to these foundations, undermine long-term investment strategies in alternative assets, reducing investment returns and diminishing the amount of contributions the foundations can make to the public welfare. Even though there is a public welfare exception from the proprietary trading and covered fund investment requirements, there continues to be confusion as to whether a special purpose vehicle created to facilitate a public welfare investment (*e.g.*, low income housing tax credit) is a banking entity, which would then trigger a multitude of Volcker Rule compliance program obligations, furthering the chilling impact on the use of these vehicles.
- *Family office relationships; customized vehicles created for or by a client.* Banks have had to decline new business from wealth management customers, particularly from family office relationships, out of concern that certain pooled investment vehicles consisting of one or more unrelated families fall within the definition of "covered fund."
- *Financial innovation.* Banks have traditionally seeded separate accounts with a nominal amount of money as a means to test new investment strategies and develop a track record, since institutional investors require a performance history before investing. The proprietary trading prohibitions curtail seeding of new investment strategies, thereby unnecessarily inhibiting financial innovation that would support the launch of new fund products for the benefit of bank customers. It also puts banks at a competitive disadvantage to non-bank affiliated investment managers that are not so constrained by the Volcker Rule.

III. Proposed Revisions to Regulation.

We believe that the statutory language of the Volcker Rule provides the Agencies with the requisite authority to revise the Regulation so that it properly aligns with the intent and purpose of the statute. The following revisions, consistent with the statute and its intent, should mitigate the Regulation's adverse impact on the national economy, banks and their affiliates, and bank customers by restoring those traditional banking practices that do not pose a threat to the financial system.

A. Scope of Regulation.

Although the Volcker Rule applies to every bank regardless of size or activity, the Agencies have broad regulatory discretion to determine how to implement its requirements in a more focused manner.⁶ We recommend that the Agencies apply the Regulation's requirements only to those banking entities that meet the prevailing systemic risk standard, as defined by the Agencies under the Regulation (*e.g.*, by institution, products, or practices), refined by regulatory interpretation as necessary and appropriate. The Agencies further may permit all other banking entities to demonstrate compliance with the statute through the normal supervisory and examination process. This would streamline the compliance costs and mitigate unproductive diversion of bank resources. Any amendments should result in banks being treated consistently with their affiliates under the Regulation.

B. Proprietary Trading.

Banks would benefit from a more straightforward way of demonstrating when they are not engaged in proprietary trading as defined under the Volcker Rule. The Regulation should be revised to focus clearly and with certainty on the activity that the statute seeks to prohibit. Banks should not be placed in a position where they are compelled to defend permissible and economically useful hedging (for themselves and their customers), ALM, and market-making on behalf of all market participants. There are several revisions that would work toward achieving this objective.

First, consistent with the statute, the Regulation should be revised to define proprietary trading as stand-alone, speculative trading principally for the purpose of selling in the near term.⁷ This revision would change the rulemaking approach by focusing on what constitutes a prohibited trading activity, in contrast to the current overbroad, overreaching definition that inadvertently captures a range of permissible activities which then need to be pried loose from the definition, such as financial intermediation, risk management, and ALM activities. This would also make Volcker Rule regulation and supervision more consistent across the Agencies and require fewer quixotic and grinding undertakings seeking a five-agency consensus on what might be permissible.

⁶ *See, e.g.*, 12 U.S.C. § 1851(h)(2) (Agencies by rule jointly may define "hedge fund" and "private equity fund" for purposes of the Volcker Rule); 12 U.S.C. § 1851(g)(3) (Volcker Rule does not limit the inherent authority of the Agencies under otherwise applicable provisions of law); 12 U.S.C. § 1851(d)(1)(J) (notwithstanding the Volcker Rule's restrictions on proprietary trading and covered fund investments, Agencies can deem such activity permissible if permitted by law and if such activity promotes and protects the safety and soundness of the banking entity and U.S. financial stability).

⁷ *See* 12 U.S.C. § 1851(h)(6).

Second, the Agencies should eliminate the rebuttable presumption that financial positions held for fewer than sixty days constitutes proprietary trading. The rebuttable presumption is a result of the Regulation’s so-called “purpose test” in which a banking entity is required to determine whether a trade was made principally for the purpose of short-term resale, benefitting from actual or expected short-term price movement, realizing short-term arbitrage profits, or hedging such a position.⁸ As Treasury notes in its recent report on the Volcker Rule, the Regulation’s rebuttable presumption “effectively requires an inquiry into the trader’s intent at the time of the transaction, which introduces considerable complexity and subjectivity into the inquiry regarding whether transactions are permitted.”⁹ In calling for elimination of the rebuttable presumption, Treasury states that:

The 60-day presumption places the burden on firms to justify the permissibility of their trading, creating undue pressure on compliance programs and leading to excessive conservatism in firms’ trading activities.¹⁰

This is precisely what has been occurring throughout the banking industry since the Regulation became effective. As a result, the rebuttable presumption has undercut banks’ ability to serve customers, out of concern that such services would be deemed proprietary trading. Eliminating the rebuttable presumption would remove both the banks’ and the regulators’ guesswork on whether a particular trade is proprietary trading, clearing the way for banks to achieve compliance certainty and for the Agencies to apply regulatory requirements predictably, consistently, and in a measured fashion. Complementary to eliminating the rebuttable presumption, the Agencies further should establish a safe harbor for (i) securities that are held “available-for-sale” or “held-to-maturity,” (ii) derivative positions that are designated as accounting hedges under Financial Accounting Standards Board ASC 815 (*Derivatives and Hedging*), (iii) positions that receive banking book and not market risk rule capital treatment, and (iv) any positions held longer than 60 days. Such a safe harbor would provide banks and examiners with clear guidance that they could follow and apply, while maintaining the guardrails on prohibited proprietary trading.

A particularly odd and vexing result of the Volcker Rule is its adverse impact on asset liability management. Banking entities engage in this essential activity in order to manage liquidity, market, credit, foreign exchange, and interest rate risks prudently, which is subject to internal governance and monitoring and to regulatory scrutiny. ALM, in other words, *advances* rather than detracts from the Volcker Rule’s objective of reducing systemic risk and enhancing safety and soundness. The Regulation’s rebuttable presumption, however, interferes with a banking entity’s ability to contain risks through ALM and thereby compromises bank safety and soundness. Moreover, the current exceptions contained in the Regulation straightjacket the flexibility and latitude required to conduct ALM activity effectively. A tighter definition of proprietary trading, together with removal of the rebuttable presumption, would restore the level of ALM required to promote and protect a banking entity’s safety and soundness and the financial stability of the banking industry.

⁸ See Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* at 74 (June 2017) (Treasury Report). See also 12 C.F.R. § 248.3(b)(1)(i) (2017).

⁹ Treasury Report at 74.

¹⁰ *Id.*

Third, the Agencies should eliminate the concept of “substantial transfer of risk” under the rebuttable presumption when determining whether proprietary trading is involved, since this concept has been interpreted in a manner that impedes banks’ ability to manage prudently their balance sheet risks. In a number of cases, banks are reporting that one or more of the Agencies are concluding that a substantial transfer of risk occurs in certain transactions (*e.g.*, the execution of an interest rate swap within 60 days of when an investment security is first bought or debt is issued), even though the bank may be retaining other significant risks in connection with holding the security, such as credit risk, liquidity risk, and market risk. Similarly, when banks and their holding companies issue fixed-rate debt for funding purposes as opposed to floating-rate debt due to the traditional investor demand for fixed-rate securities in the corporate bond market, the financial institution often swaps, at the same time, these issuances against a pay-floating interest rate swap to match the interest rate dynamics of its floating rate assets. This interest rate risk posture is fundamentally identical to a bank issuing floating-rate debt at the outset, and we believe the banking entity should not be deemed to have “substantially transferred the risk” of the security or the debt instrument to the interest rate swap within 60 days. In these instances, proprietary trading should not be confused with genuine (and prudent) risk management practices.

Fourth, the Agencies should interpret the “reasonably expected near term demand” (RENTD) requirement of the statute as being satisfied by financial intermediation activities, such as market making and underwriting, that are conducted in accordance with each bank’s existing prudential framework.¹¹ In the alternative, a framework may be designed such that RENTD is only one of several factors, including the firm’s risk-tolerance statement and other prudential risk management processes, which inform the risk management function of the banking entity. This is another instance of banks being chased away from permissible activity at the expense of serving their clients, customers, and counterparties. Rather than ensuring that prohibited proprietary trading does not take place, the Regulation’s RENTD requirements simply layer additional regulation and costs on top of the existing – and already effective – capital and liquidity rules that apply to banks, while causing banks to turn away legitimate business as a result of RENTD’s self-manufactured limits.¹² Restricting RENTD’s application to genuine instances of proprietary trading will preserve a bank’s ability to serve its customers through market making and underwriting-related activities, while upholding the Agencies’ authority to examine a bank’s policies, procedures, and practices for Volcker Rule compliance.

Fifth, the Agencies should ensure that exclusions or safe harbors from proprietary trading are implemented in a fashion upon which banks may reasonably rely. For example, banks relying on the “liquidity management” exclusion to hold and trade high quality liquid assets in a bank’s securities portfolio (as required by the Liquidity Coverage Ratio) expect to be subjected to such an extensive Volcker Rule-related supervisory examination that often they are incited to forego

¹¹ See 12 U.S.C. § 1851(d)(1)(B).

¹² A particular flaw is that RENTD is not designed to function with customer-driven derivatives. Banks enter into derivatives with customers, and conduct related hedging for the purpose of meeting customer demand. The concept of “inventory” used in the Regulation to illuminate what is considered RENTD, as well as the requirement to “routinely stand[] ready” to quote and trade in market making instruments, are inapposite with respect to customer-driven derivatives transactions. Banks enter into these derivatives based on requests from customers, often as part of a lending or custody relationship (rather than as part of a larger dealing business), and thus do not accumulate an “inventory” of market making instruments in connection with meeting customer demand.

reliance on the exception, or seek to fit within a different exception, even though such activities should not be subject at all to the Volcker Rule. Consequently, banks find themselves in a position where they hold high quality liquid assets for liquidity purposes only, but nonetheless are subject to significant compliance burdens in order to satisfy the requirements of the Regulation.

C. Covered Funds.

The Regulation's definition of "covered fund" likewise is too broad and captures a number of funds that were not intended to be covered under the Volcker Rule. It is important to keep in mind that the covered fund prohibition was enacted so that banking entities could not evade *indirectly* the prohibition on proprietary trading through the establishment and management of funds engaged in that activity. As with proprietary trading, therefore, the Regulation should be revised to *focus clearly and with certainty* on the activity that the statute seeks to prohibit, namely, engaging primarily in stand-alone, short-term proprietary trading. The following revisions would work together to help achieve this objective.

First, the definition of "covered fund" should be limited expressly to those Section 3(c)(1) and Section 3(c)(7) funds¹³ that are engaged primarily in short-term proprietary trading. This would align the definition with the statute's intent while excluding those funds that rely on those Investment Company Act exemptions but do not engage in the activity that the Volcker Rule is aimed at proscribing. The tightened, targeted definition then would allow banks to establish and/or support the funds that are not the object of the Volcker Rule's prohibitions (such as venture capital funds and funds with seeding investment strategies) and that do not raise the risks that the Volcker Rule is intended to address.

Second, the exclusions from "covered fund" currently found in the Regulation should be preserved and revised in order to identify further those funds that should not be treated as covered funds. Examples include venture capital funds, foreign retail and public funds, debt securitizations, public welfare investment entities and foundations,¹⁴ and wealth management vehicles (such as family wealth, tax, or succession planning and single-investor investment vehicles). These vehicles typically rely on section 3(c)(1) or section 3(c)(7) of the Investment Company Act in order to avoid being classified as an investment company, but should not be penalized simply for relying on a federal securities law exemption unrelated to the Volcker Rule.

Third, the Regulation's definition of "ownership interest" should be narrowed substantially in order to mitigate the regulatory uncertainty caused by its broad reach. The statute does not contemplate any expansion of the term "ownership interest" outside the ordinary understanding of the term. Inclusion of the phrase "other similar interests" within the term under the Regulation serves only to confuse and to generate uncertainty as to which situations, beyond holding equity shares or interests, would constitute "ownership interest." Therefore, the

¹³ That is, investment funds that rely on the exemptive provisions of section 3(c)(1) or section 3(c)(7) of the Investment Company Act of 1940, as amended (Investment Company Act). *See* 15 U.S.C. § 80a-1 *et seq.*

¹⁴ Such fund vehicles are used to provide programs for various areas of public welfare beyond the Regulation's narrowly drawn covered fund exception, including disaster relief, education, financial literacy, and supporting underserved communities.

definition should apply only to equity or equity-like interests that are widely understood to indicate a *bona fide* ownership interest in a covered fund.

D. Super 23A.

The Volcker Rule’s so-called “Super 23A” provision prohibits a banking entity from entering into any transaction with certain related hedge funds and private equity funds if the transaction would be a “covered transaction” as defined under Section 23A of the Federal Reserve Act.¹⁵ The Volcker Rule does not define the phrase “covered transaction.” Section 23A(d) and the Federal Reserve’s implementing Regulation W, however, list certain transactions that expressly are *excluded* from being a “covered transaction,” such as intraday extensions of credit that facilitate settlement.¹⁶ These exclusions are conditioned on the affiliated transaction being conducted on terms and conditions that accord with safe and sound banking practices.¹⁷

Consistent with Section 23A and the plain language of the Volcker Rule, we believe that a “covered transaction” under Super 23A should be construed to include the list of prohibited transactions contained in Section 23A(a)(7) of the Federal Reserve Act, *as qualified by the list of excluded transactions set forth in Section 23A(d)*, which under Regulation W includes intraday extensions of credit to an affiliate. Specifically, if Congress had intended the phrase “covered transaction, as defined by Section 23A” to mean the list of prohibited transactions in Section 23A(a)(7), without regard to the exclusions of Section 23A(d), it simply could have used the words “covered transaction, as defined by Section 23A(a)(7).” The principles of statutory construction, as interpreted by the U.S. Supreme Court, direct that when the language of the statute is clear and unambiguous, the agencies must give effect to it as written.¹⁸ The Agencies, therefore, should amend the Regulation to align it with the intent and language of the statute by interpreting a “covered transaction” under Super 23A consistently with, and to the same extent as, Section 23A. This revision would permit banks to conduct affiliate transactions with certain hedge funds and private equity funds to the same extent as they would with other bank affiliates, consistent with the regulatory requirement that they be carried out in accordance with safe and sound banking practices.¹⁹

E. Compliance Obligations.

Compliance with the Regulation should be significantly streamlined and simplified. The compliance regime should shift generally from the overbroad, prescriptive Volcker Rule-specific compliance requirements to an expectation that institutions put in place controls, processes, and recordkeeping that can be reviewed by second line and internal auditing procedures, and reviewed through the supervision and examination process. Specifically, any prescriptive regulatory or supervisory requirements or expectations with respect to Volcker Rule board

¹⁵ See 12 U.S.C. § 1851(f) (Super 23A); 12 U.S.C. § 371c (Section 23A).

¹⁶ See 12 U.S.C. § 371c(d) (Section 23A); 12 C.F.R. § 223.42(l) (exempting intraday extensions of credit from Section 23A’s prohibitions).

¹⁷ See 12 C.F.R. § 223.42; § 223.13.

¹⁸ See *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-43 (1984) (“If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.”).

¹⁹ The condition that any such transaction be conducted consistent with safe and sound banking practices serves to retain the Agencies’ authority to examine this activity for compliance with the statute, and to disallow any transaction which they believe acts as an evasion of the Volcker Rule’s requirements. See 12 U.S.C. § 1851(e)(2).

committees and annual effectiveness reviews and reports should be eliminated, and Volcker Rule compliance controls should be developed by each bank as part of its general risk management processes. Overbroad, prescriptive compliance program requirements result in duplicative or layered compliance and are unwarranted and unnecessary; any violations or evasions of the Volcker Rule should be detectable from Agency supervisory review and examination and through a bank's internal audit function. Banks also should be afforded more flexibility in establishing and implementing a compliance program, consistent with their prudential framework and risk management practices.

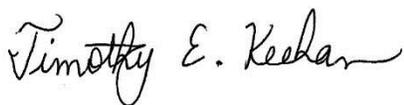
With respect to the Volcker Rule's metric requirements, for a number of required metrics, the safety and soundness benefits are not commensurate with the ongoing compliance burden imposed on banks. The Agencies already receive daily, weekly, and monthly prudential risk and source-of-revenue metrics from banking entities, which are adequate in regulating the firms with respect to excessive risk-taking – the cornerstone of the Volcker Rule. Therefore, the metrics requirements under Appendix A of the Regulation should be eliminated.

F. Examination Coordination.

We believe that coordination among the Agencies is vital for the proper implementation, application, and interpretation of the Volcker Rule and the Regulation. A key administrative principle should be that one agency be designated to examine the entire firm for Volcker Rule compliance (*i.e.*, the prudential regulator for the dominant legal entity in the bank holding company organization), in order to avoid inconsistent or “balkanized” agency supervision and examination. In particular, we encourage the federal banking regulators to explore the establishment of interagency examination procedures, perhaps through the Federal Financial Institutions Examination Council (FFIEC), so that a common set of supervisory and examination procedures can be established and applied across the entire banking industry.²⁰ This would further improve bank preparedness by setting forth agency objectives and alerting the industry to examination expectations and priorities.

Thank you for your consideration of our views and recommendations. If you have any questions or require any additional information, please do not hesitate to contact the undersigned at 202-663-5479 (tkeehan@aba.com).

Sincerely,



Timothy E. Keehan
Vice President & Senior Counsel

²⁰ The federal banking agencies have employed the FFIEC to accomplish joint agency action in critical areas, such as in Bank Secrecy Act/Anti-Money Laundering examination procedures, and more recently, regarding the FFIEC Cybersecurity Assessment Tool. The FFIEC further could work with the SEC and CFTC directly to ensure consistency of supervision and examination.

The Volcker Rule

Islands of Permission in a Sea of Prohibition



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The Volcker Rule

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. fair lending rules and regulatory practices:

- (a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;*
- (b) prevent taxpayer-funded bailouts;*
- (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;*
- (d) enable American companies to be competitive with foreign firms in domestic and foreign markets;*
- (f) make regulation efficient, effective, and appropriately tailored; and*
- (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.*

The American Bankers Association¹ offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **The complexities and vagueness of the Volcker Rule make it a drag on the economy.**
- **The Volcker Rule should be repealed.**
- **Until repeal legislation is enacted, revise rules to mitigate harmful effects on the economy.**
- **The Rule should be refocused on what is prohibited rather than a neo-quixotic search for what is permitted.**
- **Application of the Rule should be tailored to focus solely on systemic risk.**
- **The Secretary of the Treasury should employ his good offices to facilitate agency coordination in implementation of the Volcker Rule.**

¹ The American Bankers Association is the voice of the nation's \$17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits, and extend more than \$9 trillion in loans.

Introduction

Since the earliest days of the Republic, banks have been chartered by government to perform a variety of essential financial functions, for which banks have developed highly skilled competencies, continually updated and refined. These include (among others)—

- Financial Intermediation (Linking Borrowers with Savers)
- Maturity Transformation
- Custodial Services
- Trust Services
- The Payments System
- Capital Formation
- Liquidity Provision
- Cash Management
- Government Finance
- Wealth Management

For example, banks make investments to manage potential mismatches between the maturities of their assets (mostly loans) and their liabilities (mostly deposits), a practice known as “asset-liability management.” Banks intermediate in the capital markets through making markets in financial instruments, like corporate bonds, to facilitate liquidity, price discovery, and capital formation. Banks make investments that hedge, or reduce, the risk of loss for themselves and for their customers, as well as invest together with customers and other investors in private funds designed to finance start-up businesses or fund projects for the public welfare. Despite the useful and proper purposes of these investment activities by all banks, they have been caught up in the Volcker Rule’s restrictions on “proprietary trading” that were directed at very different investment activities.

Following the financial crisis, the previous Administration, in connection with systemic worries, raised concerns about what it identified as complex, “excessively risky” proprietary trading in securities and proposed enactment of what became Section 619 of the Dodd-Frank Act, known as the Volcker Rule. Banks, however, were already subject to a very constrained investment and trading environment leading up to the financial crisis. Reforms enacted during the Great Depression established restrictions on bank investments and activities, and these have largely remained in place. Nevertheless, the Volcker Rule was layered on top of existing constraints to prohibit banks and their affiliates from engaging in proprietary trading and from conducting proprietary trading indirectly by investing in (or sponsoring) certain hedge funds and private equity funds.

Federal banking and securities regulators issued regulations broadly implementing the Volcker Rule to prohibit any bank proprietary trading and investment activities regardless of their value to bank or customers, rather than specifically defining and prohibiting the trading and investment activities that were the object of the systemic worries that led to the Volcker Rule. As a result, many of the regulations’ requirements beg the question as to why are they applied to the activity to be regulated, providing little operational clarity or policy direction on compliance

requirements. This is especially so for the “permitted” activities under the regulations, which can be likened to precariously situated islands of permission in an ill-defined and turbulent and foggy sea of prohibition.

Regulators finalized these broad regulations even though it had been documented at the time that the activities prohibited in the Volcker Rule did not cause the financial crisis, a realization that has been reinforced with time. Specifically, a 2011 Government Accountability Office (GAO) report confirmed that neither proprietary trading nor investments in hedge or private equity funds by banks were a proximate cause of the financial crisis of 2008.² The GAO report further stated that “FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from standalone proprietary trading.”³ More recently, a 2016 Federal Reserve-commissioned report concludes that the Volcker Rule may have an adverse impact on liquidity in the corporate bond market.⁴

Rather than solving problems, the Volcker Rule has created problems. It has operated to impede the efficient operation of the financial system, drive banks away from providing services valued by their customers, reduce competition in affected markets, and overall act as a drag on the economy. At the same time, it has heavily involved five financial regulatory agencies in a confused and unproductive exercise to administer the new rules.

I. Harm to the Economy and Banks’ Ability to Serve Customers

Although the Volcker Rule was intended to apply only to excessively risky proprietary trading done directly or through investment funds, the regulations require that *every* banking entity’s compliance policies and procedures “include measures that are designed to prevent” the bank from becoming engaged in Volcker Rule-prohibited activity. Because the regulation treats any proprietary activity as prohibited unless it fits into narrow exceptions, *every* bank and every affiliate, regardless of its size or activities, must read and understand the Volcker Rule regulations in order to review all of its investment activities to determine which activities fit into the narrow exceptions. This has been a complex, and at times, fruitless exercise for nearly all banks. This is compounded by the problem that it is often not readily apparent under the regulations what is permissible versus impermissible trading and investment activity, much being left to regulatory judgment and the even more serious problem of variant interpretations among the several agencies by which a bank is supervised.

Indeed, in many cases, a bank may not know whether it is engaged in impermissible activities until it is notified in the course of a bank examination. In other words, a bank may be required to undertake an initial *and ongoing* careful legal analysis to determine which trades and

² See GAO Report, “Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented” (July 2011).

³ *Id.* at 26.

⁴ See Jack Bao, Maureen O’Hara, and Alex Zhou (2016). “The Volcker Rule and Market-Making in Times of Stress,” Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, <https://doi.org/10.17016/FEDS.2016.102>.

investments will, or might, fall within the constraints of the Volcker Rule regulations, and still not know with an operational degree of certainty whether its activities are outside the scope of the regulations or in compliance with them. This makes bank compliance efforts costly, risk-averse, and allocation of financial resources suboptimal.

Lasting damage to bank *customers* and to the economy overall results from this misallocation of financial resources and regulator and banker attention. Not only are banks and regulators involved in compliance exercises of uncertain value, but investment opportunities are hindered that, despite posing none of the risks that are the object of the Volcker Rule, banks relinquish because of the overbroad and uncertain scope of the regulations.

Since banking organizations have stopped conducting the proprietary trading that was the object of the Volcker Rule, the Rule's general assumption that activity is prohibited has produced an upside down exercise by banks of demonstrating an activity to be permissible. To ensure compliance, banks often constrain their activity to a greater degree than is required under a conservative interpretation of the regulations, thereby giving up more opportunities for economic activity that could benefit customers and communities.

The following are a few examples illustrative of many foregone business prospects and opportunities to serve bank customers and communities:

- Banks have had to shutter credit operations that supported the venture capital funds, stifling investment in start-up and emerging growth companies that create an average of three million jobs each year.
- Banks serving as custodians for customers have had to shift custody to outside providers as a result of the Volcker Rule's "Super 23A" provisions. Segregating fund functions and operations with third parties has disrupted customer relationships and increased operational risk and inefficiencies solely because of the potential for intraday or overnight overdrafts which the Volcker Rule prohibits.
- Banks have had to decline new business from wealth management customers, particularly family office relationships, out of concern that certain pooled investment vehicles consisting of two or more unrelated families fall within the definition of "covered fund."
- Banks have had to curtail their lawful market-making and foreign exchange activities due to concerns about possibly tripping the line on proprietary trading.
- Banks have eschewed purchasing for asset liability management purposes available-for-sale securities that are close to maturity, or purchasing short-term securities, in order to avoid tripping the Rule's 60-day presumption associated with short-term trading.
- Banks are compelled to avoid making even minor ministerial adjustments on derivatives hedging their long-term debt securities, since that may trigger Volcker trading account status under the 60-day presumption.

We note that banks already are subject to regular supervision and examination via the full panoply of regulations and interpretive guidance related to trading and investment fund activities. These *existing* regulatory tools should be leveraged (rather than doubled) in order to assist both banks and the federal bank regulatory agencies to monitor activities that might stray

into activities subject to the Volcker Rule. We recognize that there are risks with all financial activities. A targeted supervisory approach would better address the regulation and management of the risks chosen for Volcker Rule attention, through which agency oversight could be specifically applied, with excessive risks addressed and corrected.

II. Specific Recommendations

A. Repeal the Volcker Rule; In the Meantime, Mitigate the Harm

The Volcker Rule should be repealed in its entirety. Proprietary trading and investment activity did not cause the financial crisis of 2008, and a ban on these activities does not promote banking safety and soundness. Indeed, by reducing diversification in banks and decreasing the field of participants in financial markets, the Volcker Rule increases risk. Until such repeal is enacted, the federal financial regulatory agencies should mitigate the Rule's adverse effects on the economy and on bank customers by substantially amending the Volcker Rule regulations so that they are consistent with vibrant financial markets, tailored regulation, and with sound banking practices.

B. Change Focus to What is Prohibited

Agencies should amend the Volcker Rule regulations and their rulemaking approach by focusing on what constitutes *prohibited activities*, allowing banks to avoid those activities and return their attention from a quest for "permitted" activities to identifying how best to serve customers. This would also make Volcker Rule regulation and supervision more consistent across the federal financial agencies and require fewer neo-quixotic efforts to find a five-agency consensus on what might be permissible.

Implementing this approach to Volcker Rule regulation does not require statutory change. It could be accomplished by action of the regulators, involving redefinition of key terms, such as "proprietary trading," "hedge fund," and "private equity fund." The goal should be to provide certainty that the rules will not impede banks from engaging in *bona fide* market-making, asset liability management, hedging, and other trading activities, or from having relationships with ordinary corporate vehicles and other fund entities that are not those funds that the Volcker Rule is intended to regulate. This would permit banks to continue responsibly managing their non-banned trading and investment activities with the necessary degree of certainty and with a minimum of disruption to the routine banking operations on which banking customers have come to rely.

C. Tailor the Applicability

The prohibitions of the Volcker Rule should be applied exclusively in relation to systemic risk (whether in institutions, products, or practices), and vary in application directly according to the risks. Any amendments to the scope of the Volcker rule should apply uniformly to banks and their affiliates.

D. Principal Activity Should Be Presumed Permissible.

Market participants would benefit from a more straightforward way of demonstrating that they are not engaged in prohibited proprietary trading. The Rule should be refined with a clear focus on the activity sought to be prohibited, so that banks do not have to defend permissible and economically useful hedging (for themselves and customers), asset-liability management, and market making for customers. This could be accomplished through reconsideration and removal or refinement of unnecessarily opaque and restrictive provisions in the regulation.

E. Simplify Fund Investment Prohibitions

Prohibitions regarding investment funds should be more tailored and targeted. For example, the Volcker Rule regulations should apply only to those hedge funds and private equity funds that engage primarily in proprietary trading for near-term investment gains, thereby excluding funds (such as venture capital funds) or activities (such as seeding investment strategies) that do not raise the risks the Volcker Rule is intended to address.

F. Streamline the “Super 23A” Provisions

The so-called “Super 23A” provisions governing bank relationships with affiliated investment funds unnecessarily prohibit many routine business and credit-related transactions. These provisions should be amended to permit transactions between the banking entity and investment fund that are consistent with existing affiliate transaction rules.

G. Improve Interagency Coordination.

The Treasury Department should take the lead to encourage interagency coordination on the application and interpretation of the Volcker Rule. The key administrative principle should be that one agency should be designated to examine the entire firm for Volcker Rule compliance (which could be based on which prudential regulator regulates the dominant legal entity in the banking or financial organization). Moreover, there should be one agency responsible for issuing interpretive and enforcement guidance, including common examination policies and procedures. This arrangement can be established by memoranda of understanding, facilitated by the Treasury Secretary’s good offices, which can also be drawn upon to address questions of coordination.