

Michael Bradfield
Attorney at Law

February 12, 2012

Response to Request for Comment: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

A Proposal for Prior Regulatory Approval to Engage Volcker Rule Exempted Activities

I. The Agency Request for Comments

On October 11, 2011, Office of the Comptroller of the Currency, Treasury (“OCC”); Board of Governors of the Federal Reserve System (“Board”); Federal Deposit Insurance Corporation (“FDIC”); and Securities and Exchange Commission (“SEC”) (“the Agencies”) requested public comment on a proposed rule (the “Rule”) that would implement Section 619 (the “Volcker Rule”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). Comments were requested on or before January 13, 2012, a date that has been extended by the Agencies to February 13, 2012.

II. The Proposed Regulation

The Volcker Rule contains a prohibition on the ability of a banking entity and nonbank financial company supervised by the Board to engage in proprietary trading and acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund, unless otherwise provided in the Volcker Rule. The Volcker Rule occupies just 11 pages of statutory text. The Agencies regulatory proposal for the Volcker Rule contains 289 pages.

The proposed rulemaking document is composed of the proposed Common Rule¹ of 35 pages (pp. 216-251), three appendices to this Common Rule² (pp. 251-284) occupying an additional 33 pages, and 13 pages of individual Agency implementing rules established by the OCC (285-286), the FRB (286-295), FDIC (295-296), and SEC 297-298. This total of 81 pages of specific rules is preceded by 187 pages (pp.5-192) of containing an impenetrable Introduction, and 383 questions for commenters with the implication that the answers to these question would be used to modify the proposed Rule, contracting it or, more likely, expanding it as appropriate, depending on the answers.

¹ Composed of 4 substantive parts: Subpart A-Authority and Definitions, Subpart B-Proprietary Trading, Subparts C-Covered Fund Activities and Investments, and Subpart D-Compliance Program Requirements; Violations.
² Appendix A: Reporting & Record Keeping Requirements for Covered Trading Activities (pp. 251-263); Appendix B: Commentary Regarding Identification of Permitted Market Making-Related Activities (pp. 263-271; and Appendix C: Minimum Standards for Programmatic Compliance (PP. 271-284). The Commodity Futures Trading Commission had not yet issued its regulations on implementation of the Volcker Rule at the time the proposed Rule was issued for comment.

III. A One Size Fits All General Authorization to Engage Volcker Rule Exempted Activities Will Not work

This attempt at a one-size fits all rule for the relatively few banking entities and nonbank financial companies supervised by the Board that are expected to engage in some or all of the trading and hedge and private equity funds activities and investments that Congress excepted from the broad prohibitions of the Volcker Rule has been harshly criticized as impenetrable and so complicated as to make the Volcker Rule unworkable. The drafters appear to have been motivated by the laudable objective of seeking to cover every possible business activity and every possible business practice that could possibly be implemented under Volcker Rule or be used to circumvent the Volcker Rule. This is a clearly impossible task that will result in much too rigid regulatory framework that will under regulate some activities, investments and firms and over regulate others.

This approach to regulation paradoxically has, especially evident in the proposed Rule, the egregious effect of essentially leaving it up to the covered company to initially determine whether an activity is authorized or prohibited. The regulators left to playing catch-up to identify and reject activities, practices or investments that are barred by the Volcker Rule.

IV. A Prior Approval Proposal to Authorize Engaging in Volcker Rule Exempted Activities

A much better method for establishing the regulations required for implementing the Volcker Rule would be to use an applications prior approval process to establish the permissible framework for covered firms to engage in some or all of the trading and hedge and private equity funds activities and/or investments that Congress excepted from the broad prohibitions of the Volcker Rule. A firm proposing to engage in Volcker Rule excepted activities or investments would file an application with its primary supervisor setting out the terms and conditions of the proposed activity or investment, the adequacy of the capital to be devoted to supporting the activity or investment, the risk management procedures that the firm would employ to maintain the safety and soundness of the firm, information on the ability of the firm management to operate the proposed activity and/or supervise the proposed investment, and such other information as might be required by the regulator.

Adopting this regulatory framework would permit the drafting and implementation of a very short and concise rule. However, the three appendices to the proposed Rule would provide very useful guidelines for a firm in drafting its proposal for regulator review and for the regulator in considering the application made by the firm. The regulator would then act on this application, requiring such modifications as may be necessary to assure compliance with the Volcker Rule and to prevent the firm from becoming a risk to the stability of the financial system. The required compliance program could be tailored to the risks involved in the specific activities and/or investments proposed by the applicant firm and best practices for the activities involved required as part of the compliance program. The firm would gain the benefit of compliance requirements limited to only those activities in which it proposes to engage. The applying firm would also have the benefit of knowing that if it followed the plan of action set out in its approved application, it would be acting fully within the law. All firms subsequently applying to

engage in the same or similar activities and/or investments would have the same basic framework applied to their application possibly adjusted to account for any special characteristics of the applying firm.

Since many of the firms that are likely to seek to engage in Volcker Rule excepted activities or investments will be bank holding companies or nonbank financial companies supervised by the Board, their applications would be made to the Federal Reserve. The Board, which has a high degree of experience with applying such an applications process, could set a basic framework and methodology for processing such applications in a context of close cooperation and coordination with the other agencies that could receive such applications.

Uniform application of the Volcker Rule prohibitions would be particularly important for the process of achieving the financial market stability which is one of the primary goals of the Dodd-Frank Act. The Volcker Rule specifically requires that in developing and issuing Volcker Rule regulations, the Agencies "shall consult and coordinate with each other, as appropriate, for purposes of ensuring, to the extent possible, that such regulations are comparable and provide for consistent application and implementation of the applicable provisions of this section to avoid providing advantages or imposing disadvantages to the companies affected by this subsection and to protect the safety and soundness of banking entities and nonbank financial companies supervised by the Board."

A major banking industry criticism of the prior approval process has been the time it takes for agency processing of applications. If the processing function of the Agencies is adequately staffed, and given the likely rather limited number of applicants, processing delays could be limited. However, delays in responding to regulators' requests for firm information and difficult policy issues involved in determining whether or not specific activities and/or investments are exempted from the Volcker Rule prohibitions, will undoubtedly result in delays in the approval of applications. However, the premium on "getting in right" in terms of maintaining the safety and soundness of banking entities, and avoiding systemic risk is so high, and the cost of delay so relatively small, that delays in application decisions for these reasons should be an acceptable price to pay for a more stable financial system without the extraordinarily large costs to the economy as a whole from systemic disruption of the banking system.

V. Legal Authority for the Prior Approval Proposal

The Agencies have the legal authority to implement such an application methodology. The Volcker Rule simply gives the Agencies authority to "adopt rules to carry out this section..." after taking into account the study made by the Financial Stability Oversight Council. The application methodology described above is not inconsistent with the seven factors that the Council is required to consider in making its study, and, in fact, would enhance the ability of the Volcker Rule to carry out all of the objectives that the Congress instructed the Council to consider in making its study including, in particular, promoting and enhancing the safety and soundness of banking entities, and limiting activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk of loss in such banking entities and nonbank financial companies supervised by the Board.

It is important to note that there is a substantial difference between the legal framework that established the Volcker Rule and the application process for allowing bank holding companies to engage in activities that are so closely related to banking as to be a proper incident thereto under Section 4(c)(8) of the Bank Holding Company Act. This latter provision, which was adopted in 1970, allowed bank holding companies to engage in nonbanking activities pursuant to Federal Reserve Board orders or regulations, but for almost 30 years the Board required all bank holding companies to apply to the Board for prior approval regardless of whether a particular type of activity had been approved by the Board by regulation.

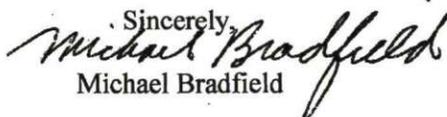
In contrast, Congress did not specifically require agency prior approval for a banking entity or a nonbank financial company supervised by the Board to engage in Volcker Rule exempted activities. However, a rule adopted by the agencies would have the force of law, and as noted above, the Congress granted the agencies very broad power to adopt rules to implement the Volcker Rule. In any event, the agencies could, if necessary, adopt a rule which, for example, could impose very high capital requirements on covered entities engaging in Volcker Rule exempted activities and/or investments in order to contain the potential risks of such activities and investments that had not received agency sanction in order to prevent avoidance of the application process.

VI. Success of the Section 4(c)(8) Prior Approval Process

The significant success of the almost 30 years of the Section 4(c)(8) applications prior approval process is a strong recommendation for applying it to the high risk activities and investments that are exempted from the application of the Volcker Rule. In this period from 1970 to 1997 bank holding companies had to obtain the prior approval of the Federal Reserve Board to engage in activities that were so closely related to banking as to be a proper incident thereto. In this period bank holding company applications were analyzed for capital adequacy, managerial capability, public benefits, and adverse effects including undue concentration of resources and decreased or unfair competition. During this whole period there were no bank failures or systemic disruptions of the banking system caused by non-banking activities approved by the Board for individual bank holding companies. Significantly, such problems arose only after the prior approval process was abandoned in 1997, and this change confirmed in 1999 when the scope of non-banking financial activities was liberalized and financial holding companies were permitted to engage in the expanded set of activities without Federal Reserve approval provided they met a standard set of general statutory requirements not directly related to the activities in which they were engaging.

VII. Conclusion

For all the reason set out above, I recommend that the Agencies adopt a prior approval applications process as part of the rules required by Dodd-Frank for the implementation of the Volcker Rule.

Sincerely,

Michael Bradfield