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4 Things To Know About The 'Volcker 2.0' Proposal

By **Jon Hill**

Law360 (June 4, 2018, 10:23 PM EDT) -- As both Washington and Wall Street pore over a proposal unveiled last week to revise the Volcker rule, legal experts spoke to Law360 about what's in this so-called Volcker 2.0, what isn't and what's next.

The U.S. Securities and Exchange Commission is expected Tuesday to give a green light to the long-awaited proposed changes to the Volcker rule, a set of restrictions on bank risk-taking that were part of the 2010 Dodd-Frank Act and finalized in 2013.

Volcker 2.0 has already received the backing of the four other agencies that oversee the rule, including the Federal Reserve, Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency. The Commodity Futures Trading Commission approved the proposal Monday in a 2-1 vote, with Commissioner Rostin Behnam, a Democrat, casting the sole "no" vote the proposal has received thus far.

The public should soon have a window of time to comment directly to the agencies about their plan to streamline the notoriously complex piece of regulation, but in the meantime, Law360 spoke with several financial services attorneys about Volcker 2.0 and its implications.

Agencies are now in the driver's seat of regulatory reform

The rollout of the proposed changes to the Volcker rule underscores how the deregulatory momentum is shifting in Washington, pushing the banking agencies to the fore of efforts to pare back post-crisis financial rules in coming months.

That's partly because, with last month's passage of the Economic Growth, Regulatory Relief and Consumer Protection Act — better known as the Crapo bill, for its architect, Sen. Mike Crapo, R-Idaho, or as the Dodd-Frank rollback bill, among its critics — Congress has likely finished fiddling with financial regulation for the time being.

Although House Republicans backed the banking bill with an understanding that they would keep pursuing additional reforms through narrower bills, they will be up against a jam-packed, midterms-capped calendar and Senate Democrats who won't have much reason to go along with them.

"In some ways, leverage has been lost because some of the changes in the law that was enacted were bipartisan changes that everyone believed were warranted," said Joseph P. Vitale, partner and co-head of the banking regulatory group at Schulte Roth & Zabel LLP. “Now that they’ve passed the things that were the lowest-hanging fruit, it isolates the more difficult things and makes it harder to get them passed as stand-alone measures than if they were coupled with things the Democrats wanted as well.”

Meanwhile, with Jelena McWilliams’ confirmation last month to lead the Federal Deposit Insurance Corp., the banking agencies now all have President Donald Trump-appointed heads either in place or about to take over, which should smooth the pathway for rulemaking on marquee issues like the Volcker rule as well as implementation of the banking bill.

“The changes in agency leadership will have an impact,” said Charles Horn, a financial services partner at Morgan Lewis & Bockius LLP. “At the top of the agencies, much of the old guard has moved on and has been replaced, and I think the new guard will be more likely to take a more deregulatory approach.”

Core Volcker rule principle remains intact

Central to the Volcker rule’s creation was the idea that government-insured banks should not be making speculative bets for their own account. The practice, known as proprietary trading, was often highly profitable for banks, but some economists have argued that it encourages excessive risk-taking, distracts from maintaining a customer focus and contributed to the financial crisis.

When Volcker 2.0 was unveiled Wednesday, consumer advocates warned that the proposal threatened to abandon that central principle.

Marcus Stanley, policy director at Americans for Financial Reform, called it “no minor set of technical tweaks to the Volcker rule, but an attempt to unravel fundamental elements of the response to the 2008 financial crisis,” for example, while Dennis Kelleher, president and CEO of Better Markets, said that the proposal was “needlessly” putting at risk the rule’s successes in turning banks away from “dangerous, destabilizing, high-risk and socially useless gambling.”

“Given the irresistible riches generated by proprietary trading, it is inevitable that weakening the Volcker rule will result in banks again pushing the envelope, gaming the system and ramping up their dangerous trading,” Kelleher said in a statement.

But experts who spoke to Law360 didn’t see Volcker 2.0 in such apocalyptic terms, describing the proposal instead as a relatively modest attempt to streamline the rule that still preserves its essence.

“The changes that have been suggested are quite reasonable and are consistent with the overall spirit of the rule,” said Anna Pinedo, a partner in Mayer Brown LLP’s corporate and securities practice.

Banks will still be prohibited from proprietary trading under the rule, for example, but the proposed changes should help to more clearly delineate the border between impermissible prop trading and other activities that look similar, like market-making, according to Vitale. That additional clarity should make it easier for banks to stay on the right side of that line and for regulators to know when they’ve strayed.

Experts noted that the proposed changes have also drawn support from regulators who would be unlikely to go along with an attempt to gut the Volcker rule.

Fed Gov. Lael Brainard, for example, is the only Democrat on the central bank’s board of governors and has warned against loosening other rules regarding bank capital and leverage, but she blessed Volcker 2.0

along with her Trump-appointed Fed board colleagues last week, calling it "crafted to implement the core purpose of the Volcker rule in a more efficient way."

Even former Fed chairman Paul Volcker has signaled his receptiveness to the idea of streamlining the rule that bears his name.

"I welcome the effort to simplify compliance with the Volcker rule," he said in a statement last week, adding that it's "critical" for this simplification not to undermine the ban on prop trading at the heart of the rule. "I trust the final rule will strongly maintain that position by, as intended, facilitating its practical application."

Volcker 2.0 is TBD when it comes to the covered funds side of the rule

The Volcker rule restricts banks' investments in and relationships with so-called covered funds — a term that generally includes hedge funds and private equity funds. As with the rule's prohibitions against proprietary trading, these covered funds limitations incorporate a number of definitions and provide for a variety of exceptions that many in the industry have argued need to be clarified and streamlined, but experts said Volcker 2.0 mostly seeks more feedback when it comes to this area of the rule.

"On the prop trading side, there are a number of actual proposals put into language, whereas on the covered-funds side, there a couple of proposals but then a lot of questions," said Hugh C. Conroy Jr., a partner in Cleary Gottlieb Steen & Hamilton LLP's banking practice.

Among other things, the questions ask for comment on whether the banking agencies should change how the rule defines "covered fund" and whether that definition should be narrowed to those investment funds that are engaged in short-term trading or investing in real estate, portfolio companies or other illiquid assets.

These and other questions in the proposal could eventually "result in a number of material changes to the funds side of the rule," Vitale said, but for Conroy, there was some disappointment that the banking agencies didn't just go ahead and suggest more changes in this area.

"They know the views of the industry," Conroy said. "Even those that are for more restrictive regulation, the regulators know their views. They've gotten lots of comments, and yet they didn't craft language on some of these things, but opted to ask more questions."

Banks under $10 billion in assets are already in the clear

Volcker 2.0 aims to alleviate some of the rule's burdens on banks by tailoring its compliance requirements to the size of a financial institution's trading activity. Under the proposal, there would be graduated tiers of compliance requirements for firms with "moderate" or "significant" trading assets and liabilities, while firms with "limited" trading assets and liabilities — defined as less than $1 billion — would enjoy a presumption of compliance.

Given that only about 40 firms fall into the "moderate" or "significant" bucket by Fed estimates, most banks would be eligible for that presumption of compliance. That would come as a major relief, except that many of these banks with "limited" trading activity were already excused from the Volcker rule last month as part of the banking bill.

The new law contains a Volcker rule exemption for banks with under $10 billion in total assets that don't do much trading. Although the banking agencies haven't had a chance yet to write a new regulation implementing that provision and will deal with it separately from Volcker 2.0, regulators have already indicated that those smaller, newly exempted banks can take a breather.

"While the agencies work to prepare regulations implementing the new law, agencies do not intend to apply or enforce the 2013 final [Volcker] rule with respect to those institutions excluded by the statute," Comptroller Joseph Otting said at a Federal Deposit Insurance Corp. board meeting Thursday.

--Editing by Pamela Wilkinson and Alanna Weissman.