Transcript of Open Board Meeting
December 10, 2013

CHAIRMAN BEN S. BERNANKE: Good morning.

Today, we and several of our sister agencies will be considering the final rule implementing the provision of the Dodd-Frank Act, commonly called the Volcker Rule. This provision of the Dodd-Frank Act has the important objective of limiting excessive risk-taking by depository institutions and their affiliates. Getting to this vote has taken longer than we would have liked, but five agencies have had to work together to grapple with a large number of difficult issues and respond to extensive public comments. I'd like to commend the staff for their dedication and hard work throughout this arduous process.

I look forward to today's discussion of the many issues raised by the rule. I note though that the ultimate effectiveness of the rule will depend importantly on supervisors who will need to find the appropriate balance while providing feedback to the Board on how the rule works in practice. I will now turn the meeting over to Governor Tarullo who in his role as Head of the Bank Supervision and Regulation Committee has played a critical role in helping to bring this rule to fruition, Governor Tarullo, who's joining us by phone.

Dan, are you there?

GOVERNOR DANIEL K. TARULLO. Yes, OK. Thank you, Mr. Chairman.

For a time, I had begun to think that the Volcker Rule was destined to become the Jarndyce vs. Jarndyce of administrative rule-making. But through the persistence of staff at the five regulatory agencies, we have before us a completed rule that is now being considered by all five of the agencies. And hopefully we'll soon have uniformity in what will actually be four separate regulations applying the statutory provisions to banks, broker dealers, commodity brokers, and other affiliates of bank holding companies.

My Dickens allusion may accurately imply that here even more than in most joint rule makings, the product of this extended process is not a regulation that would have been written by any one agency, much less by one principle at any of those agencies. But I think the text before us is an improvement both normatively and technically on the proposed rule issued on October 2011. The basic approach is quite consistent with that adopted in the proposed rule. But the many comments received from a variety of perspectives help staff make useful changes and clarifications throughout the proposed final rule. Also, of course, the "London Whale" episode allowed staff to test the procedural and substantive requirements of the proposed rule against a real world example of what should not happen in a banking organization.

Many of us, myself included, had hoped for a final rule substantially more streamlined than the 2011 proposal. I think we need to acknowledge that it has been only modestly simplified. Much of the complexity lies in the part of the rule dealing with coverage funds and a good bit of this complexity has proven hard to avoid. The part of the rule dealing with proprietary trading has been simplified somewhat particularly by reducing the number of metrics that will be used in the reporting and analysis of trading data.

Of course, the fundamental challenge is to distinguish between proprietary trading on the one hand and either market making or hedging on the other. The difficulty in doing so inheres in the fact that a specific trade maybe either permissible or impermissible depending on the context and circumstances within which that trade is made. While the proposal before us articulates standards from making those distinctions, the standards will necessarily be developed further as they are applied. Thus, as the Chairman just noted, implementation will be particularly important in shaping the Volcker Rule going forward. Because the bulk of the activities encompassed by the statute take place in broker dealers and national banks for both of which the Federal Reserve is not the primary supervisor. We will have a somewhat lesser role in this implementation process. Still, because we are the primary federal supervisor for state member banks, foreign broker dealers, subsidiaries of bank holding companies, and state charted branches of foreign banking organizations, we will have a role to play.

With that, I turn to Scott for the staff presentation.

SCOTT ALVAREZ. Thank you, Governor Tarullo.

While Governor Tarullo is adept in making allusions to great literature, this last couple of years I found myself more thinking about the Beatles. It has certainly been a long and winding road. And with Chris Paridon and Anna Harrington having worked eight days a week for the last two years and done a phenomenal job, and a lot of help from our friends at the other agencies, we made it through truly an octopus garden of issues and a thicket of comments in the Norwegian Wood. And finally we can say, "Here comes the sun."

With the--today, what we are hoping to do is explain very briefly the two main parts of the Volcker Rule: One part applies to proprietary trading, and a second applies to the acquisition and retention of ownership interest in covered funds. The--Chris Paridon will do an outline of those two provisions, then Anna Harrington will briefly explain the compliance program requirements and how they've been designed to reduce burden on community banks. Then, Sean Campbell, who has taken on the name of Dr. Kurtosis, will explain the metrics. And then, I'll do a brief presentation on the conformance period extension at the end.

So, Chris…

CHRIS PARIDON. Thank you, Scott.

The first major provision of the statute prohibits a banking entity from engaging in proprietary trading. Under the statute, proprietary trading is the purchase or sale as principle of any security, derivative, option, or contract for sale of a commodity for future delivery for the purpose of selling that position in the near-term or otherwise with the intent to resell, to profit from short-term price movements. By its terms, Section 13 of the BHC Act generally does not apply to positions taken for long term or investment purposes. The statute contains a number of exemptions, including for underwriting activities, market making activities, and risk-mitigating hedging activities. The statute also authorizes the agencies to remit any additional activity, if it would promote and protect the safety and soundness of the banking entity and the financial stability of the United States. As provided in the statute, the final rule permits the banking entity to engage in a market making-related activities that do not exceed the reasonably expected near-term demands of clients, customers, and counter parties.

The scope of this exemption was the subject to a great concern and attention from commenters, and the final rule has been modified to address comments received. For example, the definition of market making activities has been adjusted to better account for the fact that banking entities make markets in a variety in varying liquidity and depth. In addition, the preamble to the final rule explains that market making and underwriting activities include acting as a primary dealer.

In all cases, however, the final rule requires a banking entity to conduct its market making activities within a framework designed to give effect to the statute and to ensure that the banking entity effectively identifies and manages the risks of these activities. For example, the final rule requires the banking entity to establish, monitor, and enforce limits on positions that maybe taken by each market making desk on the amount of inventory maintained as a market maker and on the risks associated with those positions. In addition, the size of the market-making inventory must be supported by analysis of the historical, current, and expected near-team demands of clients and must be reviewed and adjusted on an ongoing basis. Banking entities are also expected to hedge the risks of their financial exposures accumulated in their market making activities.

Finally, the rule requires that incentive compensation programs established by banking entities not reward or incentivize prohibited proprietary trading conducted in the guides of market-making activity. As Sean Campbell will discuss in a moment, the final rule requires large banking entities to report metrics that are designed to help flag areas of activity for review both by banking entities, as well as examiners.

Like the statute, the final rule also permits a banking entity to engage in risk-mitigating hedging activity in connection with and related to individual or aggregated positions of the banking entity. The final rule includes a number of important protections to include, to ensure that hedging activities are risk mitigating at the--and that the exemption is not used to engage in prohibited proprietary trading, such as trading that attempts to offset possible effects of general economic or market developments on the overall revenues or profits of the banking entity. In particular, the final rule requires that all hedging activity demonstrably reduce risk. Importantly, these risks must be identifiable and related to identified individual or aggregated positions of the banking entity, and the final rule requires the banking entity to conduct analysis supporting the positions, techniques, and strategies used in its hedging including correlation analysis. A banking entity must also have in place limits on its hedging activity, and internal controls and audit procedures, as well as escalation process to account for any limit changes or breaches. The final rule also includes documentation requirements and a prohibition on compensation designed to incentivize or reward prohibited proprietary trading.

The statute and final rule also permit a banking entity to engage in proprietary trading in the United States--I'm sorry, in U.S. government and agency obligations, GSC obligations, state obligations and municipal securities. In response to comments the final rule provides a similar exemption to foreign banking entities for trading and foreign sovereign debt in the United States. Under this exemption, foreign banking entity may trade in the United States or through a U.S. banking entity subsidiary other than a U.S. insured depository institution in obligation with the foreign banking entities chartering sovereign. A foreign banking entity may, of course, trade debt of any foreign sovereign outside of the United States. And in addition, any banking entity may engage in market making and underwriting, including primary dealer activity involving foreign sovereign debt and may engage in risk mitigating hedging using foreign sovereign debt.

In addition and in accordance with the statute, the final rule provides an exemption that permits foreign banking entities to engage in trading activities where the risk of the trade, the decision-making, hedging, financing and accounting are located outside of the United States. This exemption is available under the final rule only if the foreign banking entity does not conduct a purchase or sale with or through any U.S. entity subject to several limited exceptions. If foreign banking entity is not limited under the final rule and a type of foreign counter party that it may transact with.

Consistent with the statute, the final rule also provides exemptions for underwriting activities, trading by a banking entity on behalf of customers such as when the banking entity acts as risk less principal and trading for the general account or as separate account of a regulated insurance company. The second major provision of Section 13 of the BHC Act generally prohibits a banking entity from requiring or retaining an ownership interest in or having certain relationships or sponsoring a covered fund subject to certain exemptions. The purpose of this prohibition is to limit a banking entity's exposure to covered funds and to ensure that banking entities do not bail out investors in covered funds. The final rule adopts a base definition of covered fund that covers issuers that would be investment companies but for Sections 3C1 or 3C7 of the Investment Company Act. These are widely used exclusions that cover a number of vehicles that own securities but that do not engage in investment activities of the types conducted by the hedge funds and private equity funds. As a consequence the final rule contains exclusions for corporate vehicles like wholly-owned subsidiaries, joint ventures and acquisition vehicles that are not designed to assemble capital from investors for investment purposes. The final rule also covers commodity pools within the definition of covered fund that share the characteristics of an entity excluded from the Investment Company Act, under the exclusions contained in Section 3C1 or 3C7 but then investing commodities rather than securities.

Because Section 13 of BHC Act applies to U.S. banking entities on a worldwide basis, the final rule adds foreign funds that resemble U.S. hedge funds and private equity funds when those funds are owned or sponsored by a U.S. banking entity or the foreign operations of a U.S. banking entity. The final rule also includes exemptions for the general and separate accounts of insurance company and for a foreign banking entity that engages in covered funds and activities and investments solely outside of the United States.

Like the statute, the final rule imposes limits on ownership of a covered fund. These limits generally prevent a banking entity from holding more than 3 percent of the total number of ownership interests of a covered fund and 3 percent of the total value of the fund. In addition, the total aggregate investment by a banking entity in all covered funds may not exceed 3 percent of that banking entities tier 1 capital and the total aggregate investment in all covered funds including retained earnings must be deducted from the tier 1 capital of the banking entity for purposes of calculating compliance with applicable regulatory capital standards.

The general definition of covered fund in the statute would apply to securitizations. However, in keeping with the statute the final rule provides an exception for loan securitizations. Thus the final rule applies only to securitizations of securities or assets other than loans such as real estate and intellectual property. Additionally because another provision of the Dodd-Frank Act requires a securitizer to retain 5 percent of the risk of a securitization in certain cases, the final rule establishes this more specific provision governing risk retention as the limit on the amount of banking entity may own of a securitization that is required to meet the applicable risk retention requirements. As under the statute, the final rule prohibits a banking entity from entering into any transaction with certain related covered funds that would be a coverage transaction under Section 23a of the Federal Reserve Act. The final rule also prohibits high-risk activities and high-risk assets as well as any activity that would result in a material conflict of interest between a banking entity and its customers.

ANNA HARRINGTON. Compliance program in the final rule is tiered to minimize burden on smaller firms, which generally do much less activity covered by Section 13. The final rule provides that no compliance program is required for banking entities that are not engaged in covered activity other than trading in obligations to the United States or in agencies, state or municipality of the United States. This will exempt many community banks.

For those banking entities with total assets of $10 billion or less that do engage in some activity regulated under the final rule, the compliance program may be limited to appropriate references in existing compliance policies appropriate to the activities, size, scope and complexity of the banking entity. Banking entities of this size are typically community banks and do not engage in securities or derivatives underwriting or market-making activities and conduct risk-mitigating hedging activities that are generally not complex and are directly related to specific positions as contemplated by the final rule. The banking agencies have developed a summary to assist community banks on how to comply with the final rule.

The final rule requires banking entities with total assets greater than $10 billion and less than $50 billion to have a compliance program that includes six pillars: first, written policies and procedures reasonably designed to ensure compliance with the final rules, including limits on underwriting and market making; second, a system of internal controls; third, a management framework with clear accountability for compliance and review of limits, hedging, incentive compensation, and other matters; fourth, independent testing and audits; fifth, training for trading personnel and management; and sixth records to demonstrate compliance retained for five years.

The final rule requires enhanced compliance programs for any banking entity with total assets greater than $50 billion, or that must report metrics. These are the entities that engage in covered activities in greater amounts and of greater complexity. These firms also post the greatest risk to financial stability. To address this greater size, complexity, and risk, the final rule requires a more detailed compliance program with detailed limits, policies, management accountability, internal audit, documented analysis, and enforcement. In addition, the CEO of a large banking entity is required to attest to the appropriate regulatory agency that the banking entity has in place a compliance program reasonably designed to ensure compliance with Section 13 of the BHC Act and the final rule.

SEAN CAMPBELL. The final rule requires banking entities with significant trading operations to furnish the relevant agency a variety of metrics designed to help firms and regulators monitor and identify prohibited proprietary trading in high-risk trading strategies. In order to minimize the burden, the reporting requirements are applied in a graduated manner, with only the very largest firms required to report metrics. The final rule requires reporting of these metrics, beginning with the data for July of 2014. In particular, a banking entity must comply with the metrics reporting requirements only if the banking entity has worldwide trading assets and liabilities of $50 billion or more, exclusive of the trading in U.S. government and agency obligations.

With respect to a foreign banking entity the same thresholds is applied to the trading assets and liabilities of the U.S. operations of the foreign banking entity. Beginning on April 30th, 2016, this threshold drops to $25 billion in applicable trading assets and liabilities, and then $10 billion beginning on December 31st, 2016. Staff of the agencies expect to review the usefulness of the metrics based on data collected through September of 2015.

The final rule requires the reporting of seven different metrics, in contrast to the 17 that were required under the proposal, that provide the most useful information about a trading desks activity. These metrics include risk measures of sources of revenue, risk management metrics, and measures of customer-facing activity. In addition to the required metrics, banks are also expected to develop their own metrics that are of particular relevance for the specific trading activities in which they are engaged. The metrics are designed to be a tool for triggering further scrutiny by banking entities and examiners in their evaluation of whether a banking entity is engaging in prohibited proprietary trading, engaging in high-risk trading strategies or maintaining exposures to high risk assets.

The final rule does not propose specific thresholds or other bright lines that the individual metrics may not breach. Moreover, the agencies recognize that the use of metrics in overseeing trading activity represents a new and untested supervisory tool. Accordingly, the agencies have committed to revisit the metrics and revive them as necessary based on data received by September 30th of 2015. Although the quantitative measurements include many that banking entities already calculate for internal risk management or other purposes, calculating and reporting the metrics according to the standardize specifications describe in the final rule is likely to require banking entities to create and implement new processes to ensure that the metrics are applied consistently and comprehensively across all of the banks trading activities.

Creating and implementing these processes may entail even for the largest firm's compliance costs and burdens. Accordingly, the final rule delays the reporting requirements for these metrics until July of 2014. These requirements have been included because they represent an effective means of faithfully implementing and enforcing this statutory prohibition on proprietary trading short of prescribing specific, standardized limits on the amount of inventory or principle risk that an underwriter or market maker may retain, which would be likely to undo the constrain of the efficiency and liquidity of trading markets.

SCOTT ALVAREZ. So the rule that we’ve presented to you today and to the other agencies is going to require a lot of adjustment by the banking entity this subject to the rule, including development of pretty detailed compliance programs for the largest institutions. Under the statute, the banking entities have until July 21st, 2014 to comply with the requirements of the rule and the statute, unless the Board provides additional time. The statute allows the Board to provide three, one-year extensions one at a time.

Because of all--because of the new requirements, the staff of the Board and with the support of the staffs of all the other agencies recommend that the Board grant a one-year extension of the conformance period until July 21st, 2015. Now, during this conformance period, there would be expectations on banking entities. As Sean just outlined, the largest institutions would be expected to report on seven metrics that we would begin to analyze during the compliance period. Also, the largest--all institutions would be expected to make good faith efforts to bring their activities and investments into compliance by the conformance date. That would include developing the kind of compliance program that is appropriate to that institution. Institutions that are--that have standalone proprietary trading operations would be expected to promptly terminate or divest those operations, and banking entities would be expected not to expand to their activities or their investments during the conformance period with the idea that they would get additional time at the end of the conformance period. So we are recommending that they do everything they can to meet the conformance date at the deadline--the extended conformance deadline.

With that, the presentation is over. We'd be happy to answer any of your questions.

CHAIRMAN BEN S. BERNANKE. Well, thank you. That was very informative, and thank you again for all the work that's been done.

Let me ask about securitization. So there are different constraints. We have risk retention constraints. On the other hand, we have the Volcker Rule that prohibits trading on its own account. Could you talk a little bit more about how securitization fits into this framework? And I'd be interested in knowing if there are any distinctions among different classes of securitizations, for example, mortgage securitization versus credit cards and those kinds of things.

SCOTT ALVAREZ. So first let me set the framework. I want to jump in. Loan securitizations--so securitizations of mortgages, securitization of auto loans, of credit card loans--those are except from the rule and aren't subject to this. On the other hand, there are some securitizations that will be covered, and therefore things like municipal securities, other kinds of securities, CDOs, which are securitizations of securitizations. There are other kinds of esoteric assets that are secured to us, like intellectual property or real estate, other things like that.

For those types of securitizations, there are generally two types of requirements. One is under the Volcker Rule, and that says that an entity that organizes and offers that kind of securitization--so, as one of the sponsors of securitization--is limited in the amount that it can own of the securitization, can own only 3 percent, it must deduct that also from its capital for capital purposes. And it can't have relationships with the securitization that would be covered by 23A, which means no loans to the securitization or purchase of assets from the securitization. That the 3 percent limit is in conflict with the risk retention rule, which requires under certain circumstances that entities that are sponsors own 5 percent, retain 5 percent of the risk. So, that is a very specific provision that applies to a very particular kind of thing, securitizations. The covered fund rule is--applies broadly to all covered funds including securitizations. So, the concept in law is when there is one law that is specific to a particular situation and it's in conflict with a more general law, the specific law governs.

And that's the proposal that we brought to you for vote that would allow an entity that's subject to the risk retention requirements to retain 5 percent of the risk in conformance with the rules of risk retention, rather than the 3 percent limit. But the 5 percent would be a limit. It couldn't be greater than that 5 percent.

CHAIRMAN BEN S. BERNANKE. So, hedging is permitted activity. Hedges are not perfect, typically. They could be basis risk or other kinds of risk. I mean, how do we--it's a difficult question. But in practice, how perfect a hedge do you have to have in order to qualify as a hedge? Is it sufficient to reduce risk to some degree or is it a stronger condition than that?

SCOTT ALVAREZ. And so, the rule does not expect that entities will perfectly hedge the risks. What it expects is when they're engaged, if they want to take a position, a financial position and call it hedging, then that financial position must demonstrably reduce the risk of another position that the entity has. So, you know, the--we don't, and we made it clear in the preamble, it doesn't require perfect hedging. It does require some analysis to demonstrate that the risks are correlated, that this will reduce risk. That there--the strategy has to be documented. And the hedging position has to be continually reviewed to make sure it continues to reduce risk. Once the hedge is put on, oftentimes, things, markets move in ways that cause new risks to emerge. So we expect the entity to have an ongoing review and address those new risks as they emerge to keep the hedges in whatever balances within the risk columns of the organization.

CHAIRMAN BEN S. BERNANKE. I guess I have one more question on incentive compensation. We already have policies related to the incentives that traders and others face. How will our existing work on incentive compensation align with the requirements in this rule? And what are the main characteristics of the restrictions in incentive compensation in this--in the Volcker Rule?

SCOTT ALVAREZ. So, the Volcker Rule provide--replaces that the incentive compensation plan cannot be designed to incentivize or reward prohibited trading activity. It's intended to build on the--and lean on the risk, the incentive compensation guideline to each of the agencies are adopting under other provisions of the Dodd-Frank Act. So, the Board is ahead of most of the other agencies in developing incentive compensation guidelines. We've had them out since before the Dodd-Frank Act, and continue to revise them and improve them. And we would be relying on that to give life to the prohibition and the regulation. And other agencies are doing the same thing with theirs.

VICE CHAIR JANET L. YELLEN. Yeah. I'd like to ask two rules that pertain to your assessment of the potential impact or economic effects of this rule. The first one has to do with the degree of liquidity in markets. I know a lot of commenters and market participants have been concerned that, for example, the degree of liquidity in markets could be diminished, that markets might become more volatile, that these restrictions could raise the cost of financing for households and businesses. And I wonder how--what your assessment is of the potential impact, and to the extent that banking organizations are restricted. Do you see potential outside the banking system to take a--to provide additional liquidity if there are such effects?

SEAN CAMPBELL. Sure. So, while the Volcker Rule is clearly going to have direct consequences on banking entities, the effects on the lighter economy, I think, are much less clear. So, in connection with the point that you made about prohibited proprietary trading, proprietary trading is prohibited by banking entities. But there are lots of entities in the economy that engage in that activity that are not prohibited from engaging in that activity. And one would--one would imagine that, in light of the current restrictions on banks, that they may actually increase their exposure to that sort of activity.

That being said, it's also the case that within the context of the statute in the final rule, market making by financial institutions is a permitted activity. Banks, as you well know, currently engage in a significant amount of market making activity that provides significant amounts of liquidity to financial markets. The current rule takes the position of that provision of liquidity in the context of market making and related services is a permitted activity. There are no hard limits on the ability of a financial institution to make markets in that capacity. And so, from that perspective, in that sense, sort of the liquidity of the financial system is being protected by the rule. And as a final matter, banks are allowed to engage in trading as a risk to those principles. They're allowed to engage in trading on the behalf of clients. They're allowed to engage in trading on behalf of both the sort of several insurance accounts. And so that further reduces any impact that this rule might have on liquidity in the financial system.

VICE CHAIR JANET L. YELLEN. Great. And the second question that I have also concerns the impact, the potential impact of the rule. And I guess I'd like to ask your assessment of what impact do you think this will have on U.S. banks in terms of, do they face potential competitive disadvantages vis-a-vis foreign banks in various global capital market activities?

MARK VAN DER WEIDE. I'll take that one. I think to some extent the question of competitive equity for U.S. banks versus foreign banks will depend on whether other countries move towards adoption of the Volcker Rule-style regime. At this point, it's not clear whether any other countries will do that. I think it's fair to say that there's not a groundswell currently of other countries that are looking to do that. The UK's Vickers proposal and the EU's Liikanen proposals have--bear a distant resemblance to the Volcker Rule. But I think they're pretty different in some significant ways. So, for example, both Vickers and Liikanen don't distinguish between proprietary trading and market making, for example, and kind of generally push trading activities out. But more importantly, both Vickers and Liikanen don't push trading activities completely outside the organization. It's more of a ringfencing regime. So they internally must be pushed out of the retail deposit taking bank, but can remain within the consolidated holding company. So those proposals are far less than what the Volcker Rule would do. There are some major European countries, Germany and France most notably, that have issued some proposals that bear a closer resemblance to the Volcker Rule, and to target prop trading specifically. But even those proposals are kind of like our derivatives push out rule. They only push out the proprietary trading to non-bank affiliates. So, in general today, Volcker- style restrictions are unlikely to apply to foreign banks in their home countries.

Given that reality, I think it's hard to assess the potential competitive harm to U.S. banks from the Volcker Rule. That's something that we'll clearly be monitoring as we do the implementation process. From one perspective in United States, the Volcker Rule, everybody is on the same footing. The Volcker Rule will apply to the U.S. operations of foreign banks. But at the same time, outside the U.S., the major capital markets, competitors of our big banks are likely to be subject to the Volcker Rule. And that's something we'll have to watch. Now--And proprietary trading and hedge fund private equity fund activities of our banks have not been large revenue drivers over history. So, even if there is some competitive disadvantage in these particular markets, quantitatively, I won't expect it to add up to a large impact.

CHAIRMAN BEN S. BERNANKE. Governor Tarullo, do you have a question?

GOVERNOR DANIEL K. TARULLO. No. Thank you, Mr. Chairman.

CHAIRMAN BEN S. BERNANKE. Governor Raskin?

GOVERNOR SARAH BLOOM RASKIN. Thank you, Mr. Chairman. And I, too, want to thank the staff for your briefing, as well as the thoughtful and deliberative process that you have all engaged in to bring this final rule before us. There's no question but that the statutory rule has been exceedingly difficult to interpret and your diligence, together with the diligence of the staffs of four other agencies, is commendable. And I have a series of questions that I'm raising in the interest of clarification.

And the first one, Anna, goes to you, and I want to thank you for indicating that there is a lesser burden for smaller banks in complying with the proposed rule. Now, I want to ask a hypothetical. So, if I'm a banker and the size of my bank is less than five billion dollars in assets and I'm not certain whether some of my trading activities are prohibited by the rule or not-- I'm not sure if I'm de minimis or not--what should I do? In particular, what do I do by way of the reporting metrics, what do I do by way of establishing a compliance plan, and what do I do by way of providing the CEO attestation?

ANNA HARRINGTON. Well, in terms of metrics, they'll only apply to banking entities that have 50 billion or more in trading assets to start out, and then goes down to 10 billion in trading assets. So, I think as a bank with 5 billion in total assets, you will not have to worry about metrics reporting. CEO attestation is part of the enhanced compliance program, so that would apply to a banking entity with 50 billion in total assets. So again, that would not apply to a bank with 5 billion or less in total assets. But I think to your point about being uncertain whether or not you engage in covered activity, as we had talked about the way the rule works, is that you don't need a compliance program if you engage in no covered activity. If you're under 10 billion assets and you do engage in some activity, you need to update your existing policies and procedures to take into account that activity. So I think, you know, at the outset, community banks will have to make a judgment call about whether or not they fall into one of those two categories.

SCOTT ALVAREZ. I think, if I could add to that, it's exactly the right answer. We will--one of the things we have to do now going forward is to train our examiners and sensitize our examiners to what activity would be permitted and not permitted. And I think we would expect the smaller banks in particular to be in dialogue with examiners about the scope of different exceptions and different activities. We think that we have exempted most of the activities that small banks engage in, five billion dollars banks are engaged in, so that there should be no problem. But there are always going to be people who have questions and we want to be able to answer those questions; we expect the supervisory process to provide a vehicle for that.

GOVERNOR SARAH BLOOM RASKIN. OK, thank you. My next question really follows up on the Chairman's question on compensation. And I've reviewed some of the research of Bebchuk, Baiman, and others regarding the extent to which particular compensation structures encourage excessive risk taking and they can prove to be ultimately financially destabilizing. And this research focuses on different sorts of problems; one problem is the divergence between incentives of traders and executives on the one hand and shareholders on the other hand, and this divergences has often been called short-termism, which is the concern that pay arrangements permit traders and others to claim large amounts of compensation based on short term results. And when this divergence exists, traders and executives are able to collect and retain large amounts of compensation when the performance on which the compensation is based may subsequently be sharpened and reversed.

So my question really follows in on that theme and questions whether the proposed final rule creates tight connections between compensation plans and long term results. So, for example, to give maybe a concrete example, would the proposed final rule permit a trader to engage in a hedge on his or her own compensation? For example, by having a put option to sell his or her shares at the current prices so as to be ensured against declines in the stock price below current levels--in other words, does the proposed final rule contain such an anti-hedging requirement in the context of compensation?

SCOTT ALVAREZ. So what you've described is not a hedge by the banking entity itself but a hedge by an individual on the individual's compensation, and that is not covered by the rule. The rule covers the incentive compensation arrangements by the banking entity itself with the trader. That said, the incentive compensation guidelines that we're developing were broadly talks about the way that these incentive compensation plans should be constructed in entities, and whether there's a real opportunity for loss by the employee in the event that a real risk does occur in the future, and that there should be a callback or deferral or some other kind of approach to take account of that risk. And then I think that's where the conversation about these kinds of hedging activities is best takes--best takes place and where it is taking place.

GOVERNOR SARAH BLOOM RASKIN. OK, thank you. And finally, is the preamble of the proposed final rule silent about the need for regulatory coordination and sharing of the aggregated amount of trading that's occurring as a result of exempted trading? In other words, if this rule is finalized, the aggregated dollar amount of proprietary trading that is occurring through the exemptions will not be known publicly.

So, my question is, does the proposed final rule reflect any need to monitor and quantify changes in the dollar amount of trades the banks and their examiners have determined to be permitted requiring any aggregation of the amounts, and then requiring the bank regulators and the market regulators to share their results with each other? More generally, I'm also interested from the perspective of public transparency and accountability whether you think there's any value in developing a disclosure regime that reveals to the public the nature of trading activities at banks and that demonstrates clearly how such trading activity may be complying with the Volcker Rule. In awhile there are legitimate business reasons and concerns with public disclosure of specific trading positions as they are taking place, the goal of demonstrating compliance with the Volcker Rule doesn't need to require such micro level disclosure, but what I'm talking about is macro level of disclosure of aggregated data. So does the proposed final rule recognize any value to such a disclosure regime?

SCOTT ALVAREZ. So the--Anna, I’m sure, will want to correct me here when I get it wrong. But the way this is structured, we don't anticipate that we would take the trading activity of all the different banking entities, and sum it up into some big aggregate and impose a market kind of limit on the amount of trading activity. The metrics are more designed to allow a horizontal comparison of entities to see if there are maybe outliers in particular areas by looking at similar metrics across similar institutions. It is contemplated that the agencies would share data among ourselves and analyze the data. It could allow us to get a picture of the bigger market. But one thought on that is that the overall size of trading in a particular market is apt to be very volatile and depends on market circumstances, on events set entity, various entities, so it didn't seem appropriate for us to try to set some overall limit on that amount of activity. But watching it on a horizontal basis, I think, is something that we do expect to do.

SEAN CAMPBELL. So yes, but I think that being said, a more direct response to the Governor's question is in the context of permitted proprietary trading. So, for example, permitted proprietary trading, say, U.S. Treasury securities, I don't think we have anything in the rule that would provide for public disclosure of the amount of trading that's occurring in that vein.

MARK VAN DER WEIDE. I do want to add, though, the Volcker Rule's only one element of our tool kit for making sure that the trading activities of banks are done in a safe and sound manner. You're suggesting a particular, I guess, market discipline-based additional avenue for getting at the problem. But we have taken a lot of steps in the last few years to get our supervisory hands and regulatory hands better wrapped around the trading risk of banking organizations. If you look at the Basel 2.5 reforms, the Basel III reforms, the Basel liquidity rules, the central clearing and swap margin requirements, the way we're doing CCAR with the special market risk shock, and some of our other work in LISCC, we're making sure that all the trading activities at the banking organizations that we're looking at are adequately regulated, whether they're permitted under Volcker or not. So we're not--meaning, only on the Volcker staff to get the job done of taking a pretty broad regulatory approach.

CHAIRMAN BEN S. BERNANKE. Governor Stein.

GOVERNOR JEREMY C. STEIN. Thank you, Mr. Chairman. Let me just add my thanks to the many people here and to the other agencies who've worked--worked so hard on this--so hard and patiently on this. You know, a number people have alluded to how challenging this rulemaking has been. My sense is this version has done a really thoughtful job of trying to balance faithfulness to the statute with the desire to not compromise legitimate liquidity provision and hedging activities.

So with that in mind, let me ask a very specific market making-oriented question. Let me try and do, like, a case here. So, let's imagine a case where you have an asset manager, let's say it's a hedge fund, maybe they’ve been a client of the particular bank. They find themselves in trouble and they have to liquidate essentially a large fraction of their inventory, and that inventory includes a bunch of illiquid stuff, corporate bonds or asset-backed securities. So hypothetically, imagine the bank were to buy these to take the other side of this kind of fire sale that's being held. But because it's a very big slug of illiquid stuff, it's sort of a special situation--it would have to work this slug off gradually, say, over a period of some months.

So the question I have is, should I think of something like this that wants to fit within the spirit of the market making exemption, and, if yes, how do I kind of think of it fitting with the language about design not to exceed, what is it, reasonably expected near term demands of clients. And there's little bit attention here because this is a big, maybe unusually big--it's market making, economically speaking--but it's an unusually big and maybe longer term position to be, to be worked off. So how would that fit, how might the metrics help me or not help me inform a judgment, or will--should I think it's going to have to come down to, sort of supervisory judgment informed by the spirit of the rule? Just kind of want to understand the thought process a little bit more.

SEAN CAMPBELL. Sure. So let me--I'll get started with trying to respond to that hypothetical and others can jump in and help me out. So I think--again, in the context of the example that you provided, I think it's exactly right but that is in the spirit of what a market maker does, they provide immediacy to their clients, asset managers and others, and so taking on that position can be consistent with the notion of market making as provided by in the rule. And so you asked a little bit, well, how would we think about--how would we think about managing that in practice in a manner that's consistent with the rule. So one of the things that the rule would require is that entities that are engaged in market making will have prescribed limits that they look to to sort of map out, if you will, what are the sort of risk tolerances and risk exposures that they can take in the context of market making and that will be insuring that their activities are done in a manner that's consistent with those limits and when those limits--you know, if those limits are breached, then there's going to have probably be some managerial sort of control or thinking about whether or not those limits should be escalated, and if so how and over what timeframe, and I imagine there’ll also be some sort of dialogue with their regulator about that specific instance.

But I think the heart of your question goes to the notion of thinking about market making as a risk bearing activity. I think the rule takes a view which is sort of widely recognized by all the regulators--and, of course, the industry as well--that market making is not a riskless business model or business line, that it does require the assumption of some risk in connecting buyers and sellers, providing immediacy to your clients, meaning to set the market makers as holding some risk for some period of time, and working that off can take a period of days or hours or weeks, it depends on the specific asset in question and market conditions. And so I think the kind of transaction that you've discussed in your hypothetical is certainly consistent with market making, and it would really sort of--the implementation of how it gets worked out by the firm would depend on sort of the limits structure that they imposed on themselves as market makers.

GOVERNOR JEREMY C. STEIN. Thanks. One other question, which is--if somebody could say a little something about liquidity management as a permitted activity. What kind of activities might or might not be able to find a home under the kind of umbrella of liquidity management? And what safeguards are there if any for things kind of migrate--things that might have otherwise not been allowed migrating to the area of liquidity management?

SEAN CAMPBELL. Sure. So, I'll kick that one off too and leave it open for my colleagues to follow on after me. So, you know, I think we all recognize that liquidity is sort of a vital aspect of the banking industry. Indeed, you know, the Board has recently finalized rules that would require banks to hold certain sufficient amounts of higher quality liquid assets on their balance sheets, the same kind of assets that are covered by this rule. And so, the rule takes a position that purchases and sales of financial assets done in connection with the liquidity management program are not prohibited proprietary trading. They're done in furtherance of the bank's liquidity needs.

That being said, I think the agencies have also recognized within the context of the rule that the ability to perform liquidity management functions could open the door to impermissible proprietary trading, and so there has to be a number safeguards in place to ensure that that activity doesn't happen. So there are number of requirements that must be satisfied in order for that kind of liquidity management function to go on inside of a bank and not run counter to the Volcker Rule. So let me just run through few of them.

So first, the bank needs to have a liquidity management plan, which describes in some detail what are the instruments in which the can make those purchases and sales, how are those instruments, and the amounts of those instruments in which they would be buying and selling related to their near-term funding needs. And then, it has to be the case that there's an ongoing process of sort of auditing and independent testing in sort of overall oversight that ensures that the activity that's going on is really going on in the context of actual liquidity management of the bank rather than something else.

CHAIRMAN BEN S. BERNANKE. Governor Powell.

GOVERNOR JEROME H. POWELL. Thank you, Mr. Chairman. I'll echo others in saying this has been a challenging, epic, multi-agency process that has required a faithful application of a complex statute to prohibit proprietary trading and certain hedge fund and private equity activities as well, and I think the final product has adamantly met that test. And in keeping with the intent of the statute, the final rule also permits traditional activities to continue, including market making, risk-producing hedging, and underwriting, and allows firms to within clear and strict limitations to continue to sponsor funds for the benefit of their clients.

I just have a couple of questions. First, one of the big differences between the proposal rule and the final rule is that portfolio--so-called portfolio hedging is not in the final rule. Can you provide some clarity on exactly what we mean by that? And, you know, what sorts of things are not permitted and are permitted under that--under the final rule?

SCOTT ALVAREZ. Sure. So one of the things we learned from the 18,000 comments was that portfolio hedging means something different to just about everyone. And so the tack the final rule takes is it sticks very closely to this statute. The statute authorizes risk-mitigating hedging of individual positions or aggregated positions. And the rule is written in those terms rather than in terms of portfolio hedging, which would just be another term we would have to figure out a way to define.

The rule also makes some distinctions between some commonly held views of portfolio hedging and the kind of hedging that's permitted under the statute by requiring that to be a risk-mitigating hedge. It has to be related to identifiable risks of identified positions at the organization. So it's tied to positions at the organization not to general revenues, to general economic developments, not to the expectations of losses, which some consider to be portfolio hedging. So the rule sticks very closely to the statute. It allows aggregated positions to be hedged. That may fit some people's idea portfolio hedging, but it's a narrower thing than the general view that folks who have of portfolio hedging.

GOVERNOR JEROME H. POWELL. Thank you.

So Mark was around this is issue, but let me just make it more explicit. You know, financial institutions lose money when markets move, and much of it has nothing to with proprietary trading. So what can the public expect to see in a way--can you talk about the fact that we may see significant losses at times when markets move that have nothing to do with proprietary trading going forward? What can you do about that?

MARK VAN DER WEIDE. Sure, I'll talk a little bit more about that. I think the Volcker Rule will be, as I mentioned in response to Governor Raskin's question, it will be an important part of the way in which the Fed and the other bank and market regulators regulate trading risks in our largest financial institutions. It will prevent those organizations that are subject to the rule from engaging in some forms of speculative activity that's unconnected to providing financial services to clients. That will reduce risk with our largest institutions. We've seen some anticipatory conduct by banks to shed some other high-risk activities already. That is, I think, good.

But I think it is important to keep in mind that the Volcker Rule is not a guarantee that firms that we supervise won't lose a lot of money in their trading operations. And I think it's important to keep in mind the significant scope limitations of Volcker as we go forward to the implementation process. Crucially as has been indicated in the presentations today, the Volcker Rule does not apply to long term buy-and-hold positions, even if they're speculative. It only applies to short-term trading activity. It only applies to short-term trading in a particular financial asset: securities and derivatives, not loans or currencies, or certain other assets that banks hold. It exempts some of the most common forms of securities that banks trade in: U.S. government securities and GSE securities. It permits market making, as you mentioned. You can lose a lot of money market making if the market turns in a particular way that you did not anticipate. And there's also rogue trader risk, which the Volcker Rule is not going to--not going to stop, and banks have shown over the last couple of decades that they can lose a lot of money by rogue trader incidents as well.

So, you know, for all of these reasons, I think it's important as I mentioned to Governor Raskin, that the Volcker Rule would be just be one piece of the regulatory arsenal that we deploy against trading risks. And so it needs to be coupled with the capital rules, the liquidity rules, the derivatives reforms, and the broader package--and tougher supervision that we're doing through the LISCC to get the job done, to make sure that we've got the best hand that we can on the trading risks of big banks.

GOVERNOR JEROME H. POWELL. A brief comment: We--As Anna was mentioning earlier, we take very seriously the fact that these regulations sometimes aren't intended to burden smaller institutions, but nonetheless do. We hear that all that time to smaller institutions. So I know that in this case as in others we're going to try very hard to communicate with smaller institutions, so they don't have to invest a ton of time just to find out that here on page 750, they're exempt. So--because that's a material investment of people, and it just adds up on them. And I think that's our obligation, and I know we take it very seriously.

So I'll just conclude by also thanking the staff for this remarkable piece of work and commending you for this great conclusion. Thanks. Mr. Chairman?

CHAIRMAN BEN S. BERNANKE. Thank you very much.

Let me remind the Board that there are two motions today: One is the Volcker Rule itself, and the second is the extension of the conformance period until July 2015. Were there any questions that anyone had about the second, about the conformance period?

[Silence.]

CHAIRMAN BEN S. BERNANKE. I see none. In that case, if I could go around the table here and just get a sense of positions. Let me start with the Vice Chairman.

VICE CHAIR JANET L. YELLEN. Thank you, Mr. Chairman.

I support the staff proposal to finalize this rule, and also the proposal to extend the conformance period. I, too, want to join in congratulating the staff for completing the work on this rule making. It's obviously involved a huge amount of work and some very difficult judgments. I strongly support the goal of the rule, which is to eliminate short-term financial speculation in institutions that enjoy the protection of the safety net, but it's also important for the liquidity of financial markets and also for the safety and soundness of financial institutions that they be permitted to engage in market making and hedging. You've obviously worked very thoughtfully to strike in this rule just the right balance, and I congratulate you for doing that. Given the absence of a lot of bright-line distinctions, I think supervisors are going to bear going forward a very important responsibility to make sure that this rule really works as intended. But I support and thank you for all your hard work.

CHAIRMAN BEN S. BERNANKE. Thank you. Governor Tarullo?

GOVERNOR DANIEL K. TARULLO. Ah, yes. Thank you, Mr. Chairman.

So, for the reasons I noted in--pardon me, my introductory statement—I, too, support the adoption of the final rule. But like the Vice Chair and you have both already indicated, implementation here more than I think in most rules is probably going to be key. And as I noted earlier, although we have a role to play there, we're sort of a third-place role, but one which I think nonetheless our supervisors are going to have to navigate pretty carefully. Thank you.

CHAIRMAN BEN S. BERNANKE. Thank you. Governor Raskin?

GOVERNOR SARAH BLOOM RASKIN. Thank you, Mr. Chairman.

I've always attempted to set a high bar for us and our regulatory colleagues in the context of rulemaking. My assessment of this proposed final rule is that collectively we have come very far towards hitting that high bar. We've strengthened the hedging language to clearly require that hedges have to be tied to specific positions or aggregated specific positions in order to qualify for the hedging-permitted activity. In addition, hedging positions must demonstrably reduce or otherwise significantly mitigate identifiable specific risks identified at the inception of the hedging trade, and must demonstrably reduce added or newly developed risks. In other words, the hedge cannot add significant new risk to the position to be hedged. And there is an attestation requirement now for the person at the top, the CEO, who will be required to make appropriate inquiries about whether the design of the compliance program reasonably meets the statutory requirements prohibiting proprietary trading. These changes are commendable and help make the rule work better.

There are two remaining challenges as I see them, and the ability to overcome these challenges may not be known until we begin to implement the rule. So these challenges must be monitored carefully as the rule begins this operation. The first challenge is one that I will just underscore--it has been mentioned--and that is regulatory implementation. The proposed final rule has taken the approach of not setting explicit limits, but permitting regulated entities to set those limits through their compliance plans and then monitoring those compliance plans. This emphasis on compliance within firm-chosen limits rather than absolute thresholds means that the role of supervisors and examiners, and in particular the role of supervisor and examiner judgment and discretion become critical. Examiners from different agencies will be leaned on heavily. For example, there have been no limits placed on the types of assets or trading strategies that can qualify for permitted activities in market making hedging and underwriting. Even though the Volcker Rule contains a statutory prohibition on engaging in any permitted activities in cases were such activities expose the banks to high-risk assets or trading strategies, the proposed final rule does not make clear what assets or types of assets can constitute such high risk assets and what types of trading strategies constitute high risk trading strategies. Instead, examiners will be asked to make these determinations. So I look forward to the formulation of guidance that assists all examiners from all the agencies in those efforts and communicates those views to the affected financial institutions so that they understand what could be problematic.

Similarly, the proposed final rule would permit trading for purposes of liquidity management. But to ensure that liquidity management is not proprietary trading in disguise, we're going to have to require examiners to assure, among other things, that liquidity management is being conducted in accordance with the written liquidity management plan and that the amounts that are being held are consistent with the near-term funding needs of the financial entity. Again, these will be determinations to be made by examiners, and I believe they will need guidance when they undertake these determinations.

In addition to restrictions on inventory accumulation under the market making and underwriting permitted activities will be determined by the regulated institutions, and examiners, again, will need to verify whether the restrictions are appropriate. Examiners will need to be willing to limit inventory buildup if the total risk accumulated under market making and underwriting grows either on an institutional level or within the entire system. This willingness will require consistency, fortitude and support.

Compounding the role of single examiner judgment is the fact that institutions within the purview of the Volcker Rule are examined differently. The SEC may bring one perspective to its supervision of broker-dealers, and the OCC may bring a different perspective to its supervision of national banks. So I look forward to the issuance of supervisory guidance and training regarding the exercise of supervisory judgment and will want to assess the effectiveness of the agencies in engaging in interagency coordination of their approaches and their perspectives and their findings.

The second challenge regards the compensation provisions of the proposed final rule. In the proposed final rule as you've indicated, it merely states that the compensation structures can't be designed to reward or incentivize prohibited proprietary trading. This statement in the rule may, in fact, be enough to alleviate concerns that the design of compensation practices and financial institutions that engage in propriety trading is still a source of financial instability, but we can't be sure until we see. In other words, it seems to me that if we're serious about minimizing financial instability in the context of the Volcker Rule, then we have to engage in some scrutiny of the design of compensation plans and ask ourselves whether various pay arrangements are thwarting the rule's goals by inducing traders and others to accept excessive levels of risk, despite the existence of compliance plans, metrics, and CEO attestations.

Because bank risk-taking imposes costs on the public and the economy that shareholders don't always internalize, shareholders' interests may be served by greater risk-taking than is in the interest of the public and the economy. This is the well-known moral hazard problem, and compensation regulation is justified by the same moral hazard reasons that underlie our longstanding system of prudential and macroprudential regulation of banks.

Substantive regulation of the terms of compensation--in other words, specifically limiting the use of structures that reward risky behavior--can advance the goals of the Volcker Rule. As the Volcker rule becomes implemented, regulators should focus specifically on the structure of compensation with the aim of discouraging excessive risk-taking. If we had such a focus, we could supplement and reinforce the goals of this rule. In fact, if we knew that compensation arrangements were discouraging excessive risk-taking, we would realize that direct regulation need not be as stringent as would otherwise be necessary. Conversely, as long as compensation arrangements are unconstrained, the Volcker Rule would need to be more restrictive. We need to stay vigilant to the possibility that the compensation arrangements at particular institutions will not be conducive possibly to the minimizing of the potential for financial instability.

With those remarks Mr. Chairman, I support the publication of the final rule and the proposed--the proposal to extend the conformance period. As noted, the agencies have collectively made great strides. My recommendation is that we move forward towards implementing it, but not waiver from the need to actively monitor how the rule is working, both from the need to assist examiner implementation and coordination and enforcement of the rule, and from the need to assess how the terms of compensation maybe furthering or thwarting the rule's goals.

CHAIRMAN BEN S. BERNANKE. Thank you. Governor Stein.

GOVERNOR JEREMY C. STEIN. Thank you, Mr. Chairman.

I also support the final rule. I support the one year extension. I just wanted to thank everybody again for their hard work.

So I agree with the comments that have been made about the challenges that still lie ahead in supervision and implementation. But having said all that, I do think the rule will be helpful. I think it's important to align expectations. I completely agree with the way Mark characterized it. I don't think we should expect that this is going to prevent all future trading-related screw-ups, and that's why robust capital against any kind of trading exposure, be it market making or otherwise, is really in some sense the first line of defense. But, you know, nevertheless I think that this rule puts in place a systematic process that forces--when they're looking at trades or hedges or whatever--to ask the right kinds of questions, and I think that's going to be helpful, and I think it's going to meaningfully improve the odds of getting around at least some of this problems. So I'm supportive.

CHAIRMAN BEN S. BERNANKE. Governor Powell.

GOVERNOR JEROME H. POWELL. As I mentioned earlier, I think that the rule is very faithful to the statute and I also think it does strike the right balance as indicated by the statute permitting activities that need to continue, and so I'm happy to support it and also to support the extension.

CHAIRMAN BEN S. BERNANKE. Thank you.

I also support the rule and the extension, I think the rule as written strikes a good balance between achieving the objectives of the statute to limit short-term risky proprietary trading while preserving legitimate functions, like market making, hedging, and underwriting. As I said before, I think the implementation--and Governor Raskin said very eloquently--implementation and feedback will be very important as we learn about how the rule works and the effects on banks, but also the effects of markets and the broader economy. And I think we should be prepared to make adjustments over time if we learn that there are unanticipated problems or unintended consequences that arise from the rule.

But as I said, again, I do support the rule as written. I think it is a major piece of work that reflects a lot of input from policymakers, from staff and certainly from the public, who submitted--as you mentioned, Scott--about 18,000 comments on the first version of the rule.

So with that, I think we're prepared to vote. The first motion is to approve the final proposed rule and related federal register notice. Can I have a second?

VICE CHAIR JANET L. YELLEN. Second.

CHAIRMAN BEN S. BERNANKE. All in favor please say aye.

ALL. Aye.

CHAIRMAN BEN S. BERNANKE. Are there any objections or abstentions?

[Silence.]

CHAIRMAN BEN S. BERNANKE. Hearing none, I need a motion to approve the proposed extension of the conformance period of final rule.

VICE CHAIR JANET L. YELLEN. So moved.

CHAIRMAN BEN S. BERNANKE. All in favor say aye.

ALL. Aye.

CHAIRMAN BEN S. BERNANKE. Objections? Seeing none. Both motions are carried. And I thank again the staff and my colleagues, particularly for coming out on a snowy day. So thank you very much.