The Volcker Rule: The Prohibitions, Compliance and the Cost on the Small Bank

Amanda R. Huff

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# The Volcker Rule: 
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Cost on the Small Bank

*Amanda R. Huff*

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*Amanda R. Huff is a student at Western State College of Law; I would like to thank Professor David Groshoff, my faculty advisor, for his continuing advisement, guidance and encouragement throughout the process of writing this article.*
I. INTRODUCTION

The Volcker Rule is a regulation on prohibited activities, "proprietary trading" and "investing in or sponsoring hedge funds and private equity funds," with the exception of certain "permitted activities." The Volcker Rule imposes "compliance program requirements" that require distinctive requirements of banking entities depending on the size of the regulated banking entity with certain minimal threshold requirements depending on whether the banking entity is engaged in the prohibited activities or not. The Volcker Rule’s “compliance program requirements” impose requirements in relation to the amount of trading and fund related activities the banking entity is engaged in, because the more "trading" or "fund [related] activities" that the banking entity conducts, the more complex the requirements must be to...
ensure "compliance." The Volcker Rule imposes minimal requirements to ensure banking entities not currently engaging in the prohibited activities do not start. The inclusion of banking entities not engaging in the prohibited activities may prevent the banking entities from ever engaging in the prohibited activities, however, this inclusion is imposing requirements on future, speculative activities, creating costs. The question that arises is how will banking entities not engaging in the prohibited activities be affected and what will these requirements cost these smaller banking entities, such as community banks, regional banks, and mutual funds? Additionally, the issue is whether the costs of implementing the Volcker Rule's requirements in relation to smaller banking entities not engaging in prohibited activities are necessary and whether these costs may be reduced.

Part I of this article provides a historical background articulating the events leading up to and the policy reasons undergirding the Volcker Rule's enactment. Part II explains the Dodd-Frank Act's purpose and how the Volcker Rule furthers this purpose. Part III will break down the Volcker Rule into separate subsections by inquiring: (A) who regulates the Dodd-Frank Act (thus the Volcker Rule), (B) what does the Volcker Rule require, (C) what entities are regulated, (D) what is regulated, (E) the activities that are still permitted, (F) the effective date and compliance timeline, and (G) the requirements of the regulated in order to comply.

Part IV discusses the Volcker Rule's potential impact in California on smaller banks, including the costs that these smaller entities may sustain. Since there is no state regulation comparable to the Volcker Rule in California law, Part V of this article inquires why California has never regulated California small banking entities in a way comparable to the Volcker Rule. Part VI discusses the Volcker Rule's major issues, criticisms, and concerns. Finally, this article articulates three modest proposals that are consistent with debated ideas and theories that address the major issues, criticisms, and concerns surrounding the Volcker Rule while upholding the Volcker Rule's intent to create "financial stability" and to reduce risk.

II. HISTORICAL BACKGROUND OF THE EVENTS THAT LED UP TO THE GREAT RECESSION

The "Great Recession," or also known as the Financial Crisis of 2008, led the U.S. government to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act. This section provides a brief overview of the U.S. economic history and the central causes of the Great Recession that drove the U.S. economy to the Great Recession and implementation of the Dodd-Frank Act.

5. Id.
6. Id.
7. FINANCIAL STABILITY OVERSIGHT COUNCIL, supra note 2, at 1-2.
In the turn of the twentieth century, the U.S. economy was experiencing an economic growth from excessive buying boosting the market. On October 24, 1929, the U.S. stock market crashed, commencing substantial effects on the U.S. economy such as banks closing, industrialization seizing, customers withdrawing from the banks, fifteen million U.S. citizens becoming unemployed and the overall flow of money in the U.S. economy decreasing. By the 1930s, the U.S. economy was experiencing an unprecedented low: the “Great Depression.” To bring the U.S. economy out of the Great Depression, President Franklin Roosevelt enacted “The New Deal” which provided “relief programs for the unemployed, [and] for the hungry,” “empowered the economy” with industrialization, and produced “agencies to regulate [United States] banks, the stock market, [and] capitalism itself.” President Roosevelt was moving the U.S. economy into an era of regulation by creating a host of new laws, including: regulating banks (the Emergency Banking Act); creating new jobs (the Civilization Conservation Corps Act); stabilizing the agriculture industry (the Agriculture Adjustment Act); and the regulation of securities (the Federal Securities Act); just to name a few.

As part of Roosevelt’s regulation, the U.S. government enacted the Glass-Steagall Act, also known as the Banking Act of 1933, which “separated commercial banking from investment banking” for the “primary purpose of . . . [making the bank industry] safer by prohibiting speculation in securities.” The Glass-Steagall Act created a wall of separation by prohibiting a commercial bank from engaging in trading activities to prevent risky proprietary trading. Additionally, in response to the vicious cycle of banks failing, from customers taking out investments believing the bank may fail and thus causing a bank to fail, the Glass-Steagall Act instituted the Federal Deposit Insurance Corporation (FDIC) to insure banking deposits to create customer reassurance. The Glass-Steagall-Act was instituted in response to the stock market crash, which “triggered upwards of 11,000 commercial bank failures between the years of 1930 and 1933” and “restored public confidence in banking practices.”

10. Id.
14. Id.
17. Id.
The Post-Depression era ushered in the full force of the economic philosophy of Keynesianism.\textsuperscript{20} During World War II the U.S. Government brought financial stability back to the U.S. economy by increasing spending and creating jobs, and brought the U.S. economy out of the Great Depression.\textsuperscript{22}

In the 1970s Keynesianism came to a halt\textsuperscript{23} and the U.S. Government was departing from its path of regulation to a movement of deregulation where markets would self-regulate as to produce a “more efficient allocation[ ] of resources and economic growth.”\textsuperscript{24} Deregulation was occurring in the airline industry where the Civil Aeronautics Board, the regulatory authority of the airlines for the past thirty years, was no longer controlling the industry-causing prices to drop and there was an increase in air travel.\textsuperscript{25} Deregulation in the banking sector was creating: “higher interest rates” by allowing banks to solicit in any state, higher risk loans being funded due to no interest rate caps, and a growth in larger banks.\textsuperscript{26}

In 2000, the U.S. Government “[f]ormal[ly] deregulat[ed] the banking sector” by passing the Gramm-Leach-Bliley Act, “which repealed the Glass-Steagall Act and ushered in the era of broad banking.”\textsuperscript{27} The Gramm-Bliley Act was passed with the intent to create an environment of “broad banking”\textsuperscript{28} in the banking industry that would reduce risk.\textsuperscript{29} Subsequently, the “Stock Market Bubble collapsed” and in response to this collapse the Federal Reserve “aggressively lower[ed] short term interest rates from 6.5 percent to 3.5 percent,” then to 1.75 percent, then again to 1.0 percent.\textsuperscript{30} Due to the reduced interest rates “financial institutions [sought] out a new range of potential investment products . . . . Borrowers, who might not otherwise have been in the market . . . sought [investment],” household debt increased and “personal disposable income decreased.”\textsuperscript{31} Lenders from financial institutions sought

\begin{enumerate}
\item \textsuperscript{20} \textit{Commanding Heights, supra} note 9.
\item \textsuperscript{21} \textit{What is Keynesian Economics?}, wisiuGEEK, http://www.wisegeek.org/what-is-keynesian-economics.htm (last visited Jan. 8, 2014) (Keynesianism is the economic theory of famous economist John Maynard Keynes’s ideas of “the circular flow of money” creating financial rehabilitation by the government imputing money into the market to increase spending, which will increase the “flow of money” thus increasing spending, and so on.).
\item \textsuperscript{22} \textit{Commanding Heights, supra} note 9.
\item \textsuperscript{23} \textit{id.}
\item \textsuperscript{24} Brian J.M. Quinn, \textit{The Failure of Private Ordering and the Financial Crisis of 2008}, 5 N.Y.U. J. L. \& BUS. 549, 556 (2009).
\item \textsuperscript{27} Quinn, \textit{supra} note 24, at 557.
\item \textsuperscript{28} See James R. Barth et al., \textit{The Repeal of Glass-Stegall and the Advent of Broad banking}, 1-2 (Econ. and Policy Analysis, Working Paper No. 2000-5, 2000), available at http://business.auburn.edu/~barthj/papers/The%20Repeal%20of%20Glass-Stegall.pdf (“Broad Banking” is the term used to describe how banks could act after the enactment of the Gramm-Leach-Bliley Act where there were fewer “restrictions” on banks and banks could conduct a more diverse portfolio of “activities.”).
\item \textsuperscript{29} Quinn, \textit{supra} note 24, at 558-59.
\item \textsuperscript{30} \textit{id.} at 563.
\item \textsuperscript{31} \textit{id.} at 563-64.
\end{enumerate}
investments that were “lock[ing] consumers into complex loans with hidden [fees].” With interest rates decreasing borrowers were taking out mortgages with the assumption that these borrowers could refinance and when the real estate market fell, interest rates were rising and borrowers could not refinance their mortgages and lenders were starting to foreclose. Financial firms were “plac[ing] massive, risky bets with borrowed money.” The financial institutions were self-regulating, rules were not being enforced, “risky bets” were being made and the “tax payers were on the hook if a big bank or financial institution ever failed.” The deregulation of the U.S. banking sector “deepened” the “current crisis” that the U.S. economy was experiencing. On January 14, 2010, in a statement by Denise Voigt Crawford, the Texas Securities Commissioner, at a committee for the Financial Crisis Inquiry Commission, the Commissioner stated, “[d]eregulation is no longer the presumptive policy prescription . . . .” The U.S. government needed a change and the U.S. government found this change in the Dodd-Frank Act.

III. THE VOLCKER RULE

The Volcker Rule is the linchpin of the Dodd-Frank Act that prohibits “proprietary trading” and investing in a “hedge fund or a private equity fund.” One reason why the Volcker Rule has been so highly debated is due to the outright ban on proprietary trading. The purpose of the prohibition of proprietary trading was to prevent banking entities from taking risky bets, because when those bets failed, the U.S. government was bailing the banks out with taxpayer money. The ban on proprietary trading may dramatically reduce the liquidity of the banking industry by banning one of the “most profitable activities” but that might not even be enough to

33. Quinn, supra note 24, at 562-67.
34. See id. at 562-67 (The “Housing Bubble” was created by lenders lending several types of mortgages including, but not limited to: “adjustable rate mortgages (“ARMS”), option ARMS, Alt-A state income loans, negative amortization loans” where these were “depend[ent] on the continued appreciation of housing prices.” Subsequently, interest rates were increased, “real estate prices” were decreasing, refinancing was declining and individual borrowers were unable to make payments on mortgages and lenders were starting to foreclose, causing the housing market “bubble” to burst.).
35. President Barack Obama, supra note 32.
36. Id.
38. Id.
41. Patterson, supra note 39.
43. Patterson, supra note 39.
bring the U.S. economy out of financial crisis.\textsuperscript{44} The Volcker Rule spans over hundreds of pages, is extremely complex, and may have a dramatic affect on the banking industry,\textsuperscript{45} raising the issue as to whether the Volcker Rule will effectively reduce risk in the banking industry or whether reducing risk in the bank industry could be accomplished by other means. To determine the answer, this article will first break down the Volcker Rule text in order to then analyze how the Volcker Rule will affect the banking industry and whether the Volcker Rule effectively reduces risk.

This article will break down the Volcker Rule into separate sections to discuss what the Volcker Rule requires. The subsequent sections are: (A) who regulates the Dodd-Frank Act, and thus the Volcker Rule; (B) what does the Volcker Rule require; (C) what entities are regulated; (D) what is regulated; (E) the activities that are still permitted; (F) the effective date and compliance timeline; and (G) the requirements of the regulated in order to comply.

A. Who Regulates the Dodd-Frank Act, and Thus Regulates the Volcker Rule

The regulatory authority under the Volcker Rule is a “coordinated rulemaking” activity where authorities from several agencies and the Board work together to regulate certain “entities.”\textsuperscript{46} Included in this “[c]oordinated rulemaking” authority is “(I) the appropriate Federal banking agencies” that regulate insured depository institutions, (II) “the Board” that regulates “any company that controls an insured depository institution, or that is treated as a bank holding company . . . any nonbank financial company supervised by the Board, and any subsidiary of any of the [entities stated above]”; (III) the Commodity Futures Trading Commission, and (IV) the Securities and Exchange Commission.\textsuperscript{47}

B. What Does the Volcker Rule Require?

The Volcker Rule states that the Financial Stability Oversight Counsel (FSOC) will conduct a study no later than December 21, 2010; this study will propose new provisions that will be promulgated under the Volcker Rule.\textsuperscript{48} The FSOC must advance the Volcker Rule’s purposes of reducing risky activities, preventing illegal activities in the banking, protecting the people, ensuring no undue burden of banking and insurance with the enactment of the Volcker Rule, providing “financial stability”, and the “enhance[ment] of safety and soundness of banking entities.”\textsuperscript{49} The FSOC

\textsuperscript{44} Kavoussi, supra note 42.
\textsuperscript{46} 12 U.S.C. § 1851(b) (2012).
\textsuperscript{47} § 1851(b)(2)(B)(i).
\textsuperscript{48} § 1851(b).
\textsuperscript{49} Id.
was created by the Dodd-Frank Act to provide the U.S. government with a uniform regulatory authority where the main aspect of the FSOC’s responsibilities was to propose new provisions under the Volcker Rule. Then, “appropriate Federal banking agencies, the Securities and Exchange Commission [(SEC)], and the Commodity Futures Trading Commission, shall consider findings of the study [by the Financial Stability Oversight Council] and adopt rules . . .” to promote the provisions of the Volcker Rule.

C. What Entities are Regulated Under the Volcker Rule’s Prohibition of Proprietary Trading?

1. The “Banking Entity”

One of the most complicated parts of the Volcker Rule is determining what entities are regulated under the Volcker Rule. To determine exactly what the Volcker Rule means by “entities” an individual must look to several cited regulations and acts to determine its specific definition. Under the Volcker Rule, the first regulated group is a “banking entity.” A “banking entity” encompasses “insured depository institution[s] . . . any company that controls an insured depository institution, or [an entity] that is treated as a bank holding company [under] Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such entity.”

An “insured depository institution” is defined under the Federal Deposit Insurance Corporation Act for purposes of the Volcker rule regulation. The Federal Deposit Insurance Corporation Act defines an “insured depository institution” as “any bank or saving association the deposits of which are insured by the Corporation pursuant to this chapter.” The purpose of including “insured depository institution[s]” in the prohibition of propriety trading under the Volcker Rule is to “prohibit [deposit] entities with access to deposit insurance from taking propriety bets using deposits while relying on a federal government backstop,” and thus preventing trading for the benefit of those entities instead of the clients and accordingly, furthering the purpose of the Volcker Rule. Included in the group of “banking entities” is “traditional commercial banks with securities and brokerage businesses, such as Bank of America, J.P. Morgan Chase, Wells Fargo, etc.” However, within

51. § 1851(b).
52. § 1851(a)(1).
53. § 1851(h)(1).
54. Id.
56. Chatterjee, supra note 18, at 42.
57. Id. For purposes of full disclosure, my faculty advisor on this article is a former JPMorgan Chase executive and maintains financial ties with the organization. See, e.g., David Groshoff, Would “Junkholder Primacy” Reduce Junk Corporate Governance?, 13 J. BUS. & SEC. L. 59 (2012) (As a result, we believe that the ethical approach requires disclosure of these facts, remote as they may be, to my authorship of this article.).
the inclusion of an “insured depository institution” there are some institutions that are
excluded from the Volcker Rule regulation, stated in the definition under the Federal
Deposit Insurance Act, if the institution “functions solely in a trust or fiduciary
capacity.” 58 Additionally the insured depository institution must meet certain
conditions to be excluded. 59

A second group of banking entities that is regulated under the Volcker Rule’s
prohibition on proprietary trading is “any company that controls an insured depository
institution, or that is treated as a bank holding company . . . .” 60 This group of banking
entities is “any company” that controls an “insured depository institution” as defined
above and bank holding companies. Examples of banking entities that fall within the
group of regulated entities are Goldman Sachs and Morgan Stanley. 61 Also included in
this group of banking entities are “U.S. branches of foreign banks . . . [as to ensure
foreign banks within the U.S.] are subject to the same restrictions [within the U.S.
market].” 62 The third group of “banking entities” that are subject to the regulation of
the Volcker Rule is “any affiliate or subsidiary of any such entity.” 63 This group is the
least technical to understand and encompasses banking entities that are considered part
of or a branch of other “banking entities” that are encompassed under the regulation of
the Volcker Rule.

The Volcker Rule’s definition of a “banking entity” affects the U.S. market on
both the national and state level because the Volcker Rule definition regulates insured
depository institutions that are insured by the FDIC, the companies that control these
insured depository institutions, entities that are treated as bank holding companies, and
any affiliate or subsidiary of the aforementioned banking entities. 64 A bank that is
FDIC insured means that the FDIC insures the deposits of the individual customer of
the bank in the event of loss up to a certain amount if the “insured bank fails. 65 The
“banking entities” that are affected include “(i) FDIC-insured national or state banks,
(ii) FDIC-insured savings associations, credit card banks and industrial loan
companies, and (iii) bank-holding companies . . . and (v) foreign banking institutions

59. See id. (The conditions of an “insured depository institution” that must be met in order to be
excluded from regulation of the Volcker Rule are: (A) “all or substantially all of the deposits of such
institution are in trust funds and are received in a bona fide fiduciary capacity;” (B) “no deposits of
such institution which are insured by the Federal Deposit Insurance Corporation are offered are
marketed by or through an affiliate of such institution;” (C) “such institution does not accept
demand deposits or deposits that the depositor may withdraw by check or similar means for
payment to third parties or others or make commercial loan;” and (D) “the institution does not (i)
exercise discount or borrowing privileges pursuant to section [11 A of the Federal Reserve Act]; or (ii) exercise discount or borrowing privileges pursuant to section [19(b)(7) of the Federal Reserve Act].

60. Id.
61. Chatterjee, supra note 18, at 42.
62. Id. at 43.
corporatelaw.jdsupra.com/post/volcker-rule-proposed-regulation.
regulated as [bank holding companies].” 66 When a bank that is FDIC insured fails, the FDIC uses FDIC insurance to pay the individual consumers with taxpayer money. 67 FDIC funding consists of payments by the insured depository institutions and FDIC earnings from the U.S. Treasury securities. 68 Thus, all FDIC insured banks, state and federal, are included in the Volcker Rule for the purpose of preventing more bailouts 69 by the FDIC when the bank fails.

2. The “Nonbank Financial Companies Supervised by the Board”

A second category that is regulated by the Volcker rule is “nonbank financial companies supervised by the Board.” 70 A “nonbank financial company” is any “company that the Council has determined under section 5323 of this title . . . .” 71 A “nonbank financial company” supervised by the Board includes companies that the Board of Governors concludes, “could pose a threat to the financial stability of the United States.” 72 To determine whether the nonbank financial company could pose a threat, the Council will consider factors such as the companies’ leverage, size, nature of activities and assets; “the extent and nature of the off-balance-sheet exposures”; ability to be a source of credit; ability to be a source of “liquidity for the United States financial system”; impact on the U.S. in the event of failure; amount of liabilities; whether regulated by another agency; and any other factor the Council sees fit. 73

D. What is Regulated Under the Volcker Rule?

The Volcker Rule’s prohibition can be broken down into two separate regulations based on whether the entity that is being regulated is a “banking entity” or a “nonbank financial institution.” This section will be broken down into two subsections that will first look at the prohibitions of “banking entities” and then “nonbank financial institutions.” The first section dealing with “banking entities” will be further broken down into the two categories of prohibition on “banking entities”: (1) prohibition in proprietary trading, and (2) the prohibition of “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.” 74 This Article breaks down what is regulated by the Volcker Rule so this Article may then determine what the potential impact will be based on the Volcker Rule regulations. Since proprietary trading is considered one of

66. jdsupra, supra note 75.
70. § 1851(a)(2) (2012).
73. § 5323(a)(2)(A)-(K).
74. § 1851(a)(1).
the main causes of the Financial Crisis, this Article will focus on the controversial prohibition of proprietary trading, the impact of this prohibition and if this prohibition reduces risk.

1. The Regulation of Banking Entities on Prohibition of Proprietary Trading

Under the Volcker Rule "proprietary trading" is an activity where a "banking entity" is prohibited from "engaging as a principal for the trading account . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract for sale of a commodity . . . for the purpose of profiting from short-term price movements." This means that the banking entity shall not acquire or trade for the banking entity's own benefit or profit instead of the benefit or profit of the client of the banking entity. The Volcker Rule defines a trading account as "any account used for acquiring or taking positions . . . ." which includes: (1) "positions for the purpose of [a] [s]hort-term sale," (2) positions that are treated as covered positions, and (3) "positions acquired or taken by certain registered securities and derivatives dealers, [which are financial institutions]." Within trading accounts are "covered positions" which include "positions (including long, short, synthetic and other positions) in securities, derivatives, commodity futures, and options on such instruments, but do not include positions in loans, spot foreign exchange or spot commodities."81

2. The Regulation of Banking Entities on the Prohibition to "Acquire or Retain Any Equity, Partnership or Other Ownership Interest in or Sponsor a Hedge Fund or a Private Equity Fund"

The prohibition on acquiring and retaining "any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund" was enacted with the "same purpose" of the prohibition on proprietary trading and can be broken down into three main reasons. These three reasons are: (1) to create "[s]eparate federal support for the banking system from speculative investing activity with the firm's own capital; [(2)] [r]educe potential conflicts of interest between a banking entity and its

77. § 1851(h)(4).
78. Chatterjee, supra note 18, at 45.
79. § 1851(h)(6).
81. Id.
customers; and [(3)] reduce [the] risk to banking entities and nonbank financial companies designated for supervision by the Board." The prohibition of acquiring and retaining these interests have been imposed because the Financial Stability Oversight Council has found from their required study under the Volcker Rule that these activities may increase risk because the “complexity of [these] investments . . . has made it more difficult for the market, investors, and Agencies to understand, properly value, and manage the risks to [these] banking entities.”

3. The Regulation of Nonbank Financial Companies Supervised by the Board: Additional Capital Requirements and Quantitative Limits

The Volcker Rule states that “[n]onbank financial companies supervised by the Board” are not prohibited from certain activities like “banking entities,” but where these nonbank financial company[ies] [that are] supervised by the Board . . . engage[ ] in proprietary trading or take[ ] or retain[ ] any equity, partnership, or other ownership interest in or sponsor[ ] a hedge fund or a private equity fund [the ‘nonbank financial company’] shall be subject, by rule . . . to additional capital requirements . . . and additional quantitative limits . . . .

These additional capital requirements and quantitative limits, when required, will be set out by “the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission . . . .” The Volcker Rule does not define and leaves open what these “additional capital requirements [or] . . . quantitative limits” are or what their scope would entail by leaving this regulation up to the appropriate aforementioned Federal Agencies to impose what the Federal Agencies would see fit as in the best interest of the U.S. market to reduce risk.

4. Permitted Activities that Banking Entities May Still Engage in

In order for a covered bank under the Volcker Rule to fully participate in the market, the bank must be aware of not only what activities are prohibited, but activities that are permitted. Although the Volcker Rule is considered a “ban” and prohibits certain activities of “banking entities” and “nonbank financial institutions,” the Volcker Rule allows for certain “permitted activities” as to ensure that “the economy and consumers continue to benefit from [the] robust and liquid capital markets and financial intermediation . . . that represent [the] core banking functions . . . .” The Volcker Rule sets out nine permitted activities that the banking entities may still

82. FINANCIAL STABILITY OVERSIGHT COUNCIL, supra note 2, at 56.
83. Id.
84. § 1851(a)(2).
85. § 1851(b)(2)(A).
86. § 1851(a)(2).
87. FINANCIAL STABILITY OVERSIGHT COUNCIL, supra note 2, at 1.
engage in apart from the prohibited activities as explained above, any restrictions by federal or state law, and any limitations the “appropriate Federal banking agencies, the Securities and Exchange Commission and the Commodities Futures Trading Commission . . .” shall issue.

The first permitted activity is “the purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof . . .” This permitted activity allows for these entities to still engage in activities to “allow[ ] for attending to U.S. government obligations . . . [as to ensure] the liquidity of [the] markets . . .” The second permitted activity allows for these entities to engage in “underwriting or market-making-related activities,” when seven additional requirements are met. The third permitted activity allows for these entities to engage in “[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions . . . designed to reduce the specific risks to the banking entity . . .” The fourth permitted activity is “[t]he purchase, sale, . . . or disposition of securities and other instruments [as] described in subsection (h)(4) [of the Volcker Rule, which is proprietary trading, (but is permitted because it is done)] on behalf of [the] customers [and not for the benefit of the banking entity].”

The fifth permitted activity is “[i]nvestments in one or more small business investment companies . . . designed primarily to promote the public welfare . . .” The sixth permitted activity is “[t]he purchase, sale, acquisition, or distribution of securities and other instruments described in subsection (h)(4) [which is proprietary trading, but done] by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate . . .” This permitted activity may only be engaged in “by any affiliate [where it is] . . . solely for the general account of the regulated insurance company, if . . . [the activity complies with the required laws of the jurisdiction]; and . . . after consultation with the Financial

88. § 1851(d)(1).
89. § 1851(d)(1)(A).
90. Chatterjee, supra note 18, at 50.
91. § 1851(d)(1)(B).
92. See Paul Hastings, LLP, Stay Current: A Client Alert from Paul Hastings, PAUL HASTINGS, LLP, 3 (November 2011) http://www.paulhastings.com/Resources/Upload/Publications/2038.pdf (The seven additional requirements that must be satisfied in order for the entity to engage in this permitted activity are: “(i) The banking entity has an established internal compliance program to ensure, among other things, that the subject activities are underwriting activities; (ii) The covered financial positions is a security; (iii) The purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter; (iv) If the subject underwriting requires the banking entity to be registered as a “securities dealer,” the banking entity has the appropriate dealer registration or otherwise is exempt or excluded from registration; (v) The underwriting activities with respect to the covered position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparts; (vi) The underwriting activities are designed to generated revenues primarily from fees, commissions, or income not attributed to price appreciation or hedging related to such activities; and (vii) Compensation arrangements of persons performing the underwriting activities do not reward proprietary risk-taking.”)
93. § 1851(d)(1)(C).
94. § 1851(d)(1)(D).
95. § 1851(d)(1)(E).
96. § 1851(d)(1)(F).
Stability Oversight Council and the relevant insurance commissioners . . . [has approved the activity].

The seventh permitted activity is

[O]rganizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having [others such as] employees who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses . . . if [eight requirements are met].

The eighth permitted activity is “[t]he acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity . . . solely outside of the United States . . . .” The ninth permitted activity is any “[s]uch other activity as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Commission determine . . . .”

In addition to these nine permitted activities, the Volcker Rule states that banking entities may engage in “de minimis investment” activities. The “de minimis investment” exception allows a banking entity to invest in “a hedge fund or private equity fund that the banking entity organizes and offers . . . [to] make a de minimis investment.” However, a “de minimis investment” is subject to three limitations and restrictions. First, the banking entity must attempt to find independent investors for the investment to diminish the percentage of the banking entity’s investment. Second, within one year of the “establishment of the fund,” the banking entity must ensure that the banking entity’s percentage of investment is at “3
percent [or less] of the total ownership interests of the fund." \[106\] Third, the investment of the banking entity must be “immaterial,” and materiality is defined by the Volcker Rule’s rule making authority, \[107\] the Board, the Commodity Futures Trading Commission, and the Securities and Exchange Commission. \[108\] However, the rule making authority’s decision on the “immaterial” investment of all of the banking entities combined cannot exceed “3 percent of the Tier 1 capital of the banking entity.” \[109\]

Lastly, the Volcker Rule imposes “capital standards” on banking entities \[110\] when the “appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission” determine that the banking entity should be subjected to “additional capital requirements and quantitative limitations, including diversification requirements, regarding the activities permitted” if these restrictions are needed to “protect the safety and soundness of [the] banking entities engaged in the activities.” \[111\] The capital standard is determined by

the aggregate amount of the outstanding investments by a banking [entity’s de minimis investments] . . . including [the] retained earnings, [which] shall be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction shall increase commensurate with the leverage of the hedge fund or private equity fund. \[112\]

5. The Effective Date and Compliance Timeline of the Volcker Rule

The Volcker Rule came into effect on July 21, 2012. \[113\] Even though the Volcker Rule is now in effect, the banking entities and nonbank financial companies supervised by the Board are subject to a “conformance period” where these entities have two years, until July 21, 2014, to “bring its activities and investment into compliance with the requirements [of the Volcker Rule] . . . .” \[114\] In addition, “the Board may, by rule or order, extend this two-year period for not more than one year at a time . . . [but] may not exceed an aggregate of 3 years.” \[115\] Overall, banking entities and nonbank financial institutions supervised by the Board “technically,” by the language of the Volcker Rule, do not have to become “fully compliant” with the Volcker Rule until July 21, 2014, or at the latest July 21, 2017, if “such an extension is

\[106\] § 1851(d)(4)(B)(ii)(II).
\[107\] § 1851(b)(2).
\[108\] § 1851(d)(4)(B)(ii)(II).
\[109\] § 1851(d)(4)(B)(iii).
\[110\] § 1851(d)(3).
\[111\] § 1851(d)(4)(B)(iii).
\[113\] 12 U.S.C. § 1851(c)(2).
\[114\] Id.
consistent with the purposes of [the Volcker Rule] and would not be detrimental to the public interest.” These dates, as will be discussed below, create ambiguity in what exactly these banking entities and nonbank financial institutions supervised by the Board are required to do in the interim.

6. The Volcker Rule Requirements

The Volcker Rule first required that no “later than 6 months after July 21, 2010, the Financial Stability Oversight Council shall study and make recommendations on implementing” the seven purposes of the Volcker Rule.\textsuperscript{117} After the Financial Stability Oversight Council completed the study and made their recommendations, the “appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission [considered] the findings of the study and . . . adopt[ed] rules to carry out [the Volcker Rule].”\textsuperscript{118} Based on the rules that the “coordinated agencies” created under the Volcker Rule, these banking entities must comply with certain requirements and compliance programs. The rules promulgated under the Volcker Rule require the bank to (1) “clearly identify which existing activities are covered” by the Volcker Rule, (2) “map trading and funds activity to exemption criteria,” (3) “conduct evaluations on tiered compliance programs, quantitative metrics and reporting requirements,” and (4) adhere to a minimum compliance program.\textsuperscript{119}

The Federal Compliance Programs require that the banks “identify the level of compliance [that] these programs will require.”\textsuperscript{120} “The level of compliance required will increase depending on the size of the trading activities [that] the banks are involved in.”\textsuperscript{121} For example, “[b]anks that are involved in trading for more than $1 billion will need to set up a tiered programmatic compliance regime and supply regulators with quantitative metrics . . . .”\textsuperscript{122} Banks that are involved in trading for

\textsuperscript{116} Id.
\textsuperscript{117} § 1851 (b)(1)(A)-(G) (The seven purposes that the Financial Stability Oversight Council must consider when making their study and recommendations are to: “(A) promote and enhance the safety and soundness of banking entities; (B) protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and [their] affiliates . . . will engage in unsafe and unsound activities; (C) limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities; (D) reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board, and the interests of the customers of such entities and companies; (E) limit activities that have caused undue risk or loss . . . ; (F) appropriately accommodate the business of insurance within an insurance company . . . ; and (G) appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions . . .”).
\textsuperscript{118} § 1851(b)(2).
\textsuperscript{120} Id.
\textsuperscript{121} Id.
\textsuperscript{122} Id.
"more than $5 billion will have a higher standard to conform to."123 However, even if the "banking entities do not engage in any [prohibited] act under the [Volcker] rule . . . [these entities are still required to adhere to the minimum] compliance program . . . ."124

a. The Compliance Program Requirements

The Compliance Program first requires "[i]nternal written policies and procedures," which requires the entities to create documents as well as describe and monitor covered trading activities.125 Second, the entities must have "[i]nternal controls [as] to ensure conformance with authorized risks, restrictions, policies, and procedures."126 For entities that are not currently engaged in proprietary trading or "fund-related businesses," these entities must create policies and procedures as to ensure that the entity will not in the future engage in activities that are prohibited by the Volcker Rule and "ident[ify] an officer . . . with oversight responsibility" of these policies and procedures.127 Third, the entities must ensure "[r]esponsibility and [a]ccountability" by the entities "top management."128 Fourth, the entity must provide for "[i]ndependent [t]esting . . . [to] evaluate overall adequacy of the [compliance] program."129 Fifth, the entity must provide "[t]raining . . . to educate trading personnel to make informed day-to-day decisions."130 Finally, the entity must "[keep records] . . . to support the operations and effectiveness of the compliance program[.]."131

b. Requirements of the Compliance Program Based on the Amount of Trading and Fund Activities of the Banking Entity

The Compliance Program applies to all entities whether that entity is engaging in the Volcker Rule's prohibited activities or not, but the Compliance Program specified above are only the minimum requirements.132 Under the Compliance Program, banking entities will have certain other requirements based on what "tier" the banking entities fall into, which is broken down into three tiers of Compliance Program regulations.133 "Tier 1" is the minimal tier that includes banking entities that are not engaging in the prohibited activities that the Volcker Rule covers where these "Tier 1" entities must comply with the minimum compliance standards,134 as detailed above. "Tier 2" includes banking entities that "engage in trading or fund activities and

123. Id.
124. Id.
125. Darragh, supra note 119.
126. Id.
127. Smith, Horn & Ireland, supra note 3, at 4.
128. Darragh, supra note 119.
129. Id.
130. Id.
131. Id.
132. Smith, Horn & Ireland, supra note 3, at 4.
133. Id. at 5.
134. Id.
investments on a relatively small scale" where the "value of the trading assets and liabilities . . . or . . . the assets of covered funds that . . . [the entity] sponsors or in which it invests are less than $1 billion [dollars]."135

"Tier 3" includes three categories of banking entities.136 First, a banking entity is tier three if the banking entity has "trading assets and liabilities (including . . . affiliates and subsidiaries on a worldwide basis)" of an "average gross sum . . . [on] the last day of each of the four prior calendar quarters, equal to or greater than either $1 billion or ten percent of the . . . total assets."137 Second, a banking entity is tier three if the banking entity "hold[s], together with . . . [the banking entity's] affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is . . . measured . . . [on] the last day of each of the four prior calendar quarters" of $1 billion or more.138 Lastly, a banking entity is tier three if the banking entity "sponsor[s] or advise[s], together with . . . [the banking entity's] affiliates and subsidiaries, one or more covered funds, the average total assets of which are . . . measured . . . [on] the last day of each of the four prior calendar quarters" of $1 billion or more.139 Additionally, "Tier 3" banking entities "that exceed . . . $5 billion for any of the activities [described] above [will be] . . . subject to certain data gathering and reporting requirements in addition to those [requirements for "Tier 3" banking entities.""]140

The Compliance Programs for "Tier 3" banking entities require that the banking entities have a more complex regime, such as “[d]etailed policies and procedures” and “[have a] complex set of internal controls, involving officials . . . [and directors] . . . at many levels of the [banking entity].”141 "Tier I" banking entities, as stated above, only have minimum compliance requirements, but should be aware of the requirements of "Tier 2" banking entities as these banking entities should "anticipat[e]" that the banking entity "will enter Tier 2."142 "Tier 2" banking entities "are urged to consider the Tier 3 requirements as a model . . . [as] Tier 2" banking entities are required to adhere to basically the same "compliance requirements . . . [of the banking entities] in Tier 3."143

135. Id.
136. Id.
137. Id.
138. Smith, Horn & Ireland, supra note 3, at 5.
139. Id.
140. Id.
142. Smith, Horn & Ireland, supra note 3, at 11.
143. Id. at 12.
IV. THE VOLCKER RULE’S IMPACT ON CALIFORNIA: THE IMPACT ON SMALLER ENTITIES AND THE COST OF THE VOLCKER RULE’S REGULATIONS AND REQUIREMENTS

A. The Impact on Small Community Banks

The Volcker Rule’s requirements and regulations may have a significant impact on “community banks and other banks” requiring these banks to adhere to the Volcker Rule’s requirements, regulations, and compliance programs even “where there is a small likelihood of systematic risk.”144 One of the greatest areas of impact by the enactment of the Volcker Rule will be felt by community banks even where there is only “profoundly modest changes in rules and supervision.”145 Community banks “generally are not engag[ing] in proprietary trading [and thus] they can ignore most of the voluminous and controversial regulations . . . [of the] Volcker rule.”146 However, as stated under the compliance program [ ] requirements, “the Volcker rule . . . [still] require[s] some action by all community banks” whether the community bank is engaged in the prohibited activities or not.147 For example, all community banks will be required to put in “place policies and procedures designed to prevent it from commencing such activities” even when the community banks are not engaged in or have accounts that fall within the regulated activities of the Volcker Rule.148 Generally community banks do not engage in the prohibited activities that the Volcker Rule encompasses, but “community banks may have [some] accounts that might fall within the definition of a trading account, [but] these [trading] accounts [are] typically [trading accounts that are] invest[ing] . . . in government securities, and the proposed regulations [of the Volcker Rule] exempts”149 these government securities as “permitted activities.”150

The Volcker Rule’s requirements and compliance programs will impact community banks by requiring the community banks, even when the community banks are not engaged in the prohibited Volcker Rule activities, to create “time-consuming and labor-intensive . . . [programs that] every bank, regardless of size” will have to adhere to.151 The Volcker Rule has the ability to possibly prohibit or burden “banks to make markets for clients, facilitate the issuance of securities or engage in hedging

147. Id.
148. Id.
149. Id.
151. Letter from Cecelia Calaby, supra note 144, at 2.
activities that are critical to bank safety and soundness.”\textsuperscript{152} The Volcker Rule could also “be so complex as to become a trap for the unwary, resulting in disruptive, contentious examinations and enforcement actions that make market-making and hedging activities impossible to conduct economically.”\textsuperscript{153} Since community banks are “smaller banks with less complicated transactions. . .[these community banks] are given less extensive requirements under the. . . [Volcker Rule] regulations.”\textsuperscript{154} Notwithstanding how regulators want to spin these “low” or “minimal” compliance program requirements these community banks are being affected by the Volcker Rule regulations even when the community banks are not engaging in the prohibited activities where they are required to follow the compliance regulations on future speculation.

B. The Impact of Mutual Funds

In addition to the substantial affect that the Volcker Rule will have on California community banks, the Volcker Rule will have an overwhelming affect on California mutual funds. The Volcker Rule will in effect prevent banking entities “from sponsoring the most highly regulated type of investment vehicle [mutual funds] and, thereby, limiting investment options for investors.”\textsuperscript{155} The Volcker Rule’s prohibitions will require “banks to . . . [restrict the bank’s] holdings in private equity. . . funds to three percent within one year.”\textsuperscript{156} Additionally, “[b]ank-owned investment subsidiaries [who] normally provide initial start-up capital for mutual funds” will be unlikely to provide initial start-up capital or might do so at an alarming low rate.\textsuperscript{157} These bank-owned investment subsidiaries will be less likely to invest due to the restriction in the holdings and being “unable to share the same name with the mutual fund, creating a major branding problem.”\textsuperscript{158} Furthermore, “some mutual fund operations could be pulled into the Volcker Rule [prohibitions] because . . . [the mutual fund] own[s] a small bank [and then the mutual fund will be forced] to divest the banking unit to avoid disruption of . . . [the mutual fund’s] central . . . interests.”\textsuperscript{159}

C. The Impact on Regional Banks

A third category of small California banking entities that will be impacted by the Volcker Rule’s prohibitions is regional banks. Regional banks “focus on deposits

\textsuperscript{152} Ludwig, supra note 145.
\textsuperscript{153} Id.
\textsuperscript{156} Id.
\textsuperscript{157} Id.
\textsuperscript{158} Id.
\textsuperscript{159} Id.
and lending rather than high-risk activities,” which is the main purpose and focus of
the Volcker Rule, and thus regional banks are protesting the inclusion of regional
banks in the prohibitions and restrictions.\textsuperscript{160} California regional banks that will be
affected by the Volcker Rule include such banks as “U.S. Bancorp, SunTrust Bank,
Inc., PNC Financial Services Group and Regions Financial Corp.”\textsuperscript{161} Regional banks,
in dealing with mostly deposits and lending, generally have most of the regional
bank’s assets tied up in “commercial and retail loans as opposed to . . . investment and
banking products” such as high-risk lending done by “JPMorgan and Goldman Sachs.”\textsuperscript{162}

Congress and regulators have gone on record and stated that although they
view regional banks differently from the high-risk banking institutions, these regional
banks are still being represented the same.\textsuperscript{163} The Volcker Rule’s requirements will
impose “increase[d] compliance costs, as . . . [the regional banks] would have to
institute expensive compliance programs despite . . . [the regional bank’s] lack of
participation in the risky activities prohibited by the [Volcker] [R]ule.”\textsuperscript{164} Under the
Volcker Rule, regional banks will have “to develop and implement, in extremely short
order, compliance [programs], internal controls, record keeping and reporting regimes
simply to ‘prove a negative’ -that . . . [the regional banks] are not engaged in
impermissible proprietary trading.”\textsuperscript{165} The Volcker Rule will require these regional
banks to “comply with . . . [most], if not all, of the same requirements applicable to the
largest financial firms with substantial trading volume and covered fund
investments.”\textsuperscript{166} Additionally, the requirements and compliance costs “could force
some banks to stop participating in activities allowed under the Volcker Rule that
provide liquidity to customers.”\textsuperscript{167}

D. The Impact: Costs, Business and the Employee

Almost every aspect of the banking realm will be affected by the Volcker
Rule’s requirements and regulations. One major impact that will occur due to the
Volcker rule will be on the bank, the bank employees, and the stockholders.\textsuperscript{168} The
Volcker rule “will undoubtedly make some banks less profitable by curtailing what has
been a major source of revenue [of the banks] since the practice [of proprietary


\textsuperscript{161} Id.

\textsuperscript{162} Id.

\textsuperscript{163} Id.

\textsuperscript{164} Id.


\textsuperscript{166} Villarreal, \textit{supra} note 160.

\textsuperscript{167} Id.

trading] was legalized in 1999" by the Gramm-Leach Bliley Act. This prohibition will curtail the activities of the banking entities leading to fewer profits, which "could . . . lead to . . . layoffs and depressed stock prices."\footnote{170}

Smaller banks, such as those that will be affected in California, "do not have the compliance staff or resources of larger banks and could be captured by a largely unclear definition of propriety trading that might include small-bank market-making, asset liability management and hedging activities."\footnote{171} The Volcker Rule is designed "around large banks, making it harder for small banks to compete with [the] large[r] banks" due to the compliance requirements.\footnote{172} "The Volcker [Rule] was clearly intended to regulate large banks, hedge funds and private equity funds"\footnote{173} and now smaller banks that do not have the resources and staff to keep up with the compliance standards are at risk.

Another impact of the Volcker rule regulations will be on the banking customers themselves due to the trickling down of costs.\footnote{174} Although the Volcker Rule might "reduce the risk" to the bank customers, the Volcker Rule "could also result in higher fees for bank customers, as banks have historically dug into customers' pockets [when the banking entities have experienced] shortfalls . . . ."\footnote{175} In addition to individual customers being affected by the Volcker Rule, small business consumers are at risk.\footnote{176} "The U.S. Chamber of Commerce argued that the [Volcker Rule] would restrict credit for small business or result in higher cost for basic financing."\footnote{177} These "[s]mall businesses will have to forgo business opportunities altogether due to the increased capital costs and diminished access to credit."\footnote{178}

V. The Volcker Rule Raises the Question of Why the State of California Does Not Have a Comparable Law to the Volcker Rule

The State of California has forty-nine acts and codes that include the California Constitution, the Business and Professions Code, the Corporations Code, and the Financial Code, just to name a few.\footnote{179} In addition, the State of California Regulations Code has twenty-eight titles covering all areas that the State of California
What does not appear in this vast array of assemblage of acts, codes, and regulations is a California State law that is comparable to the Volcker Rule's prohibitions. There are a number of California state laws that regulate banking entities, for example, that set limits on the banks total investments in securities, that allow commercial banks to "organize, sponsor, operate, control, advise, or underwrite . . . or sell securities of, certain investment companies;" and regulations on bank holding companies pertaining to reporting and the right to examine, just to name a few. However, there is no comparable act, code, or regulation to that of the Volcker Rule's prohibitions or an act, code, or regulation that mentions proprietary trading prohibitions.

The lack of a comparable California act, code, or regulation on the prohibition of proprietary trading raises the question of why the state of California does not have a comparable law to the Volcker Rule's regulations. One argument could be that the State of California has not needed a law prohibiting the act of proprietary trading because it has not been an issue with smaller state banks, such as community banks, mutual funds, and regional banks in the past. Where California has not regulated the type of prohibited activities that the Volcker Rule prohibits because smaller banks do not generally engage in those activities. Now, the Volcker Rule imposes regulations on these smaller banking entities where there has not been a need to regulate them in the past. The Volcker Rule imposes prohibitions and regulations on these smaller banking entities to provide financial stability and to reduce risk, but the Volcker Rule has also produced issues, criticism, and concerns.

VI. The Volcker Rule's Creation of Issues, Criticism, and Concerns

The Volcker Rule is "among the most heated" regulations of the Dodd-Frank Act. Before the enactment of the final version of the Volcker Rule, individuals were allowed to submit comment letters on the proposed legislation up until the February 13, 2012 deadline. The number of comment letters submitted is approximately 15,000 voicing strong opinions for and against the regulation;
however most of the comment letters are opposing the regulation.\textsuperscript{190} The issues, criticism, and concerns that will be discussed below surrounding the Volcker Rule is (1) "The Compliance Window:" what is actually required in the interim, (2) the costs of the Volcker Rule regulation, and (3) the risk reduction.

A. \textit{"The Compliance Window": What is Actually Required in the Interim}

The Volcker Rule states that a "banking entity or nonbank financial company supervised by the Board" has two years either from when "the requirements become effective" or "entity or company becomes a nonbank financial company supervised by the Board" to "bring its activities and investments into compliance . . . ."\textsuperscript{191} This means that a banking entity or a nonbank financial company has until July 21, 2014, two years from the date that the Volcker Rule became effective,\textsuperscript{192} or two years from the date that the particular "entity or company becomes a nonbank financial company supervised by the Board."\textsuperscript{193} In addition, the Board may further extend this period "one year at a time . . . not to exceed the aggregate of 3 years" where the Board finds such extension "consistent with the purposes of [the Volcker Rule] and would not be detrimental to the public interest."\textsuperscript{194}

The Volcker Rule creates this two-year, possibly five-year window, which the banking entities and nonbank financial companies must use to bring the activities and investments of the banking entity or company into compliance with the Volcker Rule \textit{by the deadline}, but the Volcker Rule does not provide guidance on what the banking entity or nonbank financial company must do in the interim. The Volcker Rule's "compliance window" creates the issue "as to whether the [Federal Government] is requiring banks to start scaling back on making bets with their own money almost immediately, or whether [the banks] can continue until the ban on such activities goes into affect in two years."\textsuperscript{195} The issue is that there is a split of thinking among "law firms, bankers, analysts, and members of Congress" of what the Volcker Rule is requiring banking entities and nonbank financial companies to do during the "compliance window" and due to this split of thinking banking entities and nonbanking financial companies are being told to act and invest inversely\textsuperscript{196} possibly creating instability. This split of thinking is boiled down to how individuals interpret the words "good faith."\textsuperscript{197}

\begin{footnotesize}
\begin{enumerate}
  \item \textit{Id.}; \textit{see also} Morrison & Foerster, \textit{supra} note 113, at 27.
  \item § 1851(c)(2) (2012).
  \item \textit{Id.}
  \item \textit{Id.}
  \item \textit{Id.}
\end{enumerate}
\end{footnotesize}
The "Federal Government states . . . that it expects banks to 'engage in good faith planning efforts' to make sure [the banking entities and nonbank financial companies] comply with the proprietary-trading restrictions by July, 21, 2014." On one side of this "good faith" interpretation some firms are telling their clients, the banks, "that the Federal Government's guidance means [the banking entities and nonbank financial companies may] continue to make bets with their own money for an additional two years." Basically, firms are stating that these banking entities and nonbank financial companies may continue as the banking entities and nonbank financial companies have done in the past, to continue proprietary trading, and disregard the rule for two years so long as the entities are compliant at the deadline.

One former Securities and Exchange Commission attorney stated the obligation "was to make a good-faith effort to move toward compliance by July 21, 2014 and before that time banks can continue to prop trade without regard to [the] Volcker Rule." This article takes the view that this interpretation of "good faith compliance" and what is required of banking entities and nonbank financial companies during the compliance window seems to be counterintuitive to the purpose of the Volcker Rule. The Volcker Rule's purpose to "strengthen [the U.S.] financial system" and to prohibit "proprietary trading" and investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions would not be furthered by this interpretation. By the U.S. Government proposing, creating, and enacting the Volcker Rule, the U.S. Government has implicitly created the interpretation opposite to this view. Although the Federal government has provided a window for banking entities and nonbank financial companies to become compliant, seemingly for the benefit of the banking entities and nonbank financial companies, it would seem that the U.S. Government's intent was not to state that banking entities and nonbank financial companies could continue to engage in this matter during the compliance window because this would be contrary to the purpose behind the Volcker Rule.

The second view, and the view that would seem to be more congruent with the Volcker Rule's purpose, is where banks "gradually shed proprietary operations during the conformance period so that any moves by the time it ends [are not] disruptive" to the Volcker Rule. Where banking entities and nonbank financial companies may not "continue business as before" the Volcker Rule became effective. In support of the argument that this view would be more congruent with the Volcker Rule's purpose Senator Carl Levin, a democratic from Michigan, states "[i]t is contrary to the law and

198. Id.
199. Id.
200. Id.
201. Patterson, supra note 195.
202. FINANCIAL STABILITY OVERSIGHT COUNCIL, supra note 2, at 1.
204. Patterson, supra note 195.
common sense to suggest that banks would be exercising ‘good faith’ efforts to comply with the law by continuing to engage in what is clearly propriety trading.”

However, the fact is that the compliance window has created a split of interpretation creating uncertainty as to what the Volcker Rule’s “good faith” standard is requiring during the compliance window.

B. The Costs of the Volcker Rule

A concern surrounding the Volcker Rule is the costs of the Volcker Rule on the U.S. economy and how the Volcker Rule might affect the economy. As stated above, the Volcker Rule may effect and create costs for community banking, mutual funds, regional banks, bank employees, bank stockholders, and the bank customers. In addition to the aforementioned are costs related to profitability, implementation of compliance programs, layoffs, and depressed stocks. The Financial Services Roundtable, after collating data on the implementation of the Volcker Rule has projected that the Volcker Rule “could cost American businesses $315 billion.”

The study also states that due to the regulations of the Volcker Rule the costs of borrowing will increase, which is mostly likely due to the “waterfall effect” of the costs to the banking entities’ new regulations and requirements where banking entities “have historically dug into customers’ pockets [when the banking entities have experienced] shortfalls.”

Additionally, The Volcker Rule’s costs may be seen in the hours of implementation of the Volcker Rule that the banks will be spending to become compliant with the regulations. The Volcker Rule’s new regulations and requirements that must be implemented by banks have been projected to require banks to “spend 6.6 million hours to implement.” In addition to those preliminary hours to become compliant, it is estimated that “1.8 million hours [will] be required every year in perpetuity.” Although this article acknowledges that these costs must be somewhat speculative and the specific monetary numbers of the Volcker Rule are yet to be determined, the costs to the smaller community banks, mutual funds, and regional banks will nevertheless most likely be more severe, no matter the number, because smaller banks lack the “compliance staff and resources of larger banks,” which may make it more difficult to implement the Volcker Rule requirements.

206. Patterson, supra note 195.
207. Bell, supra note 168.
209. Id.
210. Bell, supra note 168.
211. Fast Facts, supra note 208.
212. Id.
213. Bolger, supra note 171.
C. The Reduction of Risk

This article suggests that in considering the costs of the Volcker Rule's requirements and regulations the U.S. Government should be certain that this regulation will have a substantial impact on the reduction of risk in order for the benefits to exceed the costs and thus uphold the purpose of the Volcker Rule itself. Paul Volcker stated "that proprietary trading 'is essentially speculative in nature.'" However, other activities are essentially speculative in nature and create risk, such as "lending to commercial real estate ventures—a traditional banking activity," which is not being regulated by the Volcker Rule. The point of this statement is that although the Volcker Rule's prohibition on proprietary trading may reduce risk and benefit the U.S. economy the question is whether this is the best approach to reduce risk.

In commentary on the Volcker Rule's restrictions Paul Volcker stated, proprietary trading is "speculative in nature" and "proprietary trading entails substantial risks." However, some acts of "proprietary trading may not involve taking much risk" at all. "The risk[ ] of proprietary trading depends entirely on the nature of the assets being traded, the trading strategy, and the leverage applied." This means that if the U.S. Government could regulate the nature of the assets, how the trading takes place, or the type of leverage that is applied, this could reduce the risk as well instead of a blanket prohibition on proprietary trading itself. The Volcker Rule's blanket prohibition on proprietary trading may reduce risk because proprietary trading, not all trading, involves risk, but this prohibition will also create, as explained above, "a recipe for inflating compliance costs."

VII. The Proposal

The Volcker Rule is a "key component [to the] effort" of the U.S. Government to "strengthen the [U.S.] financial system." There is no doubt that the Volcker Rule may have a substantial impact on the U.S. financial system by providing more stability through the reduction of risky activities conducted by banking entities and nonbank financial companies supervised by the Board. In providing this stability,
the Volcker Rule has been meticulously scrutinized, analyzed,223 and highly debated224 by the U.S. Government to provide for the best possible resolution of the affects of the Great Recession. However, when forming a regulation, such as the Volcker Rule, there is the possibility that there will be some negative affects or outcomes that were not comprehended or thought possible even when constructed by the most highly intelligent principal leaders in the field. The Volcker Rule became effective on July 21, 2012,225 however the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall consult and coordinate . . . as appropriate, for the purposes of assuring . . . that such regulations are comparable and provide for consistent application and implementation . . . to avoid . . . advantages or imposing disadvantages to the companies affected . . . and to protect the safety and soundness of banking entities and nonbank financial companies supervised by the Board.226

This means that where the coordinated authority finds appropriate, the coordinated authority may amend the regulations under the Volcker Rule to avoid advantages and disadvantages and to protect the banking entities and nonbank financial companies.

This proposal serves to shed some light on and articulate thoughts, ideas, and concerns being debated surrounding the Volcker Rule’s enactment. This proposal shall set forth modest ideas consistent with the purpose of the Volcker Rule that include the topics of (1) The Compliance Window: Setting a Standard of “Good Faith”; (2) the reduction of costs to California smaller banking entities: community banks, mutual funds, and regional banks not engaged in proprietary trading; and (3) alternatives to the blanket ban on proprietary trading.

A. The Compliance Window: Setting a Standard of “Good Faith”

The Volcker Rule provides banking entities and nonbank financial companies a “compliance window,” where depending on a grant of extension of that window, the banking entity or the nonbank financial company supervised by the Board has two to five years to “bring its activities and investments into compliance with the requirements” of the Volcker Rule.227 This “compliance window” should provide the banking entity or nonbank financial company supervised by the Board sufficient time to bring the activities and investments into compliance. The aspect of granting the window does not create the dispute, but what does create a dispute is what the banking entity or nonbank financial company supervised by the Board should do in the

224. Morrison & Foerster, supra note 187 (stating that “discussions relating to the Volcker Rule were among the most heated”).
225. § 1851(c)(2)(B) (2012); see also Morrison & Foerster, supra note 113, at 27.
227. § 1851(c)(2).
The Volcker Rule interim. The issue is what is meant by the requirement that “banks . . . 'engage in good-faith planning efforts’ to make sure [the banking entities and nonbank financial companies] comply with the proprietary-trading restrictions by July 21, 2014.” This proposal suggests that the coordinated rule making authority should set a standard to sufficiently articulate what is meant by “good faith.”

In determining the “good faith” requirement meaning, the interpretation should be consistent with the purpose of the Volcker Rule to “strengthen [the U.S.] financial system” and limit those risk-taking activities. The interpretation of the “good faith” standard that would be consistent with the Volcker Rule’s purpose would be the requirement that banking entities or nonbank financial companies supervised by the Board should “gradually shed proprietary operations during the conformance period.” This “good faith” standard would require the banking entity or nonbank financial company to progressively move toward the goal of being abstinent of all prohibited activities and investments.

In progressively moving toward the goal, the “good faith” standard should set minimal procedures that the entity would be required to adhere to in order to ensure that the entity is making some progress. These minimal procedures should be articulated into “stages,” as was suggested by one law firm, that would progressively move the entity toward compliance by the July 21, 2014 deadline. The coordinated rule making authority of the Volcker Rule could set concrete “stages” that could provide evidence that the entity is actually making that “good faith” effort to become fully compliant with the Volcker Rule by the deadline. The pace that the entity moves through these “stages” should be set accordingly to the individual banking entity or nonbank financial company where the pace would not be detrimental to the entity, but is still progressively moving toward the goal. Each entity would be moving at different pace, but every entity would be moving toward the goal and reaching it at the same time.

In addition, as to ensure entities are adhering to the “good faith” standard, the coordinated rule making authority of the Volcker Rule could create an “enforcement action” provision. The “enforcement action” provision will provide that where the banking entity or nonbank financial company supervised by the Board can provide evidence that the banking entity or nonbank financial company has “demonstrated procedural

228. Patterson, supra note 195.
229. Id.
230. FINANCIAL STABILITY OVERSIGHT COUNCIL, supra note 2, at 1.
231. Patterson, supra note 195.
232. See generally Dan Ryan et al., FS Regulatory Brief, The Volcker Rule - How Much Faith is Good Faith (2012), available at http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/pwc-volcker-rule-food-faith-compliance.pdf (The “stages” requirement to show that a banking entity is complying in “good faith” with the Volcker Rule was created by the law firm of PricewaterhouseCoopers LLC, a Delaware limited liability partnership).
233. Id.
234. Letter from Cecelia Calaby, supra note 144 (In a comment letter from Cecelia Calaby of the American Bankers Association (ABA) to the Office of the Comptroller of Currency, she proposed on behalf of the ABA the “enforcement action” provision).
reasonable efforts at good faith,” there will be “no enforcement action or other adverse regulatory action” against the banking entity or nonbank financial company supervised by the Board.\textsuperscript{235} The American Bankers Association, the creators of this “enforcement action” proposition, stated that this “approach” was also taken in “Section 165 stress testing requirements for the $10-$50 billion banks” by the Office of the Comptroller of the Currency.\textsuperscript{236} The “good faith” standard “stages” could provide the evidence for the “enforcement action” that the banking entity or nonbank financial company is making “reasonable efforts at good faith”\textsuperscript{237} to comply with the Volcker Rule by the deadline. Setting this “good faith” standard would be more conducive to the Volcker Rule’s purpose as opposed to the split that is occurring presently.

B. The Reduction of Costs to California Smaller Banking Entities: Community banks, Mutual Funds and Regional Banks not Engaged in Proprietary Trading

One of the greatest costs that the Volcker Rule may impose, if not the greatest, is the impact that the Volcker Rule may have on the smaller community banks, mutual funds and regional banks. The Volcker Rule “was clearly intended to regulate large banks, hedge funds and private equity funds”\textsuperscript{238} and smaller banks may be greatly impacted by the regulation due to cost of compliance even where these smaller banks are not engaged in the prohibited activities.\textsuperscript{239} The issue is that the smaller community banks, mutual funds, and regional banks that are not engaged in the prohibited activities will be required to adhere to the “Tier 1” requirement where, although these are the “minimal requirements,”\textsuperscript{240} even “profoundly modest changes in rules and supervision” will have a substantial impact.\textsuperscript{241}

The “Tier 1” requirements state community banks, mutual funds, and regional banks that are not engaged in the Volcker rule’s prohibited activities must adhere to a six prong “compliance program” requiring the entities to have: (1) “internal written policies and procedures,” (2) “internal controls,” (3) must ensure “responsibility and accountability” by the entities “top management,” (4) “independent testing,” (5) “training . . . to educate trading personnel to make informed day-to-day decisions” and (6) “keep records . . . to support the operations and effectiveness of the compliance program.”\textsuperscript{242} This article suggests that the compliance program may create substantial costs to small banks where the bank is not even engaged in the prohibited activities and investments and will most likely not ever engage in the prohibited activities and investments and where these costs are being imposed on speculation. This proposal

\textsuperscript{235} Id.
\textsuperscript{236} Id.
\textsuperscript{237} Id.
\textsuperscript{238} Bolger, \textit{supra} note 171.
\textsuperscript{239} Smith, Horn & Ireland, \textit{supra} note 3.
\textsuperscript{240} Id.
\textsuperscript{241} Ludwig, \textit{supra} note 145.
\textsuperscript{242} Darragh, \textit{supra} note 119.
suggests alternatives to mitigate the costs to banking entities that are not engaged in proprietary trading and that will not be engaging in proprietary trading in the future.

The State of California, within its extensive culmination of acts, codes, and regulations, does not have a comparable regulation to that of the Volcker Rule where, as argued above, this may be because smaller community banks, mutual funds, and regional banks do not regularly engage in the prohibited activities and investments that the Volcker Rule is regulating. This argument lays the foundation for the proposal that the Volcker Rule does not need to regulate "Tier 1" entities, the smaller community banks, mutual funds, or regional banks; or at least provide for a less costly alternative for these entities where the entity has no history of engaging in the prohibited activity and will not in the future.

One alternative for smaller community banks, mutual funds, and regional banks that have no history of being engaged in and are not engaging in the Volcker Rule's prohibited activities and investments is to have the banks sign a contract providing that the bank has read and understood the Volcker Rule's regulations and requirements, and that the bank has not and will not engage in any prohibited activity promulgated under the Volcker Rule. In addition, under the contract, the bank will be subject to an "enforcement action" provision, similar to the one proposed under the "good faith" standard. However, under this "enforcement action" provision, if it is found that the bank has breached the contract and engaged in the prohibited activities, the bank would then be subject to penalties under the Volcker Rule, additional penalties under the "enforcement action" provision as deemed appropriate by the coordinated rule making authority, and be required going forward to comply with the "compliance program," but at a higher level as to ensure the banks compliance with the Volcker Rule.

This alternative would dramatically reduce the costs to smaller banking entities, mutual funds, and regional banks that have never and will not engage in the Volcker Rule's prohibited activities. This will also ensure that the banks are knowledgeable of the Volcker Rule requirements and are on notice to not engage in the prohibited activities. In addition, this alternative will provide a substantial deterrent effect because if the bank does engage in the prohibited activities, that bank will be subjected to far greater costs. In ensuring that the bank does comply with the Volcker Rule requirements, the bank may "self-regulate" and choose to follow the compliance program, as needed, expending the amount of money the bank wishes to expend on the compliance program. This proposal acknowledges the substantial benefit that the Volcker Rule may provide to the U.S. economy, but in furthering this effort, this approach suggests an alternative to support the Volcker Rule's efforts that

243. See generally WestlawNext, https://l.next.westlaw.com/Search/Home.html?transitionType=Default&contextData=(sc.Default) (This conclusion was based on a "WestlawNext Search" of all "California Statutes & Court Rules" and "California Regulations").

244. See Letter from Cecelia Calaby, supra note 144.
might help mitigate the costs to the smaller community banks, mutual funds, and regional banks that have never engaged in the Volcker Rule’s prohibited activities.

C. Alternatives to the Blanket Ban on Proprietary Trading

“Banking under [the] Volcker Rule is still a risky business” because although “proprietary trading is essentially speculative in nature,” so are “traditional banking activities” such as “lending to commercial real estate ventures.” Proprietary trading has a reputation for being inherently risky, but proprietary trading may not always be riskier than traditional banking activities such as “transforming short-term liquid deposits into long-term illiquid loans . . . .” One aspect that makes proprietary trading so risky is the “maturity mismatch between a bank’s deposits (its liabilities) and traditional loans (its assets) . . . .” The riskiness in proprietary trading may be based upon “the level of risk relative to the ability to bear that risk . . . .” Risk is involved in several, if not all, aspects of the banking realm and “[w]ithout the assumption of risk, there is no banking business and therefore no financial intermediation system.” This proposal suggests that there may be other ways to reduce the risk of proprietary trading besides a blanket ban.

An alternative that has been debated that could be implemented is based on risk increasing with the “maturity mismatch” of the banks liabilities and assets. In order to reduce this risk, the U.S. Government could set standards to set a maximum regulation on the amount of trading for banking entities and nonbank financial companies supervised by the Board based on their accounts and profits. The banking entities and nonbank financial companies supervised by the Board could still engage in profitable market participation, where these entities make a substantial portion of their money but the banking entity or nonbank financial company supervised by the Board will not become “too big to fail,” furthering the Volcker Rule’s purpose. This maximum of proprietary trading could be based on the capital of the banking entity because “most . . . capital in a bank is meant to support principal risk taking by the bank . . . in the form of either lending or investing . . . .” These capital requirements

245. Steil, supra note 214.
246. Id.
247. Id.
250. Id.
251. Steil, supra note 214.
252. Bell, supra note 168.
would primarily address the market risk arising from trading activities on U.S. banks and bank holding companies.\textsuperscript{255}

In support of this approach "at a hearing of the House Financial Services Committee, Treasury Secretary Timothy Geithner was asked what steps the regulators of our bank system should take to avoid another financial crisis" and his answer was "capital, capital, capital."\textsuperscript{256} "Capital assures [that the bank has a] big enough cushion[ ] to absorb extreme shocks."\textsuperscript{257} One lesson of the financial crisis in 2008 "was that large financial institutions need to be subjected to more effective capital requirements."\textsuperscript{258} This alternative of capital requirements could provide banking entities, and nonbank financial companies supervised by the Board, the cushion the bank needs to "sustain significant unexpected losses in the values of the assets [the banks] hold while still honoring withdrawals and other essential obligations."\textsuperscript{259} In support of this alternative on capital requirements, a report by the U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness stated, “the Volcker rule will have a significant negative effect on market making and liquidity provisions for many securities . . . .”\textsuperscript{260} This alternative of setting capital requirements based on the banking entity or nonbank financial company’s accounts and profits may reduce risk while upholding market making and liquidity in the market.

VIII. CONCLUSION

The Financial Crisis of 2008 was the product of several events that caused the U.S. economy "$13 trillion in wealth and 5.5 million jobs."\textsuperscript{261} Among the causes that brought about the Financial Crisis of 2008 was the "breakdown in our financial system."\textsuperscript{262} In response to the Financial Crisis of 2008 the U.S. Government enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act.\textsuperscript{263} Included in the Dodd-Frank Act is Section 619, the Volcker Rule. The Volcker Rule, “is a key component”\textsuperscript{264} in the efforts of the Dodd-Frank Act to “strengthen the [United States] financial system.”\textsuperscript{265}


\textsuperscript{257} Id.

\textsuperscript{258} Id.

\textsuperscript{259} Id.


\textsuperscript{261} Merkley & Levin, supra note 75.

\textsuperscript{262} President Barack Obama, supra note 3.


\textsuperscript{264} Financial Stability Oversight Council, supra note 2, at 1.

\textsuperscript{265} Id.
The Volcker Rule is one of the most heated and debated issues of the Dodd-Frank Act.\textsuperscript{266} In the aforementioned paragraphs this article articulated what I believe to be the three main issues, concerns, and criticism of the Volcker Rule. These three issues, concerns, and criticisms were addressed and three proposals were made in response that propose ideas on alternatives that could help mitigate costs to smaller banking entities, provide guidance, and reduce risk. This article takes the view that the Volcker Rule will help strengthen the U.S. financial system, will create stability, and will reduce risk in the banking realm. However, as with all regulations, there is some cost. The cost in this case will be the greatest on the smaller banking entities that do not engage in the prohibited activities of the Volcker Rule.

The Volcker Rule is a paramount regulation encumbered with complex language, regulations, requirements, exclusions, exceptions, timelines, and procedures. I concur with the enactment of the Volcker Rule; the Volcker Rule was compulsory, contemporaneously with the rest of the Dodd-Frank Act's provisions, to create financial stability. However, this article was written as to create awareness of the Volcker Rule's costs to the small banking entities and to provide alternatives to help mitigate those costs. Since the Volcker Rule only became effective as of 2012 the exact extent and cost of this regulation is yet to be determined.

\textsuperscript{266} Morrison & Foerster, \textit{supra} note 187.