

2013

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Matthew S. McElroy

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Matthew S. McElroy, *Make No Bonds About It: Exempting Foreign Government Obligations From The Volcker Rule*, 18 Fordham J. Corp. & Fin. L. 669 (2013).

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Cover Page Footnote

J.D., Columbia Law School, 2012. I would like to thank Margaret Tahyar for her thoughtful comments and guidance in the formation of this article. I would also like to thank the members of the Fordham Journal of Corporate & Financial Law for their editorial assistance.

VOLUME XVIII

2013

NUMBER 3



FORDHAM

JOURNAL OF
CORPORATE & FINANCIAL LAW

MAKE NO BONDS ABOUT IT: EXEMPTING FOREIGN
GOVERNMENT OBLIGATIONS FROM THE VOLCKER RULE

Matthew S. McElroy

MAKE NO BONDS ABOUT IT: EXEMPTING FOREIGN GOVERNMENT OBLIGATIONS FROM THE VOLCKER RULE

*Matthew S. McElroy**

ABSTRACT

U.S. financial regulators are considering exempting foreign government obligations from the Volcker Rule’s prohibition on proprietary trading. Bank Holding Company Act § 13(d)(1)(J), added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, governs such exemptions and sets a very high standard for regulators seeking to utilize them. This provision requires that four regulatory agencies unanimously agree to the exemption and determine that it satisfies a strict substantive standard—that it “promote[s] and protect[s] the safety and soundness of the banking entity and the financial stability of the United States.”¹

Regulators may jointly agree to make such an exemption for sovereign debt because they are facing intense political pressure to do so. Foreign governments, including several close allies of the United States, have spoken out publicly against the Volcker Rule. These governments are asking U.S. regulators to exempt sovereign debt from the trading prohibitions of the Volcker Rule because of the adverse effects it will have on their debt markets. Their concerns support the case that the substantive standard in § 13(d)(1)(J) is satisfied.

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INTRODUCTION

Congress enacted the Volcker Rule in § 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).² The Volcker Rule prohibits proprietary trading by federally-insured depository institutions and sets capital and quantitative limits on proprietary trading by nonbank financial companies supervised by the Federal Reserve Board.³ It also contains limited exceptions to the ban on proprietary trading, permitting trading in government securities, trading in connection with market-making activities, and trading on behalf of customers.⁴ Importantly, Congress did not include foreign

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1617–32 (2010). The Volcker Rule is set out in section 13 of the Bank Holding Company Act of 1956, 12 U.S.C. § 1851 (2006).

3. *Id.*

4. *See* 12 U.S.C. § 1851(d)(1)(A)–(D). The Volcker Rule also permits certain risk-mitigating hedging. *See id.* § 1851(d)(1)(C).

government obligations in the government securities exemption.⁵ As a result, U.S. banks may not proprietarily trade in foreign sovereign debt. Foreign governments, worried that the rule will restrict their ability to raise capital in public markets, are asking regulators to make an exception for sovereign debt. One possible avenue for creating this exception is a provision within the Volcker Rule allowing regulators to exempt additional activities from the prohibition on proprietary trading, if the activities meet certain requirements.⁶

Congress granted regulators the authority to exempt activities from the Volcker Rule in subsection 13(d)(1)(J) of the Bank Holding Company Act of 1956.⁷ In order for regulators—the Commodities Futures Trading Commission (“CFTC”), Securities and Exchange Commission (“SEC” or “Commission”), Office of the Comptroller of the Currency (“OCC”), and Federal Reserve Board (collectively, the “Agencies”)—to exempt an activity, they must first agree on what activity to exempt.⁸ Further, that activity must be one that “would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”⁹ Many foreign governments have submitted public comment letters asking the Agencies to exercise their authority under § 13(d)(1)(J) to exempt foreign government obligations. The statute itself does not explicitly say when the Agencies should use their exemptive power, nor does it distinguish between banned and permitted activities. As a result, the Agencies face the

5. Congress did however, exempt U.S. federal and state obligations. *See id.* § 1851(d)(1)(A).

6. *Id.* § 1851(d)(1)(J).

7. Dodd-Frank Act, Pub. L. No. 111-203, sec. 619, § 13(d)(1)(J), 124 Stat. 1376, 1626.

8. 12 U.S.C. § 1851(d)(1)(J). Section 13(d)(1)(J) applies to “banking entities,” which is defined in § 13(h)(1) as “any insured depository institution, any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.” The term “appropriate Federal banking agencies” is defined in section 3(q) of the Federal Deposit Insurance Act (the “FDIC Act”). Dodd-Frank Act, Pub. L. No. 111-203, sec. 2(2), 124 Stat. 1376, 1387. The FDIC Act states that, in the case of any bank holding company and any subsidiary (other than a depository institution) of a bank holding company, the appropriate Federal banking agency means the OCC and the Federal Reserve Board. 12 U.S.C. 1813(q). Thus, the “appropriate federal banking agencies” for a majority of “banking entities” under § 13(d)(1)(J) are the OCC and the Federal Reserve Board, as well as the CFTC and SEC, which are explicitly mentioned in the provision.

9. *Id.*

difficult task of writing rules that fill these voids. The Agencies are now struggling to determine if Congress really intended to include foreign government obligations in the ban on proprietary trading.

In October 2011, the Agencies released Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (“Proposed Rule”), containing proposed regulations for implementing the Volcker Rule.¹⁰ The Proposed Rule seeks comments on certain questions, including whether the § 13(d)(1)(J) exemptive authority should be applied to foreign government obligations.¹¹

This article analyzes the substantive and procedural hurdles of § 13(d)(1)(J) in light of the Proposed Rule’s legislative history, similar exemptive provisions in other Acts, and the ways that the Agencies have applied the section thus far. It then considers whether the Agencies will exercise their ability to exempt foreign government obligations under § 13(d)(1)(J), and how the Agencies are likely to exercise it in the future. Section I outlines the legislative history of § 13(d)(1)(J). Section II compares the text of § 13(d)(1)(J) with exemptive provisions in other statutes to determine the strictness of the exemption standard. Section III discusses how regulators propose to implement the exemptive authority in § 13(d)(1)(J), analyzes the arguments for and against creating an exemption for sovereign debt, and contains suggestions as to how the Agencies should determine future exemptions.

I. LEGISLATIVE HISTORY

Though there is limited legislative history for § 13(d)(1)(J), congressional intent can be gleaned from the changes Congress made in amendments to the proposed bill. The next section explains the standard

10. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011) (to be codified at 12 C.F.R. pt. 44, 12 C.F.R. pt. 248, 12 C.F.R. pt. 351, and 17 C.F.R. pt. 255) [hereinafter Proposed Rule].

11. The question reads:

Question 122. Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Id. at 68,878.

that Agencies must meet when exercising § 13(d)(1)(J), then examines important changes made to § 13(d)(1)(J) during the legislative process.

A. FRAMEWORK OF THE FINAL ENACTED VERSION OF § 13(d)(1)(J)

The final version of § 13(d)(1)(J) details the types of activities that can be exempted under the Volcker Rule. These activities include:

(J) Such other activity as the appropriate Federal banking agencies, the SEC, and the CFTC determine, by rule, as provided in subsection (b)(2), would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.¹²

This language presents three requirements that the proposed activity must satisfy before regulators are able to exempt it. First, the statute requires unanimity; all of the regulators must agree on the activity to be exempted.¹³ This gives each regulator *de facto* veto power over all § 13(d)(1)(J) determinations. Second, the activity must be one that promotes and protects the banking entity. The second prong thus requires the Agencies to make a factual determination as to whether the activity supports or fosters the health of those institutions taking part in it. Finally, the activity must be one that promotes and protects the financial stability of the U.S. On a macro scale, the third prong suggests that regulators must take into account the cumulative effect of all institutions that may change their behavior as a result of the exemption. To get a better understanding of the substantive standards in § 13(d)(1)(J), it is worthwhile to examine the changes Congress made before enacting it.

B. CHANGES AND AMENDMENTS TO DRAFT LANGUAGE

Original versions of the Dodd-Frank legislation did not provide regulators with authority to exempt additional activities from the Volcker Rule's ban on proprietary trading. The text of amendments on May 10, 2010 added the provision that first granted exemptive authority. It permitted exemptions for:

12. 12 U.S.C. § 1851(d)(1)(J).

13. In addition, the Secretary of the Treasury, as Chairperson of the Financial Stability Oversight Council, is responsible for coordinating the Agencies' rulemakings under Section 13 of the Bank Holding Company Act. 12 U.S.C. § 1851(b)(2)(B)(ii).

(I) Such other activity as the appropriate Federal banking agencies, in consultation with the Securities and Exchange Commission and the Commodity Futures Trading Commission, jointly determine through regulation, as provided for in subsection (c), would promote and protect the safety and soundness of the banking entity or nonbank financial company and the financial stability of the United States.¹⁴

On May 19, 2010, that language was removed and replaced with the following provision:

“(J) Such other activity as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission determine through regulation, as provided in subsection (b)(2)(B), would promote and protect the safety and soundness of the banking entity or nonbank financial company supervised by the Board and the financial stability of the United States.”¹⁵

The second draft required all four regulators to jointly decide on the regulation, whereas the first only required the appropriate Federal banking agencies to consult with the SEC and CFTC before making a determination. The revised version effectively established more powerful roles for the SEC and CFTC in the exemption process. The change suggests that Congress did not want to grant the exemptive power to a small number of Federal banking agencies.

A second difference in the first two proposed drafts of the exemptive authority is related to the process that regulators must follow to make their determination. In the first draft, regulators were directed to subsection (c), which instructed them to use the rulemaking authority in (b)(2).¹⁶ In contrast, the second draft mandated that regulators use the rulemaking process in (b)(2)(B).¹⁷ This change effectively eliminated (b)(2)(A) from the determination process.¹⁸ As a result, the regulators

14. 156 CONG. REC. S3482-83 (daily ed. May 10, 2010) (text of Sen. Jeff Merkley’s proposed amendment).

15. 156 CONG. REC. S3988 (daily ed. May 19, 2010) (text of Sen. Jeff Merkley’s proposed amendment).

16. 156 CONG. REC. S3482-83 (daily ed. May 10, 2010) (text of Sen. Jeff Merkley’s proposed amendment).

17. 156 CONG. REC. S3988 (daily ed. May 19, 2010) (text of Sen. Jeff Merkley’s proposed amendment).

18. Subsection (b)(2)(A) originally read:

would no longer need to consider the results of a Financial Stability Oversight Council study before deciding to exempt an activity.

The next (and final) version of the exemptive authority made two more changes. The final draft reads:

(J) Such other activity as the appropriate Federal banking agencies, the SEC, and the CFTC determine, by rule, as provided in subsection (b)(2), would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.¹⁹

In this version, Congress directed the regulators to make determinations by rule rather than regulation. Congress also removed the words “or nonbank financial company supervised by the Board.” These changes are relatively insignificant. What is important is that Congress kept the requirement that all four regulators must agree to the exemption.

C. RELEVANT REMARKS DURING CONGRESSIONAL DEBATE

The substantive requirement for exempting activities from the Volcker Rule in § 13(d)(1)(J) is vague, only stating that an exemption must “promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”²⁰ It does not say when Congress would condone an exemption, but due diligence discussion on the floor of the legislature sheds a bit of light on this ambiguity. The legislators’ only explicit reference to § 13(d)(1)(J) in the official record is a remark by Senator Jeff Merkley on July 15, 2010. Senator Merkley stated:

(A) IN GENERAL—Not later than 9 months after the completion of the study under paragraph (1), the appropriate Federal banking agencies, in consultation with the Securities and Exchange Commission and the Commodity Futures Trading Commission, (unless otherwise provided in this section) shall consider the findings of the study under paragraph (1) and adopt rules to carry out this section.
156 CONG. REC. S3482 (daily ed. May 10, 2010) (Sen. Jeff Merkley submitting amendment).

That section of the draft was later changed to:

(A) In general—Unless otherwise provided in this section, not later than 9 months after the completion of the study under paragraph (1), the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, shall consider the findings of the study under paragraph (1) and adopt rules to carry out this section, as provided in subparagraph (B).

12 U.S.C. § 1851(b)(2)(A).

19. 12 U.S.C. § 1851(d)(1)(J).

20. *Id.*

Subparagraph (J) permits the regulators to add additional exceptions as necessary to ‘promote and protect the safety and soundness of the banking entity and the financial stability of the United States.’ This general exception power is intended to ensure that some unforeseen, low-risk activity is not inadvertently swept in by the prohibition on proprietary trading. However, the subparagraph sets an extremely high bar: the activity must be necessary to promote and protect the safety and soundness of the banking entity and the financial stability of the United States, and not simply pose a competitive disadvantage or a threat to firms’ profitability.²¹

Senator Ted Kaufman “urge[d] the regulators to construe narrowly those activities that constitute exceptions to proprietary trading to ensure that the Volcker Rule has some teeth in it.”²² While discussing the Merkley-Levin amendment, Kaufman went on to endorse the Volcker Rule because “[i]t would not give unnecessary discretion to the same regulators who have long had the authority to prohibit speculative activities at banks but never opted to do so.”²³

From these remarks, it appears that Congress intended § 13(d)(1)(J) to be used primarily to exempt low-risk activity that had been inadvertently incorporated into the Volcker Rule. This objective makes sense, as it provides regulators with a quick and easy way to exempt clear-cut cases of harmless activity. If Congress intended for § 13(d)(1)(J) to operate as a mechanism for regulators to prevent beneficial, low-risk activities from accidentally coming under the Volcker Rule’s prohibition on proprietary trading, then clearly foreseeable activities, such as trading foreign government obligations, should not be exempted at all.

II. COMPARING § 13(d)(1)(J) TO EXEMPTIVE PROVISIONS IN OTHER STATUTES

An examination of other exemptive provisions provides an interesting contrast to the above discussion. Both the Exchange Act of 1934 and the Commodities Exchange Act contain such provisions, but

21. 156 CONG. REC. S5897 (daily ed. July 15, 2010) (statement of Sen. Jeff Merkley).

22. 156 CONG. REC. S5886 (daily ed. July 15, 2010) (statement of Sen. Ted Kaufman).

23. 156 CONG. REC. S3889 (daily ed. May 18, 2010) (statement of Sen. Ted Kaufman).

they operate very differently from § 13(d)(1)(J) in that they authorize exemptions in less extreme circumstances.

A. EXEMPTIVE AUTHORITY IN THE EXCHANGE ACT OF 1934

Congress gave broad exemptive discretion to the “Commission in the Exchange Act. The exemptive provision in the Exchange Act authorizes the Commission to “exempt any person or class of persons or any transaction or class of transactions, either conditionally or upon specified terms and conditions or for stated periods”²⁴ In addition, the Commission may make exemptions “by rule, regulation, or order[.]”²⁵

Under this provision, the Commission can exempt a wide range of entities such as people, securities, or transactions and can issue such exemptions in multiple ways including by rule, regulation, or order. The Commission’s exemptive power under the Exchange Act is further expanded because it has the authority to make exemptions of varying degrees. By contrast, § 13(d)(1)(J) of the Volcker Rule requires unanimous agreement among five regulators, as well as fulfillment of a demanding substantive standard.²⁶

B. EXEMPTIVE AUTHORITY IN THE COMMODITIES EXCHANGE ACT

Likewise, the exemptive provision in the Commodities Exchange Act (“CEA”) is much less demanding than § 13(d)(1)(J). The CEA’s exemptive provision, enacted by the same Congress that enacted the Volcker Rule, contains a provision allowing the Treasury to exempt certain derivatives from the CEA’s prohibitions. Under that provision, the Secretary of the Treasury (the “Secretary”) may “exempt foreign exchange swaps and foreign exchange forwards from the definition of the term ‘swap’”²⁷ In making the exemptive determination, the Secretary is directed by statute to consider various factors before rendering a final determination.²⁸ After making a decision to exempt a

24. 15 U.S.C. § 78m(h)(6).

25. *Id.*

26. 12 U.S.C. § 1851(d)(1)(J).

27. 7 U.S.C. § 1b(b).

28. The statute reads:

(a) Required considerations

foreign exchange swap or forward, the Secretary must explain its determination to Congress.²⁹ It must justify why those swaps or forwards are qualitatively different and ill-suited for regulation as swaps, as well as the objective differences between those swaps or forwards and standard swaps that are exempt.³⁰

Conspicuously, Congress did not give the Treasury an explicit standard to meet when exempting an instrument. None of the various considerations Congress sets out are determinative; they are merely guideposts to aid regulators. Thus, the provision confers relatively unconstrained decision making authority upon the Treasury. Most importantly, and unlike § 13(d)(1)(J), the Treasury does not have to work in conjunction with any other agency.

In determining whether to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term “swap”, the Secretary of the Treasury (referred to in this section as the “Secretary”) shall consider—

- (1) whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the U.S.;
- (2) whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by this chapter for other classes of swaps;
- (3) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
- (4) the extent of adequate payment and settlement systems; and
- (5) the use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.

7 U.S.C. § 1b(a)(1)–(5).

29. 7 U.S.C. § 1b(b).

30. The statute reads:

(b) Determination

If the Secretary makes a determination to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term “swap”, the Secretary shall submit to the appropriate committees of Congress a determination that contains—

- (1) an explanation regarding why foreign exchange swaps and foreign exchange forwards are qualitatively different from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps; and
- (2) an identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.

7 U.S.C. § 1b(b)(1)–(2).

C. THE STANDARD IN § 13(d)(1)(J) IS A VERY TOUGH HURDLE TO OVERCOME

Due to both Congress' demanding substantive standard and its requirement that all four regulators agree to exemptions, the Agencies' power to exercise exemptions under the Volcker Rule is severely limited. Additionally, in contrast to similar exemptive provisions drafted by Congress in the past, such as the Securities Exchange Act and the concurrent Amendment to the Commodities Exchange Act,³¹ the text of § 13(d)(1)(J) does not offer the Agencies much discretionary authority to make exemptions. As a result, the Volcker Rule has the potential to be inflexible and inadaptable, and may prohibit activities that do not threaten U.S. financial stability.³²

The incredible procedural hurdle that Congress placed upon the Agencies cannot be overemphasized. Consider the requirement that all four regulators must agree to an exemption. The likelihood of all of the Agencies' interests aligning at once is slim and would certainly require extraordinary political or economic circumstances. Given this burden, it appears that § 13(d)(1)(J) will be invoked rarely, and only in unexpected circumstances. The havoc that the Volcker Rule could potentially cause to foreign debt markets is unlikely to qualify as an unforeseeable circumstance under § 13(d)(1)(J). Nevertheless, the Agencies are proposing to use § 13(d)(1)(J) authority to make certain exemptions to rule proposals implementing the Volcker Rule, and have inquired about using the authority to exempt foreign government obligations.³³

III. ANALYZING AN EXEMPTION FOR FOREIGN GOVERNMENT OBLIGATIONS

A. HOW THE PROPOSED REGULATIONS TREAT THE § 13(d)(1)(J) EXEMPTIVE AUTHORITY

An examination of the Agencies' proposed exemptions provides context for how the Agencies might analyze Volcker Rule exemptions in the future. In the Proposed Rule, the Agencies requested comment on

31. *See supra* Part II.B.C.

32. Under subsection 13(d)(1)(J), regulators can exempt activities that "promote and protect" the banking entity and U.S. financial stability. 12 U.S.C. § 1851(d)(1)(J). Interestingly, this seems to indicate that the exemption would not extend to activities that are neutral to either the banking entity or U.S. financial stability.

33. *See generally* Proposed Rule, 76 Fed. Reg. 68,846 (Nov. 7, 2011).

whether and how to implement § 13(d)(1)(J) exemptions in twenty separate questions.³⁴ When the Agencies analyze § 13(d)(1)(J) decisions in the Proposed Rule, they use an assortment of unrelated factors that they apply differently in each situation.³⁵ Thus, for each exemption, the application of § 13(d)(1)(J) depends on its own particular facts, factors, and analysis that are unrelated to other exemptions. The Agencies suggest exercising their exemptive power to permit three activities under § 13(d)(1)(J) of the Proposed Rule.

Initially, the Agencies proposed to exempt bank-owned life insurance investments because they do not involve speculative risks and they reduce banking entities' cost of providing employee benefits.³⁶ Allowing banks to manage and structure their risks and obligations regarding employee benefit plans, the Agencies state, "promotes and protects" the soundness of banking entities, and "on an industry-wide level has the concomitant effect of promoting and protecting the financial stability of the United States."³⁷

The Proposed Rule would also exercise § 13(d)(1)(J) authority to exempt activities relating to loan securitization. It proposes the exclusion of certain entities from the definition of a "covered fund"—a company that a banking entity may not sponsor or own under the Volcker Rule.³⁸ The Agencies state that Congress did not intend to restrict bank dealings with these entities because they "do not engage in the type and scope of activities to which Congress intended [the Volcker Rule] to apply."³⁹ Central to that conclusion is the language in § 13(g)(2), which contains a rule of construction mandating this outcome: "Nothing in this section shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law."⁴⁰ In light of this directive, an exemption for certain

34. *Id.* The twenty questions referring to § 13(d)(1)(J) are scattered throughout the Proposed Rule.

35. *See infra* notes 36–50 and accompanying text.

36. *Id.* at 68,913.

37. *Id.*

38. *Id.* at 68,853. Specifically, the Agencies would allow a banking entity to acquire an ownership interest in a joint venture, an acquisition vehicle used to effect an acquisition or merger with the banking entity, and a wholly-owned subsidiary of the banking entity that engages principally in bona fide liquidity management services and is carried on the balance sheet of the banking entity. *Id.* at 68,913.

39. *Id.* at 68,913.

40. 12 U.S.C. § 1851(g)(2) (2006).

asset-backed securitization vehicles makes sense because they seem like just the type of low-risk activity that Congress did not want to include in the Volcker Rule.

The Agencies offer an assortment of additional separate factors supporting the loan securitization exemption. First, denying the exemption would cause many entities “to alter their corporate structure without achieving any reduction in risk.”⁴¹ Thus, for example, the Proposed Rule would use § 13(d)(1)(J) authority to allow a banking entity to obtain a limited ownership interest in an issuer of asset-backed securities.⁴² This exemption would permit banking entities to take on some of the risk of the asset-backed securities they are helping to issue. In addition, the Agencies state that retaining a minimum level of economic interest “will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.”⁴³

The Agencies further muddle the exemption analysis by permitting banking entities “to acquire or retain an ownership interest in” loan securitizations.⁴⁴ The Proposed Rule states that this exemption will promote and protect a banking entity’s safety and soundness as well as the financial stability of the U.S. because it will broaden the pool of potential participants in the sale of securitizations.⁴⁵ The Agencies argue that this exemption is warranted because it makes it easier for banks to diversify their holdings and for individuals and small businesses to raise capital.⁴⁶ Section 13(g)(2) is likely driving the result in this exemption as it prohibits any interpretation that would limit a bank’s ability to sell or securitize loans.⁴⁷

Finally, the Agencies seek to use § 13(d)(1)(J) to exempt bank sponsorship of a Small Business Investment Company, a public welfare investment, or a certain qualified rehabilitation expenditure.⁴⁸ Influencing this decision is § 13(d)(1)(E) that allows, as a permitted activity, “investments designed primarily to promote the public

41. See Proposed Rule, 76 Fed. Reg. at 68,912.

42. *Id.* at 68,854.

43. *Id.* at 68,914.

44. *Id.* at 68,853.

45. *Id.* at 68,914.

46. *Id.*

47. 12 U.S.C. § 1851(g)(2) (2006).

48. *Id.* at 68,908 n.296.

welfare.”⁴⁹ The Agencies argue that this meets the strict substantive standard in § 13(d)(1)(J) because it promotes and protects the safety and soundness of banking entities as well as the financial stability of the United States by “facilitat[ing] investment in small business and support[ing] the public welfare.”⁵⁰

In sum, there is no evidence that any exercise of §13(d)(1)(J) authority is related to any other. The results are driven by provisions elsewhere in Dodd-Frank or are geared towards tying up loose ends left by hurried drafting of the legislation. In some circumstances the Agencies are concerned with enabling banking entities to manage and structure their costs and risks; in others, their focus is on increasing the availability of capital to individuals and small businesses. At the same time, they have justified exemptions as necessary to ensure careful and prudent underwriting practices. The application of § 13(d)(1)(J) therefore depends on its own facts, factors, and analysis that are independent of other exemptions. Since there is no clear framework for making § 13(d)(1)(J) exemptions, the Agencies are free to consider any factors they deem appropriate.

B. ARGUMENTS IN FAVOR OF EXEMPTING FOREIGN GOVERNMENT OBLIGATIONS

The Agencies apply the Proposed Rule to exempt activities that Congress overlooked when drafting the Volcker Rule or where there is an explicit provision driving the result.⁵¹ Neither of these justifications applies to the sovereign debt exemption; however, public comment letters provide persuasive justifications for an exemption. These comment letters, many submitted by close U.S. allies, primarily discuss the unintended adverse economic effects that the Volcker Rule would have on their debt markets.⁵² As a result, policymakers are under

49. 12 U.S.C. § 1851(d)(1)(E).

50. See Proposed Rule, 76 Fed. Reg. at 68,908 n.292.

51. See *supra* notes 36–50 and accompanying text.

52. See, e.g., Letter from the Fin. Servs. Agency, Gov’t of Japan, and Bank of Japan, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 2 (Dec. 28, 2011), available at <http://www.sec.gov/comments/s7-41-11/s74111-78.pdf>, Letter from the Fin. Indus. Council of Austl., to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 2 (Feb. 15, 2012), available at <http://www.sec.gov/comments/s7-41->

immense political pressure to implement an exemption.⁵³ The comment letters only focus tangentially on the substantive standard in § 13(d)(1)(J). Rather than argue why an exemption would promote financial stability in the U.S., they emphasize the detrimental impact that the rule will have on their economies.⁵⁴

Without an exemption, foreign governments warn that the current rule will reduce trading and liquidity in sovereign debt markets. For example, Canadian Finance Minister James Flaherty stated that the Proposed Rule “could severely impact the liquidity of Canadian government debt markets and interfere with the risk management practices of banks in Canada.”⁵⁵ Although the Volcker Rule contains exceptions for market-making and hedging, the absence of an explicit exemption for sovereign debt will make trading in sovereign bonds a less attractive and profitable endeavor.⁵⁶ Banks subject to the Volcker Rule that wish to trade in foreign government securities under the market-making exception would have to build extensive compliance systems to prove that they were trading within the permitted market-making definition.⁵⁷ The ban on proprietary trading, combined with this

11/s74111-345.pdf; Letter from Mark Carney, Governor, Bank of Canada, to Dr. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys. 2–3 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-211.pdf>; and Letter from George Osborne, Chancellor of the Exchequer and Second Lord of the Treasury of the United Kingdom to Ben Bernanke, Chairman, Bd. Of Governors of the Fed. Reserve Sys. 1 (January 23, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-92.pdf>.

53. The Agencies have contributed to this pressure by seeking public comment on § 13(d)(1)(J) authority, and suggesting that § 13(d)(1)(J) might be applied to foreign government obligations. *See id.* at 68,878.

54. *Id.*

55. Letter from James M. Flaherty, Canadian Minister of Finance, to Timothy Geithner, Sec’y of the Treasury 1 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-212.pdf>.

56. *See* Letter from the Fin. Servs. Agency, Gov’t of Japan, and Bank of Japan, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 2 (Dec. 28, 2011), available at <http://www.sec.gov/comments/s7-41-11/s74111-78.pdf>.

57. *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit, Subcomm. on Capital Mkts. and Gov’t Sponsored Enters., H. Comm. on Fin. Servs., 112th Cong. 9–10 (2012)* [hereinafter *Hearing on the Impact of the Volcker Rule*] (testimony of Mark Standish, Pres. & Co-CEO, RBC Capital Markets) (testifying on behalf of the Inst. of Int’l Bankers), available at <http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-MStandish-20120118.pdf>.

costly regulatory compliance program, will reduce liquidity and affect prices in the sovereign debt market.⁵⁸ The Finance Industry Council of Australia (“FICA”) wrote that “the Proposed Rules would have a substantial detrimental impact” FICA cites concern about the possibility of “a number of adverse consequences, including increased sovereign funding costs . . . reduced liquidity . . . [and] inhibitions on the development of mutual funds and similar types of savings and investment vehicles outside of the U.S.”⁵⁹ The Australia Bankers Association has stated that without the unhindered ability to trade in this debt, the liquidity of the Australian Government bond market will be undermined.⁶⁰ Representatives from both Germany and Japan have echoed these sentiments.⁶¹ They concluded that decreased trading will reduce the value of sovereign debt and make it more difficult for governments to obtain adequate financing.⁶²

These governments cited another crucial consequence of the Volcker Rule; not only will U.S. banks be precluded from proprietary trading in sovereign debt, but foreign banks are precluded from trading their own domestic government debt if they have a sufficient U.S. nexus.⁶³ Withdrawal of banks from these markets would eliminate a

58. *Id.* at 10–12.

59. Letter from the Fin. Indus. Council of Austl., to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 2 (Feb. 15, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-345.pdf>.

60. Letter from the Australian Bankers Ass’n, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Sec. & Exch. Comm’n, and Commodity Futures Trading Comm’n 5 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-329.pdf>.

61. See generally *Hearing on the Impact of the Volcker Rule*, supra note 53; see also Letter from the Fin. Servs. Agency, Gov’t of Japan, and Bank of Japan, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n, supra note 52, at 2; see also Letter from Ass’n of German Banks, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 7 (Feb. 10, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-157.pdf>.

62. *Id.*

63. The Association of German Banks writes:

Thus, even if trading in EU member states’ government bonds by European and German banks may, in theory, be eligible under one of these exemptions, the extraterritorial application of their requirements may strongly incentivize many European banks to avoid, or reduce substantially, their market-making and underwriting activities for such bonds at least when involving a U.S. nexus prohibited

massive pool of potential traders.⁶⁴ Their departure could cause sovereign debt to become less liquid and more expensive to hold, which could further impede foreign governments' ability to raise capital.⁶⁵ Of course, these banks could claim that their trading in foreign debt falls within one of the Volcker Rule's permitted activity exceptions, such as market-making; however, any trading in a covered security exposes a bank to expensive and burdensome reporting requirements.⁶⁶

U.S. banks may discontinue performing basic market functions in sovereign debt markets because the Volcker Rule applies to U.S. banks abroad, thereby threatening the functions they perform in trading sovereign debt overseas.⁶⁷ Notably, U.S. banks are often active market-makers in foreign debt markets, "serving as primary dealers, in several key non-U.S. government securities markets around the world."⁶⁸ The Bank of Canada stated that if U.S. banks do not participate in foreign government debt offerings, it would restrict competition and liquidity "and ultimately undermine the resilience of the Canadian financial system."⁶⁹

Japan's Financial Services Agency and the Bank of Japan expressed similar worries, but also stated that the Volcker Rule would adversely affect the role of Japan's domestic banks in the Japanese

under the foreign trading exemption. This would not only affect European banks' earnings situation by reducing their corresponding fee income, but also interfere with their efficient management of liquidity and funding requirements, for which such government obligations serve as a major tool.

Letter from Ass'n of German Banks, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm'n 7 (Feb. 10, 2012), *available at* <http://www.sec.gov/comments/s7-41-11/s74111-157.pdf>.

64. *See id.*

65. *See id.* at 7–8.

66. *See id.* at 7; *see also* Letter from the Australian Bankers Ass'n, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Sec. & Exch. Comm'n, and Commodity Futures Trading Comm'n, *supra* note 52, at 5.

67. Letter from Mark Carney, Governor, Bank of Canada, to Dr. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys. 3–4 (Feb. 13, 2012), *available at* <http://www.sec.gov/comments/s7-41-11/s74111-211.pdf>.

68. *See Hearing on the Impact of the Volcker Rule, supra* note 49, at 10.

69. *See* Letter from Mark Carney, Governor, Bank of Canada, to Dr. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *supra* note 58, at 2.

sovereign debt market.⁷⁰ Specifically, they explained that Japanese domestic banks “might be forced to cease or dramatically reduce their U.S. operations, and Japanese subsidiaries of U.S. banks may consider exiting from [trading in Japanese government bonds altogether].”⁷¹ Thus, there is a dual threat to sovereign debt markets—the elimination of the role U.S. banks have in those markets as well as foreign banks exiting trading in their home country’s debt.

Finally, the comment letters note the unfairness of the Volcker Rule’s disparate treatment of sovereign debt and U.S. government debt. Under the Volcker Rule, banks are prohibited from proprietary trading in sovereign debt but not from U.S. government obligations.⁷² Public comment letters stress that this unequal treatment could lead to financial instability for the U.S. as bond markets become fragmented.⁷³ The Japan Bankers Association argued that “[d]isequilibrium and unfairness could cause global financial turbulence, and the destruction of the supply-demand balance in the bond market could result in an unstable market environment around the world.”⁷⁴ On the other hand, there are arguments against allowing an exemption, most of which are centered on the riskiness of trading in sovereign debt.

C. ARGUMENTS AGAINST EXEMPTING FOREIGN GOVERNMENT OBLIGATIONS

Those who oppose an exemption for foreign debt obligations argue that banks insured by the Federal Deposit Insurance Corporation should not be allowed to trade in sovereign debt because it is too speculative. They claim that sovereign debt is risky and cite several examples of countries that have defaulted, as well as banks that have collapsed from

70. Letter from the Fin. Servs. Agency, Govt. of Japan, and Bank of Japan, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 4, *supra* note 48, at 4.

71. *Id.*

72. See 12 U.S.C. § 1851(d)(1)(A).

73. See, e.g., Letter from Ass’n of German Banks, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n, *supra* note 54, at 7.

74. Letter from Japanese Bankers Ass’n, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, and Sec. & Exch. Comm’n 9 (Jan. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-69.pdf>.

speculating in foreign debt markets. Moreover, opponents argue that banks already have significant leeway under the current rule because they are permitted to hold sovereign debt as a *long-term* banking investment.⁷⁵ In addition, banks may also underwrite or make a market in sovereign debt; the main limitation is that they may not proprietarily trade sovereign debt for short-term gain. Senators Merkley and Levin, who had a hand in drafting § 619, say that there is good reason for this.

[F]oreign sovereign debt instruments can be risky instruments. In the aftermath of the collapse of MF Global, which was reportedly the result of failed proprietary trades on foreign sovereign debt, and only 15 years after [Long Term Capital Management's] collapse on derivative bets on foreign sovereign debt, it is troubling that some would contend that our financial regulators cannot set limits around such trading by our domestic banks.⁷⁶

Conversely, commentators argue that a comparison with MF Global is unfair because MF Global did not receive the same prudential oversight that a federally-insured depository institution receives. As one comment letter explained, “[t]he lesson of MF Global is not that trading in government securities is risky, but that trading in any security without prudential oversight and leverage restrictions is risky.”⁷⁷

It is clear from the vast number of governments commenting on the Volcker Rule’s treatment of sovereign debt that there is immense pressure facing U.S. policymakers to create an exemption. The comment letters contain a plethora of reasons why the current rule will negatively impact foreign economies.⁷⁸ The Agencies, therefore, could determine that the negative global impact from this financial regulation poses a risk to U.S. financial stability and that an exemption from foreign government obligations would “promote and protect the safety

75. Letter from Senators Jeff Merkley and Carl Levin, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Commodity Futures Trading Comm’n, and Sec. & Exch. Comm’n 33-34 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-362.pdf>.

76. Letter from Senators Jeff Merkley and Carl Levin, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Sec. & Exch. Comm’n, and Commodity Futures Trading Comm’n 33 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-362.pdf>.

77. Letter from Allen & Overy LLP, to Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Sec. & Exch. Comm’n, and Commodity Futures Trading Comm’n 5 (Feb. 13, 2012), available at <http://www.sec.gov/comments/s7-41-11/s74111-299.pdf>.

78. See *supra* Part III.B.

and soundness of the banking entity and the financial stability of the United States.”⁷⁹

D. IMPLEMENTING A SOVEREIGN DEBT EXEMPTION AND FUTURE
EXEMPTIONS

The Agencies are able to straightforwardly exempt activities from the Volcker Rule because § 13(d)(1)(J) does not require any formal analysis to do so. In contemplating an exemption, the Agencies should seriously consider that debt markets are a critically important source of funding for foreign governments and that a rule limiting their use will hurt foreign economies. Importantly, countries that would be affected are major trading partners and allies of the U.S.⁸⁰ Thus, the impact of their economic turbulence would directly affect the U.S. economy. Cumulatively, this could endanger the financial stability of the U.S.

In the future, the Agencies will likely only exempt activities when they feel there is overwhelming political consensus to do so. It would be unlikely for the Agencies to unanimously agree on an exemption in any other situation. The sovereign debt controversy is one such scenario because there is enormous political pressure from U.S. allies to make an exemption. In addition, by seeking public comment on the use of § 13(d)(1)(J), the Agencies are putting more pressure on U.S. policymakers and gaining additional political backing in support of an exemption.

Henceforth, the Agencies should use the § 13(d)(1)(J) authority to minimize the global impact of U.S. financial laws on foreign markets, particularly when major U.S. trading partners and allies are affected. While this is a very narrow application, the procedural hurdle in § 13(d)(1)(J) makes any broader exercise unlikely. The Agencies should consider the interests of other countries who were not consulted during the legislative process. Similarly, the Agencies should carefully weigh whether parallel rules implemented by foreign governments would have a negative impact on U.S. financial stability.

79. 12 U.S.C. § 1851(d)(1)(J) (2006).

80. Governments that have commented on this problem include Germany, Canada, Japan, Australia, France, Mexico, and the United Kingdom.