

## Public Statement

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# Proposed Amendments to the Volcker Rule



**Commissioner Robert J. Jackson Jr.**

**June 5, 2018**

Thank you, Chairman Clayton, and thank you to the exceptional Staff in the Divisions of Trading and Markets and Investment Management for their work on these proposals. I'm especially appreciative to Andrew Bernstein in the Division of Trading and Markets and Brian Johnson in the Division of Investment Management for the time each of you spent with me and my staff throughout this process.

The Commission today joins several other agencies in rolling back protections designed to keep banks from speculating with taxpayer money—more commonly known as the Volcker Rule. For the reasons Commissioner Stein has so thoughtfully explained, weakening these protections gives banks more leeway to do the kind of risky trading for which we should be ever more watchful. There are many questions raised by today's proposal, and I commend Commissioner Stein's statement to my colleagues. I'd also like to highlight three reasons why I cannot join the majority in voting to propose this rule.

First, to the degree that it was already difficult for regulators to distinguish market-making activity from prohibited proprietary trading,[1] I worry that these changes will muddy the waters even further, giving bank lawyers new ways to hide risky bets.[2] I am concerned that these changes are inconsistent with Congress's clear intent: to ban proprietary trading at these institutions.

Second, I cannot see why we are already proceeding with changes to regulations we adopted relatively recently when we have not yet finished rulemakings that have been required by law for years.[3] In fact, full compliance with the Volcker Rule was not required until July 2015, and now, less than three years later, we are pulling it back—before finishing rules Congress required us to complete years ago.[4]

But there's another clear, common-sense reason why I cannot join today's majority. There is a simple way to prevent people from doing something: don't pay them to do it. If we want to make sure bankers don't gamble with taxpayer money, we should make sure *they're not getting paid to gamble with taxpayer money*. [5] Rolling back the Volcker Rule while failing to address pay practices that allow bankers to profit from proprietary trading puts American investors, taxpayers, and markets at risk. That is a risk that I cannot accept, so I respectfully dissent.

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The financial crisis devastated our economy, and among its many victims was Americans' fundamental confidence in our markets.[6] One of the many lessons from that crisis—a lesson that nine million American families paid for with their homes—was that we must never again allow bankers to earn bonuses for gambling with taxpayer money. It was, at the time, a bipartisan lesson,[7] a basic economic truth that paying bankers to put government-insured deposits at risk makes no sense.[8]

The crisis gave us plenty of evidence that pay packages contributed to the devastation of our economy. Bonus practices offered bankers a heads-I-win, tails-you-lose proposition, paying handsomely during good times and leaving taxpayers holding the bag when things went wrong. One study famously used SEC filings to show how the top five executives at Bear Stearns and Lehman Brothers personally took *\$2.4 billion* in cash off the table before the firms collapsed in 2008.[9] By the time we understood the power of these incentives to cause excessive risktaking at broker-dealers, it was too late.

Regulating risk is exceptionally difficult, requiring foresight that often eludes markets, managers, and even the most thoughtful supervisors, both here at the Commission and across the regulatory system. That's why Congress gave regulators a wide range of tools to prevent another crisis. The Volcker Rule, as its namesake noted in response to the revisions adopted today, asks regulators to separate the risktaking functions of a firm from those backed by the government.[10] But Congress knew that we would also need to regulate incentives to truly ensure that bankers never again get paid to gamble with taxpayer money.[11]

So at the same time Congress enacted the Volcker Rule it passed Section 956 of the Dodd-Frank Act, which requires the same federal agencies who oversee Volcker to adopt rules that would prohibit pay practices that reward excessive risktaking.[12] Those agencies, including us, were required by law to adopt those rules no later than April 2011. Although our hardworking Staff proposed those rules long ago, seven years after the deadline the rules have never taken effect.[13] The agencies now acting to amend the Volcker Rule should first finish the job of making sure bankers don't get paid to take excessive risk.

One reason why is that, whatever one thinks of Wall Street's most talented traders, they can be expected to follow the money.[14] There is evidence that, since the adoption of the Volcker Rule in 2013, much of the riskiest trading on Wall Street has moved to private funds,[15] and one concern about our vote today is that weakening Volcker will bring that trading back to firms with taxpayer backing.[16] If we want to make sure this risktaking is not subsidized by taxpayers, we should prohibit those firms from paying traders on the basis of their proprietary profits. All should agree that, a decade after the financial crisis, it is time to put a stop to the pay practices that caused devastation across our economy.

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These are just a few of my concerns with today's proposal. Another problem, and a growing source of concern for me here at the Commission,[17] is the reed-thin economic analysis on which the proposal rests. A moment like this, when banking regulators around the world are watching as we consider major rule changes, demands our best work. The economic analysis supporting today's proposal does not meet that standard.

Sound economic analysis attempts to anticipate how markets might react to changes in the law.[18] Now, a rule as complex as Volcker necessarily raises analytical challenges to doing so. But in the years since the Volcker Rule became law, economists of all stripes have published pathbreaking work assessing the many costs and benefits of the Rule, including its effects on changes in liquidity,[19] trading by insiders,[20] risktaking,[21] and default probability.[22] These papers aren't perfect, but at least they reflect a serious attempt to analyze how the market will respond to our decisions.

Our economic analysis does not. Instead, the most common calculation in the economic analysis released today is multiplication of an attorney's hourly fee by the number of hours an attorney will work on Volcker compliance.[23] While I take the costs of compliance seriously, and with apologies to Shakespeare, I do not believe that lawyers sit at the center of our financial universe.[24] What is more important is how economic actors in our markets will respond to the decrease in compliance oversight that will follow today's vote. Whatever we do between the proposed- and final-rule stage in this area, I hope our economic analysis will spend more time on how markets will respond to our choices—and less time calculating the hourly costs of lawyers.

I know we will receive many comments in response to today's proposal, and I urge commenters to help us get this right. We will need rigorous, data-driven analysis of the ways in which market participants will react to these changes—and how those responses will affect investors. Although that work is hard, we now have some years of experience with the Volcker Rule to inform our analysis, and we owe it to investors to use that experience, and the

data from it, to decide what to do next. I hope very much that commenters provide the kind of analysis we can use to make more informed policy choices.

In the meantime, I urge my colleagues on the Commission and throughout the financial regulatory community to move forward with meaningful limits on banker incentives to gamble with taxpayer money. I appreciate the Staff's exceptional work on the proposals before us today, and look forward to working with my colleagues on these rules over the coming months.

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[1] For a thoughtful discussion of the sometimes-elusive nature of this distinction, see Matt Levine, *The Volcker Rule Gets a Little Easier*, Bloomberg Money Stuff (May 31, 2018).

[2] After today, for example, banks may claim that certain trades represent a hedging position despite the fact that the bank cannot show that the trade “demonstrably or otherwise significantly mitigates” the bank’s risk. Securities and Exchange Commission, *Proposing Release, Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*, Release No. 34-\_\_\_\_ (June 5, 2018), 131.

[3] See, e.g., Securities and Exchange Commission, *SEC Proposes Rules Requiring Companies to Adopt Clawback Policies on Executive Compensation* (July 1, 2015).

[4] Press Release, *Agencies Issue Final Rule Implementing Volcker Rule* (“The Federal Reserve Board announced on Tuesday that banking organizations covered by section 619 will be required to fully conform their activities and investments by July 21, 2015.”).

[5] For insights reflected in this statement, I am grateful to Ryan Bubb & Marcel Kahan, *Regulating Motivation: A New Perspective on the Volcker Rule* (forthcoming Tex. L. Rev. 2018).

[6] See, e.g., Alana Semuels, *The Never-Ending Foreclosure*, *The Atlantic* (Dec. 1, 2017) (“describing one American’s perspective after the crisis: ‘Having lived through everything I see life differently now. . . . I’m more cautious—I probably think through financial decisions three, four, five times.’”).

[7] Compare United States Department of the Treasury, *Statement by Treasury Secretary Tim Geithner on Compensation* (June 10, 2009) (describing “executive compensation practices [as] a contributing factor” to the financial crisis, because “[i]ncentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage”) with Patrick O’Connor, *GOP Lawmaker Flips on AIG Bonus Tax*, *Politico* (March 26, 2009) (statement of then-Rep. Paul Ryan) (describing certain bonuses paid in the years before the financial crisis as “completely ridiculous” because “[t]hey rewarded failure”).

[8] For the canonical case for regulating bankers’ incentives to take excessive risk, see Lucian Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 *Geo. L.J.* 247, 248 (2010).

[9] Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 *Yale J. Reg.* 257, 258 (2010).

[10] See Statement of Paul A. Volcker, *The Volcker Alliance* (May 30, 2018) (“What is critical is that simplification [of the Volcker Rule] not undermine the core principle at stake—that taxpayer-supported banking groups, of any size, not participate in proprietary trading at odds with the basic public and customers’ interests.”).

[11] Regulators knew it too, which is why the Volcker Rule includes a provision expressly authorizing supervisors to address deficiencies in banker pay. That provision, however, is no substitute for the clear rules Congress required us to adopt to ensure that firms do not give traders incentives to take excessive risk.

[12] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, Section 956 (2010).

[13] The Commission, along with the Department of the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation, and Federal Housing Finance Agency and the National Credit Union Administration

proposed those rules in mid-2016; the comment period ended in July of that year. We have not, however, acted upon that proposal, and the rules do not appear on our short-term regulatory agenda.

[14] See Bubb & Kahan, *supra* note 5; *cf. also* Cameron Crowe, Jerry Maguire (1996) (canonical example of a principal imploring his agent: “show me the money!”).

[15] See, e.g., Tommy Wilkes, *Banks Move High Risk Traders Ahead of U.S. Rule*, Reuters (April 3, 2012).

[16] See, e.g., Levine, *supra* note 1.

[17] Commissioner Robert J. Jackson, Jr., Securities and Exchange Commission, Statement on Proposed Rulemakings and Interpretations Related to Retail Investor Relationships With Investment Professionals (April 18, 2018) (“[t]he cost-benefit analyses in these proposals . . . are so slight that we should not expect, nor do we deserve, the deferential review” to which agencies are ordinarily entitled).

[18] Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. Leg. Stud. 258 (1974) (“detailing the law efficiently results in an increase in the expected gain from engaging in socially desirable activity relative to that from engaging in undesirable activity”). We are required by law, to say nothing of our commitment to investors, to attempt to measure these gains and losses in order to know whether proposed rulemaking is beneficial.

[19] Jack Bao, Maureen O’Hara & Xing (Alex) Zhou, *The Volcker Rule and Corporate Bond Market-Making in Times of Stress* (forthcoming J. Fin. Econ. (2018)).

[20] Sureyya Avci, Cindy A. Schipani & H. Nejat Seyhun, *Eliminating Conflicts of Interest in Banks: The Significance of the Volcker Rule* (forthcoming Yale J. Reg. (2018)).

[21] Jussi Keppo & Josef Korte, *Risk Targeting and Policy Illusions—Evidence from the Announcement of the Volcker Rule*, 64 Mgmt. Sci. 215-234 (2016).

[22] Sohhyun Chung, Jussi Keppo & Xuchuan Yuan, *The Impact of the Volcker Rule on Bank Profits and Default Probabilities* (working paper, 2016).

[23] Proposing Release, *supra* note 2, at 443 & n.374 (multiplication of hourly rate by estimated hours); *id.* & n.375 (same), 492 & n.419 (same), *id.* & n.420 (you get the idea). These simple calculations are usually enough to satisfy the ministerial requirements of the Paperwork Reduction Act, 44 U.S.C. §§3501 *et seq.* But we have a separate statutory obligation to assess the costs and benefits of our rulemaking decisions, see 15 U.S.C. §78c(f), and unless that statutory text has no meaning it requires more than the Paperwork Reduction Act does. The fact that our economic analysis could be (and, indeed, might have been) confused for Paperwork Reduction Act analysis says all one needs to know about what’s wrong with it.

[24] William Shakespeare, *Henry VI* (describing, as a first-step solution to policy problems, to “[f]irst[,] kill all the lawyers”).



