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Restricted Investment in Private Equity: The Volcker Rule's Incursion Into Banking?

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**RESTRICTED INVESTMENT IN PRIVATE EQUITY—THE
VOLCKER RULE’S INCURSION INTO BANKING?**

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I. INTRODUCTION

Investment in private equity originally came from individual investors and corporations. However, over the years institutional investors have become prominent in the investor pool with the hope of achieving risk adjusted returns. Banks have become significant sources of funds in the private equity market. Bank affiliate groups account for a significant share of the private equity activity as well as the banks' own capital.

A distinct feature of a leveraged buyout by a private equity firm as opposed to strategic buyouts and other transactions is the significant reliance on debt financing. Typically, shell companies with substantially no assets would be formed by the private equity firms to effect the buyout. A substantial portion of this buyout would be funded by investment banks or possibly commercial banks, issuing high yield debt and other related financial offerings. This structure makes the banks very crucial players in the buyout and exposes them directly to the risk of the upshot of the buyout.

Private equity opens avenues for diversified and promising returns. But, investment in private equity, perceived as more risky and volatile as opposed to other publicly traded securities, is being viewed by the government as less favorable in the current market dynamics. The nature of these businesses being high leveraged, make them more likely to falter in a crisis, thus adding to the systemic risk of the investors.

In 2007, the housing bubble burst and the economy took a hit, exposing a host of risky lending and investment practices. The banking sector was especially found at the center of the economic ruin. Banks involved in a variety of arenas outside the conventional commercial banking sphere became particularly critical in this economic situation. The regulators' approach towards the banks has been censorious in various respects.

Owing to the nature of private equity investment practice and the economic conditions of the US market, Section 619 of the Dodd Frank Act, known as the Volcker Rule, was proposed prohibiting banks from investing in proprietary trading and further banning investment in hedge funds and private equity, with the view that such funds can be alternative vehicles for proprietary trading. The regulatory agencies currently are in the process of formulating rules in connection with the new law. Having opened the floor for comment from various financial entities, experts, international organizations and individuals, the legislators have received mixed responses to the

proposed rules. This paper critically examines the rules by putting forward different perspectives towards their implementation and effects.

II. BANK INVESTMENT IN PRIVATE EQUITY

Before examining the intricacies and implications of regulations that govern the private equity industry, it is important to understand and digest the basic skeletal structure of private equity financing, specifically the debt aspect of it. The history of private equity finance has been a history of changing regulation, changing investment cultures and changing access to debt and sources of debt.¹ Fundamentally, private equity transactions are leveraged buyouts (LBOs), a significant portion of which is covered by debt. The debt and investment structures have a significantly role played by commercial and investment banks. Therefore, the structure of private equity investment has been tied into the willingness and capacity of the banks and financial institutions to facilitate the leverages buyouts².

Private equity firms are business and investment management organizations, many of which were originally divisions of investment banks or were begun by partners after leaving the acquisition arm of an investment bank. Many prominent investment banks operate private equity divisions that compete with other firms. These firms solicit capital from investors and that capital is then pooled as a fund that is a separate legal entity from the private equity firm.³

During the beginning of the 2000s, the bear market encouraged banks to turn to private equity as a good source of alternative investment where they can claim to deliver returns on a variety of market conditions. Commercial banks also became more inclined towards providing high levels of leverage on larger levels of debt. LBO debt raised in 2004–05 in the U.S. market amounted to \$200 billion, or 5 percent of total corporate debt outstanding.⁴ An additional

¹ JAMIE MORGAN, *PRIVATE EQUITY FINANCE 3* (Palgrave Macmillan, 2009)

² *Id.* at 13

³ *Id.* at 4

⁴ International Monetary Fund- Monetary and Capital Markets Department, *Global Financial Stability Report: Market Development and Issues* (April 2006) available at <http://www.imf.org/External/Pubs/FT/GFSR/2006/01/pdf/chp1.pdf>. See also Lily Fang, Victoria Ivashine & Josh Lerner, *Unstable Equity- Combining Banking with private Equity Investing* (Harvard Business School, Working Paper No. 10-106, 2010). Over the period between 1983 and 2009, over one-quarter of all private equity investments involved bank-affiliated private equity groups. Between 1997 and 2006, the total amount of transactions done by bank-affiliated private equity firms represented on average 9.4% of the bank's total equity during this period

advantage that bank debt brings to the table is that banks offer better terms as they want to sell other fee based services to the private equity firms and the private equity firms believe that their bank relationships are a competitive advantage.⁵ In the light of all the factors discussed, banks have found an influential presence in the private equity industry.

When the economy was thriving, they were not concerned by bad debts and defaults. However, this was no longer the same with the dawn of the economic slump. The question that had arisen in the light of the financial crisis was about the ‘liquidity’ of the private equity market. It is this very liquidity characteristic of private equity that gave impetus to for the leveraged buyouts to grow in terms of scale and frequency over the years.⁶ The availability of debt as a significant share of financing gave private equity the inherent tendency to grow. As a result, private equity buyouts began to create more vulnerable acquisitions with higher levels of leverage and complex debt structures. Consequentially private equity finance developed an element of dis-functional and unstable liquidity.⁷ The instability of liquidity resulting in periodic adverse economic conditions and problems within the financial system raised the issue of whether private equity finance must be regulated and how.⁸

Sensing the trend of banking behaviors and change in the economic climate, Mr. Rodrigo De Rato, the Managing Director of the International Monetary Fund at the 37th Washington Conference of the Council of the Americas pointed that “I (also) see significant risks in the recent increase in large private equity buyouts financed by a rising proportion of debt, as well as the deteriorating credit quality of leveraged loans. From a financial stability perspective, if some of these deals were to turn sour, it could trigger a reappraisal of risk, which would curtail market access more broadly for lower-rated corporate borrowers. This could adversely affect investment and growth prospects.”⁹

according to the study conducted and reported by the authors.

⁵Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*, EFA 2008 Athens Meetings Paper, (April 5, 2010) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017857##

⁶ Morgan, *supra* note 1, at 14

⁷ Morgan, *supra* note 1, at 14

⁸ Morgan, *supra* note 1, at 8

⁹ Rodrigo de Rato, Managing Director Of the International Monetary Fund, Speech at the 37th Washington Conference of the Council of the Americas (May 2, 2007) available at <http://www.imf.org/external/np/speeches/2007/050207.htm>

III. PAUL VOLCKER AND THE HISTORY OF THE RULE

After the great depression in the 1920s, the regulators focused on building a firewall between bank and investment banks with the objective to keep the commercial banks from dramatic economic fluctuations.¹⁰ To give effect to that approach, the Banking Act of 1933, popularly called the Glass-Steagall Act, was passed. The primary objective of the legislation was to protect the American saver from the unwarranted risks the banks resort to taking with their money.¹¹ Commercial banks activities involving securities dealings were severely curbed.¹² The 1999 passage of the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999, effectively reversed the changes made by the Glass-Steagall Act.¹³ It pulled down the wall between commercial and investment banking and lifted the ban on proprietary trading activities of the banks.¹⁴ This marked the beginning of a disaster, believed many financial experts and academics.¹⁵ Less than a decade after the deregulation, these same financial entities were at the epicenter of a global financial crisis that began in 2007 as they aggressively involved in riskier credits including leveraged loans.¹⁶

Paul Volcker, the former Chairman of the Federal Reserve Bank of New York and the economic advisor to the President has argued strongly that the repeal of Glass-Steagall, allowing financial firms to grow big in part by merging conventional banking with investment activities,

¹⁰Steven Pearlstein, *Lets Shatter the Myth on Glass-Steagall*, The Washington Post, July 28, 2012 available at http://www.washingtonpost.com/lets-shatter-the-myth-on-glass-steagall/2012/07/27/gJQASaOAGX_story.html

¹¹ DAVID SKEEL, *THE NEW FINANCIAL DEAL- UNDERSTANDING THE DODD FRANK ACT AND ITS UNINTENDED CONSEQUENCES 1* (John Wiley & Sons, 2011)

¹² Matthew Richardson, Roy C. Smith & Ingo Walter, *Large Banks and the Volcker Rule, in REGULATING WALL STREET 187* (John Wiley & Sons, 2011)- Senator Carter Glass and other contemporary critics of the universal banking model feared that bank involvement in securities and leveraged debt had directly and indirectly led banks to ramp up their holdings of long term financial instruments, exposing themselves to potentially dangerous market, credit and liquidity risk.

¹³ Gramm-Leach-Bliley Act, Pub. L. No. 106-02, 113 Stat. 1338 (1999)

¹⁴ JAMES R. BARTH, R. DAN BRUMBAUGH JR., AND JAMES A. WILCOX, *THE REPEAL OF GLASS STEAGALL AND THE ADVENT OF BROAD BANKING 1* (Office of the Comptroller of the Currency, 2000) available at <http://lccn.loc.gov/2005615866->

“Since the barriers that separated banking from other financial activities have been crumbling for some time, GLBA is better viewed as ratifying, rather than revolutionizing, the practice of banking”.

This legislation was brought into force with the objective to ‘enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks and other financial service providers.

¹⁵ Robert Kuttner, Co-founder and Co-editor of The American Prospect, Testimony before the Committee on Financial Services Rep. Barney Frank, Chairman U.S. House of Representatives Washington D.C (Oct. 2, 2007) available at <http://prospect.org/article/alarmed-parallels-between-1929-and-2007>

¹⁶ *Supra* note 12, at 191

was the primary factor that set the stage for the crisis.¹⁷ He had been waging a campaign to curb greed and speculation on Wall Street.¹⁸ His position is that banks whose fundamental function is to provide credit to consumers and business deserve governmental assistance and protection only to the extent that they restrict their role to conventional banking activities and not extend their scope into risky and unstable areas like proprietary trading and private equity- hedge fund investments.¹⁹ He said “We need to break up our biggest banks and return to the basic split of activities that existed under the Glass-Steagall Act of 1933- one highly regulated (and somewhat boring) set of banks to run the payments system, and a completely separate set of financial entities to help firms raise capital (and to trade securities).”²⁰

With respect to the specific investment and debt role played by banks in hedge funds and private equity, Volcker supports his approach in the followings ways:²¹

1. Leveraged debt places bank capital at risk in the search of speculative profit rather than in response to customer needs- Looking at private equity in specific, these investments are distinguished from conventional business processes particularly because they are based on subjective and disputable assessments of businesses, that are attached with the risk of failure in performance. Mr. Volcker emphasizes that leveraged loans jeopardize the interests of the pool of customers that are involved in traditional banking activities.

2. These activities present virtually insolvable conflicts of interest with customer relationships- Mr. Volcker opined that these conflicts cannot be resolved by merely making divisions in the Banks activities. These walls of divisions cannot be made distinct and concrete because they would at every stage face the difficulty of overlapping customer interests. Banks provide the essential intermediating function of matching the need for safe and readily available depositories for liquid funds with the need for reliable

¹⁷ Paul Krugman, *Six Doctrines in Search of a Policy Regime*, N.Y. Times, April 18, 2010 available at <http://krugman.blogs.nytimes.com/2010/04/18/six-doctrines-in-search-of-a-policy-regime/>

¹⁸ John Cassidy, *The Volcker Rule- Obama’s Economic Advisor and His Battle over The Financial-Reforms Bill*, The New Yorker, July 26, 2010 available at http://www.newyorker.com/reporting/2010/07/26/100726fa_fact_cassidy

¹⁹ *Id.*

²⁰ Simon Johnson, *Paul Volcker Finds a Hammer*, N.Y. Times, Dec 17, 2009 available at <http://economix.blogs.nytimes.com/2009/12/17/paul-volcker-finds-a-hammer/>

²¹ Paul Volcker, *How to Reform Our Financial System*, N.Y. Times, Jan. 30, 2010 available at <http://www.nytimes.com/2010/01/31/opinion/31volcker.html>

sources of credit for businesses, individuals and governments²². Private equity and hedge fund investment, as per Mr. Volcker's perception, make the necessary liquid funds shrink in quantity and unsafe in quality.

3. The private capital market institutions are in no way entirely dependent on the commercial banks- the private equity and hedge fund institutions, though widely varying in size and characteristics, are inherently capable of maintaining innovative competitive markets.²³ They are typically financed privately and heavily dependent on non-banking and private investors for a substantial portion of their investments. Commercial banks only tilts a "level playing field" without clear value added.²⁴ Mr. Volcker's school of thought believe that taking away certain banking sources for investment would not be detrimental to private equity.

4. Only a small group of banks are involved in leveraged debt- Mr. Volcker argues that only a handful of large banks, which are actively involved in private equity investment, are vital to the performance of the respective industries.²⁵ Other financial institutions are not significantly present in the private equity or hedge fund markets. He characterizes private equity and hedge fund institutions as having no adverse consequences for the viability of economy in general and therefore, proposed that regulation of those areas would not significantly affect the bigger picture.²⁶ Those who endorse the regulation also argue that this regulation is only restricting flight and not cutting the wings of the financial institutions altogether. They would still be free to innovate, to trade, to speculate, to manage private pools of capital and as ordinary businesses in a capitalist economy, to fail".²⁷

With this outlook, Mr. Volker convinced the policy makers that clarifying the range of trading activity appropriate for commercial banks in support of customer relationships and regulating them effectively is what is required to streamline banking activities that determine the

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Supra* note 12, at 191.

²⁶ *Id.* Contrary to what is stated, in 2009, the world's five largest wholesale banks were responsible for the origination of nearly 60% all capital market transactions. The figures speak for themselves and clearly dispute the reasoning given by Mr. Volcker that private equity transactions are not significant enough to have a noticeable effect on the economy.

²⁷ *Id.*

fate of the economy to a prodigious extent. He strongly advocated the approach of structural changes. The Obama government taking this approach into serious consideration, did not take the extreme measure of resetting the clock on banks, which would not for obvious reasons be taken well by the target banks. They instead, looked in the direction of measures to restrict the activities of the banks in certain specific ways. This approach took shape in the form of Section 619 of the Dodd Frank Act.

IV. THE PROPOSED LAW

Section 619²⁸ of the Dodd Frank Act states that:

PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.

The Bank Holding Company Act of 1956 is amended by adding at the end the following:

“SEC. 13. PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.

(a) IN GENERAL- (1) PROHIBITION—Unless otherwise provided in this section, a banking entity shall not— (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund. (2) NONBANK FINANCIAL COMPANIES SUPERVISED BY THE BOARD- Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund, except that permitted activities as described in subsection (d) shall not be subject to the additional capital and additional quantitative limits except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a

²⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010) & Bank Holding Companies Act, 12 U.S.C. 1851

banking entity.

The fundamental approach underlying this provision that President Obama adopted as a measure to address the financial crisis, is to end the mentality of treating banks as ‘too big to fail’.²⁹ This provision generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund³⁰ (‘covered fund’), subject to certain exemptions.³¹ The Rule takes effect upon the earlier of twelve months after the issuance of final implementing rules and two years after the date the Volcker Rule was enacted (July 21, 2012).³² The Act further requires the various regulatory agencies to formulate rules to give effect to and monitor the implementation of the provision.³³

In formulating the proposed rules as per the provisions of the Act, the Federal Agencies³⁴ have attempted to replicate the structure of Section 13 of the Bank Holding Company Act, which is to prohibit a banking entity from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting such entities to continue to provide client-oriented financial services.³⁵ The Agencies acknowledge that while it is crucial that the rules clearly define and implement the statutory requirements, they must also preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the

²⁹ Press Release, Office of the Press Secretary, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to rein in excesses and Protect Tax Payers (Jan. 21, 2010) *available at* <http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e>

³⁰ ‘Hedge fund’ and ‘private equity fund’ are defined under Section 13(f)(2), as amended by Section 619 of the Dodd Frank Act, as “a company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7) or such similar funds as determined by the appropriate Federal banking agencies.”

³¹ See 12 U.S.C. 1851 (which lays out the general prohibitions, permitted activities, the limitations, exceptions, rulemaking provisions and rules of construction according to which this provision must be implemented and interpreted.)

³² *Supra* note 28

³³ To provide greater definition, the newly created Financial Stability Oversight Council (FSOC) was also directed to undertake a study of the Volcker Rule, including recommendations regarding its implementation. The Financial Services Roundtable, Report on The Economic Impact of the Dodd Frank Act (June, 2012) *available at* http://www.fsround.org/fsr/publications_and_research/files/Economic-Impact-Dodd-Frank-Act-June-2012.pdf

³⁴ Department of the Treasury, Securities and Exchange Commission, Federal Depository Insurance Corporation and the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission

³⁵ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with Hedge Funds and Private Equity Funds, Fed. Reg. (Proposed Nov. 7, 2011)

types of financial services that are permitted.³⁶ Considering this issue, the Agencies and regulatory authorities have afforded significant time and scope to assess the responses of key industrial players that would potentially be concerned with the rules so as to implement them by incorporating the proposed changes while keeping the essence of the provisions intact.³⁷ The proposed rules will be finally designed to clarify the scope of the Volcker Rule's prohibitions on proprietary trading and hedge fund or private equity fund ownership and identify transactions and activities excepted from those prohibitions, as well as the limitations on those exceptions.³⁸

V. RESPONSES TO THE PROPOSED RULE

The private equity industry has seen a dramatic growth. For instance, in the United States in 2006 alone, leveraged buyouts firms raised over \$148 billions and accounted for almost 17% of all mergers and acquisitions.³⁹ A substantial portion of these transactions is financed with syndicated bank loans.⁴⁰ Private equity firms are important clients for banks, since the frequency and scale of their transactions are larger than those of traditional borrowers.⁴¹ The statutory restrictions under the new legislation and the proposed federal rules, have therefore attracted strong reactions from various banks and private equity participants. The reactions are noted as follows:

1. **Banks:**⁴² The primary concerns that banks and their group associations have raised are that:

³⁶ *Id.*

³⁷ Daniel K. Tarullo, Governor of the Federal Reserve System, Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives, Washington, D.C.: The Volcker Rule (Jan. 18, 2012) *available at* <http://www.federalreserve.gov/newsevents/testimony/tarullo20120118a.htm>

³⁸ Daniel M. Gallagher, Commissioner of the U.S. Securities and Exchange Commission, Remarks at the Credit Suisse Global Equity Trading Forum (Feb. 17, 2012) *available at* <http://www.sec.gov/news/speech/2012/spch021712dmg.htm>

³⁹ *Supra* note 5.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Supra* note 38 “The Proposal would reduce market liquidity, increase market volatility, impede capital formation, harm U.S. individual investors, pension funds, endowments, asset managers, corporations, governments, and other market participants, impinge on the safety and soundness of the U.S. banking system, and constrain U.S. economic growth and job creation”

i) Vagueness and Complexity: “The banking industry fears the oversized nature and complexity of this proposed rule will make it unworkable and will further inhibit U.S. banks' ability to serve customers and compete internationally. It's clear from the proposal that many important details remain unresolved. More questions are asked than answered”.⁴³ The burden on banks and regulators of complex, cross-cutting and incomprehensible rules will consequently be the most significant impediment to financial-market recovery and robust economic growth.⁴⁴

ii) Lending and credit limitations: Whatever form it may take, lending is the primary function of the bank on which it thrives. The proposed regulations pose a serious threat to banking entities by limiting their ability to lend through partnership structures and similarly structured credit funds.⁴⁵ Credit funds, particularly private equity funds, help banks diversify their risk and help them secure the supply of credit especially during the periods of market distress.⁴⁶ The proposed rules are likely to reduce that stream of credit and limit the scope of lending activities.

iii) Economic viability: One important concern that the Bankers share is the economic impact on their activities that will result from the implementation of the rule. Modern banking entities, like other corporate entities have been organizing themselves across different business lines by using wholly owned subsidiaries, joint ventures and such⁴⁷. The Proposed Rule by categorizing the investments as ‘covered funds’, subjects the banks to severe restrictions on inter-company transactions⁴⁸. This will thereby create extensive compliance costs and operational burdens, and is likely to restrict institutions from structuring themselves effectively.⁴⁹⁵⁰

⁴³ Frank Keating, President and CEO of the American Bankers Association, Statement of Comment on the Volcker Rule (Oct. 11, 2011) *available at* <http://www.aba.com/Press/Pages/101111VolckerRuleStatement.aspx>.

The broad scope of the rule raises exceedingly high number of practical questions that the Agencies will most definitely encounter when the complex concepts behind the rule are applied to reality.

⁴⁴ The Financial Services Roundtable, Report on The Economic Impact of the Dodd Frank Act (June, 2012) *available at* http://www.fsround.org/fsr/publications_and_research/files/Economic-Impact-Dodd-Frank-Act-June-2012.pdf

⁴⁵ John F.W. Roger, Chief of Staff of Goldman Sachs Group JP, Statement of Comment on the Volcker Rule (Feb. 13, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-353.pdf>

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

The estimates show that banks will have to spend nearly 6.6 million hours to implement the rule, of which more than 1.8 million hours would be required every year in perpetuity.⁵¹ That translates into 3,292 years, or more than 3,000 bank employees whose sole job will be complying with this rule.⁵² They will be transferred to a role that provides compromised customer service, generates minimal revenue and does more harm for the economy than good.

iv) Global impact- the Dodd Frank Act was passed with the objective of causing a foundational change and achieving international conformity. But, the banks believe that this trend would only be deleterious to their business. Foreign banks and financial institutions from other countries can potentially take advantage of the limitations of their American counterparts to capture their industry and would be eagerly awaiting the opportunity to pick up customers and lines of business that American banks will be forced to abandon.⁵³ The Proposed Rule would also cause U.S. banking entities with foreign presence to incur substantial expense in rebranding and restructuring their public foreign funds, while foreign competitors would not be bound by such expenses or the restrictions globally and therefore would enjoy a clear cost advantage.⁵⁴ The Rule restricts U.S. banking entities' global operations, whereas it only restricts foreign banking entities' U.S. operations.⁵⁵ This will substantially damage the American Banks' competitive strength in the global markets.

2. International impact: Various international regulatory bodies, banks and other institutions have also commented on the proposed rule and brought the international impact of the proposed rule to the Agencies' attention. These comments emphasized on

⁵⁰ There has been a latest exit by high-profile traders from traditional Wall Street firm, Morgan Stanley because of the Volcker rule. Aaron Lucchetti, Morgan Stanley Team to Exit in Fallout from Volcker Rule, Wall Street Journal, Jan 11, 2011 available at <http://online.wsj.com/article/SB10001424052748703779704576073841615141836.html>

⁵¹ *Supra* note 43

⁵² *Id.*

⁵³ *Id.*

Advisor Network, *Volcker Rule is Out, How Much Will it Hurt*, Forbes, Dec. 10, 2011- Speaking on a panel hosted by New York University's Stern School of Business last month, chief executive of JP Morgan's investment bank said that when the Volcker Rule was first introduced there were assurances made by regulators that other countries "would fall in line but we haven't seen that. Germany, France, China, Brazil. They didn't follow us."- <http://www.forbes.com/sites/halahtouryalai/2011/10/12/volcker-rule-is-out-how-much-will-it-hurt/>

⁵⁴ *Supra* note 45

⁵⁵ J. Scott Colestani et al., Faculty and Students of School of Law- Hofstra University, Statement of Comment on the Volcker Rule (April 20, 2012) available at <http://www.sec.gov/comments/s7-41-11/s74111-563.pdf>

the cross-border effect of the financial regulations and the need to collaborate with the affected countries.⁵⁶ The opinion of foreign entities across the board is that they must be excluded from the application of the rules⁵⁷ and that the definition of ‘control’ and ‘affiliate’ must be amended so as not to include such foreign joint ventures and foreign subsidiaries, which are controlled by foreign banking groups.⁵⁸

3. **Individuals**: Many commoners who save their money by way of conventional banking routes believe that the Volcker Rule is a necessary reform. They question the very nature of the concept of proprietary trading, saying that the money that the banks claim to be trading as theirs is originally their deposited savings.⁵⁹ Individual savers have taken the position that the bank must be regulated with respect to disposal of funds that are essentially their deposits.⁶⁰

4. **Ancillary entities**: Various commenters, customers, buy-side market participants, industrial and manufacturing businesses, treasurers of public companies and other constituencies with different goals and interests have responded to the proposed regulation with the view that the rule in its current form would have adverse effects on them.⁶¹ Their contentions are regarding the following aspects of the Rule:

i) **The definition and scope of the concepts of ‘affiliate’ and ‘subsidiary’-**

The use of the broad definitions creates a vast array of affiliates covered by the

⁵⁶Masamichi Kono, Vice Commissioner of International Affairs- Financial Services Agency of the Government of Japan & Kenzo Yamamoto, Executive Director- Bank of Japan, Statement of Comment on the Volcker Rule (Dec 28, 2011) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-78.pdf>, *See* Sally Miller, Chief Executive Officer- Institute of International Bankers, Statement of Comment on Volcker Rule- Interpretive Issues relevant to International Banks (May 10, 2011) *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission28_051011-3.pdf, *See also* Angela Knight, Chief Executive of the British Bankers Association, Statement of Comment on the Volcker Rule (Feb. 13, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-364.pdf>

⁵⁷ The reason behind this response is also the practical issue that the rules are home centric, reserving the regulatory and supervisory roles for the American federal agencies leaving limited scope for accommodating the implications on the other countries.

⁵⁸ *Supra* note 4

⁵⁹ Dave Donald, Statement of Comment on the Volcker Rule (Feb. 14, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-358.htm>

⁶⁰Margeret Risk, Statement of Comment on the Volcker Rule (Feb. 13, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-442.htm>,

Individuals responding to the rules referred to the banks as the ‘Banksters’. *See* Tina Gregory, Statement of Comment on the Volcker Rule (February 13, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-404.htm>

⁶¹*Supra* note 38

Volcker Rule, all of which would be subject to prohibitions that were not meant for non-financial firms.⁶²

ii) Scope of the term ‘covered funds’- The Proposed Rule collectively defines private equity funds and hedge funds as covered funds.⁶³ Though the objective of the Rule appears to focus on private equity and hedge funds, the language also captures numerous other corporate structures that are common within financial and non-financial firms that may be banking entities like centrally owned subsidiaries, joint ventures, foreign funds, securitization vehicles, funding vehicles and government sponsored programs.⁶⁴ Therefore, the entities that are involved in diverse financial and business services are expecting that the Agencies should use their discretion to carve these entities out of the definition of covered funds, thereby avoiding these disruptive consequences.⁶⁵

5. **Academics**: Some legal academics are among the few critics that sided with the legislators with respect to the Volcker Rule. An analogy was drawn to describe proprietary trading that it increased risk, just as casino gambling increases risk among gamblers.⁶⁶ They believe that the Volcker Rule is a critical and much needed control on the speculative behavior of banks. It puts back into place some of the basic protections that had protected our banks and their affiliates for six decades prior to the deregulatory frenzy of the 1990s which witnessed legal systems that encouraged and subsidized

⁶² Brackett B. Denniston, Senior Vice-President and General Counsel- GE Company & David G. Nason, Vice-President GE Company and Chief Regulatory Officer- GE Capital, Statement of Comment on the Volcker Rule (Feb. 13, 2012) available at <http://www.sec.gov/comments/s7-41-11/s74111-253.pdf>. In their comment, they expressed that thousands of affiliates of General Electric Capital Corporation that engage primarily or exclusively in non-financial activities (such as those that operate primarily in the industrial, technological, manufacturing or healthcare businesses) will be subject to the Volcker Rule's prohibitions, though an unintended consequence of the rule.

⁶³ *Supra* note 31, definitions of private equity and hedge funds have been discussed .

⁶⁴ *Supra* note 62

⁶⁵ *Id.* , In addition to the specific issues discussed, these entities estimate that the unintended consequences are amplified when they are applied to nonfinancial holdings and affiliates of banking entities in terms of costs and expenses.

⁶⁶ Lynn Stout, Professor of Corporate and Securities Law- University of California Los Angeles, Statement of Comment on the Volcker Rule (Feb. 13, 2012) available at <http://www.sec.gov/comments/s7-41-11/s74111-251.pdf>

speculative trading resulting in reduced returns, increased risks, and boom-and-bust cycles.⁶⁷

Though a few academics endorse the principle behind the Volcker Rule, they have been expressing concern about the regulations that pose the threat of expanding the scope of the rule beyond its intended purpose.⁶⁸

VI. CONCLUSION

With the enactment of the Volcker Rule under the Dodd Frank Act, the financial services regulation has come a full circle in the United States. It has come back to where it started with the Glass Steagall Act. Whether such a shift in the regulatory approach is what the economy needs in the light of the innovation, complexity and distress that it has developed over the years, is a question that is being asked pending the implementation of the legislation.

Banks having not enough ‘skin in the game’ has come as a bad news to the private equity funds, which rely extensively on their significant connections with the banking entities in terms of their capital as well as network and also to the banks, which have in most cases, been rewarded for their highly leveraged loans. The federal agencies have till date been receiving comments and recommendations on the proposed rules. What the outcome of this highly debated issue between the conservative policy makers and the audacious business entities, is awaited by the world.

Private equity has developed and grown to become an important source of funds for a wide spectrum of business entities ranging from start-up, middle-market firms and large public corporations to distressed organizations. Owing to its fundamental idea of organizational innovation, it is in my opinion one of the most needed investment mechanisms for financial and qualitative growth of businesses across the world in the current sluggish economic environment and regulation must be carefully formulated without hampering this growth.

⁶⁷ *Id.*

⁶⁸ Ken Taymor, Executive Director- Berkeley Centre of Law, Business and Economy, University of Berkeley, Statement of Comment on The Volcker Rule (Feb. 13, 2012) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-337.pdf> *See also* Anat R. Admati and Paul Pfleiderer, Graduate School of Business, Stanford University, Statement of Comments on the Implementation of the Volcker Rule (March 23, 2011) *available at* <http://www.sec.gov/comments/s7-41-11/s74111-360.pdf>