



# Distribution Problems: Volcker Rule Exemption Raises Ambiguity

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According to a recent [report](#), some large banks are contemplating a legal challenge to a regulation commonly referred to as the [Volcker Rule](#), which (subject to certain exceptions) prohibits federally insured banks from (1) engaging in proprietary trading, and (2) owning or sponsoring hedge funds and private equity funds. Specifically, according to Yahoo! Finance, certain large banks are evaluating whether a provision in the [Economic Growth, Regulatory Relief and Consumer Protection Act](#) (P.L. 115-174) that some commentators have interpreted as exempting only small banks from the Volcker Rule in fact exempts a considerable number of large banks as well. The competing interpretations of this provision ([Section 203](#)) could have significant implications for the future of the Volcker Rule, as Yahoo! Finance estimates that only the six largest U.S. banks would remain subject to the Rule under a broad reading of the exemption.

This Sidebar discusses the Volcker Rule and the interpretive issues with Section 203 that a number of large banks are reportedly considering. First, the Sidebar provides a general overview of the Volcker Rule. The Sidebar then discusses the potential ambiguity in Section 203, before analyzing the legal arguments that would likely be raised in litigation over that provision. The Sidebar concludes that although a legal challenge to the Volcker Rule premised on a broad reading of the Section 203 exemption would face a number of obstacles, Congress could nevertheless head off such a challenge by amending the underlying statute.

## The Volcker Rule

From 2007-2009, the United States experienced what many commentators believe was the [worst financial crisis since the Great Depression](#). In response to the crisis, Congress enacted comprehensive financial regulatory reform legislation in the form of the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank) in 2010. Among other things, Dodd-Frank adopted a proposal [advocated](#) by former Chairman of the Federal Reserve Paul Volcker that limits the ability of federally insured banks to engage in certain speculative trading activities. Specifically, [Section 619](#) of Dodd-Frank (commonly referred to as the Volcker Rule) prohibits federally insured banks from (1) engaging in “proprietary trading”—that is, trading securities or derivatives as a principal (as opposed to trading on behalf of a client), and (2) owning or sponsoring hedge funds and private equity funds. Supporters of the Volcker Rule have argued that

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prohibiting these activities (1) minimizes the “[moral hazard](#)” that results when the employees and shareholders of banks that are supported by federal deposit insurance, Federal Reserve liquidity, and emergency government bailouts enjoy the benefits of speculative trading while taxpayers bear the risk of failure, (2) [decreases overall risk](#) in the banking sector, and (3) eliminates [conflicts of interest](#) that may [arise](#) when banks facilitate client trades while also trading for their own account. By contrast, the Volcker Rule’s critics have argued that (1) bank proprietary trading was not a [major cause](#) of the 2007-2009 financial crisis, (2) the Rule may harm [market liquidity](#), and (3) the Rule’s complexity creates significant [compliance costs](#), which are particularly onerous for small and medium-sized banks.

Importantly, the Volcker Rule contains certain exceptions for activities that Congress deemed socially valuable. Specifically, Section 619 explicitly allows banks to take proprietary positions in connection with securities underwriting, market-making, and risk-mitigating activities notwithstanding its core prohibition on proprietary trading. Section 619 also contains several exceptions that permit banks to make certain limited investments in hedge funds and private equity funds, subject to certain conditions.

Because of the broad character of Section 619’s prohibitions and exceptions, the Volcker Rule’s implementation has involved a [protracted administrative rulemaking process](#) to clarify its scope. On December 10, 2013—over three years after Dodd-Frank was signed—the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the Agencies) adopted [final regulations](#) implementing the Volcker Rule.

Notwithstanding the adoption of the December 2013 regulations, the Volcker Rule has remained the subject of significant debate. The Financial CHOICE Act—comprehensive regulatory reform legislation that passed the House of Representatives in June 2017—would have [repealed](#) the Rule altogether. However, the regulatory reform legislation ultimately enacted in March 2018 adopted a different approach to the Volcker Rule, limiting its application rather than repealing it outright. Specifically, in a provision entitled “Community Bank Relief,” Section 203 of the Economic Growth, Regulatory Relief and Consumer Protection Act [provides](#) that for purposes of the Volcker Rule (which applies to “insured depository institutions”):

[T]he term ‘insured depository institution’ does not include an institution . . . that does not have and is not controlled by a company that has . . . (i) more than [\$10 billion] in total consolidated assets; and (ii) total trading assets and liabilities . . . that are more than 5 percent of total consolidated assets.

Six days after the enactment of P.L. 115-174, the Agencies issued a [notice of proposed rulemaking](#) identifying a number of proposed changes to the Volcker Rule. In the notice, the Agencies [acknowledged](#) that P.L. 115-174 had narrowed the range of institutions subject to the Rule, explaining that they planned to address this change through a subsequent rulemaking process. The Agencies also indicated that they will not enforce the final 2013 Volcker Rule regulations “in a manner inconsistent with” P.L. 115-174.

## Section 203 of P.L. 115-174

After the enactment of P.L. 115-174, most [commentators](#) assumed that Section 203 [exempts](#) banks from the Volcker Rule only if they meet *both* of the standards enumerated in that section. That is, most commentators interpreted Section 203 to exempt banks with trading assets and liabilities constituting less than five percent of their total assets only if those banks *also* have total assets of less than \$10 billion. According to this interpretation of Section 203, the phrase “does not have and is not controlled by a company that has” in that provision—but *not* the phrase “does not include”—is distributed over the conjunction that follows, so that banks need to meet both of the standards set forth in that conjunction in order to qualify for an exemption.

However, per the recent Yahoo! Finance [report](#), some large banks are considering whether Section 619 (as amended by Section 203) in fact exempts banks that meet *either* of those standards from the Volcker Rule.

While the exact argument that the banks are evaluating is not entirely clear, that understanding of the amended Volcker Rule exemption would follow from at least two interpretations of Section 619. First, the banks may be evaluating the argument that the *entire* operative phrase in Section 619—“does not include an institution that does not have and is not controlled by a company that has”—is distributed over the relevant conjunction (*i.e.*, the Full Distribution Reading). According to this interpretation of the statute, Section 619 would effectively read:

[T]he term ‘insured depository institution’ [for purposes of the Volcker Rule] does not include an institution . . . that does not have and is not controlled by a company that has . . . (i) more than [\$10 billion] in total consolidated assets; and (ii) [does not include an institution . . . that does not have and is not controlled by a company that has] total trading assets and liabilities . . . that are more than 5 percent of total consolidated assets.

Second, the banks may be considering a different interpretation of the Volcker Rule exemption that would have the same effect as the Full Distribution Reading—specifically, the argument that the phrase “does not have and is not controlled by a company that has” in Section 203 is *not* distributed over the following conjunction (*i.e.*, the No Distribution Reading). This reading of Section 203 seizes on the [potential ambiguity](#) in sentences of the form “A does not have X and Y.” If the phrase “does not have” is distributed over the following conjunction in sentences of this form, such sentences mean “A does not have X and A does not have Y.” By contrast, if the phrase “does not have” is not distributed over the following conjunction, such sentences mean “A does not have [X and Y],” a proposition that is true whenever A does not have X *or* A does not have Y. If the latter approach is applied to Section 203, the Volcker Rule exemption would apply to (1) banks that do not have and are not controlled by a company that has more than \$10 billion in total assets, *and* (2) banks that do not have and are not controlled by a company that has trading assets and liabilities constituting more than five percent of total assets. Both categories of banks would qualify for the exemption under this reading because both categories of banks would not qualify as banks that “ha[ve]” or are “controlled by a company that has” *both* (1) more than \$10 billion in total assets, *and* (2) trading assets and liabilities constituting more than five percent of total assets.

These possible readings of the Volcker Rule exemption would have significant consequences. While the Agencies have yet to clarify the meaning of “trading assets and liabilities,” Yahoo! Finance estimates that only the six largest U.S. banks would remain subject to the Volcker Rule under a broad reading of Section 203.

## Analysis

While the Full Distribution and No Distribution Readings of the Volcker Rule exemption are not entirely without merit, they face a number of difficulties. The U.S. Court of Appeals for the Sixth Circuit (the Sixth Circuit) addressed an interpretive question that is similar to the issues raised by the Volcker Rule exemption in *OfficeMax, Inc. v. United States*. In that case, the Sixth Circuit considered the meaning of a statute that imposes a three-percent federal excise tax on “toll telephone service,” a term the statute defines to mean “a telephone quality communication for which . . . there is a toll charge which varies in amount with the distance and elapsed transmission time of each individual communication.” Specifically, the Sixth Circuit considered whether this definition means that the excise tax applies (1) to “telephone quality communication[s] for which . . . there is a toll charge which varies in amount with” *either* “the distance” *or* “the elapsed transmission time” of “each individual communication,” or (2) only to “telephone quality communication[s] for which . . . there is a toll charge which varies in amount with” *both* “the distance” *and* “the elapsed transmission time” of “each individual communication.” In an opinion by Judge Jeffrey Sutton, a three-judge panel of the Sixth Circuit adopted the latter interpretation by a 2-1 vote. While the judges in the majority disagreed with the dissenting judge on a number of interpretive points, all three judges agreed that in analyzing which parts of a statutory provision are

distributed over a subsequent conjunction, the critical inquiry involves an evaluation of the surrounding statutory context.

The critical inquiry in determining whether either the Full Distribution or No Distribution Reading of the amended Volcker Rule exemption is viable is accordingly likely to involve an evaluation of statutory context, as opposed to the application of a strict rule concerning which parts of statutory provisions are to be distributed over subsequent conjunctions irrespective of such context. However, it is unclear whether there is any contextual evidence to support either the Full Distribution or No Distribution Reading. In fact, the available evidence appears to support a narrow reading of the Section 203 exemption. Section 203's title—"Community Bank Relief"—counsels in favor of reading Section 203 as being principally concerned with providing regulatory relief to small community banks. While the Supreme Court has [cautioned](#) that statutory titles "cannot limit the plain meaning of the text," it has also [explained](#) that "statutory titles and section headings are tools available for the resolution of a doubt about the meaning of a statute." Reading the Section 203 exemption as extending to all but the very largest megabanks would accordingly be difficult to square with how Congress characterized the scope of that exemption in Section 203's title. Moreover, it appears that Congress understood the Section 203 exemption as having only a limited effect on the scope of the Volcker Rule during deliberations over P.L. 115-174. During [floor debates](#) concerning P.L. 115-174, a [number of Members of Congress](#) indicated that they [understood](#) Section 203 as exempting *only* banks with less than \$10 billion in assets, suggesting that they did not interpret that provision as exempting large banks with trading assets and liabilities constituting less than five percent of their total assets. Finally, the Supreme Court has [explained](#) that in [certain contexts](#), statutory exemptions from regulatory schemes are to be construed narrowly. While the Court has made clear that this principle [does not apply universally](#), courts may be skeptical of interpretations of the Section 203 exemption that would dramatically limit the Volcker Rule's scope absent clear evidence that Congress intended that result.

The Full Distribution and No Distribution Readings of the Volcker Rule exemption would also face an additional obstacle if the Agencies implementing the Rule were to reject them. In a May 2018 notice of proposed rulemaking identifying a number of proposed changes to the Volcker Rule, the Office of the Comptroller of the Currency (OCC) [suggested](#) that it reads the amended Volcker Rule exemption narrowly, indicating that OCC-supervised institutions "with total consolidated assets of \$10 billion or less" are exempt from the Rule "if their trading assets and trading liabilities do not exceed 5 percent of their total consolidated assets, and they are not controlled by a company that has total consolidated assets over \$10 billion or total trading assets and liabilities that exceed 5 percent of total consolidated assets." If the Agencies were to adopt a narrow interpretation of Section 203 in a final rule, their interpretation may be entitled to [Chevron deference](#). Under *Chevron*, courts will defer to agency interpretations of ambiguous statutes they are charged with administering as long as those interpretations are reasonable. Because the majority interpretation of Section 203 appears to be at least reasonable, a court would likely defer to such an interpretation if it were to conclude that *Chevron* applied.

The Supreme Court addressed a broadly similar interpretive question in *Young v. Community Nutrition Institute*, where it deferred to an agency's interpretation of an ambiguous statute. In that case, the Court considered the meaning of a statute concerning the promulgation of regulations determining tolerance levels for harmful substances in food. Specifically, the relevant statute provided that the Food and Drug Administration (FDA) "shall promulgate regulations limiting the quantity [of harmful substances] therein or thereon to such extent as [it] finds necessary for the protection of public health." In *Young*, the Court considered whether this provision imposed a mandatory or discretionary duty on the FDA to promulgate the relevant regulations. The FDA argued that the statute imposed only a discretionary duty, interpreting the phrase "to such extent as [it] finds necessary" as modifying the word "shall." By contrast, a number of public interest groups argued that the statute imposed a mandatory duty, interpreting the phrase "to such extent as [it] finds necessary" as modifying only "the quantity therein or thereon." While the Court acknowledged that the latter reading of the statute "may seem to some to be the more natural

interpretation,” it deferred to the FDA on the grounds that its reading was “sufficiently rational” to pass muster under *Chevron*. Accordingly, even if a plaintiff were to establish that the Full Distribution or No Distribution Reading of Section 203 is the most “natural” interpretation of that provision, a court may nevertheless defer to a contrary reading adopted by the Agencies.

While a legal challenge to the Volcker Rule premised on a broad reading of Section 203 may accordingly face a number of obstacles, Congress can head off such a challenge by amending the underlying statute should it determine that a narrow reading of the exemption is warranted. Such an amendment could explicitly provide that the exemption extends only to banks that meet *both* of the conditions enumerated in Section 203.

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