The Perils of a Middle Road to Regulating Systemic Risk: The Volcker Rule's Risk Backstop Provisions

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The Dodd-Frank Act, enacted after the global financial crisis, requires U.S. financial regulators to define and regulate systemically risky firms and activities—a truly Sisyphean task. In this Essay, we identify two paths regulators have taken: a "descriptive approach," which involves restating the Congressional mandate as regulatory text and creating a qualitative, bespoke process for the identification of systemic risks; and a "prescriptive approach," which involves adopting detailed, specific, and data-driven rules that clearly delineate firms or activities that do, or do not, pose systemic risk. Each of these approaches has benefits and drawbacks—most notably the tradeoff between ex ante certainty of application (prescriptive approach) and flexibility (descriptive approach). We then describe a third approach—implemented in the Volcker Rule—of layering a broad descriptive prohibition onto a set of detailed, prescriptive rules. This middle, "backstop" approach is a tempting way for regulators to capture the benefits of both the descriptive and prescriptive approaches. However, we argue, in practice the backstop approach accentuates the drawbacks of each of the descriptive and prescriptive approaches, rather than their benefits, resulting in ex ante uncertainty while tying the hands of regulators. We therefore suggest that regulators avoid the temptation of the backstop approach when seeking to identify systemically risky firms or activities, but we also provide suggestions for minimizing these adverse outcomes should regulators nonetheless choose this approach.

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The views expressed in this Essay are the views of the authors and do not necessarily reflect the views of Davis Polk & Wardwell LLP.

INTRODUCTION

Enacted in response to the global financial crisis and aimed at addressing a perceived lack of holistic regulatory oversight,[1] the Dodd-Frank Act[2] includes several provisions designed to regulate sources of systemic risk in the U.S. financial system. Rather than take on the difficult task of identifying these sources of systemic risk, Congress drafted broad mandates that direct financial regulators to undertake this Sisyphean task.

In the five years since Dodd-Frank's enactment, financial regulators, in our view, have followed two distinct paths to implement these Congressional mandates. The first, which we call the "descriptive approach," involves restating the statutory mandate as regulatory text and developing a qualitative, bespoke process to apply the statutory framework to individual institutions or activities to determine whether they pose systemic risk. The descriptive approach has the virtue of flexibility, which is particularly important in fast-changing financial markets, but also has the significant drawback of providing little ex ante certainty to market participants as to how their activities will be viewed. In the extreme, this approach raises issues of enforceability of the regulations.[3] The second, which we call the "prescriptive approach," is to adopt detailed, specific, and data-driven rules that clearly delineate firms or activities that do, or do not, pose systemic risk. The prescriptive approach has the virtue of ex ante certainty of application but raises concerns about possible loopholes or simply missing an existing or emerging area of risky activity. In many ways, the choice between these two approaches to identifying systemic risk sounds in the age-old debate of the costs and benefits of principles-based regulation versus rules-based regulation.[4]

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1. *See, e.g.*, President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), https://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act ("For years, our financial sector was governed by antiquated and poorly enforced rules that allowed some to game the system and take risks that endangered the entire economy.").

2. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12 and 15 U.S.C.).

3. *See* Complaint, Metlife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. Jan. 13, 2015) (discussed *infra* p. 129).

4. *See generally, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

A middle road or "backstop" approach—coupling specific rules that prohibit enumerated activities with a qualitative safety net that broadly prohibits risky activity—is a tempting way for regulators to close loopholes and maintain regulatory flexibility while providing ex ante certainty. We present the Volcker Rule[5] as an example where regulators have mixed the descriptive and prescriptive approaches; while the conventional wisdom portrays the Rule as highly detailed, prescriptive, and quantitative, two often-overlooked "risk backstops" provide a qualitative veto that regulators can use to override any prescriptively permitted activity. This Essay argues, however, that such an approach, rather than combining the virtues of the descriptive and prescriptive approaches into a stronger, more flexible regulatory regime, instead accentuates the drawbacks of both.

II. TWO APPROACHES TO IDENTIFYING SYSTEMIC RISK

The preamble to the Dodd-Frank Act describes the Act first and foremost as intended "to promote the financial stability of the United States."[6] To achieve this goal, the Act includes a number of provisions targeted at identifying institutions and activities that pose substantial risks to the United States financial system and economy—otherwise known as systemic risk. These provisions, each focused on different aspects of the financial system, use remarkably similar language in describing the types of risk Congress seeks to regulate.

For example, in requiring the Financial Stability Oversight Council (FSOC) to identify nonbank financial institutions as systemically important, the Act directs the FSOC to determine whether "material financial distress at [a] U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a *threat to the financial stability of the United States*."[7] Similarly, the Act requires the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to identify "major swap participants"—a categorization meant to capture large market participants (like AIG Financial Products prior to the crisis) that are not regulated as swap dealers. The Act directs the SEC and CFTC

5. Dodd-Frank Act § 619, 12 U.S.C. § 1851 (2012).
6. *Id.*, pmbl.
7. *Id.* § 113(a)(1), 12 U.S.C. § 5323(a)(1) (2012) (emphasis added).

to identify entities "whose outstanding swaps create substantial counterparty exposure that could have *serious adverse effects on the financial stability of the United States banking system or financial markets*" or that surpass a threshold "prudent for the effective monitoring, management, and oversight of entities that are *systemically important or can significantly impact the financial system of the United States*."[8] Other examples of similar language abound.[9]

Broadly mandating the regulation of systemic risks, however, is far easier than identifying those risks, a critical prerequisite to regulating them. Faced with this challenge across a myriad of markets and activities, regulators have, in our view, converged on two distinct paths in implementing their systemic risk identification mandates.

The first path is to adopt rules that are as broad as the underlying statutory provision and to supplement those rules with qualitative factors or assessment methodologies that guide, but do not bind, regulatory determinations. We refer to this as the descriptive approach. The second path is to provide detailed, quantitative, data-driven rules that provide clear results as to whether activities or firms are systemically risky. We refer to this as the prescriptive approach.

The regulations implementing the two systemic risk provisions described above—the FSOC's regulation of nonbank systemically important financial institutions (colloquially referred to as nonbank SIFIs) and the SEC's and CFTC's regulation of MSPs—illustrate each approach.[10] In developing rules to identify and designate nonbank SIFIs, the FSOC followed

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8. Dodd-Frank Act § 721(a)(16), 7 U.S.C. § 1a(33)(A)(ii), (B) (2012) (emphases added).

9. These include, among many others, the general mandate of the new Financial Stability Oversight Council to "identify risks to the financial stability of the United States" and "identify gaps in regulation that could pose risks to the financial stability of the United States," *id.* § 112(a)(1)(A), (2)(G), 12 U.S.C. § 5322(a)(1)(A), (2)(G) (2012), the mandate of the Office of Financial Research to "develop and maintain metrics and reporting systems for risks to the financial stability of the United States" and to engage in "an analysis of any threats to the financial stability of the United States," *id.* § 154(c)(1)(A), (d)(2)(A), 12 U.S.C. § 5344(c)(1)(A), (d)(2)(A) (2012), and the Federal Reserve's stress tests requirements, including to "develop and apply such other analytic techniques as are necessary to identify, measure, and monitor risks to the financial stability of the United States," *id.* § 165(i)(1)(B)(iii), 12 U.S.C. § 5365(i)(1)(B)(iii) (2012).

10. There are other examples of these approaches in Dodd-Frank Act rulemaking. The regulations issued by the Federal Reserve Board of Governors and the FDIC governing resolution plan requirements for systemically important banking organizations is an example of the descriptive approach. *See* Resolution Plans Required, 76 Fed. Reg. 67,323 (Nov.

the descriptive approach.[11] These rules restate the statutory mandate, together with the eleven statutory factors required to be considered, including "[a]ny other risk-related factor that the [FSOC] deems appropriate."[12] The FSOC also included, as an appendix to its rules, guidance that describes "the manner in which the [FSOC] intends to apply the statutory standards and considerations."[13] These guidelines include three "channels of transmission" of systemic risk, a grouping of the eleven statutory factors into a six-category framework, and 31 metrics (some overlapping) that would inform each of the six categories.[14] Each of these factors is described as a potential consideration for the FSOC in designating nonbank SIFIs; the guidelines do not specify the weighting of these different variables or whether and how they would be applied to any given nonbank financial institution. Thus, rather than providing specific rules to implement its statutory mandate to identify nonbank SIFIs, the FSOC restates that mandate and supplements it with a bespoke consideration process—a decidedly descriptive approach to identifying systemic risk.

The SEC and CFTC's approach in identifying "major swap participants" is an example of the prescriptive approach.[15] In these rules, the SEC and CFTC take Congress's broad mandate to identify market participants whose swap activities pose systemic risk and create a set of specific quantitative tests that define what it means to pose systemic risk. The MSP regulations set out quantitative safe harbors, as is common for prescriptive rules, with which firms may comply to avoid MSP registration, in addition to the specific thresholds against which a firm must calculate its exposure on a daily basis.[16] The MSP test requires a firm that enters into swaps or security-based swaps to calculate its current uncollateralized exposure—the

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1, 2011) (amending 12 C.F.R. pts. 243, 381). The SEC and CFTC rules implementing systemic risk reporting for private funds under Title IV of the Dodd-Frank Act are an example of the prescriptive approach. *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011) (amending 17 C.F.R. pts. 4, 275, 279).

11. FSOC Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012) (amending 12 C.F.R. pt. 1310).

12. 12 C.F.R. § 1310.10–.11 (2015).

13. *Id.* app. A.

14. *Id.*

15. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30,596 (May 23, 2012) (amending 17 C.F.R. pts. 1, 240).

16. 17 C.F.R. §§ 1.3(hhh), 240.3a67-1 (2015).

amount of money it currently owes counterparties on swaps or security-based swaps—and its future potential exposure—calculated by multiplying the notional amount of swap or security-based swap positions by a risk factor matrix and coefficients reflecting mark-to-market margining, clearing, and netting agreements.[17] The current uncollateralized exposure and potential future exposure are combined in various predefined ways and measured against set numerical thresholds.[18] That is, in the MSP context, regulators quantified the meaning of systemic importance—a clear indicator of the prescriptive approach to identifying systemic risk.

Each of these approaches has its virtues and drawbacks. The descriptive approach provides a regulator with the ability to use its discretion in weighing various inputs to determine whether a particular type of activity or institution gives rise to systemic risk. Regulators can use this flexibility to adjust their treatment of firms or activities based on the particular facts and circumstances and to address emerging activities or concerns without formally amending the rule. In addition, a regulator can take action against activities that the regulator determines are inconsistent with the spirit of the rule. However, these advantages come at the cost of ex ante certainty for market participants. In the case of the FSOC's nonbank SIFI designation rules, MetLife, an insurance firm that was designated by the FSOC as systemically important, sued the FSOC on the basis that the nonbank SIFI designation rules are "unconstitutionally vague" and that the designation process "violated MetLife's due process rights."[19]

The prescriptive approach, on the other hand, seeks to provide regulators and market participants with ex ante certainty as to whether the market participant or its activities will be deemed systemically important.[20] However, it places a heavy burden on regulators to anticipate all of the circumstances in which the rules will be applied, a particularly difficult task in the context of the ever-changing financial markets. The approach thus restricts regulators' flexibility and may result in over-inclusive systemic risk assessments, resulting in unnecessary regulation of non-systemic activities, or in under-inclusive assessments that fail to identify key drivers of systemic risk.

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17. *Id.*

18. *Id.*

19. Plaintiff MetLife, Inc.'s Cross-Motion for Summary Judgment at 81, MetLife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. June 16, 2015).

20. Of course, the goal of ex ante certainty can be undermined where a rule is overly complex or if it fails to adequately address common market practices or realities.

The prescriptive approach's flaws can be seen in the example of the MSP rules. To date, those rules have identified two entities that met the quantitative MSP thresholds.[21] However, both of these entities were in the process of being wound down at the time they registered, and neither anticipated engaging in new swap activities.[22] Given the types of regulatory requirements with which MSPs must comply—which largely relate to prospective conduct when entering into swaps—and grandfathering provisions that largely exempted legacy swaps from these requirements, it may have been beneficial for the CFTC to be able to exercise greater discretion to exempt these entities in wind-down from MSP registration and regulation.

III. THE VOLCKER RULE: A MIDDLE ROAD

The statutory provisions of the Volcker Rule, found in Section 619 of the Dodd-Frank Act and named for former Federal Reserve Chairman Paul Volcker, prohibit banking entities from engaging in certain speculative trading, directly or indirectly through investments in hedge funds and private equity funds.[23] The statutory text permits short-term trading and fund investments in limited cases deemed by Congress to be beneficial to the financial markets, such as market making, risk-mitigating hedging and underwriting.[24]

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21. *Provisionally Registered Major Swap Participants as of March 1, 2013*, COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LawRegulation/DoddFrankAct/registermajorswappart (last visited Sept. 11, 2015).

22. Matt Cameron & Joe Rennison, *Zombie Firms Are First Dodd-Frank Major Swap Participants*, RISK MAG. (Mar. 7, 2013), http://www.risk.net/risk-magazine/news/2252713/zombie-firms-are-first-doddfrank-major-swap-participants; *cf.* Ass'n of Fin. Guar. Insurers, SEC Meeting: Application of "Swap Definitions" and "Major Swap Participant" Requirements to Financial Guaranty Insurers (Aug. 6, 2012), https://www.sec.gov/comments/s7-34-10/s73410-97.pdf.

23. Dodd-Frank Act § 619, 12 U.S.C. § 1851 (2012). Section 619 of the Dodd-Frank Act is generally referred to as the "Volcker Rule" as a result of President Obama's use of that term in a January 21, 2010 speech expressing his administration's support for incorporating prohibitions in the regulatory reform legislation that became the Dodd-Frank Act. President Barack Obama, Remarks by the President on Financial Reform (Jan. 21, 2010), https://www.whitehouse.gov/the-press-office/remarks-president-financial-reform ("It's for these reasons that I'm proposing a simple and common-sense reform, which we're calling the "'Volcker Rule"'—after this tall guy behind me. Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.").

24. 12 U.S.C. § 1851 (2012).

The conventional wisdom is that, in implementing the statutory Volcker Rule, regulators opted for the prescriptive approach. Indeed, the Volcker Rule regulations and the explanatory preamble, in 882 pages of text, provide detailed, multi-factored tests implementing the statute's high-level instructions on the types of activities that are permitted and prohibited. Chairman Volcker himself is not a fan, saying that it "[is] much more complicated than I would like to see,"[25] and supporting a more descriptive approach, a "much simpler bill . . . a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance."[26]

Yet, buried within the thousand pages of the Volcker Rule regulations are ten pages that set out two "risk backstops," which simply restate the statutory provisions on which they were based.[27] Specifically, Sections 248.7 and 248.15 state that an activity, even if it is permitted under the terms of a prescriptive Volcker Rule exemption, is nonetheless prohibited if it would "result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States."[28]

"High-risk asset" and "high-risk trading strategy" are defined in the regulations simply by reference to the likelihood that the asset or strategy "would pose a threat to the financial stability of the United States."[29] No

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25. Rachel Armstrong, *Paul Volcker Says Volcker Rule Too Complicated*, REUTERS, Nov. 9, 2011, http://www.reuters.com/article/2011/11/09/us-regulation-volcker-idUSTRE7A83KN20111109.

26. James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, N.Y. TIMES, Oct. 22, 2011, http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?_r=0.

27. The Volcker Rule also includes a third backstop that prohibits otherwise permitted activity if it "would involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties." Dodd-Frank Act § 619(d)(2)(A)(i), 12 U.S.C. § 1851(d)(2)(A)(i) (2012). However, unlike the risk backstops, this conflict-of-interest backstop was implemented by the regulators in a prescriptive manner. *See* 12 C.F.R. § 248.7(a)(1), .7(b), .15(a)(1), .15(b) (2015). Thus, for purposes of this analysis, we classify the conflict-of-interest backstop as part of the prescriptive Volcker Rule rulemaking and not part of the descriptive risk backstops.

28. 12 C.F.R. § 248.7(a)(2)–(3), .15(a)(2)–(3) (2015); *see also* 12 U.S.C. § 1851(d)(2)(A)(ii)-(iv) (2012) (statutory text).

29. Specifically, the regulators define "high-risk asset" as "an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States" and a "high-risk trading strategy" as "a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the

further description or guidance is provided. These provisions stand in stark contrast to the highly detailed regulations provided by the regulators to implement other parts of the statutory rule—such as those setting out the prohibition on proprietary trading and permitted activity exemptions—many of which are derived from equally vague statutory text. While the regulators state that they "intend to develop additional guidance regarding best practices for addressing . . . high-risk assets and trading strategies and practices that pose significant risks to safety and soundness and to the U.S. financial system as [they] and banking entities gain experience with implementation of the requirements and limitations in [the Volcker Rule],"[30] no such guidance was provided prior to the Rule's compliance date, leaving uncertain what activities might be prohibited by these risk backstops.

The risk backstops effectively transform the Volcker Rule from a prescriptive-approach rulemaking into one that combines the prescriptive and descriptive approaches. The risk backstops layer a broad, descriptive prohibition onto set of detailed, prescriptive rules that describe what activities are prohibited or permitted under the Volcker Rule. While these backstops originate in the statute, regulators could have chosen to implement them in a prescriptive manner, as they did with the rest of the statute. Instead, regulators chose a descriptive approach. In homage to the Volcker Rule, we call such a combination of a generally prescriptive approach with a descriptive catch-all, the "backstop approach."

IV. PROBLEMS WITH THE BACKSTOP APPROACH AND POLICY SUGGESTIONS

The backstop approach is a tempting way for regulators to capture the benefits of both the descriptive and prescriptive approaches. In theory, regulators can provide ex ante certainty by identifying specific activities as

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banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States." *Id.* § 248.7(c), .15(c) (2015). No further description or guidance is provided as to what types of activities may implicate the safety and soundness of a banking entity or that might "pose a threat to the financial stability of the United States."

30. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5658–59 (Jan. 31, 2014).

posing, or not posing, systemic risk—the key benefit of the prescriptive approach.[31] At the same time, regulators can, in theory, retain flexibility and discretion to take ex post action against activity that may pose systemic risk but that was not contemplated as part of an initial rulemaking—the key benefit of the descriptive approach. In short, from the perspective of regulators, the backstop approach seems to be the best of both worlds.

In practice, however, the backstop approach accentuates the drawbacks of the descriptive and prescriptive approaches rather than building on their strengths. First, instead of providing the ex ante certainty of the prescriptive approach, the backstop approach leaves market participants faced with the possibility that activities that would be deemed not to pose systemic risk under the prescriptive elements of the rule will nonetheless be viewed as posing systemic risk under the descriptive backstop. Second, in contrast to the flexibility provided to regulators under the purely descriptive approach, the backstop approach provides only the flexibility to identify otherwise-permitted activities as systemically risky; similar to the prescriptive approach, it does not allow regulators to use their discretion to permit non-systemically important activity that is inadvertently caught by the prescriptive portion of a rulemaking. Finally, the backstop approach results in its own, unique drawback: regulators and regulated firms will inevitably focus their interpretive and compliance efforts disproportionately on the prescriptive portion of the rulemaking. Each of these weaknesses of the backstop approach is starting to become evident in the Volcker Rule, less than two months after it has come into full force.

First, the prescriptive approach's benefit of ex ante certainty is undermined by layering onto a prescriptive backdrop a vague prohibition that calls into question the status of any activity, even if it squarely fits within the prescriptive requirements. A financial institution seeking to ensure that it only engages in activity that is not systemically risky may follow every requirement of the prescriptive rule, but still faces the possibility that its activity may be deemed systemically risky. In short, the backstop approach suffers from the same drawbacks as a purely descriptive rule like the FSOC's nonbank SIFI designation rule described above—ex ante uncertainty as to application and, as a result, the potential for legal challenges

31. The complexity of rulemaking, particularly around issues of systemic risk, often results in a situation in which a written rule must be clarified through regulatory pronouncement or through the examination process before the ex ante certainty benefits of the prescriptive approach can be fully achieved.

based on vagueness. In the Volcker Rule context, market participants have been faced with this uncertainty in light of the overlay of the risk backstops on the prescriptive requirements of the permitted activities such as market making. The Volcker Rule may yet be too new for any firm to have brought a legal challenge (such as the one brought against the FSOC by Metlife), but this could change once regulators assert the backstops to require a regulated firm to cease an activity that is otherwise permissible under the Rule.

Second, the backstop approach fails to provide regulators the same range of flexibility as the descriptive approach. A typical descriptive-approach rulemaking allows regulators to tailor the identification of systemic risk to a specific set of facts and circumstances. Imposing a descriptive backstop on prescriptive requirements, on the other hand, gives regulators authority to identify otherwise-permitted activity as systemically risky, but not to recognize that certain activities prohibited by the prescriptive rules are not systemically risky. Thus, the backstop serves as a one-way ratchet, allowing tightening, but not loosening, of prescriptive requirements. Like the SEC and CFTC's MSP rulemaking, the backstop approach leaves insufficient flexibility for regulators to accommodate evolving regulatory viewpoints or changing markets.

In the Volcker Rule context, market participants and regulators have already identified circumstances in which the prescriptive rules defining prohibited proprietary trading may unintentionally capture activity that does not pose systemic risks, or even risks to individual firms. For example, all financial institutions that engage in customer-driven activity have "error accounts"—accounts held by the institution to which positions are booked in case of a mistake. A relatively common example of an error account mistake is a "fat finger" error, in which an employee of the financial institution accidentally purchases more of a security (or a different security) for a client account than the client has ordered. To fix such an error, the financial institution may purchase the erroneously acquired security from the customer, at a price designed to make the customer whole, and subsequently seek to sell the security into the market to avoid being exposed to the risks of the position. Where error accounts are used to correct errors made as part of the financial institution's brokerage or dealing business, the purchase and sale of the security is "proprietary trading" under the Volcker Rule. Moreover, there is no clear exemption available for these error account activities, notwithstanding the fact that the position was taken on only to ensure no harm

befalls the financial institution's customer and sold quickly to avoid unnecessary or unwanted risk exposure. If the risk backstops permitted the regulators to identify activities that should not be considered prohibited proprietary trading notwithstanding their inadvertent capture by prescriptive rules, such a backstop could be used to permit error accounts.[32] Without it, market participants and regulators have struggled to determine the proper treatment of error accounts.

Finally, the backstop approach suffers from an additional drawback that is unique to its combination of descriptive and prescriptive rulemaking: in terms of interpretive and implementation efforts, the descriptive requirements inevitably will be overshadowed by the prescriptive ones. In results-oriented environments where resources are constrained, personnel charged with ensuring an institution's compliance with a set of complex regulations will naturally focus on those areas where they can identify and meet specific, quantifiable, and measurable goals. Regulators will receive the most questions, and therefore will focus interpretive efforts, on prescriptive requirements that give rise to detailed, discrete concerns. Regulated firms will focus their resources on building compliance programs and addressing interpretive issues arising under the more detailed and specific prescriptive requirements. Because it is difficult to address the vague risk backstop provisions through specific compliance or business requirements (particularly where little guidance is provided), firms will devote fewer resources and less time to addressing them.

In the Volcker Rule context, interpretive and implementation efforts have certainly focused on the prescriptive elements of the Rule. None of the sixteen formal FAQs released by the Volcker Rule regulators have addressed the risk backstops.[33] Similarly, regulated firms have focused their

32. Although Section 13(d)(1)(J) of the Volcker Rule statutory text provides regulators the ability to grant additional exemptions from the proprietary trading and covered funds prohibitions, that Section must be implemented by a formal rulemaking and only if the exempted activity would "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." 12 U.S.C. § 1851(d)(1)(J) (2012). Thus, it is not clear whether the error account issue—where the prohibition as applied to error account seems not to serve the policy of the Volcker Rule but an exemption would not, in itself, seem to promote safety and soundness or U.S. financial stability—could be addressed by regulations through a Section 13(d)(1)(J) exemption.

33. *Volcker Rule: Frequently Asked Questions*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm (last visited Sept. 11, 2015).

efforts on understanding and putting in place compliance programs that address the prescriptive requirements of the Volcker Rule. Compliance programs of regulated firms generally include hundreds (if not thousands) of pages of polices and procedural documents that specify in detail how different parts of a banking organization will address and comply with the prescriptive requirements of the Volcker Rule. These policies and procedures reflect the almost 1,000 pages of rule text and preamble guidance that set out these prescriptive provisions. While these compliance programs also address the risk backstop provisions, they do so at a level commensurate with the 10 (or so) pages of rule text and guidance that accompanied those provisions.

Taken together, the lack of interpretive guidance and clarity have led market participants to view the risk backstops as a "gotcha" mechanism that will be used ex post by regulators to crack down on disfavored, but not clearly prohibited, activity. This view may further contribute to the belief that there is nothing they can do to implement the risk backstops, contributing to the descriptive backstops being treated as second-order priorities.

In short, the backstop approach fails to improve on either the prescriptive or descriptive approaches and is in many ways less than effective than either of its components. Regulators should, therefore, resist the temptation to use a backstop approach when writing rules to identify and regulate sources of systemic risk. Even where statutory language contains a "catch-all," as with the Volcker Rule risk backstops, regulators can provide detailed guidance to develop the catch-all into a set of prescriptive requirements which can evolve as regulators' understanding of regulated activities and market circumstances deepens. This approach is precisely what the Volcker Rule regulators did in implementing the rest of the high-level framework provided by the statutory text through a prescriptive approach.

However, where regulators determine it is, nonetheless, appropriate to identify systemic risk using a backstop approach, they should work to mitigate the severity of the associated drawbacks. First, regulators should make clear that they intend to apply the backstops only in a prospective manner, based on guidance provided to all regulated firms, rather than using the backstops as a "gotcha" mechanism. As regulators' views about the types of activities that implicate the backstop prohibitions evolve, they should provide guidance to regulated firms and should not regulate such activities as systemically risky until regulated firms have sufficient time and notice to come into compliance with those views. That is, regulators should, over

time, use the risk backstops as a mechanism to provide more nuanced and detailed guidance—in the spirit of the prescriptive approach—about how the backstops will be applied in practice.

Second, regulators should (where permitted by statute) employ two-way backstops. That is, any backstops should allow for regulators to identify activity that is captured by the prescriptive rules but does not raise systemic risk concerns, rather than only the inverse. We acknowledge that whether this is possible depends on how much flexibility is provided in the statue, though regulators have tools other than formal rulemaking, such as examination guides, interpretive guidance, and no-action letters, that can be used to the same effect.

The Volcker Rule regulators may in fact be considering using these mitigants. We understand that regulators may be considering providing further interpretive guidance, through FAQs or otherwise, with respect to some activities—such as error accounts—that technically run afoul of the prescriptive provisions of the Rule but do not raise systemic risk concerns. Perhaps more importantly, in adopting the Volcker Rule regulations, the regulators indicated that they intend to provide guidance on the risk backstops. We believe that doing so well in advance of any effort to enforce the backstop provisions, along with open discussions with regulated firms, should reduce the possibility of challenges to regulatory action based on the backstops and will provide for a better-functioning tool with which to regulate systemic risk.