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Proprietary Trading: Of Scourges, Scapegoats, and Scofflaws

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PROPRIETARY TRADING: OF SCOURGES, SCAPEGOATS, AND SCOFFLAWS

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Perhaps it is just the lure of alliteration, but one cannot help but hear echoes of the Volstead Act[1] in the Volcker Rule.[2] The excesses and perceived calamitous consequences of public drunkenness in the early twentieth century were viewed with such opprobrium that critics persuaded legislators that only outright prohibition, rather than responsive regulation, could cure social decay.[3] The United States quickly became a "nation of scofflaws,"[4] however, as activity migrated from regulated manufacturers, distributors and dealers to clandestine facilities, and well-placed dealers (and their legislative and regulatory lackeys) found ways to skirt enforcement.[5] The consequences of such unregulated activity—both to the health of consumers and public safety—became so apparent that repeal was the only option.[6] A well-meaning, but short-sighted, experiment ended with little to show but the shame of hypocrisy and the scars of lost productivity.[7]

Prohibition aptly captures the tension between the expressive significance of the Volcker Rule (the Rule) and the impracticability of its implementation.[8] The highly profitable, yet risky trading activity of

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1. National Prohibition Act (Volstead Act), ch. 85, 41 Stat. 305 (1919) [hereinafter Volstead Act], *repealed by* Liquor Law Repeal and Enforcement Act, ch. 740, 49 Stat. 872 (1935).

2. Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), Pub. L. No. 111–203, § 619, 124 Stat. 1620 (2010) (codified at 12 U.S.C. § 1851 (2010)). Throughout this Article, I will refer to Section 619 of the Dodd–Frank Act as the "Volcker Rule" or the "Rule."

3. *See generally* EDWARD BEHR, PROHIBITION: THIRTEEN YEARS THAT CHANGED AMERICA (Arcade Publ'g, 1996).

4. *See Prohibition: A Film by Ken Burns and Lynn Novick* (PBS 2011), *available at* http://www.pbs.org/kenburns/prohibition/. According to the *Oxford English Dictionary*, the word "scofflaw" was the winning entry in a contest to create a word to characterize the "lawless drinker" of illegally made or illegally obtained liquor. *Scofflaw*, THE BIG APPLE (Dec. 28, 2004), http://www.barrypopik.com/index.php/new_york_city/entry/scofflaw/.

5. *See* DAVID E. KYVIG, REPEALING NATIONAL PROHIBITION 17–19 (Kent State Univ. Press, 2d ed. 2000).

6. U.S. CONST. amend. XXI; BEHR, *supra* note 3, at 221, 234–36.

7. *See* Eleanor Roosevelt, *My Day*, July 14, 1939 ("Little by little it dawned upon me that this law was not making people drink any less, but it was making hypocrites and law breakers of a great number of people.") (syndicated column), *available at* http://www.pbs.org/wgbh/americanexperience/features/primary-resources/eleanor-my-day/.

8. The Rule provides for coordinated rulemaking and enforcement by the following federal

commercial and investment banking groups represented the moral failures of the financial community, if not the root cause of the crisis.[9] Proprietary trading by banks and their affiliates ostensibly flouted the moral hazard created by the federal guarantee of fiscal assistance for the benefit of firms "too big" or "too interconnected to fail."[10] Moreover, the conflicting interests entailed in proprietary trading created a risk that financial services providers might profit at the expense of clients and counterparties who put faith in their advice and discretion.[11]

The Volcker Rule was designed to strike a compromise between reestablishing the firewall between investment and commercial banking activities under the Glass–Steagall Act and retaining the synergistic benefits of bundling such services championed by the Gramm–Leach–Bliley Act.[12] In sum, the rule prohibits federally insured banks and all of their affiliates from engaging in proprietary trading, *except* when performing certain socially valuable, "client-oriented" services[13]—such as underwriting, market making, securitization, government securities dealing, and asset management—*but only to the extent* that such activities do not pose material conflicts, result in exposure to high-risk assets or trading strategies, pose a threat to safety and soundness, or

financial regulators: The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (FRB or the Board), the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC, and collectively, the Agencies). 12 U.S.C. § 1851(b)(2)(B)(i) (2010).

9. GRP. OF 30, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 24–26 (2009), *available* at http://www.group30.org/rpt_03.shtml; Darrell Duffie, *Market Making Under the Proposed Volcker Rule* 25 (Rock Ctr. for Corporate Governance, Working Paper No. 106, 2012), *available at* http://ssrn.com/abstract=1990472; Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets* 41 n.10 (Cornell Legal Studies Research Paper No. 11-19, 2011), *available at* http://ssrn.com/abstract=1856633; FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY COMMISSION REPORT 65–66 (2011) [hereinafter FCIC REPORT], *available at* http://fcic.law.stanford.edu.

10. *See* S. REP. NO. 111-176, at 8–9 (2010).

11. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-529, PROPRIETARY TRADING: REGULATORS WILL NEED MORE COMPREHENSIVE INFORMATION TO FULLY MONITOR COMPLIANCE WITH NEW RESTRICTIONS WHEN IMPLEMENTED 10–13 (2011) [hereinafter GAO Proprietary Trading Study].

12. *See* David Weidner, *The Innocents of 1933; Today's Financial Overhaul Only Underscores the Impact of Depression-Era Laws*, WALL ST. J., (Aug. 5, 2010), http://online.wsj.com/article/SB10001424052748704017904575409334043400658.html.

13. Jeff Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 538-39 (2011). Trading activity may be considered "socially valuable" to the extent that it has positive spillover effects, such as improving the allocative efficiency of capital markets and the informational efficiency of trading markets. *See, e.g.*, Letter from Paul A. Volcker to the Dep't of the Treasury et al., Attachment at 1, 5 (Feb. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0209); *see also* CHAIRPERSON OF THE FIN. STABILITY OVERSIGHT COUNCIL, STUDY OF THE EFFECTS OF SIZE AND COMPLEXITY OF FINANCIAL INSTITUTIONS ON CAPITAL MARKET EFFICIENCY AND ECONOMIC GROWTH 7 (2011); Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 30 (2011).

otherwise threaten the financial stability of the United States. However clear the spirit of the Rule, the mechanics were left for regulators to devise, and commentators both supportive of and opposed to the policy behind the Rule have voiced their concerns in the course of its implementation.[14]

Given the open-ended nature of the Rule and the considerable nuance of the first iteration of proposed rulemaking,[15] the punditocracy cannot agree whether the Rule is a "bloated and weak" monstrosity that is "as good as dead,"[16] or whether it restores the "old dividing line" as if it were Glass–Steagall reincarnated.[17] Even as some regulators have hinted at additional rounds of rulemaking,[18] the financial services industry appears to be taking the Rule quite seriously. Several banking groups have publicly discussed the possibility of closing down or spinning off their investment banking operations,[19] whereas others have moved their trading desks into asset management divisions.[20] Meanwhile, some prominent traders at commercial banking groups have abandoned their posts to go "in house" or to start up private funds.[21] Such moves could herald a new, more opaque marketplace, as markets

14. *See* Kimberly D. Krawiec, *Don't "Screw Joe the Plummer:" The Sausage-Making of Financial Reform* 22–24 (Working Paper, 2012), *available at* http://ssrn.com/abstract=1925431.

15. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846, 68849 (Nov. 7, 2011) [hereinafter Joint Proposing Release] (notice of proposed rulemaking under Section 619 of the Dodd–Frank Act); *see also* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (Feb. 14, 2012). The CFTC published a separate proposing release, in which it adopted the commentary of the Proposing Release in full and made only agency-specific changes to the text of the published rule. *Id.* at 8332.

16. Jesse Eisinger, *The Volcker Rule, Made Bloated and Weak*, N.Y. TIMES DEALBOOK (Feb. 22, 2012), http://dealbook.nytimes.com/2012/02/22/the-volcker-rule-made-bloated-and-weak/.

17. Steven M. Davidoff**,** *Under Volcker, Old Dividing Line in Banks May Return*, N.Y. TIMES DEALBOOK (Feb. 21, 2012), http://dealbook.nytimes.com/2012/02/21/under-volcker-old-dividing-line-in-banks-may-return/.

18. *Compare* Sarah N. Lynch, *US SEC's Paredes Calls for New Volcker Rule Draft*, REUTERS (Feb. 24, 2012), http://www.reuters.com/article/2012/02/24/sec-volcker-idUSL2E8DO9SS20120224, *with* Ben Protess & Peter Eavis, *Progress Is Seen in Advancing a Final Volcker Rule*, N.Y. TIMES DEALBOOK (May 2, 2012), http://dealbook.nytimes.com/2012/05/02/progress-is-seen-in-advancing-a-final-volcker-rule (suggesting that implementation is "on track for completion sooner than some bankers had expected").

19. *See, e.g.*, Michael J. Moore, *Morgan Stanley Said to Consider Commodities Unit Sale*, BLOOMBERG NEWS (June 6, 2012), http://www.bloomberg.com/news/2012-06-06/morgan-stanley-said-to-consider-commodities-unit-sale.html; Dawn Kopecki & Chanyaporn Chanjaroen, *JPMorgan Said to End Proprietary Trading to Meet Volcker Rule*, BLOOMBERG NEWS (Aug. 31, 2010), http://www.bloomberg.com/news/2010-08-31/jpmorgan-is-said-to-shut-proprietary-trading-to-comply-with-volcker-rule.html.

20. Tommy Wilkes, *Banks Move High Risk Traders Ahead of U.S. Rule*, REUTERS (Apr. 3, 2012), http://www.reuters.com/article/2012/04/03/us-volckerrule-trading-idUSBRE8320GS20120403.

21. *See* Halah Touryalai, *Volcker Rule Refugees*, FORBES (Mar. 21, 2012), http://www.forbes.com/sites/halahtouryalai/2012/03/21/volcker-rule-refugees/.

become more dependent on lightly regulated trading systems or other market speakeasies where hedge funds and professional traders provide liquidity outside the direct oversight of regulators.

This Article will approach the topic from the perspective of regulators who must grapple with the Volcker Rule's implementation. On the one hand, the financial community can be expected squarely to resist any aggressive attempt to implement the Rule—perhaps in the expectation of a shift in executive and legislative policy—or at least to ensure there are enough loopholes to permit some proprietary trading to flourish.[22] On the other hand, failure to adopt a set of rules and an associated supervisory, compliance, and enforcement program would almost surely result in regulators taking significant heat if the Rule does not at least have some impact on the configuration of Wall Street's activities or the internal organization of financial conglomerates, particularly if another crisis were to follow.[23] Moreover, such efforts must be implemented in a manner that complements (without itself exacerbating the consequences of) other initiatives mandated by Dodd–Frank, many of which themselves may cramp the profitability of banking organizations and other nonbank financial companies.[24]

The regulators have, on the recommendation of the Financial Stability Oversight Council,[25] staked out a three-pronged approach: (1) formalizing the classification of trading activities on the basis of existing account structures, (2) adopting quantitative measures for monitoring anomalous trading activity, and (3) mandating a system of internal controls that provides a roadmap for regulatory compliance, supervision, and enforcement.[26] The Proposed Rulemaking leaves considerable

22. *See, e.g.*, Francesco Guerrera & Gillian Tett, *Goldman President Warns on Bank Rules*, FIN. TIMES (Jan. 26, 2011), http://www.ft.com/cms/s/0/f9753506-2990-11e0-bb9b-00144feab49a.html#axzz1yUbVmM9q.

23. *See, e.g.*, Letter from Sen. Jeff Merkley and Sen. Carl Levin to the Agencies 1 (May 17, 2012) [hereinafter Merkley & Levin Letter], *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0427) ("The massive failed bet by JPMorgan Chase provides a stark reminder why we desperately need your agencies to implement the Volcker Rule—a modern Glass–Steagall firewall that separates our core banking system from high-risk, hedge fund-style proprietary trading.").

24. Throughout this Article, "banking organizations" refers to entities organized as bank holding companies (BHCs) or financial holding companies (FHCs) under the Bank Holding Company Act (BHCA) by virtue of their affiliation with a FDIC-insured depository institution. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 1841 (2011). Likewise, "nonbank financial companies" (NFCs) refers to investment banks, insurance companies, private funds, and other companies predominantly engaged in financial activities that are not BHCs or FHCs. *Cf.* Dodd–Frank Act § 102(a)(4) (defining "nonbank financial company").

25. FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 31–32 (2011) [hereinafter FSOC Study].

26. Joint Proposing Release, *supra* note 15, at 68849.

ambiguity for regulators—and thus discretion for firms—in determining when activity constitutes proprietary trading and what the consequences of such trading will be. For example, quantitative measures of risk, revenue, revenue relative to risk, and customer-facing activity could either result in excessive restrictions on activity or little to no restriction at all, depending upon how much discretion regulators retain (or require compliance personnel to exercise). Moreover, as discussed below, fragmented jurisdiction over banking affiliates and differing regulatory attitudes and supervisory resources create a palpable risk of unequal enforcement.

Part I of this Article considers the arguments made for and against the limitation or regulation of proprietary trading, with a particular (if not exclusive) focus on banking entities and other financial intermediaries. Part II describes the structure of the Volcker Rule, while Part III concentrates on its implementation by the federal banking and financial regulators, and the questions raised by commenters (and by the regulators themselves) on the effectiveness of the proposed rules. Part IV offers some concluding remarks on how regulators might advance the moral imperative of the Rule by reorienting the proposed rules to complement other areas of Dodd–Frank rulemaking.

I. PROPRIETARY TRADING: SCOURGE OR SCAPEGOAT?

How one defends the prohibition against proprietary trading necessarily depends on how one defines the term.[27] The Dodd–Frank definition (discussed in Part II below) generally focuses on the buying and selling activity of a "banking entity" that is "engaging as a principal" for its "trading account" in a range of financial instruments.[28] The structure of the Rule provides more guidance as to the specific kinds of activity Congress sought to address. For example, the Rule's definition of a "trading account" focuses on "short-term price movement" and "near term" purchases and sales, rather than long-term appreciation in the value of a financial instrument.[29] The Rule's safe

27. The Eighteenth Amendment, after all, may have survived to this day had the Volstead Act not defined "intoxicating liquors" so aggressively. Volstead Act, *supra* note 1, at 307–08 (defining the term to include "any beverage containing one-half of 1 per centum or more of alcohol by volume").

28. Some commentators have used broader definitions—such as "the purchase or sale of a financial instrument with the intent to profit from the difference between the purchase price and sale price"—though such definitions do not necessarily reflect the distinction between "trading accounts" and other accounts for regulatory purposes. Duffie, *supra* note 9, at 2.

29. *See* 12 U.S.C. § 1851(h)(6) (2010) (definition of "trading account"). The Joint Proposing Release suggests that a "near term" trading horizon for purposes of classifying trading activities under guidance provided under relevant accounting standards is "generally measured in hours and days rather than months or years." Joint Proposing Release, *supra* note 15, at 68859 n.102 (quoting FASB ASC Master Glossary definition of "trading").

harbors for underwriting, market making, and securitization likewise appear to contemplate a distinction between activity that facilitates trading by clients, customers, and counterparties (for which the firm is presumably compensated in spreads, commissions, or other fees) and activity in which the entity shares in profits with (or seeks to profit from trading against) clients, customers, and counterparties.[30]

The Rule reflects growing concern about the importance of proprietary trading within banking organizations and the risks posed by such activity.[31] The gradual rise in proprietary trading as a source of revenues and risk for investment and commercial banks reflects a variety of factors. Competition among public bank holding companies and the transformation of investment banks from partnerships to public holding company structures has put the financial services industry at the mercy of shareholders (including executives and traders receiving equity compensation) fixated on short-term quarterly performance.[32] The profitability of traditional commercial and investment banking activity has declined as a result of deregulation and heightened competition.[33] In addition, the last decade's subprime lending boom (and bust) fed the growth of the market for credit default swaps and other derivatives[34] and the proliferation of highly leveraged structured products, many of which were marketed to hedge funds,[35] which themselves in some cases were sponsored, capitalized, or financed through prime brokerage arrangements by investment or commercial banks.[36]

A causal relationship between such proprietary trading and the financial crisis is more difficult to establish, although it is easier to

30. *See* 12 U.S.C. § 1851(d)(1)(B) (safe harbor for "underwriting or market-making-related activities").

31. *See* Merkley & Levin, *supra* note 13, at 520–22; FCIC REPORT, *supra* note 9, at 35, 49, 65–66.

32. *See, e.g.*, ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 236–38, 276–80 (2007).

33. *See, e.g.*, Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 227 (hypothesizing that the banking industry's "stability and low-risk profitability have largely vanished since the mid-1970s" on account of these trends).

34. FCIC REPORT, *supra* note 9, at 38–51, 190–95.

35. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, HEDGE FUND SURVEY, charts 7–8, *available at* http://fcic.law.stanford.edu/resource/staff-data-projects/hedge-fund-survey (illustrating increased holding of equity positions in residential mortgage-backed securities and collateralized debt obligations from Dec. 2005 to Dec. 2007).

36. *See, e.g.*, *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 53–54 (2010) (statement of Deputy Secretary Neal S. Wolin, Department of the Treasury) (observing that some investment banks, such as Bear Stearns, were forced to bail out their sponsored hedged funds during the crisis and thereby imperiled their own capital adequacy).

assert that proprietary trading exacerbated the impact of the crisis.[37] As discussed below, advocates of dampening, segregating, or restricting proprietary trading by banking organizations have offered a variety of justifications, including heightened moral hazard, conflicts of interest, or destabilization of cash and derivatives markets. Advocates of less intrusive regulation argue that the root causes of the financial crisis are either attributable to activities unrelated to the proposed Volcker Rule prohibition (e.g., loan defaults and securitization) or will have been adequately addressed by other regulatory efforts—such as leverage and net capital limitations, and centralized trading, clearance, and reporting of derivatives transactions. Each of these justifications is discussed in turn.

A. Exacerbating Moral Hazard

Chief among the criticisms of proprietary trading is that it allows firms with special access to government assistance to reap profits from their trading activity while shifting losses in their trading portfolios to the public. In Chairman Volcker's words:

> Proprietary trading of financial instruments—essentially speculative in nature—engaged in primarily for the benefit of limited groups of highly paid employees and of stockholders does not justify the taxpayer subsidy implicit in routine access to Federal Reserve credit, deposit insurance or emergency support.[38]

As promulgated, however, the Rule extends to banking affiliates that are not expressly entitled to federal assistance. For example, the Rule applies to any control person of an FDIC-insured depository institution (such as bank holding companies) and any non-bank affiliate or subsidiary of an FDIC-insured depository institution (such as a broker–dealer, swaps entity, insurance company, or other financial services

37. Duffie, *supra* note 9, at 25 (suggesting that the losses from loan defaults on conventional banking activities were far greater in magnitude than market making losses, though that crisis "was nevertheless exacerbated by the proprietary trading losses of some large broker dealers . . . and the broker–dealer affiliates of Citibank and some foreign banks"); Julian T.S. Chow & Jay Surti, *Making Banks Safer: Can Volcker and Vickers Do It?* 14–15 (Int'l Monetary Fund Working Paper 11-236, 2011) (finding a "[p]ositive association . . . between susceptibility to distress and the importance of trading income as a revenue generated for U.S. and European banks," but not Asian banks); *see also* GAO Proprietary Trading Study, *supra* note 11, at 24–26 (finding that the six largest bank holding companies "usually experienced larger revenues and losses from activities other than stand-alone proprietary trading and investments in hedge and private equity funds" based on the firm's publicly reported net income during the period from June 2006 to Dec. 2010).

38. Letter from Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board, to the Agencies, Attachment at 1 (Feb. 13, 2012) (emphasis omitted), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0209).

provider).[39]

The Rule does not apply to entities that are not affiliated with a bank, on the premise that they are not entitled to federal assistance in the event of material distress. As a result, bank-affiliated financial services providers may be at a competitive disadvantage to freestanding investment banks or insurance companies to the extent that the latter may freely engage in proprietary trading. Congress has addressed this asymmetry to a certain degree by giving the Federal Reserve Board the authority to impose "additional capital requirements for and additional quantitative limits" with regard to proprietary trading by certain "nonbank financial companies" if the Financial Stability Oversight Council (FSOC) determines that their activities may pose a threat to the financial stability of the United States.[40]

To the extent that the moral hazard created by such federal assistance is a justification for Rule, some critics argue that segregation of proprietary trading activities into bankruptcy-remote affiliates, rather than outright prohibitions on proprietary trading by banking affiliates, would have adequately addressed moral hazard.[41] For example, Section 716 of the Dodd–Frank Act (the Lincoln Amendment) contemplates compartmentalization of certain swaps trading activities into nonbank affiliates of an insured depository institution as a condition of federal assistance.[42] Other critics of the Rule have observed that Dodd–Frank's

39. *See* text accompanying notes 64–66.

40. *See supra* note 24 (defining "nonbank financial company"). Section 113 of the Dodd–Frank Act authorized FSOC to require U.S. "nonbank financial companies" to become subject to prudential standards and supervision by the Federal Reserve Board if the Council determines that "material financial distress" or "the nature, scope, size, scale, concentration, interconnectedness, or mix" of its activities "could pose a threat to the financial stability of the United States." FSOC has published final rules and interpretive guidance regarding the administrative process for such determinations. Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. § 1310 (2012).

41. *See* R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders it Ineffective and a New Solution is Needed to Adequately Regulate Proprietary Trading*, 8 BYU INT'L L. & MGMT. REV. 33, 61 (2011), *available at* http://ssrn.com/abstract=1857371. In the UK, the Independent Commission on Banking (the Vickers Commission) created by the Chancellor of the Exchequer has recommended a requirement that banks "ring fence" certain retail deposit-taking and commercial lending activities within a single entity that would be subject to higher capital charges. INDEP. COMM'N ON BANKING, FINAL REPORT 233–37 (2011), *available at* http://bankingcommission.independent.gov.uk.

42. 15 U.S.C. § 8305 (2012) (codifying the Lincoln Amendment). Banks are permitted to enter into hedging and other similar risk mitigation activities directly related to the insured depository institution's activities—which include interest rate, currency, and related index derivatives to hedge the bank's lending and payment systems activities. *Id.* § 8305(d)(1). Banks are also permitted to engage in swaps activities related to their traditional role in underwriting U.S. government, agency, and municipal securities. *Id.* § 8305(d)(2). Moreover, § 716 permits banks to enter into credit default swaps (e.g., on individual debt or asset-backed securities, or baskets of or indices based on a group of asset-backed securities) as long as they are cleared through an SEC-registered clearing agency or CFTC-registered derivatives clearing organization. *Id.* § 8305(d)(3).

alternative approaches to risk regulation, such as heightened capital, leverage and margin requirements, are more precise in their application than outright prohibition.[43]

One might rightly question, however, whether the Treasury or the Federal Reserve Board could credibly commit to not bail out any systemically significant affiliate; a recent study suggests that systemically significant financial institutions continue to enjoy significant subsidies (up to 80 basis points in funding costs) from such implicit guarantees, notwithstanding higher capital requirements and new orderly liquidation regimes adopted in various financial centers.[44] Capital charges alone, moreover, would not necessarily serve as a deterrent to proprietary trading; indeed, higher capital charges could have the unintended consequence of reducing the level of banking services provided by banking entities that elect to divert more capital to proprietary trading.

B. Conflicts of Interest

Another justification for imposing restrictions on proprietary trading by financial intermediaries generally is that they invariably create conflicts of interest, whether as a matter of customer protection, investor confidence, or corporate governance. Principal trades with customers as part of a firm's market making or dealing activity—whether purchasing customer securities or selling securities to customers from inventory—necessarily put the interests of the firm at odds with those of the customer.[45] A firm with prior knowledge of customer trading interest or

43. *See, e.g.*, Letter from Barry L. Zubrow, Exec. Vice President, JPMorgan Chase & Co., to the Dep't of the Treasury et al., at 3 (Feb. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0277) [hereinafter *JPMorgan Chase*] (claiming Volcker Rule creates "intrusive compliance regime" and same purposes achieved through margin requirements, concentration limits, and risk-based deposit insurance premiums); Letter from David Hirschmann, President and Chief Executive Officer, U.S. Chamber of Commerce, to the Fin. Stability Oversight Council (Feb. 5, 2012), *available at* http://regulations.gov (retrieved using document ID: FSOC-2010-0002-1344) (suggesting use of pro-growth heightened capital requirements and liquidity standards as alternative to Volcker); Letter from Scott C. Goebel, Senior Vice President, Fidelity Investments, to the Fin. Stability Oversight Council (Nov. 5, 2010), *available at* http://regulations.gov (retrieved using document ID: FSOC-2010-0001-0066) (criticizing Volcker Rule while noting that "capital, leverage and liquidity requirements, and short-term debt and concentration limits" are "tools of choice" to regulate banks).

44. Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions* 1–5 (Int'l Monetary Fund Working Paper No. 12-128, 2012). *Cf.* Curtis J. Milhaupt, *Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?*, 77 WASH. U. L.Q. 399, 406–07, 430–31 (1999) (arguing that "[e]mpirical observation . . . discredits the view that a world without deposit insurance is a world of market discipline for banks" because market participants will assume the existence of implicit deposit protection).

45. *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 7 (2010) (statement

trading portfolios might also trade on the basis of such information in a manner that harms the customer's interests as well as the interests of other investors.[46] More generally, traders employed by publicly traded financial institutions are in conflict with their employers' public shareholders, to the extent that their compensation does not precisely mirror the risk and return to the firm created by their activity.[47]

The nature of the product being marketed may also create conflicts of interest. Traders who obtain nonpublic information about the financial condition of a client of one of its banking or underwriting affiliates may use that information to trade at the expense of other security holders of the firm.[48] In addition, "complex, highly structured, or opaque" products, such as asset-backed securities, collateralized debt obligations, or more exotic derivatives, elevate such concern[49]: to the extent that such products are often bespoke, do not trade in a liquid market, and are sensitive to a variety of risks, banks have a considerable informational advantage over their customers with respect to pricing.[50]

Cultural changes on Wall Street stand to further exacerbate such conflicts. The increasing fungibility of trading and other investment banking skills and the public company structure of many commercial

of Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board) ("When the bank itself is . . . trading for its own account—it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. 'Inside' hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same 'inside' funds may be favored over outside competition in placing funds for clients."); *see also* Stanislav Dolgopolov, *A Two-Sided Loyalty?: Exploring the Boundaries of Fiduciary Duties of Market Makers*, 12 U.C. DAVIS BUS. L.J. 31, 35–46 (2011) (summarizing judicial decisions analyzing the application of fiduciary law to conduct by exchange specialists and market makers).

46. FSOC Study, *supra* note 25, at 48.

47. Will Bunting, *The Trouble with Investment Banking: Cluelessness, Not Greed*, 48 SAN DIEGO L. REV. 993, 1028–29 (2011). This risk is addressed, to a certain degree, by rulemaking under Section 956(a) and (b) of the Dodd–Frank Act, which require disclosure of, and in some cases prohibit, executive compensation arrangements offered by certain financial institutions that either provide "excessive compensation, fees, or benefits" or "could lead to material financial loss." *See* Incentive-Based Compensation Arrangements, 12 C.F.R. § 42 (2011) (proposed rules).

48. FSOC Study, *supra* note 25, at 49.

49. *Id.* For example, Goldman Sachs conceded in its well-reported settlement with the SEC that certain information regarding the composition of the synthetic CDOs in the ABACUS transaction (namely, the role and interests of Paulson's hedge fund in selecting the credit-default swaps selected for inclusion in the CDO) were not properly disclosed to the customers to whom those products were sold. Brief for Defendant, SEC v. Goldman, Sachs & Co., No. 10-CV-3229, 2010 WL 2779309 (S.D.N.Y. July 14, 2010).

50. For example, Dodd–Frank requires dealers and major market participants in swaps and security-based swaps to disclose any material risks and conflicts of interest and provide daily marks to counterparties in connection with such transactions in order to address this informational asymmetry. *See* 15 U.S.C. § 78o-7(h)(3) (2012) (business conduct requirements under new Section 15F of the Securities Exchange Act); 7 U.S.C. § 6s(h)(3) (2012) (business conduct requirements under new Section 4s of the Commodity Exchange Act).

and investment banking groups has sharply reduced the long-term alignment of interests between traders and their firms.[51] Young bankers indoctrinated to believe that high reward is coupled with high job insecurity train their focus on short-term gains, regardless of the long-term consequences for the firm or its clients.[52] As one former investment bank executive observed, such "people who care only about making money" will not sustain the long term trust of clients:

> What are three quick ways to become a leader? a) Execute on the firm's "axes," which is Goldman-speak for persuading your clients to invest in the stocks or other products that we are trying to get rid of . . . b) "Hunt Elephants" . . . get your clients—some of whom are sophisticated, and some of whom aren't—to trade whatever will bring the biggest profit to Goldman . . . c) Find yourself sitting in a seat where your job is to trade any illiquid, opaque product with a three-letter acronym.[53]

Policymakers, however, have been reluctant to return to a complete segregation of financial services, in part because U.S. banks would be at a competitive disadvantage relative to European and Asian "universal banks," but also in part on account of the widely held assumption that the cross-provision of services promises benefits for both financial services providers and their customers.[54] Instead, regulatory policy continues to focus on regulating conflicts of interest through informational barriers and business conduct rules, which are enforced through a combination of internal controls and regulatory oversight.[55]

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51. *See* MORRISON & WILHELM, *supra* note 32, at 281 (suggesting that partner tenure has declined and staff mobility has increased at investment banks as a result of the "codification" of trading and investment banking skills and the increased transparency of publicly traded investment banks).

52. *See* KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET 285–94 (2009) (discussing the consequences of the "high reward/high risk" employment structure of Wall Street, both with respect to serving longer-term client needs and social welfare).

53. Greg Smith, *Why I Am Leaving Goldman Sachs*, N.Y. TIMES, Mar. 14, 2012, at A27.

54. Stephen Labaton, *Congress Passes Wide-Ranging Bill Easing Bank Laws*, N.Y. TIMES (Nov. 5, 1999), http://www.nytimes.com/1999/11/05/business/congress-passes-wide-ranging-bill-easing-bank-laws.html (quoting among others Treasury Secretary Lawrence Summers and Senator Phil Gramm as supportive of the relaxation of the Glass–Steagall restrictions). *But see* Kenneth A. Carow et al., *Safety-Net Losses from Abandoning Glass–Steagall Restrictions*, J. MONEY, CREDIT & BANKING 22–24 (forthcoming), *available at* http://ssrn.com/abstract=1802007 (finding evidence that the removal of product line restrictions has resulted in increased bank bargaining power, which can increase customer funding costs and reduce capital market access, especially vis-à-vis credit-constrained customers); Vincent DiLorenzo, *Cost–Benefit Analysis, Deregulated Markets, and Consumer Benefits: A Study of the Financial Services Modernization Experience*, 6 N.Y.U. J. LEGIS. & PUB. POL'Y 321, 347–374 (2002) (questioning whether the expected benefits of "[e]nhanced competition and efficiency" following Gramm–Leach–Bliley were realized).

55. FSOC Study, *supra* note 25, at 50; *see, e.g.*, Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 139–41 (2004) (describing the emergence of information barriers in investment bank regulation); Peter C. Buck & Krista R. Bowen, *Intrabank Conflicts of Interest*, 3 N.C. BANKING INST. 31 (1999) (same for commercial bank regulation).

C. Market Destabilizing Activity

A third charge against proprietary trading is that, in excess, it increases the complexity, opacity, and latent interconnectedness of over-the-counter derivatives markets. Commercial and investment banking groups dominate trading in over-the-counter derivatives markets, much of which trading is concentrated in transactions among the largest such institutions.[56] In the absence of markets or clearinghouses to standardize such instruments and require adequate collateralization, the accumulation of significant indirect counterparty credit risk with respect to one or more firms, such as in the case of Lehman and AIG, could have potentially devastating consequences.[57]

On a certain level, these justifications relate more to the integrity of market structure, rather than the stability of the U.S. financial system. The "flash crash" episode of May 2010, for example, focused concern on the technological capacity of exchange operators, the adequacy of SEC and self-regulatory monitoring of exchange and other reported transactions, and the lack of effective circuit breakers to prevent human errors or unanticipated algorithmic trading from cascading. Likewise, Congress sought to address the role of over-the-counter derivatives in the recent crisis through the creation of mandatory trade execution, clearing and reporting facilities (Title VII facilities) for certain classes of non-exchange traded derivatives (swaps and security-based swaps, as defined in the Act).

To the extent, however, that commercial banks rely on such derivatives markets for hedging and risk-mitigation in connection with their banking activities (e.g., through interest, currency, and credit-default swaps), the interpretation of the safe harbors for such activities under both the Volcker Rule and the Lincoln Amendment rely to a significant degree on the efficacy of such regulation. For example, the Lincoln Amendment requires banks to effect transactions in credit default swaps through Title VII facilities as a condition of qualifying for the safe harbor.[58] The Volcker Rule, in coordination with the provisions of Title VII, thus regulates the ability of banks and their affiliates to outsource risk management to swap counterparties.

56. *See* S. REP. NO. 111-176, at 29 (2010) (noting that as of Dec. 2008, the top 5 derivatives dealers in the United States accounted for 96% of outstanding OTC contracts made by the leading bank holding companies).

57. *Id.* at 29–35; FCIC REPORT, *supra* note 9, at 363–64.

58. 15 U.S.C.A. § 8305(d)(3) (2012).

II. STRUCTURE OF THE VOLCKER RULE

The Volcker Rule, as discussed above, was ostensibly designed to strike a compromise between reestablishing the firewall between investment and commercial banking activities under the Glass–Steagall Act, on the one hand, and retaining the synergistic benefits of bundling such services championed by the Gramm–Leach–Bliley Act, on the other. The Glass–Steagall Act erected a barrier between commercial banking activities (e.g., deposit-taking and custodial services) and investment banking activities (which included, among other things, proprietary trading in connection with underwriting, market making, and dealing activities).[59] Over the next sixty years, a series of orders issued by federal banking regulators (culminating in the Federal Reserve Board's 1998 Citigroup Order)[60] and sympathetic judicial decisions rendered this barrier obsolete.[61] The Gramm–Leach–Bliley Act of 1999 repealed this prohibition and permitted well capitalized and well managed bank holding companies to affiliate with other financial services providers, subject to "functional regulation" of each affiliate.[62]

To a certain degree, the Volcker Rule reflects the Glass–Steagall philosophy that certain activities should not, for political or practical reasons, coexist in the same corporate structure. Like Glass–Steagall, the Rule ostensibly takes the position that bank holding companies must

59. Of the four key provisions of the Glass–Steagall Act, sections 16 and 21 remain in force. 12 U.S.C. § 24 (2012) ("The business of dealing in securities and stock . . . shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock."); 12 U.S.C. § 378(a)(1) (2012) (forbidding any company or person in the business of "issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage . . . in the business of receiving deposits"). The two key provisions of the Glass–Steagall Act relating to the permitted activities and governance of affiliates of U.S. depository institutions, Sections 20 and 32, were repealed by the Gramm–Leach–Bliley Act of 1999. *See* 12 U.S.C. §§ 377, 78 (1996).

60. In 1998, the Board issued an order permitting the merger of Citigroup and Travelers Group, even though Travelers' insurance underwriting activities and the investment banking activities of its affiliate Salomon Smith Barney would not have been consistent with the BHCA's restrictions and revenue limitations. *Order Issued Under Section 3 & 4 of the Bank Holding Company Act*, FED. RES. BULL., Nov. 1998, at 985. Prof. Wilmarth notes that the FRB's approval permitted Citigroup to operate as a de facto "universal bank" for up to five years without divesting these subsidiaries, and that many contemporary commentators viewed the transaction as a gamble that Congress would dismantle the Glass–Steagall prohibitions against such affiliation within that time. Wilmarth, *supra* note 33, at 221.

61. Wilmarth, *supra* note 33, 318–20; Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: the Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 703–04 (1987).

62. Gramm–Leach–Bliley Act, Pub. L. No. 106-112, § 101, 113 Stat. 1338 (1999) (repealing Sections 20 and 32 of the Glass–Steagall Act); *see also* 12 U.S.C. § 1843(k)(1) & (*l*)(1) (2012) (providing that a "financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity" determined to be "financial in nature or incidental to such financial activity," or "complementary to a financial activity," provided that its depository institution subsidiaries are "well capitalized" and "well managed").

terminate or spin off certain proprietary trading activities, whether because of the nature of the product being traded or because of the nature of the activity. The Rule, however, recognizes that a complete ban would put U.S. banking groups at a competitive disadvantage in the international marketplace, and therefore permits non-bank subsidiaries of financial holding companies to continue to engage in certain enumerated categories of customer-oriented proprietary trading, as envisioned by Gramm–Leach–Bliley.[63]

Structurally, the Volcker Rule consists of a general prohibition on proprietary trading by banking entities (including the acquisition or retention of an interest in certain funds that engage in proprietary trading), subject to several safe harbors for permitted activities and permitted fund investments, which are further qualified by certain statutory limitations on activities or investments. Each of these elements is discussed in turn.

A. General Prohibition on Proprietary Trading

The Volcker Rule states that, unless otherwise provided, a "banking entity" shall "not engage in proprietary trading" or "acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[64] "Banking entity," for this purpose, is defined to include all insured depository institutions and their subsidiaries and affiliates,[65] although the Federal Reserve Board is empowered to adopt "additional capital requirements for and additional quantitative limits with regards to" such activity if conducted by SIFIs subject to FRB supervision.[66]

More importantly, "proprietary trading" is defined to mean:

> [E]ngaging as a principal for the trading account of the [relevant entity] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule . . . determine.[67]

A "trading account," in this context, refers to "any account used for acquiring or taking positions in [such securities and instruments] for the

63. *See* Gramm–Leach–Bliley Act, Pub. L. No. 106-112, § 101, 113 Stat. 1338; 12 U.S.C. § 1843(k)(1) & (*l*)(1).

64. 12 U.S.C. § 1851(a)(1)(A) and (B) (2010).

65. *Id.* § 1851(h)(1).

66. *Id.* § 1851(a)(2).

67. *Id.* § 1851(h)(4).

purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts" so designated by the relevant regulators.[68]

B. Permitted Activities

Despite the breadth of the statutory prohibition, the Volcker Rule enumerates several "permitted activities" in which banking entities may engage, subject to certain statutory limitations as well as any limitations or restrictions imposed by the relevant federal financial regulator. Permitted activities include several of the activities national and state member banks were permitted to engage in under Glass–Steagall, such as brokerage activities and dealing in government, agency and municipal securities.[69] "Risk-mitigating hedging activities in connection with and related to individual and aggregated positions, contracts, or holdings" (such as the use of interest rate and currency swaps in connection with banking activities) also qualify for an exemption, although the Rule requires that such activities be "designed to reduce the specific risks to the banking entity" with respect to "such positions, contracts, or other holdings."[70] Moreover, securitization—itself one of the most risky activities identified during the recent financial crisis—remains a permitted activity under Dodd–Frank.

The Volcker Rule also contains exceptions designed for affiliates of financial holding companies (FHCs) subject to functional regulation by other federal or state regulators.[71] For example, regulated insurance companies may trade in securities and other instruments "in compliance with, and subject to" state insurance law.[72] Likewise, bank-affiliated brokers and dealers are permitted to engage in "underwriting or market-making-related activities" as SEC- or CFTC-registered intermediaries,

68. *Id.* § 1851(h)(6). The bank regulators have separately been charged with carrying out a study on bank investment activities. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111–203, § 620, 124 Stat. 1376, 1631.

69. 12 U.S.C. § 1851(d)(1)(A) and (D). Proprietary trading and other restricted activity conducted outside of the United States by foreign qualified banking organizations and certain other predominantly foreign banking organizations under BHCA §§ 4(c)(9) and (13) is also entitled to a safe harbor from the Rule. *Id.* § 1851(d)(1)(H) and (I).

70. *Id.* § 1851(d)(1)(C).

71. *See* 12 U.S.C. § 1841 (defining a "financial holding company" to mean any bank holding company that meets the requirements of 12 U.S.C. § 1843(*l*)(1) and is therefore generally permitted to engage in any activity that is "financial in nature," "incidental to such financial activity," or "complementary to a financial activity" pursuant to 12 U.S.C. § 1843(k)(1)).

72. *Id.* § 1851(d)(1)(F)(i). This authority is qualified by the proviso that the activity in question has not been determined by the appropriate federal banking agencies to be "insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States." *Id.* § 1851(d)(1)(F)(ii).

as long as their activities are not "designed . . . to exceed the reasonably expected near term demands of clients, customers, or counterparties."[73] While the regulators have the authority to preserve "[s]uch other activity as [they determine] . . . would promote and protect the safety and soundness of the banking entity and the financial stability of the United States,"[74] regulators are understandably loath to assert such authority to expand specific safe harbors (at least in the first iteration of rulemaking).

C. Sponsorship of Private Funds

In addition to prohibiting proprietary trading by banking entities themselves, the Act also provides that banking entities shall not "acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or private equity fund."[75] Banking entities may organize, offer, and manage a private fund for their customers in connection with bona fide trust, fiduciary, or investment advisory services provided that the entity does not (and discloses to its customers that it does not) guarantee, assume, or insure the fund's obligations.[76] Investments may also be made to provide funds with "sufficient initial equity . . . to permit the fund to attract unaffiliated investors," provided that the entity "shall actively seek unaffiliated investors to reduce or dilute the investment" and reduce its investment to a de minimis amount.[77]

D. Statutory Limitations

The Volcker Rule qualifies all of the above activities with certain statutory limitations—or rather, restatements of the articulated policy reasons motivating the Rule—which federal financial regulators must implement through rulemaking. The first such limitation permits regulators to restrict any transaction, class of transactions, or activity that would "involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties."[78] The statutory language is sufficiently ambiguous to

73. *Id.* § 1851(d)(1)(B).

74. *Id.* § 1851(d)(1)(J).

75. *Id.* § 1851(a)(1)(B).

76. *Id.* § 1851(d)(1)(G). Moreover, a banking entity may offer prime brokerage services to funds in which it has such an investment, notwithstanding the limitations imposed by the Rule on relationships between banking entities and such funds analogous to those under § 23A of the Federal Reserve Act, as long as the banking entity is certified to be in compliance with the Act's restrictions. *Id.* § 1851(f)(1)–(3).

77. *Id.* § 1851(d)(4).

78. *Id.* § 1851(d)(2)(A)(i).

permit regulators to intervene in situations not only where a conflict of interest imperils the financial condition of a banking entity, but also where the transaction might put clients, customers, and counterparties of the banking entity at risk.

The second and third statutory limitations permit regulators to restrict any transaction, class of transactions, or activity that would "result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies" or "pose a threat to the safety and soundness of such banking entity."[79] For example, regulators could prohibit certain forms of algorithmic trading, even if conducted in accordance with the market making or brokerage safe harbors or in permitted instruments. The final statutory limitation parallels the mandate of the Financial Stability Oversight Council and the Federal Reserve Board to identify and restrict activity that would "pose a threat to the financial stability of the United States,"[80] regardless of the impact of such activity on the firm.

III. DIFFICULTIES IN IMPLEMENTATION

However clear the spirit of the Rule may be, its language is frustratingly vague; accordingly, much depends on both the resourcefulness and fidelity of the federal financial regulators to carry out its purposes. The comments received on the proposed rules suggest that the battle between the "wets" and the "dries" has only begun. The wets, dumbfounded by the federal financial regulators' inability to appreciate the important contribution of bank proprietary trading to the liquidity of financial markets, have roundly criticized the proposed rules (which, in many cases, merely track the statute itself) as exceeding Congressional intent.[81] The dries, postulating that a return to the status quo thirty years ago should not be that difficult to achieve, have urged federal financial regulators to tighten the rules even more.[82]

While a comprehensive discussion of the rulemaking is impossible, it may be useful to focus on particular aspects of the proposed rulemaking

79. *Id.* § 1851(d)(2)(A)(ii)–(iii).

80. *Id.* § 1851(d)(2)(A)(iv).

81. *See, e.g.*, *JPMorgan Chase*, *supra* note 43; Letter from Simon Greenshields, Global Co-Head of Commodities, Morgan Stanley, to the Agencies, Attachment No. 2, 8, 12–13 (Feb. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0304).

82. *See, e.g.*, Letter from Edmund Mierzwinski, Consumer Program Dir., U.S. Pub. Interest Research Grp., to the Fin. Stability Oversight Council (Nov. 5, 2010), *available at* http://regulations.gov (retrieved using document ID: FSOC-2010-0002-1346); Letter from Americans for Financial Reform to the Bd. of Governors of the Fed. Reserve Sys. et. al. (Feb.13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0308); Letter from Occupy the SEC to the Fed. Reserve Bd. et al. (Jan. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0221).

that have drawn the most industry and academic attention. In the following subparts, I consider in turn (1) the difficulty of defining the scope of key terms under the Rule, (2) the difficulty of devising quantitative metrics that capture the spirit of the Rule, and (3) the difficulty of administering the supervisory, enforcement, and compliance structure contemplated by the Rule and the proposed rulemaking.

A. Defining Permitted Activities Qualitatively

As discussed above, the Volcker Rule prohibits any banking entity from engaging as a principal for its "trading account" in any transaction involving certain enumerated financial instruments unless such activity falls within one of the permitted activities under the Rule. Industry commenters have requested that the financial regulators interpret them in the manner that preserves the status quo as much as possible—for example, by viewing the safe harbors as "guidelines" or principles to be enforced through ongoing supervision rather than "hard coded" rules, noncompliance with which can trigger regulatory action.[83]

The difficulty faced by regulators, however, is that any rulemaking under the safe harbors will necessary entail qualitative distinctions based on the intent of the trading entity. It is conceivable that regulators could rely entirely on quantitative metrics to detect activity that exceeds the safe harbors, but such an ex post application of a qualitative standard could shift the enforcement burden significantly to regulators and thus allow the safe harbors to swallow the Rule.[84] Moreover, as discussed below, some types of trading activity—such as "market-making-related activities or "risk-mitigating hedging activities"—are susceptible to a wide range of interpretation. To the extent that such statutory terms or concepts are hardwired into other parts of the federal financial regulatory scheme, any effort to reinterpret them expansively in the context of the Volcker Rule could be viewed as an unwanted precedent.

83. *See, e.g.*, Letter from Randolph C. Snook, Executive Vice President, Sec. Ind. and Fin. Markets Ass'n (SIFMA), to the Fin. Stability Oversight Council 11–12 (Nov. 5, 2010), *available at* http://regulations.gov (retrieved using document ID: FSOC-2010-0002-0909). Prof. Cunningham describes the complications inherent in implementing or enforcing a "principles-only system" of regulations. *See* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1433 (2007) (stating principles-based regulation alone without specific implementing rules is "vulnerable to abuse").

84. *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 621–24 (1992) (contrasting the ex ante costs of developing rules with the ex post costs of applying and enforcing standards).

1. "Trading Account"

Proprietary trading, as discussed above, is specifically defined by reference to the term "trading account," which the Rule defines as "any account used for acquiring or taking positions" in certain covered financial instruments "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)."[85] Banks subject to the market risk capital rule must already book "trading assets" into a "trading account" for purposes of calculating the market-risk-related capital charge.[86] To avoid evasion of this requirement (as well as to address trading assets held at affiliates not subject to Board regulation), the regulators have expanded the definition of "trading account" to include accounts that meet the purpose-driven test articulated in the statute as well as any account used by an SEC- or CFTC-registered dealer in connection with the activities requiring such registration.[87]

Some commenters have recommended decoupling the definition of "trading account" from specific accounts used for purposes of computing capital charges.[88] In their view, the cost–benefit analysis for allocation of trades into the "trading accounts" contemplated by the market risk capital rule is significantly different than the Volcker Rule.[89] For example, the Rule could result in lower capital charges if firms move assets currently held in a trading account for prudential reasons to nontrading accounts in order to avoid the Rule's restrictions. Similarly, federal financial regulators might come under pressure to keep capital charges for trading accounts low: if banking organizations move problematic trades out of their existing nontrading accounts to avoid triggering the rebuttable presumption, the positions they hold in trading accounts could increase significantly.

More controversially, the agencies have adopted a "rebuttable

85. 12 U.S.C. § 1851(h)(6) (2010).

86. BD. OF GOVERNORS OF THE FED. RESERVE SYS., INSTRUCTIONS FOR PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS FOR BANK HOLDING COMPANIES, at GL-77 to GL -78 (2007) (defining "Trading Account"), *available at* http://www.federalreserve.gov/reportforms/forms/FR_Y-9C20110630_i.pdf.

87. Joint Proposing Release, *supra* note 15, at 68945 (proposed joint rule § ___.3(b)(2)(i)(C)). A dealer may, of course, be required to register with any of the federal financial regulators depending on the nature of the instruments in which it deals (e.g., corporate debt and equity securities, government securities, municipal securities, swaps, security-based swaps).

88. *See, e.g.*, Letter from SIFMA-ABA-Fin. Servs. Roundtable & the Clearing House to the Agencies, at A-16 (Feb. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0174) [hereinafter *SIFMA-ABA*]; Letter from Juliana S. O'Reilly, Vice President & Chief Bank Regulatory Counsel, Am. Express, to the Bd. of Governors of the Fed. Reserve Sys. 12–14 (Feb. 9, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0136) [hereinafter *American Express*].

89. *See, e.g.*, *American Express*, *supra* note 88, at 11.

presumption" that an account (other than a dealer account or bank trading account) may nevertheless be deemed a "trading account" if used to acquire or take a covered financial position for less than sixty days. Some commenters have suggested removing the presumption—and instead relying solely on the purpose test—and further applying a "negative presumption" that positions held over sixty days are not effected for short-term profit.[90] Even if such a rebuttable presumption were deemed procrustean, absent a bright-line rule, firms could easily reallocate long-term positions to such accounts in order to create doubts about the "purpose" or "intent" of the activity in an account.[91]

Regulators will ultimately have to decide whether further account delineations will result in fairer application of the Rule or simply more opportunities for evasion by sophisticated banking entities at the expense of smaller ones. The account-by-account approach is not only strongly implied by the text of the Rule itself, but also likely imposes the least administrative cost on banks (and the least administrative burden on bank supervisors)."[92] Any attempt to complicate account structure will only heighten the temptation to undermine existing accounts to accommodate trading activity—for example, by abusing suspense accounts, customer discretionary accounts, and custodial accounts, in addition to any accounts for investment activities and permitted proprietary trading accounts.[93]

2. Market-Making-Related Activities

One of the Rule's most controversial exemptions is for "underwriting and market-making-related activities." The safe harbor permits banking affiliates to engage in these traditional investment banking activities and related hedging activities, subject only to the requirement that such

90. *See, e.g.*, *SIFMA-ABA*, *supra* note 88, at A-19 to A-20.

91. Indeed, some supporters of the Rule have balked at the regulators' proposal categorically to exclude from the definition of "trading account" both bona fide liquidity management accounts and accounts used for repurchase agreements and securities loans, to the extent that such short-term financing transactions can (particularly if inadequately collateralized) result in naked positions that place banking institutions at significant risk in the event of a counterparty default. *See, e.g.*, Merkley & Levin Letter, *supra* note 23, at 11–13.

92. *Cf.* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1835 (2012) ("In a contemporary legal and political climate that is defined by a rising skepticism of government and more particularly of regulation, the SEC (and for that matter all independent regulatory agencies) must accept that it cannot support its rulemaking only through generalized, undeveloped assertions of a proposed rule's impact on competition, efficiency, and capital formation.").

93. *See generally* Jeffry L. Davis et al., *Using Finance Theory to Measure Damages in Cases Involving Fraudulent Trade Allocation Schemes*, 49 BUS. LAW. 591 (1994) (describing the potential abuses in trade allocation when financial intermediaries trade the same security or commodity for several accounts during the course of a business day).

activities are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."[94] The regulators have explicated this safe harbor by requiring that the entity hold itself out as a market maker and be duly registered as such with the relevant regulator.[95] More controversially, the relevant banking entity's activities must be "designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable" to appreciation in the value of covered positions or the hedging of such positions.[96] As required by the Rule and discussed in Part C below, the entity is further required to establish an internal compliance program to ensure compliance with these requirements.[97]

Commentators have objected to defining "market-making-related activities" by reference to risk and revenue (and the more precise metrics discussed in Part B), largely by arguing that the term refers not just to traditional market making in publicly traded equity securities (where market makers post continuous quotes), but also facilitating customer trading in less liquid instruments such as corporate debt and over-the-counter derivatives, for which prices are not publicly quoted but privately negotiated.[98] For such transactions, market makers assume significant proprietary risk both because (1) finding a party willing to take the opposite side of trade might take a significant period of time and (2) they are subject to the risk of adverse selection when dealing with parties who may be better informed as to the value of a security.[99] Because the compensation earned for such "capital commitment" varies with these risks, industry commentators have considered a standard for market making based on a schedule of fees and commissions or quoted spreads to be inappropriate.[100]

The regulators have endorsed this expansive view in the Proposing Release, although they have not had significant success in distinguishing market making from dealing in the over-the-counter market. Critical to the regulators' position is the view that over-the-counter market making can be identified as a low-risk, passive, customer-initiated service.[101] Supporters of a more restrictive rule have differing interpretations.

94. 12 U.S.C. § 1851(d)(1)(B) (2010).

95. Joint Proposing Release, *supra* note 15, at 68946–48 (proposed joint rule § ___.4(b)(2)(iv)).

96. *Id* at 68947 (proposed joint rule § ___.4(b)(2)(v)).

97. *Id.* (proposed joint rule § ___.4(b)(2)(i)).

98. *See, e.g.*, Letter from Jim Rosenthal, Chief Operating Officer, Morgan Stanley et al., to the Agencies 21 (Feb. 16, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0304); Duffie, *supra* note 9, at 4, 10.

99. *See* Duffie, *supra* note 9, at 10–11.

100. *Id.*

101. *See* Joint Proposing Release, *supra* note 15, at 68960–63 (commenting on the identification of permitted market-making-related activities).

First, much of the customer facilitation that the industry would like to include in the definition of "market-making-related activities"—particularly with illiquid, hard-to-value instruments—has the potential to create the kind of conflicts of interest and market destabilizing activity that the Volcker Rule is also designed to address.[102] Second, those supporting a more restrictive implementation argue that the Rule does not call into question the desirability of market making, but merely the need to rely on banking entities to perform it.[103]

More importantly, broadening the definition of market maker could significantly affect the authority of the SEC, CFTC, and FRB in policing the Securities Exchange Act and the Commodity Exchange Act. "Market making," as defined in the Exchange Act,[104] refers to a specific role played by dealers in equity and options markets for which they are entitled to preferential treatment under federal securities law.[105] These provisions exist in part not only because regulators consider market making activity to be less risky than proprietary trading,[106] but also because concerns about financial responsibility and conflicts of interest must yield to the objective of facilitating continuous trading on organized exchanges.[107]

While the agencies have been receptive to the idea of broadening the Rule's concept of "market making" to encompass all firms that hold themselves out as regularly providing liquidity to the market,[108] those

102. *See, e.g.*, Letter from Joseph E. Stiglitz, Columbia Bus. Sch., to the Fin. Stability Oversight Council 2 (Nov. 6, 2010), *available at* http://regulations.gov (retrieved using document ID: FSOC-2010-0002-1133).

103. *See, e.g.*, *id.* at 1–2.

104. Section 3(a)(38) of the Exchange Act, 15 U.S.C. § 78(c)(38) (2012) (defining "market maker" to mean "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis"). 15 U.S.C. § 78(c) (2012). The reference to "block positioners," in this definition, could either be construed as a mandate to permit a broader scope of proprietary trading under the guise of market making or simply reflect the ability to accommodate the "near term demands" of customers and clients.

105. *See, e.g.*, *id.* § 78g(c)(3)(B) (exemption from margin requirements for equity securities), § 78k(a)(1)(A) (exception from parity, priority, and precedence rules).

106. *See, e.g.*, Joint Proposing Release, *supra* note 15, at 68961 (asserting that a market maker "typically generates significant revenue relative to the risks that it retains" and accordingly "will typically demonstrate consistent profitability and low earnings volatility under normal market conditions"). Market making, of course, is nevertheless not a risk-free activity. *See, e.g.*, MAUREEN O'HARA, MARKET MICROSTRUCTURE THEORY 20–29 (1997) (describing generally the relationship between a market maker's or dealer's risk of failure and the spread it quotes); LARRY HARRIS, TRADING & EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 401 (2003) (describing generally the risks and strategies of market makers).

107. *See, e.g.*, H.R. REP. NO. 103-76, *reprinted in* 1993 U.S.C.C.A.N. 1666, 1678 (publishing SEC comment that the market making exception in Section 11(a)(1) of the Exchange Act was included because market making was considered "beneficial to the markets").

108. *See* Joint Proposing Release, *supra* note 15, at 68870–71.

efforts will necessarily set potentially unhelpful precedents for the application of that term in other areas. For example, SEC and FINRA rulemaking with respect to market making in corporate debt has been sporadic because of the complexity of defining the role of such dealers in contributing to the liquidity of markets. Moreover, the SEC and CFTC are still scratching the surface in terms of regulating the market structure in which other financial instruments trade, and, as I argue below, can best implement the market making exemption in tandem with such market structure rules.[109]

3. Risk-Mitigating Hedging Activities

The implementation of the safe harbor for "risk-mitigating hedging activities" has also been the subject of considerable attention by commentators supportive of and opposed to the Volcker Rule prohibition. The statutory safe harbor is limited to those activities "in connection with and related to individual or aggregated positions, contracts, or other holdings" that are "designed to reduce the specific risks to the banking entity" in connection therewith.[110] The focus of the implementing regulations, and the surrounding commentary, is the congruity of the relationship between the positions, contracts, or other holdings arising from the banking entity's core or permissible activities and the accompanying hedge.

The proposed regulations, by way of substance, require that a proposed purchase or sale of a covered financial position hedge or mitigate one or more specific risks related to individual or aggregated positions—giving, as examples, risks that are the subject of Basel II classification, such as market risk, credit or counterparty credit risk, and currency or foreign exchange risk. Moreover, the proposed purchase or sale must be "reasonably" (not "tangentially," but also not "fully"[111]) correlated to the risks it is intended to hedge and must not "give rise, at the inception of the hedge, to significant exposures that were not already present" and which are not contemporaneously hedged.[112] The

109. *See infra* Part IV.

110. 12 U.S.C. § 1851(d)(1)(C) (2010). The "mini-Volcker Rule" similarly excepts "[h]edging and other similar risk mitigating activities directly related to [an] insured depository institution's activities" from the requirement that the swaps activity of such depository institutions be pushed out to an FRB-supervised affiliate registered with the SEC or CFTC as a condition of receiving federal assistance. 15 U.S.C. § 8305(d)(1) (2010).

111. Joint Proposing Release, *supra* note 15, at 68875.

112. *Id.* at 68948. Procedurally, the proposed regulations require that such hedging activities be conducted in accordance with the written policies, procedures and internal controls of the banking entity, and that any hedge be continuously monitored and managed to maintain "a reasonable level of correlation" and mitigate "any significant exposure arising out of the hedge after inception." Moreover, the persons responsible for performing such hedging activities may not be rewarded for proprietary risk-

Proposing Release seeks further comment as to whether the statutory references to "aggregated" positions, contracts or other holdings provide sufficient justification for "portfolio hedging" strategies (or create the potential for abuse of such strategies).[113]

Critics of the Rule have sought greater flexibility, both with respect to the variety of hedging strategies permissible and the scope of hedging permitted. Thus, for example, industry commenters have asked regulators to reconsider the "correlation" requirement in order to facilitate "scenario hedging" or "macro hedging," which may, for example, address low-probability "tail" events without necessarily correlating with specific positions in the firm's portfolio.[114] Firms have also sought clarification as to their flexibility to pursue the most cost-effective hedging strategies, including the freedom to hedge positions across affiliates or to choose from a variety of hedging strategies.[115]

Advocates of more congruent hedging, by contrast, have pushed back on the regulators' proposal to permit dynamic and portfolio hedging on the assumption that traders may use the weaker correlation permitted by such methodologies to mask proprietary trading.[116] The publicity surrounding JPMorgan Chase's recent multibillion dollar losses following an improperly placed corporate bond hedge has provided some support to the argument that even firms with the most rigorous risk management practices can enter into or fail properly to maintain hedges that rely on hedging aggregated positions or other more abstract hedging methodologies.[117]

The structure of the Volcker Rule once again puts regulators into the awkward position of defining hedging qualitatively and in a manner that might contradict the scope of exemptions for permitted bona fide hedging in other contexts.[118] In theory, the regulators could rely on capital or margin computations to measure the effectiveness of proposed

taking under their compensation arrangements. *Id.* (proposed joint rule § ___.5(b)(2)(v)).

113. *Id.* at 68877.

114. *See, e.g.*, *JP Morgan Chase*, *supra* note 43, at 24–25.

115. *See, e.g.*, *id.* at 25; *SIFMA-ABA*, *supra* note 88, at A-91.

116. *See* Merkley & Levin Letter, *supra* note 23, at 29; Letter from Better Markets, Inc. to the Fed. Deposit Ins. Corp. et al. 18–19 (Feb. 13, 2012), *available at* http://regulations.gov (retrieved using document ID: OCC-2011-0014-0254).

117. *See, e.g.*, David Reilly, *J.P. Morgan, Hedges and 'Asymmetric Accounting'*, WALL ST. J. (May 23, 2012), http://online.wsj.com/article/SB10001424052702304065704577422422211831822.html.

118. *See, e.g.*, General Regulations Under the Commodity Exchange Act, 17 C.F.R. § 1.3 (2012) (defining "bona fide hedging transaction" for economic or commercial indices, rates, values, levels or other measures that are considered an "excluded commodity" under the Commodity Exchange Act); 17 C.F.R. pt. 151, app. B (2012) (providing examples of "bona fide hedging" transactions for purposes of position limits and position reporting in swaps); 17 C.F.R. § 240.11a1–3(T) (2012) (defining "bona fide hedge transactions" in certain securities for purposes of parity, priority, and precedence rules).

transactions in eliminating or reducing risk. A rule that relied solely on the quantitative impact of a hedge on the risk of a firm's portfolio, however, would shift the burden to bank supervisors and regulators to identify and challenge transactions that result in inappropriate exposure to risk under the firm's own risk-management framework.

B. Measuring the Effect of Proprietary Trading

An essential component of the regulatory framework developed by the federal financial regulators in implementing the Volcker Rule is the recordkeeping and monthly reporting of certain quantitative measurements for firms of sufficient size.[119] The statistics are required to be compiled by each trading unit, with the level of detail dependent on whether the entity is engaged in market-making-related activities or underwriting, hedging, and other permitted activities.[120] Market-making-related activities require the most detailed reporting, including not only measures of risk management and sources of revenue (most of which are also applicable to other permitted activities), but also measures of revenue relative to risk and customer-facing activity.[121] The purpose of these recordkeeping and reporting obligations, among other stated goals, is to assist the banking entity and its regulator in monitoring trading activity, identifying activity warranting further review, and evaluating compliance with the safe harbors for permitted activities.[122]

From the regulators' perspective, the recordkeeping and reporting requirements are a double-edged sword. First, the existence of the statistics themselves will alter the behavior of regulated entities. Second, once the regulators have information, they have to decide what to do with it—when investigations should be triggered, how noncompliance with the Rule will be defined and how the quantitative measures will factor into those decisions, and what steps the regulator will take to correct violations. While all of the federal financial regulators juggle similar metrics in connection with their oversight of capital adequacy and liquidity, the qualitative aspects of the Volcker Rule—which turn on externalities to the federal government, counterparties, and markets, rather than the financial solvency and

119. The requirements are applicable to banking entities and their subsidiaries and affiliates that (on a consolidated basis) have trading assets and liabilities the gross sum of which is greater than or equal to $1 billion, with heightened requirements applicable if the gross sum is greater than or equal to $5 billion. Joint Proposing Release, *supra* note 15, at 68956–57.

120. *Id.* at 68957.

121. *Id.* at 68957–60.

122. *Id.* at 68956.

stability of the firm—will make those judgments significantly more difficult in practice, particularly when the two goals conflict.

1. Revenue Metrics

In addition to daily calculation of certain risk-management statistics used by firms and financial regulators,[123] the federal financial regulators have requested banking entities to calculate daily by trading unit certain source-of-revenue measurements.[124] For market-making-related activities, banking entities must further calculate certain measures of profit volatility (Comprehensive P/L Volatility and Portfolio P/L Volatility), ratios of profits to volatility, and additional statistics (number of unprofitable days and skewness and kurtosis of profit and loss).[125] While risk-management practices are part of the firm's overall risk-management obligations under existing and enhanced regulation, the revenue and risk-to-revenue metrics are meant to flag whether activity is attributable to impermissible proprietary trading, on the assumption that market-making-related activity is associated with lower risks and more stable returns.

Firms have certainly questioned these assumptions, particularly with respect to dealing in illiquid instruments that require sustained capital commitment and carry greater risk.[126] Academic and industry commenters have also observed that the regulations fail expressly to take into account the variety of financial instruments and the different conditions under which they trade.[127] One scholar has specifically noted that the metrics themselves might encourage firms to withdraw from dealing in such instruments, preferring to "cream skim" easy order flow, and thus withdrawing liquidity in the market from the instruments that need it the most.[128]

The proposed metrics, as the federal financial regulators note, "are *not* intended to serve as a dispositive tool for the identification or permissible or impermissible activities,"[129] and firms are required to consider asset classes in establishing risk factor sensitivities in their risk-management policy. But the incentive structure created by such metrics,

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123. These include VaR, Stress VaR, VaR Exceedance, certain Risk Factor Sensitivities, and Risk and Position Limits. *Id.* at 68957.

124. These include Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution to specific market and risk factors. *Id.* at 68958.

125. *Id.* at 68957–60.

126. *See, e.g.*, *JPMorgan Chase*, *supra* note 43, at 13.

127. *See* Whitehead, *supra* note 9, at 69–70; *see, e.g.*, *SIFMA-ABA*, *supra* note 88, at A-109.

128. Duffie, *supra* note 9, at 4, 20.

129. Joint Proposing Release, *supra* note 15, at 68956.

both within and across firms, should give regulators some pause. Within firms, the Volcker Rule may create significant incentives to parcel proprietary trades throughout an organization's trading units, based on each unit's relative capacity to "absorb" additional risk and volatility.[130] Moreover, as banking organizations continually acquire and absorb other financial institutions, it is inevitable that compliance personnel will lag in demarcating boundaries of trading units.

Across firms, the Volcker Rule may create incentives for firms collectively to identify certain "targets" for risk and revenue metrics, with a view to making it difficult for regulators to identify anomalous activity at any one firm, or among trading units executing identical or similar strategies at different firms. Because that collective activity would be framed as an attempt to achieve compliance with federal financial regulation, rather than cartelization of the financial sector, it would be difficult to challenge its legality. That behavior could significantly increase the cost of financial services to the extent that competitors such as hedge funds or independent investment banks could not fill the void.

2. Customer-Facing Metrics

In addition to measures of revenue and revenue volatility, the proposed rules require firms to record and report certain statistics relating to the extent to which their trading activity is with and reasonably expected to meet the near term need of customers. In addition to statistics relating to the ratio of trades effected with customers and non-customers,[131] banking entities are required to record and report statistics relating inventory turnover (weighted by risk) and the aging of inventory and liabilities. Industry commenters have viewed some of these statistics as misleading, insofar as concepts like "inventory" may not readily apply to certain financial instruments,[132] while academic commenters have further noted that trading across

130. While trading units are intended to be identified based on a common revenue-generating strategy (and in the case of trading operations, as a single unit), it is not difficult to imagine a market making desk seeking to place a trade in the account of another unit within the firm or within one of the firm's affiliates, with a view to disguising the nature of the risk undertaken.

131. For this purpose, a counterparty is considered to be a "customer" if it is neither a counterparty on a securities or commodity exchange nor a broker, dealer, swap dealer, market maker or affiliate thereof. Joint Proposing Release, *supra* note 15, at 68960. More generally, however, the regulators have intimated that the scope of term "customer," as used in the interpretation of the market making related activities exception, may vary depending on the asset class of the financial position and the market in which it trades. For example, in over-the-counter markets, a "customer" might include any market participant that "makes use" of the services of a market maker, either upon request or in the context of a continuing relationship. *Id.*

132. *See, e.g.*, *SIFMA-ABA*, *supra* note 88, at A-112 to A-113.

market makers contributes significantly to customer liquidity even when an individual market maker does not trade directly with a customer.[133]

Much of the criticism seems focused on the desirability of market making as a form of financial intermediation, on the assumption that only banking entities have the means to conduct such activity subject to effective supervision. An equally pressing concern is whether the resulting incentive structure creates a heightened risk of conflicts of interest with customers. Requiring banking entities to interact principally with their customers and control inventory as a condition of the market-making-related activities safe harbor seems like a recipe for conflicts, if market makers conclude that they must push overpriced inventory to customers to remain profitable. This could mean not only squeezing more profits out of customers, but also increasing the risk to customers of unsuitable products.

C. Difficult to Enforce

Having defined the framework of accounts within which banking entities must conduct their permissible proprietary trading activity, and having specified the metrics that banking entities must compile and report with respect to such activity, the question remains as to how regulators themselves will supervise banking organizations subject to the Volcker Rule. Much of the initial burden will fall on the firms themselves: depending on their size, firms may be required to establish (1) "written policies and procedures" regarding activities covered by the Rule, (2) "internal controls" reasonably designed to monitor and identify potential areas of noncompliance (for example, based on the quantitative metrics required by the financial regulators), (3) a "management framework" that presumably escalates potentially noncompliant activity as necessary for review and appropriate remedial action, (4) "independent testing" of the compliance program for effectiveness, (5) training and (6) sufficient recordkeeping to demonstrate compliance.[134]

Even as that the Rule's quantitative metrics and the minimum standards for a firm's internal controls under Appendix C of the Rule only target the largest firms (generally speaking, those with $1 billion or more in gross trading assets plus liabilities),[135] affected BHCs could

133. *See* Whitehead, *supra* note 9, at 55–56.

134. Joint Proposing Release, *supra* note 15, at 68853.

135. Joint Proposing Release, *supra* note 15, at 68957 (application of metrics); *id.* at 68956 (application of additional standards under appendix C). The additional standards under appendix C also apply to any firm whose gross trading assets plus liabilities exceed 10% of its total assets, as well as to any firm that has a relationship with or invests in a covered fund that meets certain thresholds or to any firm that the relevant federal financial regulator deems appropriate. *Id.* at 68918 (proposed joint rule § ___.20(c)(2)(i)–(iii)).

have a family of affiliates potentially regulated by each of the five Agencies. Not only must the regulators therefore figure out how they will carry out their supervisory and enforcement programs individually, they must also develop a means to monitor, verify, and take appropriate enforcement action collectively when possibly prohibited activity takes place across affiliates.

1. Interface with Regulator

The proposed rules force regulators into a realm where iterative supervision will displace "rules and standards"—a realm in which some regulators may not be equipped to thrive. Bank regulators have long enjoyed significant financial independence from Congress to finance their supervisory and enforcement activities; by contrast, market regulators such as the SEC and the CFTC have had to rely on less generous Congressional appropriations, which are dependent on the political cycle.[136] The danger is that this state of affairs may embolden firms to take greater liberties with the Rule, particularly with respect to their SEC/CFTC affiliates, on the assumption that any conduct in which the nation's premier banking conglomerates elect to engage cannot be found to violate the regulations as drafted and enforced.

For example, the SEC's failure to prevent the collapse of Bear Stearns was not necessarily due to a lack of information or attention to its program for supervising consolidated supervised entities (CSE), but rather a lack of regulatory resources.[137] The SEC's Office of the Inspector General found that SEC staff members responsible for supervising Bear Stearns were well aware of Bear Stearns' significant concentration of risk in mortgage-backed securities,[138] its risk management personnel's lack of expertise, staffing, and independence from traders,[139] and its failure to comply with "the spirit of Basel II" and

136. Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 253–56 (2004) (describing the appropriations process for the SEC and the desirability of self-funding); Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 525 (2000). *See also* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REGULATION 253, 270–74 (2007) (noting that the "costs of banking regulation in the United States are dramatically higher than the costs in any other jurisdiction" surveyed, whereas in the area of securities regulation, the level of regulatory intensity is lower than in common law countries such as Australia, the UK, and Canada).

137. *See* Onnig H. Dombalagian, *Requiem for the Bulge Bracket? Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 796 (2010) (summarizing OIG's findings with respect to the SEC's oversight of Bear Stearns).

138. U.S. SEC. AND EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM 17–18 (2009).

139. *Id.* at 20–23.

to update its internal models to reflect the risks posed by its business.[140] The SEC's inability to address these problems stemmed from, among other factors, inadequate staffing,[141] the lack of an effective process for tracking material issues to ensure that they were resolved,[142] and a lack of coordination with other divisions and other regulators.[143] While the CSE program was voluntary, it was at the core of the SEC's mission—unlike the prohibitions of the Volcker Rule, which ostensibly protect the safety and soundness of the broker–dealer's affiliates.

These problems are compounded by the express sanctions and stated intentions of the regulators in enforcing the Rule's prohibition. In addressing the question of enforcement, the Rule provides only that, among other available remedies, the appropriate regulatory agency shall, whenever it has reasonable cause to believe a firm has engaged in an activity that functions as an evasion of the Rule or a violation of its restrictions, "order, after due notice and opportunity for hearing, the banking entity . . . to terminate the activity and, as relevant, dispose of the investment."[144] The proposed rules, moreover, provide little further indication as to how the Rule will be enforced.[145] If these intimations are correct, enforcement of the Volcker Rule may well be no more effective than periodic Prohibition raids, with trading desks routinely spotting and exploiting trading opportunities, until such activity is detected, wound down, and then proscribed after the fact in internal controls.[146]

2. Coordination Among Regulators

Regulatory arbitrage will be another potential risk. The largest banking organizations may well locate their proprietary trading activities in the affiliate least likely to attract regulatory scrutiny, either because of the size and experience of its supervisory staff or the nature of its supervisory or compliance inspection program, or reallocate proprietary trading activities to affiliates supervised by regulators sympathetic to such activity.[147] To further confuse matters, firms may also purport to engage in risk-mitigating activities across affiliates within a banking organization. For example, to the extent that the mini-Volcker Rule

140. *Id.* at 24–33.

141. *Id.* at 49–50.

142. *Id.* at 37–38.

143. *Id.* at 41–44, 51.

144. 12 U.S.C. § 1851(e)(2) (2010).

145. *See* Joint Proposing Release, *supra* note 15, at 68956 (proposed joint rule § ___.21).

146. *See* BEHR, *supra* note 3, at 79–80.

147. For example, regulators sensitive to the profitability of their charges may feel compelled to allow revenues from proprietary trading to make up for losses incurred in other business lines.

requires firms to push most of their swaps activity out of insured depository institutions as a condition to receiving federal assistance,[148] it will be difficult for federal financial regulators to argue that derivatives activity should be corralled within individual banking entities. As a result, regulators will need to coordinate their efforts to verify that cross-affiliate transactions are not intended to evade the Volcker Rule.

Some commentators have suggested that the appropriate response to this problem is for regulators such as the SEC and CFTC to delegate to the Federal Reserve Board primary responsibility for handling Rule violations.[149] That delegation would be consistent with the pattern of granting the Federal Reserve Board greater authority to oversee and take remedial action with respect to the activities of all affiliates of banking groups, notwithstanding the formal regulation of affiliates by their "functional" regulators contemplated by Gramm–Leach–Bliley.[150] While the regulators have taken some steps in this regard,[151] the history of allocation of rulemaking and enforcement authority among federal financial regulators does not suggest that regulators will feel comfortable relinquishing their prerogatives.[152]

IV. THE VOLCKER RULE'S IMPERATIVE: A "REBALANCING OF INCENTIVES"[153]

If the Volcker Rule stands as a moral statement about the failure of the financial services industry to tame excesses reaped at the expense of clients, counterparties, and the public interest, what is notably missing from the proposed rules is any inclination by the regulators to give meaning to this moral imperative. Although the proposed rulemaking faithfully adheres to the text of the Rule, there is a danger that the regulatory regime they have created will evolve in a manner that shifts

148. *See supra* text accompanying note 108.

149. *See, e.g.*, *SIFMA-ABA*, *supra* note 88.

150. *See* 12 U.S.C. § 1844(c) (2012) (as amended by Section 604 of Dodd–Frank).

151. *See, e.g.*, Joint Proposing Release, *supra* note 15, at 68971 (describing 17 C.F.R. § 255.10, by which the SEC would delegate its rulemaking authority over investment advisers with respect to restrictions on covered fund activities or investments to the appropriate regulatory authority for the banking entity with which the investment adviser is affiliated, subject to reservation of enforcement authority).

152. *See, e.g.*, Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 27–67 (2005) (describing the difficulties in coordinating rulemaking, supervision, information sharing, and enforcement among the federal financial regulators); *see also* U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 197–206 (2008) (surveying past Executive and Treasury regulatory reform efforts).

153. Paul Volcker, Chairman, President's Economic Recovery Advisory Board, Keynote Address at the Atlantic's Economy Summit (Mar. 14, 2012), *available* at http://atlanticlive.theatlantic.com/AtlanticEconomySummit_PaulVolcker_with_ SteveClemons.pdf.

the burden of demonstrating noncompliance onto regulators. For regulators that have the resources and expertise to exercise ongoing supervision, as well as the discretionary authority over their regulated entities required to coerce compliance, such a regulatory framework may be appropriate. For those that lack the resources, political leverage, and comparative expertise to monitor the activity of the world's largest financial institutions, it is feckless, particularly if those agencies have other regulatory priorities.

A more vexing danger is that the rules will continue to evolve in a manner that focuses on the literal interpretation of the concepts in the Rule (e.g., "market making" versus "dealing"). Such a framework for implementation could become so technical that the largest and best established financial services providers will exploit the Rule's complexity and the uncertainty to secure a competitive advantage. In such a world, the largest bank holding companies would strengthen their monopoly on derivatives dealing, because smaller banking groups without the scale or range of activities to cloak their trading activity in routine customer businesses are unable to exploit the Rule's nuances. Meanwhile, the residual trading activity by hedge funds and private traders would fail to provide end users of financial products with the flexibility and efficiency they have come to expect.

For the Rule to have meaning requires identifying its moral imperative and designing a regulatory framework that weaves the Rule's moral imperative into each regulator's unique brand of regulation. In my view, the Rule's moral imperative is to link the ability of the major financial services providers to reap profits from proprietary trading activity—particularly when trading with clients—to the value of the services they demonstrably provide to the marketplace. While a discussion of this approach is beyond the scope of this Article,[154] a Rule focused on such an imperative might work in connection with market structure reforms, such as Dodd–Frank's Title VII regime for swaps and security-based swaps, to create a competitive market structure that fills the void created by the restrictions on proprietary trading by banking organizations, while at the same time providing banking organizations with a means to justify that their trading activity in such markets satisfies the requirements of the Rule.

Prohibition came to an end in part through the efforts of reformers

154. More specifically, I have argued elsewhere that regulators will need to (1) create a critical mass of nonbank financial companies to participate in such markets, (2) create mechanisms for nonbank financial companies to trade competitively with established banking entities in such markets, and (3) establish benchmarks for Volcker Rule compliance that are linked to the competitiveness of such markets. *See* Onnig H. Dombalagian, *Expressive Synergies of the Volcker Rule* 31–39 (Tulane University School of Law Public Law & Legal Theory Research Paper Series No. 12-15, 2012), *available at* http://ssrn.com/abstract=2097007.

who advocated "moderation and restraint" in the use of "intoxicating liquors."[155] Whether the Volcker Rule will meet the same fate as the Volstead Act will naturally be decided through the political process. As the political wheels turn in the background, regulators can either yield to the call of the industry to allow the safe harbors to swallow the Rule, or take advantage of the Rule's mandate to encourage banking entities to structure financial markets in a manner that may help achieve the social and political ends for which the Rule was enacted. The approach outlined above engages the Dodd–Frank Act holistically from the perspective of achieving the "rebalancing of incentives" intended by the Rule's framers.

155. KYVIG, *supra* note 5, at 122.

