IT'S COMPLICATED: WHY THE VOLCKER RULE IS UNWORKABLE

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I. INTRODUCTION

Unless you have been living under a proverbial rock for the past three years, you are aware that America is in the midst of economically-troubling times stemming from the recent international financial crisis.[1] On the heels of said crisis and its prominent role in the subsequent and ongoing recession, elected officials, consumer protection advocates, and many American citizens have been and are still calling for financial reform, particularly in the banking industry.[2] Congress responded to these calls by enacting the most expansive financial reform since the 1930s in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[3]

Section 619 of the Dodd-Frank Act, commonly referred to as the "Volcker Rule,"[4] prohibits a banking entity from "engag[ing] in proprietary trading" or "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge

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[1] *See* Craig Torres, *Fed Cuts Outlook for 2012, Sees 8.6% Jobless*, BLOOMBERG (Nov. 2, 2011, 2:32 PM), http://www.bloomberg.com/news/2011-11-02/fed-lowers-economic-growth-outlook-for-next-year-sees-8-6-unemployment.html.

[2] *See* Michael McAuliff & Max J. Rosenthal, *Occupy Wall Street's Message Gains Momentum in Congress*, HUFFINGTON POST (Nov. 2, 2011, 4:15 PM), http://www.huffingtonpost.com/2011/11/02/occupy-wall-street-congress_n_1071745.html.

[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in sections of 12 U.S.C.).

[4] *See generally* David Cho & Binyamin Appelbaum, *Obama's 'Volcker Rule' Shifts Power Away from Geithner*, WASH. POST, Jan. 22, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104935.html. The rule is named after its original proponent, famous economist and former chairman of the Federal Reserve, Paul Volcker.

fund or private equity fund," subject to certain exceptions.[5] As this Comment will expound upon, defining what exactly is—and is not—proprietary trading in the banking context is no easy task,[6] but for now it can be best understood as "when a [bank] trades for direct gain instead of commission dollars . . . from processing trades."[7] According to Senators Jeff Merkley and Carl Levin—the authors of the initial provisions on proprietary trading and conflicts of interest within the Volcker Rule—the prohibition of proprietary trading stems from the significant contribution of banks' proprietary trading losses to "the freezing of global markets, helping to precipitate more than $17 trillion in investment losses and necessitating bailouts by governments all over the world."[8]

The significance of the role proprietary trading played in the banking crisis, and the subsequent "freezing of global markets," however, is far from clear.[9] There is evidence that banks' losses were primarily due to extensive decreases in the value of long-term investments, most notably mortgage-backed securities that banks held to maturity rather than traded, in addition to collateralized debt obligations repurchased from off-balance-sheet funding vehicles.[10]

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[5] 12 U.S.C. § 1851(a), (d) (2006).

[6] *See* Kate Kelly, *Banks Gear Up for a Battle*, WALL ST. J., Feb. 2, 2010, *available at* http://online.wsj.com/article/SB10001424052748703422904575039502973649716.html.

[7] *Definition of Proprietary Trading*, INVESTOPEDIA, http://www.investopedia.com/terms/p/proprietarytrading.asp#axzz1cbW3StI3 (last visited Aug. 27, 2011).

[8] Senator Jeff Merkley & Senator 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, 515 (2011).

[9] *See* Charles Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 HARV. BUS. L. REV. 39, 41–42 (2011).

[10] *Id.* at 41 (citing RAGHURAM G. RAJAN, FAULT LINES 173 (2010)) (arguing that holding the mortgage-backed securities instead of the proprietary trading of such securities led to banks' large losses); Michael Mckenzie, *'Super-senior' CDO Investors Flex Their Muscles*, FIN. TIMES, Apr. 14, 2008, *available at* http://www.ft.com/intl/cms/s/0/8473466c-0a85-11dd-b5b1-0000779fd2ac.html. It bears mentioning that even if the banks held mortgage-backed securities and related collateralized debt obligations to maturity, they were probably using them as part of a repo trade to get cash for other investments, and that trade could lead to the liquidity effect the Senators describe, without being central to the financial crisis generally. Mortgage-backed securities are debt obligations that represent rights (or claims) to the cash flows (proceeds) of mortgage loans. The mortgage loans purchased from banks and other originators are assembled into pools by a separate entity (either a governmental or private entity) that then issues securities that represent claims on the principal and interest payment made by borrowers on the pool's loans. *See Mortgage-Backed Securities*, SEC (July 23, 2010), http://www.sec.gov/answers/mortgagesecurities.htm. These securities greatly depreciated as borrowers (often of subprime mortgage loans) failed to make payments. Collateralized debt obligations are trusts that sell

On the other hand, there is also evidence that proprietary trading contributed substantially to the losses that *some* large commercial banks suffered. For instance, Goldman Sachs recently disclosed an additional $5 billion in investment losses, which brought their total losses stemming from the financial crisis to $13.5 billion.[11]

More importantly, the idea that proprietary trading was one of the driving forces behind the financial crisis is highly debatable. In fact, Mr. Volcker himself has actually said that "proprietary trading in commercial banks was . . . not central" to the crisis.[12] Furthermore, U.S. Treasury Secretary Timothy Geithner testified that "most of the losses that were material . . . did not come from [proprietary trading] activities."[13] Senators Merkley and Levin state two particular goals of the prohibition: "to protect (1) the U.S. economy from suffering another debilitating financial crisis; and (2) taxpayers from again being called upon to rescue failed financial firms."[14] But in his Harvard Business Law Review article on how the Volcker Rule fails to consider the complexities of evolving financial markets, Charles Whitehead argues that "the Rule's ultimate intention was less to cure a particular cause of the financial crisis and more to champion the populist view that commercial banking should be separated from investment banking."[15] This is evidenced by frequent arguments by proponents of the rule—including Senators Merkley and Levin—that proprietary trading had distracted banks from their fiduciary duties to their customers and banks' more traditional activities such as real estate and small-business loans.[16]

Serious doubts have been raised as to whether the Volcker Rule

bonds to raise money with the overriding aim of using the money to procure assets with a greater yield (i.e., return) than that of the bonds sold to raise money for the CDO. In this context, mortgage-backed securities and collateralized debt obligations go hand-in-hand because the mortgage-backed securities often were a significant part of a bank's collateralized debt obligation's assets. *See* Peter Eavis, *CDOs explained*, CNN MONEY (Nov. 26, 2007, 10:36 AM), http://money.cnn.com/2007/11/24/magazines/fortune/eavis_cdo.fortune/index.htm.

[11] *See* Francesco Guerrera & Kara Scannell, *Goldman Reveals Fresh Crisis Losses*, FIN. TIMES, Jan. 13, 2011, *available at* http://www.ft.com/intl/cms/s/0/f1dcbf2e-1f56-11e0-8c1c-00144feab49a.html#axzz1cbMyWCSW.

[12] Kim Dixon & Karey Wutowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS (Mar. 20, 2010, 4:55 PM), http://www.reuters.com/article/2010/03/30/us-financial-regulation-volcker-idUSTRE62T56420100330.

[13] *Hearing Before the Congressional Oversight Panel*, 111th Cong. (2009) (testimony of Sec. of Treasury Timothy Geithner).

[14] Merkley & Levin, *supra* note 8, at 515.

[15] Whitehead, *supra* note 9.

[16] *See* Merkley & Levin, *supra* note 8, at 539.

will accomplish its goals.[17] Perhaps most notably, Volcker himself has recently said that even with the Dodd-Frank Act, the problem of banks that are too economically significant to be allowed to fail has "not yet been convincingly settled," despite being "the heart of the reform question."[18] But the Volcker Rule might not only fail in rectifying the problems that led to its creation, it may also create a slew of other problems such as eliminating potentially profitable activities of banks across the board.[19] It follows that this would result in banks not only decreasing lending, but also lending at less favorable rates.[20] Further, the rule may decrease the competitiveness of U.S. banks in the truly global market.[21] It may also create uncertainty for banks that could stifle investing activities that the legislature did not intend to be prohibited. Even worse, the rule may incentivize banks to find out what is allowed under the Volcker Rule by pushing the envelope or even attempting to disguise proprietary trading as something else, such as market-making.[22]

Whether any of these ill-effects will materialize is only speculative at this point. Regardless, the Volcker Rule is borderline unworkable.[23] This Comment fleshes out the Volcker Rule and the problems that arise from the law's ambiguity, complexity, and sheer size. Part II describes the background that led to the Volcker Rule, including a brief history of financial institution regulation, focusing on the collapse of Lehman Brothers as an illustrative example. Part III details the Volcker Rule and its ban on proprietary trading, including the ambiguities that play a significant role in making the rule ineffective. Part IV argues that the Volcker Rule in its current form is not only misguided, but borderline unworkable and at the very least unduly burdensome. This part explains that the statutory language of the ban is too vague while identifying the problems that

[17] *See* Douglas J. Elliott, *Why The Volcker Rule is Still a Bad Idea*, CNN MONEY (Mar. 21, 2012, 12:32 PM), http://money.cnn.com/2012/03/21/markets/volcker-rule-banks/index.htm.

[18] Bonnie Kavoussi, *Paul Volcker: Too-Big-To-Fail Problem 'Not Yet Convincingly Settled'*, HUFFINGTON POST (Sept. 20, 2011, 3:16 PM), http://www.huffingtonpost.com/2011/09/20/paul-volcker-too-big-to-fail-dodd-frank_n_971593.html.

[19] *See* Elliott, *supra* note 17 ("It will also raise costs and lower revenues for banks, pushing them to charge customers more in other ways.").

[20] *Id.* ("The Volcker Rule will raise the cost of credit to our suffering economy.").

[21] *See* Suzanne McGee, *Wall Street's Loopholes*, UPSTART (Sept. 10, 2010), http://upstart.bizjournals.com/views/columns/streetwise/2010/09/10/wall-street-investment-banks-may-find-way-to-skirt-proprietary-trading-ban-in.html.

[22] *Id.*; *see also infra* Part 0.

[23] *See* James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, N.Y. TIMES, Oct. 22, 2011, at B1.

the ambiguities create as well as the adverse effects from trying to reconcile such ambiguities. Further, Part IV concludes that such ambiguities and possible loopholes cannot be eliminated under the rule's current misguided rules-based approach, and from both a legal and economic standpoint, such an approach will lead to adverse effects on the American banking industry. Part V sets forth the recommendation that Congress should repeal the ban in favor of legally mandated oversight to prevent and penalize unethical/reckless proprietary trading including full disclosure of banks' trading activity to the appropriate regulatory bodies who will have discretion in enforcement of the rule. In Part VI, this Comment concludes by emphasizing why Congress needs to consider the shortcomings of the Volcker Rule immediately rather than simply letting the ban play out and hoping for the best.

II. BACKGROUND

The substantive federal regulation of the banking and securities industries that is so well-established today really did not begin to gain steam until the 1930s. Following the stock market crash of 1929 and the Great Depression, President Roosevelt and Congress passed a series of laws setting forth strong regulations of said industries, including the Banking Act of 1933[24] ("Glass-Steagall Act"), the Securities Act of 1933[25] ("Securities Act"), and the Securities Exchange Act of 1934 ("Exchange Act").[26] The Glass-Steagall Act established an array of significant reforms, most notably the creation of the Federal Deposit Insurance Corporation (FDIC)[27] and the restriction of bank activities to establish a separation between financial institutions involved in commercial banking and those engaged in investment banking and securities trading.[28] The creation of federal deposit insurance was deemed essential to protect depositors, and the imposition of restrictions on banks' activities was

[24] Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162 (1933).

[25] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933).

[26] Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934).

[27] Glass-Steagall Act §§ 8, 12B, 48 Stat. at 168–90. The FDIC is a U.S. government corporation that provides deposit insurance, which guarantees the safety of deposits in member banks, up to $250,000 per depositor per bank as of January 2012. The FDIC also supervises and examines certain financial institutions like banks for safety and soundness, performs certain consumer-protection functions, and manages banks in receivership (failed banks). *See FDIC Mission, Vision, and Values*, FDIC, http://www.fdic.gov/about/mission/index.html (last visited Dec. 19, 2011).

[28] Glass-Steagall Act §§ 16, 20, 21, 32, 48 Stat. at 184–85, 188–89, 194.

viewed as necessary because "commercial bank participation in securities trading was identified as a major cause of the financial collapse [of 1929]."[29] The result was that banks were effectively barred from engaging in investment banking activities, and consequently, there was almost complete separation from commercial banks and firms engaging in investment banking.[30]

On the other hand, the Securities Act and the Exchange Act instituted regulations on the investment banking industry.[31] The Securities Act focused primarily on regulation of new issuances of securities.[32] In particular, it prohibited the sale or offer of any security that was not registered, or did not qualify for an exemption under section 3, subsection A of the Securities Act, and also mandated specific disclosures by the issuers of the securities.[33] In contrast, the Exchange Act mandated new rules for the secondary trading of securities and is probably best known for its creation of the Securities and Exchange Commission (SEC) to monitor and regulate financial markets in the United States.[34] Collectively, these three new laws aimed to instill confidence in America's financial system by limiting the risks that investors and depositors create.[35]

The division of commercial banking from investment banking under the Glass-Steagall Act remained in place for decades.[36] But both technological and market changes—i.e., the development of derivatives and securitization[37]—provided "powerful new financial

[29] Merkley & Levin, *supra* note 8, at 517 (citing JOHN KENNETH GALBRAITH, THE GREAT CRASH: 1929, at 43–65, 100–15, 147–54 (Mariner Books 2009) (1954)). Many people blamed the stock market crash in 1929 on commercial banks that were too zealous in putting deposits at risk in the stock market, which the Glass-Steagall's separation of commercial and investment banks put a swift end to. *See* Joshua Brockman, *Death of the Brokerage: The Future of Wall Street*, NPR (Sept. 22, 2008), http://www.npr.org/templates/story/story.php?storyId=94894707.

[30] Merkley & Levin, *supra* note 8, at 517.

[31] *Id.*

[32] 48 Stat. 74.

[33] *Id.*

[34] 48 Stat. 881.

[35] *See* Merkley & Levin, *supra* note 8, at 517.

[36] *Id.* at 518.

[37] *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 972 ("During the 1980s and 1990s, federal regulators opened loopholes in the Glass-Steagall wall in response to growing competitive pressures in the financial marketplace. In 1987 and 1989, the Federal Reserve Board (FRB) allowed bank holding companies to underwrite debt and equity securities to a limited extent by establishing 'Section 20 subsidiaries.' During the 1990s, the FRB progressively relaxed its restrictions on Section 20 subsidiaries. By 1997, those subsidiaries could compete effectively with securities firms for underwriting mandates.").

tools" for both commercial and investment banks, and the ideology of financial regulation began to shift towards deregulation among lawmakers and regulators.[38] In 1999, President Clinton and Congress passed the Financial Services Modernization Act of 1999 ("Graham-Leach-Bliley Act"), which repealed the separation of commercial and investment banks restriction of the Glass-Steagall Act.[39] Under the Graham-Leach-Bliley Act, commercial banks were now permitted to invest and trade securities for their own accounts as well as offer banking, securities, asset management services, and even insurance products under one corporate umbrella.[40] As a result, commercial banking groups were now in direct competition with investment banks.[41] The purpose of the act was "to reduce and, to the maximum extent practicable, to eliminate the legal barriers preventing affiliation among depository institutions, securities firms, insurance companies, and other financial service providers."[42] Congress believed that permitting such multi-service financial institutions "[would] also lead to greater efficiency, lower interest rates, and greater access to credit. It [would] also lead to greater innovation in the new marketplace with greater competition."[43] Due to intense competition and the evolution of complex financial markets, both commercial and investment banks grew dramatically, and continue to grow today.[44] Notably, this was only fourteen years ago, and considering that banks did grow dramatically, it is interesting that the banking crisis has led to many advocating a return to the pre-Graham-Leach-Bliley Act regulatory climate with seemingly little consideration of other possible solutions.[45] As mentioned, the financial markets have become much more complex over the years, and it is hard to understand why the legislature has approached this issue as a one-way-or-the-other situation.

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[38] *See* Merkley & Levin, *supra* note 8, at 518 ("The rise of competition from investment banking and other 'shadow banking' firms put pressure on commercial bankers, who responded by seeking to engage in activities that had long been walled off.").

[39] Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999).

[40] Examples include Bank of America Corp. and Citigroup, Inc.

[41] *See* Merkley & Levin, *supra* note 8, at 519 (citing Arthur E. Wilmarth, Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates?*, *in* FINANCIAL MODERNIZATION AFTER GRAHAM-LEACH-BLILEY 65, 65 n.1 (Patricia C. McCoy ed., 2002), *available at* http://ssrn.com/abstract=291859).

[42] H.R. Rep. No. 106-74, at 138 (1999).

[43] 145 Cong. Rec. S13883, S13912 (Nov. 4, 1999) (testimony of Sen. Evan Bayh).

[44] *See* Merkley & Levin, *supra* note 8, at 520.

[45] *See* Merkley & Levin, *supra* note 8.

No matter how one identifies the role that proprietary trading played in the financial collapse of 2008, it is safe to say that the Volcker Rule or any significant financial regulation reform would not have occurred but for the collapse.[46] In January 2009, the Group of Thirty,[47] chaired by Paul Volcker, released a broad financial reform proposal, and discussion of the issue began at Senate Banking Committee hearings beginning that spring.[48] The Obama Administration's initial reform proposal did not significantly consider proprietary trading because the draft legislation that the Treasury Department sent to Congress in August 2009 did not include restrictions on proprietary trading.[49] On November 10, 2009, Senator Dodd released his first comprehensive financial reform bill, which again did not include any provision restricting proprietary trading or conflicts of interest.[50] On December 11, 2009, the House of Representatives voted to pass financial reform legislation, which did not include any restrictions on proprietary trading.[51]

According to Senators Merkley and Levin, the next major date in the legislative history of the Volcker Rule was on January 21, 2010, when President Obama declared his support for a ban of proprietary trading.[52] The inclusion of the Volcker Rule in the Dodd-Frank Act seemed to be relatively hasty considering that the proposal was met

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[46] *See* BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY, SUMMARY (2010) (declaring that "Congress responded to the crisis by enacting the most comprehensive financial reform legislation since the 1930s" while also noting that there was no proposed reform plan until the summer of 2009).

[47] The Group of Thirty is a "private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia" that "aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choice available to market practitioners and policymakers." *History of the Group*, GROUP OF THIRTY, http://www.group30.org/about.shtml (last visited Nov. 3, 2011).

[48] *See* Kevin G. Hall, *Economists: Banks that Survive Need Tougher Rules*, MCCLATCHY NEWSPAPERS (Jan. 15, 2009), http://www.mcclatchydc.com/2009/01/15/59763 /economists-banks-that-survive.html.

[49] *See Wall Street Reform: How We Got Here*, DEP'T OF THE TREASURY, http://replay.waybackmachine.org/20100826004406/http://www.financialstability.gov/roadtostability/timeline.html (last visited Sept. 4, 2011).

[50] *See* Stephen Labaton, *Senate Plan to Overhaul Wall Street is Unveiled*, N.Y. TIMES, Nov. 11, 2009, at B1.

[51] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1117 (2009).

[52] *See* Merkley & Levin, *supra* note 8, at 533 ("The prospects for including a restriction on proprietary trading in the final financial reform bill increased dramatically on January 21, 2010.").

with much backlash; even Chairman Dodd described it as coming too late into the process.[53] Moreover, "when Senators Merkley and Levin introduced their Prop Trading Act," in early March 2010, it was viewed as additional evidence that the rule was "dead" because, otherwise, it would have been included in the overall financial reform bill.[54]

This belief was ultimately incorrect as Chairman Dodd introduced a revised financial reform bill on March 15, 2010, which included the Volcker Rule with the additional requirement that the Financial Stability Oversight Council (FSOC) conduct a study that would include recommended modifications to the rule's "definitions, prohibitions, requirements, and limitations."[55] The SEC's filing of fraud charges against Goldman Sachs on April 16, 2010 has been cited as a major momentum booster of the rule's inclusion in the Dodd Frank Act.[56] On May 10, 2010, Senators Merkley and Levin introduced a modified version of the Prop Trading Act as an amendment to the Dodd-Frank Act.[57] The amendment to the Dodd Frank Act including the Volcker Rule was passed by the House of Representatives on June 30, 2010, and by the Senate on July 15, 2010; President Obama signed the bill into law on July 21, 2010.[58] The legislative process since then will be discussed in greater detail in Part IV, but a few quick points bear mentioning here. It should come as no surprise that Wall Street lobbied substantially throughout the process, but what is surprising is the extensive public interest in the legislative process behind the Volcker Rule, including almost 8,000 public-comment letters received by the FSOC in the initial public-comment period.[59] Now, over two years removed from the rule's passage, and following considerable delays, the regulators have

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[53] *See* Randall D. Guynn, *The Financial Panic of 2008 and Financial Regulatory Reform*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Nov. 20, 2010, 11:22 AM), http://blogs.law.harvard.edu/corpgov/2010/11/20/the-financial-panic-of-2008-and-financial-regulatory-reform.

[54] *Id.*

[55] Merkley & Levin, *supra* note 8, at 5 (quoting S. 3217, 111th Cong. § 619(g)(1)(B) (as introduced to the S. Banking Comm., Mar. 15, 2010)).

[56] *See* Guynn, *supra* note 53; *see generally* SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011), *cert. denied*, No. 10 Civ. 3229 (BSJ) (MHD), 2011 WL 4940908 (S.D.N.Y. Oct. 17, 2011).

[57] S. Amdt. 3931, 111th Cong. (2010); 156 CONG. REC. S3482-83 (daily ed. May 10, 2010) (amending S. 3217).

[58] Jim Puzzanghera, *Financial Overhaul is Signed Into Law*, L.A. TIMES, July 22, 2010, at A1.

[59] *See* Kimberly D. Krawiec, *Don't "Screw Joe The Plummer": The Sausage-Making of Financial Reform* 6–7 (Duke Law Scholarship Repository, Working Paper No. 2445, 2012), *available at* http://scholarship.law.duke.edu/faculty_scholarship/2445.

released a 298-page draft proposal[60] that "includes 350 questions on which the regulators have requested public input."[61]

In the end, the question remains: why target proprietary trading? As mentioned in Part I, the prohibition of proprietary trading stems from the significant contribution of banks' proprietary trading losses to "the freezing of global financial markets, helping to precipitate more than $17 trillion in investment losses and necessitating bailouts by governments all over the world."[62] But this contention is highly disputed. For instance, Senators Merkley and Levin point only to the unethical proprietary trading of Goldman Sachs and Merrill Lynch—which both resulted in the SEC filing extensive charges of fraud against them[63]—in describing the ills of banks' proprietary trading.[64] But the rule will have an impact on 2,096 U.S. national banks, according to a recent impact analysis conducted by the Office of the Comptroller of the Currency (OCC).[65] Of those 2,096 banks, 1,831 will only have the minimal compliance requirements, but still, the OCC estimates that the rule will create an aggregate of $50 million in annual legal and compliance costs.[66] Further, the OCC estimates an additional $917 million in capital costs.[67] Most of these capital costs stem from the rule's prohibition on "banks having more than three percent of their Tier 1 capital[68]

[60] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011) [hereinafter "Proposed Volcker Rule"].

[61] Ted Kaufman, *The Volcker Rule and Occupy Wall Street*, HUFFINGTON POST (Oct. 17, 2011, 8:59 PM), http://www.huffingtonpost.com/sen-ted-kaufman/the-volcker-rule-and-occu_b_1016053.html.

[62] Merkley & Levin, *supra* note 8, at 515.

[63] *See* SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011), *cert. denied*, No. 10 Civ. 3229 (BSJ) (MHD), 2011 WL 4940908 (S.D.N.Y. Oct. 17, 2011); Press Release, SEC Charges Merrill Lynch for Misusing Customer Order Information and Charging Undisclosed Trading Fees, SEC (Jan. 25, 2011), *available at* http://www.sec.gov/news/press/2011/2011-22.htm.

[64] *See* Merkley & Levin, *supra* note 8, at 515, 525–26.

[65] *See* Silla Brush, *Volcker Rule Will Cost Banks $1 Billion, U.S. Government Says*, BLOOMBERG (Oct. 28, 2011, 12:01 AM), http://www.bloomberg.com/news/2011-10-28/volcker-rule-to-cost-banks-1b-u-s-government.html.

[66] *Id.* These costs refer to the estimated expenses incurred by banks on an annual basis to comply with the Volcker Rule. *Id.*

[67] *Id.* Capital costs are the one-time expenses incurred in a project. *See Cost of Capital Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/costofcapital.asp#axzz1d3uD3Nqc (last visited October 27, 2011). So, in this case, the capital costs refer to the expenses incurred by banks in bringing their operations in line with the Volcker Rule.

[68] Tier 1 Capital refers to a business association's "core equity capital," which consists of the sum of the entity's equity capital (i.e., stock) and disclosed reserves,

invested in hedge and private equity funds," and thus the majority of these costs would fall on large national banks "with at least $1 billion in trading accounts or investments in hedge funds and private equity funds."[69] While these costs certainly appear large when considered in a vacuum, they are not necessarily significant relative to the size of the financial institutions in question.

Sometimes across-the-board regulation, even at the expense of innocent parties, is necessary and just, but banks' proprietary trading is not one of those situations.[70] Analysts have estimated that the ban on proprietary trading "could cost billions of dollars in annual revenue."[71] Further, not only does the Volcker Rule take away a potentially profitable activity from banks, it will be costly to banks, in both the form of the aforementioned compliance costs and economic consequences that can affect the entire American economy.[72] For example, Brad Hintz, a Sanford C. Bernstein & Co. brokerage analyst, recently predicted that banks' fixed-income desks could see revenue fall as much as twenty-five percent under the measures of the most recently proposed draft.[73] Furthermore, the Securities Industry and Financial Markets Association and consulting firms have warned that "the Volcker Rule could lead to higher funding and debt costs for U.S. companies and increased inefficiencies in trading that would lead to lower returns over time for investors."[74] These costs, compared to the compliance and capital costs previously discussed,

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and "sometimes non-redeemable, non-cumulative preferred stock." *Tier 1 Capital Ratio Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/t/tier-1-capital-ratio.asp#axzz1mPA8bQcU (last visited Feb. 11, 2012).

[69] Brush, *supra* note 65 ("The capital deduction provision would affect 34 national banks with at least $5 billion in trading accounts or covered funds and would cost them $770 million . . . .").

[70] *See* Andrew Verstein & Roberta Romano, *Assessing Dodd Frank* 143–44 (Yale Law Sch. Ctr. for the Study of Corporate Law and Yale Law Sch., Research Paper No. 434, 2011), *available at* http://www.law.yale.edu/documents/pdf/WGM_Roundtable_July.pdf ("I have one banking organization that has got to shut down its prop trading. In something like 30 years, there hasn't been a single quarter in which they've lost money, not a single quarter, even through the crisis. So why is it you would want to restrain them from a market-making activity that adds liquidity to the marketplace, which has been shown demonstrably to be safe and sound, and basically rip it out of the banks?" (quoting Eugene A. Ludwig, former Comptroller of the Currency under President Clinton)).

[71] Victoria McGrane & Aaron Lucchetti, *Volcker Rule Delay is Likely*, WALL ST. J. (Sept. 12, 2011), *available at* http://online.wsj.com/article/SB10001424053111904265504576564623589787108.html.

[72] *See* Elliott, *supra* note 17 ("[The Volcker Rule] will do considerably more harm than good for the economy.").

[73] *See* Brush, *supra* note 65.

[74] McGrane & Lucchetti, *supra* note 71 (internal quotation marks omitted).

are much more significant. This proposition received additional credence on October 10, 2011, when Moody's Investors Service said that the Volcker Rule would be a "credit negative" for bondholders of Bank of America, Citigroup, Goldman Sachs, and Morgan Stanley because they all "have substantial market-making operations."[75]

A counterargument to this support is that even if proprietary trading is generally profitable, the risk of extraordinary losses outweighs such benefit. The findings from the Dodd-Frank Act's mandated study of banks' proprietary trading by the General Accountability Office (GAO)[76] help to counter such pushback. The GAO's study was based on data of twenty-six stand-alone proprietary trading desks at the six largest U.S. bank holding companies[77] from June 2006 through December 2010.[78] The GAO found that, over thirteen quarters, stand-alone proprietary trading produced combined revenues of $15.6 billion in six firms, but losses over the five other quarters of $15.8 billion, resulting in an overall loss of about $221 million.[79] First, this means that, as a whole, the six banks lost an average of about $12.25 million a quarter, which fails to establish the extraordinary danger and risk of banks taking part in proprietary trading. It also seems to explicitly go against the proposition that proprietary trading is a significant revenue stream for banks. If one were to discount the extreme losses of five quarters, revenues would be near $20 billion. Even more telling is that four of the six firms made money from stand-alone proprietary trading over the four-and-a-half-year period, and only two lost money, which is not readily apparent from the study because the GAO "portrayed the activity in the aggregate . . . ."[80]

While the fact that only two of the six banks suffered losses adds doubt to the proposition that proprietary trading was a major cause

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75 *See* Brush, *supra* note 65 (internal quotation marks omitted). The relevance of these companies having substantial market-making activities stems from the difficulty in distinguishing between market-making and proprietary trading. *See infra* Part III.

76 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 (2011) [hereinafter GAO-11-529], *available at* http://www.gao.gov/new.items/d11529.pdf.

77 Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley. *Id.* at 3 n.5.

78 *See id.* at 14.

79 *Id.*

80 Bradley K. Sabel, *General Accountability Office Struggles with Dodd-Frank's Volcker Rule*, THE HARVARD L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (Aug. 26, 2011, 10:11 AM), http://blogs.law.harvard.edu/corpgov/2011/08/26/general-accountability-office-struggles-with-dodd-franks-volcker-rule.

of the financial crisis, looking at the data while eliminating the large losses of five quarters seems to ignore the argument that the rule is justified because the risk of large losses outweighs the potential benefit. Even the GAO study indicated that "stand-alone proprietary trading generally produced small revenues over several years as opposed to large losses during the financial crisis."[81] But the key phrase is "during the financial crisis," and the merit of analyzing the numbers without the extreme losses of five particular quarters is justified because the proprietary trading that resulted in such significant losses was due to the mortgage crisis rather than typical proprietary trading. Banks' losses resulted primarily from a decrease in the value of long-term investments, most notably "mortgage-backed securities that banks chose to hold to maturity rather than trade—as well as collateralized debt obligations they repurchased from off-balance-sheet funding vehicles."[82] It was not the activity—proprietary trading—that was problematic; rather, it was the particular object of some of such activity that was troublesome. Considering this in conjunction with the fact that only two of the six banks still suffered losses on their proprietary trading, a prohibition on all banks' proprietary trading may be overreaching and ultimately misguided. Even the GAO, while pointing out that proprietary trading as well as hedge and private equity fund investments are riskier than traditional trading activities, indicated that, outside of the crisis, both activities produced revenue for the banks.[83]

Presumably, the remaining justification for an across-the-board ban, even though not every bank took part in unduly risky proprietary trading, is that the actions of a few can have an overwhelming impact on the market as a whole, especially if those few are some of the most powerful banks. This assumption, while conceptually valid, still does not adequately address the inequity of penalizing all for the acts of some by prohibiting proprietary trading. Rather, it simply sets forth an excuse for doing so. The fact remains that there has not been any showing that proprietary trading prohibited under the Volcker Rule was "responsible for the collapse or near collapse of any regulated bank . . . ."[84] So, again, why proprietary trading? Volcker himself was asked during his February 2010 testimony before the Senate Banking Committee to name a

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[81] *Id.*

[82] Whitehead, *supra* note 9, at 41–42 n.10; *see also* RAJAN, *supra* note 10; Mckenzie, *supra* note 10.

[83] *See* GAO-11-529, *supra* note 76, at 22.

[84] *See* Verstein, *supra* note 70, at 121–22.

bank that had collapsed because of proprietary trading losses, and he could not name any.[85] Instead, Volcker answered that the rule was intended to deal with future concerns rather than actual problems in the past.[86] Obviously, thinking about the future is prudent, but as H. Rodgin Cohen of Sullivan & Cromwell articulately explained recently:

> [I]t would seem that an expansive reading of a prohibition is less justified when it is directed to speculation about the future rather than being necessary to respond to demonstrated problems. . . . [T]he regulators must take care that the statutory provisions are not implemented to cause the very damage they were designed to prevent.[87]

While this Comment will expand on Cohen's point in Part V, Volcker's comments and Cohen's response provide an answer the question of "why proprietary trading?" The answer is concern over risk for the banking system.[88]

A. *Further Look at the Banking System and Why Its Exposure to Risk is Worthy of Concern*

In order to understand the Volcker Rule itself, it is necessary to look further at the banking system to determine why there is such significant concern over its exposure to risk. Thousands of pages from the Federal Reserve (the "Fed"), obtained under the Freedom of Information Act, and central bank records of more than twenty thousand transactions from 2007 to 2009 recently uncovered details of the largest bank bailout in U.S. history.[89] Banks were in such a bind that they requested and received from the Federal Reserve $1.2 trillion on December 5, 2008—their single neediest day.[90] The fact that the Federal Reserve provided emergency relief to the banks is not problematic itself, as "[s]erving as a 'lender of last resort' is historically one of the main roles of a central bank."[91] But the Fed

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85 *Id.* at 122.

86 *Id.*

87 *Id.*

88 *Id.*

89 *See* Bob Ivry, Bradley Keoun & Phil Kuntz, *Secret Fed Loans Gave $13 Billion Undisclosed to Congress*, BLOOMBERG (Nov. 27, 2011), http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html.

90 *Id.*

91 Matthew Yglesias, *How the Fed's Generosity Made $13 Billion for America's Biggest Banks*, SLATE (Nov. 28, 2011, 8:39 AM), http://www.slate.com/blogs/moneybox/2011/11/28/how_the_fed_s_generosity_made_13_billion_for_america_s_biggest_banks.html.

loans given to the banks were "among the cheapest around, with funding available for as low as 0.01 percent in December 2008."[92] Regrettably, while almost all of the loans were repaid and the Treasury did not sustain any losses, the significantly below-market rates of the loans allowed banks to make an estimated $13 billion of income gained at the expense of taxpayers.[93]

But again, these loans were not made to make up for losses sustained in proprietary trading, and as the aforementioned GAO study showed, the largest banks did not typically suffer significant, if any, losses from proprietary trading.[94] Many, perhaps most, banks that received the loans needed more liquidity due to decreasing confidence following the collapses of Bear Sterns and Lehman Brothers, among others.[95] In fact, when it comes to the true dangers stemming from risky proprietary trading, the collapse of Lehman Brothers[96] is illustrative as it not only shows why many banking entities take on such risk, but how better monitoring and control of such risk could prevent an adverse, large-scale fallout.

Lehman's business strategy was like other major investment banks' strategies at the time, as they followed a high-risk, high-leverage model.[97] Lehman was a publicly-traded corporation and thus followed the idea of shareholder primacy, meaning the company's foremost objective was to maximize shareholder value (i.e., increase the stock price).[98] The concept of shareholder primacy stems from the fundamentals of corporate governance laws that have their roots in agency law, namely the fiduciary duties that corporate directors—the agents—owe to shareholders—the principals.[99] At the end of January 2008, Lehman reported record revenues of almost $60 billion and income over $4 billion for the preceding fiscal year.[100] At

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[92] *Id.*

[93] *See* Ivry et al., *supra* note 89.

[94] *See generally* GAO-11-529, *supra* note 76.

[95] *See* Ivry et al., *supra* note 89.

[96] *See generally In re* Lehman Bros. Holdings, 433 B.R. 113 (Bankr. S.D.N.Y. 2010).

[97] *See* Report of Anton. R. Valukas, Examiner, at 3, *In re* Lehman Bros. Holdings, No. 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010 (08-13555 (JMP)), *available at* http://www.jenner.com/lehman/lehman/VOLUME%201.pdf.

[98] *See* Steve Denning, *The Dumbest Idea in the World: Maximizing Shareholder Value*, FORBES (Nov. 28, 2011, 1:19 PM), http://www.forbes.com/sites/stevedenning/2011/11/28/maximizing-shareholder-value-the-dumbest-idea-in-the-world/.

[99] *See generally* Spencer Weber Waller, *Corporate Governance and Competition Policy*, 18 GEO. MASON L. REV. 833, 836–38 (2011). Of course, not everyone believes in shareholder primacy. *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

[100] *See* Report of Valukas, *supra* note 97, at 2.

this time, Lehman's stock traded up to $65.73 per share, but less than eight months later, "on September 12, 2008, Lehman's stock closed under $4," a decrease of almost 95% from January 2008.[101] Three days later, Lehman filed for Chapter 11 bankruptcy, "the largest bankruptcy proceeding ever filed."[102]

How exactly did this happen to an investment bank that maintained "approximately $700 billion of assets, and corresponding liabilities, on capital of approximately $25 billion"?[103] Well, the assets were largely long term, while the liabilities were predominantly short term, and because of this, to meet its liabilities, Lehman had to "borrow tens or hundreds of billions of dollars in those markets each day from counterparties to be able to open for business."[104] Under such a scenario, lender confidence in Lehman was obviously of the utmost importance.[105] In 2006, Lehman had decided to take on significantly greater risk and greatly increase leverage on its capital.[106] In 2007, the subprime mortgage crisis reached full steam, and Lehman failed to recognize this "developing storm and its spillover effect" upon its other business lines.[107]

Instead of cutting its losses—remember the concept of shareholder primacy, and note that corporate directors are elected by shareholders—Lehman consciously decided to "double down" in hopes of turning a profit and under the idea that the mass exodus of subprime originators actually provided a substantial opportunity to those who could weather the storm.[108] In doing so, Lehman "significantly and repeatedly exceeded its own internal risk limits and controls."[109] This is an important point as it shows that a mess like Lehman's is not inevitable when it comes to proprietary trading, and sufficient internal controls—if followed of course—can limit the risk of the banking industry that Volcker invokes as justification for a prohibition of proprietary trading.

It was not long until it became abundantly clear that Lehman's "double-down" strategy was doomed from its inception, especially after Bear Sterns imploded in March 2008 as "[t]he markets were

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101 *Id.*
102 *Id.*
103 *Id.* at 3.
104 *Id.*
105 *Id.*
106 *See* Report of Valukas, *supra* note 97, at 4.
107 *Id.*
108 *Id.* (internal quotation marks omitted).
109 *Id.*

shaken by Bear's demise, and Lehman was widely considered to be the next bank that might fail."[110] But to buy more time and maintain the previously mentioned critical confidence, Lehman used an "accounting-gimmick," legal under Generally Accepted Accounting Principles—an example of the ills of a rules-based approach—to "paint[] a misleading picture of its financial condition."[111] On September 12, two days after Lehman reported a $41 billion liquidity pool, the pool actually contained less than $2 billion of liquid assets.[112] Lehman's bankruptcy had widespread effects: the Dow Jones index plunged 504 points on September 15, and on the following day, in part due to losses suffered on its exposure to Lehman, AIG was on the verge of collapse until "the Government intervened with a financial bailout package that ultimately cost about $182 billion."[113]

Adding to the necessity of some regulation aimed at curbing such risk, the Examiner in the Chapter 11 proceeding found that Lehman's senior officers did not violate their fiduciary duties through their actions that led to the corporation's financial condition and ultimate failure.[114] But the Examiner also concluded that "Lehman was more the consequence than the cause of a deteriorating economic climate," and in his report noted that by their own admissions, Government agencies "might better have anticipated or mitigated the outcome."[115] These two points—in conjunction with the fact that Lehman consciously decided to take on risk greater than its own internal controls allowed for—support the recommendation that the ban be repealed in favor of legally mandated oversight to prevent and penalize unethical or reckless proprietary trading, including full disclosure of banks' trading activity to the appropriate regulatory bodies who will have discretion in enforcement of the rule.[116]

III. BREAKDOWN OF THE VOLCKER RULE

The Volcker Rule prohibits banking entities from taking part in proprietary trading or investing in or sponsoring any private equity

[110] *Id.* at 5.
[111] *Id.*
[112] Report of Valukas, *supra* note 97, at 10.
[113] *Id.* at 13–14 (identifying the collapse of a $62 billion money market fund and the congressional passing of a $700 billion Troubled Asset Relief Program rescue package as other possible effects).
[114] *Id.* at 43–58.
[115] *Id.* at 2–3.
[116] *See* discussion *infra* Part 0.

firm or hedge fund.[117] This Comment will focus primarily on the ban of proprietary trading, but will discuss some of the more important implications regarding the regulation of banks' investments in, and relationships with, hedge funds and private equity funds. Thus, for now, it is sufficient to point out that the limitation on investing in or sponsoring such funds has three central purposes:

> (1) [e]nsure that banking activities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule's restrictions on proprietary trading; (2) [c]onfine the private fund activities of banking entities to customer-related services; and (3) [e]liminate incentives and opportunities for banking entities to "bail out" funds that they sponsor, advise, or where they have a significant investment.[118]

The rule also mandates, among other restrictions, additional capital requirements and quantitative limitations to be imposed on non-bank financial firms supervised by the Board of Governors of the Federal Reserve System (the "Board").[119]

Subsection B of the rule required the FSOC to conduct a study and make recommendations for the rule's implementation with specific attention to certain factors that include, but are not limited to (1) protecting taxpayers and consumers by enhancing financial stability through minimizing the risk that banking entities engage in, (2) promote and enhance the safety and soundness of banking entities, (3) reduce conflicts of interest between the self-interest of banking entities and their customers, and (4) limit activities that have caused unreasonable risk or loss in banking entities.[120] The FSOC Study was published on January 18, 2011.[121] The FSOC set forth ten recommendations:

> (1) Require banking entities to sell or wind down all impermissible proprietary trading desks.
> (2) Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness.
> (3) Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary

[117] 12 U.S.C. § 1851(a) (2006).

[118] FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 6 (2011).

[119] § 1851(a)(2).

[120] § 1851(b)(1).

[121] FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 3.

> trading without provisions for safe harbors.
> (4) Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
> (5) Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
> (6) Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
> (7) Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers.
> (8) Prohibit banking entities from engaging in transactions that would allow them to "bail out" a hedge fund or private equity fund.
> (9) Identify "similar funds" that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
> (10) Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.[122]

The FSOC study also stressed that regulators must be "flexible and dynamic" in implementing and policing the rule, in part because "markets, products and trading activities will continue to evolve."[123] This is in reference to the rule's requirement that within nine months of the FSOC completing its study, the OCC, Treasury, the Board, the FDIC, and the SEC shall consider the findings of the study and adopt rules to carry out the Volcker Rule.[124] Thus, there was originally an October 18, 2011 deadline for the finalized Volcker Rule, but that deadline has lapsed as the aforementioned regulatory bodies released their proposed draft on October 6, 2011, and the public comment period did not end until February 13, 2012.[125]

The statute mandates that the Volcker Rule take effect on July 21, 2012.[126] But as of January 2013, the Volcker Rule has not been

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[122] *Id.*

[123] *Id.* at 26, 32.

[124] § 1851(b)(2)(A).

[125] Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011); *see also* Cheyenne Hopkins, *Regulators Extend Comment Period on Volcker-Rule Proposal*, BLOOMBERG (Dec. 23, 2011, 3:04 PM), http://www.bloomberg.com/news/2011-12-23/u-s-regulators-delay-comment-period-on-volcker-rule-proposal.html. Some had speculated that the delay was a "sign of the Volcker Rule's complexity and controversy." McGrane & Lucchetti, *supra* note 71. This speculation has arguably proved to be correct as will be expanded upon in Part IV.

[126] § 1851(c)(1).

finalized, and thus, has yet to take effect.[127] Regardless, banks are granted an initial grace period of two years to bring their operations and investments into compliance with the rule.[128] The Board may extend the grace period one year at a time, but cannot give such extensions to a bank that exceeds an aggregate of three years, which means it is conceivable that a bank can have a grace period up to five years.[129] Furthermore, the Board can extend the period even further as necessary to fulfill a contractual obligation that was in effect on May 1, 2010, to keep an interest in an illiquid fund.[130] This is a one-time extension, but may be as long as five years.[131] Finally, additional capital requirements, as the Board deems necessary, can be imposed on any banking entity during the transition period.[132] Implementing these recommendations, specifically the ones that impose an affirmative duty on banks to collect and test new data, such as the quantitative metrics and to compare bank trading with hedge fund and other proprietary operations, will likely be expensive.[133]

The specificity of bank activity definitions will be crucial to the rule's effectiveness. Realizing this, the FSOC included in its study some recommended quantitative metrics to help distinguish proprietary trading from the rule's permitted activities.[134] While this Comment will discuss these quantitative metrics and the implications of the current definitions at greater length in Part IV, for now, it is important to note some of these definitions. Subsection (h) of the rule lists its central definitions.[135] As noted earlier, the statute explicitly prohibits a banking entity from "engag[ing] in proprietary trading" or "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund," subject to certain exceptions.[136] The term "banking entity" means "any insured depository institution . . . , any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International

[127] *Fragmented U.S. Regulatory System Stalls Dodd-Frank Rules-GAO*, REUTERS (Jan. 23, 2013, 6:41 PM), http://www.reuters.com/article/2013/01/23/financial-regulation-gao-idUSL1N0ASHV320130123.

[128] § 1851(c)(2).

[129] *Id.*

[130] § 1851(c)(3)(A).

[131] § 1851(c)(3)(B).

[132] § 1851(c)(5).

[133] *See* Whitehead, *supra* note 9, at 52; *see also* Stewart, *supra* note 23.

[134] FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 36–37.

[135] § 1851(h).

[136] § 1851(a), (d).

Banking Act of 1978, and any affiliate or subsidiary of any such entity."[137]

The term "proprietary trading," as used in the statute, is defined as

> engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board 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 [SEC], and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.[138]

Central to this definition is the term "trading account," which is defined as "any account used for acquiring or taking positions in securities and [financial] instruments . . . 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)" and other accounts the regulators may identify.[139] Again, the implications—including some problems that the ambiguity and/or impracticality of the definitions create—are expounded upon in Part IV.

Subsection (d) of the Volcker Rule lists exemptions from the rule in the form of permitted activities that would otherwise be considered proprietary trading.[140] Permitted activities include, but are not limited to, market-making,[141] hedging to mitigate risk,[142] trading activities "on behalf of customers,"[143] and proprietary trading conducted by a banking entity provided that the trading occurs "solely outside of the United States and [] the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States."[144] All four of these permitted activities raise serious questions, and depending on how they are interpreted, can possibly lead to adverse effects on the American economy. This point is discussed further in

137 § 1851(h)(1)(A)–(D). Certain limited purpose trust institutions are not considered banking entities under this section.
138 § 1851(h)(4).
139 § 1851(h)(6).
140 § 1851(d).
141 § 1851(d)(1)(B).
142 § 1851(d)(1)(C).
143 § 1851(d)(1)(D).
144 § 1851(d)(1)(H).

Part IV.

The full scope of the permitted activities remains to be finalized as the rule also gives regulators the ability to permit any trading activities that "promote and protect the safety and soundness of banking entities and U.S. financial stability."[145] But any of the otherwise-permitted activities will still be prohibited if it will result in a "material conflict of interest" with clients or a "material exposure to high-risk assets or high-risk trading activities."[146]

The FSOC Study included factors—with minimal detail—that regulators can consider.[147] For instance, Charles Whitehead has argued that one of the factors—"that concerns are 'elevated' when instruments are complex, highly structured or opaque, illiquid or hard-to-value"—would "require coordination across multiple business units within a bank, or involve significant information asymmetries."[148] Furthermore, assets and/or strategies can be considered "high risk" simply because "they involve new products with rapid growth, embedded leverage, high volatility, or assets whose values cannot be externally [priced] or effectively hedged."[149] Until regulators make it clear how they will make "high risk" and "material conflict of interest" determinations, there will be significant uncertainty for banks. This could have the unfortunate consequence of stifling banks' investment activities that the Volcker Rule was not intended to encompass.[150]

The two most significant permitted activities are market-making and hedging.[151] Neither term is precisely defined in the rule.[152] This is another area of concern going forward, but it is not necessarily fair to blame the rule-makers and regulatory bodies for this, as distinguishing market-making from prohibited speculative proprietary trading is far from easy.[153] It is worth noting that this is particularly disconcerting because of the integral role that market-making plays in banks' capital-raising by "helping to fill a temporal gap between sellers and buyers of financial assets."[154] Put a different way, market-making is a traditional bank function as it provides

145 § 1851(d)(1)(J); *see* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 16.
146 § 1851(d)(2)(A).
147 *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 16.
148 *See* Whitehead, *supra* note 9, at 50.
149 *Id.*
150 *See infra* Part 0.
151 § 1851(d)(1)(B), (C).
152 Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011).
153 *See infra* Part 0.
154 Whitehead, *supra* note 9, at 50.

liquidity to lenders without affecting borrowers' access to reliable sources of capital; the difference is that it relies "on capital markets rather than traditional buying channels."[155] Market-making accomplishes this by having banks serve as the middle-man between clients aiming to buy or sell financial assets and third parties seeking to sell or buy the same assets.[156] Bank customers can either sell assets immediately to a market-maker or delay the sale until a sufficient offer is found.[157] The risk is that the price may move adversely to the seller while they wait. Market-makers—banks—have the ability to bear that risk and, therefore, offer immediate liquidity, but almost always at a discount from the price that the seller might have otherwise received in the future.[158] Thus, the market-maker generates income in the form of the difference between its purchase price and the greater price at which it later sells the held assets.[159]

Hedging is also an essential aspect of banks' business operations, and banks can hedge in numerous ways.[160] In their traditional lending business, banks may hedge interest rates and credit risk, and banks may also hedge their exposure to financial assets, including those acquired in market-making activities.[161] Because hedging risk can be accomplished in many different ways, and by hedging, a bank can trade financial instruments, which in turn could replicate proprietary trading, it may appear to an outside party that a legitimate hedging transaction is a violation of the Volcker Rule since a direct link between risk and hedging is not always possible.[162] The FSOC has realized this problem, and in its study, it recommended the use of objective data points to help regulators distinguish between proprietary trading and permitted activities.[163] In their proposed draft, the regulatory bodies expanded the role of such metrics.[164]

While this Comment will discuss some possible shortcomings of these metrics, they are a step in the right direction and will definitely be useful in regulating banks' proprietary trading. As mentioned, the

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[155] *Id.*
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] Felix Salmon, *How Banks Hedge Counterparty Risk*, PORTFOLIO.COM (Oct. 3, 2008, 11:44 AM), http://www.portfolio.com/views/blogs/market-movers/2008/10/03/how-banks-hedge-counterparty-risk/.
[161] Whitehead, *supra* note 9, at 51.
[162] *Id.*
[163] *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 36.
[164] *See* Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011).

difference between proprietary trading and the rule's permitted activities can be very difficult to determine, and these metrics do help provide a clearer picture. But because the statute seeks to *prohibit* proprietary trading rather than regulate it in a more discretionary manner, banks and regulators will have a lot at stake when trying to distinguish between the two. This begs the question of not only whether a prohibition rather than a more discretionary regulation is more effective, but also whether it is sensible. The rest of this Comment will focus on answering this question, while ultimately advocating for a more discretionary approach that would require transparency of banking entities' trading activities to the regulatory bodies.

IV. THE VOLCKER RULE IS UNWORKABLE AND INEFFECTIVE

The aforementioned difficulties in distinguishing proprietary trading from the rule's permitted activities raise numerous issues. Government regulators have been cognizant of these issues and have gone to great lengths to combat them.[165] Unfortunately, these efforts have led to a tremendously complex rule that will be near impossible to effectively enforce without unfairly and adversely affecting banks and perhaps the U.S. economy in general. The result is a rule that is not only unworkable, but also one that fails to achieve its intended goal.

First, the aforementioned questions regarding the definitions of the terms used in the rule have created a number of problematic issues that the FSOC study and the regulatory bodies' proposed draft have failed to resolve. This ambiguity, combined with the rule giving regulators broad authority to interpret and modify the statue, creates uncertainty. This in turn can potentially inhibit banking practices even further because banks tend to crave certainty.[166] The rule and its ongoing implementation process, however, will force banking groups to remain in uncertain territory for some time.[167] The ambiguous definition of proprietary trading and the corresponding definition of "trading account" have created some critical issues. For instance, trading activity varies among markets and types of assets, so what

[165] *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118; Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011).

[166] *See generally* McGee, *supra* note 21. Banks tend to crave certainty because the nature of their activities (i.e., lending decisions—how much, at what rate, etc.) rely heavily on not only the current state of affairs but the foreseeable future. Uncertainty makes these activities riskier and more difficult.

[167] *Id.*

constitutes a "near term" or "short term" transaction for one instrument could be significantly different for another.[168] Further, this definition makes the prospect of uniform enforcement much less likely because different firms employ different trading strategies. Accordingly, what the regulators would view as constituting proprietary trading at one firm may not be the same at another.[169]

The lack of a definition for the permitted activity of market-making is even more problematic. As discussed in Parts II and III, banks generate revenue from market-making.[170] Banks are contacted daily to trade billions of dollars of financial instruments.[171] Traders outside of a bank can buy, sell, and even speculate in financial instruments from derivatives[172] to gold. Whitehead uses the example of airlines that buy oil futures to lock in energy prices and explains that as a result, banks can acquire an inventory of such financial assets and maintain exposure to risk in order to meet or prepare for customer demand.[173] Proprietary trading can be strikingly similar as it accumulates positions with the expectation of profiting from future transactions and thus, both involve principal trading with customers or third parties where the bank may gain or lose as a result of short-term changes in the market value of the assets.[174] This is why distinguishing between two activities, one prohibited and the other permitted, can be very difficult.[175]

Notably, this lack of a definition is not the fault of the legislature or regulatory bodies, but rather stems from the difficulty of distinguishing market-making activities from proprietary trading. In fact, any attempt at distinguishing the two through definitions may prove fruitless as

[168] Whitehead, *supra* note 9, at 48.

[169] *Id.* at 49 ("A longer-term investment, for example, may be resold quickly in the face of an increasingly volatile market. How can regulators distinguish between changes in strategy and prohibited transactions?").

[170] *See* discussion *supra* Part 0.

[171] *See* Whitehead, *supra* note 9, at 50.

[172] A derivative is "a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage." *Definition of Derivative*, INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp#axzz1d3uD3Nqc (last visited Oct. 27, 2011).

[173] Whitehead, *supra* note 9, at 50.

[174] *Id.* at 51.

[175] *See* McGee, *supra* note 21 (arguing that "no one seems to know just where the blurry line between proprietary trading and market-making is drawn").

> Goldman Sachs—and other firms as well—are unlikely to accept any regulatory finding that some of those market-making endeavors are really proprietary trading in disguise. . . . [a]nd while [it is] technically accurate that they aren't[,] . . . the already-blurry line between market-making and proprietary trading [is] likely to become still more indistinct.[176]

This is a major issue, especially considering that at firms like Goldman Sachs, proprietary trading, while significantly successful, drastically pales in comparison to its market-making activities.[177] Both the FSOC and the regulatory bodies have noted that current market-making activities often include elements of proprietary trading and that, in conjunction with differences in market-making for various assets and markets, distinguishing between permissible and impermissible trading is significantly challenging.[178]

In recognition of such difficulties, the regulatory bodies have mandated the use of quantitative metrics by banks to help distinguish prohibited proprietary trading from the rule's permitted activities.[179] Whitehead, however, makes the astute observation that while the metrics will assist banks' compliance with the Volcker Rule, they create the risk of trading strategies that satisfy the objective quantitative metrics while still violating the legislative intent of the rule.[180] Moreover, the metrics may alter the way that banks do business to comply with the definitions of permitted activities, which could have the unfortunate consequence of delaying the emergence of novel instruments and strategies.[181] As this Comment will explain further in Part V, these potential problems with the metrics only exist because they would be used under the backdrop of a bright-line prohibition. If the rule were discretionary, these quantitative metrics would be very helpful in providing adequate clarity to combat the uncertainty that would come with such a discretionary approach.

Another problem arising from defining key terms in the rule stems from its exception of banks that operate "solely" outside the United States.[182] Foreign banks claim that a strict interpretation of

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[176] *Id.*

[177] *Id.*

[178] *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118; Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011).

[179] *See* discussion *supra* Part 0; FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 118, at 50.

[180] *See* Whitehead, *supra* note 9, at 51.

[181] *Id.*

[182] 12 U.S.C. § 1851(d)(1)(H) (2006).

the rule may also force them to fire, or in the best case, relocate U.S. employees who are involved in proprietary trading, even if no American money is at risk.[183] Foreign banks frequently hire American investment advisers and managers to work on offshore proprietary trading, and according to the Institute of International Bankers (IIB), if such trading were forbidden under the Volcker Rule because U.S. employees are involved, the banks would simply move those jobs overseas.[184] Sally Miller, the CEO of the IIB, has said that "it's a jobs issue—if we can't use a U.S. sub-adviser,[185] we're going to use an adviser sitting in London or Frankfurt, so that job is not here anymore."[186] International banks employ more than 250,000 U.S. citizens and permanent residents according to the IIB; Credit Suisse Group AG, Societe Generale, and Deutsche Bank AG are among the overseas banks that manage trades in the United States and would be affected by the rule.[187] Furthermore, extending the Volcker Rule to foreign banks could make U.S. securities less attractive to foreign banks, according to Miller, because employing U.S. firms as sub-advisers encourages foreign banks to invest in American securities.[188] This incidental effect is intuitive, as employing U.S. firms naturally increases foreign banks' awareness of U.S. securities because such American firms will often bring these securities to the attention of foreign banks in the course of their business relationship.

Finally, perhaps the most significant issue with the "solely outside the U.S." exemption is that it places domestic banks at a disadvantage to foreign rivals that are not subject to the same restrictions in their home countries. Wayne Abernathy, the Vice President of the American Bankers Association, explains that, "[a] lot

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[183] *See* Kalyan Nandy, *Volcker Rule Extension Risks Jobs?*, ZACKS INVESTMENT RESEARCH (Sept. 19, 2011), http://www.zacks.com/stock/news/61017/Volcker-Rule-Extension-Risks-Jobs (explaining with supporting quotes from the CEO of the International Banks Institute that the rule is believed to extend to any foreign bank with operations within the United States, and if this is the case, foreign banks will close any U.S. operations, which currently employ over 200,000 Americans).

[184] *Id.*

[185] A sub-adviser is another management team or firm that manages a sub-advised fund, such as a hedge fund or mutual fund, rather than the firm where the assets are held. *Definition of Sub-Advised Fund*, INVESTOPEDIA, http://www.investopedia.com/terms/s/subadvisedfund.asp#axzz2CFFxISmb (last visited Nov. 14, 2012).

[186] Cheyenne Hopkins & Ian Katz, *Volcker Rule May Be Extended to Overseas Banks With Operations in the U.S.*, BLOOMBERG (Sept. 17, 2011, 12:00 AM), http://www.bloomberg.com/news/2011-09-16/volcker-rule-may-be-extended-to-overseas-banks-with-operations-in-the-u-s-.html.

[187] *Id.*

[188] *Id.*

of what the banks have been doing in recent years to diversify their services are activities that can easily be done by foreign competitors."[189] Further, banks will lose their top traders, and "that ground will have been ceded to hedge funds, foreign financial institutions, and specialist trading firms."[190] In their previously-mentioned study, the GAO admitted that foreign regulators indicated that the Volcker Rule could cause U.S. banks to lose business to their competitors in Europe and elsewhere.[191] Of course, this is an easy argument to make—especially at this speculative stage—but banks in other countries are subject to other, different requirements such as much higher capital requirements for European banks,[192] and it is unclear as to which rule is worse from a bank's perspective.

Even if the rule was effective in eliminating banks' direct risk exposure, there is still the question of whether they will continue to be exposed to such risk in an indirect manner. In regard to the rule failing to decrease banks' risk exposure, Whitehead posits that the rule's prohibited activity by banks will shift to hedge funds, if it has not done so already.[193] Whitehead argues that the Volcker Rule failed to take into account the new relationships within evolving financial markets:

> Over the past thirty years, new market participants—in many cases, hedge funds—have begun to perform bank-life functions that permit banks to extend more credit or do so at lower cost. By causing proprietary trading to move to the hedge fund industry, banks continue to be exposed to the same risks—perhaps less directly than before, but now in an industry also subject to less regulation.[194]

This "be-careful-what-you-wish-for" point is important because shifting the risk to an industry with significantly less regulation not only fails to rectify the concerns that inspired the Volcker Rule, it may also increase such concerns because an industry like hedge funds incentivizes risk-taking.

Regulators have made great attempts to address such issues, but the result is a proposed draft that is 298 pages accompanied by 1,300

[189] *Id.* (internal quotation marks omitted).

[190] *See* McGee, *supra* note 21.

[191] *See* GAO-11-529, *supra* note 76, at 28.

[192] David Enrich, *EU's Banks Must Keep Shields Up*, WALL ST. J. (Oct. 3, 2012, 2:29 PM), *available at* http://online.wsj.com/article/SB10000872396390444223104578034331569558620.html.

[193] Whitehead, *supra* note 9, at 72–73.

[194] *Id.*

questions covering 400 topics.[195] Despite the regulators' best intentions, this increased complexity has made the rule borderline unworkable while also exacerbating its ineffectiveness.[196] The draft itself notes that putting the Volcker Rule into operation "often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice."[197] In attempting to shed light on such subtle distinctions, regulators have provided a possible path for circumventing the ban through its permitted activities.[198] Put differently, it could turn out to be relatively simple for banks to continue to take proprietary bets with their own capital when they choose:

> [S]hutting off one kind of risk taking—proprietary trading—won't necessarily reduce the amount of risks banks take, especially as the crisis recedes further in time and bankers begin to breathe more easily. Rather, there is a risk that it will simply change the type of risk that those institutions take. True, a bank won't be putting its capital on the line in a prop-trading division, but will it compensate by allocating more capital to its market-makers and encouraging them to take more risk? Or by looking for new ways to earn higher returns from new and riskier businesses—the next-generation of subprime structured products, whatever they prove to be?[199]

Even some that have previously supported the Volcker Rule agree with this notion. As former Senator Ted Kaufman, Democrat of Delaware, has said, "the key word in the rules [is] 'exemption' . . . as soon as you see that, it's pronounced 'loophole.' That's what it means in English. . . . I know these folks, these Wall Street guys . . . [y]ou give them the smallest little hole, and they'll run through it."[200] Representative Peter Welch, Democrat of Vermont, added, "I support the concept of the Volcker Rule . . . but these rules aren't going to be effective. We've taken something simple and made it complex."[201] Even Mr. Volcker has admitted to being disappointed with the rule in

[195] Proposed Volcker Rule, 76 Fed. Reg. 68,846-01 (proposed Nov. 7, 2011).
[196] *See* Stewart, *supra* note 23.
[197] Proposed Volcker Rule, 76 Fed. Reg. 68,846-01, 68,849 (proposed Nov. 7, 2011).
[198] Ben Protess, *Banking Industry Revamp Moves Step Closer to Law*, DEALBOOK (Oct. 11, 2011, 9:24 PM), http://dealbook.nytimes.com/2011/10/11/banking-industry-revamp-moves-step-closer-to-law.
[199] *See* McGee, *supra* note 21.
[200] Stewart, *supra* note 23.
[201] *Id.*

its current state, claiming he would "write a much simpler bill."[202]

To further illustrate just how expansive Mr. Volcker's original, relatively simple idea has become, the proposed draft estimates that banks will have to collectively spend more than six million hours putting the rule into effect.[203] The agencies also estimated that 10,000 U.S. banks may eventually spend a combined 1.74 million hours a year complying with the rule.[204] This is a staggering amount of time to spend on an activity that does not generate revenue or provide customer service, especially for a rule that may ultimately be ineffective. All things considered, serious questions remain as to the rule's practicality and effectiveness.

V. RECOMMENDATION

The significance of the issue and potential problems of the current proposed regulation suggest that it may be best to start taking a different direction when it comes to regulating banks' investment activities. The banking crisis and the subsequent bailout of some banks illustrated the significance of the "too-big-to-fail" problem and why we need greater regulation of banks' investment activities. The current approach of the Volcker Rule has proved to be very difficult to define and implement with problems exacerbating the further we go down the rabbit hole. While many would refute some of these problems as speculative, the fact is everything is speculative at this stage, and when dealing with an issue of this magnitude, it is better to take a more measured approach rather than hastily pick a side and hope for the best. The perils of the No Child Left Behind Act,[205] another well-intentioned yet expansive federal regulation that was made in response to a crisis facing this country, support this.[206] As an alternative, a three-component approach would avoid the pitfalls of

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[202] *Id.*

[203] Proposed Volcker Rule, 76 Fed. Reg. 68,846-01, 68,849, 68,938 (proposed Nov. 7, 2011); *see also* Protess, *supra* note 198.

[204] *Id.*; s*ee also The Value of the Volcker Rule*, WASH. POST, Oct. 28, 2011, *available at* http://www.washingtonpost.com/opinions/the-value-of-the-volcker-rule/2011/10/18/gIQATZhUQM_story.html.

[205] 20 U.S.C. § 6316 (2006).

[206] *See* Rachel D. Godsil, *Opinion: No Child Left Behind at 10: Lessons Learned*, THE BERGEN RECORD (Jan. 15, 2012 7:10 AM), *available at* http://www.northjersey.com/news/education/nochild_011512.html (suggesting No Child Left Behind's enactment was "prompted by a sense of crisis"); *see also* Shavar D. Jeffries, *The Structural Inadequacy of Public Schools for Stigmatized Minorities: The Need for Institutional Remedies*, 34 HASTINGS CONST. L.Q. 1, 38 n.147 (2006) (explaining that No Child Left Behind's accountability provisions, while well-intentioned, have resulted in micro-managing).

the Volcker Rule while promoting positive regulation: (1) foregoing a bright-line prohibition of proprietary trading in favor of a principles-based regulation that gives full discretion to the regulatory bodies in penalizing violations of such principles; (2) requiring full disclosure of all investment activity, proprietary or not, by banks to the regulatory bodies on an as-close-to-real-time basis as practicable; and (3) imputing some form of significant personal liability to the board of directors and individual proprietary traders for violations of the rule.

The first step is discarding a black-and-white prohibition of proprietary trading on banks in favor of principles-based regulation that does not prohibit proprietary trading but instead gives the appropriate regulatory bodies the discretion to mandate the elimination and/or stay of banks' particular trading deemed too risky and to penalize egregious violations of the regulation's principles. These principles would include responsible risk-taking that does not put the safety of a bank's continued operations at any risk, due diligence in assessing all trading risk relative to the amount of exposure to the risk, and refraining from taking any position that could be contrary to customers' interests. The stated principles would be the spirit of the rule. This would eliminate the unfairness of an across-the-board prohibition of proprietary trading and escape the unfortunate result of taking away revenue from all banks and the problems that it creates.[207] More importantly, it evades any inherent limitation on the rule's effectiveness. Bright-line rules typically promote a search for loopholes as their very nature lends themselves to "you said this, but you didn't say this" defenses.[208] With a principles-based approach, banks will be unable to make arguments like "this isn't proprietary trading, it's market-making" to evade the regulation because if regulators think it violates the spirit of the rule, such classifications—that are likely under the current approach—

[207] *See* discussion *supra* Part 0.

[208] The Generally Accepted Accounting Principles (GAAP) that provide the rules of financial reporting for U.S. Corporations is a well-known example of a rules-based approach that lends itself to such defenses, and the SEC has been considering changing from GAAP to International Financial Reporting Standards, a principles-based system of accounting. *See* Lance J. Phillips, *The Implications of IFRS on the Functioning of the Securities Antifraud Regime in the United States*, 108 MICH. L. REV. 603, 616–17 (2010) ("[R]ules provide detailed guidance on how an entity should behave. They decline to inquire into the substance of a specific situation and opt instead to focus on the form. Under a rules-based system, a predetermined legal result flows from the existence of certain particularized facts. . . . Conversely, principles provide an entity with a broadly stated directive, but allow the entity flexibility in choosing a course of conduct.").

would be irrelevant.[209] Regulators would have the authority to issue injunctions on particular trading activity whether it is individual or collective. Moreover, they can penalize egregious violations of the principles including violations of any injunction issued. Because this approach could lead to some uncertainty, banks would be able to present a proposed action—similar to the SEC and their "no-action letters"—to the regulatory bodies and receive a timely response as to whether such action would be allowed.[210] Also, the quantitative metrics currently proposed by the regulators could serve as a further guide.

To be able to effectively exercise such authority, the rule would require banks to disclose all trading activity to the regulatory bodies. To be sure, transparency would be limited to only the regulatory bodies, so this does not raise any "trade secrets" concerns. This data would be kept in independent warehouses. In their proposed draft, regulators have raised a similar possibility that banks might turn over their data to independent warehouses.[211] Such disclosure would be made as soon as reasonably practical, and because the independent data warehouses would be online, it should not be difficult to disclose almost immediately. In fact, having individual proprietary traders immediately disclose a trade would limit the extensive time and cost spent on such disclosure, as it eliminates the need to separately collect such data and disclose it at a later time. When analyzing banks' trading activity, regulators must also consider the risk of the activity in the aggregate rather than just that of individual banks because what might not be deemed too risky by an individual bank may constitute undue risk if banks in the aggregate take part in such activity. This does raise the question of whether regulators would be sophisticated enough to adequately analyze such activity. To combat this, regulators charged with responsibility should be paid a competitive salary, and while this requires increased funding, nothing suggests that such increased funding would be any greater than the costs of enforcing the current version of the rule. The severity of this

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209 *See* discussion *supra* Part 0.

210 *See* No Action Letters, SEC (Mar. 5, 2005), *available at* http://www.sec.gov/answers/noaction.htm ("An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a 'no-action' letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and if the staff grants the request for no action, concludes that the SEC staff would not recommend that the Commission take enforcement action against the requester.").

211 *See* Protess, *supra* note 198.

issue suggests that it would be money well-spent. Another way to increase the sophistication of regulators is to improve education, for example, by providing incentives for universities to create undergraduate and/or graduate programs in financial regulation.[212]

The final component of this principles-based approach includes imputing some form of personal liability to banks' boards of directors and individual proprietary traders. Failure to do so is a major shortcoming of the current rule, as the proposed draft only includes a question for public comment on the possibility of "C.E.O. attestation."[213] The proprietary trading targeted by the Volcker Rule "has a 'tails I win heads you lose' character, ensuring that profits are for bank executives and shareholders, but losses are for everybody else."[214] Citigroup's recent settlement with the SEC over fraud charges stemming from some of its proprietary trading is illustrative of this. While Citigroup is paying $285 million to settle the charges, "its chief executive at the time the deal was marketed and closed, Charles Prince, will pay nothing."[215] Changing incentives helps to control risk-taking where expanded regulation falls short.[216] Such personal liability would require trading decision-makers, and those who profit significantly from them, to share the losses when banks fail. Regulation is the only realistic way to institute this personal liability because even if shareholders and creditors significantly pressured banks' boards of directors to amend its corporate charter, they would unlikely succumb.[217] This would be far from unprecedented as even recently, provisions in the Sarbanes-Oxley Act not only create the possibility of personal liability for executives at publicly traded companies, but also subjects them to criminal charges as well.[218] While imputing personal liability to bank executives will

[212] Eugene Ludwig, former Comptroller of the Currency under President Clinton, recently suggested a creation of undergraduate degrees in "regulation and supervision" at the Yale Law School Center for the Study of Corporate Law's Weil, Gotshal & Manges Roundtable on Assessing Dodd-Frank which was held on April 1, 2011. *See* Verstein, *supra* note 70, at 129.

[213] *See* Protess, *supra* note 198.

[214] Claire A. Hill & Richard W. Painter, *Another View: A Simpler Rein Than the Volcker Rule*, DEALBOOK (Oct. 28, 2011, 2:37 PM), http://dealbook.nytimes.com/2011/10/28/another-view-a-simpler-rein-than-the-volcker-rule/.

[215] *See* Stewart, *supra* note 23.

[216] *See* Hill & Painter, *supra* note 214 ("Investment banks were compensated extravagantly when their bets paid off. When their bets failed, they might lose their jobs, but they could take lucrative severance packages with them and walk away from a firm's liabilities. Other people's money was other people's problem.").

[217] *Id.*

[218] *See* 18 U.S.C. § 1514A (2012); 15 U.S.C. § 7242 (2012).

likely lead to more measured risk-taking, increased internal control, and improved information systems when it comes to proprietary trading, the recent fallout of the "rogue trader" at UBS suggests that it is at least possible that an individual trader can expose banks to undue risk without the knowledge of a firm's executives.[219] While this may have been the result of lackluster internal control, the rogue trader has intimated that because he was fearful of losing his job, he kept trading to get out of the hole.[220] Personal liability of individual traders would combat this as it provides something additional to consider rather than simply fearing unemployment.

This recommendation, which grants full discretion to regulators and imputes personal liability on bank directors/executives, will have significant opposition, but there is at least one person who would support it: Paul Volcker, himself. Mr. Volcker, expressing some of his disappointment with the current version of the rule to the New York Times, added, "I'd write a much simpler bill. I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I'd have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them."[221]

VI. CONCLUSION

The current version of the Volcker Rule, despite its good intentions, will fail to achieve its goal of protecting American citizens from hazardous risk-taking by banks backed by an implicit too-big-to-fail safety net from the U.S. government. Adequately distinguishing proprietary trading from permitted traditional bank activities such as hedging and market making, as is necessary in implementing a bright line rule, has proved to be incredibly difficult. Both the legislature and its regulatory bodies have gone to great lengths, but it seems that with every additional consideration, the problems of the current Volcker Rule only intensify. Moreover, the American citizens—whom the rule seeks to protect in troubling economic times—face adverse effects from the rule, whether it be direct, such as facing additional bank fees created by banks to make up for their costs under the rule,

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[219] Noreen Malone, *A Rogue Trader at UBS Lost $2 Billion*, NEW YORK MAG. (Sept. 15, 2011, 9:00 AM), *available at* http://www.nymag.com/daily/intel/2011/09/a_rogue_trader_at_ubs_lost_2_b.html.

[220] *See* Rupert Neate, *Tearful Trader Kweku Adoboli Tells Trial: 'UBS was my Family'*, THE GUARDIAN (Oct. 26, 2012, 2:39 PM), *available at* http://www.guardian.co.uk/business/2012/oct/26/trader-kweku-adoboli-trial-ubs?newsfeed=true.

[221] Stewart, *supra* note 23.

or indirect, such as banks decreasing lending or lending at less favorable rates due to the loss of revenue from proprietary trading. The common thread of these problems with the current rule is that they are all a consequence of its bright-line nature in prohibiting all proprietary trading.

The recommendation put forth in this Comment not only eliminates this attempt at a black-and-white rule and replaces it with a more appropriate principles-based approach, but it goes even further. By requiring transparency in all trading activities on a close-to-real-time basis, this Comment's principles-based approach forces banks to put everything on the table, which should increase the probability of spotting a potential problem before it snowballs into catastrophic territory. This is because full disclosure by all banks allows regulators to see the entire picture at all times such as the aggregate of the banks' trading activity, rather than having to piece bits together. Finally, imputing some personal liability to banks' boards of directors and individual proprietary traders provides a direct attack on the "too-big-to-fail" problem.

Whether or not in favor of an approach similar to this Comment's recommendation, the legislature and regulatory bodies need to reconsider their current approach. A "well, we've come this far" attitude is inappropriate considering the magnitude of the issue and the current state of the U.S. economy. Many believe reinstating the Glass-Steagall Act could solve all of this, but as stated, such a belief is an oversimplification because the Act would not have prevented the banking crisis and its taxpayer-funded bailout. Still, it would have limited the extent of the crisis, and thus, we should learn from the hastily-done repeal of Glass-Steagall. When it comes to regulating the American economy, before acting, it is imperative to take the time to sufficiently consider the possible repercussions. A failure to do so would result in taking an undue risk at the possible expense of American taxpayers. Sound familiar?