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DICTIONARIES FAIL: THE VOLCKER RULE'S RELIANCE ON
DEFINITIONS RENDERS IT INEFFECTIVE AND A NEW
SOLUTION IS NEEDED TO ADEQUATELY REGULATE
PROPRIETARY TRADING.

R. Rex Chatterjee

Abstract

In the wake of the recent financial crisis, Congress enacted legislation to regulate the proprietary trading activities of Wall Street banks. The Volcker Rule, passed into law as section 619 of the Dodd-Frank Act, bans proprietary trading for deposit-taking banks and bank-holding companies with deposit-taking subsidiaries or affiliates. It nevertheless allows these institutions to continue to trade on behalf of customers, a category of transactions necessary for the healthy functioning of both the U.S. and global financial systems. The Rule proposes that regulators devise rules to distinguish between permissible, often client-facing trades, and impermissible proprietary trades. The rules rely on definitions and metrics to form bright-line distinctions. The thesis of this article is that such a system is doomed to fail because of inherent methodological flaws.

This article analyzes the regulation of banking entities under the Glass-Steagall Act of 1933 in order to demonstrate the successful implementation of a structure-based regulatory regime that separated investment banks from commercial banks. As a result, proprietary trading activities were structurally insulated from institutional access to the Federal Reserve Bank's Discount Window. This article acknowledges the argument that a return to a Glass-Steagall-style regulatory regime is infeasible following the passage of the Gramm-Leach-Bliley Act of 1999, which gave rise to modern financial institutions. This explains why the Volcker Rule focuses on transactions instead of structure.

This article concludes by proposing an alternative regulatory plan that would sidestep the problem-laden task of attempting to distinguish proprietary from non-proprietary trading on a bright-line basis; instead, the proposed regime would focus on regulating all sales and trading activities together on a structural level. The plan would cleave trading operations from the banking entities' structures by separating them into subsidiary entities with independent capitalization and ownership. This plan is engineered to isolate traders from the moral hazards created by institutional access to the Federal Reserve Discount Window. Furthermore, it would shackle the continuance of their client-serving operations to the risks taken in their proprietary books.

I. INTRODUCTION

This article analyzes issues arising from the proposed implementation of Section 619 of the Dodd-Frank Act, also known as the Volcker Rule. First proposed by Paul Volcker, former Chairman of the Federal Reserve Bank, the Rule tightly restricts the ability of banking entities to engage in certain financial activities, namely, proprietary trading, investing in hedge funds, and investing in private equity funds. Congress targeted these activities because of their high potential for creating substantial financial risk, on both a firm and system-wide level. The Rule specifically targets banking entities with access to the Federal Reserve Bank's Discount Window¹ because the availability of "cheap" federal funds can yield a greater tolerance for risk at the expense of the U.S. taxpayer. Ultimately, this creates a moral hazard problem. This article focuses on the inefficiency of the Volcker Rule in regulating banking activity, specifically in terms of prohibiting proprietary trading.

Part II of this article provides a concise discourse on the ways in which financial reform legislation after the crash of 1929 focused on the securities dealing and investment banking activities of commercial banks. It analyzes the Glass-Steagall Act of 1933, which banned commercial banks from engaging in securities dealing, and the effect of its eventual repeal through the Gramm-Leach-Bliley Act of 1999. The legislation process for the Dodd-Frank Act originated as a reaction to a major financial crisis in the United States. In this way, it is similar to the process which yielded the Glass-Steagall Act of 1933. Glass-Steagall isolated the business of commercial banking from that of investment banking on an institutional level. The recombination of these business lines within modern financial institutions, as permitted by Gramm-Leach-Bliley, gave rise to certain perverse incentives which the Volcker Rule has been designed to address. Part II then proceeds to explain why a return to Glass-Steagall-style regulation of the financial industry would be impractical in the present situation because of developments in the structures of financial institutions since 1999. The section concludes with the notion that the Volcker Rule effectuates the same principles of financial regulation as Glass-Steagall without its burdensome restrictions on the structure of financial institutions.

Part III begins with an exploration of exactly what proprietary trading is. The Glass-Steagall Act prohibited US depository institutions from engaging in proprietary trading. Proprietary trading is regarded as

¹ The Discount Window, as it is referred to here, is a credit facility operated by the US Federal Reserve Bank to allow financial institutions to borrow money from the Federal Reserve in order to cover a liquidity shortage. The loans are generally made on a secured basis and are made at the "discount rate." For the purposes of this article, it is important to understand simply that financial institutions with access to the Discount Window have access to federal government money at a very low interest rate. For further reading, see generally *Discount Window*, WIKIPEDIA, http://en.wikipedia.org/wiki/Discount_window (last modified Sept. 14, 2011, 10:11 AM). See also, *Discount Window*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/discountwindow.asp> (last visited Oct. 25, 2011).

one of the many causes of financial instability which gave rise to the system-wide crash and subsequent recession. The section then proceeds to highlight certain instances where proprietary trading caused significant instability within major US financial institutions. It concludes with a discussion of public sentiment in reaction to proprietary trading.

Part IV of this article focuses on the interconnections between proprietary trading and so-called “permitted banking activities.” Despite the harm that proprietary trading caused during the crisis of 2008-2009, it would cripple financial markets worldwide if all proprietary trading were made illegal in one fell swoop of the legislative pen. The Volcker Rule includes a carve-out provision to maintain the legality of certain proprietary trading activities. These activities are necessary to maintain adequate liquidity in financial markets, support access to capital markets through underwriting, and to pursue other legitimate business purposes. However, at the margins, it becomes difficult to distinguish proprietary trading from many of the permitted banking activities. Significant issues arise in attempting to distinguish one set from the other. Proprietary trading is defined in Part III. Part IV discusses the set of permitted activities, and then proceeds to discuss how banking entities may seek to disguise proprietary trading activities as permitted activities in order to evade the Volcker Rule.

Part V of this article discusses different potential definitions of a set of key terms which set the boundary between proprietary trading and permissible banking activities. It will be necessary for a regulatory system to precisely and predictably distinguish the two. Overly broad definitions will negatively impact capital market liquidity as well as myriad types of financial transactions worldwide. Overly narrow definitions will render the statute meaningless and will do little to prevent a future crisis. Imprecise definitions will lead to a cat-and-mouse game between banking entities and regulators. The statute, as written, leaves much discretion to US financial regulatory agencies.

Part VI concludes that the Volcker Rule will be ineffective in its mission of prohibiting harmful proprietary trading. Furthermore, the section hypothesizes that regulatory regime that will be created to enforce the rule will be overwhelmed by largely unnecessary tasks and that agencies will be beset by litigation over the definition of the key terms highlighted above.

Part VII, an epilogue to this article’s analysis of the Volcker Rule, suggests an alternative regime for the regulation of proprietary trading. The alternative regime utilizes bankruptcy-remoteness and the partnership model as two techniques to align managerial incentives with an amount of risk-aversion necessary for the ongoing health of the global financial system. The section provides a skeleton-level outline of the regime and notes where future study will be necessary to develop it. It analyzes potential ramifications of the proposed regime and discusses barriers to its implementation.

II. GLASS-STEAGALL, GRAMM-LEACH-BLILEY, AND THE ROAD TO THE 2008 CRISIS

A. *The Role of Proprietary Trading in Shaping the Glass-Steagall Act of 1933*

The stock market crash of 1929 triggered upwards of 11,000 commercial bank failures between the years 1930 and 1933.² In response to the catastrophic event, Congress passed the Glass-Steagall Act, also known as the Banking Act of 1933.³ The congressional hearings on the bill examined the causes of the crash and identified specific banking practices that led to instability within the financial system.⁴ Many of the identified practices were proprietary in nature, particularly banks' practice of underwriting transactions and investments in securities.⁵ Members of Congress viewed these activities with skepticism because the activities subjected commercial bankers—entrusted to give depositors sound and impartial investment advice—to the pecuniary financial incentives of investment bankers and securities dealers, who generate profits by underwriting, sales, trading, and distribution of securities.⁶ Congressmen were of the opinion that as the securities businesses of banks grew larger, the pecuniary incentives became more powerful and increasingly destabilized the US financial system, partially causing the 1929 crash.⁷

In 1932, Congress formed the Pecora Commission to investigate banking practices in the years leading up to 1929 crash.⁸ The Commission published its findings in 1934 and largely confirmed Congress's proposed 'factors' that gave rise to the 1929 crash, including proprietary trading.⁹ For example, the Commission found that investment banks' incentives conflicted with the fiduciary duties owed to

² Matthew Bender & Company, Inc., § 96.02 *Separation of Investment and Commercial Bank Services*, in *BANKING LAW* 1 (2010).

³ Banking Act of 1933, 12 U.S.C. § 24 (1994).

⁴ See generally Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 *BANKING L.J.* 483 (1971).

⁵ S. REP. NO. 73-77 (1933).

⁶ See, e.g., 75 CONG. REC. 9875, 9912 (1932) (remarks of Senator Bulkley) (The banker ought to be regarded as the financial confidant and mentor of his depositors. . . . Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.)

⁷ See, e.g., 75 CONG. REC. 9904 (1932) (statement of Senator Walcott) ("Most of the banks had been engaged in underwriting, and still are. The security business became such an important part of the operations of some of the banks, particularly of two or three of our larger banks, that some fear was occasioned that they would get away from the strictly commercial business for which they were organized and put out securities of doubtful value. At any rate, there was a conflict of opinion; there was a conflict between the business of marketing securities and the business of protecting depositors' money.").

⁸ See generally GEORGE J. BENSTON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED* (1990).

⁹ See generally S. REP. NO. 73-1455 (1934).

commercial bank depositors.¹⁰ The report stated that if a bank can act as both a dealer and as a customer agent on the same transaction, then it has an inherent conflict of interest.¹¹ These findings further substantiated Congress's opinion that as banks increased their involvement in securities trading, their pecuniary incentives became more powerful, resulting in behavior that destabilized the U.S. financial system and partially caused the 1929 crash.¹²

B. The Glass-Steagall Act of 1933 and the Effect of its Repeal Through the Gramm-Leach-Bliley Act of 1999

The securities activities of commercial banks led to the enactment of the Glass-Steagall Act. Glass-Steagall cleaved investment banking from commercial banking, thus curbing the ability of commercial banks to engage in securities dealing (i.e., trading securities for their own accounts).¹³ Glass-Steagall also prohibited securities underwriters from taking deposits¹⁴ and it likewise prevented member banks from affiliating with companies that primarily engaged in underwriting or securities dealing.¹⁵ Commercial banks had to cease their securities dealing activities. Many banks chose to spin off their investment banking and securities businesses into separate firms. For example, J.P. Morgan & Co. split into two entities: a commercial bank keeping the name J.P. Morgan & Co. and an investment bank called Morgan Stanley.¹⁶ Although commercial banks eventually expanded their ability to underwrite securities even under the Glass-Steagall Act's regulations,¹⁷ it strictly prohibited banks from engaging in proprietary trading.

¹⁰ *Id.* at 87.

¹¹ *Id.* at 20 ("The New York Stock Exchange has adopted a rule prohibiting a member, when acting as a broker, from buying or selling for his own account or that of a partner or for any account in which he or a partner is interested, securities, the order for the sale or purchase of which has been accepted by him or his firm or a partner for execution, except under the conditions specified in the rule. However assiduous the exchange authorities may be in protecting the rights of the customer, the conflict between the broker's self-interest and his duty to his customer is present, and the customer's welfare is thereby endangered.").

¹² See, e.g., 75 CONG. REC. 9904 (1932) (statement of Senator Walcott) ("Most of the banks had been engaged in underwriting, and still are. The security business became such an important part of the operations of some of the banks, particularly of two or three of our larger banks, that some fear was occasioned that they would get away from the strictly commercial business for which they were organized and put out securities of doubtful value. At any rate, there was a conflict of opinion; there was a conflict between the business of marketing securities and the business of protecting depositors' money.").

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* (2001).

¹⁷ *Id.* ("In the 1980s, commercial banks began trying to push back on Glass-Steagall's prohibition on securities underwriting. They started with commercial paper, but quickly moved on to corporate debt securities. In 1989, the Fed permitted J.P. Morgan to underwrite a bond offering by the Xerox Corporation. This was the first time since the institution of Glass-Steagall that a commercial bank was allowed to underwrite corporate debt.").

The 1999 passage of the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999, effectively reversed the changes made by the Glass-Steagall Act.¹⁸ It repealed Glass-Steagall's prohibition of commercial banks from affiliating with securities firms or investment banks and engaging in proprietary securities dealing. It also amended the Bank Holding Company Act¹⁹ to make mergers between banks, insurers, and securities firms legal under a holding company structure.²⁰

Nine years after the repeal of the Glass-Steagall restrictions by Gramm-Leach-Bliley, the United States underwent a financial crisis similar in magnitude to the 1929 crash. Nobel laureate economist Paul Krugman has stated that the repeal of the Glass-Steagall reforms was one of the causes of the financial crisis of 2008.²¹ Others have joined in blaming Gramm-Leach-Bliley's removal of Glass-Steagall's restrictions on the trading activities of banks for the economic calamity.²² Without those restrictions, large banking entities could allow their investment arms to take on increased risk in their trading activities while relying on their commercial bank's access to the Federal Reserve Bank's Discount Window as a financial backstop.²³ This reintroduced what economists call a "moral hazard" for banks²⁴—a perverse incentive, the prevention of which is a main purpose of lawmaking itself.

¹⁸ Gramm-Leach-Bliley Act, Pub. L. No. 106-02, 113 Stat. 1338 (1999); *see also* S. 900, 106th Cong. (1999).

¹⁹ 12 U.S.C. §§ 1841-50 (amended 1999).

²⁰ Gramm-Leach-Bliley Act.

²¹ Paul Krugman, *Bankers Without a Clue*, NEW YORK TIMES ONLINE (Jan. 14, 2010), <http://www.nytimes.com/2010/01/15/opinion/15krugman.html>. ("But the truth is that the United States managed to avoid major financial crises for half a century after the Pecora hearings were held and Congress enacted major banking reforms. It was only after we forgot those lessons, and dismantled effective regulation, that our financial system went back to being dangerously unstable.")

²² Damian Paletta & Kara Scannell, *Ten Questions for Those Fixing the Financial Mess*, THE WALL STREET JOURNAL ONLINE (Mar. 10, 2009), <http://online.wsj.com/article/SB123665023774979341.html>. ("President Barack Obama argued on the campaign trail that one bill – the Gramm-Leach-Bliley Act of 1999 – led to deregulation that helped cause the crisis. Among other things, that law allowed for the creation of giant financial supermarkets that could own investment banks, commercial banks and insurance firms, something banned since the Great Depression. Its passage, critics say, cleared the way for companies that were too big and intertwined to fail.")

²³ THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 18 (Richard Scott Carnell, Jonathan R. Macey & Geoffrey P. Miller eds., Aspen Publishers 4th ed. 2009).

²⁴ Robert B. Ekelund & Mark Thornton, *More Awful Truths About Republicans*, LUDWIG VON MISES INST. (Sep. 4, 2008), <http://mises.org/daily/3098>. ("The Financial Services Modernization Act of 1999 would make perfect sense in a world regulated by a gold standard, 100% reserve banking, and no FDIC deposit insurance; but in the world as it is, this 'deregulation' amounts to corporate welfare for financial institutions and a moral hazard that will make taxpayers pay dearly. Such government privileges are nothing new to Republicans—consider the effective subsidies to the pharmaceutical, sugar, and steel industries—but this particular gift to financial institutions is what allowed the credit bubble to expand to such absurd proportions, because it allowed banks of all types to engage in increasingly risky transactions and to greatly expand the leverage of their balance sheets.")

C. The Impracticalities of a Return to Glass-Steagall-style Regulation in 2011

Krugman argued that as Congress forgot the lessons it learned from the Pecora Commission, it set itself up for a replay of the 1929 crash.²⁵ He identified the need for new legislation that would prevent a future crash of a similar nature from occurring.²⁶ If figures such as Krugman thought that the repeal of Glass-Steagall contributed significantly to the 2008 crash, it follows logically that they argued for a return to Glass-Steagall-type regulation.²⁷ In December 2009, Senators John McCain and Maria Cantwell jointly proposed to reenact the Glass-Steagall Act,²⁸ but the bill did not pass.²⁹

A return to Glass-Steagall's restrictions on financial conglomerates—e.g. combinations of commercial banking, investment banking, and insurance underwriting—would be problematic because it would force major U.S. financial institutions to dissect themselves and reduce their global competitiveness in order to comply.

For example, Citicorp's (a commercial bank) merger with Travelers Group (an insurer) and its subsequent acquisition of SmithBarney (a brokerage) was legalized by the Gramm-Leach-Bliley Act in 1999.³⁰ It would have to be unwound if the United States were to return to a strict Glass-Steagall regulatory regime. In another example, Bank of America acquired Merrill Lynch on September 14, 2008, after the latter's losses from trading in collateralized debt obligations (CDOs) threatened to collapse the firm.³¹ The acquisition illustrates how structural combinations between commercial banks and securities firms are too intertwined and vital in today's financial markets to be undone. The acquisition gave Bank of America, a leader in the U.S. financial sector, a stronger competitive position worldwide.³²

It is important to note that the financial industry, like everything else, is becoming increasingly globalized as the new millennium progresses. Among the many consequences of globalization is increased international competition for business. The ability of businesses to

²⁵ *Id.*

²⁶ *Id.* ("Sooner or later, this runaway system was bound to crash. And if we don't make fundamental changes, it will happen all over again.").

²⁷ Paul Krugman, *Glass-Steagall, Part Deux*, N.Y. TIMES BLOG (Jan. 21, 2010), <http://krugman.blogs.nytimes.com/2010/01/21/glass-steagal-part-deux>.

²⁸ *Press Release of Senator Cantwell* (Dec. 16, 2009), <http://cantwell.senate.gov/news/record.cfm?id=320823>.

²⁹ Banking Integrity Act, S. 2886, 111th Cong. (2009) (referred to S. Comm. on Banking, Housing and Urban Affairs, Dec. 16, 2009, no further action taken.); *see also* Glass-Steagall Restoration Act, H.R. 4375, 111th Cong. (2009) (referred to H. Comm. on Financial Services, Dec. 16, 2009, no further action taken).

³⁰ *See generally* Lissa Lamkin Broome & Jerry W. Markham, *The Gramm-Leach-Bliley Act: An Overview* (2001), available at http://www.symtrex.com/pdfdocs/glb_paper.pdf.

³¹ Matthew Karnitsching, Carrick Mollenkamp, & Dan Fitzpatrick, *Bank of America to Buy Merrill*, WALL ST. J. (Sept. 15, 2008), at A1.

³² *Id.* ("Merrill could give Bank of America strength around the world, including emerging markets such as India. And Merrill is also strong in underwriting, an area Bank of America identified last week at an investors' conference where it would like to be more aggressive.").

relocate across jurisdictions creates some level of international regulatory competition to attract business. The nation with the most robust presence of banks will find that its corporations have cheaper access to capital than nations where the banking sector is weaker. Therefore, shifts in a nation's banking law affect all businesses, not just the banking businesses. In this light, it is easy to see why maintaining and increasing the strength of the U.S. economy requires a robust U.S. corporate sector, and thus a robust U.S. banking sector. The U.S. government does not want banks to flee the U.S. for England, the EU, or Asia. From the U.S.'s standpoint, therefore, it is imperative that U.S. legislation not disadvantage U.S. banks compared to their European and Asian counterparts, because then business would flow from the former to the latter.³³

Returning to a Glass-Steagall-style regulation would have substantial negative effects on the banking industry. For example, if Congress were to reenact Glass-Steagall through the proposed (but defeated) Banking Integrity Act of 2009, Bank of America would be forced to sell the brokerage unit of Merrill Lynch, which it bought through a government-orchestrated sale.³⁴ This would have three major consequences. The first is intuitive: Bank of America would lose a huge advantage it gained over other U.S. and (more importantly) foreign financial institutions—the acquisition of a powerful brokerage business. Second, it would force the sale in a recessionary period, which could lead to systemic effects and further hurt a troubled global financial system.³⁵ Third, it would make the U.S. government look foolish because the government had just finished engineering not only the sale of Merrill Lynch to Bank of America, but also the sale of Bear Stearns to J. P. Morgan, and others. Returning to Glass-Steagall would illegalize those combinations and force their undoing.³⁶

³³ It may be said that this point imputes a "protectionist" or "neomercantilist" agenda to the U.S. government in its regulatory treatment of U.S. banks. The U.S. government is doing nothing, however, to affect the regulatory regimes to which U.S.-based banks are subjected in their operations in foreign nations, nor is it discriminating against foreign banks in their regulatory treatment in the U.S. (compared with the domestic regulatory treatment of U.S. banks). Rather than protecting U.S. banks against competition from foreign banks, the U.S. is trying to provide a total package (regulatory regime being just one component of what an international bank considers in choosing where to base its business) that is competitive with, if not outrightly victorious over, the packages offered by other nations. The U.S. is not trying to help its own banks compete against foreign banks; the U.S. itself is competing as a nation against foreign nations for the home-basing and business of international banks.

³⁴ See Cyrus Sanati, *Yearning for Glass-Steagall on Capitol Hill*, N.Y. TIMES DEALBOOK (Jan. 22, 2010, 3:17 PM), <http://dealbook.nytimes.com/2010/01/22/yearning-for-glass-steagall-on-capitol-hill/> ("Under the Volcker Rule, for example, Bank of America would still be able to keep Merrill Lynch's brokerage services and investment banking units. But if Glass-Steagall were to return, Bank of America would need to sell virtually all of Merrill Lynch and return to being just a retail bank.")

³⁵ *Id.* ("I think introducing Glass-Steagall now across the board in a weak economy would be counterproductive because you would force sales and the like," said Representative Barney Frank of Massachusetts, the Democratic chairman of the House Financial Services Committee and a supporter of the president's plan.)

³⁶ *Id.* ("That major change is too much for some lawmakers to swallow, especially after the government helped orchestrate Bank of America's acquisition of Merrill Lynch in the first place in 2009 — not to mention JPMorgan Chase's takeover of Bear Stearns earlier in the year.")

While it seems that Congress was focused on re-regulating the financial industry in the same vein as Glass-Steagall, for the aforementioned reasons, it is also apparent that a purely structure-based regulatory regime—one which focuses on the structure of financial institutions as commercial banks, investment banks, insurers, etc.—would not be feasible in 2011.³⁷ The Obama administration felt that the system had grown too structurally complex and that broad structural regulation unilaterally undertaken by the U.S. government would be ignorant of many of the positive developments and unchangeable realities of the modern global financial system.³⁸ The government opted instead for stronger capital requirements under the Basel III international banking standard,³⁹ hoping to create a larger equity cushion for banks, and hoping for the Volcker Rule to eliminate the pernicious conflicts of interest that Glass-Steagall had sought to eradicate.⁴⁰

D. The Volcker Rule as an Implementation of Glass-Steagall Regulation Principles

The Volcker Rule, codified as 12 U.S.C. § 1851, has regulatory ambitions very similar to the Glass-Steagall Act. The Volcker Rule proceeds not on a structural basis (saying what commercial banks can or cannot own) but rather on an “activities” basis (saying what commercial banks can or cannot do). The Volcker Rule’s proprietary trading provisions seek to limit the types of trades that so-called “banking entities” are able to make for their own accounts in an effort to prevent these institutions from relying on the federal backstop⁴¹ and using depositor money to make proprietary financial bets.⁴² Moreover, taxpayers do not want to be responsible for the bailout of a financial institution that has brought itself to financial calamity because of proprietary trading activities, whether undertaken with the traders’ reliance on the federal backstop (and thus exposure to the moral hazard)

³⁷ See *supra* text accompanying notes 31-44.

³⁸ Michael Hirsh, *An Odd Post-Crash Couple*, NEWSWEEK (Dec. 14, 2009), <http://www.newsweek.com/2009/12/14/an-odd-post-crash-couple.html>.

Obama administration officials have dismissed the idea that the financial sector should or can be changed in more fundamental ways than they are now proposing. You can’t turn back the clock, they say... ‘I think going back to Glass-Steagall would be like going back to the Walkman,’ says one senior Treasury official.

Reinstating Glass-Steagall would be almost akin to unscrambling an egg. By the time it was formally repealed in 1999, commercial banks like Citigroup had been moving gradually into investment banking for nearly two decades. Glass-Steagall had come under continual pressure as traditional commercial banks sought to follow their old clients into the capital markets, issuing stocks and bonds instead of borrowing the old way. Innovators like JPMorgan had gone global while the law still reigned at home, becoming big in the Euromarkets. *Id.*

³⁹ Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, revised June 2011), *available at* <http://www.bis.org/publ/bcbs189.pdf> [hereinafter *Basel III*].

⁴⁰ *Id.*

⁴¹ This federal backstop is another term for the “Discount Window” the Federal Reserve makes available to banks for inexpensive intraday loans. See *supra* note 1.

⁴² 12 U.S.C. § 1851(d)(1)(A) *et. seq.*

or not. Taxpayers would be responsible for financial contribution to the banking entities, however, through the U.S. government's commitments under the FDIC.

While Glass-Steagall focused on the structure of banks and prohibited combinations of commercial banks with investment banks or insurance companies (among other types of financial institutions), the Volcker Rule proceeds by limiting the activities of "banking entities." This begs the question of what exactly *is* a banking entity? Subsection (h)(1) of the Volcker Rule bases its definition of "banking entity" on the definition of "insured depository institution" under the Federal Deposit Insurance Act (12 U.S.C. § 1813).⁴³

The Federal Deposit Insurance Act defines "insured depository institution" as "any bank or savings association the deposits of which are insured by the Corporation pursuant to this Act [12 U.S.C. §§ 1811 et seq.]."⁴⁴ This definition conforms to the rationale stated earlier for the enactment of the Volcker Rule: to prohibit entities with access to deposit insurance from taking proprietary bets using deposits while relying on a federal government backstop. In this way, the Volcker Rule tracks Glass-Steagall as a reaction to the risk-taking activities of deposit-taking banks.

The focus on the FDIC shows that the government is concerned mainly with regulating risk-taking by banks to which the U.S. taxpayer provides protection in the event of insolvency. This includes traditional commercial banks with securities and brokerage businesses, such as Bank of America, J.P. Morgan Chase, Wells Fargo, etc. But what about the two major Wall Street investment firms, Goldman Sachs and Morgan Stanley, which were not traditionally commercial, deposit-taking institutions with FDIC insurance? The Volcker Rule expands upon the definition in § 1813 by also including institutions which control insured depository institutions.⁴⁵ Because Goldman Sachs and Morgan Stanley became Bank Holding Companies during the financial crisis of 2008 and

⁴³ 12 U.S.C. § 1851(h)(1):

(1) Banking entity. The term "banking entity" means any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (*12 U.S.C. § 1813*)), 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 Banking Act of 1978, and any affiliate or subsidiary of any such entity. For purposes of this paragraph, the term "insured depository institution" does not include an institution that functions solely in a trust or fiduciary capacity, if--

(A) all or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity;

(B) no deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution;

(C) such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others or make commercial loans; and

(D) such institution does not--

(i) obtain payment or payment related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act (*12 U.S.C. 248a*); or

(ii) exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act (*12 U.S.C. 461(b)(7)*).

⁴⁴ 12 U.S.C. § 1813(c)(2).

⁴⁵ 12 U.S.C. § 1851(h)(1).

now control insured depository institutions under the 12 U.S.C. § 1813(c)(2) definition,⁴⁶ they themselves are now within the purview of the Volcker Rule as “banking entities” under the 12 U.S.C § 1851(h)(1) definition. Goldman and Morgan were the last two “independent investment banks” on Wall Street before their conversion to Bank Holding Companies and submission to regulation by the Federal Reserve.⁴⁷ After their conversion, all of Wall Street’s major players had access to the Federal Reserve’s Discount Window, which strikes many as somewhat of a windfall. However, because access to the Discount Window facility requires all of the banks to be or control insured depository institutions,⁴⁸ the major banks and bank holding companies all fall within the Volcker Rule’s definition of a “banking entity” and are thus subject to its restrictions.

However, as stated before, the U.S. government has an interest in enabling its banks to compete on an international scale. Doing this requires avoiding the imposition of restrictive regulation on domestic banks while allowing foreign banks unfettered access to the U.S. financial system. To maintain an even playing field, U.S. branches of foreign banks qualify as “banking entities” under the Volcker Rule and are subject to the same restrictions as their U.S. counterparts. The Federal Deposit Insurance Act contains a provision which reads, “The term ‘insured depository institution’ includes any uninsured branch or agency of a foreign bank or a commercial lending company owned or controlled by a foreign bank for the purposes of section 1818 of this title [12 U.S.C.S. § 1818].”⁴⁹ Thus, the U.S. branches of foreign banks (such as UBS, Credit Suisse, Deutsche Bank, Nomura, Mizuho, etc.) are banking entities under the Volcker Rule’s definition in 12 U.S.C. § 1851(h)(1).

In enacting the Volcker Rule, Congress seemed to have been trying to lasso in the same group of entities as it did when enacting the Glass-Steagall Act. In both pieces of financial legislation, Congress sought to place restrictions on the activities of deposit-taking banks operating in the United States and whose deposits would be backstopped by the U.S. government. Banks with this sort of backstop would be subject to a moral hazard: reliance on federal insurance of their deposits could artificially enlarge the banks’ appetites for risk, to their own detriment and that of the global financial system. The Glass-Steagall Act and the Volcker Rule aimed to constrain, if not eliminate, the influence of this

⁴⁶ As *Goldman and Morgan Shift, a Wall St. Era Ends*, N.Y. TIMES DEALBOOK (Sept. 21, 2008, 9:35PM), <http://dealbook.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies>. (“In its statement, Goldman said that it would become the nation’s fourth-largest bank holding company, with its small existing deposit-taking units to be rolled into GS Bank USA. Morgan Stanley will convert its Utah industrial bank into a deposit-taking national bank, to be called Morgan Stanley Bank.”).

⁴⁷ *Id.* (“Goldman Sachs and Morgan Stanley, the last two independent investment banks, will become bank holding companies, the Federal Reserve said Sunday night, a move that will fundamentally alter the landscape of Wall Street.”).

⁴⁸ 12 U.S.C. § 1811.

⁴⁹ 12 U.S.C. § 1813(c)(3).

moral hazard. However, they went about their mission in separate ways. Glass-Steagall took a structural approach, as discussed.⁵⁰ It chalked out categories of entities, such as commercial banks, investment banks, insurance companies, etc., and prevented combinations between commercial banks and others.⁵¹ The Volcker Rule does not focus on structure. It defines only one set of entities with which it is concerned: the “banking entities” discussed above. The Volcker Rule regulates the entities’ activities, designating as “impermissible” those activities which Congress suspects would give rise to a moral hazard problem for the banking entity.⁵²

The Volcker Rule takes a two-pronged approach in regulating the activities of banking entities. Its title reads, “Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.”⁵³ The first prong deals with proprietary trading activities of banking entities and prong two focuses on the activities of banking entities in relation to hedge funds and private equity funds. For the sake of maintaining a tight focus, this article shall focus solely on the prohibition of proprietary trading.

III. THE ROLE OF PROPRIETARY TRADING IN THE 2008 FINANCIAL CRISIS

A. *What is Proprietary Trading?*

The Volcker Rule defines “proprietary trading” in the following manner:

The term “proprietary trading,” when used with respect to a banking entity or nonbank financial company supervised by the Board, means 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 Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.⁵⁴

This definition lays the foundation for what ultimately becomes a web of defined terms used to circumscribe the trading activities that Congress wished to prohibit. It is important to unpack these terms piece by piece.

⁵⁰ 12 U.S.C. § 24 (1994); *see supra* pp. 10-13.

⁵¹ *Id.*

⁵² 12 U.S.C. § 1851 (h)(4).

⁵³ 12 U.S.C. § 1851.

⁵⁴ 12 U.S.C. § 1851(h)(4).

The second clause of the first sentence, “when used with respect to a banking entity or nonbank financial company supervised by the Board,”⁵⁵ states the two classes of entities for which the term “proprietary trading” shall be defined by the definition in 12 U.S.C. § 1851(h)(4). For entities that are neither banking entities nor nonbank financial companies supervised by the Board (such as foreign banks doing business in foreign territories), the term proprietary trading is *not* defined under the definition in 12 U.S.C. § 1851(h)(4). Furthermore, it bears mentioning that while this definition of the term “proprietary trading” is the same with respect to nonbank financial companies supervised by the Board⁵⁶ as it is to banking entities,⁵⁷ it does not mean that proprietary trading is *prohibited* for nonbank financial companies supervised by the Board. Banking entities cannot engage in proprietary trading,⁵⁸ but nonbank financial companies supervised by the Board can. They are merely subject to more stringent capital requirements and quantitative limits with regard to their proprietary trading activities.⁵⁹

The next important phrase is “engaging as a principal.”⁶⁰ Since the statute does not further define the term, it is necessary to look to industry definitions. The investment encyclopedia *Investopedia* defines “principal” with regard to trading as “[t]he main party to a transaction, acting as either a buyer or seller for his/her own account and risk.”⁶¹ It is commonly defined in opposition to the term “agent,” which *Investopedia* defines as “[a]n individual or firm that places securities transactions for clients.”⁶² With the term “engaging as a principal,” Congress is targeting traders who are trading on their own impetus and for their own profit, not to match a customer order, or “customer flow” as it is called on trading floors.

The phrase which follows is “for the trading account of the banking entity or nonbank financial company...”⁶³ The term “trading account” is further defined in the following manner:

The term “trading account” means any account used for acquiring or taking positions in the securities and instruments described in paragraph (4) principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange

⁵⁵ *Id.*

⁵⁶ 12 U.S.C. § 1851(h)(3).

⁵⁷ 12 U.S.C. § 1851(h)(1).

⁵⁸ 12 U.S.C. § 1851(a)(1)(A).

⁵⁹ 12 U.S.C. § 1851(a)(2).

⁶⁰ 12 U.S.C. § 1851(h)(4).

⁶¹ *Principal*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/principal.asp> (last visited Oct. 20, 2011).

⁶² *Agent*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/agent.asp> (last visited Oct. 20, 2011).

⁶³ 12 U.S.C. § 1851(h)(4).

Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.⁶⁴

This definition, like the previous one, deserves some unpacking in order to make sense of the implications for the Volcker Rule. The heart of this definition is the phrase “principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)...”⁶⁵ First, “the near term” must be defined. The statute does not define it. Instead, it is presumably up to the regulatory bodies (i.e., the Federal Reserve, SEC, and CFTC) to determine. How it is defined will significantly impact the strength of the Volcker Rule.

The same goes for the phrase “profit from short-term price movements.”⁶⁶ What is a short-term price movement? Also, what does “profit from” mean? An investment bought and held for five years still accumulates wealth with each “short term” upwards price movement because, if they last, these price movements become long-term price movements. Does “profit[ing] from” require a sale or an exercise? If so, is the required action different across different asset classes? How these terms are defined will impact the success of the Volcker Rule in policing the trading activities of Wall Street banks.

Two lines of analysis emerge from the definition of trading account in the Volcker Rule: 1) trading account as defined by the length of security-holding, and 2) trading account as defined by profiting from short-term movement in securities. As shall be demonstrated, the finance world’s understanding of the term has clearly influenced the definition of “trading account” in the Volcker Rule. Although the two are not the same, it seems as though the Volcker Rule is proceeding on the same two lines as Wall Street in distinguishing a trading account from the other main type of securities account—an investment account. *Investopedia* defines “trading account” as “[a]n account held at a financial institution and administered by an investment dealer that the account holder uses to employ a trading strategy rather than a buy-and-hold investment strategy.”⁶⁷ The focus of the industry’s definition is whether the investments in the account are “buy-and-hold.” A “buy-and-hold” investment strategy is defined by *Investopedia* as “[a] passive investment strategy in which an investor buys stocks and holds them for a long period of time, regardless of fluctuations in the market. An investor who employs a buy-and-hold strategy actively selects stocks, but once in a position, is not concerned with short-term price movements and technical indicators.”⁶⁸

⁶⁴ 12 U.S.C. § 1851(h)(6).

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Trading Account*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/tradingaccount.asp> (last visited Oct. 20, 2011).

⁶⁸ *Buy and Hold*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/buyandhold.asp> (last visited Oct. 20, 2011).

This definition turns on two factors. The first factor is temporality: strategies executed from an investment account involve holding a security for a “long period of time.”⁶⁹ Trading accounts are distinguishable from investment accounts because they do not involve long-term-hold strategies. This ambiguous factor presents difficulties in maintaining clear distinctions between investment and trading accounts because there is no set length of time that divides them. The second factor is binary: passive or active investing. Investment accounts are defined as passive investing, whereas trading accounts are those with which traders execute active strategies. These non-passive strategies involve rigorous risk monitoring and sometimes frequent trading to manage and hedge that risk. Again, the difficulty is in creating a clear standard to distinguish trading accounts from investment accounts vis-à-vis the amount of trading activity (as a proxy for active versus passive investing).

B. How Did Proprietary Trading Play a Role in the Financial Crisis of 2008?

Wall Street firms boomed in the mid-2000s, and Goldman Sachs provides an excellent case study of the importance of trading in the boom: “of the \$6.7 billion [Goldman] earned before taxes [in 2004]...75% came from trading and investments like its 15.5% stake in Archipelago.”⁷⁰ If Wall Street in the mid-2000s was a car, trading was certainly its engine. But how much horsepower is too much horsepower? How far should firm-funded trading go? The following two examples of proprietary trading illustrate the irresponsible and risk-blind nature of the practice as it existed in the years leading up to the financial crisis.

In an article appearing in *Time* magazine, former Lehman Brothers bond trader, Lawrence McDonald, recounts his experience of meeting a college-junior-level intern. During his winter break, this intern was trading derivatives for Lehman Brothers out of his \$150 million book funded by the firm.⁷¹ Broker-dealers were apparently giving college students millions of dollars to engage in proprietary trading during their school breaks.⁷² The article goes on to list the proprietary trading losses of various firms, noting that Lehman lost \$32 billion from proprietary trading and principal transactions.⁷³ Lehman Brothers subsequently collapsed and is currently in bankruptcy.⁷⁴

⁶⁹ *Id.*

⁷⁰ Justin Fox, *Goldman: We Run Wall Street*, CNN MONEY (May 16, 2005), http://money.cnn.com/magazines/fortune/fortune_archive/2005/05/16/8260146/index.htm.

⁷¹ Stephen Gamdel, *Is Proprietary Trading Too Wild for Wall Street?*, TIME (Feb. 5, 2010), <http://www.time.com/time/business/article/0,8599,1960565,00.html>.

⁷² While it is true that Lehman Brothers would not be considered a “banking entity” under the Volcker Rule definition, all of the surviving major Wall Street banks are now banking entities with deposit-taking institutions, and so the point is moot in the post-crash period.

⁷³ Gamdel, *supra* note 71.

⁷⁴ Investopedia Staff, *Case Study: The Collapse of Lehman Brothers*, INVESTOPEDIA (Apr. 2, 2009), <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp>.

In addition to Lehman Brothers, several other banks faced serious losses due to proprietary trading. Merrill Lynch lost close to \$20 billion from its proprietary collateralized debt obligation (CDO) bets.⁷⁵ Its liquidity threatened and its future uncertain, Merrill Lynch was sold to Bank of America in September 2008 at a 40% discount to its share price in May of that year.⁷⁶ Morgan Stanley lost \$4 billion from proprietary trading in the fourth quarter of 2007 alone.⁷⁷ A single Morgan Stanley trader, Howard Hubler, accounted for approximately \$9 billion in the firm's proprietary trading losses.⁷⁸ One year later, Morgan Stanley's application to become a Bank Holding Company was approved by the Federal Reserve Board amidst one of the worst months for the solvency of financial institutions in the history of modern banking.⁷⁹ Citigroup lost nearly \$15 billion on CDO bets.⁸⁰ In February 2009, the U.S. government exchanged \$25 billion in emergency bailout funds for a 36% equity stake in the company.⁸¹

When all the dust settled, a report by the U.S. Government Accountability Office showed that “during [the] five quarters spanning the financial crisis...proprietary trading accounted for \$15.8 billion in losses” at the six largest bank holding companies.⁸² Let that serve as a succinct summary of the role of proprietary trading in the financial crisis of 2008.

C. Public Reaction to Proprietary Trading, the Financial Crisis, and the Volcker Rule

It is not difficult to imagine that the actions of Wall Street traders, viewed by many as the cause of the 2008 financial crisis, angered the average American citizen. As commanded by subsection (b) of the Volcker Rule, the Financial Stability Oversight Council (FSOC) conducted a comment period from the date of passage of the Dodd-Frank

⁷⁵ Gamdel, *supra* note 71.

⁷⁶ Charlie Gasparino, *Bank of America to Buy Merrill Lynch for \$50 Billion*, CNBC (Sept. 14, 2008, 7:42 PM), http://www.cnbc.com/id/26708319/Bank_of_America_to_Buy_Merrill_Lynch_for_50_Billion.

⁷⁷ Gamdel, *supra* note 71.

⁷⁸ Max Abelson, *Howie Hubler of New Jersey: The Return of a Subprime Villain*, THE N. Y. OBSERVER (Mar. 23, 2010), <http://www.observer.com/2010/wall-street/howie-hubler-new-jersey-return-subprime-villain>.

⁷⁹ Press Release, Morgan Stanley, Morgan Stanley Granted Federal Bank Holding Company Status by U.S. Federal Reserve Board of Governors, (Sept. 21, 2008), <http://www.morganstanley.com/about/press/articles/6933.html>.

⁸⁰ Gamdel, *supra* note 71.

⁸¹ See *U.S. Will Boost Stake in Citigroup to 36%*, CNBC (Feb. 27, 2009, 1:01:58 PM), http://www.msnbc.msn.com/id/29421397/ns/business-consumer_news. But see *U.S. Treasury Plans to Sell Citigroup Common Shares in 2010*, BLOOMBERG BUS. W. (Mar. 29, 2010), <http://www.businessweek.com/news/2010-03-29/u-s-treasury-plans-to-sell-citigroup-common-shares-in-2010.html> (The US government would go on to sell the securities for a significant profit from its original cost basis for acquisition of the shares, thus earning the taxpayer a tidy profit from the bailout).

⁸² Scott Patterson & Victoria McGrane, *The Multibillion-Dollar Leak*, THE WALL ST. J. (Oct. 7, 2011), <http://online.wsj.com/article/SB10001424052970204294504576615382298044922.html>.

Act (July 25, 2010) until November 5, 2010.⁸³ Many of the comments came from everyday American citizens who were outraged that Wall Street traders were able to take on risk from proprietary trading while their institutions held backstops from the federal government (i.e., the U.S. taxpayer).⁸⁴ These individuals perhaps viewed a lax regulatory regime as an implicit governmental sanction for proprietary trading and financial risk-taking, and demanded the strict implementation of the Volcker Rule to prevent future occurrences of the same. For example, a commenter wrote, “institute the Volker [sic] rule and more you weasels. the banks have been allowed to enslave Americans for too long. stop [sic] it now do your regulatory jobs.pass [sic] and enforce laws that put the American people first, not banks and corporations. [T]homas Tague, voter.”⁸⁵ Such comments may seem firebrand, but they are rather representative (at least in sentiment if not in rhetoric), of the statements submitted to the FSOC’s request for comment on the Volcker Rule. Popular opinion—at least as reflected by the private citizen comments delivered to the FSOC—seems to view the Volcker Rule as an apt and necessary solution for the perceived problem of unchecked proprietary trading by traders at banking entities.

Currently, the Volcker Rule comes under fire as a symbolic but ultimately meaningless piece of legislation, enacted solely to quell the sort of public outcry quoted above while actually doing little to prevent the activities and subsequent harm it purports to prevent.⁸⁶ As discussed briefly above and in more depth below, the definition of “proprietary trading” is complex and contingent upon the definitions given to many other terms (e.g., “trading account,” “near term,” etc.). Depending on how the terms are defined, the Volcker Rule may have strong or weak effects with regards to preventing firms from making proprietary bets. While the U.S. constituency may believe that the Volcker Rule represents the government taking a strong step towards reining in the excesses of Wall Street power, it may be just another example of an “appease and deceive” strategy by lawmakers torn between the populist outcries of their constituents and the allure of Wall Street’s lobbyists.

⁸³ 12 U.S.C. § 1851(b) (2010).

⁸⁴ See *infra* note 85.

⁸⁵ Comment from Thomas Tague, public citizen member, <http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1372> (last visited Sept. 26, 2011). Another commenter, Louis Spain, Jr., wrote, “If anything is done other than following the Volcker Rule, I would have to suspect that the people in your organization are domestic terrorists working secretly for the Taliban. We now know that the financial institutions in this country may as well be. Predatory, irresponsible and just plain incompetence don’t even begin to describe the behavior of the financial instry [sic] in this country. Do not disappoint us on this!” Comment from Louis Spain, Jr., Personal, <http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1378> (last visited Sept. 26, 2011).

⁸⁶ See, e.g., Kid Dynamite, *More Thoughts on the Volcker Rule*, SEEKING ALPHA (Feb. 5, 2010), <http://seekingalpha.com/article/186862-more-thoughts-on-the-volcker-rule>.

IV. THE INTERPLAY OF PROPRIETARY TRADING AND PERMITTED ACTIVITIES

A. What are “Permitted Activities?”

Title 12 U.S.C. § 1851(d)(1) explicitly permits certain activities, despite the general prohibition on proprietary trading and investments in hedge funds and private equity funds.⁸⁷ The relevant classes of permitted activities in the U.S. or to U.S. banks⁸⁸ are as follows:

- Trading in U.S. Government obligations, including obligations of the States, municipalities, and obligations of Fannie Mae, Freddie Mac, and Ginnie Mae.⁸⁹
- Trading “in connection with underwriting or market-making-related activities, to [an] extent ...not to exceed the reasonably expected near term demands of clients, customers, or counterparties.”⁹⁰
- “Risk-mitigating hedging activities ... related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.”⁹¹
- Transactions on behalf of customers.⁹²
- Other trading activities that the Federal Reserve, SEC, and CFTC determine⁹³ would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.⁹⁴

The first point, (d)(1)(A), allows for attending to U.S. government obligations. This allowance seems logical because Congress does not want to impair the liquidity of markets on which the solvency of the U.S. government depends. Banking entities are therefore allowed to make proprietary trades (“prop trade”) in treasury bills, state bonds, muni bonds, Ginnie bonds (which are backed by the full faith and credit of the U.S. government),⁹⁵ and Fannie and Freddie bonds (which are backed by the guarantee of the respective corporations).⁹⁶ Mortgage-backed

⁸⁷ 12 U.S.C. § 1851(d)(1) (2010).

⁸⁸ § 1851(d)(1)(H) This section carves out proprietary trading conducted entirely outside the US by banking entities that are not organized within the US or controlled by any banking entity organized within the US. Query: Why would the Federal Reserve Board, SEC or CFTC have jurisdiction over the transaction anyhow? Perhaps because the transaction could involve securities registered under the ‘33 Act and so the SEC has jurisdiction over transactions in them? However, this does not mean that the Volcker Rule, which is US federal banking law, applies.

⁸⁹ § 1851(d)(1)(A).

⁹⁰ § 1851(d)(1)(B).

⁹¹ § 1851(d)(1)(C).

⁹² § 1851(d)(1)(D).

⁹³ § 1851(d)(1)(J) (pursuant to their rulemaking authority under subsection (b)(2)).

⁹⁴ § 1851(d)(1)(J).

⁹⁵ *Full Faith and Credit*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/f/full-faith-credit.asp> (last visited Sept. 26, 2011).

⁹⁶ *Mortgage-Backed Securities*, SEC.GOV, <http://www.sec.gov/answers/mortgagesecurities.htm> (last modified July 23, 2010).

securities (MBS) issued by Ginnie, Fannie, and Freddie are also permissible because they are issued by the agencies themselves, not securitization trusts which may not fall into the (d)(1)(A) safe harbor.⁹⁷

The second point, (d)(1)(B), preserves the ability of banks to undertake securities trading activities with regards to their investment banking arms' underwriting activities. Congress likely wanted to ensure that corporations' access to the capital markets was not disrupted by regulation seeking to curb excessive risk-taking in proprietary trading. Since Congress likely did not seek to restrict securities trading related to IPOs and other underwriting activity, it seems appropriate that it is included in the (d)(1) safe harbor.

In addition to allowing underwriting activities, (d)(1)(B) also permits trading in connection with market-making-related activities. Market-making, however, is a bit trickier. *Investopedia* explains "making a market" as "[a]n action whereby a dealer stands by ready, willing and able to buy or sell a particular security at the quoted bid and ask price."⁹⁸ To perform this task, a trader must have an inventory of the securities of the type for which he or she is making a market. *Investopedia* defines "Market Maker" as a broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Each market maker competes for customer order flow by displaying buy and sell quotations for a guaranteed number of shares. Once an order is received, the market maker immediately sells from its own inventory or seeks an offsetting order. This process takes place in mere seconds.⁹⁹

If a trader anticipates demand for a security and is tasked with making a market in it, he or she will need to stock up on inventory to sell. This is fundamental market-making. However, a bank uses its own capital to acquire securities and place them in a trading account, thereby hoping to gain from the transaction. This is very close to the line demarcating permitted activity from proprietary trading, an issue addressed later in this Article.¹⁰⁰

Third, (d)(1)(C) allows traders to undertake risk-mitigating hedging on an individual or aggregate basis. Traders may therefore hedge individual securities transactions or entire portfolios of securities. Hedging plays an incredibly important role in trading because it allows traders to lock in profits and protect themselves from declines in the

⁹⁷ See generally FANNIEMAE, GUARANTEED MORTGAGE PASS-THROUGH CERTIFICATES 1 (Oct. 1, 2010), http://www.efanniemae.com/syndicated/documents/mbs/mbspros/MF_October_1_2010.pdf (prospectus indicating that Fannie issues the MBS directly, not through a securitization trust); WELCOME TO THE GINNIE MAE INVESTORS' HOME PAGE, GINNEMAE.GOV, <http://www.ginniemae.gov/investors/investors.asp?subTitle=Investors><http://www.ginniemae.gov/investors/investors.asp?subTitle=Investors><http://www.ginniemae.gov/investors/investors.asp?subTitle=Investors> (last visited Sept. 27, 2011).

⁹⁸ *Make a Market*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/m/makeamarket.asp> (last visited Sept. 26, 2011).

⁹⁹ *Market Maker*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/m/marketmaker.asp> (last visited Sept. 26, 2011).

¹⁰⁰ See *infra* text accompanying pp. 30-32.

prices of assets they hold in inventory. For instance, suppose that a trader holds a pile of illiquid agency mortgage bonds.¹⁰¹ Maybe he cannot sell them because there is not much of a market,¹⁰² or he does not want to sell them because he anticipates a customer order.¹⁰³ A risk-mitigating hedging activity would be to sell TBAs,¹⁰⁴ which would cancel out much of the interest rate risk of holding the bonds.

The fourth point, (d)(1)(D), indicates that transactions on behalf of customers are permissible, and it also relates to the second point, (d)(1)(B). If the trader at a banking entity gets an order and does not have the securities in inventory, Congress wants him to be able to execute the order on the market for the customer. The trader is expressly enabled to do this under (d)(1)(D).

The fifth point, (d)(1)(J), is a catch-all provision that gives the regulatory agencies power to determine whether they should permit other types of transactions. Provisions such as this are important because agencies can act much more swiftly than Congress. Should something in the Volcker Rule cause calamity in the financial markets, the government would need to act immediately. Thus, if a certain type of trade is necessary for financial stability but is proprietary in nature, and does not qualify under the permitted activity safe harbors (and thus is prohibited by the Volcker Rule) then the Federal Reserve, SEC, and CFTC are given the power to allow that type of trade, and they would be able to grant the exception in a relatively short amount of time.

Congress has also included a catch-all clause that allows the regulatory agencies to prohibit, under certain circumstances, any of the permitted activities under 12 U.S.C. § 1851(d)(1), and delineates the reasons for when such a prohibition would be appropriate. Section 1851(d)(2) states that the aforementioned “permitted activities” would not be permitted if they trigger any of the following conditions:

- The transaction involves or results in a material conflict of interest between the banking entity and its clients, customers, or counterparties. Each agency has the authority, granted by subsection (b)(2) of 12 U.S.C. § 1851, to define “material conflict of interest.”¹⁰⁵
- The transaction would expose the banking entity to high risk assets or involve the banking entity in high risk trading strategies. “High risk assets” and “high risk trading strategies” are also terms that shall be defined by the appropriate agencies, under the authority of subsection (b)(2) of 12 U.S.C. § 1851.¹⁰⁶

¹⁰¹ Remember that Agency bonds are expressly permissible for proprietary trading.

¹⁰² Congress wants the trader to hold the bonds because this encourages market liquidity for the particular asset.

¹⁰³ Congress wants traders to be able to make a market for clients with any security.

¹⁰⁴ To Be Announced. *TBA*, INVESTOPEdia, <http://www.investopedia.com/terms/t/tba.asp> (last visited Nov. 1, 2011) (“A term used to describe a forward mortgage-backed securities trade. Pass-through securities issued by Freddie Mac, Fannie Mae and Ginnie Mae trade in the TBA market.”).

¹⁰⁵ 12 U.S.C. § 1851(d)(2)(A)(i) (2010).

¹⁰⁶ § 1851(d)(2)(A)(ii) (2010).

- The transaction would pose a threat to the safety and soundness of the banking entity.¹⁰⁷
- The transaction would pose a threat to the financial stability of the United States.¹⁰⁸

It appears that the regulatory agencies have wide latitude in determining whether to permit or prohibit transactions, and to prescribe the lines by which one makes that determination. Making the Volcker Rule effective will require an active policing of transactions by the regulatory agencies to make sure that banking entities are not masking proprietary and impermissible transactions under banners of permissibility such as “market making” or “on behalf of a customer,” etc.

B. How Can Banking Entities Disguise Proprietary Trading as a “Permitted Activity?”

Banking entities may disguise impermissible proprietary trading as a “permitted activity” in a variety of ways. Entities may count the activity as market making or base it on customer flow. Indeed, Goldman Sachs has moved much of its proprietary trading staff to its Asset Management division and changed the name from Proprietary Trading to Client Trading.¹⁰⁹ Suppose a trader deals in Treasury notes and bonds. A customer, hedge fund Alpha, comes to the trader and wants to buy \$10 million in Treasury long bonds. The trader believes that hedge funds Beta and Gamma, two other customers, will come to him with similar orders, so he buys \$30 million in the bonds, fills Alpha’s order, and keeps \$20 million in inventory. The price of the bonds rises and then Beta and Gamma come knocking, each with the same order for \$10 million. The trader sells out his inventory, and profits not just from the bid-offer spread (which are his profits from providing the liquidity), but also from the price rise in the bonds while held in inventory. The question arises: is this proprietary trading?

An article in *The Atlantic* by Daniel Indiviglio poses a similar hypothetical.¹¹⁰

This year, for example, several large insurance companies approached Goldman Sachs, looking to bet that the markets would not stay quiet. Goldman gladly took the other side of the trades, but

¹⁰⁷ § 1851(d)(2)(A)(iii) (2010).

¹⁰⁸ § 1851(d)(2)(A)(iv) (2010).

¹⁰⁹ Courtney Comstock, *Gasparino: Goldman Plans to Circumvent the Volcker Rule by Changing the Name from “Prop Trading” to “Client Trading,”* BUSINESS INSIDER (Jul. 27, 2010, 3:38 PM), <http://www.businessinsider.com/gasparino-goldman-plans-to-circumvent-the-volcker-rule-by-changing-the-name-from-prop-trading-to-client-trading-2010-7>.

¹¹⁰ Daniel Indiviglio, *Should We Be Outraged Banks Are Skirting the Volcker Rule?*, THE ATLANTIC (Aug. 26, 2010, 2:24 PM), <http://www.theatlantic.com/business/archive/2010/08/should-we-be-outraged-banks-are-skirting-the-volcker-rule/62114>.

when the markets turned choppy in May, the firm was caught short and quickly lost \$250 million.

The “other side” of the bet is what might have been considered prop trading. But in this case, Goldman was fulfilling the order of a client, so it can also be classified as a case of the bank acting as a market maker. The question, then, is whether we should be outraged if banks are still able to make bets for their own profit if it is in the context of making a market for a client.¹¹¹

The example above begs the question of whether this is proprietary trading. The answer probably lies somewhere in the definition of “reasonably expected near term demands of clients...”¹¹² The trader’s activities, to fall within the safe harbor of (d)(1)(B), must only keep the bonds in inventory within the reasonably expected near-term demand of clients. However, the statute does not specify the length of “near term.” In reality, it depends on the liquidity of the market. For treasuries, it should be a short duration. For something highly illiquid, where the trader must act as principal, the asset should be allowed to remain on the trader’s books longer.

The key challenges in regulating this aspect of the Volcker Rule and trading are: a) the amount of the asset that the trader should be allowed to keep as inventory, and b) the duration for which inventory should be allowed to be held. Goldman’s activity, falling more closely under (d)(1)(D)’s exception for customer-based orders, basically allows a banking entity to prop trade so long as someone else initiates the trade. A possible needed restriction here might require banking entities to not solicit another entity to “make a trade” with the bank that the bank wanted to make in the first place.

Traders may also disguise proprietary trading by masking their positions as simply hedges of permitted trades, though in truth the ‘hedge’ position is actually their real purpose. For instance, if a trader wants to pick up some derivatives, he can take on an interest rate swap as a hedge for a permitted position on Fannie or Freddie MBS. As long as the trader can show that he purchased the interest rates’ derivatives to offset his mortgage positions, then he can engage in mortgage arbitrage under (d)(1)(C). He only has to show that the IR swap position was “in connection with and related to” the MBS position and that he chose the IR swap position to reduce risk to the banking entity.¹¹³ The choice of a complicated “MBS hedged by IR swap” illustrates an important point: when considering this trade, the notional amounts are not very relevant. When hedging the MBS, simply buying a notional amount of the IR swap hedge does not make sense. Traders instead look to facets such as duration and convexity and hedge with respect to those. A trader could

¹¹¹ *Id.*

¹¹² 12 U.S.C. § 1851(d)(1)(B) (2010).

¹¹³ § 1851(d)(1)(C) (2010).

demonstrate that an MBS position is hedged by an IR swap position because it is duration-neutral or convexity-neutral (and thus permissible under (d)(1)(C)), and yet still have an IR swap position that is notionally larger than the MBS position it is supposed to be hedging.

V. A DEFINITIONAL SOLUTION: DRAWING LINES IN A SANDSTORM

Regulators use definitions to draw lines in the sand to create clear guidelines for regulated entities to follow. But in the complex environment of sales and trading, regulators have to draw lines in a sandstorm—a difficult and fruitless process.

A. Trading Accounts Versus Investment Accounts

First, the law needs a definition that will provide a clear distinction between trading and investment accounts. Making proprietary trading impermissible when conducted in trading accounts creates an incentive to shift proprietary operations over to investment accounts, if possible. A caveat here: how an account is defined—whether as a trading account or investment account—has consequences for the bank balance sheet because of the way in which it is accounted. Investment accounts, because of their long-term-hold strategy, are marked under book value accounting rules.¹¹⁴ Trading accounts, on the other hand, fall under mark-to-market rules as per the standards in FASB Statement 157.¹¹⁵ So, while proprietary trading may be conducted out of investment accounts because it is only prohibited for trading accounts, these sorts of investments will appear differently in the banking entity's financial statements and may pose a problem for moving certain activities from trading accounts to investment accounts. European and American accounting standards boards have been at odds about how to account for financial products in trading accounts, and this only complicates the debate.¹¹⁶

Of greater concern in the trading account versus investment account debate is the nature of the investments made in each account, and the losses that result from them. If the definition of “trading account” turns on the “near term” requirement, it will conveniently overlook illiquid assets for which there is no constant market. If something trades every three months or so, would its purchase be booked to a trading or

¹¹⁴ *Book Value*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/bookvalue.asp>. (last visited Nov. 1, 2011).

¹¹⁵ *FASB 157*, INVESTOPEDIA, http://www.investopedia.com/terms/f/fasb_157.asp. (last visited Nov. 1, 2011) (“A Financial Accounting Standards Board (FASB) Statement that requires all publicly-traded companies in the U.S. to classify their assets based on the certainty with which fair values can be calculated. This statement created three asset categories: Level 1, Level 2 and Level 3. Level 1 assets are the easiest to value accurately based on standard market-based prices and Level 3 are the most difficult.”).

¹¹⁶ Yalman Onaran, *Fight over Fair Value in Global Finance Making Volcker Rue FASB Dissonance*, BLOOMBERG, (Nov. 21, 2010, 5:00 PM), <http://www.bloomberg.com/news/2010-11-22/fight-over-fair-value-in-global-finance-making-volcker-rue-fasb-dissonance.html>.

investment account? If it is booked to anything other than a trading account, it is permissible proprietary trading for purposes of the Volcker Rule. Thus, the Volcker Rule does not police, and perhaps incentivizes, undertaking principal investments in highly illiquid assets. This could be highly detrimental for the financial health of those firms.

In response, David Einhorn of Greenlight Capital called out Lehman Brothers for marking up its highly illiquid real estate investments it had made on a proprietary basis.¹¹⁷ These investments were held in investment accounts, not trading accounts. Because of their illiquid nature they would still be permissible under the Volcker Rule. These same investments turned out to be overvalued on Lehman's books and ultimately caused fatal losses for the firm.¹¹⁸ In light of that, "highly detrimental" is an understatement; perhaps "catastrophically detrimental" is more appropriate.

Considering the complexity of distinguishing between different account-types and the potential for entities to circumvent the Volcker Rule's trading-account exclusion, it would be prudent to place restrictions on proprietary trading in investment accounts as well. The Federal Reserve, SEC, and CFTC have authority to widen the definition of "trading account" under 12 U.S.C. § 1851(h)(6), the provision which defines "trading account," and includes "any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine."¹¹⁹ A truly meaningful restriction would be to remove the "account arbitrage" opportunity and make proprietary trading impermissible regardless of the type of account in which or for which it is done.

B. "Engaging as a Principal," Market-Making and Customer Flow

The second definition required is that of "engaging as a principal." While this appears in the definition of proprietary trading in subsection (h)(4), the term ties closely to the safe harbor for market-making activities delineated in subsection (d)(1)(B). Essentially, proprietary trading on a principal basis is impermissible unless it is part of market-making activities to meet customer flow.¹²⁰ A clear standard is needed to separate market-making from proprietary holding. That is, there needs to be a clear difference illustrated between holding inventory to make a market versus holding inventory to profit from an upward movement in the asset price. Defining market-making as matching inventory to customer order is not adequate, particularly with regard to volatile and/or illiquid markets where traders would need to anticipate customer orders

¹¹⁷ Hugo Lindgren, *The Confidence Man*, NEW YORK (Jun. 15, 2008), <http://nymag.com/news/businessfinance/47844>.

¹¹⁸ See generally ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (1st ed. 2009).

¹¹⁹ 12 U.S.C. § 1851(h)(6) (2010).

¹²⁰ § 1851(d)(1)(B) (2010).

and purchase inventory in advance in order to stabilize the market and provide liquidity.

The Financial Stability Oversight Council study on the Volcker Rule has indicated that customer-flow metrics could be applicable for determining whether a trader has taken proprietary positions that do not correlate to appropriate customer flow.¹²¹ Many in the community have flagged the idea as an intelligent solution.¹²² While this is a promising idea, it bears mentioning that the agencies would need to collect data on customer flow for a meaningful number of trading-books on a meaningfully frequent basis to make the regulation relevant. The SEC, for instance, would need to review the flow metrics of enough traders' books frequently enough that it would be able to catch instances of impermissible inventory-building where customer flow is lacking. To do so for every trading book, at every "banking entity," every quarter, would produce a volume of data that the SEC may be unable to handle and rigorously process. It could, however, be done on an audit basis.

Perhaps the best solution for this is to measure market liquidity and compare it to inventory turnover. The Financial Stability Oversight Committee suggests inventory metrics as part of their rigorous compliance regime.¹²³ The study states,

Inventory Turnover: This metric calculates the ratio of assets that are transacted each day to assets that are retained in inventory. The metric takes into account the need for market makers to hold inventory (volume of retained assets), but relates it to the asset's observed customer demand (volume of transacted assets).

Impermissible proprietary trading seeks to profit from the appreciation of an asset. Retaining assets well in excess of customer demand may be an indicator that the trader is seeking to profit from the appreciation of inventory. Conversely, market makers with a near term goal of serving customers will acquire and sell (or, for some instruments, hedge) within as short a timeframe as possible in order to profit from the bid-ask spread.¹²⁴

This is likely to be the best solution to the problem. The more liquid a market is, the shorter the duration should be for which it is permissible

¹²¹ FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 36 (Jan. 2011), <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%2020619%20study%20final%201%2018%2011%20rg.pdf>. "Customer-Flow Metrics: These metrics evaluate the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for the purposes of building inventory or hedging. Significant trader-initiated, rather than customer-initiated, order volume could indicate that impermissible proprietary activity has occurred." *Id.* at 37.

¹²² See, e.g., *More on the Volcker Rule Study*, ECONOMICS OF CONTEMPT (Jan. 28, 2011, 1:13 AM), <http://economicsofcontempt.blogspot.com/2011/01/more-on-volcker-rule-study.html>.

¹²³ FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 39 (Jan. 2011), <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%2020619%20study%20final%201%2018%2011%20rg.pdf>.

¹²⁴ *Id.*

for a trader to hold assets in connection with his “market-making” function. For highly liquid assets, like equities, liquidity is easy to measure: just look at the bid-ask spread. Something illiquid, like a tranche of the Countrywide Alternative Loan Trust, might trade once every few months or so. The equities trader should be required to “go flat,” or have a clean slate of inventory, in a shorter period than the trader in pieces of Countrywide’s Alt-A trust.

Issues of LIFO versus FIFO accounting are clearly factors here which need to be sorted. LIFO accounting would make the most sense because FIFO accounting would require a trader to sell completely out of inventory in order to “go flat.” True market liquidity is a fairer measure than customer demand. However, it is more difficult to measure, and the volume of customer orders received by a desk may be a far more feasible proxy.

One way to trick a system like the aforementioned, however, would be to “churn” one’s inventory. In a highly liquid market, a trader’s portfolio could have a high number of transactions that make it seem as though a lot of market-making activity is taking place. However, the trader could be masking a held proprietary position by making numerous small market-making transactions and thus raising the appearance that the book has “gone flat” when in fact a position is being held all along.

C. Hedging

Third, and finally, a definition of “in connection with and related to” is required, as the phrase exists in the hedging safe harbor in subsection (d)(1)(B). How does a trader demonstrate that a hedging position relates to a permissible trading position? What is the close connection or relation? Particularly, what will be the impact of the prohibition on trading desks taking positions in assets outside of the desk’s coverage? The financial law blog “Economics of Contempt” had a particularly good insight on this matter:

If a bank wants to build up a proprietary position in equities, it’s not going to do it from the MBS desk; it’s going to do it from an equities desk. So there likely won’t be a deviation from the types of products used on the desk. And in fact, sometimes trading desks do actually use products for which they’re normally not approved as part of legitimate hedging strategies. For example, a fixed-income desk trying to hedge its largest counterparty exposure may have to resort to buying puts if, say, they can’t buy enough CDS protection to cover the counterparty exposure....¹²⁵

¹²⁵ See, e.g., *More on the Volcker Rule Study*, ECONOMICS OF CONTEMPT (Jan. 28, 2011, 1:13 AM), <http://economicsofcontempt.blogspot.com/2011/01/more-on-volcker-rule-study.html>.

As stated in the earlier example of hedging an MBS trade with an IR swap, normal Wall Street transaction hedges often occur outside of the product lines of the asset being hedged. Barring desks from reaching outside of their asset class would not prohibit proprietary trading as much as it would diminish the banking entity's ability to hedge its positions. Regulators should want banks to hedge, as it mitigates risk of loss on outstanding positions.

Prohibiting desks from going across product classes may also yield further costs because a "central hedging coordinator" would be necessary.¹²⁶ For instance, an MBS trader who wanted to hedge an MBS position with an IR swap, but could not because of regulations restricting him from deviating from his asset class, would call the swap desk and ask them to take on a swap position on their book to hedge his MBS position held on his book. Eventually, it seems logical that some sort of a "coordination desk" would arise out of the confusion to arrange cross-book hedges. The solution would be messy for banks and even messier for regulators trying to figure out what is going on inside banks. Asset-class-based limitations seem like a bad idea for everyone involved.

Solutions that attempt to identify particular hedges for particular transactions and bar all others would be counterproductive because they would infringe on a trader's ability to be creative and innovative as products and product lines become more intricate and new sources of risk emerge. Definitions based on notional amounts are meaningless when considering hedges that exist to cover duration, convexity, or other factors for which the straight face value of the asset is irrelevant.

In general, it seems that the definitional approach is unsuitable for regulating hedging because the nature of the market and its structure yield too many exceptions for any possible definition to be sensible and effective. Hedging is what makes traders, and their creativity, valuable. Limiting the tools available to traders in designing hedges strips away much of the value from sales and trading as business lines for banking entities. This subsequently reduces profit by reducing the number of profitable opportunities available to the bank. Banks will be forced to take on more risk to keep profit trading at prior levels, and shareholders of banking entities should be unhappy with this. Frankly, *everyone* should be unhappy with this.

VI. CONCLUSION

The Volcker Rule seems to do more to create busywork for federal regulatory agencies than it does to meaningfully regulate the financial industry. The loopholes and gaps in its definitions are too broad. The banks and their lawyers have wide gaps through which to shuttle proprietary trading disguised as any number of permitted activities. One possible solution is to return to Glass-Steagall-style structure-based

¹²⁶ *Id.*

regulation, cleaving proprietary trading firms from investor adviser firms.

As Michael Lewis wrote in a Bloomberg column, there is a simpler solution for the problem the Volcker Rule sets out to solve:

...ban any sort of position-taking at the giant publicly owned banks. To say, simply: You are no longer allowed to make bets in the same stocks and bonds that you are selling to investors.

If that means that Goldman Sachs is no longer allowed to make markets in corporate bonds, so be it. You can be Charles Schwab, and advise investors; or you can be Citadel, and run trading positions. But if you are Citadel you will be privately owned. And if you blow up your firm, you will blow up yourself in the bargain.¹²⁷

Lewis's solution is brutal but not incomprehensible. It resonates with the McCain-Cantwell proposal to reinstate the Glass-Steagall prohibition on combinations of investment and commercial banks. As discussed above, however, there are significant pressures against reverting to such a system. Put simply, because of globalization, the financial services industry as we know it has crossed that Rubicon. Many of the large firms that function as both commercial and investment banks—the so-called “banking entities”—are too vital to the health of the U.S. and global economies to cleave them into separate parts: commercial bank from investment bank, or client-servicing firm from trading firm. The Volcker Rule represents Congress's best effort in responding to populist anger at Wall Street banks' risk taking while dealing with the inescapable reality that such entities have grown so powerful and vital that any strong-worded regulation of them would perhaps do more harm than good (if it were able to get off the ground in Congress in the first place). The definitional suggestions presented in this article represent a proposed strategy in a game of roulette at the casino. Try as you might, don't be surprised if the house ends up with all your money at the end of the night.

VII. EPILOGUE

The Volcker Rule's passage into law makes it perhaps unlikely that any further regulation of proprietary trading will occur. But if Congress were to eventually realize that the Volcker Rule's separation of proprietary trading from marketmaking is functionally impossible to implement, then the following idea may serve as a better regulatory model.

¹²⁷ Michael Lewis, *Proprietary Trading Goes Under Cover: Michael Lewis*, BLOOMBERG (Oct. 27, 2010, 2:48 PM), <http://www.bloomberg.com/news/2010-10-27/wall-street-proprietary-trading-under-cover-commentary-by-michael-lewis.html>.

The problem with the Volcker Rule is that it tries to regulate actions instead of structures. Structures are limited in nature and not easy to modify. Glass-Steagall's separation of investment banking from commercial banking—its regulation of structures—drew broad and bright lines in flat and unshifting concrete. Trading actions are vague, numerous, and easy to modify. Defining them, much less regulating them, is like drawing lines in the sand of the Sahara Desert during a sandstorm with 80 mile per hour winds—a futile task. The sand changes shape before the lines are fully drawn, just as trades can be reconfigured and redefined before regulations are set into place. An action-based regulatory model, as stated above, will simply never work.

A return to Glass-Steagall, as addressed in Part III, is unfeasible. However, structures do provide a reliable set of lines to draw. Because trading actions are too hard to define, it is not worthwhile to try to distinguish market-making from proprietary trading. The model proposed here would not distinguish between the actions taking place on a trading desk. All of the types of sales and trading activity that were legal before the passage of the Volcker Rule would still be legal. The key to this system, just as in the effective Glass-Steagall Act, lies in structure. Sales and trading need to be insulated from the deposit-taking institution owned by the bank holding company¹²⁸ and thus the holding company's access to the Discount Window. This is to prevent the moral hazard problem present when Bank Holding Companies can bail out their imploding trading desks with taxpayer money, accessed through the Discount Window. This is accomplished by taking the sales and trading units of each of the large bank-holding companies and forcing the holding companies to spin them off into wholly owned subsidiary corporations. The subsidiary corporation would be a bankruptcy-remote entity. In the event of the subsidiary corporation's insolvency, its creditors would not be able to go after the assets or the Federal Reserve Discount Window facility of the parent holding company. The bank holding companies would provide the starting capital for its subsidiary corporation, and would receive all of the trading profits, less the amount used to pay its employees or to be held in reserve, as a dividend.

The idea of the subsidiary's "capital reserve" is important. Under this system, the parent company is only able to provide the subsidiary corporation with capital at its formation. After that time, the subsidiary corporation's only capital flow is outward, from the subsidiary to the parent in the form of a dividend. If the subsidiary corporation needs additional funds, it has to rely on its reserve, or it may borrow against its assets from anyone except its parent-holding company or any company under its parent's control. This is because when the subsidiary's own capital can be replenished by taxpayer capital, then the firm, and thus the

¹²⁸ Small commercial banks are held by large Bank Holding Companies as a means of gaining access to the Fed's Discount Window facility.

traders, have no “skin in the game.” But there is a strong taxpayer incentive to force them to have skin in the game.

A regulatory regime that permits proprietary trading (because it is too difficult not to) needs to make sure that if a subsidiary trading corporation goes bust, the traders and the bank are the ones that hurt the most. They need to be the ones to lose a proverbial finger.

If the bank were free to capitalize as many subsidiary trading corporations as it wished to, it would have no desire to bail out a failing subsidiary when it could easily sponsor a new one the next day. The proposed regime would mandate that a bank-holding company only be allowed to have one subsidiary trading corporation under its control. This corporation would manage all of its sales and trading operations. In the event of that subsidiary’s insolvency, there would be a ten-year waiting period before the bank-holding company would be able to sponsor another one. This puts skin in the game.

The effect of this is to say that a bank’s traders may engage in all manner of risky proprietary trading. However, if they blow up, the bank loses out on the extensive revenues gained from client-facing trades, the clients leave for rival banks, the bank suffers significant reputational harms, and the traders lose their jobs because the bank no longer has a sales and trading subsidiary. This creates the incentive for the banks to heavily police the activities of their traders, and for the traders to keep a watchful eye on their own risk. Both stand to suffer greatly otherwise.

Regulation of this sort would be novel and perhaps of the sort to drive banks elsewhere. As stated before, the United States government has an interest in keeping banks like Goldman Sachs and Morgan Stanley based in the U.S. It is unlikely that such a sweeping change to the regulation of sales and trading would be passed in the U.S. unilaterally for fear that banks would flee for Europe or Asia. However, the U.S. also occupies a position as world leader for legal innovation. Successful implementation of effective financial regulation would require the coordinated efforts of the U.S., the UK, and several other G-20 nations in order to ensure that no international regulatory arbitrage opportunities exist.