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RECONCILING THE VOLCKER RULE WITH THE DODD-FRANK ACT'S OBJECTIVES: HOW TO BEST COMBAT SYSTEMIC RISK

*Michael Leonidas Nester**

This Note examines the Dodd-Frank Act's ban on proprietary trading and on banks sponsoring hedge funds and private equity funds, known as the Volcker Rule. This Rule has been a point of contention since the Act was passed in 2010. Some argue that the ban is either a detriment to bond market liquidity or is unnecessary because a tenuous nexus exists between proprietary trading and true causes of the 2008 financial crisis. Proponents cite the role of proprietary trading in the crisis and the inherent risk that banks accept when engaging in such trading. The controversy surrounding the Volcker Rule has led individuals in politics and finance to discuss whether to amend, or even repeal, the Rule.

This Note explores arguments for and against the Volcker Rule and ultimately offers recommendations to amend the Rule while maintaining its (and Dodd-Frank's) venerable goal of curbing systemic risk. First, this Note begins with a discussion of the causes of the financial crisis and systemic risk before explaining the Rule's provisions. This background provides the groundwork for the ongoing debate about the Volcker Rule and whether there should be a change in the language of the Rule. Proponents and opponents have clashed on multiple issues, such as whether proprietary trading played a significant role in the financial crisis and whether it actually reduces systemic risk. Understanding arguments on both sides is crucial to assess whether and how the Volcker Rule should be amended in light of systemic risk. This Note concludes that neither outright repeal of the Rule nor leaving it fully intact are appropriate. Rather, this Note offers recommendations to amend it in a way that balances banks' desires to engage in profitable trading with the global interest in curbing systemic risk in the financial system.

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INTRODUCTION

The financial crisis of 2008 shook the U.S. economy and caused Americans to lose faith in financial markets. While the causes of the crisis are debated, many entities were held accountable for this economic collapse.[1] The Financial Crisis Inquiry Commission (FCIC) was tasked with determining the causes of the crisis, and its final report assigned blame to

1. *See generally* FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011) [hereinafter FCIC FINAL REPORT], https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/RAD9-DZT9].

many private actors in the financial sector[2] but also chastised public entities for their role in the crisis.[3] Banking institutions shared much of the blame.[4]

Congress passed, and President Obama signed, the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, in response to the crisis, which reflected concern for the role banks played in causing these financial troubles.[5] The Act's stated purpose illustrates the government's focus on curtailing banking institutions' reckless behavior and protecting the nation's financial stability. This purpose makes clear that the Act seeks "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices."[6]

Dodd-Frank has proven to be a point of contention, especially as talk about amending the law consumed Capitol Hill after the 2016 presidential election.[7] One of the Act's most prominent provisions is the Volcker Rule, which is implemented in Title VI of the Act and named for former Federal Reserve Chairman Paul Volcker.[8] The Rule's aim to prohibit proprietary trading remains contentious in the national discussion of post-financial crisis banking regulations.[9]

2. *Id.* at xxv ("[T]he failures of credit rating agencies were essential cogs in the wheel of financial destruction.").

3. *Id.* at xxi ("[T]he government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.").

4. *See id.* at xviii–xix ("[D]ramatic failure of corporate governance and risk management at many systematically important financial institutions were a key cause of this crisis. . . . We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis."). While a majority of the Commission's members concluded that financial institutions were at least partially culpable, the final report includes two dissents that question the blame assigned to these institutions. For more information on these dissents, see *infra* Part I.A.I, which alludes to research that suggests that proprietary trading, which the Volcker Rule prohibits, played no role in the financial crisis.

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

6. *Id.* pmbl., 124 Stat. at 1376.

7. *See* Gabriel T. Rubin, *Biden Defends Dodd-Frank, Other Obama Financial-Regulation Policies*, WALL ST. J. (Dec. 5, 2016, 6:05 PM), https://www.wsj.com/articles/biden-defends-dodd-frank-other-obama-financial-regulation-policies-1480975072 [https://perma.cc/4HTS-7DN3]; *see also* Robert Schmidt, *Trump Administration to Call for Modest Changes to Banking Rules*, BLOOMBERG (June 12, 2017, 1:52 PM), https://www.bloomberg.com/news/articles/2017-06-12/trump-administration-to-call-for-modest-changes-to-banking-rules [https://perma.cc/U98V-3LXU].

8. *See* 12 U.S.C. § 1851 (2012); *see also* William J. Sweet, Jr. & Brian D. Christiansen, *The Volcker Rule*, SKADDEN 1 n.1, https://files.skadden.com/newsletters%2FFSR_The_Volcker_Rule.pdf [https://perma.cc/B77W-CTVM].

9. *See, e.g.*, John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1073–74 (2012) (noting that there is "almost no evidence that proprietary trading was responsible for the failure of any financial institution" in the crisis and that the Volcker Rule "contains numerous loopholes and exceptions"); *see also* Dakin Campbell, *Blankfein Says Banks Should Be Unshackled from Volcker Rule*, BLOOMBERG (May 9, 2017, 3:37 PM), https://www.bloomberg.com/news/articles/2017-05-09/blankfein-says-banks-should-be-unshackled-from-volcker-rule [https://perma.cc/VPW4-DRB8] (noting that Lloyd Blankfein,

In general, banks engage in proprietary trading when they invest for their own direct gain instead of trading on behalf of clients for a commission.[10] The Rule defines proprietary trading—such as derivative transactions creating counterparty risk[11]—to include instances in which banking entities act as the principal for their own trading accounts[12] to buy or sell securities, derivatives, futures, options, or any other securities determined by certain federal agencies.[13]

President Donald Trump has promised to amend the Volcker Rule since his presidency began, and the Treasury Department has already taken steps toward that goal.[14] Those in favor of the Rule cite concern for the dangers associated with a further deregulated banking industry, given the risks associated with proprietary trading.[15] Opponents, conversely, downplay proprietary trading's role in the crisis: this mitigation would render the Rule unnecessary when trying to rectify the irresponsibility in the financial industry that led to the crisis,[16] especially given its detrimental effect on banking institutions.[17]

This Note assesses whether and how the Volcker Rule should be amended in light of its aim to reduce systemic risk in the U.S. financial system. The

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Chairman and CEO of Goldman Sachs Group, Inc., believes that the Volcker Rule hinders a "market-making function that provides a valuable public service"); Schmidt, *supra* note 7 ("The Treasury Department's much anticipated report on banking regulations is set to include measured proposals for revising post-crisis rules, indicating the Trump administration is more focused on scaling back the 2010 Dodd-Frank Act than blowing it up.").

10. *See Proprietary Trading*, INVESTOPEDIA, http://www.investopedia.com/terms/p/proprietarytrading.asp [https://perma.cc/AVQ9-GGFL] (last visited Apr. 13, 2018) ("Firms or banks that engage in proprietary trading believe that they have a competitive advantage that will enable them to earn excess returns.").

11. *See infra* note 83 and accompanying text (discussing how various interdependencies between banks produce systemic risk).

12. The Volcker Rule defines "trading account" as

> any account used for acquiring or taking positions in the securities and instruments described in [the rule's proprietary trading definition] 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 . . . determine.

12 U.S.C. § 1851(h)(6).

13. *Id.* § 1851(h)(4) ("Engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell . . . 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 . . . that the appropriate Federal banking agencies . . . determine.").

14. *See* Schmidt, *supra* note 7. To view the Treasury Department's full evaluation of the Volcker Rule and other banking regulations, see *infra* note 185.

15. *See* Press Release, Luis A. Aguilar, Comm'r, SEC, Statement on the Volcker Rule: Reducing Systemic Risk by Banning Excessive Proprietary Trading with Depositors' Money (Dec. 10, 2013), https://www.sec.gov/news/public-statement/2013-spch121013laa [https://perma.cc/HC6C-EJA9] ("The recent financial crisis and subsequent events show the dangers that can result when banks trade for their own accounts while disregarding their customers' interests.").

16. *See* Coffee, *supra* note 9, at 1073 ("[T]he Volcker Rule faces political problems. First, there is almost no evidence that proprietary trading was responsible for the failure of any financial institution in the 2008 crisis.").

17. *See* Campbell, *supra* note 9.

Rule hopes to further Dodd-Frank's goals of promoting financial stability and ending "too big to fail" and bailouts,[18] although there are conflicting reports about whether the Rule actually does so.[19] Part I explains the alleged causes of the financial crisis, systemic risk, and the Volcker Rule's various provisions. Part II then discusses arguments both for and against the Volcker Rule and whether it adequately reduces systemic risk. Finally, Part III offers recommendations for how to amend the Volcker Rule to allow banks to continue engaging in profitable trading while ensuring they do not engage in excessive risk-taking.

I. ORIGINS OF THE VOLCKER RULE

The financial crisis of 2008 prompted polarizing discussions about the adequacy of American financial regulations. Systemic risk became a key issue as the crisis marred many American consumers' views on the financial system's integrity and reputation. Congress had an opportunity to curtail systemic risk after the crisis and used the Volcker Rule as a tool to further this laudable goal, which was set forth in Dodd-Frank.[20] This Part reviews systemic risk and alleged causes of the financial crisis and discusses the Volcker Rule's various provisions. Part I.A discusses the financial crisis generally, while Part I.B discusses the Volcker Rule.

A. Financial Crisis: Concerns About Systemic Risk and Tightened Financial Regulations

To set up this Note's introduction to the Volcker Rule,[21] this Part analyzes the financial crisis and how it prompted arguments about its causes as well as systemic risk in the banking system. Part I.A.1 begins with an overview of various arguments about what caused the crisis. Part I.A.2 explains the concept of systemic risk and how it pertains to the crisis.

1. Causes of the Financial Crisis

Conversations about the financial crisis quickly become contentious, due in part to uncertainty surrounding its principal causes. As noted above, the FCIC released a report in 2011, which examined the causes of the then-current financial and economic crisis.[22] The report, which contains one majority and two dissenting opinions, recognizes the difficulties in

18. *See supra* note 6 and accompanying text.

19. *Compare* Julie A.D. Manasfi, *Systemic Risk and Dodd-Frank's Volcker Rule*, 4 WM. & MARY BUS. L. REV. 181, 211–12 (2013) ("The claims that the . . . Volcker rule walls are needed to decrease systemic risk have not been supported. . . . [W]e need a better understanding of systemic risk before we erect a wall that may decrease economies of scope and complementaries of these businesses."), *with* Press Release, Luis A. Aguilar, *supra* note 15 ("Today's adoption [of the Volcker Rule] is a step forward in reining in speculative risk-taking by banking entities and preventing future crises.").

20. *See* 12 U.S.C. § 5301 (2012).

21. *See infra* Part I.B.

22. *See supra* notes 1–4 and accompanying text.

understanding the "broad and sometimes arcane subjects" it attempts to explain to the many people who suffered in the wake of the crisis.[23]

The FCIC's majority assigned blame to private and public entities alike. Government housing policies set aggressive goals to extend credit to families in need of mortgages,[24] which led to the collapse of mortgage-lending standards and allowed the mortgage-securitization pipeline to fuel irresponsible lending.[25] On the consumer side, lenders often willfully disregarded borrowers' inability to pay their mortgages, and when home prices began to crash and borrowers defaulted, this collapse "lit and spread the flame of contagion and crisis."[26] On the banking side, as financial institutions began to create residential mortgage-backed securities (RMBS), their excessive borrowing with these risky investments made them susceptible to disaster if their investment values dropped even slightly.[27] The majority opinion in the FCIC report called risk management at these institutions a dramatic failure, which allowed banks to recklessly take on too much risk with too little capital.[28] Not only was the government "ill prepared" for the crisis,[29] but credit rating agencies enabled the crisis as they allowed investors to rely on their "seal of approval" of RMBSs.[30]

The majority particularly criticizes failures of corporate governance and risk management at "systemically important financial institutions" as a "key cause" of the crisis.[31] These institutions began to engage in riskier trades over time as they "took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities."[32] They had inadequate compensation systems that rewarded short-term gains without considering long-term consequences, which further diluted banks' sense of risk management.[33] The majority opinion noted "stunning instances" of governance breakdowns, highlighted by Merrill Lynch's shock when its $55 billion in "super-safe" RMBSs resulted in billions of dollars in losses.[34]

The FCIC's report concluded that large banks were at least partially culpable, but its two dissents questioned the blame assigned to those banks.[35]

23. FCIC FINAL REPORT, *supra* note 1, at xii.
24. *See id.* at xxvii.
25. *See id.* at xxiii.
26. *Id.*
27. *See id.* at xix.
28. *See id.*
29. *Id.* at xxi.
30. *Id.* at xxv ("From 2000 to 2007, Moody's rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded.").
31. *Id.* at xviii.
32. *Id.* at xix. To emphasize this point, the majority's authors analogized banks to ancient Greek mythology: "Like Icarus, they never feared flying ever closer to the sun." *Id.*
33. *See id.*
34. *Id.*
35. *See supra* note 4 and accompanying text; *see also* FCIC FINAL REPORT, *supra* note 1, at 411, 441.

The dissenters' claims give context to arguments alluding to how proprietary trading lacked a role in the crisis.[36]

At the FCIC, Commissioner Keith Hennessey, Commissioner Douglas Holtz-Eakin, and Vice Chairman Bill Thomas wrote the report's first dissenting view. Their opinion focuses on the global nature of the financial crisis as a counterargument to the majority's call for "across-the-board more restrictive regulations, in conjunction with more aggressive regulators and supervisors."[37] The dissenting opinion noted that many large European financial firms—whose regulatory and supervisory processes differed from that of U.S. firms—also failed, even though not all of them were exposed to U.S. housing assets.[38] Many of these firms actually had stricter financial regulations but still failed in similar ways to their U.S. counterparts.[39] The dissent then posed a rhetorical question about U.S. financial regulations: "How can the 'runaway mortgage securitization train' detailed in the majority's report explain housing bubbles in Spain, Australia, and the United Kingdom, countries with mortgage finance systems vastly different than that in the United States?"[40] This inquiry highlights some of these dissenters' skepticism of the majority opinion's call for tighter financial regulations after the crisis.

This dissent lists ten causes, global and domestic, that, its authors believe, explain the financial crisis.[41] It does not reference proprietary trading. First, a global credit bubble appeared in the late 1990s when large developing countries maintained large capital surpluses and loaned these savings to the United States and Europe—where the bubble formed—causing interest rates to fall.[42] This decreased the cost of borrowing for risky financial instruments.[43] Second, a housing bubble appeared in the United States, to which "many factors" contributed.[44] Third, with increasing optimism about U.S. housing prices and cheap credit, mortgage originators engaged in poor origination practices that extended "nontraditional mortgages" to borrowers, which were sometimes deceptive, often beyond borrowers' ability to repay, and frequently confusing.[45] Fourth, the dissenters highlight failed credit ratings and securitization. Banks "transformed bad mortgages into toxic financial assets," which combined with erroneous credit ratings to facilitate the creation of more bad mortgages.[46]

36. For further discussion on competing arguments about proprietary trading's role in the financial crisis, see *infra* Parts II.A.1, II.B.1.

37. FCIC FINAL REPORT, *supra* note 1, at 414.

38. *See id.* at 414–15.

39. *See id.* at 415.

40. *Id.* at 416.

41. *See id.* at 417–19.

42. *See id.* at 417–18.

43. *See id.* at 417.

44. *Id.* at 418 ("The bubble was characterized both by national increases in house prices well above the historical trend and by rapid regional boom-and-bust cycles.").

45. *Id.*

46. *Id.*

Fifth, financial institutions concentrated correlated-housing risk as they bet on high housing prices and held substantial amounts of housing debt on their balance sheets.[47] Sixth, banks held far too little capital and became too highly leveraged, which amplified liquidity risk.[48] Seventh, the risk of contagion is described as an "essential cause of the crisis."[49] Large firms' interconnectedness created counterparty credit risk, which led certain banks to be deemed "too big to fail" and highlighted systemic risk inherent in the financial system.[50] Eighth, large housing losses created a common shock that hit both large and small banks, but especially the large ones that were undercapitalized.[51] Ninth, financial shock and panic ensued in late 2008 after "failures, near-failures, and restructurings of ten firms triggered a global financial panic."[52] Finally, the shock and panic catalyzed the economic crisis, which created severe harm to the real economy that is still felt today.[53]

FCIC Commissioner Peter J. Wallison and Arthur F. Burns, a fellow in Financial Policy Studies at the American Enterprise Institute, wrote the report's second dissenting view. Their conclusion criticized the majority's call for stricter regulations by questioning whether any financial system, however heavily regulated, could have survived the blow that the U.S. housing market was dealt.[54] They direct most blame to the vast number of risky mortgages, whose values depreciated rapidly as the housing bubble began to deflate. They note that "the role played by the housing policies of the United States government over the course of two administrations" was the but-for cause of the risky mortgages and their subsequent decline in value.[55]

Wallison and Burns rejected several alleged causes of the crisis that the majority highlighted. First, to combat the notion that deregulation was a primary cause, they noted that no significant deregulation occurred since before the 1980s.[56] Despite the repeal of Glass-Steagall provisions,[57] which

47. *Id.*

48. *Id.*

49. *Id.* at 419.

50. *See id.*

51. *See id.*

52. *Id.*

53. *See id.*

54. *See id.* at 469 ("Instead of thinking through what would almost certainly happen when these [housing] assets virtually disappeared from balance sheets, many observers—including the Commission majority in their report—pivoted immediately to blame the 'weaknesses and vulnerabilities' of the free market or the financial or regulatory system, without considering whether *any* system could have survived such a blow.").

55. *Id.* at 451 ("As a result of these [housing] policies, by the middle of 2007, there were approximately 27 million subprime and Alt-A mortgages in the U.S. financial system—half of all mortgages outstanding—with an aggregate value of over $4.5 trillion. These were unprecedented numbers, . . . and the losses associated with the delinquency and default of these mortgages fully account for the weakness and disruption of the financial system that has become known as the financial crisis.").

56. *Id.* at 445.

57. In 1933, Congress passed the Glass-Steagall Act to help prevent bank runs and mitigate shocks in financial markets. *Id.* at 29. Among other things, it "strictly limited commercial banks' participation in the securities markets" as a partial response to highly speculative trading in the 1920s that preceded the Great Depression. *Id.* at 32.

allowed commercial and investment banks to affiliate, there is "no evidence . . . that any bank got into trouble because of a securities affiliate."[58] The losses that banks incurred were due to low quality mortgages, and Glass-Steagall had always permitted trading RMBSs.[59]

Second, the majority scorned financial institutions for having inadequate risk management.[60] Wallison and Burns explained that this claim is easy to argue with the benefit of hindsight:

> [I]t is easy to condemn managers for failing to see the dangers of the housing bubble or the underpricing of risk that now looks so clear . . . . The fact that virtually all participants in the financial system failed to foresee this crisis—*as they failed to foresee every other crisis*—does not tell us anything about why this crisis occurred *or what we should to do prevent the next one*.[61]

Third, the majority criticized securitization and structured products, which facilitated the flow of toxic assets.[62] Wallison and Burns stated that the inherent problem was with the risky loans that securitization financed rather than with the securitization process itself.[63] When discussing collateralized debt obligations (CDO)[64] specifically, the dissenters noted that despite "all their dramatic content," they were merely a path on which risky loans traveled throughout the global financial system to cause the actual losses in the crisis.[65]

Finally, the majority assigned blame to predatory lending, which Wallison and Burns agreed "undoubtedly occurred."[66] However, they encouraged looking at the other side of these transactions as well. Despite predatory lending, borrowers benefited from low mortgage underwriting standards to receive mortgages "they knew they could not pay unless rising housing prices enabled them to sell or refinance."[67] These "predatory borrowers" were a key contributor to the facilitation of high-risk mortgages in the financial system.[68]

Despite stark differences between the report's three opinions, the majority is correct in stating that conclusions about the financial crisis "must be viewed in the context of human nature."[69] The majority noted that blaming the crisis on greed alone is simplistic and that a few "bad actors" cannot be

58. *Id.* at 446.
59. *See id.*
60. *See id.* at xviii–xix.
61. *Id.* (emphasis added).
62. *See id.* at xxiii.
63. *See id.* at 447.
64. *See generally Collateralized Debt Obligation*, INVESTOPEDIA, https://www.investopedia.com/terms/c/cdo.asp?optly_redirect=integrated&lgl=myfinance-layout-no-ads [https://perma.cc/S7HX-JPRN] (last visited Apr. 13, 2018) (defining a CDO as "a structured financial product that pools together cash flow-generating assets and repackages this asset pool into discrete tranches that can be sold to investors").
65. FCIC FINAL REPORT, *supra* note 1, at 447.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.* at xxii.

blamed for a crisis of this proportion.[70] The majority ultimately stated, "[I]t was the failure to account for human weakness that is relevant to this crisis."[71] Despite the contentiousness surrounding discussions of the alleged causes of the financial crisis, it is crucial to recognize the debate surrounding these causes as this Note turns to a discussion of systemic risk and later to how the Volcker Rule attempts to curb it.

2. Systemic Risk

Systemic risk has no formal definition, but according to Professor Julie Manasfi, "systemic risk in general can be thought of as a cascading failure, like dominoes, that affects the real economy."[72] Various working definitions of the phrase have been recognized and typically focus on economic shocks and interconnectedness.[73] For instance, the Group of Ten[74] has used the following definition that concerns effects on the real economy:

> Systemic financial risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainly about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy . . . . The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values.[75]

Even absent a formal definition, systemic risk is crucial to understand because banking entities play a unique role in the stability of the U.S. financial system.

Systemic risk in the financial system involves "a potential cascading failure in a system or market due to . . . interdependencies"[76] where "the failure of one significant financial institution can cause or significantly contribute to the failure of other significant financial institutions."[77] This hazard is significant because the financial system affects the real economy

70. *Id.* at xxiii.

71. *Id.*

72. Manasfi, *supra* note 19, at 191. The "real economy" is defined as the part of the economy concerned with producing goods and services rather than buying and selling in financial markets. *See Definition of Real Economy*, FIN. TIMES, http://lexicon.ft.com/Term?term=real-economy [https://perma.cc/AG4T-WPY4] (last visited Apr. 13, 2018).

73. *See, e.g.*, Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1353 (2011) (noting that multiple, and sometimes inconsistent, definitions have been used, while providing an example focused on economic shock and market failure).

74. The "Group of Ten" is a group of countries that have agreed to lend money to the International Monetary Fund. *See* S.N. CHAND, DICTIONARY OF ECONOMICS 153 (2006).

75. GROUP OF TEN, REPORT ON CONSOLIDATION IN THE FINANCIAL SECTOR 126 (2001), http://www.bis.org/publ/gten05.pdf [https://perma.cc/6LCU-X34J].

76. Manasfi, *supra* note 19, at 189.

77. Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 673 (2010).

directly and significantly through bank lending.[78] Such danger can also hinder the "multiplier effect," the dynamic between banks and borrowers whereby changes in bank deposits change the money supply and the amount of outstanding credit.[79] When a bank receives a deposit, it may keep a portion of it on reserve and loan out the rest, which increases the economy's money supply.[80] The borrower of that subsequently loaned-out portion can deposit it in a bank that in turn keeps a portion of that deposit and loans out the rest.[81] Systemic risk's threat to this dynamic can create a gradual collapse in the financial system that eventually ripples into the real economy and can create distress beyond just banks and investors.[82]

Professor Hal Scott identified four interdependencies between banks that produce systemic risk, but only one—counterparty risk on derivative transactions—is relevant to this analysis.[83] These transactions create counterparty risk and were a key issue in the 2008 crisis.[84] Credit default swaps (CDS) were widely held derivatives, and investors seeking to hedge against losses from RMBSs fueled their popularity.[85] This practice encouraged the mortgage-securitization pipeline that ultimately collapsed.[86] When the housing bubble burst and RMBSs lost their value, CDS holders sought protection from the CDS seller who insured their principals, which caused sellers to incur tremendous losses:

> [W]hen the housing bubble popped and crisis followed, derivatives were in the center of the storm. AIG, which had not been required to put aside capital reserves as a cushion for the protection it was selling, was bailed out

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78. *See id.* at 673 n.7; *see also* Manasfi, *supra* note 19, at 189 (citing Adam B. Ashcraft, *Are Banks Really Special?: New Evidence from the FDIC-Induced Failure of Healthy Banks*, 95 AM. ECON. REV. 1712, 1728 (2005)).

79. *Multiplier Effect*, INVESTOPEDIA, http://www.investopedia.com/terms/m/multipliereffect.asp [https://perma.cc/P98V-QPBA] (last visited Apr. 13, 2018).

80. *See* Manasfi, *supra* note 19, at 189.

81. *See id.*

82. *See id.* at 191.

83. *See* Scott, *supra* note 77, at 673–75. The other three interdependencies Scott discusses are interbank deposits through loans and correspondent accounts, net settlement payment systems, and imitative bank runs. *Id.*

84. *Id.* at 675 ("Here the concern is that if institution *X* fails to settle its derivative position with institution *Y*, both *X* and *Y* will fail. If *Y* in turn cannot settle its positions, other institutions will also fail."). These derivative transactions are also particularly important when considering the failure of nonbanks. *Id.* ("This is one area in which the failure of non-banks is a major concern, but the severity of this form of systemic risk and the degree of interconnectedness among financial institutions is currently unknown.").

85. *See* FCIC FINAL REPORT, *supra* note 1, at xxiv. Credit default swaps are a type of derivative that transfers credit exposure from fixed income products between two or more parties. *See Credit Default Swaps–CDS*, INVESTOPEDIA, http://www.investopedia.com/terms/c/creditdefaultswap.asp [https://perma.cc/5LQE-962E] (last visited Apr. 13, 2018). An investor who buys a fixed income asset, like a bond, may also purchase a CDS from a business who insures the principal amount between the bond issuer and the investor. The investor receives the CDS in return for periodic payments to the seller until the bond's maturity date. If the bond defaults, which renders the investor unable to receive future interest payments, the CDS allows the investor to receive the principal from the seller. *See id.*

86. *See* FCIC FINAL REPORT, *supra* note 1, at xxiv ("Companies sold protection—to the tune of $79 billion, in AIG's case—to investors in these newfangled mortgage securities, helping to launch and expand the market and, in turn, to further fuel the housing bubble.").

> when it could not meet its obligations. The government ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the global financial system.[87]

Interdependencies that create risk do not only exist in the context of large banks—AIG, for example, is an insurance company—even though banks shouldered much of the blame for the crisis.[88] Dodd-Frank listed various traits to consider when determining nonbank financial companies' systemic risk, such as a company's leverage, its financial assets, and "the extent and nature of the transactions and relationships of the company with [significant banks and nonbanks]."[89]

B. The Volcker Rule: Hindering the Proprietary Trading Activities of Financial Institutions

The Volcker Rule is implemented in Title VI of the Dodd-Frank Act, entitled "Improvements to Regulation of Banks and Savings Association Holding Companies and Depository Institutions."[90] The Rule restricts banking entities[91] from engaging in proprietary trading and from sponsoring, acquiring, or retaining any equity, partnership, or other ownership interest in a hedge fund or a private equity fund.[92]

The Rule has broad reach, which can be partially attributed to its definition of "banking entity." "The term 'banking entity' means any insured depository institution . . . , any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity."[93] An "insured depository institution" means any bank or savings association whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) pursuant to the Federal Deposit Insurance Act.[94] A "company that controls an insured depository institution" may be a bank holding company or a savings and loan holding company.[95] A company that "is treated as a bank holding company" under the International Banking Act of 1978 is generally a foreign bank that has a

87. *Id.* at xxv.

88. *See* Manasfi, *supra* note 19, at 190–91; *see also* Scott, *supra* note 77, at 676 ("The threat of systemic risk (whether real or imagined) results in both the need for government bailouts at taxpayer expense and in an increase in moral hazard. . . . The politics of supplying money to banks are unpopular and unsustainable by the Federal Reserve over the long term without intense public scrutiny and loss of independence.").

89. 12 U.S.C. § 5323(a)(2)(C) (2012).

90. *Id.* § 1851.

91. See *infra* text accompanying note 93 for the definition of "banking entity."

92. 12 U.S.C. § 1851(a)(1).

93. *Id.* § 1851(h)(1).

94. *See Id.* § 1813(c)(2)–(3) ("[T]he term 'insured depository institution' means any bank or savings association the deposits of which are insured by the [FDIC] pursuant to this Act. . . . [The term] includes any uninsured branch or agency of a foreign bank or a commercial lending company owned or controlled by a foreign bank . . . .").

95. *See* 12 C.F.R. § 248.2(c)(ii) (2018); *see also* SULLIVAN & CROMWELL LLP, VOLCKER RULE 7 (2014), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Volcker_Rule.pdf [https://perma.cc/6KDS-PWP6].

branch in the United States.[96] An "affiliate" or "subsidiary" of these three previously defined banking entities are also considered to be banking entities. However, the following are excluded from the "affiliate" or "subsidiary" designation: a "covered fund,"[97] a portfolio company held under the Bank Holding Company Act for merchant banking or insurance investments,[98] or a "portfolio concern" controlled by a small business investment company.[99]

The Rule's prohibition on proprietary trading restricts banking entities from being the principal for their own trading accounts[100] or from buying or selling securities, derivatives, futures, options, or any other securities determined by certain federal agencies.[101] Under the Volcker Rule, such trading is permitted if it is "designed not to exceed the reasonably expected near term demands of clients"[102] or where the trader plans to hold the instrument as an investment for more than sixty days.[103] Despite the Rule's broad prohibitions, it allows multiple "permitted activities," such as transactions involving federal and state governments and agencies, market-making activities, and risk-mitigating hedging activities.[104] Some of these activities allow for offshore trading.[105]

The Rule's other prohibition on sponsoring, acquiring, or retaining interests in hedge funds or private equity funds prevents banks from buying assets with funds containing some of their clients' and their own money.[106]

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96. *See* 12 U.S.C. § 3106(a) ("Except as otherwise provided in this section (1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary shall be subject to the provisions of the Bank Holding Company Act of 1956, and to section 1850 of this title and chapter 22 of this title *in the same manner and to the same extent that bank holding companies are subject to such provisions*." (emphasis added)).

97. SULLIVAN & CROMWELL LLP, *supra* note 95, at 60 ("[C]overed funds—the Final Rule's term for any fund that it covers—apply to many entities and investment activities that would not traditionally have been referred to as 'hedge funds' or 'private equity funds.'").

98. *Id.* at 7 n.25 ("[Section 4(k) of the Bank Holding Act] describes the authority of financial holdings companies to engage in activities that are . . . 'financial in nature.' Subject to several conditions, this authority may extend to holding an ownership interest 'as part of a bona fide underwriting or merchant or investment banking activity' in a company that engages in activities that are impermissible for the financial holding company itself . . . .").

99. *Id.* at 7 n.26.

100. The Volcker Rule defines trading account as:

> [A]ny account used for acquiring or taking positions in the securities and instruments described in paragraph (4) [(the proprietary trading definition)] 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 . . . determine.

12 U.S.C. § 1851(h)(6). For the Volcker Rule's definition on proprietary trading, see *supra* note 13.

101. 12 U.S.C. § 1851(h)(4).

102. *Id.* § 1851(d)(1)(B).

103. *See Final Volcker Rule, Flowcharts: Prop Trading*, DAVIS POLK 4 (Dec. 23, 2013), https://www.davispolk.com/files/DavisPolk_Final_Volcker_Rule_Flowcharts_Prop_Trading.pdf [https://perma.cc/T9K6-LP9C] ("A rebuttable presumption that a trade is for a trading account arises if the banking entity . . . holds the instrument for fewer than 60 days . . . .").

104. 12 U.S.C. § 1851(d)(1).

105. *See id.* § 1851(d)(1)(H)–(I).

106. *Id.* § 1851(a)(1)(B).

These fund activities may also be considered a permitted activity; this asset management exception allows banks to sponsor, acquire, or retain an interest in a covered fund provided that they satisfy certain requirements.[107] Banks must provide bona-fide-trust, fiduciary, or investment-advisory services—around which the fund is organized—only to customers of such services of the bank.[108] They can neither make more than de minimis investments in the fund[109] nor insure its obligations.[110] They cannot share the same name, or a variation thereof, with the fund.[111] Bank directors and employees cannot retain interest in the fund unless they provide investment-advisory or other services directly to the fund.[112] Banks must provide written disclosures to investors that they, not the bank, bear losses in the fund.[113]

The prohibition on hedge fund and private equity fund activities includes other significant exceptions. A fund may be considered a "wholly owned subsidiary" where all of the ownership interests of the issuer are owned by the banking entity or its affiliate, in which case it is not a covered fund.[114] Certain joint ventures[115] and acquisition vehicles[116] are also not considered covered funds. Within the asset management exception,[117] banks may retain interest in these funds if they own no more than 3 percent of the fund's assets.[118]

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107. *See id.* § 1851(d)(1)(G); *see also Final Volcker Rule, Flowcharts: Prop Trading*, *supra* note 103, at 24.

108. *See* 12 U.S.C. § 1851(d)(1)(G)(i)–(ii).

109. *Id.* § 1851(d)(1)(G)(iii).

110. *Id.* § 1851(d)(1)(G)(v).

111. *Id.* § 1851(d)(1)(G)(vi).

112. *Id.* § 1851(d)(1)(G)(vii).

113. *Id.* § 1851(d)(1)(G)(viii).

114. *See Final Volcker Rule Regulations, Flowcharts: Funds*, DAVIS POLK 15 (Jan. 6, 2014), https://www.davispolk.com/files/Davis.Polk_.Final_.Volcker.Rule_.Flowcharts.Funds_.pdf [https://perma.cc/795Q-RHQH]; *see also supra* note 97 and accompanying text.

115. *See Final Volcker Rule Regulations, Flowcharts: Funds*, *supra* note 114, at 16. To determine whether a joint venture is a covered fund, several issues arise. Ownership of the issuer must include unaffiliated coventurers, where ownership is divided between a banking entity and at least one unaffiliated person. There cannot be more than ten unaffiliated coventurers. The issuer must engage in activities permissible for the banking entity, which does not include investing in securities for resale, such as merchant banking. Finally, the issuer cannot be held out as a private equity or hedge fund. *See id.* It cannot raise money primarily to "invest[] in securities for resale or other disposition or otherwise trad[e] in securities," which includes merchant banking, insurance company investing, or hedge fund activities. *Id.*

116. *See id.* at 17. Fewer issues arise to determine whether an acquisition vehicle is a covered fund. First, it must have limited purpose: the issuer must be formed solely for engaging in a bona fide transaction. Second, it must be limited in time: an issuer must exist only for the time necessary to complete the transaction. *See id.*

117. *See supra* notes 107–13 and accompanying text.

118. *See Final Volcker Rule Regulations, Flowcharts: Funds*, *supra* note 114, at 27 ("The maximum permissible investment . . . by a banking entity and its affiliates in a single covered fund under the asset management exemption, when aggregated with any ownership interests acquired or retained under the underwriting and market making exemption, is 3% of the total number or value of the outstanding ownership interests of the covered fund . . . .").

The Rule's activity restrictions address the compliance of nonbank financial companies.[119] Such companies are subject to additional capital requirements and quantitative limits with respect to the prohibited activities.[120] However, any permitted activities[121] that they engage in are not subject to these new sanctions "except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a banking entity."[122]

II. CONTROVERSY SURROUNDING THE VOLCKER RULE

This Part discusses arguments for and against the Volcker Rule in light of Dodd-Frank's aim to curb systemic risk. Politicians and the U.S. Securities and Exchange Commission (SEC) typically employ pro-Volcker Rule arguments, which generally focus on proprietary trading's role in the financial crisis[123] and its inherent risk.[124] Part II.A discusses these arguments. In contrast, many economists and law professors have voiced displeasure with the Rule for multiple reasons, including its ambiguity, its off-the-rack promulgation, and its creation of illiquidity in bond markets.[125] Part II.B speaks to these arguments.

A. Proponents of the Rule: Why It Works

This Part examines two primary arguments in favor of the Volcker Rule. Part II.A.1 discusses how proprietary trading played a role in the financial crisis, and Part II.A.2 analyzes the inherent risk in proprietary trading.

1. The Role of Proprietary Trading in the Financial Crisis

One primary argument in favor of the Volcker Rule is that proprietary trading must be curbed due to its role in the financial crisis. Luis Aguilar, SEC Commissioner from 2008 through 2015, makes this argument in his statement on the Volcker Rule upon its promulgation.[126] Aguilar alludes to the sentiment that public bailouts forced taxpayers to cover banks' losses due to their proprietary trading, a "key contributor to th[e] crisis."[127] He notes

119. *See* 12 U.S.C. § 1851(a)(2) (2012). The Board of Governors is permitted to determine which nonbank financial companies it can supervise. *See Id.* § 5323(a)(1); *see also supra* note 89 and accompanying text.

120. *See* 12 U.S.C. § 1851(a)(2).

121. *See id.* § 1851(d)(1).

122. *Id.* § 1851(a)(2); *see also id.* § 1851(d)(3) ("The appropriate Federal banking agencies, the [SEC], and the Commodity Futures Trading Commission shall, *as provided in subsection (b)(2)*, adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, regarding the activities permitted under this section if the appropriate Federal banking agencies . . . determine that additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities." (emphasis added)).

123. *See infra* Part II.A.1.

124. *See infra* Part II.A.2.

125. *See infra* Part II.B.

126. Press Release, Luis A. Aguilar, *supra* note 15.

127. *Id.*

that proprietary trading creates substantial investor protection risks: "Indeed, banks have, in the past, created and marketed products that were secretly designed to fail."[128] Commissioner Aguilar lauds the Volcker Rule and concludes that "[p]roprietary trading . . . racked up huge losses and was one of the factors that forced American taxpayers to bail out the banking system."[129]

Professor Onnig Dombalagian's similar comments reinforce Commissioner Aguilar's statement that taxpayers were forced to cover banks' losses due to proprietary trading.[130] Dombalagian writes that regardless of whether proprietary trading was a precipitating cause of the crisis, it plainly "exacerbated losses in connection with the securitization and related derivatives activities that contributed to the recent collapse of the financial sector."[131]

Dombalagian further notes that proprietary trading's destabilization of cash and derivatives markets, which exacerbated losses in the crisis, is a justification for the Rule.[132] Proponents of the Rule argue that proprietary trading "increases the complexity . . . and latent interconnectedness of over-the-counter derivatives markets."[133] The largest banking institutions conduct most transactions in these over-the-counter (OTC) markets so, absent adequate collateralization and markets to standardize these instruments, indirect counterparty credit risk rises dramatically.[134] In early 2010, Neal Wolin, former Deputy Secretary of the Treasury, made this statement to the Senate Banking Committee: "Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms 'bailed out' their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most."[135] With this statement, Wolin echoes Dombalagian's concern for counterparty credit risk in proprietary trading before the crisis, as discussed above.

2. Proprietary Trading's Inherent Risk

A second argument in favor of the Rule rests on the inherent risk of proprietary trading, which banks seemingly transfer to their clients. The notion that banks marketed products that were designed to fail, as Commissioner Aguilar stated, resonates in an article by Senators Jeff

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128. *Id.*

129. *Id.*

130. *See* Onnig H. Dombalagian, *Proprietary Trading: Of Scourges, Scapegoats, and Scofflaws*, 87 CIN. L. REV. 387, 392–93 (2012) [hereinafter Dombalagian, *Of Scourges, Scapegoats, and Scofflaws*] ("A causal relationship between such proprietary trading and the financial crisis is more difficult to establish, although it is easier to assert that proprietary trading exacerbated the impact of the crisis."); Onnig H. Dombalagian, *The Expressive Synergies of the Volcker Rule*, 54 B.C. L. REV. 469, 470 (2013) [hereinafter Dombalagian, *Expressive Synergies*].

131. Dombalagian, *Expressive Synergies*, *supra* note 130, at 470.

132. *See* Dombalagian, *Of Scourges, Scapegoats, and Scofflaws*, *supra* note 130, at 393.

133. *Id.* at 398.

134. *See id.*

135. S. REP. NO. 111-176, at 9 (2010).

Merkley and Carl Levin on combating proprietary trading after the crisis.[136] Senators Merkley and Levin, both staunch Volcker Rule supporters, argue that creating and marketing products to clients that were secretly designed to fail is a notable way in which banks put their own proprietary trading interests ahead of their clients' interests.[137] After massive financial deregulation in the late twentieth century, competition rose and commercial and investment banks grew rapidly, which fueled proprietary trading.[138] This increase allowed banks to deal with more complex assets whose risk was transferred to clients.[139]

The Senators' argument centers on a study of a CDO that Goldman Sachs created in 2006 to reduce its exposure to RMBSs.[140] Dodona I, LLC, invested in two synthetic CDO offerings from Goldman, named Hudson Mezzanine Funding 2006-1 ("Hudson 1") and Hudson Mezzanine Funding 2006-2 ("Hudson 2").[141] Dodona purchased $3 million of Hudson 2 notes and $1 million of Hudson 1 notes in early 2007.[142] The CDOs' credit quality deteriorated rapidly as the housing market collapsed, and their ratings subsequently plummeted as Goldman received insurance payouts due to the downgrades.[143] In April 2011, the U.S. Senate Permanent Subcommittee on Investigations cited Hudson 1 and Hudson 2 in its findings on the financial crisis.[144] With respect to these CDOs, the Subcommittee concluded that Goldman "issued and sold to clients . . . CDO securities containing or referencing high risk assets that Goldman Sachs wanted to get off its books."[145]

The Senators' description of the Rule's prohibition against proprietary trading illustrates their broad defense of the Volcker Rule: "This is a self-executing Rule of law that establishes a clear and strong statutory prohibition on banks engaging in high-risk activities."[146] They further recognize how important, yet difficult, implementation of the prohibition and its exceptions would be: "The statutory language provides significant direction . . . but regulators must still flesh out the details. This will be a challenging process.

136. *See* Jeff Merkley & Carl Levin, *The Dodd-Frank Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 523 (2011).

137. *See id.*

138. *See id.* at 521–22.

139. *See id.*

140. *See id.* at 523–34.

141. *See* Dodona I, LLC v. Goldman, Sachs & Co., 847 F. Supp. 2d 624, 630 (S.D.N.Y. 2012).

142. *See id.* at 635.

143. *See id.* ("By mid-2008, Standard & Poor's had downgraded $286 million of the Hudson 2 notes, and the Hudson 1 notes were downgraded to junk status.").

144. *See id.*; *see also Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 111 Cong. VII–IX (2010).

145. *Dodona I*, 847 F. Supp. 2d at 635. Dodona sued Goldman Sachs, alleging violations of the Securities Exchange Act of 1934 as well as common law fraud, aiding and abetting fraud, fraudulent concealment, and unjust enrichment. *Id.* at 630. For a discussion of the outcome of this lawsuit, see *infra* Part II.B.

146. Merkley & Levin, *supra* note 136, at 539.

In particular, the permitted activities covered by 'market-making,' 'risk-mitigating hedging,' and 'organizing and offering' private funds . . . deserve special attention."[147] They certainly echo Commissioner Aguilar's concerns for both the role of proprietary trading in the crisis and its riskiness, which certain securities offerings—those seemingly designed to fail—have demonstrated.

B. Opponents of the Rule: Why It Fails

This Part examines various arguments against the Volcker Rule to counter the pro-Volcker stances discussed in Part II.A. Part II.B.1 discusses how proprietary trading played an insignificant role, if any at all, in the financial crisis. Part II.B.2 then addresses alleged ambiguity in the Rule's language. Part II.B.3 suggests that the Rule is unable to actually reduce systemic risk. Next, Part II.B.4 introduces the notion that the Rule's promulgation was primarily crisis-driven. Part II.B.5 discusses how the Rule may have a detrimental impact on bond market liquidity. Finally, Part II.B.6 examines how parties that are not as regulated as banks have absorbed risk as a result of the Rule.

1. Proprietary Trading's Limited Role in the Financial Crisis

The most notable criticism of the Volcker Rule may be that the role of proprietary trading in the financial crisis was insignificant.[148] As mentioned above, although Professor Dombalagian believes that this type of trading exacerbated losses after the crisis, he also believes that the notion that proprietary trading actually led to the crisis is relatively tenuous: "A causal relationship between such proprietary trading and the financial crisis is more difficult to establish, although it is easier to assert that proprietary trading exacerbated the impact of the crisis."[149]

Some argue that the Rule's definition of proprietary trading does not cover much activity that led to the crisis.[150] According to Professor John C. Coffee Jr., "there is almost no evidence that proprietary trading was responsible for the failure of any financial institution in the 2008 crisis."[151] He notes that firms that failed, such as Lehman Brothers, did so because of "ill-advised principal investments."[152] In particular, Lehman made undiversified, overleveraged acquisitions of both real estate lenders and developers.[153] The Rule exempts these principal investments, which Coffee uses to suggest that the Rule may even be "seriously underinclusive" of the true causes of institutional failure during the crisis.[154]

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147. *Id.* at 542–43.

148. *See, e.g.*, Coffee, *supra* note 9, at 1073–74 (citing Terry Pristin, *Risky Real Estate Deals Helped Doom Lehman*, N.Y. TIMES, Sept. 17, 2008, at C6).

149. Dombalagian, *Of Scourges, Scapegoats, and Scofflaws*, *supra* note 130, at 392–93.

150. *See, e.g.*, Coffee, *supra* note 9, at 1074.

151. *Id.* at 1073.

152. *Id.* at 1073–74.

153. *Id.* at 1074.

154. *Id.*

The FCIC report's two dissenting opinions reflect many critics' arguments that proprietary trading was absent in the crisis.[155] For instance, the dissents contradict the majority's use of Goldman Sachs CDOs as an example of proprietary trading's role in the crisis. In the second dissent, Wallison and Burns refer to CDOs as merely a method of transporting risky mortgages—the true culprits—which undermines Senators Merkley and Levin's criticisms of Goldman Sachs's Hudson CDOs.[156] Although these CDOs made Dodona incur significant losses at Goldman's expense, based on their reasoning, it is possible that Wallison and Burns might advocate fixing securities with inherent, substantial risk, rather than scorning the methods by which they are traded.

According to Wallison and Burns, such scorn for the banks' use of CDOs does not focus on the main source of market risk that precipitated the crisis: twenty-seven million nontraditional mortgages that poor origination standards perpetuated[157] with a value exceeding $4.5 trillion.[158] To stress this point, Wallison and Burns critique statements made in a private interview between FCIC members and Larry Summers—former head of the White House Economic Council and one of President Obama's key advisors—about whether the mortgage meltdown was a key contributor to the crisis.[159] Summers stated that the meltdown was like a "cigarette butt" thrown in a dry forest, which created a forest fire that was the financial crisis.[160] Wallison and Burns attack this claim with their own interesting analogy to stress the apparent role that the creation of subprime mortgages played in the crisis:

> Let's use a little common sense here: $4.5 trillion in high risk loans was *not* a "cigarette butt;" they were more like an exploding gasoline truck in that forest. The Commission's [majority] report blames the conditions in the financial system; I blame 27 million subprime and Alt-A mortgages—half of all mortgages outstanding in the U.S. in 2008 . . . . No financial system, in my view, could have survived the failure of large numbers of high risk mortgages once the bubble began to deflate . . . .[161]

As a potential counterargument to how banks' use of CDOs built market risk, Dodona's suit against Goldman ultimately failed in the Southern District of New York years after Senators Merkley and Levin's article was published.[162] The court eventually granted summary judgment to Goldman against Dodona's fraud-based claims.[163] Finding that such an apparently damning trading practice lacked fraud may further undermine the Senators' use of this anecdote in their article to condemn proprietary trading's alleged design to fail. The court noted that Dodona lacked evidence to demonstrate

155. *See supra* Part I.A.1.
156. *See supra* notes 141–45 and accompanying text.
157. *See* FCIC FINAL REPORT, *supra* note 1, at 451.
158. *See id.* at 470.
159. *See id.* at 469.
160. *Id.*
161. *Id.* at 470.
162. *See generally* Dodona I, LLC v. Goldman Sachs & Co., 132 F. Supp. 3d 505 (S.D.N.Y. 2015).
163. *Id.* at 510.

certain risks that Goldman knew of but failed to disclose; such thinking was merely speculation.[164] Although emails from Goldman employees indicated that they thought that mortgage credit markets were deteriorating, such language did not establish that Goldman's practice of concealing risk was a "knowing business strategy."[165] Goldman also had no duty to disclose its strategy of reducing exposure to RMBSs through the Hudson CDOs.[166]

Although Dodona claimed Goldman concealed the likelihood that the CDOs would decline in value, Dodona again lacked evidence showing that Goldman concealed material investment risk.[167] Dodona's expert testimony established that Goldman had asymmetric information about its intent and purpose but could not support a finding for material omissions.[168] In fact, the expert testimony actually established that Goldman had disclosed the disputed material information.[169]

2. The Volcker Rule's Ambiguity

The role of proprietary trading in the crisis aside, many articles employ other arguments criticizing the Volcker Rule. The Rule's sheer ambiguity and intractability is noted as "Wall Street's most frequent complaint" about the Volcker Rule.[170] This ambiguity has burdened banks as it has "force[d them] to stay away from the edges of what's allowed."[171] This anti-Volcker argument has actually received a degree of bipartisan support.[172] When agreeing with Republican Senator Mike Crapo, the Senate Banking Committee Chairman, about the need to simplify the Rule, Democratic Senator Heidi Heitkamp stated, "It is my experience that when a rule's too complicated, there isn't much compliance, so it doesn't really get you what you need."[173]

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164. *See id.* at 513.

165. *Id.* at 514.

166. *Id.*

167. *See id.*

168. *See id.* at 515.

169. *See id.* ("If . . . Plaintiffs' expert had actually indicated that Goldman concealed 'important information,' such as realized loss, there might be a genuine dispute as to a material fact. However, . . . their expert actually stated that the remittance reports available to investors *did* show 'realized loss' data.").

170. Benjamin Bain & Jesse Hamilton, *Wall Street Regulators Are Set to Rewrite the Volcker Rule*, BLOOMBERG (Aug. 1, 2017, 4:00 AM), https://www.bloomberg.com/news/articles/2017-08-01/volcker-rewrite-is-said-to-start-as-trump-regulators-grab-reins [https://perma.cc/MS6M-CDSE].

171. *Id.*; *see also* Jesse Hamilton, *Why Volcker Rule Review Is Music to Bankers' Ears: Quick Take Q&A*, BLOOMBERG (Aug. 1, 2017, 3:46 PM), https://www.bloomberg.com/news/articles/2017-05-18/why-volcker-rule-review-is-music-to-bankers-ears-quicktake-q-a [https://perma.cc/2V5F-BX2D] ("Regulators have tried to define the kinds of trades that are banned, but banks say the agencies have issued confusing guidance and overstepped their bounds.").

172. *See* Rob Tricchinelli, *Volcker Rule Changes Likely as Focus Shifts to Regulators*, BLOOMBERG (June 23, 2017), https://www.bna.com/volcker-rule-changes-n73014460637/ [https://perma.cc/65ZJ-7FGG] ("Senate Banking Committee Chairman Mike Crapo (R-Idaho) said there is bipartisan interest in 'simplifying the Volcker Rule.' Panel Democrat Sen. Heidi Heitkamp (N.D.) was inclined to agree.").

173. *Id.*

The Rule went through the administrative process both incomplete and contested before it even entered the rulemaking phase.[174] Even before publishing the Rule's notice of proposed rulemaking (NPRM), effectively implementing the Rule required differentiating banned proprietary trading from permitted proprietary trading, such as market making.[175] Although this inquiry required extensive rulemaking, it is still problematic today.[176] Much political tension accompanied this issue as critics and proponents clashed on how broadly or narrowly the Rule should define terms.[177] The Financial Stability Oversight Council received more than 8000 comments on the rule in a thirty-day period before the NPRM, which is uncommonly high.[178] This high comment activity continued into the post-NPRM period, when nearly 18,500 comments were given.[179] This onerous promulgation left tremendous uncertainty about the Rule's scope, costs and benefits, and many of its provisions.[180]

Outside of the Volcker Rule's promulgation, there are two particular sources of ambiguity in the Rule's language. First, the definition of "proprietary trading"[181] turns in part on the definition of "trading account."[182] Proprietary trading under the Rule concerns "engaging as a principal for the *trading account* of [a] banking entity,"[183] and trading accounts refer to "any account used for . . . taking positions in the securities and instruments described in [proprietary trading's definition] *principally for the purpose of selling in the near term*."[184] This "purpose test" in the definition of "trading account" has become a subjective, fact-intensive inquiry into the traders' intent at the time of the transaction, which introduces considerable complexity.[185]

The second instance of ambiguity is in the line between proprietary trading and the exception for market-making activities.[186] The root of this exception's complexity is primarily based on whether such activities exceed the reasonably expected near-term demands of clients, which imposes a limit on the amount of securities banks can hold in their market-making

174. *See* Kimberly D. Krawiec & Guangya Liu, *The Volcker Rule: A Brief Political History*, 10 CAP. MARKETS L.J. 507, 522 (2015).

175. *See id.* at 511.

176. *See id.* at 510–11.

177. *See id.* at 511.

178. *Id.* at 513 ("[S]tudies repeatedly show limited comment activity in connection with most rulemakings, [except for relatively few] high-salience issues . . . . Eight thousand comments . . . is, therefore, a surprisingly high level . . . and suggests that the [Rule] was a high salience issue, even [before NPRM]." (footnote omitted)).

179. *Id.* at 516.

180. *See id.* at 522.

181. 12 U.S.C. § 1851(h)(4) (2012).

182. *Id.* § 1851(h)(6).

183. *Id.* § 1851(h)(4) (emphasis added).

184. *Id.* § 1851(h)(6) (emphasis added).

185. U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS 74 (2017) [hereinafter TREASURY REPORT].

186. *Compare* 12 U.S.C. § 1851(h)(4) (defining proprietary trading), *with id.* § 1851(d)(1)(B) (defining the market-making exception).

inventory.[187] The Treasury has noted that this "Reasonably Expected Near Term Demands" (RENTD) framework is problematic because banks may not have enough inventory to make markets in instruments where the RENTD is too narrow.[188]

3. Lack of Evidence Suggesting the Volcker Rule's Ability to Reduce Systemic Risk

Another attack on the Volcker Rule cites a lack of evidence that the Rule decreases systemic risk. Professor Hal Scott similarly criticizes the Rule for its inability to curb systemic risk.[189] He posits three main reasons for this belief. First, proprietary trading is relatively uncommon among banks: "Wells Fargo and Bank of America, two of the largest deposit-funded banks, are estimated to earn less than 1% of revenues from proprietary trading."[190] Second, systemic risk in the financial system is not concentrated solely in banks.[191] None of the most notorious failures of the financial crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns, or Lehman—occurred in deposit-taking banks.[192] Third, losses from lending and securitization were the real cause of the financial crisis and, therefore, focusing on and prohibiting proprietary trading is improper.[193] Scott cites supporting data from Goldman Sachs, which estimates that losses from lending and securitization constituted about 80 percent of U.S. banks' overall credit losses.[194]

Professor Julie Manasfi's article on systemic risk and the Volcker Rule similarly posits that no evidence exists to establish either that deregulation led to the financial crisis or that the Rule will decrease systemic risk.[195] Like Wallison and Burns's dissent,[196] Manasfi cites the removal of the Glass-Steagall wall, but she highlights its boons: "[It] may have allowed banks to achieve diversification, liquidity, complementaries, and global competitiveness."[197] Manasfi warns that banning proprietary trading might erode these benefits and would ignore the "underlying causes of the excessive risk taking" that facilitated the crisis.[198]

Manasfi stresses the need for more studies on excessive risk-taking before implementing a broad prohibition on proprietary trading.[199] She echoes claims that proprietary trading carried a diminished role in the crisis: "[T]he

187. *Id.* § 1851(d)(1)(B); *see also* TREASURY REPORT, *supra* note 185, at 75.
188. *See* TREASURY REPORT, *supra* note 185, at 75 (quoting 12 C.F.R. § 248.4(b)(2)(ii) (2018)).
189. *See* Scott, *supra* note 77, at 676–77 ("[T]he 'Volcker Rules' and related limitations on bank size . . . do not have much if any potential to reduce systemic risk.").
190. *Id.* at 677.
191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.*
195. *See* Manasfi, *supra* note 19, at 209, 211.
196. *See* FCIC FINAL REPORT, *supra* note 1, at 445–46.
197. *See* Manasfi, *supra* note 19, at 209.
198. *Id.*
199. *See id.* at 211–12.

financial crisis . . . was likely caused by failures in our financial system that reach beyond proprietary trading in general."[200] Because of this diminished role, immediate calls to prohibit this trading activity—especially considering its potential benefits—may be overstated. The benefits of proprietary trading aside, such an outcome would put U.S. banks at a global disadvantage.[201] Her conclusion asks, "If we are trying to reduce systemic risk, why not study excessive risk taking in general and regulate more precisely instead of banning proprietary trading by banks and systemically significant entities altogether?"[202] This question summarizes Manasfi's argument as a call to properly diagnose the problem to treat its specific causes before implementing overinclusive solutions.

4. An "Off-the-Rack," Crisis-Driven Regulation

Manasfi's call to investigate excessive risk-taking before prohibiting proprietary trading alludes to another argument against the Volcker Rule: it is an "off-the-rack," crisis-driven regulation. Professor Roberta Romano best describes this argument as she criticizes "crisis-driven legislation" because it "often adopts off-the-rack solutions along with open-ended delegation to regulatory agencies . . . who perceive a political necessity to act quickly."[203] She explains that the Volcker Rule's promulgation was tedious and involved a "lengthy gestation period," albeit without evidence of industry capture.[204] This lack of capture demonstrates the "deep and genuine intellectual disagreement on both the efficacy and workability of the Volcker Rule."[205] This conflict may further undermine the plausibility of promulgating a rule quickly in response to a crisis without sufficiently evaluating the financial industry's comments on the matter.

Romano reiterates the notion that proprietary trading played "no meaningful role" in the crisis,[206] which further questions the need to enact a rule concerning an issue that may be irrelevant to Dodd-Frank's broad objective of curbing systemic risk. She attacks legislators for focusing on potentially irrelevant activities like proprietary trading rather than pertinent ones: "Although legislation plainly should seek to anticipate future financial crises and not solely address past ones, directing . . . regulatory efforts on resolving known and pressing regulatory issues over speculative ones is self-evidently a more rational and prudent regulatory agenda, given scarcity in

200. *Id.* at 212.
201. *See id.*
202. *Id.*
203. Roberta Romano, *Further Assessment of the Iron Law of Financial Regulation: A Postscript to Regulating in the Dark* 18 (European Corp. Governance Inst., Working Paper No. 273/2014, 2014).
204. *See id.* at 19. Industry capture regarding the rule's promulgation refers to "industry delaying tactics and resistance to wear down, or otherwise convince, regulators to adopt definitions favorable to banks." *Id.* For more context on the rule's promulgation, see *supra* Part II.B.2.
205. Romano, *supra* note 203, at 20–21.
206. *Id.* at 22 (quoting TIMOTHY F. GEITHNER, STRESS TEST REFLECTIONS ON FINANCIAL CRISES 414 (2014)).

agency time and resources."[207] This lack of focus becomes even more troubling when one considers that the Volcker Rule is estimated to cost banking entities nearly, if not more than, $4 billion.[208] Romano advocates sunsetting, which would allow Congress to reassess and revise the Rule.[209]

5. The Volcker Rule as a Detriment to Bond Market Liquidity

Another criticism of the Volcker Rule is that it stifles bond market liquidity. In his study of the Rule, Jack Bao, Principal Economist for the Federal Reserve, provides an empirical analysis of the Rule's impact "on liquidity for corporate bonds, particularly during stress events."[210] Bao uses downgrades of corporate bonds to junk status as stress events where clients demand liquidity. He then compares this illiquidity to a control group both before and after the Rule's promulgation.[211] Bao concludes that prohibiting proprietary trading has "significant costs."[212]

The study's primary finding is that the Rule's net effect is detrimental to corporate bond liquidity and that, under the Rule, dealers are less willing to provide liquidity during times of stress.[213] Some weak evidence even suggests that dealers not subject to the Rule have provided liquidity in these stress times.[214] With respect to the market-making exception in particular, Bao states that

> the rules defining this exemption are cumbersome, and their implementation unwieldy, with the result that bank dealers have indeed pulled back from corporate bond market making in stress periods post-Volcker. This may suggest . . . that "an attempt to separate legitimate and acceptable market-making from speculative and risky market-making is not productive."[215]

The finance community has echoed Bao's concerns: "Bankers say it stifles what is the essence of Wall Street—trading stocks, bonds and other instruments."[216] Lloyd Blankfein of Goldman Sachs has affirmed these illiquidity worries:

> "[Banks] should be able to be principals because market-making is a very important public function of companies like ours," Blankfein said. "If we don't do that, the drop in liquidity will not allow . . . industries and investors

207. *Id.*
208. *See id.* at 23.
209. *See id.*
210. Jack Bao et al., The Volcker Rule and Corporate Bond Market-Making in Times of Stress 2 (Jan. 26, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2836714.
211. *Id.* at 3.
212. *Id.* at 6.
213. *See id.* at 31, 37.
214. *See id.*
215. *Id.* at 32.
216. Bain & Hamilton, *supra* note 170.

> to accomplish their objectives, which are beneficial to the financial markets. There should be more flexibility."[217]

6. Less Regulated Nonbank Entities May Absorb Risk That Banks No Longer Assume

A final criticism of the Volcker Rule is that it pushes risk inherent in proprietary trading to less-regulated nonbank entities. Professor Darrell Duffie's paper on market making under the Rule suggests that prohibiting proprietary trading could push certain market-making activities to nonbank entities such as hedge funds or insurance companies, neither of which are heavily regulated.[218] Duffie argues that this shift contradicts congressional intent and may also "have unpredictable and potentially adverse consequences for the safety and soundness of our financial system."[219] He admits that the Financial Stability Oversight Council still designates large nonbank dealers as systematically important but notes that the Federal Reserve's liquidity support is more difficult to arrange for such dealers.[220] The assumption that nonbank market makers will have adequate regulatory supervision, liquidity, and effective capital and liquidity requirements seems idyllic.[221]

Private equity firms' entrance into the RMBS market is evidence that some nonbank entities have begun engaging in proprietary trading, which reinforces Duffie's concerns.[222] Banks and government lenders pulled back from this space after regulatory crackdowns during the financial crisis, which allowed other entities to purchase their delinquent mortgages.[223] Large private equity firms entered this space and began purchasing, securitizing, and selling RMBSs as banks had done before the crisis, but with far less oversight.[224] These firms saw an opportunity to invest in distressed assets that banks and lenders were looking to sell quickly:

> As new regulations prompted banks to scale back their servicing of mortgages, companies owned by private equity went on a buying spree. Private equity sensed an opportunity as the mortgage servicing business

217. Campbell, *supra* note 9. In contrast to these liquidity concerns, a report from the SEC's Division of Economic and Risk Analysis found mixed evidence of any impact on corporate bond markets, which illustrates the difficulty of directly attributing illiquidity to the Volcker Rule. SEC, ACCESS TO CAPITAL & MARKET LIQUIDITY 8 (2017). The report noted that although the Rule and other reforms may reduce liquidity in corporate bond markets—as dealers have reduced their capital commitment since 2007—other alternative explanations exist. *Id.* Such explanations may include "crisis-induced changes in dealer assessment of risks" and "the effects of a low interest rate environment." *Id.*

218. *See* Darrell Duffie, *Market Making Under the Proposed Volcker Rule* 5 (Rock Ctr. for Corp. Governance, Working Paper No. 106, 2012).

219. *Id.* at 6.

220. *See id.*

221. *See id.*

222. *See id.* at 5.

223. *See* Matthew Goldstein et al., *How Housing's New Players Spiraled into Banks' Old Mistakes*, N.Y. TIMES (June 26, 2016), https://www.nytimes.com/2016/06/27/business/dealbook/private-equity-housing-missteps.html [https://perma.cc/8M3G-B8PV].

224. *See id.*

> became a liability for the banks, leading Bank of America alone to reach settlements worth billions of dollars over federal accusations of using illegal foreclosure documents and unfair rejections of loan modifications. Since 2012, Nationstar[, a private equity firm that became the fourth-largest collector of mortgage bills,] has bought the rights to collect payments on more than $450 billion in mortgages, much of it from Bank of America.[225]

Although evidence suggests that private equity activity in the RMBS market has benefited the U.S. economy,[226] seizing this opportunity has garnered sharp criticism. Banks, unlike private equity firms, are obligated to meet the credit needs of low-income neighborhoods under the Community Reinvestment Act.[227] Private equity investment in RMBSs has not benefited poor neighborhoods in the way that banks would have if they were the investing entity.[228] Private equity firms are also allegedly foreclosing on homeowners quickly and losing families' mortgage paperwork, mistakes that banks have been accused of.[229] Private equity firms' mortgage-originating subsidiaries face less scrutiny than banks, which raises further concerns that there is inadequate testing for their financial soundness.[230]

III. AMENDING THE VOLCKER RULE

The Volcker Rule seeks to advance Dodd-Frank's broad objective of curbing systemic risk, but it does so at some apparent expense to the community it regulates. The issue of whether the Rule ultimately advances Dodd-Frank's goals, as well as whether it should actually be repealed or amended, still persists. Despite tremendous complexity surrounding the Rule and its implications, this Note proposes certain amendments to the Volcker Rule with an aim to demystify its ambiguous language. Part III.A discusses how amending the Volcker Rule is appealing because it is feasible to allow banks to engage in profitable trading while regulating and curbing excessive risk-taking. Part III.B details this Note's recommendations for amending the Rule: simplify the definition of proprietary trading, broaden the market-making exception to the Rule's prohibition, and implement greater protections against risk-taking that do not affect trading directly.

A. Striking a Balance: Allowing Banks to Profit and Curbing Excessive-Risk-Taking Are Not Mutually Exclusive

Neither repealing the Volcker Rule nor completely upholding its current version seem proper. Notwithstanding credible concerns about its hurting

225. *Id.*

226. *See id.* ("The firms displaced poorly performing banks. They also helped stabilize the nation's housing market, and it achieved that through smart business decisions about where to put its money. That, in turn, rewarded investors—which is how private enterprise is supposed to work.").

227. *See id.*

228. *See id.*

229. *See id.*

230. *Id.*

bond liquidity,[231] it is plausible that the Rule does not fully achieve Dodd-Frank's goal of eliminating systemic risk.[232] Arguments that proprietary trading played an insignificant role in the crisis[233] certainly fuel criticism that the Rule is an unnecessary, off-the-rack regulation.[234] In contrast, whether the Rule actually does promote illiquidity is uncertain and may be impossible to know.[235] Excessive risk-taking and increasingly risky trading activities fueled the crisis[236] as proprietary trading undoubtedly exacerbated losses due to securitization and derivative transactions.[237]

Rather than outright repealing the Rule or completely upholding it, striking a balance between both sides of this debate seems more proper. This balance entails curbing systemic risk while allowing banks to continue to profit by finding a way to allow banks to engage in and profit from proprietary trading while ensuring that they are not induced to show excess profits in a way that causes them to carry enormous risk. That latter inducement is an inherent problem because banks are publicly traded companies; they will always want to show growing profits to appease their shareholders. This natural inclination will inevitably push banks toward proprietary trading or other risky, yet profitable, activities.

The opportunity to potentially amend the Volcker Rule may help regulators to strike a balance between letting banks follow their natural public-company instinct while curbing excessive risk-taking in their pursuits. Banks are likely to be more receptive to this balance than to full repeal.[238] Jerome Powell, the Chairman of the Federal Reserve, spoke to this notion directly at a Senate Banking Committee hearing after his nomination for his current role: "In our view, there is room for eliminating or relaxing aspects of the implementing regulation in ways that do not undermine the Volcker Rule's main policy goals."[239]

This Note recommends amending the Volcker Rule primarily by simplifying the Rule's language. Members of both political parties recognize issues arising from such ambiguity and complexity[240]—their most frequent complaint—which must be rectified to allow banks to engage in profitable trading while operating within clear boundaries of the law.[241] Such clarity

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231. *See* Bao et al., *supra* note 210, at 31–32, 37.

232. *See* Scott, *supra* note 77, at 676–77.

233. *See, e.g.*, Romano, *supra* note 203, at 22.

234. *See id.* at 18–21.

235. *See* SEC, *supra* note 217, at 8.

236. *See supra* notes 27–28 and accompanying text.

237. *See* Dombalagian, *Expressive Synergies*, *supra* note 130, at 470.

238. *See* Ben Protess, *Jamie Dimon Shows Some Love for Volcker Rule*, N.Y. TIMES (May 21, 2012), https://dealbook.nytimes.com/2012/05/21/jamie-dimon-shows-some-love-for-volcker-rule [https://perma.cc/GF5P-NLS3] (noting that, although Jamie Dimon, Chairman and CEO of JP Morgan Chase & Co., does not disagree with the Volcker Rule's intent, he stated that "if you want to be trading, you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something").

239. Tricchinelli, *supra* note 172.

240. *See id.*

241. *See supra* note 171 and accompanying text.

may also help corporate liquidity and market making during times of stress.[242]

B. Recommendations

First, this Note recommends eliminating the "purpose test" to simplify the definition of proprietary trading.[243] Such a modification would likely have support from both the financial services industry[244] and the Treasury Department.[245] This test determines whether a trading account is used "principally for the purpose of selling in the near term," which establishes whether a trading account exists.[246] Satisfying this subjective, fact-intensive inquiry governs whether a particular activity is deemed to be proprietary trading.[247] Eliminating this test from the definition of trading account will focus that definition on whether short-term trading occurs, which subsequently simplifies the definition of proprietary trading. The rebuttable presumption that a trade constitutes proprietary trading if a position on a trading account is held for less than sixty days, a generally accepted notion,[248] may supplant the purpose test to establish a bright-line rule that minimizes confusion and maximizes judicial economy. The amended language of § 1851(h)(6) should read:

> The term "trading account" means any account used for acquiring or taking positions in the securities and instruments described in paragraph (4) . . . for . . . selling in the near term . . . , *which is defined as a position that is held for less than sixty days*, and 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.[249]

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242. *See supra* notes 213–15 and accompanying text.

243. *See supra* notes 183–85 and accompanying text.

244. *See Volcker Rule*, SIFMA, https://www.sifma.org/explore-issues/volcker-rule/ [https://perma.cc/5R2D-SKDK] (last visited Apr. 13, 2018) ("[The Volcker Rule] should at the very least be modified to address concerns of vagueness, breadth and complexity. For instance, the definition of proprietary trading should focus on short-term trading and eliminate the intent-based test currently in the rule.").

245. *See* TREASURY REPORT, *supra* note 185, at 74 ("A definition that centers on the purpose of a purchase or sale effectively requires an inquiry into the trader's intent at the time of the transaction, which introduces considerable complexity and subjectivity into the inquiry regarding whether transactions are permitted.").

246. 12 U.S.C. § 1851(h)(6) (2012).

247. *See id.* § 1851(h)(4) ("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* . . . ." (emphasis added)).

248. *See supra* note 103 and accompanying text; *see also* TREASURY REPORT, *supra* note 185, at 74.

249. *See* 12 U.S.C. § 1851(h)(6). The italics indicate this Note's proposed modified language.

Second, this Note recommends broadening the exception to market making.[250] Both actors in financial services[251] and the Treasury Department[252] would likely welcome fewer constraints on this crucial activity.

An opt-out provision from the RENTD framework if certain criteria are met, as the Treasury has suggested, may unshackle banks from limits to engaging in market making.[253] The Treasury offers two approaches. First, a bank may opt out of the RENTD requirement if it "adopts and enforces narrowly tailored trader mandates that ensure that its activities constitute market making, provided that the [bank] complies with all the other conditions of the market-making exemption."[254] Second, a bank may opt out if it "fully hedges all significant risks arising from its inventory of" the investment at issue.[255] Regardless of which opt-out provision a bank uses, it still must comply with all other clauses in the market-making exception and the Rule's broader proprietary trading ban.[256] An example of altered language of § 1851(d)(1)(B) follows:

> The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making-related activities, to the extent that any such activities permitted by this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, *but where a banking entity fully hedges all significant risks arising from its inventory of the instrument in the transaction, it may waive the requirement of not exceeding the reasonably expected near term demand*.[257]

Third, this Note recommends implementing three protections to further buffer systemic risk, which do not adversely affect banks' abilities to profit. Under the first protection, various risk and conflict of interest disclosures may be required for certain transactions made under one of the Rule's exceptions.[258] Julie Manasfi posits that requiring additional disclosures may better reduce systemic risk—particularly by correcting potential conflicts of interest—than banning proprietary trading before having seriously studied excessive risk-taking:

> If we are trying to correct potential conflicts of interest, why not regulate and require additional disclosures that protect the public from such

250. *Id.* § 1851(d)(1)(B).

251. *See* Campbell, *supra* note 9 (noting that the Chairman and CEO of Goldman Sachs believes that the Volcker Rule hinders a "market-making function that provides a valuable public service").

252. *See* TREASURY REPORT, *supra* note 185, at 75 ("Market-making is an important service provided by banks that does not pose the same risks as speculative proprietary trading, but banks must comply with a host of conditions to fit within the market-making exemption under the rule.").

253. *Id.*

254. *Id.* at 76.

255. *Id.*

256. *See id.*

257. *See* 12 U.S.C. § 1851(d)(1)(B) (2012). The italics indicate this Note's proposed modified language.

258. *Id.* § 1851(d).

> conflicts of interest? If we are trying to reduce systemic risk, why not study excessive risk taking in general and regulate more precisely instead of banning proprietary trading by banks and systemically significant entities altogether?[259]

The majority opinion in the FCIC's report noted its concern that, before the crisis, traders were rewarded for quick trades without realizing the long-term consequences; this helped to catalyze a dramatic failure in risk management.[260] The majority viewed this failure as a "key cause" of the financial crisis.[261] The need to complete various disclosures about trades exempt from the Volcker Rule's prohibition may help to placate these concerns. It would make traders think more deliberately about future consequences of their transactions while slowing down the process.

The second protection calls for a change in compensation systems at large financial institutions whereby banks cannot pay traders based on trading profits, which may promote better risk management. This protection would further mitigate the FCIC majority's concerns that the inadequate compensation systems of large banks rewarded short-term gains without considering long-term consequences.[262] The effect of this proposed protection would complement the first protection of requiring additional disclosures.[263] Ryan Bubb and Marcel Kahan propose a prohibition on paying traders based on trading profits, which they posit is a "better way to achieve the objectives of the Volcker Rule, at far lower cost."[264] Notwithstanding intent—whether a transaction is proprietary trading whereby the trader intends to create profit or the trading is merely incidental to making profit, such as market making—this approach would target the ability of banks to engage in proprietary trading directly.[265] It would also avoid an unintended, adverse effect of the Volcker Rule's "define-and-ban approach." Under the Rule, banks feel threatened and are incentivized to find loopholes that conceal their trading, which perpetuates the need for increasingly complex regulation.[266]

The third protection involves supporting more capital and liquidity requirements, which may conservatively buffer market-making risks. This protection is intended to mitigate risks associated with broadening the market-making exception directly. For instance, Darrell Duffie writes that regulatory capital and liquidity requirements may help treat the systemic risk associated with banks' market making more effectively than the Rule itself.[267] In contrast with the Rule's market-making exception—which may only reduce the capacity of market making that banks provide—such

259. Manasfi, *supra* note 19, at 212.
260. FCIC FINAL REPORT, *supra* note 1, at xviii–xix.
261. *Id.*
262. *See supra* note 33 and accompanying text.
263. *See supra* notes 258–61 and accompanying text.
264. Ryan Bubb & Marcel Kahan, *Regulating Motivation: A New Perspective on the Volcker Rule* 4 (N.Y. Univ. Sch. of Law, Working Paper No. 17-27, 2017).
265. *Id.* at 43.
266. *Id.*
267. Duffie, *supra* note 218, at 22.

requirements treat risk on a portfolio-wide basis and directly consider a bank's soundness and potential to cause systemic risk.[268]

CONCLUSION

The financial crisis of 2008 created a debate about the adequacy of U.S. financial regulations that will likely persist for generations. It will undoubtedly prompt future actors in politics and in the financial services industry to think about how the early 2000s ushered in a new economic era haunted by true fears of systemic risk.

The Dodd-Frank Act embodied this debate over the causes of the financial crisis as many of its provisions have proved politically contentious. The Act's venerable objective of curbing systemic risk was met with particular quarrel when the Volcker Rule was enacted—proponents and opponents of the Rule clashed on the topic of proprietary trading. The issues of whether proprietary trading precipitated the crisis, whether it is actually a source of systemic risk, and whether the Volcker Rule truly limits systemic risk have culminated in President Trump's vow to at least amend the Rule. He has taken a tangible first step[269] by successfully nominating Jerome Powell for Chairman of the Federal Reserve, who publicly stated that the Rule can be simplified without hindering its vision.[270] We now must wait to see whether Powell will take action on the Volcker Rule during his tenure as Chairman.

As the Volcker Rule's fate seems in flux, neither an outright repeal nor the status quo seem proper given credible arguments on both sides. It seems most appropriate to strike a balance between allowing banks to engage in profitable trading while ensuring that they do not take excessive risk or perpetuate systemic risk in the financial system. This balance requires an understanding of the sources of ambiguity and complexity in the Rule. Simplifying the definition of proprietary trading, broadening the market-making exception, and implementing further protections to bolster risk management and buffer market-making risk may help to establish this balance. Despite this Rule's remarkable complexity, finding this balance may be key to ensuring a sound financial system with healthy banks, large and small, that can regain the trust of American consumers.

268. *Id.*

269. The Federal Reserve Chairman has no amendment power so this step may not create an immediate path to new legislation. Powell's opinion on the Rule may continue a dialogue about amending the Rule during his tenure that may spur legislative change.

270. *See* Tricchinelli, *supra* note 172.