III. The Dodd-Frank Act Regulation of Proprietary Trading—The Volcker Rule

A. Introduction

On July 21, 2010, President Obama signed into law the much-anticipated Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act").[1] One of the more controversial parts of the Act is Section 619, which codifies the infamous "Volcker Rule."[2] Section 619 amends the Bank Holding Company Act of 1956 to restrict proprietary trading within banking entities.[3] Congress included the restriction in response to what proponents of the Volcker Rule describe as reckless risk-taking on the part of banking institutions using taxpayer guaranteed depositor funds, resulting in institutional and systemic risk.[4]

Proprietary trading is essentially the investing of institutional funds, including depository funds, to augment profit.[5] The practice became popular among larger banks after the effective repeal of the Glass-Steagall Act in 1999 by the Gramm-Leach-Bliley Act.[6] In response to Section 619, many banks have begun restructuring their

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[1] Press Release, Office of the Press Secretary, Background on the President's Bill Signing Ceremony Today (July 21, 2010), *available at* http:// www.whitehouse.gov/the-press-office/background-presidents-bill-signing-ceremony-today.

[2] *See* John Kemp, *Volcker Rule Unexpectedly Revived by Dodd Bill*, REUTERS, Mar. 16, 2010, http://blogs.reuters.com/great-debate/2010/03/16/volcker-rule-unexpectedly-revived-by-dodd-bill/ ("The Volcker Rule's surprise survival comes despite fierce opposition from the banking industry and after many commentators had written it off as a short-term political gimmick . . . .").

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010).

[4] *See also* John Cassidy, *Scandals*, NEW YORKER, May 3, 2010, at 21.

[5] *See Proprietary Trading*, INVESTOPEDIA, http://www.investopedia.com/terms/p/proprietarytrading.asp (last visited Oct. 6, 2010) (defining proprietary trading as "when a firm trades for direct gain instead of commission dollars").

[6] Jeff Merkley & Carl Levin, *Making the Dodd-Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work*, ROOSEVELT INSTITUTE, Oct. 6, 2010, http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf ("[S]ince 2004, trading revenues have sky-rocketed at the largest banks, and by the end of 2009, accounted for all of their net operating revenues.")

proprietary trading operations or divesting themselves of proprietary trading desks altogether.[7] Part II of this article will evaluate the need for a ban on proprietary trading. Part III will detail the provisions of Section 619 as signed into law and will describe how Section 619 will be implemented by the agencies so tasked. Part IV will examine reaction to the legislation by affected institutions and commentators.

B. The Lead-Up to Dodd-Frank: Proprietary Trading and the Perceived Risk

In Washington, D.C., the last-minute inclusion and passage of Section 619 was heralded as a way to "reduce systemic risk to our financial system and protect American taxpayers and businesses from Wall Street's risky bets."[8] When President Obama first promoted the idea of a ban on proprietary trading in January 2009, he said proprietary trading "can create enormous and costly risks . . . ."[9] Some critics of Wall Street claimed proprietary trading was the "key driving force" behind the crisis.[10] Such statements, while probably effective at driving support for a ban, are misleading. Even prominent proponents of the rule admit uncertainty as to whether an earlier ban on proprietary trading would have prevented the 2008 financial crisis.[11] Only a handful of banking institutions participate in the types of activities halted by Section 619.[12] Even Paul Volcker, a former Federal Reserve chairman and namesake of the rule, said that proprietary trading, while a contributing factor, was "not central" to

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[7] *See* Charles Wallace, *Is Wall Street Reshaping Itself in Response to Dodd-Frank?*, DAILY FINANCE, Aug. 4, 2010, http://www.dailyfinance.com/story/investing/wall-street-reshaping-after-dodd-frank/19579716/

[8] Meredith Shiner, *Volker Rule Backers Praise Bill*, POLITICO, June 25, 2010, http://www.politico.com/news/stories/0610/39035.html.

[9] President Barack Obama, Remarks by the President on Financial Reform (Jan. 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.

[10] Stephen Gandel, *Is Proprietary Trading Too Wild for Wall Street?*, TIME, Feb. 5, 2010, http://www.time.com/time/business/article/0,8599,1960565,00.html.

[11] Editorial, *Volcker Rules: The Obama Administration's New-Old Approach to Bank Regulation*, WASH. POST, Jan. 24, 2010, at A12 ("It is not clear that the Volcker Rule would have prevented the current financial crisis . . . .").

[12] Paul Volcker, *How to Reform Our Financial System*, N.Y. TIMES, Jan. 31, 2010, at WK11.

the crisis.[13] Most experts, including those in the current administration, seem to agree that most of the activities that led to a market crash in 2008 did not take place in depository institutions.[14] Treasury Secretary Timothy Geithner stated that proprietary trading was not at the root of the crisis and expressed doubt as to whether a trading ban would help prevent future crises.[15] The major failures contributing to the crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns or Lehman Brothers—did not involve deposit-taking institutions and would not have been subject to any ban on proprietary trading.[16]

Another concern forwarded by proponents of the Volcker Rule was the apparent conflicts of interest that are presented between a financial institution and its customers when the institution is trading on its own account.[17] Proponents rarely cite specific examples.[18] Most likely, the conflict of interest proponents have in mind occurs when a bank is tempted to sell financial products to a client, only to short the same securities on its account, essentially betting against its client.[19] The practice received a lot of attention (and infamy) during the run up to the Dodd-Frank Act as the SEC launched an investigation into a Goldman Sachs deal, alleging that the company defrauded clients by engaging in a similar scheme.[20] Given that such practices are already illegal, as illustrated by the SEC enforcement action, it is unclear why the Volcker Rule was necessary to put an end to such activity.

Though it may be generally accepted that proprietary trading played a minimal, if any, role in the recent crisis, and that the effect of the Volker Rule on conflict of interest concerns is likely to be

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[13] Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS, Mar. 30, 2010, http://www.reuters.com/article/idUSTRE62T56420100330.
[14] Karey Wutowski, *Proprietary Trading Ban Positive: FDIC's Blair,* REUTERS, Jan. 29, 2010, http://www.reuters.com/article/idUSTRE60S4F820100129.
[15] *Id.*
[16] Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System,* 33 Harv. J.L. & Pub. Pol'y 671, 677 (2010).
[17] Obama, *supra* note 9.
[18] *See* Volker, *supra* note 12.
[19] *See* Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1.
[20] Gretchen Morgenson & Louise Story, *S.E.C. Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1.

minimal, there is a more compelling argument for the adoption of the Volcker Rule. Proprietary trading amounts to government-subsidized risk-taking when engaged in by deposit-taking institutions, giving those institutions an unfair advantage in the market place.[21] Because banking functions are essential to the national economy, institutions that provide them are provided a governmental "safety net" comprised of federal insurance and the availability of Federal Reserve lending.[22] These government safety nets and the ability for large banking institutions to rely on the government to bail them out result in government-subsidized risk-taking on behalf of banks trading on their own account.[23] While it probably did not play a large role in the financial crisis of 2008, and does not significantly contribute to overall systemic risk in the financial system, proprietary trading arguably does not comport with a free and fair market.

C. The Volker Rule in Action: The Prohibitions and Implementation of Section 619

The Dodd-Frank Act amends the Bank Holding Company Act of 1956 by adding an additional section devoted to proprietary trading.[24] Section 619(a)(1)'s general prohibitions at first glance appear to be simple. They prohibit activities that can be easily identified: banking entities are prohibited from engaging in proprietary trading, defined as "engaging as a principal for the trading account . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract . . . ."[25] Such entities are also prohibited from acquiring or retaining any ownership interest in a private equity or hedge fund,[26] though a later exception allows three percent of capital to be invested in such funds.[27] Section 619(d)(1) allows exceptions to the prohibitions that range from simple to enigmatic. Simple exceptions allow banking entities to invest in various government-related securities such as Treasury and

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[21] Obama, *supra* note 9.
[22] *Id.*
[23] Cassidy, *supra* note 4.
[24] § 619, 124 Stat. at 1620.
[25] *Id.* at 1630
[26] *Id*. at 1620
[27] *Id.* at 1627

FNMA bonds, small businesses as defined by the Small Business Investment Act of 1956, certain investments to promote the public welfare and investments that are qualified rehabilitation expenses under the U.S. Tax Code.[28] The harder-to-define exceptions allow trading undertaken for the purpose of hedging risk related to other holdings, market-making activities that are not designed to exceed "reasonably expected" client demand, trades on behalf of customers and certain foreign activities.[29]

Finally, Section 619(d)(4) allows a banking entity to invest in a hedge fund or private equity fund that the entity organizes and offers, so long as the investment does not constitute more than three percent total ownership of the fund, and the aggregate of all such investments does not exceed more than three percent of the banking entity's Tier 1 capital.[30] Of course, if any of these exceptions result in or involve a "material conflict of interest," "material exposure . . . to . . . high-risk assets . . . or strategies," or a threat to the "safety and soundness of such banking entity" or the "financial stability of the United States," it is prohibited by 619(d)(2)(A).[31]

Banking entities are not the only ones affected by the Volcker Rule. Under Section 619(a)(B)(2), non-bank financial companies that are under the supervision of the Federal Reserve Board ("Board") and engage in proprietary trading or retain ownership in private equity funds or hedge funds may be subject to increased capital requirements at the agency's discretion.[32] Thus, if a company such as Goldman Sachs, in order to avoid divesting itself of proprietary trading units, decides to declare itself a non-bank or denounce its status as a bank holding company, it can still be subjected to extra capital requirements. Exactly what those capital requirements would entail is uncertain, and their determination is subject to the same rulemaking as the rest of Section 619.

It will be left up to the agencies to define the vague prohibitions, exemptions and potential capital requirements outlined above. Section 619(b)(1) tasks the newly-formed Financial Stability Oversight Council ("FSOC") with studying and making recommendations on how to implement Section 619 so as to promote the safety and soundness of the banking industry, minimize unsafe

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[28] *Id.* at 1623-24.
[29] *Id.* at 1624-25.
[30] *Id.* at 1627.
[31] *Id.* at 1626.
[32] *Id.*

and unsound activities, reduce conflicts of interest and limit activities that create undue risk.[33] No later than nine months after the completion of the study, the appropriate federal banking agencies, the Securities and Exchange Commission ("SEC") and the Commodities Future Trading Commission ("CFTC") are directed to issue rules and regulations to implement Section 619. Thus, what defines "risk-mitigating hedging activities," "reasonably expected near-term demand," "high-risk trading strategies" and the other less-than-clear contours of Section 619 are largely a matter of agency discretion.

The FSOC has already begun the process of gathering public comment in order to begin its study pursuant to Section 619(b).[34] The public Notice and Request for Public Information filed by the FSOC solicits comments regarding virtually every paragraph of Section 619, looking for input on definitions, ways to minimize risk, which activities are historically the riskiest, and relationships with private equity and hedge funds.[35] According to a study conducted by the U.S. Chamber of Commerce, the entire act will require regulators to complete approximately 520 rulemakings, eighty-one studies, and ninety-three reports.[36]

D. Reaction

Section 619 allows banks a total of four years to divest themselves of their proprietary trading activities, and they can apply for up to three one-year extensions to that requirement.[37] However, compliance efforts have already begun at some of the nation's largest banks.[38] Most banks were able to begin reducing proprietary operations without making significant structural changes. Shortly after the bill's passing, reports surfaced that Morgan Stanley would be spinning off its subsidiary FrontPoint Partners, a hedge fund

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[33] *Id.*

[34] Public Input for the Study Regarding the Implementation of Prohibitions on Proprietary Trading, 75 Fed. Reg. 61758-02, 61758 (2010).

[35] *Id.* at 61759-60

[36] Tom Quaadman, *Financial Regulatory Reform—Uncertainty Grows*, CHAMBERPOST, July 13, 2010, http://www.chamberpost.com/2010/07/financial-regulatory-reform-uncertainty-grows.html.

[37] § 619, 124 Stat. at 1622-23.

[38] Wallace, *supra* note 7.

sponsor.[39] Goldman Sachs, widely regarded as having one of the largest and most aggressive proprietary trading groups among the large banks, moved about half of its proprietary traders into its asset management group, where they will advise and place trades for clients.[40] Citigroup is rumored to be considering several options to comply with the new law, including moving proprietary traders to its hedge fund unit, where they will manage hedge funds whose shares are owned by clients.[41] Bank of America has announced plans to terminate just under one-third of their proprietary trading jobs.[42]

While banks seem to be taking the new regulation in stride, many commentators are not pleased with the final draft of Section 619. Most of the criticism aimed at Dodd-Frank's codified version of the Volcker Rule argues that the statute does not go far enough to mitigate risk in the nation's banks. Receiving the most criticism is the section's exemption allowing banks to invest up to three percent of their Tier 1 capital in hedge funds and private equity funds.[43] The allowance was the result of last-minute legislative deal-making to garner a few Republican votes in the Senate. The allowance originally included a strict dollar limit and allowed for three percent of tangible common equity.[44] As negotiations went forward, the dollar limit was removed and "tangible common equity" was changed to "Tier 1 capital," allowing banks to invest approximately forty percent more capital in funds than did the original compromise.[45] Paul Volcker himself recalls being "disappointed" in

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[39] Courtney Comstock, *FrontPoint is Going to Completely Spin Off From Morgan Stanley and Everyone Wants a Piece*, BUSINESSINSIDER, Aug. 2, 2010, http://www.businessinsider.com/morgan-stanley-frontpoint-spin-off-2010-8.

[40] Charlie Gasparino, *Goldman Already a Step Ahead of FinReg*, FOX BUSINESS, July 27, 2010, http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg/.

[41] Bradley Keoun, *Citigroup May Move Prop Traders to Hedge Funds for Volcker Rule*, BLOOMBERG BUSINESSWEEK, July 28, 2010, http://www.businessweek.com/news/2010-07-28/citigroup-may-move-prop-traders-to-hedge-funds-for-volcker-rule.html.

[42] Christine Harper, *Bank of America Said to Cut More Than 20 Prop Trading Jobs*, BLOOMBERG, Sept. 29, 2010, http://www.bloomberg.com/news/2010-09-29/bank-of-america-is-said-to-eliminate-more-than-20-proprietary-trading-jobs.html.

[43] § 619, 124 Stat. at 1624.

[44] John Cassidy, *The Volcker Rule*, NEW YORKER, July 26, 2010, at 25.

[45] *Id.*

the final version of his namesake rule after learning about the removal of these limitations.[46]

Critics are quick to point out that the three percent allowance will permit banks to continue almost the same amount of proprietary trading that they were engaged in before the bill was passed, as long as it is done through a private equity or hedge fund instead of pure proprietary trading.[47] Despite the bank actions listed above, those critics are, for the most part, correct. Banks do not report how much of their capital is tied up in pure proprietary trading and hedge and private equity funds, and it may be because they do not track the figure.[48] But there is some sense of how much revenue is generated by proprietary trading. Citigroup's proprietary trading activities, including those placed in hedge fund or private equity investments, account for less than three percent of the bank's total revenue, according to sources there.[49] Citigroup therefore, aside from divesting itself of its pure proprietary trading operations, will be mostly unaffected. Bank of America finds itself in a similar situation.[50] Estimates place JP Morgan's proprietary trading revenues at under one percent of total revenue, though the bank also manages the world's largest hedge fund and may have to sell some of its hedge fund interest.[51] The only bank that will be materially impacted by Section 619 is Goldman Sachs.[52] The bank generates about ten percent of its revenue via proprietary trading, both pure and fund related, and so will have to restructure much more than the other banks.[53]

Another concern with the three percent allowance is that it may, perversely, increase the amount of risk banks are willing to take with hedge funds they sell to clients. Often, banks will be heavily invested in their own funds to convince outside investors that they

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[46] *Id.*
[47] *See* Daniel Indiviglio, *Dodd-Frank Bill's Volcker Rule a Win for Big Banks,* ATLANTIC, June 25, 2010, http://www.theatlantic.com/business/archive/2010/06/dodd-frank-bills-volcker-rule-a-win-for-big-banks/58747/.
[48] John Carney & Cadie Thompson, *Senators Prepare a Citigroup-Sized Hole in Volcker Rule*, CNBC.COM, June 23, 2010, http://www.cnbc.com/id/37879514/Senators_Prepare_A_Citigroup_Sized_Hole_In_Volcker_Rule
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*

are confident in the fund's portfolio.[54] Competition between funds encouraged banks to put more and more "skin in the game."[55] However, with the Volcker rule's three percent allowance in place, the banks have a good excuse not to have much at stake in the funds they market to clients.[56]

Any risk mitigation accomplished by Section 619 is further hampered by the difficulty of determining what constitutes proprietary trading versus trading at the behest of a customer, also known as market making. Neither Section 619 nor any other part of the Dodd-Frank Act restricts risky trades, just those done on the bank's own account. Much non-proprietary trading activity done at the behest of clients exposes the bank to the same type of market risk the bank would face were it making the trade on its own account.[57] Traditionally, banks were intermediaries who matched up buyers and sellers to take either side of a trade.[58] More frequently, they now place their own capital at risk, and can either hedge to remain neutral, or hold the position if the investment aligns with the bank's market outlook.[59] Earlier this year, Goldman Sachs lost $250 million taking the other side of a trade when several institutional clients approached the bank looking to bet that the market would not stay quiet.[60] In a similar trade, JP Morgan's commodities unit lost $130 million taking the other side of trades initiated by clients expecting coal prices to rise, which they did.[61] The risk involved in both trades was not what would be considered by most to be proprietary, and is expressly allowed under the market making exception of 619(d)(B).[62] Any hedge taken against such position would also be allowed under 619(d)(C).[63] These examples show how a bank can essentially place trades using their own capital, for their own gain, but in the process of making markets, which is allowed under 619(d)(B).

[54] John Carney, *Why Wall Street Will Love the 3% Solution in Reform Bill,* CNBC.COM, June 25, 2010, http://www.cnbc.com/id/37921692.
[55] *Id.*
[56] *Id.*
[57] *See* Nelson D. Schwartz & Eric Dash, *Despite Reform, Banks Have Room for Risky Deals*, N.Y. TIMES, Aug. 25, 2010, at A1.
[58] *Id*.
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] § 619, 124 Stat. at 1624.
[63] *Id.* at 1624

E. Conclusion

If the purpose of the Volcker rule was to reduce the magnitude of risk undertaken by banks, it falls short; while pure proprietary trading is expressly prohibited, the risk will most likely remain, albeit under a different name. This type of scenario is best avoided by a Glass-Steagall type ban on investment banking activities by depository institutions, the stricter version of the Volcker Rule many proponents were hoping for.[64] The ability for banks to invest three percent of their capital in hedge or private equity funds and the difficulty in drawing a line between proprietary trading and market-making activities essentially takes the effectiveness out of the Volcker Rule.

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[64] *See* Terry Smith, *Volcker Rule is Necessary to Prevent Bank Failures Turning into a Crisis,* TELEGRAPH, Jan. 24, 2010, at 5.
[65] Student, Boston University School of Law (J.D. 2012).