

Comments

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Creating a Future Economic Crisis: Political Failure and the Loopholes of the Volcker Rule

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INTRODUCTION

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, one aspect of which was what President Obama called the “Volcker Rule.” The Volcker Rule was intended to minimize systemic risk in the financial system by limiting the authority of insured depository institutions to manage hedge funds and to engage in proprietary trading. The legislative process, however, weakened the Volcker Rule. The final version of the rule contains several loopholes and the Act leaves many significant details for a patchwork of regulatory agencies to resolve.

This Comment will focus on the Merkley-Levin Amendment to the Act that would have codified the Volcker Rule. The amendment was one of the most controversial aspects of the Act. Focusing on this amendment provides a window into understanding what happened in Congress and why, and how the amendment invested regulatory agencies with immense rulemaking authority.

First, this Comment describes the Volcker Rule and explains why the rule is needed. It walks through the amendment as introduced. Second, the Comment describes the political pressures that influenced the final form of the Act. Third, it walks through the loophole-filled version of the amendment that Congress enacted. Fourth, it discusses the rulemaking process in terms of public choice theory and attempts to convey the immense burden that the Act placed on agencies. Finally, it suggests possible agency solutions to close some of the loopholes in the Volcker Rule, focusing in particular on hedge fund regulations.

I

THE VOLCKER RULE AND THE DODD-FRANK WALL STREET REFORM
AND CONSUMER PROTECTION ACTA. *The Volcker Rule*

In 2009, the Group of Thirty, an international group of financial experts, placed blame for what was already the worst financial crisis in more than sixty years on proprietary trading and conflicts of interest in the financial system.¹ Paul Volcker, who was the Federal Reserve System Chairman under Presidents Carter and Reagan, and is the current chair of President Obama's Economic Recovery Advisory Board, chairs the Group of Thirty.² The Group found that large losses in proprietary trading, bank sponsorship of hedge funds, and exposure to structured credit products had placed the viability of the entire financial system at risk.³ The Group concluded that the complexities of the proprietary capital market and the perceived need for confidentiality limit the transparency of the system, increase risks to creditors and investors, and make regulation of the system difficult.⁴ Moreover, there is an air of unfair competition because some firms that are supervised by the government are permitted to engage in risky banking transactions.⁵ But, after implementation of the Troubled Asset Relief Program (TARP), those firms are essentially insulated from the full force of possible failure.⁶

To taper the risks that proprietary trading and bank-managed hedge funds pose to the financial system, the Group of Thirty recommended that "systemically important banking institutions should be restricted" from engaging in risky trading activities and activities that pose conflicts of interest.⁷ Their recommendations essentially embraced the spirit of the Glass-Steagall Act by urging placement of limitations on the ability of financial institutions to engage in high-risk

¹ 156 CONG. REC. S5894 (daily ed. July 15, 2010) (statement of Sen. Merkley).

² See Jeff Zeleny, *Obama Names Volcker to Head New Economic Panel*, CAUCUS (Nov. 26, 2008, 9:54 AM), <http://thecaucus.blogs.nytimes.com/2008/11/26/obama-plans-to-name-volcker-as-head-of-new-economic-panel>.

³ GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 27 (2009), http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf.

⁴ *Id.*

⁵ *Id.*

⁶ See *id.* at 24–25, 27.

⁷ *Id.* at 28.

speculative investments.⁸ The Group also recommended that steps be taken to eliminate conflicts of interest between the bank's own investments and the investments of its clients.⁹ Specifically, the Group suggested that banking institutions should be prohibited from comingling their own funds in hedge funds in which their clients are also invested.¹⁰ Furthermore, the Group suggested that proprietary trading should be subject to strict liquidity and capital requirements.¹¹

Chairman Volcker later testified before the Senate Banking Committee that he hoped, through these reforms, to end “too big to fail” and the era of government bailouts, and to change the expectations of banking institutions to reduce moral hazard.¹² He hoped that with the adoption of the proposed procedural safeguards, the government would step in when a bank failed—not to bail out the institution, but to facilitate an orderly liquidation of its assets.¹³ Chairman Volcker advocated that banks should expect “euthanasia, not a rescue.”¹⁴

In January 2010, President Obama announced a need for banks to adhere to their central purpose—serving their customers.¹⁵ To do so, the President favored “common-sense” restrictions on proprietary trading and restrictions on hedge fund investing to reduce conflicts of interest.¹⁶ He called the proposal the “Volcker Rule.” The President outlined the Volcker Rule in no uncertain terms: “Banks will no longer be allowed to own, invest, or sponsor hedge funds, private

⁸ See 12 U.S.C. § 378 (2006) (identifying the spirit of the Glass-Steagall Act of 1933 to be that “it shall be unlawful . . . [f]or any person, firm, corporation, association, [or] business trust . . . engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit . . . or upon request of the depositor”).

⁹ GROUP OF THIRTY, *supra* note 3, at 28.

¹⁰ *Id.*

¹¹ *Id.*

¹² See *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 5–8, 49–51 (Feb. 2, 2010) [hereinafter Volcker Testimony] (statement of Hon. Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board).

¹³ *Id.* at 6.

¹⁴ *Id.*

¹⁵ President Barack Obama, Remarks by the President on Financial Reform (Jan. 21, 2010), <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>.

¹⁶ *Id.*

equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.”¹⁷

Freshman Senator Jeff Merkley (D-Or.) and Senior Senator Carl Levin (D-Mich.) took up President Obama’s call for implementation of the Volcker Rule in Congress and cosponsored the Merkley-Levin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

As proposed, the Volcker Rule was limited in scope. It would affect trading activities only by insured depository institutions and their affiliates.¹⁸ The regulations would have no direct impact on funds and investments that are not “systemically important.” Chairman Volcker testified before the Senate Banking Committee that funds that were not “systemically important” (of which there are thousands) will be “free to trade, to innovate, to invest—and to fail,” as they should in a free market system.¹⁹ The Chairman also emphasized that commercial banks would remain free to offer a wide range of traditional and profitable services.²⁰ These include basic payment services such as ATM machines and cash balance management services; safe and liquid depository facilities; extending credit to individuals, governments, and businesses, including originating and securitizing mortgages, commercial lending, underwriting and market-making activities; maintaining brokerage accounts, including “prime brokerage,” investment management, and advisory services, including “funds of funds,” trust and estate planning, and safe keeping of valuables.²¹

A brief review of banking regulations and banking practices that led to the 2008 recession illustrates why the Group of Thirty, President Obama, and Senators Levin and Merkley, among others, thought that passing a strong form of the Volcker Rule, limiting risk in bank investments, was crucial to protecting the stability of our economy.

¹⁷ *Id.*

¹⁸ 12 U.S.C. § 1851(h)(1) (Supp. 2011) (defining the banking entity as “any insured depository institution”).

¹⁹ Volcker Testimony, *supra* note 12, at 50.

²⁰ *Id.*

²¹ *Id.* at 57.

B. Background: Why We Need the Volcker Rule

Since the founding of the United States, banks and the government have been engaged in a delicate courtship influenced by centuries of debate about the appropriate relationship between the two. After the Great Depression, there was a flurry of economic regulation, with the passage of the Banking Act of 1933, the centerpiece of which was the Glass-Steagall Act.²² The Glass-Steagall Act essentially severed the relationship between commercial banks and investment banks.²³ Over the next sixty years, our economy grew and globalized, while our regulatory structure remained largely unchanged.²⁴

In the 1990s, under the Clinton administration, the Commodity Futures Trading Commission released a paper suggesting that the burgeoning complex derivative swap market should be regulated.²⁵ Response to the report was swift; lobbyists met with the Commissioners at least thirteen times in the two months following release of the report.²⁶ They warned that imposing regulations on the market could have dire consequences, and that the trades are so sophisticated that bank self-regulation was the only appropriate way to control them.²⁷ At a congressional hearing on the report, Federal Reserve Chairman Alan Greenspan likened the Commission's proposal to "trying to punch the capital markets in the nose."²⁸

Instead of strengthening financial regulation, Congress further deregulated the financial industry. The movement towards deregulation culminated in Congress's 1999 repeal of the Glass-Steagall Act's restrictions on high-risk speculative investments.²⁹ The largely unregulated derivative swap market grew from \$28.7

²² MARK T. WILLIAMS, UNCONTROLLED RISK 20 (2010).

²³ *Id.*

²⁴ *PBS NewsHour: As Economy Jitters Persist, Geithner "Confident We're Going to Grow,"* (PBS television broadcast July 6, 2010) (transcript available at http://www.pbs.org/newshour/bb/business/july-dec10/geithner_07-06.html).

²⁵ Jake Bernstein & Sharona Coutts, *Former Clinton Official Says Democrats, Obama Advisers Share Blame for Market Meltdown*, PROPUBLICA (Oct. 9, 2008, 4:07 PM), <http://www.propublica.org/article/former-clinton-official-says-democrats-obama-advisers-share-blame-for-marke>.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ Daniel Weeks, Opinion, *Wall Street's Influence Weakened Volcker Rule*, ROLL CALL (Aug. 3, 2010, 12:00 AM), http://www.rollcall.com/issues/56_16/-48921-1.html.

trillion in 1998 to \$531.2 trillion a decade later.³⁰ By 2010, ten percent of Goldman Sachs's revenue came from proprietary trading.³¹

In 2007, the housing bubble burst, revealing a host of risky lending and investing practices. The decline in housing prices produced a domino effect of economic ruin across the economy.³² In 2008, Former Comptroller of the Currency, Eugene Ludwig, testified before a Senate Committee that “[t]he paradigm of the last decade has been the conviction that un- or under-regulated financial services sectors would produce more wealth, net-net. If the system got sick, the thinking went, it could be made well through massive injections of liquidity. This paradigm has not merely shifted—it has imploded.”³³

Like other private companies, banks suffered tremendous losses when the economy entered a recession. However, banks are not like other private companies. Banks are central to the national and global economy, and when their investments fail, the effects can be dire. A bank's primary purpose is to operate as the intermediary for securing loans between individuals or businesses and creditors.³⁴ The financial sector accounts for twenty percent of gross domestic product³⁵ and is central to all financial transactions.

The impending collapse of many of the nation's largest banks prompted the government to acknowledge that there are some private entities so central to the economy that if they were to fail, the results could be disastrous. Federal Reserve Chairman Ben Bernanke believed that without intervention, the recession “could have rivaled or surpassed the Great Depression.”³⁶ Fear of another Depression led Congress to pass TARP in October 2008, which allowed the U.S. Treasury to purchase up to \$700 billion worth of troubled assets in many industries, including the financial industry.³⁷ Proponents

³⁰ Bernstein & Coutts, *supra* note 25.

³¹ Jia Lynn Yang, *Banks Gird for Financial Overhaul's Ban on Speculating with Their Own Money*, WASH. POST, Aug. 14, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/08/13/AR2010081303688.html>.

³² S. REP. NO. 111-176, pt. III, at 40–42 (2010).

³³ *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. (2008) (statement of Eugene A. Ludwig, Chief Executive Officer, Promontory Financial Group).

³⁴ LAURENCE J. KOTLIKOFF, *JIMMY STEWART IS DEAD* xviii (2010).

³⁵ *Id.* at 6.

³⁶ Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech to the 43rd Annual Alexander Hamilton Awards Dinner (Apr. 8, 2010).

³⁷ U.S. DEP'T OF TREASURY, OFFICE OF FIN. STABILITY, TROUBLED ASSET RELIEF PROGRAM: TWO YEAR RETROSPECTIVE (2010).

justified the bailout of several of the nation's largest financial institutions on the ground that some companies are simply "too big to fail."³⁸

In a fractious political environment, distaste for the bailout was almost universal. President Obama described TARP as necessary, but "as popular as a root canal."³⁹ Reflecting Wall Street's and the public's distaste for the bailout, the Dow fell 157 points the day after President Bush signed TARP.⁴⁰

Only about \$428 billion of the allotted \$700 billion rescue package was or will be disbursed, and \$278 billion of that had been repaid by December 2011.⁴¹ In December 2011, the Congressional Budget Office estimated that the net cost of the TARP program would be \$32 billion,⁴² much less than initially projected.⁴³ Yet the risks of government bailouts and more importantly, the effect that the practical assurance of future government bailouts would have on banking practices ought to cause the government to consider structural reform that would avoid future government bailouts.

In a financial system in which the largest financial institutions enjoy at least an implied government guarantee against failure, the question should be how to regulate the financial system. If the government is going to be on the hook to bail out bank losses, the government needs to oversee the banks and impose regulations to limit the risk of loss in order to prevent the need for bailouts in the

³⁸ John Crawley & Rachele Younglai, *Congressional Oversight Panel: TARP Helped Perpetuate a 'Too Big to Fail' System*, HUFFINGTON POST (March 16, 2011, 7:40 PM), http://www.huffingtonpost.com/2011/03/16/wachdog-tarp-too-big-to-fail_n_836376.html ("Federal intervention transformed the notion of 'too big to fail' into a stark reality."); see also *Another Accounting of TARP*, GOP.GOV (Dec. 6, 2010), <http://www.gop.gov/policy-news/10/12/06/another-accounting-of-tarp>.

³⁹ TROUBLED ASSET RELIEF PROGRAM, *supra* note 37, at i (noting that President Obama commented on TARP that "[i]f there's one thing that has unified Democrats and Republicans, and everybody in between, it's that we all hated the bank bailout. I hated it. You hated it. It was about as popular as a root canal.").

⁴⁰ David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1.

⁴¹ CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM—DECEMBER 2011, http://cbo.gov/sites/default/files/cbofiles/attachments/12-16-TARP_report.pdf.

⁴² CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM—MARCH 2012, at 1, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-28-2012-TARP.pdf>.

⁴³ Robert Bowen, *Wall Street Bailout (TARP) Cost Taxpayers Less than Projected*, EXAMINER.COM (Mar. 30, 2012), <http://www.examiner.com/article/wall-street-bailout-tarp-cost-taxpayers-less-than-projected>.

future. When it passed, Democrats pledged that TARP was only the first half of a plan to rescue the economy and that they would proceed to enact a “sweeping overhaul” of the financial regulatory system.⁴⁴

In reforming the regulation of the financial industry, the government needed to strike a balance that would not upset the free market system or America’s ability to remain competitive and innovative in the global economy.⁴⁵ At the same time, sufficient safeguards were needed to ensure that such risks would “not again imperil our nation’s economic well-being.”⁴⁶

Congress’s solution was the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁴⁷ At 848 pages, it has been hailed as “the most substantial reform of the country’s financial system since the Great Depression.”⁴⁸ The scope of the Act is ambitious; the preamble of the Act describes its purpose as, “To 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.”⁴⁹ The Act attempts to minimize systemic risk and conflicts of interest, to end taxpayer bailouts of companies perceived to be “too big to fail,” and to create a comprehensive regulatory oversight scheme.⁵⁰

C. The Amendment as Proposed

As introduced, the Merkley-Levine amendment to the Dodd-Frank Act would have codified the Volcker Rule as the Group of Thirty initially recommended and as President Obama endorsed. The Volcker Rule distinguishes between permissible and impermissible bank trading activities. The Amendment begins with a broad

⁴⁴ Herszenhorn, *supra* note 40.

⁴⁵ See GROUP OF THIRTY, *supra* note 3.

⁴⁶ Press Release, Senator Jeff Merkley, Senators Call on Regulators to Implement Strong Merkley-Levin Provisions (Oct. 28, 2010) (citing Letter from Hon. Paul Volcker, Chairman, President’s Econ. Recovery Advisory Bd., to the Members of the Fin. Stability Oversight Council (Oct. 28, 2010)), www.merkley.senate.gov/newsroom/press/release/?id=be745ff9-1820-43df-978e-35809510cbac.

⁴⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴⁸ Editorial, *A New Era for U.S. Finance*, JAPAN TIMES, July 28, 2010, <http://www.japantimes.co.jp/text/ed20100728a1.html>.

⁴⁹ Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376.

⁵⁰ *Id.*

prohibition on proprietary trading and bank involvement in hedge funds, both practices that have been blamed for the economic crisis. Section 619 of the amendment declares that “a banking entity shall not—(A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”⁵¹ The amendment defines “proprietary trading” as any trade in derivatives or securities in which the bank engages as a principle.⁵² This straightforward prohibition is preceded by language that could, and later did, render it largely toothless: “Unless otherwise provided in this section.”⁵³

The original amendment exempted certain trades from the prohibition, while still focusing on the intended purpose—risk mitigation and removal of conflicts of interest. The amendment exempted the purchase and distribution of securities “in connection with underwriting, market-making, or in facilitation of customer relationships,” so long as the activities are not designed to exceed the “expected near term demands of clients.”⁵⁴ Risk-mitigating hedging activities and investments in small businesses designed to promote the public welfare were permitted.⁵⁵ The amendment permitted proprietary trading outside of the United States if a U.S. citizen does not control the company that is engaging in the trading.⁵⁶ Finally, the amendment permitted acquisition of an equity or ownership interest in a hedge fund that is solely outside the United States so long as no ownership interest in the fund is offered to a resident of the United States.⁵⁷

To ensure that these permitted activities would not hamper the ultimate purpose of the amendment—to limit risk in banking investments—the proposed amendment placed limitations on the permitted activities. The permitted activities would not be allowed if the transaction would cause a conflict of interest between the financial institution and its clients, would unsafely expose the financial institution to high-risk assets or trading strategies, would pose a threat

⁵¹ S. 3217, 111th Cong. § 619, sec. 13(a)(1) (2011).

⁵² *Id.* sec. (i)(4).

⁵³ *Id.* sec. (a)(1).

⁵⁴ *Id.* sec. (d)(1)(b).

⁵⁵ *Id.* secs. (d)(1)(C), (E).

⁵⁶ *Id.* sec. (d)(1)(G).

⁵⁷ *Id.* sec. (d)(1)(H).

to the soundness of the financial institution, or would threaten the financial stability of the United States.⁵⁸

The proposed amendment also placed limitations on the permitted relationships financial institutions may enter into with hedge funds and private equity funds. Hedge funds and private equity funds are those that trade in securities on behalf a small number of wealthy investors.⁵⁹ Macro hedge funds make speculative investments, usually based on complex economic or mathematical calculations, designed to find inequalities in the market.⁶⁰ Hedge funds frequently bet on exchange rate devaluations, interest rate changes, and macroeconomic movements.⁶¹ Furthermore, hedge funds are often highly leveraged in the hope of further magnifying their profits.⁶²

Banks may be motivated to bail out failing hedge funds to minimize the reputational risks of being associated with a failing fund.⁶³ The proposed Merkley-Levin Amendment's hedge fund restrictions are designed to remove the incentive for banks to bail out failing hedge funds with which they are affiliated.

The proposed amendment would have prohibited banking entities that serve, directly or indirectly, as the investment advisor of a hedge or private equity fund from entering into a covered transaction with the fund.⁶⁴ This proposal would have helped to regulate conflicts of interest by classifying hedge funds managed by banking institutions as affiliates of those banking institutions.⁶⁵ The amendment would have also prohibited hedge funds from sharing the name of a banking entity.⁶⁶

Section 619B of the amendment addresses conflicts of interest. The amendment first placed a general ban on engaging in trading that would create a conflict of interest between the banks and their

⁵⁸ *Id.* secs. (d)(2)(A)(i)–(iv).

⁵⁹ See KEVIN DOWD, CATO INST., TOO BIG TO FAIL? LONG-TERM CAPITAL MANAGEMENT AND THE FEDERAL RESERVE 2 (1999), <http://www.cato.org/pubs/briefs/bp52.pdf>; see also discussion *infra* Part V.B.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ FIN. STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS 56 (2011) [hereinafter FSOC STUDY].

⁶⁴ S. 3217, 111th Cong. § 619, sec. (2)(f)(1) (2011).

⁶⁵ *Id.* sec. (f)(2).

⁶⁶ *Id.* sec. (g)(6)(C).

clients.⁶⁷ It then directed a commission to issue rules to implement the ban on conflicts of interest.⁶⁸ The proposed amendment concluded with an exception permitting financial institutions to enter into a transaction that creates a conflict of interest if the conflict is necessary for the bank to engage in risk-mitigating hedging activities.⁶⁹

As with the final version of the amendment, the proposed version left many details to be filled in by regulatory agencies.

The proposed amendment laid out a strong framework to achieve the intended result—reducing the investments and conflicts of interest in today’s financial industry that create systemic risks. The proposed amendment included limited exceptions for trades that are necessary for banks to serve clients and to engage in responsible risk-hedging betting, which would further strengthen the financial system. The proposed amendment thoughtfully balanced the necessary regulations to protect taxpayers from being on the hook for bailouts and to protect consumers from unfair competition without placing U.S. financial institutions at a competitive disadvantage internationally. The amendment, however, laid out broad principles rather than detailed instructions on how to realize those tenets.

II THE POLITICS

Despite the apparent need for financial reform, the recommendations by many of the world’s leading economists, a personal endorsement from Chairman Volcker, and a vow from President Obama that the Wall Street Reform and Consumer Protection Act was “a fight [he was] ready to have,”⁷⁰ support for the Act, and for the “common-sense” Volcker Rule in particular, was fractured.

Support for the bill was largely split along party lines⁷¹ and it became clear that work on the bill would spill into a bitter election

⁶⁷ *Id.* § 619B, sec. (a).

⁶⁸ *Id.* sec. (b).

⁶⁹ *Id.* sec. (c).

⁷⁰ Obama, *supra* note 15.

⁷¹ See *CNN Poll: Americans Split on Two Top Obama Initiatives*, CNN (June 2, 2010, 2:57 PM), <http://politicalticker.blogs.cnn.com/2010/06/02/cnn-poll-americans-split-on-top-two-obama-initiatives> (noting that increased regulation was popular with Democrats and Independents but a bare majority of Republicans opposed increased regulation); see also Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST, July 16, 2010,

season, which would further deepen the political divide. Republicans were not the only group against the bill; while the Act was a fight the President was ready to have, it was a fight that Wall Street was already waging. Wall Street had already assembled a legion of lobbyists to wage battle on Capitol Hill.

Wall Street dispatched two thousand lobbyists to Washington as part of a \$600 million campaign to assure that their interests were well represented.⁷² In 2009, there were 13,676 registered and active lobbyists in Washington,⁷³ which means that roughly fifteen percent of all the active lobbyists in Washington were lobbying on behalf of Wall Street interests. While the Act passed, Republicans and Wall Street lobbyists succeeded in weakening the Volcker Rule by inserting loopholes.

Legislation reflects the efforts of people and diverse groups and is the result of compromise.⁷⁴ Several political theories attempt to explain the external and internal forces at work in the political process.⁷⁵ These theories can generally be divided between those that attempt to explain the process through the activity of interested groups, and those that explain legislation as the result of the internal structures of government.⁷⁶

A. Interest Group Theories

Interest group theory is a normative political theory that attempts to explain legislative results through the external interest groups that

<http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464.html> (noting that the bill passed the Senate by a vote of 60–39, with three Republican senators, including Senator Scott Brown, supporting the bill and only one Democrat voting against because it “didn’t go far enough”).

⁷² Weeks, *supra* note 29.

⁷³ *Lobbying Database*, OPENSECRETS.ORG, <http://www.opensecrets.org/lobby/index.php> (last updated Apr. 26, 2012).

⁷⁴ Donald J. Boudreaux & Dwight R. Lee, *Politics as the Art of Confined Compromise*, 16 CATO J. 365, 365–66 (1997), available at <http://www.cato.org/pubs/journal/cj16n3-6.html>. Political philosopher Jean Bethke Elshtain noted of political compromise: “But compromise is not a mediocre way to do politics; it is an adventure, the *only* way to do democratic politics.” *Id.*

⁷⁵ See WILLIAM N. ESKRIDGE, JR. ET AL., *CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY* 48 (4th ed. 2007) (stating that interest group theories, proceduralist theories, and institutional theories attempt to describe the congressional process).

⁷⁶ *Id.*

influence Congress.⁷⁷ The notion that interest groups will play an important role in the political process dates from the founding of our country. James Madison addressed the inevitability of the formation of factions, groups of citizens motivated by common self-interests that are contrary to the common good.⁷⁸ Madison quickly dismissed the threat of minority factions, arguing that our majoritarian form of government would be sufficient to protect against minority factions.⁷⁹ Madison also argued that the organization of the political process would protect minorities from the imposition of the will of a majority faction.⁸⁰

Interest group theory hinges on three assumptions: (1) citizens organize into groups based on common interests for political action, (2) this results in a spreading of political power across the groups, and (3) policy makers enact policies that reflect the desires of interest groups.⁸¹ The theory holds that the overlap of interests and membership among the groups, and active competition between the groups, will help prevent one group from oppressing others.⁸²

In theory, the presence of active and organized interest groups competing in a system of standard rules will result in moderate, well-considered public policy.⁸³ Crucial to this view is that all interests are effectively represented.⁸⁴ But more often than not, in reality, one interest group will be more powerful than the others and will be able to pass or block legislation that affects their interests, often at the expense of others.⁸⁵

Madison would likely be disappointed by the disproportionately strong influence certain minority factions, or interest groups, exert on the political process today. In the fight over the Dodd-Frank Act, the interest groups broke down between Wall Street and “Main Street,” as

⁷⁷ See *id.* at 48–54.

⁷⁸ THE FEDERALIST NO. 10 (James Madison) (Clinton Rossiter ed., 1999).

⁷⁹ *Id.* at 75.

⁸⁰ *Id.*

⁸¹ ESKRIDGE, *supra* note 75, at 49.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* at 50.

⁸⁵ Boudreaux & Lee, *supra* note 74. “[N]ot all parties affected by political choices are represented at the political bargaining table. . . . [T]he fact that many politically affected people are not party to these compromises means that political compromises are selective, at best.” *Id.*

the media and politicians were fond of describing it.⁸⁶ As it did in the 1990s, Wall Street was still advocating for “self-regulation” of the financial market.⁸⁷ Main Street, harmed by the excesses of Wall Street, wanted Congress to do something to prevent similar crises in the future.

Several factors affect the influence certain groups will have on the political process.⁸⁸ An analysis of these factors as split between Main Street and Wall Street will help to explain how interest groups influenced the final Volcker Rule.

First, the number of members in an interest group influences its effectiveness.⁸⁹ The Main Street interest group fighting for reform was greater in number than the Wall Street interest group.⁹⁰ Main Street represents the “common American” who works or goes to school; many aligning with Main Street lost their jobs and savings because of Wall Street’s risky actions. Only a very small percentage of Americans work on Wall Street.

Strength in numbers can often be negated, however, when a group is diffuse, poorly organized, and lacks access to the political process.⁹¹ This means that the political system is less responsive to the concerns of consumers and other general citizens.⁹² Elmer Schattschneider, a pluralist skeptic, argued that “[t]he flaw in the pluralist heaven is that the heavenly chorus sings with a strong upper-class accent. Probably about 90 per cent of the people cannot get into

⁸⁶ See, e.g., Russ Choma, *Wall Street’s New Weapon or Main Street Strikes Back?*, OPENSECRETS BLOG (Apr. 9, 2012, 11:28 AM), <http://www.opensecrets.org/news/2012/04/wall-streets-new-weapon-or-main-str.html>; Suzy Khimm, *Main Street Banks Break Away from Wall Street with Their Own SuperPAC*, WONKBLOG (Apr. 5, 2012, 1:30 PM), http://www.washingtonpost.com/blogs/ezra-klein/post/main-street-banks-break-away-from-wall-street-with-their-own-superpac/2012/04/05/gIQAOpWexS_blog.html.

⁸⁷ See, e.g., Charles Reiger Gallagher III, *Too Big to Fail: The Role of the Banking Lobby on Consumer Protection Laws*, AVVO (Mar. 2012), <http://www.avvo.com/legal-guides/ugc/too-big-to-fail-the-role-of-the-banking-lobby-on-consumer-protection-laws>.

⁸⁸ See ESKRIDGE, *supra* note 75, at 49–65.

⁸⁹ See *id.* at 49–51.

⁹⁰ The “Main Street” lobby later evolved into the “99% lobby,” based on the belief that “99% of America” (Main Street) is paying for the excesses of the 1% (Wall Street). See generally *We Are the 99 Percent*, <http://wearethe99percent.tumblr.com> (last visited May 17, 2012).

⁹¹ Boudreaux & Lee, *supra* note 74 (“[P]olitical decisionmaking is overly sensitive to the demands of organized interest groups and relatively insensitive to the demands of unorganized groups.”).

⁹² E.E. SCHATTSCHNEIDER, *THE SEMISOVEREIGN PEOPLE: A REALIST’S VIEW OF DEMOCRACY IN AMERICA* 34–35 (1960).

the pressure system.”⁹³ The Main Street lobby consisted largely of the ninety percent that could not get into the system, and Wall Street, the well-connected upper class.

The Main Street lobby was able to influence Congress by writing to its representatives or testifying before committees demanding relief—demanding that Congress take action to prevent similar economic catastrophes in the future. But the “inattentive public” may be sated with legislation that is largely symbolic.⁹⁴ While the Main Street lobby was united in its call for action, which Congress heeded, the lobby was fractured over what steps to take. Wall Street, on the other hand, is a small, well-connected, well-organized, and extremely wealthy interest group that plainly possessed unique expertise in the topics the Dodd-Frank Act addresses. Wall Street was united in its opposition to regulation and many members of the Main Street coalition actually joined Wall Street in opposing increased regulation.⁹⁵

The way interest groups formed in response to the Act lends credence to Mancur Olson’s interest group theory.⁹⁶ Rather than the spontaneous formation of interest groups of the classic pluralist theory, Olson predicted that interest groups are most likely to form when there are a few interested members and each member has a large stake in the outcome.⁹⁷ Bank risk is typically an issue that inspires little public action; however, the recession temporarily transformed the issue into one of great public interest, though the public had little expertise by which to judge the outcome of the legislative battle.⁹⁸ While the people on Main Street would benefit from new financial regulations, the impact on them would be less direct than the impact on those on Wall Street. Main Street will benefit in the long run from a more stable financial system. Wall Street, however, feared that it would see reduced profits almost

⁹³ *Id.* at 35.

⁹⁴ See ESKRIDGE, *supra* note 75, at 53 (citing R. DOUGLAS ARNOLD, *THE LOGIC OF CONGRESSIONAL ACTION* (1990)).

⁹⁵ *CNN Poll*, *supra* note 71. Sixty percent of Americans favored increased federal regulation over Wall Street financial institutions, with thirty-eight percent opposed. *Id.* Increased regulation was popular with Democrats and independents, but a bare majority of Republicans opposed increased regulation. *Id.*

⁹⁶ See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

⁹⁷ See *id.*

⁹⁸ Kim Krawiec, *Dodd-Frank by the Numbers: A Volcker Rule Case Study*, FACULTY LOUNGE (July 21, 2011, 8:03 AM), <http://www.thefacultylounge.org/2011/07/dodd-frank-by-the-numbers-a-volcker-rule-case-study.html>.

immediately as a result of regulation.⁹⁹ This possible direct and immediate impact encouraged Wall Street's organized and fervent lobbying effort.¹⁰⁰

While Main Street enjoyed the advantage in numbers, Wall Street won the interest group battle with its organized army of lobbyists and well-stocked political war chest. Despite the large numbers on Main Street, "the pressure community [in Washington] is heavily weighted in favor of business."¹⁰¹ Businesses naturally enjoy an advantage over citizen groups because they have the resources and organization to employ full-time professional lobbyists to work on their behalf. In the case of the Wall Street lobby employed for the Dodd-Frank Act fight, in addition to Wall Street's ability to deploy a legion of professional lobbyists on its behalf, Wall Street enjoyed close ties with many of the key political actors involved with the Act.

There are many ways that interest groups can exert influence over the political process. Interest groups can lobby members directly on issues that are important to them, and they can also form connections with the key players in Washington through campaign contributions. Wall Street has engaged in both of these strategies to grow its influence on Capitol Hill. The close relationship between Wall Street and Capitol Hill led then-Senate Majority Whip Dick Durbin (D-Ill.) to remark that "[the banks] frankly own the place."¹⁰²

First, Wall Street has been forging relationships with the playmakers in Washington for decades. From 1990 to 1998, during the Clinton Administration debate over regulating Wall Street and the successful repeal of the Glass-Steagall Act, Wall Street contributed \$232 million to federal political candidates.¹⁰³ In the decade since then, Wall Street has nearly tripled its campaign giving to \$686 million, directing most of its contributions to whichever political party was in power.¹⁰⁴ "The leading beneficiaries of Wall Street's

⁹⁹ See Robin Sidel et al., *Financial Firms Fear Revenue Loss*, WALL ST. J., Jan. 22, 2010, <http://online.wsj.com/article/SB10001424052748704423204575017543293379422.html>.

¹⁰⁰ *Id.* ("Bank executives scrambled . . . to interpret Mr. Obama's remarks, assess their potential impact and begin mobilizing their political weight in Washington for an upcoming fight over the proposals.")

¹⁰¹ KAY LEHMAN SCHLOZMAN & JOHN T. TIERNEY, ORGANIZED INTERESTS AND AMERICAN DEMOCRACY 68 (1986).

¹⁰² Weeks, *supra* note 29.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

[political contributions] . . . were members of the oversight committees charged with regulating the financial system.”¹⁰⁵

In addition to raising and donating money to political campaigns, Wall Street can also tempt politicians—and their staff—with lucrative positions if they push for favorable policies. Following the repeal of the Glass-Steagall Act, two of the lead sponsors of the repealing legislation and hundreds of staffers who worked on the bill accepted jobs lobbying for Wall Street.¹⁰⁶

Ultimately, the most powerful factor in the political process is inertia.¹⁰⁷ Interest groups advocating to maintain the status quo enjoy an advantage from the start, regardless of number, wealth, or organization.¹⁰⁸ Passing legislation requires agreement between a large number of people, all representing diverse beliefs and backgrounds. As a result, preservation of the status quo is the easiest result to achieve because building consensus for specific change is at best challenging, and often impossible. The pull towards maintaining the status quo is particularly strong when the status quo clearly serves the interests of a strong and active interest group at the expense of a less organized interest group.¹⁰⁹

During the debate over regulation in the 1990s, Wall Street’s powerful lobby succeeded in establishing a financial sector that was essentially free from meaningful regulation.¹¹⁰ Lawmakers and regulators were able to see the possible consequences of allowing the financial industry to operate with minimal regulatory oversight; but at the urging of Wall Street’s lobby, and without a tangible crisis to rouse the passions of Main Street, Congress opted to keep the enemy it knew, rather than accept the unknown risks that increased regulation might pose. In the Dodd-Frank fight, the status quo aligned with Wall Street’s interests, not Main Street’s, further tipping the scales in Wall Street’s favor.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ David Rothkopf, *Inertia You Can Believe In*, FOREIGN POL’Y (Oct. 25, 2010, 12:15 PM), http://rothkopf.foreignpolicy.com/posts/2010/10/25/inertia_you_can_believe_in (noting that Henry Kissinger observed that inertia is the most powerful force in American politics).

¹⁰⁸ See SCHLOZMAN & TIERNEY, *supra* note 101, at 314–15.

¹⁰⁹ See ESKRIDGE, *supra* note 75, at 57, 62 (stating that organized interest groups are more likely to form to derail legislation with broadly distributed benefits and concentrated costs, and groups opposing legislation enjoy an advantage because of the organization of the political process).

¹¹⁰ See discussion *supra* Part I.B.

In the aftermath of the collapse of 2008, the momentum for change was strong enough to overcome the pull of the status quo, but the natural inclination to maintain the status quo, and the organizational and resource advantages enjoyed by Wall Street, was sufficient to allow members of Congress to weaken the Volcker Rule by inserting loopholes.

Congress reacted to the competing interest groups by trying to find a middle ground pleasing both sides. Congress heeded the call of Main Street and passed *something*, but allowed Wall Street to influence what that something would look like. Passage of the Dodd-Frank Act was hailed as a victory for Main Street America.¹¹¹ And it was, in that any reforms were passed at all. But ultimately, the final version of the bill was a victory for Wall Street.

B. Procedural Theories

Procedural political theories can help explain how certain individual members of Congress were able to exert disproportionate influence over the content of the bill.¹¹² There are many steps in the political process that a bill must navigate in order to become a law. Bills must pass out of committees, often more than one, and both chambers of Congress, and be signed by the President.¹¹³ If a bill fails any of these steps, it does not become a law.¹¹⁴ It is these steps, sometimes called vetogates¹¹⁵ for their ability to shut down legislation, that make the status quo so difficult to overcome. Proponents of legislation must succeed at each step in the process in order for their proposal to become law, while opponents of proposals need only succeed at one step in order to block the proposal from becoming law.¹¹⁶ In the 102nd Congress, of the more than 11,000 bills introduced, only approximately fourteen percent were reported out of committee.¹¹⁷

¹¹¹ After the Act's passage, President Obama declared "the American people will never again be asked to foot the bill for Wall Street's mistakes." Obama, *supra* note 15.

¹¹² See ESKRIDGE, *supra* note 75, at 29.

¹¹³ I'M JUST A BILL (SCHOOLHOUSE ROCK!), YOUTUBE, <http://www.youtube.com/watch?v=tyeJ55o3El0> (uploaded Sept. 1, 2008).

¹¹⁴ *Id.*

¹¹⁵ See McNollgast, *Legislative Intent: The Use of Positive Political Theory in Statutory Interpretation*, 57 LAW & CONTEMP. PROBS. 3, 7, 18 (1994).

¹¹⁶ ESKRIDGE, *supra* note 75, at 62.

¹¹⁷ STEVEN S. SMITH ET AL., THE AMERICAN CONGRESS 99 (4th ed. 2006); *see also* ESKRIDGE, *supra* note 75, at 29 (stating that the Committee process transfers power from

It is at each of these vetogates that individual members can find themselves thrust into the center of debate over a bill with the power to block it from moving forward.¹¹⁸ Members who are generally not playmakers can find themselves with the singular power to block a proposal, even a proposal as important and expansive as the Dodd-Frank Act. In order to pass through a vetogate, proponents of a proposal may need either to remove or to insert certain provisions into the bill in order to gain the support of those who control the vetogate.¹¹⁹ This aspect of our political system allows interest groups to effect significant changes in proposals by exerting their influence on a few select members of Congress who find themselves with the power to block or pass the proposal.¹²⁰

While the Senate was considering the Volcker Amendment, Senator Scott Brown changed the political make up of the Senate in a stunning special election victory.¹²¹ Freshman Senator Scott Brown (R-Mass.), who replaced the late Lion of the Senate, Senator Ted Kennedy (D-Mass.),¹²² found himself at the heart of the Volcker Rule debate.

With a Republican holding Senator Kennedy's seat, Senate Democrats were one seat shy of the sixty-seat majority needed to defeat a Senate filibuster.¹²³ This change in the political makeup of the Senate made Senator Brown's vote highly sought after, particularly since Senator Brown publicly declared his belief that the Senate needed to enact measures to overhaul the financial system to prevent another collapse.¹²⁴ Senator Brown, however, was

the chamber majority to a small number of lawmakers, particularly committee chairs); Paul Singer, *Members Offered Many Bills but Passed Few*, ROLL CALL (Dec. 1, 2008, 12:00 AM), http://www.rollcall.com/issues/54_61/-30466-1.html (noting that the 110th Congress proposed 14,000 bills, the most of any Congress since 1980, but only 3.3% were signed into law, the lowest percentage since 1976).

¹¹⁸ See ESKRIDGE, *supra* note 75, at 67.

¹¹⁹ *Id.*

¹²⁰ *Id.* ("Because legislation can be stopped at many points along the legislative path, groups [trying to block a proposal] need to secure the assistance of only one key player to succeed.").

¹²¹ Michael Cooper, *G.O.P. Senate Victory Stuns Democrats*, N.Y. TIMES, Jan. 20, 2010, <http://www.nytimes.com/2010/01/21/us/politics/21elect.html>.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ Press Release, Senator Scott Brown, Statement on Financial Regulation Cloture Vote (May 19, 2010), http://scottbrown.senate.gov/public/index.cfm/news?ContentRecord_id=9967cc52-6187-40e2-a11e-5c5c30f3d0ff&ContentType_id=c705917c-84f4-49fd-a587-420cd0fcc26f&096fa988-9da3-4a1a-87bc-4ee9d9c2ef47&Group_id=34087a75-290f-488b-97a4-2314e6991fb5&MonthDisplay=5&YearDisplay=2010.

particularly concerned about the effect that the proposed Volcker Rule would have on Massachusetts banks.¹²⁵ He announced the price of his support: the bill could not be funded by new taxes on banks¹²⁶ and businesses in Massachusetts must be able to continue to operate as they had been doing for decades.¹²⁷

Senator Brown's concern for the Massachusetts banking industry is understandable. Massachusetts is at the heart of the mutual fund industry. The securities and investment industry was also the second largest industry to contribute to his political action committee, donating nearly \$750,000,¹²⁸ and his top individual contributor was a financial institution.¹²⁹ His advocacy during the Dodd-Frank Wall Street Reform and Consumer Protection Act debate apparently pleased his securities and investment industry supporters because they donated nearly \$2 million to his 2012 campaign.¹³⁰

III

THE FINAL VERSION

Changes to proposed bills are inevitable in a legislative process that requires political compromise. Proponents of the political system contend that political compromise is necessary to produce well-tempered public policy.¹³¹ But even to a seasoned political realist

¹²⁵ *Id.*

¹²⁶ Press Release, Senator Scott Brown, Brown Sends Letter to Dodd, Frank Opposing \$19 Billion Bank Tax in Financial Reform Bill (June 29, 2010), http://scottbrown.senate.gov/public/index.cfm/news?ContentRecord_id=51d77c2f-5043-41c8-9020-38221a93aa40&ContentType_id=c705917c-84f4-49fd-a587-420cd0fcc26f&096fa988-9da3-4a1a-87bc-4ee9d9c2ef47&Group_id=34087a75-290f-488b-97a4-2314e6991fb5&MonthDisplay=6&YearDisplay=2010.

¹²⁷ Press Release, Senator Scott Brown, Statement on Financial Regulation Cloture Vote (May 20, 2010), <http://www.scottbrown.senate.gov/public/index.cfm/2010/5/senator-scottbrownstatementonfinancialregulationcloturevote>.

¹²⁸ *Senator Scott P. Brown 2005–2010, Top Industries*, OPENSECRETS.ORG, <http://www.opensecrets.org/politicians/industries.php?cycle=2010&cid=N00031174&type=I&newmem=N> (last visited May 17, 2012).

¹²⁹ *Senator Scott P. Brown 2005–2010, Top 20 Contributors*, OPENSECRETS.ORG, <http://www.opensecrets.org/politicians/contrib.php?cycle=2010&type=I&cid=N00031174&newMem=N&recs=20>.

¹³⁰ *Scott Brown 2011–2012, Top Industries*, OPENSECRETS.ORG, <http://www.opensecrets.org/politicians/industries.php?cycle=2012&type=I&cid=N00031174&newMem=N&recs=20> (last visited May 17, 2012).

¹³¹ See Orlando Patterson, Opinion, *Affirmative Action: The Sequel*, N.Y. TIMES, June 22, 2003, <http://www.nytimes.com/2003/06/22/opinion/affirmative-action-the-sequel.html?pagewanted=all&src=pm>; see also ESKRIDGE, *supra* note 75, at 49.

like Chairman Paul Volcker, the final version of the Volcker Rule was a disappointment.¹³² Chairman Volcker believes that the final version of the Act stops short of sufficiently curbing potentially problematic banking activities, particularly hedge fund investment.¹³³ “The [bill] went from what is best to what could be passed,” he said.¹³⁴

Many significant changes came after a nearly twenty-hour marathon House and Senate Conference Committee work session on the bill to meet a self-imposed deadline.¹³⁵ The session began at 10:00 a.m. on Thursday, June 24, 2010, and the final vote was not held until 5:40 a.m. on Friday.¹³⁶

The final version of the amendment keeps the same basic framework as the proposed version. It begins with an unchanged broad prohibition on proprietary trading and hedge fund investing by banking entities. The final version of the bill, however, adds significantly to the exceptions that were contained in the proposed version.

Not all of the changes to the “permitted activities” weakened the proposal. The original version of the amendment permitted banks to purchase and sell securities in connection with underwriting, market making, and vaguely, “in facilitation of customer relationships,” to the extent that the activities did not exceed the near term demands of clients.¹³⁷ The final version removed transactions “in facilitation of customer relationships” from the permitted transactions.¹³⁸ The final version also narrowed the broad edict of the original that permitted banking entities to engage in risk-mitigating hedging activities. The final version requires that risk-mitigating hedging be “related to individual or aggregated positions, contracts or other holdings” that are designed to reduce specific risks.¹³⁹ This change essentially outlines what the oversight agencies will consider when determining whether investments are “risk-mitigating hedging.”

¹³² *A New Era for U.S. Finance*, *supra* note 47.

¹³³ Louis Uchitelle, *Volcker, Loud and Clear*, N.Y. TIMES, July 11, 2010, at BU1.

¹³⁴ *Id.* at BU7.

¹³⁵ Shahien Nasiripour, *Financial Reform Bill Passes: Banks Keep Derivatives Units, Volcker Rules Softened; House-Senate Conference Passes Financial Reform Bill After Marathon Session*, HUFFINGTON POST (June 25, 2010, 7:37 AM), www.huffingtonpost.com/2010/06/25/financial-reform-bill-pas_n_625191.html.

¹³⁶ *Id.*

¹³⁷ S. 3217, 111th Cong. § 619, sec. (d)(1)(B) (2011).

¹³⁸ 12 U.S.C. § 1851(d)(1)(B) (Supp. 2011).

¹³⁹ *Id.* § (d)(1)(C).

The most problematic change between the introduced version of the Merkley-Levin Amendment and the final version was that the final version expanded the permitted activities of regulated financial institutions. In the original version, the banks were to be involved in hedge funds only if their interest was solely outside of the United States and no ownership interest in the fund was offered to a resident of the United States. The final version rewrote the permitted hedge fund involvement exception, inserting a potentially large loophole.

In addition to the initial hedge fund exception of the original version, the final version permits a bank entity to serve as a general partner, managing member, or trustee of a hedge fund, or to have a controlling interest in the hedge fund, if certain conditions are met. Banks may organize and invest in hedge funds and private equity funds up to a *de minimis* investment to facilitate customer services so long as the following is true: the hedge fund does not share a variation of the bank's name, the bank provides bona fide investment advisory or trust services and the fund is organized only in connection with those services, the bank never acquires an interest in the fund beyond a *de minimis* investment, no employee or director of the banking entity has an ownership interest in the trust unless they are directly providing services to the fund, and the banking entity never guarantees or otherwise assumes the obligations of the trust.¹⁴⁰ Even if all of these conditions are met, a bank's involvement with a hedge fund may still be prohibited if its involvement exposes the banking entity to significant risk or creates a conflict of interest between the bank and its customers.¹⁴¹

This potential loophole could permit banks to structure hedge fund units in a way to meet the conditions while still exposing the bank to risk of loss and providing incentive to bail out the fund if it fails. The best way to prevent bank losses in hedge funds is to prohibit bank involvement with hedge funds entirely. The final version does leave open the possibility of closing this loophole by allowing the regulatory agencies to promulgate any additional rules designed to insure that hedge fund losses are borne solely by the investors, not the banking entity.

Under the final version of the bill, banks are permitted to operate hedge funds (with the above limitations), but banks are not allowed to

¹⁴⁰ FSOC STUDY, *supra* note 63, at 58 (summarizing 12 U.S.C. § 1851(d)(1)(G)).

¹⁴¹ 12 U.S.C. §§ 1851 (d)(2)(A)(i)–(iv).

invest in hedge funds themselves. Of course, there are exceptions. Those exceptions are that banking entities are permitted to retain an investment in a hedge fund in order (1) to establish the fund and to provide it with enough initial equity to attract unaffiliated investors and (2) to make de minimis investments.¹⁴² These two exceptions come with certain limitations.

Enter Senator Scott Brown, the newest Senator representing the hub of asset management—Massachusetts. The initial Volcker Rule prohibited banking entities from investing their own funds in hedge funds and proprietary trading with only very narrow exceptions.¹⁴³ But Senator Brown insisted on a compromise—that banking entities be allowed to invest a small amount of its own capital in the funds.¹⁴⁴ The initial compromise was to allow banking entities to “invest up to three percent of [a bank’s] tangible common equity in hedge funds and private equity firms.”¹⁴⁵ Tangible common equity comprises shareholder equity and is “considered to be the strongest form of bank capital.”¹⁴⁶

Several hours into the marathon work session, in political maneuvering designed to hold on to key votes, Senator Brown succeeded in further amending the proposal. Senator Brown’s amendment increased the amount of permissible investment from three percent of tangible common equity to three percent of Tier 1 capital.¹⁴⁷ With that small change in the text, Senator Brown increased the amount of capital that banking entities may place in risky investments by as much as eighty percent, depending on the bank.¹⁴⁸

As passed with Senator Brown’s amendment, the final bill limits banking entity investments in hedge funds and private equity funds in the following two ways: first, the banking entity’s investment in the fund cannot exceed more than three percent of the capital in the fund one year after the establishment of the fund; second, the aggregate of

¹⁴² *Id.* § (d)(4)(A).

¹⁴³ See discussion *supra* Part I.C.; see also S. 3217, 111th Cong. § 619, secs. 13(a)(1), (d)(1)(b) (2011).

¹⁴⁴ David Cho et al., *Lawmakers Guide Dodd-Frank Bill for Wall Street Reform Into Homestretch*, WASH. POST, June 26, 2010, www.washingtonpost.com/wp-dyn/content/article/2010/06/25/AR2010062500675.html.

¹⁴⁵ Nasiripour, *supra* note 135.

¹⁴⁶ *Id.*

¹⁴⁷ See *id.*

¹⁴⁸ *Id.*; see also *A New Era for U.S. Finance*, *supra* note 47.

the banking entity's interest in the fund cannot exceed three percent of the Tier 1 capital of the banking entity.¹⁴⁹

Three percent of any amount of capital may seem like a modest amount. However, the primary banking entities that engage in hedge fund investing and proprietary trading, those whose impairment would pose the gravest threat to the United States financial system, deal in almost unimaginable amounts of capital. The amendment would allow Bank of America, for example, the nation's largest bank with more than \$2.3 trillion (\$2,300,000,000,000) in assets, to invest \$4.8 billion in hedge funds and private equity funds, an increase of eighty percent over the amount that would have been allowed under the tangible common equity requirement.¹⁵⁰ JPMorgan Chase is the nation's second largest bank and has assets totaling more than \$2.1 trillion.¹⁵¹ Senator Brown's change to Tier 1 capital increased the amount JPMorgan will be able to invest in hedge funds by \$1.1 billion, to \$4 billion.¹⁵² BNY Mellon and State Street Corp., the thirteenth and nineteenth largest banks with \$221 billion and \$153 billion in assets, respectively, directly lobbied Senator Brown to weaken the Volcker Rule.¹⁵³

A study completed by the Financial Stability Oversight Council found three reasons for the ban on hedge fund trading: (1) to ensure that banking entities do not use hedge funds to circumvent the Volcker prohibition on proprietary trading, (2) to confine banking's private fund activities to those activities that are customer-related, and (3) to eliminate incentives and opportunities for banks to "bail out" funds that they sponsor or in which they invest.¹⁵⁴ The original version flatly stated that "[n]o banking entity that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund may enter into a covered transaction" with the fund.¹⁵⁵ The final version expands the base of entities that cannot invest in hedge funds by prohibiting sponsors and

¹⁴⁹ 12 U.S.C. §§ 1851(d)(4)(B)(ii)(I)–(II) (Supp. 2011).

¹⁵⁰ Nasiripour, *supra* note 135. Additionally, "Morgan Stanley can invest \$1.4 billion, a 58% increase, while Goldman Sachs can invest \$1.9 billion, an increase of just 10%" over the tangible equity standard. *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ FSOC STUDY, *supra* note 63, at 6.

¹⁵⁵ S. 3217, 111th Cong. § 619, sec. 13(f)(1) (2011).

affiliates of the fund from entering into covered transactions with the fund.¹⁵⁶

The final version of the Act then proceeds to permit banking entities, at the discretion of the regulatory agencies, to enter into any prime brokerage transaction with any hedge or private equity fund managed, sponsored, or advised by the bank if (1) the banking entity is in compliance with the above-described limitations, (2) the bank director certifies annually in writing that the bank is in compliance, and (3) the responsible regulatory agency has determined that such transactions do not jeopardize the “safe and sound operation” of the banking entity.¹⁵⁷ By placing this provision at the discretion of the regulatory agencies, Congress has made it possible for this loophole to be closed in the agency rulemaking process.

The enacted Merkley-Levin Amendment defines “banking entity” as an insured deposit institution, but excepts institutions that function solely in a trust or fiduciary capacity if (1) all or almost all deposits at the institution are in a trust fund and (2) no deposits are federally insured.¹⁵⁸ This exemption, which was not included in the amendment as proposed, limits the scope of the bill only to those institutions in which the government has a stake through federal insurance.

The enacted amendment prohibits banks from operating or investing in hedge funds that are completely divorced from their customers’ needs. Bank involvement in hedge funds encourages banks to bail out failing funds to preserve the banks’ reputation.¹⁵⁹ Furthermore, the complexity of the financial market has made it difficult to evaluate the risk of hedge fund investments, making it hard for banks to invest prudently. The amendment also attempts to curb the opportunities for banks to use hedge fund operations to circumvent the bans on proprietary trading.

One of the crucial elements for effectively regulating hedge funds is how hedge funds are defined. Hedge funds, by their nature, are slippery entities. The final version of the Act defined hedge funds, proprietary trading, and illiquid funds (a special form of hedge fund) but provides leeway for the rulemaking agencies to alter the definitions as needed.¹⁶⁰ As discussed below, crafting a careful

¹⁵⁶ 12 U.S.C. § 1851(f)(1) (Supp. 2011).

¹⁵⁷ *Id.* §§ (f)(3)(A)(i)–(iii).

¹⁵⁸ *Id.* § (h)(1).

¹⁵⁹ FSOC STUDY, *supra* note 63, at 56.

¹⁶⁰ *See* 12 U.S.C. §§ 1851(h)(2), (4), (7).

definition of hedge fund may be one of the most important tasks the regulatory agencies face as they attempt to fill in the details of the Act.

IV

REGULATORY RULEMAKING: A LONG ROAD AHEAD

Following the marathon work session on the bill, a teary-eyed Senator Chris Dodd (D-Conn.), Chair of the Senate Banking Committee and namesake of the bill, announced that “[n]o one will know until this is actually in place how it works.”¹⁶¹ Senator Merkley noted that the principle of the Volcker Rule was embodied in the final version of the Act, but that the effectiveness of the Rule will come down to the level of enforcement.¹⁶² “If those regulators are not vigilant,” he said, “we will have a giant loophole.”¹⁶³ Chairman Volcker agreed, stating that “[t]he success of this approach is going to be heavily dependent on how aggressively and intelligently it is implemented.”¹⁶⁴

The next stage in the reform process is a two- to five-year rulemaking period in which at least a dozen regulatory agencies will need to research and write approximately 250 new regulations.¹⁶⁵ Each agency will be responsible for drafting the rules to which they have been tasked, with some regulations requiring cooperation between two or more agencies.

A. Public Choice Theory and the Agency Burden

The final version of the Act, with broad prohibitions and large rulemaking responsibility delegated to the regulatory agencies to fill in details, was predictable given the economic cost-benefit distribution among the interest groups. Public choice theory applies an economic model to the political process, assuming that politicians

¹⁶¹ Cho, *supra* note 143.

¹⁶² David Sarasohn, Op-Ed., *The Bank Legislation, and Education, of Jeff Merkley*, OREGONIAN (July 1, 2010, 5:08 PM), http://www.oregonlive.com/news/oregonian/david_sarasohn/index.ssf/2010/07/the_bank_legislation_and_educa.html.

¹⁶³ *Id.*

¹⁶⁴ Uchitelle, *supra* note 133, at BU 7.

¹⁶⁵ SIFMA, DODD-FRANK RULEMAKING RESOURCE CENTER: OVERVIEW, <http://www.sifma.org/Issues/Regulatory-Reform/Dodd-Frank-Rulemaking/Overview> (last visited May 11, 2012).

are rational utility maximizers. The theory uses a supply and demand equation to predict or explain legislative outcomes.¹⁶⁶

Public choice theory assumes that the costs and benefits of any policy are distributed broadly or narrowly.¹⁶⁷ The distribution of costs and benefits can be determined by whether the policy would benefit a large or a small group of people, and whether the costs of the policy would be felt widely or narrowly across the community.¹⁶⁸ Distribution of costs and benefits can help predict or explain the formation of interest groups on each side, and how strong and well organized those interest groups will be.¹⁶⁹ Generally, the theory predicts that organized interest groups are more likely to form in response to policies with concentrated costs or benefits.¹⁷⁰

The Dodd-Frank Wall Street Reform and Consumer Protection Act has broadly distributed benefits, with the costs borne by a significantly smaller group. The benefits are broadly distributed across the population because everyone will benefit from a stable economy and financial sector. However, the small number of people on Wall Street will feel the costs of the regulations directly.

Under the public choice theory, public policies with broad benefits and concentrated costs, like the Dodd-Frank Act, generally have well-organized opposition, as was the case with the Wall Street lobby. The resulting policy, then, tends to be only as strong as the minority bearing the costs is willing to pay.¹⁷¹

Public choice theory also uses the cost-benefit distribution of policies to predict what the resulting legislation will look like. The theory predicts that laws like the Dodd-Frank Act, with distributed benefits and concentrated costs, will be more ambiguous and leave more details to agency rulemaking than other types of policies.¹⁷² Because policies with concentrated costs generally face better-organized opposition, it is difficult for Congress to reach a consensus on specific details, which Congress then leaves to the agencies to

¹⁶⁶ See OLSON, *supra* note 96; see also JAMES Q. WILSON, *POLITICAL ORGANIZATIONS* (1973).

¹⁶⁷ See MICHAEL T. HAYES, *LOBBYISTS AND LEGISLATORS: A THEORY OF POLITICAL MARKETS* (1981).

¹⁶⁸ See ESKRIDGE, *supra* note 75, at 54–60.

¹⁶⁹ See *id.*

¹⁷⁰ See *id.*

¹⁷¹ See *id.* at 56–57 (“Proposals with distributed benefits and concentrated costs will face opposition, and the majority may impose its will on the minority, but only up to the capacity the minority can pay.”).

¹⁷² See *id.* at 54–60.

work out.¹⁷³ By passing broad legislation intended to convey distributed benefits, but without including any contentious detail, both sides of the debate can claim victory. This allows politicians to curry favor with interest groups on both sides of the issue, which is essentially a victory for the politicians.

This is exactly what happened with the Dodd-Frank Act. Main Street demanded action, but the Wall Street Lobby made it nearly impossible for Congress to come to agreement on many details of the bill. Congress then delegated the responsibility for filling in the details to regulatory agencies. This delegation can result in agency capture.¹⁷⁴ Agency capture occurs when the agency becomes beholden to the special interests it is tasked with regulating rather than to the public interests it was created to serve. In this case, the level of detail left to the agencies gives the Wall Street and Main Street lobbies another opportunity to influence the ultimate form and reach of the Volcker Rule.

B. The Agency Burden

The Dodd-Frank Act creates new agencies and also directs the regulatory agencies to complete studies and to adopt rules to implement the entire Dodd-Frank Act, including the Volcker Rule. The final bill directs agencies to consider the following factors in their studies: how to promote the soundness of banking entities, how to protect taxpayers and consumers, how to “limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities,” how to limit activities that have caused undue risk and losses for banking entities, how to appropriately accommodate the insurance business while protecting affiliated banking entities, and how to time the divestiture of illiquid assets affected by the implementation of the Volcker Rule.¹⁷⁵ The proposed amendment contained a directive that the agency rules “not unreasonably raise the cost of credit or other financial services[or]

¹⁷³ See *id.* at 58–59.

¹⁷⁴ See, e.g., Thomas W. Merrill, *Capture Theory and the Courts: 1967–1983*, 72 CHL-KENT L. REV. 1039, 1050 (1997).

¹⁷⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1621 (2010) (codified at 12 U.S.C. § 1851(b)(1) (Supp. 2011)).

reduce the availability of credit or other financial services,”¹⁷⁶ but this consideration for study was removed from the final bill.

The Act permits the agencies “to impose additional capital requirements and restrictions . . . on any equity, partnership, or ownership interest in . . . a hedge fund . . . by a banking entity.”¹⁷⁷ The agencies may also impose additional requirements on banking entity/hedge fund relationships to ensure that losses sustained by the fund are borne by the investors in the fund, and not by the banking entity. The agencies also are given broad discretion to regulate or prohibit any “other” activity the agencies determine would promote the soundness of banks and the U.S. financial system.¹⁷⁸ The agencies may also impose additional limitations on permitted activities by rule if the agencies determine the activity would create a conflict of interest or expose the banking entity to high risk.¹⁷⁹ The Act also gives agencies broad discretion to impose “additional capital requirements and quantitative limitations, including diversification requirements.”¹⁸⁰

The agencies are struggling with the broad scope of the rule and the lack of congressional guidance, as well as with coordinating the rules between the laundry list of agencies that have been tasked with formulating the regulations. The Act created new agencies, such as the Bureau of Consumer Financial Protection (CFPB),¹⁸¹ the Financial Stability Oversight Council (FSOC),¹⁸² and the Office of Financial Research (OFR, part of FSOC).¹⁸³ These new agencies will join the Commodity Futures Trading Commission (CFTC), the Department of Education, the Federal Deposit Insurance Corporation (FDIC), the Federal Energy Regulatory Commission (FERC), the Government Accountability Office (GAO), the Municipal Securities Rulemaking Board (MSRB), the National Credit Union Administration Board (NCUAB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) in promulgating new banking regulations and completing studies.¹⁸⁴

¹⁷⁶ S. 3217, 111th Cong. § 619, sec. 13(b)(1)(A)(v) (2011).

¹⁷⁷ Dodd-Frank Act § 619, 124 Stat. at 1623 (codified at 12 U.S.C. § 1851(c)(5)).

¹⁷⁸ *Id.* § 619, 124 Stat. at 1626 (codified at 12 U.S.C. § 1851(d)(1)(J)).

¹⁷⁹ *Id.* § 619, 124 Stat. at 1626 (codified at 12 U.S.C. §§ 1851(d)(2)(A)(i)–(ii)).

¹⁸⁰ *Id.* § 619, 124 Stat. at 1626 (codified at 12 U.S.C. § 1851(d)(3)).

¹⁸¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, tit. X, I, subtit. A.

¹⁸² *Id.* tit. I, subtit. A.

¹⁸³ *Id.* subtit. B.

¹⁸⁴ SIFMA, *supra* note 165; *see also* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered section of the U.S. Code). For a helpful chart

The U.S. Securities and Exchange Commission (SEC), the Federal Reserve Board (FRB), and the U.S. Department of the Treasury are not mentioned specifically in the Act, but they are also heavily involved in the oversight or operation of the U.S. financial system and economy. These agencies coexist with independent state regulatory schemes and, for banks that also operate outside the United States, international regulations.

With the congressional struggle to pass the Volcker Rule in the past, a multitude of agencies now face the difficult task of working together to craft comprehensive and comprehensible rules regulating deeply entrenched, highly lucrative, yet poorly understood financial practices.

C. Closing the Loopholes of the Volcker Rule Through the Rulemaking Process

1. Another Opportunity for Interest Groups to Influence the Form of the Rule

While the Volcker Rule is no longer before Congress, the debate continues. Because so much was left to the agencies to craft, interest groups can still influence the scope and effect of the rule. Critics of the Volcker Rule break down into two groups: those who believe that the rule itself, in any form, is ill-advised and those who feel that the Volcker Rule did not go far enough. Both camps, no doubt, will try to influence the rulemaking process: those who oppose the rule will work to maintain or enlarge the loopholes, minimizing the rule's impact on banking practices, and those who support the rule will work to close the loopholes and to strongly enact the underlying principles.

Critics, as well as some supporters, of the rule warn against enacting a "draconian" form of the Volcker Rule with the concern that a poorly conceived rule could have unintended effects.¹⁸⁵ Regulators should be careful to avoid possible unwanted consequences, "such as reduced liquidity, higher funding costs for U.S. companies, less credit for small businesses, higher trading costs and lower investor returns, less ability to transfer risk, and

illustrating the new regulatory structure, see *Too Big Not to Fail*, *ECONOMIST*, Feb. 18, 2012, at 21, 23.

¹⁸⁵ Halah Touryalai, *Volcker Rule Will Hit Goldman Sachs, Morgan Stanley Hardest*, *FORBES* (Oct. 7, 2011, 2:31 PM), <http://www.forbes.com/sites/halahtouryalai/2011/10/07/volcker-rule-will-hit-goldman-sachs-morgan-stanley-hardest>.

competitive disadvantages for U.S. banks relative to foreign banks.”¹⁸⁶

In addition to possible unintended consequences that the rule may have on the economy, simply implementing the Volcker Rule would cost national banks almost one billion dollars “for compliance and capital,” according to an impact analysis conducted by the OCC.¹⁸⁷ Furthermore, Moody’s Investors Services has stated that the rule would be considered a “credit negative” for bondholders of several of the largest banking firms that have “substantial market-making operations,” including Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley.¹⁸⁸

Other critics believe that the Volcker Rule’s focus on proprietary trading is misplaced, instead placing the blame for the financial crisis on real estate trading. Less than twenty-five percent of bank lending in 1965 was to real estate; that number rose to fifty-five percent in 2005.¹⁸⁹ Reduced diversification of bank investments makes the health of the banking system dependent on whatever market comprises the majority of banking investments, in this case, real estate.¹⁹⁰ Hence, when the real estate market crashed, the banks followed.

Supporters of the rule, such as MIT economist Simon Johnson, believe that the Volcker Rule was too watered down in the legislative process to have much of an effect on banking practices or to adequately restrict proprietary trading, regardless of what rules are implemented.¹⁹¹ But officials at the top banks say that they are already feeling the effects of the restrictions.¹⁹² In anticipation of the

¹⁸⁶ *Id.*

¹⁸⁷ Silla Brush, *Volcker Rule Will Cost Banks \$1 Billion, U.S. Government Says*, BLOOMBERG (Oct. 27, 2011, 9:01 PM), <http://www.bloomberg.com/news/2011-10-28/volcker-rule-to-cost-banks-1b-u-s-government.html>.

¹⁸⁸ Wes Goodman, *Volcker Rule Is “Credit Negative” for U.S. Banks, Moody’s Says*, BLOOMBERG (Oct. 10, 2011, 10:21 PM), <http://www.bloomberg.com/news/2011-10-10/volcker-rule-is-credit-negative-for-u-s-banks-moody-s-says.html>; *see also* Brush, *supra* note 187.

¹⁸⁹ Peter J. Wallison, *Volcker Rule Is Stuck in a Bygone Era*, AM. BANKER (Nov. 9, 2011, 6:54 PM), <http://www.americanbanker.com/bankthink/volcker-rule-is-stuck-in-a-bygone-era-1043967-1.html>. The financial services industry’s daily trade newspaper, however, is likely to look to place the blame for the financial crisis outside the financial industry.

¹⁹⁰ *Id.*

¹⁹¹ John Maggs, *Big Banks Brace for Curbs*, POLITICO (Jan. 12, 2011 8:48 AM), <http://www.politico.com/news/stories/0111/47447.html>.

¹⁹² *Id.*

rules and effective dates, some banks attempted to come into compliance with some of the broader declarations of the Act almost immediately after President Obama signed it. Goldman Sachs, Morgan Stanley, and Bank of America, among others, announced plans to wind down their proprietary trading desks before regulators released proposed rules or even studies.¹⁹³ At the end of the third quarter of 2011, the value of Bank of America's private equity investments was \$1.8 billion, compared to \$4.8 billion only one year earlier.¹⁹⁴ Banks are concerned that what value now remains in their private equity investments will be more difficult to sell at a good price.¹⁹⁵ A top official with the American Banker's Association is concerned that divestiture of certain assets at the same time across the market may cause liquidity problems in those markets.¹⁹⁶

Some traders in the bank's proprietary trading branches are leaving on their own, citing diminished earning opportunities¹⁹⁷ because they would no longer be able to make commissions on certain trades under the Volcker Rule.¹⁹⁸ Some traders will transfer to other bank branches, but others are leaving to work for nonbank affiliated hedge funds and trading houses.¹⁹⁹ In the six months following the Act's approval, before the agencies released any studies or proposed rules, Goldman Sachs lost eleven traders in their proprietary trading branch operations to nonbank affiliated hedge or private equity funds.²⁰⁰

The banks' moves to shutter their proprietary trading offices and traders' jumps to private firms may be premature. The chief financial officer of Goldman Sachs said that market inefficiencies created by the Volcker Rule might make trading more profitable, which was not

¹⁹³ Justin Baer, *Goldman Winds Down Proprietary Trading Arm*, FIN. TIMES, Feb. 16, 2011, <http://www.ft.com/cms/s/0/bd4d2d2a-3964-11e0-97ca-00144feabdc0.html#axzz1EKk71jio>.

¹⁹⁴ Dave Clark & Joe Rauch, *Banks Seek to Avoid Volcker Rule "Fire Sale"*, REUTERS, Dec. 7, 2011, <http://www.reuters.com/article/2011/12/07/us-financial-regulation-volcker-idUSTRE7B60QZ20111207>.

¹⁹⁵ *Id.* (noting that banks might "have already sold off the low-hanging fruit").

¹⁹⁶ *Id.* (citing Wayne Abernathy).

¹⁹⁷ Maggs, *supra* note 191.

¹⁹⁸ *Volcker Rule: CNBC Explains*, CNBC.COM (Apr. 19, 2012, 3:44 PM), http://www.cnbc.com/id/44891917/Volcker_Rule_CNBC_Explains.

¹⁹⁹ See Cyrus Sanati, *JPMorgan Shifting Its Proprietary Trading Desk*, N.Y. TIMES DEALBOOK (Sept. 27, 2010, 7:06 PM), <http://dealbook.nytimes.com/2010/09/27/jpmorgan-is-shifting-its-prop-trading-desk>.

²⁰⁰ Maggs, *supra* note 191.

the drafter's intent.²⁰¹ But more importantly, the Act lays out a timeline for the regulatory agencies to conduct more than twenty studies²⁰² and to draft and implement the rules, so the final form of the rule is not yet set. The rules are scheduled to be finalized before the July 2012 effective date of the Act,²⁰³ but Congress might extend that deadline. Senator Richard Shelby (R-Ala.) expressed concern that the "unrealistic" deadlines set forth in the Act is forcing agencies "to focus on speed rather than deliberation" and that the Senate is considering extending the timeline for the agencies' rulemaking.²⁰⁴ Before the final rules are released, the agencies will produce studies and proposed rules, which will be followed by a public comment period. The public comment period provides the best opportunity for lobbyists, including Wall Street, to again influence the content and extent of the Volcker Rule.

2. *The Agencies Struggle to Craft Clear Directives*

In January 2011, the Financial Stability Oversight Council (FSOC) released the *Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds* as directed by section 619 of the Act.²⁰⁵ The study was intended to help the agencies draft rules that will protect taxpayers and consumers, promote the safety of the banking system, and reduce conflicts of interest.²⁰⁶ The agencies considered the study while drafting the proposed rules,²⁰⁷ which were released in October 2011. The Act requires that the rules become effective one year after the issuance of the final rules, or two years after enactment of section 619 of the Act, and provides a grace period of up to several years for institutions to come into compliance.²⁰⁸

²⁰¹ *Too Big Not to Fail*, *supra* note 184, at 24.

²⁰² Cho et al., *supra* note 144.

²⁰³ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

²⁰⁴ Stacey Kaper, *Senators Raise Fears on Industry Stability, Dodd-Frank Burden*, BANK INV. CONSULTANT (Feb. 18, 2011), <http://www.bankinvestmentconsultant.com/news/dodd-frank-senate-banking-committee-2671591-1.html>.

²⁰⁵ FSOC STUDY, *supra* note 63.

²⁰⁶ Dodd-Frank Act, § 619, 124 Stat. 1376, 1621 (codified at 12 U.S.C. § 1851(b)(1) (Supp. 2011)).

²⁰⁷ Ronald D. Orol, *Bank Chiefs May Be Forced to Sign Off on Trades*, MARKETWATCH (Jan. 18, 2011), http://articles.marketwatch.com/2011-01-18/industries/30691956_1_proprietary-trading-banks-volcker-rule.

²⁰⁸ Dodd-Frank Act, § 619, 124 Stat. at 1622–23 (codified at 12 U.S.C. §§ 1851(c)(1)–(3)).

To assist with the study, the FSOC solicited comments from the public. The Council received nearly eight thousand comments during a one-month period.²⁰⁹ Most comments urged strong implementation of the Volcker Rule.²¹⁰ The FSOC summarized the letters as largely urging the agencies to implement the Volcker Rule so as to (1) unambiguously prohibit banks from engaging in proprietary trading and investing in hedge funds, (2) define terms so as to eliminate potential loopholes, and (3) to provide clearer guidance to banking entities as to permitted and prohibited conduct.²¹¹

The study makes broad declarations and, rather than making concrete suggestions, lays out a series of possible paths that agencies may take while promulgating rules. Those declarations demonstrated that the FSOC appreciates the general principles underlying the Volcker Rule. The study encouraged agencies to strive to close potential loopholes through rulemaking and to effect the strongest regulations possible to prevent proprietary trading and to reduce conflicts of interest, while respecting the permitted market making and hedging activities that will ultimately strengthen our financial system.

The study lays out five broad principles to which agencies should adhere when drafting the Volcker rules. Those principles are: (1) agencies should use all necessary tools to prohibit improper proprietary trading, (2) rules should be flexible to respond to evolving financial products, trading practices, and hedging strategies, (3) rules should “enable comparisons among banking entities” to ensure the regulations do not result in “uneven competitive dynamics,” (4) rules should be clear enough that banking entities may easily discern between permitted and prohibited activities, and (5) rules should take into account differences between asset classes, such as different strategies for hedging risk and the volume of the transactions.²¹²

The restrictions on bank affiliation with hedge funds are guided by the same purposes underlying the restrictions on proprietary trading: (1) separate federal support for crucial financial institutions from speculative investing, (2) reduce risk to board-supervised financial entities, and (3) reduce potential conflicts of interest between

²⁰⁹ FSOC STUDY, *supra* note 63, at 10.

²¹⁰ *Id.* (noting that roughly 6550 of the comments were largely form letters arguing for strong implementation).

²¹¹ *Id.*

²¹² *Id.* at 25–27.

customers and their banking institutions.²¹³ These considerations are ultimately intended to prevent the need for TARP-like legislation in the future, protecting the government from intervening when speculative investments threaten the integrity of banking entities that are crucial providers of credit in our economy.²¹⁴

Beyond reiterating the Volcker Rule's underlying principles, the FSOC's study provided few concrete examples of how the agencies might draft the rules in order to most effectively promote those principles. The Government Accountability Office (GAO) also released a study that revealed the agency's struggle with the scope of the Act. The GAO based its analysis on data gathered between 2006 and 2010 from standalone proprietary trading desks at the six largest U.S. bank holding companies.²¹⁵ The study, which was of a more limited scope than mandated by the Act, addressed (1) the information available on the risk and conflict of interest with proprietary trading as well as the Act's possible effects on proprietary trading, and (2) how regulators have overseen proprietary trading in the past and the challenges they face in implementing the Volcker Rule restrictions.²¹⁶ The GAO had difficulty collecting the information necessary to finish its study, leading the agency to conclude that agencies should collect and review even more information on proprietary trading before drafting the proposed rules.²¹⁷

The study did, however, largely endorse the recommendations that the FSOC outlined in its study, particularly that the primary challenge facing the agencies will be how to distinguish between prohibited proprietary trading and permitted market making activities as well as how to define relevant terms.²¹⁸ The GAO also agreed with the FSOC that regulating agencies should use certain quantitative metrics, such as revenue and customer flow, to monitor more complicated prohibited transactions, such as customer transactions combined with

²¹³ *Id.* at 56.

²¹⁴ *Id.*

²¹⁵ See Bradley K. Sabel, *General Accountability Office Struggles with Dodd-Frank's Volcker Rule*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Aug. 26, 2011, 10:11 AM), <http://blogs.law.harvard.edu/corpgov/2011/08/26/general-accountability-office-struggles-with-dodd-franks-volcker-rule>.

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

proprietary positioning.²¹⁹ Going a step beyond the FSOC study, the GAO recommended that the FSOC direct the Office of Financial Research to compile more information on trading practices before the agencies issue the final rules.²²⁰

The GAO advocated for strong oversight because it concluded that the risks of stand-alone proprietary trading outweigh any benefits,²²¹ despite acknowledging weaknesses in the data it analyzed.²²² Senators Merkley and Levin stated that they were disappointed with the GAO study because, by studying only the six largest bank holding company trading practices, the agency failed to capture the scope that Congress intended the rule to have.²²³ The GAO also aggregated the results of its study, concluding that the activity resulted in losses, while in fact, four of the six firms studied ultimately profited from proprietary trading.²²⁴

The FDIC, the SEC, and the Federal Reserve released the first draft of the proposed Volcker rules in October 2011;²²⁵ the first draft was no more illuminating than the FSOC and GAO studies. The proposed rules posed more questions than they answered. Even though the principles behind the Volcker Rule are complicated, the length and complexity of the Volcker Rule seems to expand almost exponentially as it passes through each level of government.²²⁶ Chairman Volcker outlined his proposal to the President in three pages; section 619 of

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *See id.* For example, stand-alone desks saw small revenue during good years and large losses during the recession (\$15.6 billion in revenue over thirteen quarters of gain but losses over five quarters of \$15.8 billion for a total of \$221 million in lost revenue over the period), and while generating the same amount of revenue as other trading practices, proprietary trading involves much higher risk. *Id.*

²²² Those weaknesses include a small data set, the inability of some companies to report revenue data for some trades, and the exemption from the Volcker Rule of some of the trading activity analyzed. *See id.*

²²³ *See id.*

²²⁴ *See id.*

²²⁵ Bruce Watson, *Volcker Rule Made Simple: Banks Can't Gamble With Our Money (Probably)*, DAILYFINANCE (Oct. 12, 2011, 3:45 PM), <http://www.dailyfinance.com/2011/10/12/volcker-rule-made-simple-banks-cant-gamble-with-our-money>.

²²⁶ *See* Ben Protess, *Volcker Rule Divides Regulators*, N.Y. TIMES DEALBOOK (Oct. 16, 2011, 9:48 PM), <http://dealbook.nytimes.com/2011/10/16/volcker-rule-divides-regulators> (“While the Volcker Rule itself ‘would be a worthy study for Talmudic Scholars, complicate this with five agencies having to write the rules and you have geometric expansion of complexity.’” (quoting *FDIC Board to Consider Volcker Rule Proposal on October 11*, PRICEWATERHOUSECOOPERS, <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/fdic-volcker-proposal.jhtml> (last visited May 12, 2012))).

the Act, which codifies the Volcker Rule, is ten pages; the proposed regulations consumes 298 pages. The rule is so complex that a “rule map” produced by law firm Davis Polk to help clients understand the Volcker Rule has 355 distinct steps.²²⁷

The Wall Street Journal described the proposed rules as “regulators essentially wonder[ing] out loud how they can possibly write this rule.”²²⁸ The proposed rules include 383 questions, many with multiple parts,²²⁹ for a total of more than 1300 queries on four hundred topics.²³⁰ A banker who publicly supports the bill described the proposed rules as “unintelligible any way you read [them].”²³¹ It seems that issues that caused conflict between the agencies were turned into queries rather than firm rules. For example, one of the more contentious issues among the agencies is how actually to enforce the Volcker Rule.²³² The FDIC proposed that chief executives be required to attest to compliance with the rule.²³³ The OCC objected to the rule and announced that CEO attestation would be a “deal-breaker.”²³⁴ Despite regular interagency working group meetings, the only compromise the agencies could come to on the issue by the publication deadline was to turn it into a query.²³⁵

Given the broad powers delegated to the regulatory agencies by Congress, the substantive effect of the Act cannot be known until after the agencies promulgate rules and perhaps not even then. The following Part suggests ideas for the agencies to consider when drafting the rules.

V

SUGGESTIONS TO CLOSE THE LOOPHOLES OF THE VOLCKER RULE

Despite extensive delineations between permitted and prohibited activities in the Act, several areas remain that must be filled in by agency rules. Most areas involve defining key terms and the scope of the permitted and limited activities. Listed below are suggestions on

²²⁷ *Too Big Not to Fail*, *supra* note 184, at 22.

²²⁸ Opinion, *So Much for the Volcker Rule*, WALL ST. J., Oct. 25, 2011, at A14.

²²⁹ *Id.*

²³⁰ James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, N.Y. TIMES, Oct. 22, 2011, at B1.

²³¹ *Too Big Not to Fail*, *supra* note 184, at 22.

²³² Protess, *supra* note 226.

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.*

six issues agencies face as they write the rules within the parameters of the FSOC study.

A. Bank and Fund Reporting of Risk Exposure

In addition to the explicit limitations on permitted proprietary trading and hedge fund investing, such as capital requirements, the amendment places additional general limitations on certain investments. The Act prohibits even permitted trades and investments if the trades expose the banking entity to high risk.²³⁶ The Act directs agencies to define “high-risk assets or high-risk trading activities” by rule.²³⁷ Rather than laying out specific high-risk assets or trading activities, a nearly impossible task in the expansive and rapidly changing financial market, the agencies should require banks to disclose their level of risk, both overall and in individual investments.

Reporting of risk exposure is important for two reasons. First, acknowledging risk exposure can encourage the banking entity itself to increase risk-mitigating hedging activities or alter investment strategies to achieve more stable investments. Second, appreciation of risk exposure and trends in individual financial institutions, and the financial system generally, will put oversight agencies in a better position to intervene more quickly and effectively in the face of impending institutional collapse than was possible in 2008.

The idea of requiring hedge funds and banks to report their level of risk to the oversight committees is good in theory. Unfortunately, it encounters logistical problems. Banks and hedge funds themselves do not always know the level of risk to which their investments have exposed them. This is apparent when one looks at what happened to Long-Term Capital Management. Long-Term Capital Management (LTCM), founded in 1994, was one of the most successful hedge funds (until it was not). The fund managers believed, based on complex computer equations, that the long- and short-term net risk of their investments was small.²³⁸ They were wrong. In 1998, LTCM’s investments soured and in order to prevent potential systemic meltdown, the Federal Reserve Bank of New York organized a rescue package in which a consortium of fourteen private investment and

²³⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, 12 U.S.C. § 1851(d)(2)(A) (Supp. 2011).

²³⁷ *Id.*

²³⁸ Joe Nocera, *Risk Management*, N.Y. TIMES MAG., Jan. 2, 2009, <http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?pagewanted=all>.

commercial banks injected \$3.6 billion into the fund.²³⁹ In 1997, the year before the fund collapsed, two of LTCM's board members shared the Nobel Prize in Economics for developing "a new method to determine the value of derivatives."²⁴⁰ Oftentimes hedge fund managers and the world's most brilliant economic minds are unable to appreciate the true risk of their investments.

As recommended by the FSOC and the GAO, instead of requiring banks and hedge funds to report their risk exposure themselves, the regulatory agencies should require the banks and funds to disclose certain aspects of their investments and business ledgers, as qualitative metrics, particularly the leverage of their investments, so that the regulatory agencies may calculate the systemic risk from the information themselves. This will limit the ability of the banks and funds to manipulate their numbers to report lower investment risk than they actually are exposed to and provide uniform and neutral guidelines for calculating risk based on raw data. But even if banks accurately report their numbers and the agencies can calculate perceived risk from those reports, it is likely that risk, as demonstrated by the LTCM example, will still be significantly underappreciated, threatening the stability of the financial system. In light of the complexity and uncertainty of risk exposure calculations, agencies must do more than oversee risk exposure in order to promote a stable financial system.

Finally, as markets change quickly, banks should be required to report their risk exposure often. Periodic risk assessment will give regulators a better opportunity to identify trouble sooner, making it easier to avert a potential financial disaster than if they receive risk assessments only rarely.

B. Defining "Hedge Fund" and "Venture Capital Fund"

Defining "hedge fund" is challenging. Much of hedge funds' appeal, and much of their utility, lies in the fact that hedge funds are designed to avoid many of the regulations under the Investment Advisor's Act, the Investment Company Act, the Securities Act, and the Securities Exchange Act.²⁴¹ The amendment acknowledges this

²³⁹ Bernstein & Coutts, *supra* note 25.

²⁴⁰ *The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 1997*, NOBELPRIZE.ORG, http://nobelprize.org/nobel_prizes/economics/laureates/1997/index.html (last visited May 12, 2012).

²⁴¹ See Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 275-78 (2007).

aspect of hedge funds by defining them as “issuers that rely on the exclusion from the definition of investment company under . . . the Investment Company Act.”²⁴² Under the exclusion from the Investment Act, hedge funds are defined as those funds that have outstanding, not publicly offered securities for fewer than one hundred investors, or are owned entirely by “qualified purchasers.”²⁴³ But the Dodd-Frank Act allows agencies to bring other “similar funds” under the definition at their discretion.²⁴⁴

Many hedge funds rely on these exceptions but so do many other funds and legal entities.²⁴⁵ Many who made recommendations during the public comment period following release of the FSOC study urged regulatory agencies to exclude venture capital funds from the definition of hedge and private equity funds because venture capital funds encourage innovation and their nature is fundamentally different than hedge and private equity funds.²⁴⁶ Venture capital funds are a subset of private equity funds that use their pooled capital to launch or expand small businesses.

Under a directive from the Dodd-Frank Act, the SEC has proposed rules to distinguish venture capital funds from other forms of funds that are excluded from the Investment Company Act.²⁴⁷ The agencies should apply the SEC definitions to exclude venture capital funds from coverage under the Volcker Rule as well.

Additionally, there are many hedge and private equity funds that do not rely on those exclusions, such as commodity pools.²⁴⁸ Agencies should use their authority granted by Congress to include “such similar funds” that do not rely on the Investment Company Act but that nonetheless pursue a hedge fund strategy under the definition of hedge fund. Congress should look to the defining characteristics of hedge funds in order to bring those funds into the scope of “similar funds.”²⁴⁹

These characteristics should look beyond the time period of return. Earlier this decade, the SEC unsuccessfully tried to increase

²⁴² FSOC STUDY, *supra* note 63, at 61; *see also* 12 U.S.C. § 1851(h)(2) (Supp. 2011).

²⁴³ 15 U.S.C. §§ 80a-3(c)(1), (7) (2006).

²⁴⁴ FSOC STUDY, *supra* note 63, at 61.

²⁴⁵ *Id.* at 61–62.

²⁴⁶ *Id.* at 62.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

regulation over hedge funds by focusing on whether the fund provided a redemption option to clients within the first two years, which provides liquidity for the fund's *investors*.²⁵⁰ While most hedge funds do focus on relatively short-term investments, the time period of return is not a defining characteristic and can easily be rearranged to avoid time-period-reliant definitions.²⁵¹

Instead, the agencies should focus on the defining characteristics of hedge and private equity funds—liquidity and leverage—when expanding the definition of those funds. Liquidity of the *fund's* investments is one attribute of hedge and private equity funds that distinguishes them from other types of funds.²⁵²

Leverage is another defining characteristic of hedge funds, because most hedge funds use material leverage to increase the returns of their investments.²⁵³ For example, LTCM, discussed above, had invested five billion dollars of client money, but “had borrowed [an additional] \$125 billion—a leverage factor of roughly thirty to one.”²⁵⁴ While leverage can increase returns on successful investments, making it appealing to investors, leverage also magnifies loss when investments are not successful.²⁵⁵

By basing the definition of hedge funds on the liquidity and leverage of funds, the agencies would be focusing on the attributes that make those funds so risky in the first place, reinforcing the primary purpose behind the Volcker Rule²⁵⁶—to minimize risk in our financial system by reducing short-term, highly leveraged trading practices in banks.

²⁵⁰ See Letter from Professor Robert C. Illig, Assoc. Professor, Univ. of Or., to Chairman Timothy Geithner, Sec’y of the Treasury, U.S. Dep’t of the Treasury (Nov. 5, 2010) [hereinafter Illig Letter] (on file with author); see also 17 C.F.R. §§ 275, 279 (2007) (redefining “client” for funds that permit redemptions for clients within the first two years of operation). The rule was struck down on other grounds in 2006. *Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006).

²⁵¹ See Illig Letter, *supra* note 250.

²⁵² See *id.*

²⁵³ See FSOC STUDY, *supra* note 63, at 63.

²⁵⁴ SUNGARD, CASE STUDY: LTCM—LONG-TERM CAPITAL MANAGEMENT 2 (2010), <http://www.econ-pol.unisi.it/tonveronachi/2010-11/LTCM.pdf>.

²⁵⁵ Jonathan Burton, *Leveraging Your Bets*, WALL ST. J., June 7, 2010, <http://online.wsj.com/article/SB10001424052748704269204575270324191270584.html>.

²⁵⁶ Illig Letter, *supra* note 250.

C. Defining “Customer” to Determine the Scope of Permitted Activities

The amendment permits bank trading with hedge funds “only in connection with the provision of . . . services . . . to . . . customers.”²⁵⁷ Agencies will need to define “customers” to ensure that this language is not used as a way around the prohibition on proprietary trading. There already are definitions of “customer” in both banking and securities laws, although the definitions differ.²⁵⁸

Bank regulations define a “customer relationship” as a “continuing relationship” between the banking entity and the consumer in which the bank provides financial products to the customer that are to be used for “personal, family, or household purposes,” such as maintaining a deposit account with or receiving loans from the banking entity.²⁵⁹ Securities regulations, offer a more nuanced definition requiring a “substantive and pre-existing relationship.”²⁶⁰ This means that the customer had a relationship with the bank before the terms of the sale were developed and offered to the customer, and the relationship involved knowledge by the bank of the customer’s sophistication and financial objectives.²⁶¹ Securities law draws a sharp distinction between a “client” and a mere “customer” of the bank.²⁶²

Because hedge fund pools often consist of contributions from wealthy and sophisticated investors, the definition of “customer” for Volcker Rule purposes should more closely mirror the definition used in security law. The definition should require that the banks had a continuing relationship with the customer prior to the hedge fund investment, and that the existing relationship was substantial enough that the banking entity could develop knowledge of the customer’s financial situation, goals, and risk tolerance. The definition should not depend on whether the relationship existed between the banking entity and the customer directly, or between the banking entity and the customer’s financial advisor, so long as the relationship allowed the bank to develop particularized knowledge of the customer’s financial situation and goals. Finally, the customer relationship with

²⁵⁷ 12 U.S.C. § 1851(d)(1)(G)(ii) (Supp. 2011).

²⁵⁸ FSOC STUDY, *supra* note 63, at 63–64.

²⁵⁹ 12 C.F.R. §§ 216.3(i)(1), (2)(i)(A)–(B) (2009).

²⁶⁰ FSOC STUDY, *supra* note 63, at 64.

²⁶¹ *Id.*

²⁶² *Id.* at 64.

the hedge fund should be initiated by the customer or his agent rather than solicited by the banking entity.

By structuring the definition of “customer” in this way, it will be easier for agencies to distinguish between trades initiated on the customer’s behalf rather than as a subterfuge for banks themselves to engage in prohibited proprietary trading. Furthermore, such a definition will help reduce conflicts of interest between the banking entity and its customer’s investments because the customer, not the bank, will need to initiate the hedge fund relationship and investing.

D. Defining the Relationship Between Permitted “De Minimis Investments” and the Permitted Three-Percent Investment of Tier 1 Capital

The amendment permits banking entities to “make and retain” de minimis investments in hedge funds that are organized and offered by the banking entity itself.²⁶³ A de minimis investment is one that is so trifling²⁶⁴ that it will be “immaterial” to the banking entity, and therefore unable to pose a threat to the stability of the institution. In addition to permitting only de minimis investments, the amendment caps the amount banking entities may invest in their own hedge funds at three percent of Tier 1 capital.²⁶⁵ An additional limitation on the de minimis investment is that the investment cannot account for more than three percent of each fund after a one-year start-up period during which the bank’s investment may account for up to one-hundred percent of the fund’s capital.²⁶⁶ The de minimis limit reduces the incentive for the bank to bail out the fund if it fails.²⁶⁷

The agencies should treat the de minimis requirement and the “three percent of Tier 1 capital” requirement as two independent but interrelated limits on investing. This would mean that banks for which an investment of three percent of Tier 1 capital could affect the security of the institution, making it more than a de minimis investment, would be prohibited from providing the three-percent

²⁶³ 12 U.S.C. § 1851(d)(4)(A)(ii) (Supp. 2011).

²⁶⁴ Black’s Law Dictionary defines “de minimis” as “1. trifling, minimal. 2. (of a fact or thing) so insignificant that a court may overlook it in deciding an issue or case.” BLACK’S LAW DICTIONARY 464 (8th ed. 2004).

²⁶⁵ 12 U.S.C. § 1851(d)(4)(B)(ii)(II).

²⁶⁶ *Id.* § (d)(4)(B)(ii)(I).

²⁶⁷ FSOC STUDY, *supra* note 63, at 66.

maximum allowed to the investment. Conversely, banks for which a ten-percent investment of capital would have no significant effect on the stability of the institution, making a ten-percent investment of Tier 1 capital a de minimis investment, would still be capped at a three-percent investment of Tier 1 capital. Essentially banks could invest up to three percent of Tier 1 capital in hedge funds, unless doing so would constitute more than a de minimis investment for that institution.

The agencies should also define the three-percent limits as expansively as possible to include as much of the fund's capital that is tied to the banking entity as possible. For example, if bank employees invest in the fund, as permitted by the amendment with significant restrictions,²⁶⁸ those investments should count towards the three-percent cap on the bank's investment in the fund.

The rule requires that after the fund has been open to investors for one year, the banking entity's investment in the fund cannot exceed more than three percent of the fund's capital.²⁶⁹ Agencies should require an independent audit of the fund on the anniversary of its inception to ensure that the banking entity has met this requirement. But a one-time audit is insufficient to ensure that banks continue to comply with this mandate. Instead, agencies should require periodic audits to ensure continued compliance with the three-percent limit.

E. Further Refining the Statutory Definition of "Banking Entity"

Another key definition in the Volcker Rule is that of "banking entity." The statute defines "banking entity" as including any "affiliate or subsidiary" of an insured depository institution.²⁷⁰ Including affiliates and subsidiaries under the definition of "banking entity" is important because without that inclusion, banking entities could simply rearrange their trading, placing the prohibited activities, like proprietary trading, into their affiliated companies. However, the existing statutory definitions of "affiliate" and "subsidiary" could bring bank-offered hedge and private equity funds under the definition of "banking entity." Including hedge funds under the

²⁶⁸ Employees and directors of the banks are prohibited from investing in the bank's hedge funds unless they provide their services directly to the fund, 12 U.S.C. § 1851(d)(1)(G)(vii), and non-ERISA qualified employee compensation plans, FSOC STUDY, *supra* note 63, at 67.

²⁶⁹ 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

²⁷⁰ *Id.* § (h)(1).

definition of “banking entity” as an affiliate or subsidiary would create a catch-22 because banking entities and their affiliates are prohibited from engaging in proprietary trading or investing in hedge funds, but those activities are also explicitly permitted for hedge funds.

Without correction, this definition could have several unintended consequences. Companies (even nonfinancial companies) that are controlled by a bank-controlled hedge or private equity fund, and SEC-registered investment companies controlled by a banking entity would be subject to the Volcker Rule.²⁷¹ The definition would also prohibit hedge funds that are controlled by a banking entity from investing in other funds and require each fund in a family of funds controlled by a banking entity to have a distinct name.²⁷² Agencies must clarify that hedge funds and private equity funds are not considered affiliates or subsidiaries of banking entities so far as the applicability of hedge fund and proprietary trading guidelines are concerned in order to avoid results that Congress clearly did not intend.

F. Transparency and Director Accountability

The Act requires that the chief executive officer of a banking entity must certify annually in writing that the bank complies with the requirement that they disclose to all hedge fund investors in writing that the banking entity does not insure the performance of investment funds.²⁷³ But the Act gives agencies broad discretion to impose additional limitations on bank involvement in hedge funds to ensure that fund losses are borne solely by the investors of the fund.²⁷⁴ Directors of banking entities must be held accountable for ensuring that their banking entities have procedures in place to assure that they are compliant with the Volcker Rule and applicable regulations.

The board of directors should actively monitor the risk exposure of their banking entity’s investments and have strategies in place for how to respond when a fund or investment exceeds the appropriate risk level. The agencies should use their discretion to require that bank boards of directors submit response plans for how to divest funds when they exceed the de minimis or Tier 1 capital limitations.

²⁷¹ FSOC STUDY, *supra* note 63, at 68.

²⁷² *Id.* at 68–69.

²⁷³ 12 U.S.C. § 1851(f)(3)(A)(ii).

²⁷⁴ *See id.* § (d)(1)(G)(viii).

One way of encouraging active participation and oversight of banking entities by their Boards of Directors is to require the banking entities to publicly publish information about the banking entity's investments and risk exposure.²⁷⁵ Requiring public disclosure of aspects of the banking entity, such as the type and amount of investments, returns, and leveraging, essentially mandates that the board of directors must be actively involved in oversight. Directors would no longer be able to protect themselves by claiming ignorance of the expansive investments of the entity that they oversee, and entities that deal with dangerously-invested or -leveraged companies will better be able to protect themselves.²⁷⁶ Disclosure will also allow regulatory agencies to see better the interconnectedness and weak points of the system, making them better able to intervene to prevent a domino collapse rather than only being able to react in the face of one.

Furthermore, by publishing this information publicly, consumers will be able to protect themselves and make informed decisions about which companies they should bank with and where they should invest their money. Honest public disclosure of these facts will also encourage responsible investment strategies by opening investment strategies to public scrutiny. Banks fear that they will lose a competitive edge by either disclosing investment strategies or causing reputational harm.²⁷⁷ The agencies should take care to ensure that the information they require to be disclosed publicly will be general enough not to affect proprietary secrets, but specific enough to allow the public and regulatory agencies to appreciate the risk or safety of the banks' investment strategies. Agencies should be less concerned about releasing information that could cause reputational harm to the

²⁷⁵ FSOC STUDY, *supra* note 63, at 70.

²⁷⁶ See KOTLIKOFF, *supra* note 34, at 27–29. The AIG and the Lehman Brothers collapses provide examples of how lack of knowledge about, or indifference to, the risk exposure of financial institutions can have a domino effect on the system when one company's investments collapse. AIG had sold credit default swaps to Goldman Sachs and others. When Lehman went under, AIG had to pay out on their default swaps, which AIG was unable to adequately cover. Treasury Secretary Paulson was blindsided by the revelation of AIG's exposure. Two days before Lehman collapsed, when asked if he had been watching AIG, Paulson replied: "Why, what's wrong with AIG?" Paulson had mistakenly believed that the New York State Insurance Commission was monitoring AIG's risk exposure and liquidity. *Id.*

²⁷⁷ Kathleen Vermazen Radez, *Financial Crisis May Subject Financial Institutions to FOIA*, COLUM. BUS. L. REV. ONLINE (Aug. 6, 2010, 9:57 PM), <http://cblr.columbia.edu/archives/11309>.

entities because the threat of reputational harm to banks is likely to encourage them to invest safely and responsibly.²⁷⁸ Opening up the risk and investment strategies to public scrutiny will shift competition away from the riskiest investments with the chance to reap the highest returns toward secure investments that are properly hedged. The information disclosed, either publicly or only to the oversight agencies, must also be comprehensive enough that the agencies will be able to determine if the banks are creatively skirting the Volcker Rule's prohibitions on proprietary trading.

Due to the likely length and complexity of the disclosures, it is unlikely that most investors will properly be able to analyze the disclosed information and to form informed opinions about their investment strategies.²⁷⁹ The primary value served by public disclosure is the perceived threat of reputational harm by disclosing unsafe investment practices, as well as the fact that public disclosure will require boards of directors to be more involved in the oversight of the company's investments.

CONCLUSION

President Obama has been echoing themes extolled by one of his predecessors nearly eighty years ago. In his first inaugural address, President Franklin D. Roosevelt stated that "we require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people's money."²⁸⁰ The Dodd-Frank Act was an attempt to re-strengthen those safeguards in a way that seems to have been forgotten in the intervening decades. However, that Act, while declaring a policy of more oversight to encourage prudent banking practices, appears to have delegated too many details to the regulatory agencies to be able to fully realize the edicts promoted in the Act.

²⁷⁸ See W. Timothy Coombs, *Protecting Organization Reputations During a Crisis: The Development and Application of Situational Crisis Communication Theory*, 10 CORP. REPUTATION REV. 163 (2007) (arguing that crises pose a threat to an organization's reputation and that when an organization is seen as being responsible for a crisis, the response strategy should accept responsibility, which requires accountability).

²⁷⁹ Kathleen L. Casey, Comm'r, SEC, Speech at Directors' Forum 2011: The Regulatory Implementation and Implications of Dodd-Frank (Jan. 23, 2011), <http://www.sec.gov/news/speech/2011/spch012311klc.htm>.

²⁸⁰ Franklin D. Roosevelt, President of the United States, Inaugural Address (Mar. 4, 1933).

Congress should have foreseen that providing a general directive to regulatory agencies to define proprietary trading and classify trades would be too great of a task for the agencies. In 2005, regulators attempted to define proprietary trading in order to better oversee the activity, but were ultimately unable to craft an adequate definition, concluding that preventing proprietary trading would require a “subjective, case-by-case evaluation.”²⁸¹ Some senators recognized the risks of such extensive delegation; Senator Richard Shelby (R-Ala.), the only Republican to support an earlier, stricter incarnation of the Volcker Rule, stated through a spokesperson that the proposed regulations are “filled with central questions that Congress should have answered before even drafting Dodd-Frank.”²⁸²

Despite the Volcker Rule’s extensive delineations between permitted and prohibited activities, there remain several areas that must be filled in by agency rules. Most involve defining the scope of the permitted and limited activities. The devil, of course, is in the details, which Congress left to the agencies. From the fight and compromises in Congress as well as the studies and proposed rules the agencies released, it is clear that filling in the details is a gargantuan task. The more central the agency rules are to the final form of a law, the greater the opportunity for agency capture. But could the Dodd-Frank Act go further and exceed the capabilities of our regulatory system? Watching the agencies struggle not only to meet the rulemaking deadlines but also to formulate any concrete rules or definitions at all, it is difficult not to wonder whether Congress’s delegation to the agencies simply asked too much of them, leaving our financial system unregulated and at risk of another, possibly more severe recession.

²⁸¹ Sabel, *supra* note 215.

²⁸² Stewart, *supra* note 230.

