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ARTICLE

A RETURN TO OLD-TIME RELIGION? THE GLASS-STEAGALL ACT, THE VOLCKER RULE, LIMITS ON PROPRIETARY TRADING, AND SUSTAINABILITY

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INTRODUCTION

A leading book about the Enron debacle is entitled "The Smartest Guys in the Room."[1] I am certainly not that. I may be, however, the oldest guy in the room, at least the room in which this symposium is being held. It is from that perspective that I wish to pursue the subject of my article.

I have long taken an interest in policy and in public law legislation affecting the structure and regulation of the financial markets. I have written on the subject, including one of the leading law review articles of a bygone era.[2] The contention is that only by taking the long view can we understand the sources of systemic risk that can rise up to strike down various aspects of or, indeed, our entire financial services sector.

The new watchwords have become, rather than risk taking and profit maximization, or maximization of shareholder return, "sustainable" or "sustainability." Simply put, sustainability means that our goal has become that particular enterprises or institutions will be in existence to serve well our grandchildren's children, and generations to come.[3] With that lodestar, as well as the historical background, in mind, we can evaluate various reforms

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1. *See generally* BETHANY MCCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2004).

2. *See, e.g.*, Douglas M. Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy, and the Individual Investor*, 75 NW. U. L. REV. 857 (1980).

3. "Sustainability is defined as the persistence over an apparently indefinite future of certain necessary and desired characteristics of the socio-political system and its natural environment." Kent Portney, *Environmental Justice and Sustainability: Is There a Critical Nexus in the Case of Waste Disposal or Treatment Facility Siting?*, 21 FORDHAM URB. L.J. 827, 832 (1994), *citing* John Robinson et al., *Defining a Sustainable Society: Values, Principles and Definitions*, 17 ALTERNATIVES 36, 39 (1990).

proposed, including the arguments for and against them, including most particularly the Volcker Rule that, with exceptions, prohibits proprietary trading by large financial institutions.[4]

Part I of this article sets out the ancient, ancient history, namely, the adoption in 1933 of the Glass-Steagall Act, which separated investment and commercial banking. Part II continues with the merely ancient history, which includes the entry of securities entities into the business of taking deposits, through the advent of money market mutual funds in the late 1960s and early 1970s. Money market funds' success led to disintermediation, the outflow of funds from banks and thrifts to money market funds, which in turn led to requests by the bankers for deregulation so that banks could offer interest rates competitive with brokerage and securities firms. Deregulation, and responses to the consequences of it, became the cause of the 1980s savings and loan (S & L) crisis.

Part III picks up with the response of the brokerage and securities firms to the deregulation of banks. Those entities wanted greater inroads into the banking business. In turn, banking entities wanted, and with a wink and a nod from the regulators, received, *de facto* permission for entry into the securities business. All at once, the reality was not only that every type of entity wanted into every other type's previously sacrosanct fiefdoms, but that with securities affiliates and money markets funds they were already there, in each others' businesses. "One stop financial shopping," "cross-selling," and "level playing field" became watchwords of the 1990s.

Those events and those watchwords made almost anti-climatic the 1999 repeal of the Glass-Steagall Act by the Graham-Lilly-Bliley financial modernization act. Now everyone who was in everyone else's business was free of legislative and regulatory impediments to branching out.

So why not repeal Glass-Steagall? Let the market sort it out. The reasoning supposedly behind repeal of Glass-Steagall was on the sell side. If a particular financial entity cross-sold a service or product, say, a bank trying to sell life insurance that the public did not desire, the market would penalize the selling entity. The selling entity would soon stop offering the service or face the consequences, including possible bankruptcy.

Yet it is the unforeseen consequences that get you every time. Repeal of Glass-Steagall also led to new-found freedom on the investment as well as the selling side. According to one historian, brokers and banks suddenly went from a regime in which they earned a nice living making money for their clients to a regime where the total emphasis became making money for themselves, which they could now do by buying and selling securities

4. For a good overview of the Volcker Rule see Scott Patterson, *Tougher Rule Set to Curb Banks—'Volcker' Approval Expected Tuesday*, WALL ST. J., Dec. 10, 2013, at A-1.

for their own account.[5] Aided by the low cost of borrowing engendered by the Federal Reserve, financial firms borrowed heavily, the proceeds of which they could invest in trading for their own accounts, mainly in asset-backed securities, the products of structured finance. Leverage ratios at financial institutions went to impossibly high heights, from 30-1 at Freddie Mac and Fannie Mae, to 32-1 at Merrill Lynch, 34-1 at Bear Stearns, and 40- or 42-1 at Lehman Brothers.

Then the housing crisis hit. The collateral for many of the loans consisted of promissory notes secured by mortgages on residential and commercial real estate. Mortgage-backed securities and other structured finance products fell in value as homebuyers and other real estate owners defaulted and were foreclosed upon. Financial firms saw the Armageddon coming, closing their mortgage origination subsidiaries and curtailing proprietary investing, but the firms could not deleverage fast enough or, with the value of collateral falling so fast, could not deleverage at all.

Freddie Mac and Fannie Mae entered receivership on Labor Day weekend, 2008. Lehman Brothers failed on September 15. Effectively, Bear Stearns had failed earlier, falling into J.P. Morgan's outstretched arms. Bank of America rescued Merrill Lynch. J.P. Morgan snapped up a failing Washington Mutual Savings Bank as well. Wells Fargo obtained Wachovia Bank, laid low by its earlier acquisition of Golden West Financial and Golden West's subprime loan portfolio.

Part IV scrolls through that recent history, flatly contradicting Jamie Dimon and other bankers' smug assertions that proprietary trading by financial institutions did not contribute to the near-death economic experiences of 2008–09.[6] Proprietary trading and the inordinate risks of excessive leverage were a central cause of what occurred.

Part V reviews the Volcker Rule, its exceptions, and the steadfast, constant opposition by bankers and their trade groups to repeal it, modify it, or nullify it through "the disintegrating erosion" of countless further exceptions. Is the Volcker Rule the return to old-time religion that we need? On the one hand, do we need a return to old-time religion at all? Alternatively, is the Volcker Rule still too forgiving, and on the premise that "the center cannot hold" (paraphrasing W.B. Yeats),[7] should we reinstate the absolute ethical wall Glass-Steagall put in place 70 years ago?

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5. *See generally* LAWRENCE G. MCDONALD, THE COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (2009).

6. Bankers assert, to this author disingenuously so, that proprietary trading did not lead to the 2008 financial crisis. *See, e.g.,* Scott Patterson & Deborah Solomon, *Crisis Plus Five: A Simple Bank Rule Proves Difficult to Write*, WALL ST. J., Sept. 11, 2013, at A-1 (claiming that banks argue "that reining [proprietary trading] in would needlessly deprive U.S. banks of a profit source, putting them at a disadvantage globally and end up curbing legitimate banking activities").

7. William Butler Yeats, *The Second Coming* (1919), *in* MICHAEL ROBARTES AND THE DANCER (W.B. Yeats ed., 1921).

I. Ancient, Ancient History: Glass-Steagall and 1933

The Act,[8] sponsored by Senator Carter Glass of Virginia and Representative Henry Steagall of Alabama, provided that for a national bank, "[t]he business of dealing in securities and stock . . . shall be limited to purchasing and selling such securities, without recourse, solely upon the order of, and for the account of customers, and . . . the [bank] shall not underwrite any issue of securities."[9]

Financial entities, most of which before 1933 engaged in both investment and commercial banking had to make a choice. Some, such as J.P. Morgan, became commercial banks, shedding their investment banking and securities operations. Others, Brown Brothers Harriman, for example, became investment bankers exclusively.

The reasons for erection of a wall between the two fields trace their roots to the Great Depression. In the 1920s, the commercial side of combined entities made improvident loans to keep afloat or otherwise assist corporate clients the investment banking side had taken public. Again, on the commercial banking side, trust officers (wealth managers today) had caused accounts over which they had authority to invest in corporations the shares of which the bank had underwritten—even when those investments might not have been appropriate for the accounts.

On the underwriting side, the investment banking house assisted in the offering to the public of stock in corporations to whom the commercial side had made loans, often loans that had become troubled.

Another explanation is that Glass-Steagall was mostly a political play. Small banks lobbied for legislation that would clip the wings of large money center banks which, primarily, were those doing investment banking and securities business in addition to commercial banking. That the unlikely sources of the legislation's sponsors were Virginia and Alabama, places in which small banks predominated, at least in those days, supports this view.[10]

Some exceptions to a strict separation were necessary. In 1933, no brokers had offices in the likes of Salina, Kansas or Williamsport, Pennsylvania. Moreover, the personal computer, Schwab and other discount brokers' accounts, and the computer's use in stock trading were far, far in the future. So the individual investor who wished to purchase 100 shares of AT&T or U.S. Steel went to one of the local banks, of which there were several in Salina, Kansas.

Under Glass-Steagall, the bank could assist in the transaction, for it was selling of securities "without recourse, solely upon the order, and for

8. Banking Act of 1933 (Glass-Steagall Act), ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C. § 24 (1933)).

9. *Id.* § 16; 12 U.S.C. § 24 (repealed 1999).

10. Interview with Roberta Romano, Professor, Yale Law School (Apr. 10, 2014).

the account of" the customer. The banks, though, were itching to delve a bit further into the securities business. A few banks instituted an automatic investment service (AIS), principally for run-of-the-mill investors. For a small fee, the customer would authorize the bank to invest a set amount of funds (say, $1000 a month) in shares the customer had designated from a list of twenty-five or so actively traded stocks.

Banks who offered the service still went through a brokerage firm for execution of the trades. Nonetheless, the brokerage and mutual fund industries were zealous in guarding against any bank incursion onto their turf. The New York Stock Exchange (NYSE) sued for application of the Glass-Steagall Act to the AIS programs. The district court found the AIS programs to be within the parameters of what Glass-Steagall permitted, namely, the purchase of securities "without recourse, solely for the account of, and on the order of" the customer.[11] Not to be defeated, five years of lobbying, regulatory and legislative, against banks' provision of any sort of securities selling followed.[12]

An earlier Supreme Court decision, *Investment Company Institute v. Camp*,[13] had interpreted Glass-Steagall to shut down another securities service by banks. The Court held that Glass-Steagall prohibited banks from securities activities in which the banks had a "salesman's stake" in the design and performance of the securities-based financial products but not from activities in which the bank merely acted as a conduit to the securities markets. [14] In *Camp*, the banks had purchased shares in various corporations for the banks' own accounts, then merchandized individual interests in those accounts to their banking customers. The arrangement was functionally equivalent to the bank organizing and selling a mutual fund.

The line seemed to have been clearly drawn. Banks could engage in securities activities for the convenience of the customer, an example of which would be that putative investor in Salina, Kansas. Banks crossed the line, though, when they offered the service for the convenience, that is, the profit, of the bank, rather than that of the customer. In that case, the bank had taken on a salesman's stake in the securities activity in question.[15]

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11. N.Y.S.E. v. Smith, 404 F. Supp. 1091, 1096–1101 (D.D.C. 1975), *vacated as not ripe for decision sub. nom.*, 562 F.2d 736 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 942 (1978).

12. *See generally* H. Lee Barfield, *The Legal Status of a National Bank's Automatic Stock Investment Service Under Sections 16 & 21 of the Glass-Steagall Act of 1933*, 27 VAND. L. REV. 1217, 1218–22 (1974). *See also* John M. Welch, Jr., *Bank-Sponsored Investment Services: Statutory Proscriptions, Jurisdictional Conflicts, and a Legislative Proposal*, 27 FLA. L. REV. 776, 792–94 (1975).

13. Inv. Co. Inst. v. Camp, 401 U.S. 617 (1971).

14. *Compare* Investment Co. Inst. v. Camp, 401 U.S. 617, 630–38 (1971), *with* Investment Co. Inst. v. Camp, 401 U.S. 617, 624–25.

15. *See generally* Branson, *supra* note 2, at 900–05. Of course, the irony is that all of these legislative and judicial maneuvers, in furtherance of a turf war, took place during a time when the traditional brokerage industry was rapidly cutting service to the individual and small investor—customers the banking industry thought it might be able to serve. *Id.* at 905.

II. Less Ancient History

In recent times, investors are confronted with a myriad of mutual fund (investment company) complexes and products. They can choose from Dreyfus, Vanguard, Fidelity, T. Rowe Price, Federated, IDS, USAA, Putnam, and scores of other fund sponsors. From an individual sponsor's menu of funds, the investor meets another dazzling array of fund choices: index, emerging market, international, large cap, medium cap, small cap, blue chip, information tech, health care, oil and gas, and on and on. More recently, exchange traded funds (ETFs), somewhat similar to closed-end investment companies, have become popular, parroting fund families in the array of choices and specialties offered.

Today, investors can choose a loaded fund (say, Putnam, IDS or Dreyfus), mostly sold by brokers (financial advisers, as they now prefer to be called). Or, by use of their personal computer, or by means of a 1-800 telephone number, or even with a mobile device, an investor can invest in no-load funds, into the sale of which no broker intervenes and no sales commission (load) is charged. The growth of the mutual fund industry and the choices available to the investor have been astronomical.

Given the size and prominence of the mutual fund industry today, many younger readers will find it difficult to believe that in the late 1960s the mutual fund industry appeared to be dying. Of the ten institutional investor categories the *SEC Statistical Bulletin* tracked, only the mutual fund industry appeared to be in decline. Pension funds, casualty insurers, life insurers, and university and other charitable endowments, all showed robust, inexorable growth in the size of their portfolios—but not the mutual fund industry. The investment company (mutual fund) industry was in decline, displaced in part by the increased institutionalization of the market, as well as not on an upward trajectory like pension funds and other institutional sectors were.

That is, until the advent of the money market mutual fund, which began to appear in the late 1960s. Regulated as they were, in everything including interest rates, banks and S & L's all offered the same interest rate on deposits, usually a relatively low rate at that. Instead of offering higher rates, say, 5 percent instead of the prevailing 4.5 percent, banks and thrifts competed for customers, and had to compete, only by giving away toasters, luggage, or record albums to individuals who opened new accounts. Banks, and especially thrifts, were low key, comfortable places.

Sensing an opening for new business, brokerage firms and mutual fund complexes began offering customers thrift institutions that had always served money market funds. In a Merrill Lynch money market fund, which was not restricted as to the rate of interest it could pay, that customer could obtain 6.5 or even 7 percent on her funds. She even received a checkbook, although to distinguish their product from banks' checking accounts, Merrill Lynch and other complexes limited withdrawals, say, to five per month.

A vast outflow of funds occurred from banks to brokerage firms and mutual fund complexes. The jaw-breaking technical term was disintermediation. Mutual fund firms and the mutual fund industry revived, seemingly overnight. For the managers of thrift institutions especially, the opposite was true. Suddenly, the world had turned upside down.

Managing a thrift institution in the era of regulated rates was all about managing the spread. The liability side carried with it an obligation to pay interest at the rate regulators set, say, 4.5 percent. The asset side, consisting of notes secured by mortgages, produced a yield that could easily be calculated. The thought was that managers had to achieve at least a 1.5 percent spread between the two rates. Such a spread was sufficient to pay salaries, cover other fixed costs, compensate managers, and pay them handsomely with bonuses at year's end. Because most thrifts were mutual—owned by the depositors—the mangers did not have to worry too much about profits after expenses and dividends to shareholders.[16]

Suddenly, through disintermediation, thrifts and other institutions were losing deposits by the fistful. Moreover, limited in the rates thrifts could pay to attract deposits, thrifts could not compete with the new-fangled money market funds. So they went to Congress, lobbying for deregulation of various aspects of their businesses, most particularly in the rates they could pay. Sponsored by Senator Jake Garn of Utah and Representative Ferdinand St. Germain of Rhode Island, Garn-St. Germain deregulated the S & L industry and, to some extent, the banking industry as well.

Be careful what you wish for, the saying goes, and it applied especially to bank and S & L managers. Thrift managers could now compete for deposits, offering a 7 percent or 7.5 percent rate competitive with what Merrill Lynch or T. Rowe Price was paying. But conditions on the asset side remained the same: old mortgage portfolios still churned out a 5.5 or 6 percent return. Managers were now faced with negative spreads. No more golf on Wednesdays and every other Friday.

Managers had to scramble, trying as best they could to narrow, if not reverse, the negative spread.

There was hope. The typical mortgage has a life of thirteen or so years, not the thirty-year term that appears on the face. Homeowners sell in order to upsize, to downsize, to move to another neighborhood, suburb, city, or state, and so on. New mortgages, yielding better returns, would replace the previously existing and low paying mortgage portfolio—eventually.

16. Much of the text is based upon the author's personal involvement as a consultant to several banking and thrift institutions, including United Bank, Westside Federal Savings & Loan, Prudential Savings Bank, Puget Sound National Bank, and Pacific First Federal S & L, from the mid-1970s until the early 1990s.

What to do in the interim, to tide institutions over until transformation of the portfolio could take place and a positive spread restored? One, many S & L's made improvident high-risk loans in areas in which the yields were much higher. The loans backfired; often, the lenders ended up owning the collateral. Jokingly perhaps, it was said that every S & L owned a golf course in Texas.

Two, thrift managers used depositors' funds to invest in junk bonds that would have a much higher yield than mortgages, old or new. Connie Bruck's book *The Predators' Ball* chronicles Drexel Burnham Lambert's semi-annual Beverly Hills bacchanalia conducted to showcase bond offerings to bank managers from Utica, Dayton, Ft. Wayne, La Crosse, and other outposts in the hinterlands.

Three, managers caused institutions to convert from the mutual form, owned by the depositors, to stock corporations, owned by the shareholders. Soon after the conversion process came an initial public offering, producing $60, $70, or $80 million to tide the institution over until managers could reverse the negative back to a positive spread.

III. Leveling the Playing Field

Efforts to deregulate rates on deposits so that all institutions, from whatever sector, could compete as to price (interest they could offer to pay) was the first accomplishment in a chorus of refrains that continues to the present day, namely, for regulators and Congress to "level the playing field."

Most particularly, leveling the playing field, as well as eradicating all barriers between adjoining fields, was motivated by financial industry managers' incessant call for one-stop financial shopping and cross selling.

Under the Bank Holding Company Act of 1956, [17] banks could reorganize as holding companies. Most did so. The holding company format then permitted formation of several subsidiaries, often termed "affiliates." The bank, of course, would be the principal affiliate. Other affiliates might be an escrow company, a mortgage servicing subsidiary, a loan origination company, and so on. For a time, several banks formed travel agency affiliates—although the relation of a travel agency to the business of banking seems difficult to perceive. The Act did forbid holding companies formed pursuant to it from owning non-financial or non-finance-related businesses.

Beginning in the late 1980s, most bank holding companies formed securities affiliates. If you walked into the lobby of a principal branch or the headquarters of a bank or thrift institution, you might see in the corner a desk separated by a wooden railing or a glass partition. Within the fenced area sat one or more of the securities affiliate's representatives. Any pre-

17. 12 U.S.C. § 1841(k) (2014) (defining bank holding company and affiliates).

tense of delving into the securities business solely for the convenience of the customer, as the Glass-Steagall Act permitted, was gone. With the complete acquiescence of the banking regulators, banks ran roughshod over the Glass-Steagall bar against banks engaging in the securities business on a plenary basis. Banks operated securities facilities for the convenience of the bank, as potential profit centers, rather than "without recourse, solely upon the order of, and for the account of, customers."

Little harm conceivably could come from all this—or so the banking regulators thought—but some did. If an older customer walked into a branch of Lincoln Savings in order to purchase a certificate of deposit, she might be diverted to a corner desk. There the securities representative would attempt to redirect the customer's attention to Lincoln Savings bonds, which paid a slightly better interest rate than would a certificate of deposit. The difficulty came later when the bank failed. The customer found that rather than holding a federally insured banking product, namely, the certificate of deposit, all she held was an unsecured claim in bankruptcy that would pay a few cents on the dollar, if at all. Senior citizens in Arizona and California lost billions of dollars.[18] Lincoln Savings was owned and controlled by the infamous Daniel Keating who later went to jail after being convicted of criminal violations of the federal securities laws.[19]

Lincoln Savings may be an extreme case. Ever present in the operation by banks and thrifts of securities operations, though, are suitability problems. A registered representative must insure herself that an investment she recommends is suitable for the customer, given the age, occupation, net worth, and investment objectives of the customer. On the other hand, many, or most, individuals entering a banking or thrift institution have a nearly identical objective, namely, the preservation of capital while earning some modest return. Uniformly, they possess a profile that tolerates little or no risk. In the case of banks' securities affiliates, then, at a minimum, the suitability problem is magnified. To some, the suitability issue alone is sufficient to bar banks from the securities business.

Nonetheless, by the mid-1990s, everyone seemed to be in everyone else's business. Securities firms were offering money market and conservative bonds funds. Banks and thrifts were offering, or attempting to offer, securities products. The response to anyone who clamored for ethical walls, or barriers, between securities and banking businesses was that the market

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18. The Lincoln Thrift episode spawned a great deal of litigation. The civil case was denominated *First Baptist Church v. Keating* (In re. Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig.), 49 F.3d 541 (9th Cir. 1995). Actions involving Charles Keating, the CEO and controlling shareholder of Lincoln Thrift, include *Keating v. Office of Thrift Supervision*, 45 F.3d 322 (9th Cir. 1995), and *Keating v. National Union Fire Ins. Co.*, 995 F.2d 154 (9th Cir. 1993).

19. Five United States Senators, including Senator John McCain of Arizona, lobbied the Department of Justice on Charles Keating's behalf. The Department of Justice was at the time prosecuting Keating for bank and securities criminal fraud, for which he was ultimately convicted and sentenced to prison. Those five senators became widely known as the Keating Five.

would sort it out. But was the admixture of various aspects of the two different businesses a pathway to the long-term sustainability of our financial institutions? Senator Phil Gramm and Representatives Jim Leach and Thomas Bliley said "yes," deregulation should be complete. The events of 2008–09 said "no," demonstrating that complete eradication of all barriers led to a near-complete financial apocalypse.[20]

IV. Gramm-Leach-Bliley and the Meltdown of 2008–09

The United States economy was booming in the 1990s. Microsoft, Oracle, Cisco, and other knowledge-based and new economy U.S. corporations had achieved world domination. Very recently, in the 1980s, predictions had been that United States old economy companies, mostly manufacturing entities, were losing out to Japan, Korea, and countries of the European Union. Toyota, Nissan, Hyundai, and Volkswagen had been outpacing Ford and General Motors, year in and year out, throughout the 80s.

The 1990s were a revival of heady times. An exemplar was Sandy Weill's formation of Citigroup, Glass-Steagall and Bank Holding Company Act prohibitions be damned. Weill engineered the merger of Travelers' Insurance—already into insurance, investment banking, and retail brokerage (Smith Barney)—with Citibank, by some measures the third largest financial entity in the United States. The new entity, Citigroup, represented a gigantic and sprawling financial supermarket.[21] Almost as an afterthought, Citigroup sought and obtained from the Federal Reserve a two-year waiver of the Glass-Steagall and Bank Holding Company Act provisions.

Meanwhile, commercial and investment bankers as well as brokerage firm CEOs lobbied for permanent relief from the strictures of Glass-Steagall. They found a willing ear in that of Senator Phil Gramm of Texas, then chair of the Senate Committee on Banking, Housing, and Urban Affairs, who shepherded through the Congress the Financial Services Modernization Act of 1999, more popularly known as Gramm-Leach-Bliley (GLB).[22]

Most famously, GLB repealed the heart of the Glass-Steagall Act, "decimating the depression-era firewalls between commercial banks, investment banks, insurance companies, and securities firms."[23] GLB's propo-

20. As part of his total deregulation agenda, Senator Phil Gramm, a professor of economics at Texas A&M University, advocated abolition of the Securities and Exchange Commission (SEC).

21. Sandy Weill, The Real Deal: My Life in Business and Philanthropy 329 (2006) ("an online financial supermarket"). *See also id.* at 389 ("Citibank customers avidly used brokerage services provided by Solomon Smith Barney and purchased annuities manufactured by our insurance company. Brokerage clients bought our bank's credit cards.").

22. Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act (GLB)), Pub. L. No. 106-102, 113 Stat. 1338 (1999).

23. David Corn, *Foreclosure Phil*, Mother Goose (Aug. 2008), http://www.motherjones.com/politics/2008/05/foreclosure-phil.

nents argued that consumers wanted financial supermarkets and one-stop shopping so they could switch back and forth between savings deposits and stock market or other investments without changing financial institutions.

Countering those arguments, but failing to carry the day, Representative John Dingell presciently predicted that GLB and its abolition of Glass-Steagall would result in the creation of large entities that would be "too big to fail."[24]

One interesting sidelight is that although GLB abolished Glass-Steagall, it did not repeal the Bank Holding Company Act prohibition on holding companies owning non-financial businesses. Repeatedly, the reason that firewall was left in place was the concern prevalent in financial services that without the Bank Holding Company Act bar, Wal-Mart, the largest U.S. retailer, would form a bank holding company with the existing retailer as one affiliate but with a commercial bank as another.

GLB now permits more than the marketing and cross-selling of various financial products to the consumer. GLB permitted the newly created financial conglomerates to own securities, not just on the order of and for the account of customers. They could purchase securities for their own benefit, and they did.

Borrowing money at low interest rates, financial firms purchased mortgage-backed, other asset-backed, and structured investment products, to the tune of achieving 100 percent and higher annual returns on invested capital. They pushed beyond securities backed by conventional mortgages to Alt-A and then subprime mortgages on which interest rates were significantly higher.[25] They formed captive loan origination firms as well as purchasing notes and mortgages, leases, and loan participations from Countrywide, Washington Mutual Savings Bank, Golden West Financial, World Savings Bank, and others.

At the peak, Freddie Mac, supposedly a mortgage packager and wholesaler, was retaining over 50 percent of the mortgages it purchased using the low-cost borrowing available to it.[26] Lehman Brothers leverage ratio reached as high as 42-1, which it concealed through window dressing at the end of each quarter. Using repurchase transactions (Repo 105s) where Lehman would sell securities and at the same time agree to repurchase them (treating this as a sale, but in reality a borrowing), Lehman reached $50 billion or more per quarter. Temporarily paying down its debt with funds

24. *See House Session: Program 153391-1* (C-SPAN television broadcast Nov. 4, 1999), *available at* http://www.c-span.org/video/?153391-1/house-session (statement at 01:59:15).

25. Alt-A mortgages are mortgages given by borrowers whose credit score is "less than perfect" but not so low as to place them in the subprime category. *See, e.g.*, KIRSTEN GRIND, THE LOST BANK 137–38 (2012) (discussing lending practices at Washington Mutual Savings Bank).

26. The author was a consultant and expert witness in the administrative proceeding Housing and Urban Affairs commenced to deny deferred salary and severance payment to Freddie Mac's CEO and other executive officers.

obtained on the repos, Lehman published its quarterly results, including leverage ratios reduced from 42-1 to perhaps 34-1. Days later, Lehman would repay the loan (buy back the securities), and for accounting purposes record this as the repurchase of securities it had earlier resold.[27]

Bonuses, salaries, and stock option grants went through the roof at banks and financial services firms, as these items were based on the vast increases in profits at Wall Street and other firms. Most financial institutions purchased or formed loan origination subsidiaries, which quickly transitioned into Alt-A and then subprime mortgages, areas in which the interest rates and therefore the yields were significantly higher.

Loan origination entities enticed consumers into purchasing homes that they could not afford, often homes which they should not have purchased at all. To do so, they used a number of marketing devices:

- Teaser rates: mortgagors were offered low initial interest rates on, say, two-year adjustable rate mortgages (ARMs). When the introductory period ended, homeowners found that their monthly payments doubled and tripled, which they could not afford.
- Pick-a-Payment loans: mortgagors could choose from a variety of schemes such as the ability to omit two monthly payments per year. Under these schemes, homeowners' balances increased rather than decreased as the months went by (negative amortization).
- Options ARMs: the homeowner could choose from a variety of options, not just as to payment amounts and periodicity but other aspects as well.[28]
- NINJA loans: this became one nickname for subprime loans to individuals who had no income, no job, and no assets, or some combination of the foregoing.
- Liar loans: these subprime loans were made to individuals who fabricated, often with encouragement from loan underwriters, jobs, incomes, assets, and the like. Underwriters fast-tracked loan applications, conducting none of the employment and income verifications, credit checks, or other devices the home mortgage industry had used in the past.
- Jingle foreclosures: when doubled or tripled monthly payments became too much to bear, homeowners often abandoned homes, mailing the keys to the mortgage company, bank, or savings and loan company, rather than waiting for judicial and other foreclosure processes to proceed.

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27. The author served as expert witness in a FINRA arbitration against Richard Fuld, former CEO of Lehman Brothers, that was initiated by the Booth Foundation, to which Lehman had sold a high-yield Lehman promissory note just weeks before Lehman's bankruptcy filing.

28. *See, e.g.*, GRIND, *supra* note 25, at 118.

As foreclosures mounted, reaching 50 percent of the housing stock in some communities (Stockton, California, became the poster child), the value of collateral backing asset-backed securities (ABSs) fell like a rock.

Because homeowners were no longer making monthly payments on promissory notes they had signed, returns on the ABSs dwindled and then disappeared. When ABSs became worthless, or nearly so, financial institutions, holding as they did several trillion dollars of ABSs, could not deleverage fast enough, which they needed to do to repay banks and other lenders who had provided the funds with which to buy the securities. In fact, the value of collateral fell so rapidly, whether it be in the form of packages of mortgages or in the form of securities backed by the mortgages, financial institutions found themselves unable to deleverage at all. No buyers existed for either the mortgages themselves or the securities, too toxic even for so-called "vulture funds."

Three of the "Big Five" failed. In April 2008, Bear Stearns disappeared into the arms of commercial bank J.P. Morgan Chase for $2 per share (later raised to $10). Bank of America acquired a failing Merrill Lynch. On September 15, 2008, Lehman Brothers entered bankruptcy. Goldman Sachs and Morgan Stanley, left standing, were nonetheless limping badly. Both found it necessary to become banks so that they could obtain low cost funds through the Federal Reserve's discount window.

V. The Volcker Rule: Fences on the Level Field

Paul Volcker served as president of the Federal Reserve from 1979 until 1987. In 2009, President Obama appointed Volcker chair of the President's Economic Recovery Advisory Board, a capacity in which he served until 2011. In the latter position, Chairman Volcker argued that excessive risk had resulted from banks and financial institutions investing depositors' funds, including governmentally insured funds, into investment products for their own accounts.[29] Volcker authored a page-and-a-half memorandum suggesting that rather stringent restrictions be placed upon banks doing so. The result was a 953-page regulation[30] issued early in 2014 and jointly adopted by no less than five federal agencies: the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency (Department of Treasury), and the Federal Reserve. Twenty-two high-ranking federal officials had to sign off on the rule.[31]

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29. John R. Emshwiller & Damian Paletta, *U.S. News: Volcker Calls for Restricting Banks' Risk, Trading Activity*, Wall St. J., Sept. 17, 2009, at A-2.

30. Dan Fitzpatrick & Scott Patterson, *Dimon Applauds Certainty With Final Rule*, Wall St. J., Dec. 12, 2013, at C-10 (discussing the "final 953 page edict").

31. Scott Patterson & Deborah Solomon, *Crisis Plus Five: A Simple Bank Rule Proves Difficult to Write*, Wall St. J., Sept. 11, 2013, at A-1.

A. Authority in Dodd Frank

The heart of the new rule is a flat prohibition: "[A] banking entity may not engage in proprietary trading. *Proprietary trading* means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."[32] Thereafter, the rule contains a number of carve-outs from the basic prohibition. For example, "[p]roprietary trading does not include . . . [a]ny purchase or sale of one or more financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement."[33] Other carve-outs are for purchases and sales pursuant "to a documented liquidity management plan" or in connection with the bank's "deferred compensation, stock bonus, profit-sharing, or pension plan."[34]

A large carve-out is for banks' underwriting activities.[35] Another significant exception is for "fiduciary transactions," falling under the general heading of "Permitted trading on behalf of customers": "The prohibition [on proprietary trading] does not apply to the purchase or sale of financial instruments by a banking entity acting as a trustee or in a similar fiduciary capacity."[36] The exception is large enough to permit customer specific as well as common and pooled trust funds for smaller trust accounts.

The three exceptions that involved the largest amount of lobbying and that received the greatest amount of media and other attention are market-making, hedging activities, and the three percent rules. The latter limit investments in hedge or private equity funds ("covered funds") to no more than 3 percent of the particular fund and, overall, no proprietary trading exceeding an amount equal to 3 percent of the bank's "tier one capital."

B. Market-Making

Historically, securities trading is on an agency basis. The person with whom you deal and call your broker technically is a registered representative. The person on the floor of the stock exchange, entitled to be there because his or her firm owns a seat on the exchange, is the real broker. So the registered rep is your agent and the broker is a subagent. If you desire to sell 1,000 shares of Alcoa, say, in Seattle, there will be the mirror image of the Seattle apparatus but on the buy side, say, in Tampa. Trading is done

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32. Final Common Rules: Proprietary Trading and Certain Interests in and Relationships with Covered Funds § B(3)(a) (2013), *available at* http://online.wsj.com/public/resources/documents/1210volckerregtext.pdf (emphasis in original). The common rules are then to be adopted and promulgated by each of the five applicable federal agencies. *See also* Rules and Regulations, 7 Fed. Reg. 21 (Jan. 31, 2014).

33. Final Common Rules, *supra* note 32, § B(3)(d)(1).

34. *Id.* §§ B(3)(d)(3), B(3)(d)(8).

35. *Id.* § 4 ("Permitted underwriting and market making-related activities").

36. *Id.* § 6(c)(1).

through agents and subagents who charge a commission, which must be usual and customary and which must be disclosed.

Today, however, greater and greater amounts of trading are done on a dealer rather than an agency basis. The over-the-counter (OTC) market always has been predominantly a dealer market, also traditionally characterized by trading in the securities of smaller companies. In the modern era, however, many large household name corporations, such as Microsoft, Starbucks, or Intel, have chosen to remain in the OTC market rather than to graduate to the NYSE, as once large companies did after they had grown and become more prominent.

In a dealer market, there is no centralized place such as an exchange trading floor into which buy and sell orders flow. Instead, scattered all over the country and all over the world, connected by telephone lines, telegraph wires, or computer broad-band, are various dealers. These dealers maintain inventories in a number of companies' shares, much as a hardware dealer might maintain inventories in various brands of hammers or pliers. These securities dealers make known their willingness to buy and sell various securities, historically through publication in the sheets ("the pink sheets") and today by virtue of computerization of a large portion of the OTC market by the National Association of Securities Dealers (NASD), through the NASDAQ (AQ for Automated Quotation) system.

Although it advertises itself as a stock exchange, NASDAQ is not an exchange in the technical sense. The dominant tenor of the trades that NASDAQ facilitates is a dealer rather than agency basis. Financial firms stand willing to buy and sell from inventories. They do so after tacking on a markup, like hammers in a hardware store, rather than adding a commission, as an agent would. An investor finds out who those firms are and what terms of trade they are willing to offer through use of a personal computer.

More and more stock trading is done on a dealer basis, including substantial portions of the NYSE list whose securities are "dual traded," that is, traded OTC and on off-exchange computerized markets. Now free to engage in the securities business, many banks have become "market-makers," in the parlance of the trade, standing willing to buy and sell in captive dark pools they maintain. As earlier recounted, many securities firms, historically the primary market-makers, now also are banks, to whom the strictures apply.

What concerned those drafting the Volcker Rule is that banks could evade the limits on proprietary trading by disguising ownership of securities for their own accounts as market-making activity, that is, maintenance of an inventory for potential purchase by customers. So, as adopted, the Volcker Rule section 4 contains a number of provisions dealing with the subject.

Section 4(b) begins with a carve-out: "The prohibition [on proprietary trading] does not apply to a banking entity's market-making-related activities conducted in accordance with paragraph (b) of this section."[37] There follows a description of six prerequisites and requirements:

> 1. The trading desk that establishes and maintains the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments . . . .
> 2. The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers or counterparties . . . .
> 3. The banking entity has established and implements, maintains, and enforces an internal compliance program . . . .
> 4. To the extent that any limit . . . is exceeded, the trading desk takes action to bring the trading desk into compliance . . . promptly . . . .
> 5. The compensation arrangements of persons performing the activities . . . are designed not to reward or incentivize prohibited proprietary trading.
> 6. The banking entity is licensed or registered . . . in accordance with applicable law.[38]

In anticipation of strictures being placed on proprietary trading and on market-making, many banks and financial service firms complained vociferously.[39] At the same time, they let go those employees who would have done such trading, or they left voluntarily. "Two key elements of how Wall Street does business [thus] have changed: the makeup of its trading units and its personnel policies." The employees who would have performed riskier transactions "took their talents to private-equity firm and hedge funds not covered by the rule."[40] Non-traders have replaced traders as top dogs at most houses.

"If a firm like Goldman Sachs, which is now a bank, can't speculate, then the pendulum will swing."[41] But "a closer look at the inner workings of the securities industry suggest that the pendulum has been in motion for some time."[42] Alternatively, even before adoption of a final rule, many banks shut down proprietary trading desks, transferring all or most of the operation, including employees, to a hedge fund.[43] In any such fund,

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37. FINAL COMMON RULES, *supra* note 32, at § 4(b).

38. *Id.* §§ 4(b)(i)–(vi).

39. *See, e.g.*, Deborah Solomon, Andrew Ackerman & Scott Patterson, *Rule Push Nears End*, WALL ST. J., Dec. 7, 2013, at B-2 ("Banks have complained that defining market making too tightly would hinder their ability to serve clients . . . .").

40. Francesco Guerrera, *As Map Evolved, Street Changed*, WALL ST. J., Dec. 10, 2013, at C-1.

41. New York University Professor of Finance William Silber, *quoted in* Guerrera, *supra* note 40.

42. Guerrera, *supra* note 40.

43. *See, e.g.*, Rob Copeland, *RBC Nixes Desk in Win for the Regulators*, WALL ST. J., Apr. 16, 2014, at C-1.

the rule permits the bank to have no more than a 3 percent ownership interest.[44]

C. Limits on Hedging Activities

Firms frequently take second positions in another security or derivative to mitigate some or all of the risks that otherwise would exist with the original position. Volcker Rule's draftspersons' worry was that such hedging activities could be used to disguise or mask from view forbidden proprietary trading, similar to worries about use of market-making activity to do so.

An example of a hedge would be the purchase of a put with a strike place below the current market price of a security the banks owns. The put (a form of option that is the opposite of a call option, which gives the right to purchase at the strike price) gives the purchaser (the bank) the right to force the put's seller to purchase the security, again, at the strike price. So, say the bank purchases the security at $50 with the expectation the price may go to $80 or $90. But to hedge against the risk that the security's price might fall, the bank buys a put with a strike price at $40. If the price falls precipitously or the market as a whole declines severely, the bank has purchased some but not complete downside protection. The bank has hedged against the risk.

It has even been held that the failure of officers and directors of a commodities business not to engage in some hedging activities constitutes violation by those directors of their duty of care.[45]

As first promulgated, the Volcker Rule had some limitations on hedging activities, but the loss by J.P. Morgan Chase of $6.5 billion in hedging activity against generalized risks, done by a trader in London who came to be known as the "London whale," resulted in a much stricter rule.[46] The bank, awash in deposits but with a reduced ability to invest them because of the collapse of the structured finance market, "bulked up on corporate bonds" to the tune of "17 times levels seen before the onset of the financial crisis." [47] The risk of a severe decline in the value of this bond portfolio apparently was the risk the London trader sought to mitigate, mainly through the purchase of credit derivatives. Forbidding hedging against these unspecific generalized risks, known as "Black Swan events" in the trade, "would limit firms' ability to avoid getting sideswiped by unforeseen risks," or so the banks argued.[48]

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44. *See infra* notes 55–61 and accompanying text.

45. Brane v. Roth, 590 N.E.2d 587 (Ind. App. 1993) (corporation owning and operating grain elevator).

46. Solomon et al., *supra* note 39 ("the $6.5 billion 'London whale' loss").

47. David Reilly, *Volcker Rule Will Trim the Banking Hedge*, WALL ST. J., Dec. 10, 2012, at C-10.

48. *Id.*

But the London whale episode and banks' protests against stricter Volcker Rule-permitted hedging activity had the opposite effect.[49] As adopted, the Volcker Rule permits only hedging activity which would "reduce or alleviate one or more specific identifiable risks, such as market risk, currency or foreign exchange risk, interest rate risk, or others."[50] Criticism, saying "that the Volcker Rule leaves the U.S. financial industry vulnerable to competition from other countries,"[51] where fewer or no restrictions exist, fell on deaf ears.

Volcker Rule section 5 begins with a carve-out from the prohibition on proprietary trading contained in section 3:

> The prohibition . . . does not apply to the risk-mitigating hedging activities of a banking entity in connection with and related to individual positions, contracts, and other holdings . . . designed to reduce the specific risks to the baking entity in connection with and related to such positions, contracts, or other holdings.[52]

Banks must have internal compliance programs, internal controls, monitoring, and "relevant escalation procedures" to ensure that hedging transactions stay within the limits higher-ups put in place.[53]

The rule reaffirms and expands on what its lead-in sentence provides: the only hedging activity allowed is that which "significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks arising in connection with and related to identified positions, contracts, or other holdings of the banking entity."[54] The reasoning behind the emphasis is to prohibit, in no uncertain terms, hedging for generalized risks such as Black Swan events, similar to what occurred in the London whale episode.

D. *Three Percent Limitations*

There are two such limitations. One, the bank's investment in a particular "covered fund" may not exceed 3 percent of the total fair market value of the ownership interests of the fund." [55] Two, overall, "[t]he aggregate

49. Fitzpatrick & Patterson, *supra* note 30 ("Bankers who found their bargaining power weakened after the Whale episode privately blamed J.P. Morgan for giving regulators an opening to toughen the final rule.").

50. Scott Patterson, *Banks Brace for Tighter Regulation*, WALL ST. J., Dec. 4, 2013, at A-1 (internal quotation marks omitted) (regulators agreed to change the language back to include stricter hedging provisions).

51. *Id.*

52. FINAL COMMON RULES, *supra* note 32, § 5(a).

53. *Id.* § 4(b)(1).

54. *Id.* § 4(b)(2)(ii).

55. *Id.* § 10(a)(2)(ii)(B).

value of all ownership interests of the banking entity and its affiliates . . . may not exceed 3 percent of the tier 1 capital of the banking entity."[56]

The definition of covered fund is a long and prolix one, including, *inter alia*, any investment company, commodity pool, offshore investment entity, foreign public fund, joint venture, acquisition vehicle, foreign pension or retirement funds, and on and on.[57]

The umbrella 3 percent limitation amount is determined by first calculating the tier 1 capital under the Basel III Accords, which are voluntary, global guidelines established by the banking regulators of various nations. The United States banking regulators have made mandatory these guidelines, or their versions of them, in order to further strengthen the ability of the banking system to withstand sustained bank runs and other financial meltdowns of the type which occurred in 2008–09. Later on, the Federal Reserve increased requirements so that large bank holding companies (Citigroup, J.P. Morgan Chase, BNY Mellon, Wells Fargo, Goldman Sachs, Morgan Stanley) must have tier 1 capital equal to 5 percent of assets. Their banking subsidiaries must have tier 1 capital equal to 6 percent of capital, at least if they are FDIC insured. Holding companies are restricted in paying increased dividends, instituting share buybacks, or raising executives' bonuses and salaries until those new capital plateaus are achieved.[58]

Briefly put, tier 1 capital consists of the balance sheet totals for common stock and for retained earnings. These items are the most irretrievably committed capital for the enterprise, represent the residual interests, and are the types of capital most certain to be there if a bank run or similar event occurs.

A sample calculation or two illustrates the scale of what the Volcker Rule exceptions permit in the way of proprietary trading. Taking PNC Financial, the nation's eighth largest bank by assets, tier 1 capital is approximately \$39.7 billion.[59] Three percent of that amount would be approximately \$119 million. So, under the Volcker Rule, PNC, an entity with \$320 billion in balance sheet assets, could engage in proprietary trading only to the tune of a *de minimus* amount equaling less than one-half of one percent of its assets.

Looking at our nation's largest bank by assets, J.P. Morgan Chase, tier 1 capital appears to be \$157 billion, more or less. [60] Three percent of that

56. *Id.* § 10(a)(2)(iii).

57. *See generally id.* § 10 (addressing the "[p]rohibition on acquiring or retaining an ownership interest in and having certain other relationships with a covered fund").

58. *See* Stephanie Armour & Ryan Tracy, *Banks Must Add to Capital as Rule Shifts*, WALL ST. J., Apr. 9, 2014, at C-2 (estimates are that eight largest bank holding companies may have to add as high as \$68 billion; eighteen largest banks have added \$500 billion since 2008).

59. *See* PNC Financial Services Group, Consolidated Balance Sheet for 2013.

60. J.P. MORGAN CHASE BANK, N.A., CONSOLIDATED FINANCIAL STATEMENTS FOR THE THREE YEARS ENDED DECEMBER 31, 2013 (2013), *available at* https://www.jpmorgan.com/cm/BlobServer/New_Zealand_bankstats13.pdf?blobkey=id&blobwhere=1320637390828&blobhead

amount would be $471 million. So, under the Volcker Rule, J.P. Morgan Chase, an entity with $2.03 trillion in total assets, could engage in proprietary trading not to exceed one-four-thousandth of its assets.

Based as they are on tier 1 capital, the Volcker Rule limitations on proprietary trading are much more constraining than they appear to be at first blush. They have generated much griping by banking leaders. For example, Jamie Dimon, CEO of J.P. Morgan Chase, has taken shots at Paul Volcker, stating, "By his own admission [he] has said that he doesn't understand capital markets. He has proved that to me."[61]

VI. Future of the Volcker Rule

The scramble was already on as the rule was being crafted. For instance, by summer 2013, lobbyists for J.P. Morgan Chase met seventeen times (that we know of) to seek enlargement or elimination of the restrictions on hedging against generalized risks, and other amelioration of the rule's impact.[62] "Asked if [adoption of the rule] amounted to creation of a cottage industry for law firms and consultants, [a former SEC Commissioner] said, 'It's an awfully big cottage.'"[63] A similar emergence of a plethora of consulting firms and software programs followed adoption of the Sarbanes-Oxley legislation in 2002.[64]

Banks and those who support them tend to hate the rule. "The Volcker rule is merely an example of Washington's tendency to combine arrogance with ignorance. . . . [T]he industry did not need the regulatory onslaught," wrote one commentator.[65]

Bankers and banking associations have persuaded individual representatives to introduce various pieces of legislation to roll back various aspects of the rule.[66] An especially intense effort has been underway to remove restrictions on banks' trading in collateralized loan obligations. In those transactions, banks and other lenders securitize secured loans. Traditionally, the purchaser of such asset-backed securities have included other banks.[67]

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61. Fitzpatrick & Patterson, *supra* note 30.

62. *Id.*

63. Ryan Tracy, James Sterngold & Stephanie Armour, *'Volcker' Battle Lines Are Drawn*, Wall St. J., Dec. 12, 2013, at C-1 ("The Volcker rule post-fight is on").

64. *See, e.g.*, Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom Era*, 58 S.C. L. Rev. 65 (2006).

65. Brad Schaeffer, *The Dodd-Frank Effect: "Too Small to Succeed*," Wall St. J., Apr. 10, 2014, at A-19.

66. *See, e.g.*, Rob Tricchinelli, *House Financial Services Committee Set to Pass CLO Rollback, Four Other Bills*, BNA Daily Sec. Reg. & L. Rep., (Mar. 14, 2014).

67. *See* Jeff Bater, *Financial Industry Group Urges Lawmakers to Provide Relief for Banks on Volcker Rule*, BNA Daily Sec. Reg. & L. Rep. (Mar. 14, 2014) (the Financial Services Roundtable).

The principal regulator of national banks and S & Ls, the Comptroller of the Currency (OCC), has estimated that the costs of implementing the Volcker Rule could range as high as $4.3 billion. On the other hand, the costs may be as low as $412 million. [68] Needless to say, the banking industry and its lobbyists have seized upon the higher figure, inflated it, and folded it into arguments they are making for repeal of some or all of the Volcker Rule. [69]

In litigation, doctrines known as law of the case and *res judicata* prevent parties from re-litigating issues that have been adequately aired in the instant or a prior lawsuit. Collateral estoppel may prevent a party from raising an issue that the party has had an opportunity to raise in another suit in which it was involved even though that suit was not identical. These doctrines help ensure an efficient use of legal resources.

No such thing as *res judicata* or collateral estoppel exists in the legislative or regulatory processes. Banks and their lobbyists know this. Based upon their activities so far, it appears that banks will try and try again to weaken or eliminate Volcker Rule restrictions on proprietary trading, year after year. An analogy might be made to extractive industries such as coal mining, in which miners practice what is known as long wall mining. Miners continue to drill and blast holes along a long wall's entire face until the entire length crumples and falls. The banking industry's strategy may be, and so far resembles, long wall mining (or undermining) of the Volcker Rule.

The overall argument against the Volcker Rule is that United States banks are small and suffer competitively, not on a national but on a global basis. Only one U.S. bank, J.P. Morgan Chase, ranked number five, can count itself as being among the world's ten largest banks.[70] Only two other U.S. banks, Bank of America and Citigroup, are within shouting distance of the world's ten largest.[71]

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68. Jeff Bater, *Volcker Rule Could Cost Banks Up to $4.3 billion to Implement*, BNA Daily Sec. Reg. & L. Rep. (Mar. 21, 2014).

69. *See, e.g.*, Sheila Bair, *When it Comes to the New Banking Rules, More Isn't Always Better*, *in* FORTUNE 57 ("Buffalo's M & T Bank estimates that [with the Volcker rule pending] its annual compliance costs have nearly doubled, from $50 million in 2003 to $95 million in 2011, more than 10% of its earnings.").

70. *See* The 10 largest banks in the world, www.bankrate.com/finance/banking/largest-banks-in-the-world-1.aspx (last visited Mar. 28, 2014). The world's ten largest banks, with asset totals in parentheses, are as follows: 1. Industrial and Commercial Bank of China (CICBC) ($2.95 trillion); 2. HSBC Holdings ($2.68 trillion); 3. Deutsche Bank ($2.6 trillion); 4. Credit Agricole Group ($2.58 trillion); 5. BNP Paribas ($2.51 trillion); 6. Mitsubishu Financial Group ($2.49 trillion); 7. Barclay's PLC ($2.41 trillion); 8. J.P. Morgan Chase ($2.39 trillion); 9. China Construction Bank ($2.36 trillion); 10. Japan Post Bank ($2.12 trillion).

71. *See* America's Biggest Banks, www.forbes.com/pictures/eehd45egjjk/top-10-banks-in-america/ (last visited March 28, 2014). The U.S. top ten are: 1. J.P. Morgan Chase ($2.39 trillion); 2. Bank of America ($2.07 trillion); 3. Citigroup ($1.88 trillion); 4. Wells Fargo ($1.01 trillion); 5. BNY Mellon ($356 billion); 6. U.S. Bancorp ($355 billion); 7. HSBC (U.S. affiliate) ($305 billion); 8. PNC Financial Group ($301 billion); 9. Capital One ($300 billion); 10. TD Bank ($223

Populists counter with arguments based upon long standing biases against aggregation of economic power in single or few sets of hands, dating to enactment of the Sherman Act in 1890 and before. The distribution among and diversification of sets of hands holding economic power is a strength, not a deficiency, of the U.S. economy.

Conclusion

Recall that the Volcker Rule is not a resurrection of the Glass-Steagall Act divide. Under the Volcker Rule, for instance, banks can and will underwrite offerings of securities, something strictly prohibited under Glass-Steagall.

Many informed sources call for legislation to go further than the Volcker Rule has gone, reenacting the Glass-Steagall Act and other safeguards taking banks out of the securities business altogether.[72] Senator Elizabeth Warren notes that the four largest banks are "30% larger than they were five years ago" (in 2008).[73] Senator Sherrod Brown expresses a concern that "big banks could 'game' recently proposed capital rules," such as Basel II and III and the Volcker Rule.[74] Senator John McCain believes that "[b]ig Wall Street institutions should be free to engage in transactions with significant risk, but not with federally insured deposits."[75]

Reenacting the Glass-Steagall barrier would require repeal or reversal of other developments. Large financial institutions such as Goldman Sachs or Morgan Stanley could no longer be banks, as they became in 2008, and would have to deregister. Many onlookers, though, support that proposition. Banks should be what banks should be, and securities firms should be restricted to what they have been historically. "Focusing on what banks do, rather than their absolute size, may prove to be a better way of making financial behemoths safer."[76]

Supporters of the rule "argue that the rule doesn't go far enough, for example, restricting activities related to market making." Supporters of a complete separation of banking and securities activities go further, asking "[w]hy commercial banks should be in the business of market making in the first place."[77]

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billion). Only three U.S. banks are within the same ballpark as the world's largest banks and, after them, the asset totals for other U.S. banks fall off sharply.

72. *See generally* Michael Crittenden, *New Glass-Steagall Sought*, Wall St. J., July 12, 2013, at C-3 ("A bipartisan group of U.S. Senators . . . is pushing to reinstate Depression-era laws separating plain vanilla banking activities like collecting deposits from riskier investment banking bets.").

73. *Id.*

74. *Id.*

75. *Id.*

76. David Reilly, *Volcker Should Be a Means to an End*, Wall St. J., Dec. 11, 2013, at C-14.

77. *Id.*

Reenactment of provisions akin to those found in Glass-Steagall would forestall some of the headlong growth of bank holding companies typified by Sandy Weill's engineering of the insurance-banking-securities conglomerate Citigroup. We seem, temporarily at least, to have gone a different direction, however, away from prohibition of entities that later on become regarded as "too big to fail."

Instead, U.S. policy seems to be to pursue a strategy of "too solid to fail." That strategy has at least two components. One is represented by the last several years' ratcheting up of capital requirements, and of relatively less risky capital, begun with the Basel I Accords and continuing through Basel II and Basel III. Discussion of that component is beyond the scope of this article. Suffice it to say that requirements for banks to withstand a sustained bank run or similar dislocation seem to be working. Twenty-five of thirty large U.S. banks recently passed a stress test designed to evaluate their ability to survive an onslaught on their capital base.[78]

The other component of the strategy is to lessen the risks banking entities may face, at least where the risk can be identified and isolated, as it can with the Volcker Rule and proprietary trading. The Volcker Rule, though, is a halfway measure, as opposed to the complete separation a Glass-Steagall enactment would represent. A difficulty with any halfway measure is that it contains nooks and crannies that facilitate chipping away, and chipping away further, as banks undoubtedly will do with the Volcker Rule. An absolute rule might be preferable.

The famous lines of William Butler Yeats's *The Second Coming* (1919), written to describe an altogether different phenomenon, may be apropos here:

> Things fall apart; the center cannot hold
> Mere anarchy is loosed upon the world
> The blood-dimmed tide is loosened,
> and everywhere,
> The ceremony of innocence is drowned,
> The best lack all conviction,
> While the worst
> are full of passionate intensity.[79]

78. *See* Suzanne Kapner, James Sterngold & Stephanie Armour, *Citi Investors Face a Wait for Cash*, WALL ST. J., Mar. 29, 2014, at B-1.

79. W.B. YEATS, *The Second Coming* in W.B. YEATS, MICHAEL ROBARTES AND THE DANCER (1921).