NOTE

MIND THE GAP: A COMPARATIVE APPROACH FOR FIXING VOLCKER, LEARNING FROM LIIKANEN, AND USING VICKERS TO REPAIR THE U.S. BANKING SYSTEM

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INTRODUCTION

Mention of the "London Whale"[1]—a moniker for Bruno Iksil—still stirs the inflamed passions of regulators throughout the United States and the United Kingdom.[2] Prosecutors, frustrated by their futile

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1. The "London Whale" refers to Bruno Iksil himself. The associated trading scandal has likewise been termed "the London Whale trading scandal" or even just the "London Whale." The eponymous scandal involved hedging—a practice which marks positions in a credit derivatives portfolio at inflated prices. *See* Patricia Hurtado, *The London Whale,* BLOOMBERG (February 23, 2016, 5:04 PM), https://www.bloomberg.com/quicktake/the-london-whale (describing the London Whale's scheme broadly and defining the key players involved in the scandal).

2. For further expression of regulators' angst over Iksil and Martin-Artajo's mess, look no further then Thomas Curry, Scott Waterhouse, and Michael Sullivan's question and answer session during the Permanent Subcommittee on Investigations' Hearing entitled "J.P. Morgan Chase Whale Trades: A Case History of Derivatives Risks & Abuses," wherein the Office of the Comptroller (OCC) was humiliated by three senators with minimal finance training—telling the subcommittee that they were surprised by stories of illicit derivatives swaps and kept deferring to J.P. Morgan for more information. *See* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 113TH CONG., REP. ON J.P. MORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 216 (Comm. Print 2013) [hereinafter DERIVATIVES RISKS AND ABUSES]. When questioned about exactly which OCC examiner was tasked with overseeing J.P. Morgan's Chief Investment Office, the OCC advised the subcommittee that the examiner "was then on vacation, [and] his subordinates failed to notice the size of the loss and no one made any call to the bank to ask about it." *Id.* at 242–243; *see also* Gregg Fields, *Whale-Sized Institutional Corruption:*

attempts to extradite several J.P. Morgan desk traders, engaged in four years of criminal litigation to no avail.[3] These desk traders—Bruno Iksil and three of his colleagues—all worked in the Chief Investment Office (CIO) at J.P. Morgan—and managed in excess of $350 billion deposits at the UK trading desk.[4] Martin Artajo and Iksil, the rogue traders housed within J.P. Morgan's Chief Investment Office, worked on the bank's synthetic credit portfolio—a mere guise for hedging.[5] Due to the irresponsible maneuvers of CIO members, J.P. Morgan absorbed the losses imposed by these rogue traders.[6] In 2012, world credit markets fared one of the worst losses in history—squandering $6.2 billion dollars due to a series of proprietary trades executed by rogue traders.[7] These trading behaviors were not isolated to J.P. Morgan—they were ubiquitous at nearly every systematically important financial institution (SIFI) leading up to the financial crisis of 2008.[8] Central to this "tempest in a teapot"[9] were these four J.P. Morgan traders whose illicit corporate behavior attracted the attention of the Securities and Exchange Commission and an international audience. A series of recorded phone calls and instant messages between the group of desk

Regulatory Capture and the JP Morgan Derivatives Scandal, HARVARD UNIVERSITY EDMOND J. SAFRA CENTER FOR ETHICS (Mar. 29, 2013), https://ethics.harvard.edu/blog/whale-sized-institutional-corruption (describing the Senate Permanent Subcommittee report's condemnation of J.P. Morgan's practices).

3. *See Acting U.S. Attorney Announces Filing of Motion to Dismiss Pending Charges in United States v. Javier Martin-Artajo and Julien Grout*, U.S. DEP'T OF JUST. U.S. ATT'Y'S OFF. S. DIST. OF N.Y. (July 21, 2017), https://www.justice.gov/usao-sdny/pr/acting-us-attorney-announces-filing-motion-dismiss-pending-charges-united-states-v (noting that two former traders were first indicted in 2013 in the office's announcement of intent to dismiss charges in 2017). Prosecutors seeking charges against Iksil and company found that, "[b]ased on a review of recent statements and writings made by Iksil, however, the Government no longer believe[d] that it [could] rely on the testimony of Iksil in prosecuting this case, even if the defendants appeared. Based on these developments, among other factors, the Government . . . decided not to keep these charges pending, but rather to seek their dismissal at this time." *Id.*

4. *See* DERIVATIVES RISKS AND ABUSES, *supra* note 2, at 1, 3–4.

5. *Id*. at 1.

6. *Id*. at 4.

7. *Id*.

8. *See id*. at 219 ("The OCC also initiated a review to determine whether similarly risky activities were being conducted in the asset management functions at other banks, but found 'no activity similar to the scale or complexity' of the credit derivatives trading that took place at J.P. Morgan Chase."); *see also* Vinãls SDN, *infra* note 103, at 12 (noting that in an empirical study examining the roots of the financial crisis, the results suggested that leverage and liquidity, rather than business model, were the key risk factors contributing to bank failure).

9. Nathan Vardi, *Jamie Dimon's Five Stages of Grief,* FORBES (Apr. 11, 2013, 11:02 AM), https://www.forbes.com/sites/nathanvardi/2013/04/11/jamie-dimons-five-stages-of-grief/?sh=2968d0c47563 (quoting Polya Lesova, *Dimon: London Whale Issues "Tempest in a Teapot"*, MARKETWATCH (Apr. 13, 2012), https://www.marketwatch.com/story/dimon-london-whale-issues-tempest-in-a-teapot-2012-04-13-937450).

traders perhaps best illustrates the magnitude of the traders' illegal speculative activities.[10]

> "I can't hold on anymore to this thing." . . . "I don't know where he wants to stop . . . but it's becoming idiotic . . . [N]ow it's worse than before . . . there's nothing that can be done, absolutely nothing that can be done, there's no hope . . . The book continues to grow, more and more monstrous."[11]

By mismarking their Synthetic Credit Portfolio book to hide hundreds of millions of dollars in losses, employing manipulating models, and misinforming investors, regulators, and the public, Iksil and his colleagues engaged in high-risk behaviors hidden from federal comptrollers and from their superiors within J.P. Morgan.[12] J.P. Morgan's London Whale scheme highlights the need to increase oversight of individual trading activities and specifically derivatives trading.[13]

The Dodd-Frank Wall Street Reform Act[14] tried to solve the problem by reducing derivatives-related risk through legislative provisions that increased capital and liquidity requirements for all banks.[15] Likewise, the Act introduced a series of compliance and

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10. *See* DERIVATIVES RISKS AND ABUSES, *supra* note 2, at 14 ("Recorded telephone calls, instant messages, and the Grout spreadsheet disclosed how the traders booking the derivative values felt pressured and were upset about mismarking the book to minimize losses.").

11. Instant message from Bruno Iksil, Chief Investment Office at J.P. Morgan (Mar. 23, 2012) (on file with author); *see also* Instant message from Bruno Iksil, Chief Investment Office at J.P. Morgan (Mar. 23, 2012) (on file with author) Iksil clearly indicated that he knew his claim that the synthetic credit portfolio had become "too big for the market" would garner little sympathy, writing "I am going to be hauled over the coals. . .you don't lose 500M without consequences." DERIVATIVES RISKS AND ABUSES, *supra* note 2, at 83, 59. Iksil's mysterious "book" refers to J.P. Morgan's Synthetic Credit Portfolio trading book. While some "books" contain a compilation of equities, debts, commodities, and derivatives, the book referred to contained only derivatives managed by Iksil and his team. By manipulating the value of "the book," Iksil impressed his superiors by inflating derivatives earnings beyond the $500 million dollars to a whopping 1.05 billion dollars—only to lead his employer, J.P. Morgan, to incur $6.3 billion in losses.

12. *See* Jill E. Fisch, *The Mess at Morgan: Risk, Incentives and Shareholder Empowerment*, 83 U. CIN. L. REV. 651, 656 (2015) (describing how JP Morgan attempted to hide the London Whale's trading loses).

13. *See* Steven L. Schwarcz, *Regulating Derivatives: A Fundamental Rethinking*, Harvard Law School Forum on Corporate Governance (Feb. 11, 2020), https://corpgov.law.harvard.edu/2020/02/11/regulating-derivatives-a-fundamental-rethinking/ (noting that credit default swaps "that have one or more systemically important counterparties should be regulated").

14. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C.).

15. *Id*. (Imposing further regulatory restraints upon OTC derivatives, under the synonymous term "swaps," in Title VII of the Act).

whistleblower incentives.[16] Yet, banks continued to find means to subvert the system and Congress remained relatively silent on the issue after the passage of Dodd-Frank—failing to amend Dodd-Frank in any meaningful way.[17] Perhaps the Dodd-Frank Act's "Volcker Rule" has beguiled lawmakers who initially intended to prevent future major economic collapse.[18] Looking towards European peers for guidance about how to reform the United States' banking regime has often been discussed but rarely embraced by legislatures.[19] After all, the Volcker Rule's complexity and ambiguity have long been reviled and our European peers have wholly dismissed its viability for solving their own debt woes.[20]

The European sovereign-debt crisis, nearly contemporaneous with the mortgage crisis, imperiled the economies of previously thriving countries.[21] In the wake of the crisis, a group of experts based in Finland

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16. *Id*. (Section 922 of the Act establishes a whistleblower program which pays awards to eligible whistleblowers who assist the SEC with enforcement actions).

17. *See* Broome & Markham *infra* note 47, at 14 (discussing congressional silence on reforming banking laws prior to the enactment of Dodd-Frank); *see also* Eric J. Spitler, *The Long Game: The Decade-Long Effort to Dismantle the Dodd-Frank Act*, 24 N.C. BANKING INST. 1, 69 (2020) ("First, the effort expended in so many different arenas in attacking the Dodd-Frank Act created something of a multiplier effect. For example, congressional letters and hearings elicit responses that provide fodder for judicial decisions, which in turn generate additional congressional hearings, document requests and letters This creates a closed loop of constant attacks on the Dodd-Frank Act. With each attack building on prior attacks, opponents have been able to delay and alter implementation. These delays often extended until a new line of attack presented itself.").

18. One of the few legislative modifications to Dodd-Frank, the Economic Growth, Regulatory Relief, and Consumer Protection Act, failed to meaningfully modify Dodd-Frank—exempting community banks which possess less than $10 billion in assets from the Volcker Rule. Nevertheless, the Act did modify which bank holding companies (BHCs) are to be designated as Systemically Important Financial Institutions (SIFIs). *See* Richard M. Alexander, et al., *Passage of the Economic Growth Act Modifies the Dodd-Frank Act and Provides Other Financial Regulatory Relief*, Arnold & Porter (June 1, 2018), https://www.arnoldporter.com/en/perspectives/publications/2018/06/passage-of-the-economic-growth-act-modifies. (discussing the various changes that the 2018 Act introduced—including the enhanced prudential threshold for Bank Holding Companies and elimination of supervisory stress testing).

19. *Id*.

20. Paul Volcker, himself, said the Volcker rule is "much more complicated than I would like to see." Rachel Armstrong, *Paul Volcker Says Volcker Rule Too Complicated*, REUTERS (Nov. 9, 2011, 7:54 AM), https://www.reuters.com/article/us-regulation-volcker/paul-volcker-says-volcker-rule-too-complicated-idUSTRE7A83KN20111109.

21. *See* Federico Fabbrini, *The Euro-Crisis and the Courts: Judicial Review and the Political Process in Comparative Perspective*, 32 BERKELEY J. INT'L. L. 64, 70–72 (2014) (discussing the origins of the European sovereign-debt crisis in 2009 and providing a timeline of the events that precipitated various European nations' adoption of banking reforms); *see also* Jeffery Atik, *EU Implementation of Basel III in the Shadow of Euro Crisis*, 33 REV. BANKING & FIN. L. 283, 293 (2013) (referring to the European Union's adoption of Basel III reforms, which served as

also released the Liikanen Report.[22] Similar to the Dodd-Frank Act, the Report disavowed universal banking, and proposed a series of regulatory reforms that would compartmentalize risky trading activities and allow banks to enter bankruptcy without requiring a government bail-out.[23]

Likewise, in 2011, the Independent Commission on Banking in the United Kingdom released "The Vickers Report," which specified recommendations for its own banking reforms including a ring-fencing operation imposing similar barriers between retail "utility" banking from investment banking and corporate finance activities.[24] At a glance, ring-fencing separates *high street banks* from *investment banks*,[25] but in reality, the proposition involves a series of requirements. Ring-fenced banks must establish a completely separate legal entity within their corporate group structures to insulate safer retail banking operations from riskier trades. Such separation ensures continuous banking services by ring-fenced banks in the event of broad failure of financial institutions.[26]

Europe's direct response to the European sovereign debt crisis). Basel III, adopted in 2009, and the Dodd-Frank Act, originally published in 2010, served as Europe and the United States' respective responses to their shared economic woes. Section 619 of the Dodd-Frank Act, the Volcker Rule, is specifically at issue here. Comparatively, the Volcker Rule was adopted in 2014 after years of bipartisan discussion on how to curb short-term proprietary trading of securities, derivatives, and commodity futures.

22. Erkki Liikanen et al., HIGH-LEVEL EXPERT GROUP ON REFORMING THE STRUCTURE OF THE EU BANKING SECTOR (2012), available at https://ec.europa.eu/info/publications/liikanen-report_en [hereinafter LIIKANEN REPORT].

23. *Id.* at iii. Universal banking, a system adopted by Switzerland, Germany, the Netherlands, and other European countries, provides a wide variety of comprehensive financial services, including banking activities in the retail, commercial, and investment sectors. *Id.* at 42. Likewise, universal banking has been adopted in the United States—with banks providing commercial and investment services. *See id.* at 84–85 (discussing the Glass-Steagall Act's mandated separation between commercial and investment activities and Gramm Leach Bliley's subsequent modernization of the banking sector, permitting the combination of such activities).

24. INDEP. COMM'N ON BANKING, FINAL REPORT: RECOMMENDATIONS 9–12 (2011), available at https://webarchive.nationalarchives.gov.uk/ukgwa/20120827143059/http://bankingcommission.independent.gov.uk/ [hereinafter VICKERS REPORT].

25. High street banks include Barclays, Royal Bank of Scotland Group (RBS), Lloyds Bank, and HSBC. Akin to the term, "Main Street," which is commonly accepted in the United States, high street banks are everyday banks for typical consumers of financial services. High street banks provide retail banking services to individuals and small- to mid-sized businesses and those seeking loans or liens. Comparatively, investment banks provide banking services to larger institutional entities and charge service fees for complex transactions, including mergers and acquisitions and bond issuances. Examples of UK investment banks include Goldman Sachs and J.P. Morgan.

26. *See generally* MATTHIAS LEHMANN, LSE LAW, SOCIETY AND ECONOMY WORKING PAPERS 25/2014, VOLCKER RULE RING-FENCING OR SEPARATION OF BANK ACTIVITIES: COMPARISON OF STRUCTURAL REFORM ACTS AROUND THE WORLD 2 (2014) [hereinafter

In an effort to increase competition and limit certain financial institutions' ability to capture a disproportionate share of banking activities, the Vickers Report proposed capitalizing on the divestment of Royal Bank of Scotland and Lloyds Banking Groups to create a new bank.[27] The proposed banking reform's paramount goal was to increase transparency and accountability of financial institutions by heightening their oversight. Yet, the drastic reduction in the number of serious competitors within the industry minimized banks' inclination to increase accountability.[28] The UK government unilaterally accepted all of the proposals with only one exception.[29] The government agreed to ring-fencing, depositor preference, specific equity requirements to forge greater separation between high street and wall street, and measures for improved competition, but it did not accept the recommendation regarding the divestment of Lloyds Banking Group. The government argued that such divestment would invariably involve violating European Commission competition laws.[30] While the European Union's banking regime is more tightly regulated due its centralized structure,[31] the regulatory framework can still be imported to the US system.[32] While this Note does not endorse adopting a

LEHMANN] (describing the complexities of ring-fencing provisions); *see also* John Vickers, *Consequences of Brexit for Competition Law and Policy*, 33 OXFORD REV. OF ECON. POL'Y S70, S70 (2017) (noting that Brexit significantly complicated installation of any ring-fencing provisions because regulators in both the United Kingdom and European Union are still grappling how to review international mergers and competition law). These laws were once completely overseen by the EU's regulators. To OCC and SEC regulators' chagrin, such Brexit-related complications cannot be used as any formidable excuse here.

27. VICKERS REPORT, *supra* note 24, at 16.

28. *Id*. at 7; *see also* Kent Matthews et al., *Competitive Conditions Among the Major British Banks*, 31 J. OF BANKING & FIN. 2025, 2027 (2007) (describing the trend towards consolidation and diversification among UK banks which engaged in acquisitions and demutualizations—reducing the amount of banks in the industry).

29. *See generally* Barnabas Reynolds, *The Vickers Report and the Future of UK Banking,* Harvard Law School Forum on Corporate Governance (March 29, 2012) (discussing the various proposals set forth in the Vickers Report and the UK government's response).

30. *Id.*

31. *See generally* EUROPEAN CENTRAL BANK, *ECB's In-Depth Review Shows Banks Need to Take Further Action* (November 4, 2014), *available at* https://www.ecb.europa.eu/press/pr/date/2014/html/pr141104.en.html. Single Supervisory Mechanism, an oversight function of the European Central Bank, serves as the primary authority for supervising banks. The ECB directly supervises the larger banks and indirectly oversees the smaller banks. The European Central Bank oversees significant banks—with 119 entities holding over 82 percent of the assets of the European banking sector. The second pillar is a Single Resolution Mechanism—a self-financed agency with members appointed by the EU Council.

32. The Bank Recovery and Resolution Directive (BRRD), established in 2014 after the Eurozone crisis, provides "comprehensive and effective arrangements to deal with failing banks at national level" and "cooperation arrangements to tackle cross border banking failures." This bank resolution employs the proposed bail-in mechanism to ensure that both banks and creditors

centralized banking regime or any banking directives, it does propose a series of lockstep modifications to current oversight provisions.

The Vickers Report and Liikanen Report provide fertile ground for a series of reforms for United States banking— reforms that increase the chance for resolution and creditor bail-in.[33] This Note will use these two reports as guideposts for reform—adopting and modifying core provisions of both reports to provide banks with a platform for increased oversight over rogue traders. Although this Note finds that the blanket separation of commercial and investment banking activities intrinsic to the Volcker Rule does not serve banks or consumers well; Threshold separation of banking and trading activities with an embedded bail-in mechanism will assist both banks and regulators from major losses stemming from speculative trades. Establishing a threshold for maximizing capital and liquidity can prevent crises in which proprietary trading activities "gone wrong" once again threaten to collapse the market. Part I will explore the evolution of banking regulations within the United States. Part II will address why the Volcker Rule fails to thwart illicit banking activities. Part III considers the European Union's proposals and whether their implementation would be compatible with United States' securities law. Part IV proposes using bail-in debt instruments to assist with the separation of 'speculative activities' from deposit-related and customer-oriented activities. Part V suggests a need for internal controls to ensure that agents are accountable within large financial institutions. Last, Part VI considers the public policy benefits of demystifying banking law by reforming the Volcker Rule. European peers have not shied away from such reforms—neither should the United States.

remain accountable to shareholders. If this bail-in mechanism proves inadequate, the BRRD, set forth parameters to ensure that there be "orderly resolution" for failing banks. The BRRD includes rules to set up a national resolution fund that must be established by each EU country. All financial institutions must contribute to these funds. The contributions are calculated based on institution size and risk profile. In contrast, various agencies oversee the United Stating banking system—including the Federal Reserve Board, Federal Deposit Insurance Scheme, and Securities and Exchange Commission. The Federal Reserve provides the broadest oversight by analyzing the safety and stability of financial institutions. This agency is most akin to the BRRD with its centralized framework. The Federal Deposit Insurance Corporation is funded by premiums paid by banks and small financial institutions—guaranteeing depositor accounts up to $250,000 at any of its member banks. EUROPEAN COMMISSION: FINANCIAL STABILITY, FINANCIAL SERVICES AND CAPITAL MARKETS UNION, *Bank Recovery and Resolution* (Apr. 30, 2019), https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/bank-recovery-and-resolution_en.

33. VICKERS REPORT, *supra* note 24, at 13; *see also* LIIKANEN REPORT, *supra* note 22, at iii (recommending that banks have resolution plans and use bail-in instruments).

I. A BRIEF HISTORY OF BANKING REGULATION

This section will explore why the US banking system is ripe for change through a historical overview of regulatory changes shaping the interactions between investment and commercial banks. While the breadth of financial institutions has greatly expanded since the 1930s, policy reforms have largely involved volleying between complete separation of *investment* and *commercial* banking activities—leading to confusion among politicians and laymen alike.[34] In 2017, then-President Trump articulated a need for change within the United States banking system. Speaking on the subject, former President Trump said, "[s]ome people . . . want to go back to the old system, right? So we're going to look at that."[35] Though not completely clear, Trump's reference to the "old system" seems to refer to the banking structure established by the Glass-Steagall Act of 1933, which completely separated commercial and investment banking.

Yet, at the same time, Senator Elizabeth Warren crafted a bill entitled, "the 21st Century Glass-Steagall Act,"[36] advocating for an overhaul of several banking acts.[37] Most notably, the Act proposed restricting financial holding companies from engaging in nonfinancial activities.[38] Likewise, Senator Warren sought to prohibit foreign banks from engaging in nonbanking activities in the United States and disallow the national banking association from purchasing or selling securities, stocks, or other financial products or controlling or holding any interest in a financial subsidiary.[39]

34. Jennifer Jacobs & Margaret Talev, *Trump Weighs Breaking Up Wall Street Banks, Raising Gas Tax,* BLOOMBERG (May 1, 2017, 10:23 AM), https://www.bloombergquint.com/politics/trump-says-he-s-considering-moves-to-break-up-wall-street-banks.

35. *Id*.

36. 21st Century Glass-Steagall Act of 2017, S. 881, 115th Cong. (2017).

37. *E.g.* Federal Deposit Insurance Act, 12 U.S.C. 1831a (1994 & Supp. IV 1998); Bank Holding Company Act of 1956, 12 U.S.C. 1841(k) (1994), International Banking Act of 1978, 12 U.S.C. § 3101.

38. 21st Century Glass-Steagall Act of 2017, S. 881, 115th Cong. §§ 5(c), 4(c) (2017). All of this to say—banks, stay in your lane. In addition to the 21st Century Glass-Steagall Act, Warren has been a leading proponent of reigning in rogue traders' behaviors by introducing legislation, the Ending Too Big to Jail Act, which makes it substantially easier to investigate senior executives for fraud.

39. *See* Press Release*,* Senators Cantwell, Warren, McCain, and King Introduce 21st Century Glass-Steagall Act (April 6, 2017), https://www.cantwell.senate.gov/news/press-releases/senators-cantwell-warren-mccain-and-king-introduce-21st-century-glass-steagall-act.
The bill would create a permanent investigative unit for financial crimes, require big bank certifications, and mandate judicial oversight of deferred prosecution agreements. As the creator of the Consumer Protection Financial Bureau, Warren, to Republican lawmaker's dismay, is

Senator Warren, however, did not advocate for the same notion of a return to Glass-Steagall, as President Trump incorrectly implied in previous statements.[40] President Trump, while proclaiming a need for change, actually implemented policies that ran counter to this declaration. The Trump Administration modified regulations pertaining solely to small banks and effectively deregulated them while ignoring the real problem—what to do with the big banks.[41] In response to Trump's confusion about the changes inherent in returning to the "old system," Margaret Tahyar, a partner at Davis Polk who often represents these banks, put it wonderfully: "[t]hey all use the words 'Glass-Steagall,' but they have nothing in common with each other. We're talking about a fish, a bird and a reptile."[42] So, how do we reconcile these differing conceptions of Glass-Steagall? An analysis of the historical debate about how much regulation is too much provides an ideal starting point.

A. The Gramm Leach Bliley Act

Congress' passage of the Gramm Leach Bliley Act of 1999[43] repealed Glass-Steagall's requirement that commercial and investment banking activities be strictly separated.[44] The 1980s and 1990s saw reforms of the Glass-Steagall provisions—allowing "bank holding

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perhaps the most authoritative figure paving the way for reforms—and her proposals have received broad bipartisan support. In fact, the 21st Century Glass-Steagall Act was introduced not only by Warren, but also former Senator John McCain (R-AZ), Senator Maria Cantwell (D-WA), and Senator Angus King (I-ME).

40. Matt Egan, *Trump Wants to Revive a 1933 Banking Law: What that Means is Very Unclear*, CNNMONEY (May 9, 2017, 2:42 PM), https://money.cnn.com/2017/05/09/investing/donald-trump-glass-steagall/index.html.

41. Jacob Pramuk, *Trump Signs the Biggest Rollback of Bank Rules Since the Financial Crisis*, CNBC (May 24, 2018,7:45 PM), https://www.cnbc.com/2018/05/24/trump-signs-bank-bill-rolling-back-some-dodd-frank-regulations.html.

42. *Id*.

43. The Gramm Leach Bliley Act was not the first revision of the Glass Stegall Act. The Banking Act of 1935 clarified the 1933 legislation by resolving several internal inconsistencies. These revisions included provisions limiting banks' dealings in non-governmental securities for customers and their ability to invest in non-investment grade securities for themselves. Additionally, the regulations specifying the underwriting processes non-governmental securities and permissible affiliations with corporations were detailed. The Bank Holding Company of 1956, the last legislative reform before the Gramm Leach Bliley Act, was imposed a failsafe for the banking industry after the financial woes following World War II. The law prohibited a bank holding company from engaging in non-banking activities. This reform is still law today and forms the basis for the type of supervision endorsed in this Note. After these modifications, the state of the law remained relatively stagnant—mostly due to partisan division on the issue. It is therefore, no surprise, that lawmakers remain reticent to engage in an overhaul of banking.

44. Gramm-Leach-Bliley Financial Services Modernization Act of 1999, Pub. L. No. 106-102, §101(a), 113 Stat. 1338, 1341 (codified as amended in scattered-sections of 12 and 15 U.S.C.).

companies [such as] Bankers Trust, Citicorp, and J.P. Morgan to establish subsidiaries for underwriting and dealing in residential mortgage-backed securities, municipal revenue bonds, and commercial paper."[45] The decision catalyzed a period of continued deregulation—allowing ties to be formed between commercial banks and securities affiliates.[46] Combined with other deregulation measures,[47] the Gramm Leach Bliley Act allowed banks to affiliate with a variety of other financial service providers—including securities firms, mutual funds, and merchant banking firms.[48] Banks may hold financial instruments if they illustrate that the trading activities are directed at minimizing risk, and there is no showing of proprietary trading.[49]

The challenges in distinguishing between proprietary trading and market-making activities were unanticipated by the drafters of the Gramm Leach Bliley Act. When crafting the Act, Congress primarily intended to "modernize" the financial services industry by providing limited privacy protections against the selling of private financial information,[50] and end regulations that prevented the merger of banks. Once these banks merged, enormous amounts of personal data became consolidated within fewer institutions with the newly vested ability to analyze and sell personal details of customers.[51] To safeguard against the dissemination of this personal information, the GLBA included provisions to protect personal data.[52] The most consequential effect of

45. Jan Krahnen et al., *Structural Reforms in Banking: The Role of Trading*, 3 J. OF FIN. REG. 66, 75 (2017) [hereinafter *Structural Reforms in Banking*] (alteration in original).

46. *Id*.

47. *See generally* Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act,* 25 J. CORP. L. 723 (2000) (discussing the evolution of the Gramm-Leach-Bliley Act and Congress's reluctance to adopt other regulations for financial services).

48. Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. REV. 195, 211 (2000).

49. Gramm-Leach-Bliley Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered-sections of 12 and 15 U.S.C.).

50. Shockingly, such information was, and continues to be, sold: including bank balances and account numbers—which are regularly bought and sold by banks, credit card companies, and other financial institutions.

51. *See* Steve Culp, *For Banks, Safeguarding Consumer Privacy is More Important Than Ever,* FORBES (Apr. 16, 2020, 10:32 AM), https://www.forbes.com/sites/steveculp/2020/04/16/for-banks-safeguarding-consumer-privacy-is-more-important-than-ever/?sh=43d975c353ef (discussing the secondary effects of Gramm-Leach Bliley on data privacy).

52. Gramm-Leach-Bliley Financial Services Modernization Act of 1999, Pub. L. No. 106-102, §§ 501–503, 113 Stat. 1338, 1436–39 (codified as amended in 15 U.S.C. 6801, 6802, 6803). "[B]anks . . . must securely store personal financial information. Second, they must advise you of their policies on sharing of personal financial information. Third, they must give consumers the option to opt-out of some sharing of personal financial information." *The Gramm-Leach-Bliley Act*, EPIC.ORG, https://epic.org/privacy/glba/ (last visited Oct. 18, 2021).

the Act for banks, however, was language in the GLBA that permitted banks to engage and affiliate with securities firms, which was previously forbidden by the Glass-Steagall Act.[53] Likewise, the Act expanded permissible activities for certain banks. One key provision, the creation of financial holding companies, authorized eligible bank holding companies to engage in any activity that is, "financial in nature or incidental to financial activities,"[54] and activities that the Federal Government defines as "complementary to a financial activity" and do not pose undue risks to the financial system.[55]

1. The Net Capital Rule

Over time, the Securities and Exchange Commission began to weaken the sharp divisions between banking and trading activities once mandated by Glass-Steagall. First, the SEC loosened the net capital rule, which specified the bare minimum amount of liquid assets, or net capital, a firm must hold to ensure the firm has sufficient capital to liquidate.[56] Broker dealer subsidiaries would then house the riskier debt instruments such as derivatives and mortgages.[57] Second, the SEC required increased reporting compliance from holding companies—forcing them to report their capital adequacy in a way that was consistent with international reporting standards and to discount their

53. *See e.g.*, Mitchell Martin, *Citicorp and Travelers Plan to Merge in Record $70 Billion Deal: A New No. 1: Financial Giants Unite,* N.Y. TIMES (April 7, 1998), https://www.nytimes.com/1998/04/07/news/citicorp-and-travelers-plan-to-merge-in-record-70-billion-deal-a-new-no.html. Glass-Steagall followed in the wake of Citicorp attempting to merge with the Travelers Group, which had itself merged with Solomon Brothers.

54. 12 C.F.R. § 225.86 (2019). The exhaustive list of activities that are "financial in nature" include: "lending, exchanging, transferring, investing for others, or safeguarding money or securities, all existing activities approved for bank holding companies as 'closely related to banking,' insuring, guaranteeing or indemnifying against loss, harm, damage, illness, disability or death, or providing and issuing annuities, and acting as principal, agent or broker for purposes of the foregoing, in any state providing financial, investment or economic advisory services, including advising an investment company, issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly, underwriting, dealing in or making a market in securities, and certain merchant banking activities." *The Gramm-Leach Bliley Act: What's in it for Banks and Thrifts*, FINDLAW FOR LEGAL PROFESSIONALS (Mar. 26, 2008), https://corporate.findlaw.com/finance/the-gramm-leach-bliley-act-what-s-in-it-for-banks-and-thrifts.html Basically, anything related to the Bank could be defined as "financial" or "complimentary to financial activities. *Id.* It is not difficult to see how risk managers at banks could get creative with interpreting this lingo.

55. 12 U.S.C. § 1843(k)(1)(B) (2018).

56. 17 C.F.R. Part 240.

57. *See Division of Trading and Markets Broker-Dealer Net Capital and Books and Records Guidance*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/divisions/marketreg/bdnetcapital.htm (last accessed Oct. 18, 2021) (listing the plethora of requirements for broker-dealers in the United States banking industry).

assets for market, credit, and operational risks.[58] The SEC had assumed responsibility of regulating Wall Street's holding companies, hence giving them greater latitude to deregulate the industry.[59] Previously, the SEC only micro-managed the broker-dealer subsidiaries within them. Likewise, broker-dealers and investment banks were limited to a 12-1 leverage ratio prior to the financial crisis.[60]

2. Leverage

Leverage, the ratio of debt or assets to equity, and leveraging, its associated practice, allows a business to fund its assets with borrowings rather than equity.[61] Lehman Brothers 31:1 leverage led to their untimely demise.[62] For every $31 in debt, there was $1 in equity[63]—leaving Lehman with only a minimal amount of cash set aside for losses or heavy outflows.[64] The over-leveraging primarily stemmed from Lehman Brothers' unsavory investments in mortgage-based securities and imprudent underwriting decisions.[65]

As the leverage ratio increases and a bank's equity relative to debt decreases, banks assume greater risk and take on ever-increasing debt to fund lending.[66] With bail-in mechanisms, the banks would bear the risk; under bail-outs, the government bears the risk. U.S banks are subject to a balance sheet leverage ratio requirement—compelling them to maintain a ratio of tier 1 capital to balance sheet assets at a minimum level of 4 percent.[67] To qualify as a "well-capitalized bank," banks must achieve a 5 percent supplemental leverage ratio.[68] The more

58. *Structural Reforms in Banking*, *supra* note 45, at 68.

59. *Id.* at 66.

60. *See* William D. Cohan, *How We Got the Crash Wrong*, THE ATLANTIC (June 2012), https://www.theatlantic.com/magazine/archive/2012/06/how-we-got-the-crash-wrong/308984/ (noting the pre-financial crisis cap on leveraging which was ultimately foiled by Lehman's 33:1 leverage ratio).

61. Karen Berman & Joe Knight, *Lehman's Three Big Mistakes*, HARV. BUS. REV. (Sept. 16, 2009), https://hbr.org/2009/09/lessons-from-lehman.html.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* In the case of the MBSs, when it was revealed that the assets used as collateral for those mortgage-backed securities were worth a lot less than they thought, the MBSs became worthless and Lehman Brothers' spread went from positive to negative. *Id.* In balance sheet terms, Lehman Brothers started with a balance sheet in which they owned more than they owed. *Id.*

66. *See id.* ("[T]he bias to use high levels of financial leverage to increase returns, combined with risky debt-to-equity ratios and upside-only bonuses, was a recipe for disaster.").

67. DAVID W. PERKINS, CONG. RSCH. SERV., IF10809, INTRODUCTION TO BANK REGULATION: LEVERAGE AND CAPITAL RATIO REQUIREMENTS 1 (2019).

68. *Id.* Basel III established a 3 percent minimum requirement for the Tier 1 leverage ratio but did not specify whether the threshold should be increased for large financial institutions. In

telling figure, the leverage ratio itself, deserves greater attention. While the SLR indicates a bank is maintaining a strong market position, the leverage ratio itself is highly misleading.[69] Banks like Bear Stearns masked their true leverage levels with securitized debt and off-balance sheet devices to conceal their collaterized debt obligations.[70] The 2004 changes to the net capital rule enabled this over-leveraging that ultimately contributed to the 2008 financial crisis.[71]

In 2004, the Securities and Exchange Commission modified the net capital rule in a variety of ways: instituting risk-based weighing which reduced capital requirements for A-level securities,[72] assuming the responsibility of regulating holding companies, and requiring holding companies to change their reporting standards to conform to European capital adequacy standards—discounting assets for market, credit, and operational risks.[73]

2014, the Federal Reserve Board, the Office of the Comptroller released regulatory capital rules which instituted higher leverage ratios for large banks (effective as of January 1, 2018). Bank holding companies retaining more than $700 billion in consolidated assets or more than $10 trillion in assets under management must maintain a 2 percent buffer—hence a requirement that banks maintain 5 percent of liquid capital for its total leverage exposure. Without diving into the mathematical formulations employed by the FDIC, A high debt-to-equity ratio shows that a bank is engaging in aggressive financing its activities with debt.

69. *See id.* at 2 ("In addition, a leverage ratio alone may not accurately reflect a bank's riskiness because a high concentration of risky assets could produce a similar ratio as a high concentration of safe assets").

70. Cohan, *supra* note 60 (describing explanations of the 2008 crash involving debt leverage and the collapse of institutions including Bear Stearns).

71. *See* John Carney, *The SEC Rule That Broke Wall Street,* CNBC (Mar. 21, 2012), https://www.cnbc.com/id/46808453 ("Legend has it that a 2004 change to a rule governing capital adequacy at Wall Street firms allowed broker-dealers to double their leverage, making them highly fragile and likely to fail in a crisis.")

72. *See id.* (explaining the intricacies of the 2004 amendment and the resulting impact on Wall Street's broker dealers).

73. *SEC Regulation of Investment Banks: Testimony before the Financial Crisis Inquiry Commission*, 111th Cong. 3-4 (2010) (testimony of Prof. Erik Sirri, Babson College) [hereinafter Sirri Testimony]. In response to broad criticism that changing the net capital rule led to over-leveraging, Erik Sirri, the former Director of the SEC's Division of Trading and Markets, stated "[t]he Commission did not undo any leverage restrictions in 2004." While the SEC rule did provide flexibility for banks to manipulate their capital balances, Sirri argued that the rule modifications were not to blame. The five financial institutions which significantly over-leveraged had actually calculated capital requirements as a percentage of customer receivables, rather than based on their investments. This argument fails to reach the greater issue—the loosened capital adequacy requirements led to lax monitoring standards for Wall Street and increased methods for broker-dealers to conceal their losses. The rule fundamentally changed the way that broker-dealers could calculate their net capital. Sirri admitted this in the same statement. "But the rule did change the way that broker-dealers were allowed to calculate their net capital; in other words, it changed the way you calculate the denominator. In fact, Sirri concedes this." James Kwak, *What Did the SEC Really Do in 2004?* THE BASELINE SCENARIO (Jan. 30, 2012), https://baselinescenario.com/2012/01/30/what-did-the-sec-really-do-in-2004/. While the formulaic

From 2004 to 2008, Bear Stearns' leverage went from 12-to-1 in 2004 to 33-to-1 in 2008.[74] A 33-to-1 leverage ratio equates to "a mere 3 percent drop in the value of a firm's assets [which] can wipe out its equity."[75] Therefore, the risks posed to the bank for lending with such high leverage were considerable. A minor financial blow to the bank in a situation in which the financial institution was not over-leveraged could have minimal consequences.[76] Conversely, the high ratio of debt leveraging combined with an adverse liquidity event could yield enormous consequences—banks could easily flounder under the weight of these mounting debts.[77]

In 2007, the housing bubble burst in the aftermath of years of predatory lending. As emphasized by leading economist Paul Krugman, the only element common among the residential and commercial bubbles—*leverage*—was to blame.[78] Debt leveraging reached new heights with banks administering funds to unwitting consumers seeking loans for their homes.[79] As banks continued to over-leverage, the SEC and international regulators only exacerbated the situation—willingly reducing bank capital requirements that would have otherwise limited borrowing activities.[80] This toxic combination of circumstances and government laxity led to soaring leverage ratios and unanticipated debt levels among consumers.[81]

changes are not relevant to this note, the lack of administrative oversight is—Wall Street is comprised of traders who are attuned to rule modifications and the ways to manipulate capital and satisfy unenforced standards.

74. *See* Cohan, *supra* note 60 (noting that leverage "went from about 12-to-1 in 2004 to 33-to-1 in 2008").

75. *See id.* (discussing a theory of the financial impact of increases in leverages).

76. *See id.* (describing a narrative of the financial crisis that significant increases in leverage "on the balance sheets of Wall Street firms" left "virtually no margin for error.")

77. *See id.* ("In an August 2008 essay in *American Banker*, Pickard lambasted the 2004 change, which he believed allowed Bear Stearns to incur 'high debt leverage' without 'substantially increasing [its] capital base'" (quoting Lee A. Pickard, *Viewpoint: SEC's Old Capital Approach Was Tried – And True*, 173 AMERICAN BANKER 10 (2008)).

78. *See* Paul Krugman, *Bubbles and the Banks*, NY TIMES (Jan. 7, 2010), https://www.nytimes.com/2010/01/08/opinion/08krugman.html (explaining that stock bubble created risk and that "[b]y increasing leverage that is, [sic] by making risky investments with borrowed money banks could increase their short-term profits").

79. Due to the scope of this Note, the intricacies of the residential mortgage-backed securities crisis will not be explored, yet, it is imperative to note that home buyers had been permitted to take out mortgages with minimal down payments.

80. *See* Kwak, *supra* note 73 ("A major benefit for the broker-dealer will be lower deductions from net capital for market and credit risk that we expect will result from the use of the alternative method. . . taking advantage of the alternative capital computation would realize an average reduction in capital deductions of approximately 40 percent.").

81. *Id.*

Secretary of the Treasury Janet Yellen and other economists have posited that leveraged loans and CLOs are unlikely to be the next catalyst of the banking crisis.[82] Though this may be the case, "[b]anks are counterparties to these nonbanks in all kinds of transactions."[83] Over-leveraging promises to be the fatal flaw in the existing Volcker framework—nonbanks, including retail entities, can still engage in proprietary trading activities. Leveraging is a symptom, not the problem.

B. The Volcker Rule: An Exercise in Overreach

1. Volcker's Framework

Lawmakers surmised a solution to over-leveraging and risky trading—more legislation. In 2008, the United States Congress crafted its answer to the financial crisis—the Volcker Rule. The Volker Rule represents a futile legislative attempt to reform the banking system.[84] In fact, the only three bright-line rules established were the default prohibitions on banking activities that are clearly delimited in the text: "(i) banks are prohibited from any 'high-risk' asset trading, (ii) banks are not allowed to engage in any trading activities which might incur material conflict of interest', and (iii) all compensation schemes must be designed to deter proprietary trading."[85] This Note suggests that Volcker, and the Dodd-Frank Act as a whole, fail the US banking system with blanket prohibitions on proprietary trades.[86] Unlike the European Union and United Kingdom's rules that permit trading activities and deposit-taking activities to be conducted by separate members within the same banking group, the Volcker Rule prohibits proprietary trading from being carried out by any of the entities in the

82. Sunny Oh, *Here's Why the Fed and Global Regulators are Ringing the Alarm over Leveraged Loans and CLOs*, MARKETWATCH (Mar. 12, 2019), https://www.marketwatch.com/story/heres-why-the-fed-and-global-regulators-are-ringing-the-alarm-over-leveraged-loans-and-clos-2019-03-12.

83. *Id.* (explaining that "regulators are worried their relationships with nonbank players can play out in unpredictable ways").

84. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C.) (amending 12 U.S.C. 1851 to place "prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds").

85. *Structural Reforms in Banking*, *supra* note 45, at 75–76.

86. *See generally Final Volcker Rule Regulations, Flowcharts*: Funds, DAVIS POLK (Jan. 6, 2014), https://www.davispolk.com/files/Davis.Polk.Final.Volcker.Rule_.Flowcharts.Funds_.pdf [https://perma.cc/795Q-RHQH] (providing flowcharts summarizing key prohibitions and permissible activities under the Volcker Rule).

banking group.[87]

2. Volcker's Market-Making Exception

Congress embedded an exemption relating to "certain market making-related activities" from the Volcker Rule.[88] Such exemptions must be removed to prevent trading schemes like the London Whale trades from re-occurring. Even though market-making ensures liquidity of assets and provides stability to financial markets,[89] the exemption makes the line between proprietary trading and market-making itself unclear. The Volcker Rule expressly prohibits banking entities from engaging in proprietary trading, which occurs within trading accounts.[90] The Rule defines these illegal trades, noting that their purpose is to, "acquire or take one or more covered financial positions: . . . principally for the purpose of (1) [s]hort term resale (2)[b]enefiting from actual or expected short-term price movements, (3) [r]ealizing short term arbitrage profits; or (4) [h]edging . . . ."[91]

The Volcker Rule permits market-making related hedging transactions so long as the institutions engaging in such behavior abide by a series of requirements.[92] While most of the procedural requirements dictate compliance programs and compensation arrangements, banking entities can engage in market-making related hedging if the covered financial position "reduces a specific risk in connection with related individual or aggregated positions" and is one of the "permitted risk-mitigating hedging activities as outlined in

87. *Id.*

88. *Id.* at 26.

89. *See* Bryan Settelen, *VIII. The Volcker Rule's Market Making Exemption*, 31 REV. BANKING AND FIN. L. 556, 556 (2012) ("Market making plays an important role in providing liquidity and stability to financial markets . . . .").

90. *Id.* at 558 (quoting Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,945 (Nov. 7, 2011) (to be codified in 12 C.F.R. pts. 44, 248 & 351 & 17 C.F.R. pt. 255)). The statute defining "account" considers an "account" a "trading account" if the banking entity holds a covered financial position for sixty days or less. Conversely, Congress defines a trading account as an account "used for acquiring or taking positions." The differing definitions of trading accounts lay the groundwork for even more vastly dissimilar conceptions of proprietary trading. The Volcker classifies only principal trading in a trading account as prohibited proprietary trading while Congress recognized that banking entities must be able to freely engage in client-oriented financial services and exempted principal trading for specific services.

91. Settelen, *supra* note 89, at 558 (quoting Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68,945, §_.3(b)(2)(i)(A)-(C) (Nov. 7, 2011) (to be codified in 12 C.F.R. pts. 44, 248 & 351 & 17 C.F.R. pt. 255).

92. *Id.* at 560.

proposed regulations."[93]

Nevertheless, while this Note does not find that Volcker's exception is especially problematic,[94] it does find the 2013 Rule change[95] to be a step in the wrong direction. The 2013 modification removed the requirement that banking entities that rely on the risk-mitigating hedging exemption must perform correlation analysis to illustrate that the risk-mitigating hedging activity demonstrably reduces or otherwise significantly mitigates the specific risks being hedged.[96] The rule also eliminated compliance requirements, compensation restrictions, and documentation requirements for the activities of a banking entity with consolidated gross trading assets and liabilities of less than $10 billion to qualify for the risk-mitigating hedging exemption.[97]

3. Volcker's Compliance Problems

In 2020, the Federal Reserve approved the Trump Administration's "Volcker 2.0" that softened some requirements—including simplifying the methodology for determining which types of trades are permitted and which are not, and eliminating a 3 percent cap on ownership of a venture capital fund.[98] The revamped rule would also permit banks to

93. *Id.* at 561.

94. *See* John Ramsay, Acting Dir., Sec. and Exch. Comm., Div. of Trading and Mkts, Remarks on the Volcker Rule's Market Making Exemption (Feb. 4, 2014) [hereinafter Ramsay Statement] (arguing "[m]arket making is of course critical to the function that broker-dealers perform in supplying liquidity and helping to raise capital. To me, that means, at a minimum, that the agencies were tasked with trying to implement the exemption in a way that honors the general proprietary trading ban, but preserves the public benefit that comes from active participation by banking entities in supplying liquidity to the securities and derivatives markets"). Ramsay's conclusion is correct—market-making is a fundamental element of United States' banking activities. It likewise is a core element of banking in Germany, Italy, France and other developed economies. Their reforms have not touched the issue. Neither should this one. Ramsay's reticence to excise the market-making exemption from the Volcker Rule, contrasted with his enthusiasm for public policy reforms such as hard risk limits on trading activities and increased internal controls illustrates that these two objectives are not incompatible—lending credence to the idea that the 2013 reforms were a step in the wrong direction.

95. *See* 17 C.F.R. § 75.1(b) (2019) ("This part implements section 13 of the Bank Holding Company Act by . . . establishing prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds, and further explaining the statute's requirements."); *see also* Memorandum from the Staff of the Bd. of Governors of the Fed. Res. Sys. Seeking Approval of the Volcker Rule Regulations to the Bd. of Governors 2 (Dec. 9, 2013) (on file with author), available at http://www.federalreserve.gov/aboutthefed/boardmeetings/board-memo-volcker-20131210.pdf (describing the requirements of the draft final rule).

96. *See* Lee Meyerson & Keith Noreika, *Finalized Changes to Volcker Rule*, Harvard Law School Forum on Corporate Governance (September 12, 2019), https://corpgov.law.harvard.edu/2019/09/12/finalized-changes-to-volcker-rule/.

97. *See generally id.*

98. Jesse Hamilton, *Banks Get Easier Volcker Rule and $40 Billion Break on Swaps (4)*,

invest in debt-based funds. Volcker 2.0, however, did not respond to the banking industry's requests.[99] In its letter dated March 2020, Goldman Sachs Group Inc. pressed regulators to eliminate certain Volcker provisions that have "restricted our ability to invest in certain incubator companies that provide capital and 'know-how' to startup companies and entrepreneurs."[100] The Federal Reserve and Trump Administration failed to respond to such a request.[101] The only way to satisfy such a request is to isolate the trading entity—a proposition unilaterally rejected by the Trump Administration, but embraced by both the United Kingdom and European Banking Union.

Volcker was crafted as a response to the high frequency of proprietary trades and the recent failures of Lehman Brothers and AIG.[102] At nearly the same time as the mortgage-backed securities crisis in the United States, the European Union suffered a very similar setback within its own cross-border banking industry. Some banks[103] had to go so far as to apply for emergency liquidity aid from the Bank of England in September of 2007.[104] Termed the "Eurozone" debt crisis, the crisis imperiled the entirety of the European banking structure.[105]

A prolonged political process ensued to proverbially "rescue" Greece, Ireland, and Portugal; restore market confidence; and revive the European banking sector.[106] Institutional investors liquidated their

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BLOOMBERG LAW (Jun. 25, 2020, 4:56 pm), https://news.bloomberglaw.com/banking-law/banks-get-easier-volcker-rule-and-40-billion-reprieve-on-swaps.

99. *Id.*; *see also* Volcker Rule Update: Final Rule Includes New Exclusions from the Definition of "Covered Fund", SEWARD & KISSEL LLP (July 28, 2020), https://www.sewkis.com/publications/volcker-rule-update-final-rule-includes-new-exclusions-from-the-definition-of-covered-fund/(describing the impact that the Trump Administration's modifications to the Volcker Rule had on various market caps).

100. Hamilton*, supra* note 98 (noting that Goldman Sachs' letter was unpersuasive to the federal government).

101. *Id.*

102. *See* Hal S. Scott, The Reduction of Systemic Risk in the United States Financial System, 33 HARV. J.L. & PUB. Pol'y 671, 677 (2010) (explaining that "The Volcker Rules would prohibit bank holding companies and all of their subsidiaries from engaging in proprietary trading" and listing AIG and Lehman as a "prominent failure of the financial crisis").

103. *See* José Vinãls et al., *Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?*, at 21, IMF SDN/13/4 (May 14, 2013) [hereinafter Vinãls SDN] (naming Northern Rock, Royal Bank of Scotland, Hypo Real Estate-Depfa and the German Landesbanken).

104. *See id.* (noting that "[i]n some cases—for example, Northern Rock—leverage was a function of weaknesses in the definition of capital as subordinated debt took the place of common equity in large amounts. In others—for example, RBS—it was a function of pre-crisis acquisitions that resulted in expansion of undercapitalized trading exposures.").

105. *See generally* Mark Copelovitch et al., *The Political Economy of the Euro Crisis*, 49 COMP. POL. STUD. 811 (2016).

106. *Id.* at 821–822.

holdings of financial stocks and were reluctant to invest in European bank shares.[107] The Eurozone had encountered the perfect storm of undesirable financial events—a balance-of-payments crisis, coupled with the inability to fall back on devaluation, the dwindling financial stability of many European states within an increasingly globalized economy, and most importantly high-risk lending and borrowing practices.[108] Having dealt with such a nightmarish turn of events, European Central Bank members looked for answers. Erik Liikanen, the Governor of the Bank of Finland and a council member of the European Central Bank, put forth a proposal carefully crafted to learn from the past mistakes of the European Debt Crisis and set forth structural reforms to address the next move for banks deemed "Too Big to Fail."[109]

II. LIIKANEN AND VICKERS AS A BASIS FOR REFORM

A. The Key Provisions of Liikanen

The Liikanen Report, created by a high-level expert group in the EU, provides structural reforms to make the EU banking sector more resilient to crises.[110] This Note endorses Liikanen's novel proposition for separation between proprietary trading and high-risk activities, without ring-fencing—illustrating how *intervention* rather than *insulation* mechanisms can be effective tools for mitigating risk. The Liikanen Report's plan to separate trading activities from speculative activities, including a bank's deposit-taking activities, presents an innovative method for emerging from a debt crisis with strengthened internal and external controls.[111] Under the Liikanen Report's proposed division of assets, several investment vehicles would be strictly separated: "loans, loan commitments, or unsecured credit

107. LIIKANEN REPORT, *supra* note 22, at 8. "By 2010, many institutional investors had completely liquidated their holdings of financial stocks and were reluctant to invest in European bank shares. They considered banks as too complex, insufficiently transparent and with uncertain future cash flows." *Id.*

108. Copelovitch et al., *supra* note 105, at 817.

109. *See* LIIKANEN REPORT, *supra* note 22, at iii ("The Group recommends a set of five measures that augment and complement the set of regulatory reforms already enacted or proposed by the EU, the Basel Committee and national governments.").

110. *Id.* at i.

111. *See id.* at 107 ("The restriction of speculative risk-taking and the limitation of the use of guaranteed deposits to fund or subsidise significant trading activities facilitate the supervision of the largest and most complex banks within a Single Supervisory Mechanism and facilitate the closer linking of deposit guarantee schemes by limiting the risks insured by those schemes.").

exposures to hedge funds, . . . SIVs and other such entities of comparable nature, as well as private equity investments" would be "assigned to the trading entity."[112] Essentially, Liikanen prohibits global systemically important institutions, or any financial institution that maintains a balance sheet with robust assets or significant proprietary trading activities that cross a predetermined threshold, from carrying on proprietary trading.[113]

The United States banking regulatory structure is ripe for change. Adopting the Liikanen proposal's core measures to restrict proprietary trading and other high-risk lending activities could greatly mitigate rogue traders' ability to manipulate both investment and retail activities. The Liikanen Report proposes that:

> proprietary trading and all assets or derivative positions incurred in the process of market-making, other than the activities exempted below, must be assigned to a separate legal entity, which can be an investment firm or a bank (henceforth the 'trading entity') within the banking group.[114]

To best explain the foundational elements of Liikanen and how key provisions of Liikanen can be applied to the United States banking system, several forms of separation must be employed. First, the Liikanen Group proposed that, to address proprietary trading, speculative trades must be wholly separated from commercial activities. The Group put forth a threshold-based approach which this Note endorses.[115] This separation would only apply to "big banks"—as big banks are the only financial institutions with a large enough volume of trading activities to wield a significant impact on national economies.[116] The Liikanen group suggested that the mandatory separation proceed in two stages. This Note endorses the two-step approach with only slight modifications. In the first stage, regulators must determine whether a bank's assets qualify for separation based on their asset volume.[117] The threshold endorsed by Liikanen articulates that "if a bank's assets held for trading and available for sale, as currently defined, exceed (1) a relative examination threshold of 15-25 percent of the bank's total

112. *Id.* at 101.
113. *Id.*at v.
114. *Id.*
115. *Id.*
116. *See id.* (providing that "mandatory separation applies to all banks for which the activities to be separated are significant, as compared to the total balance sheet" and that "the smallest banks" are exempt).
117. *Id.*

assets or (2) an absolute examination threshold of €100 billion, the banks would advance to the second stage examination."[118] Applied to the United States, the same threshold— €100 billion in trading assets or $120 billion—could be used to evaluate whether the bank qualifies as a "big bank."[119] Though the responsibility of determining whether banks meet the threshold is vested in the European Banking Commission, the United States' counterpart, the Securities and Exchange Commission, would be responsible for determining whether that particular bank qualifies for separation. The Liikanen proposal recommends that once a bank exceeds the threshold, all trading activities should be transferred to a "legally-separate trading entity."[120]

Second, in line with the Liikanen proposal, the legally-separate deposit bank and trading entity can survive within a bank holding company structure, but the deposit bank itself must be "sufficiently insulated"[121] from the risks of the trading entity.[122] The European Banking Commission's threshold-level inquiry can be directly applied to the United States' banking infrastructure with the proper oversight of the Securities and Exchange Commission—doing so will greatly reduce the burden on regulators to decipher whether speculative trades are occurring while mitigating risk among small and large banks.

B. Liikanen's Threshold Level Inquiry for Separation

Liikanen recognizes the significance of maintaining both high net capital and high liquidity—a challenge for most financial institutions. Banks, distinctive in that they carry little equity compared to other institutions, maintain special capital structures that can expose them to

118. *Id.*

119. *See Structural Reforms in Banking, supra* note 45, at 14 (discussing the threshold *de minimis rule* relating to the absolute size of the bank in terms of assets in its trading book under the Volcker Rule). The threshold established by Liikanen also establishes 15-25 percent of total assets as a baseline. LIIKANEN REPORT, *supra* note 22, at v. For the purposes of this note, and because volume-based thresholds would be more challenging to apply to US bank regulations, the trading threshold in dollars is endorsed.

120. LIIKANEN REPORT, *supra* note 22, at v.

121. *Id.* By "sufficiently insulated," Liikanen does not propose that banks be insulated by ring-fencing. *See id.* (proposing the insulation revolve around strategic limitations on banks which meet a high net capital threshold). Even with insulation, the deposit bank and trading entity would be permitted to operate within the same banking group. *See id.* ("The legally-separate deposit bank and trading entity can operate within a bank holding company structure. However, the deposit bank must be sufficiently insulated from the risks of the trading entity.") (emphasis omitted).

122. *Id.*

failure.[123] Receiving 90 percent of their capital funding from debt, banking institutions in the United States hold debt "in the form of transaction accounts, which are payable on demand at par and are readily transferable by the accountholder to third parties."[124] Thus, readily transferable accounts create a toxic concoction of highly liquid liabilities and illiquid assets.[125]

During the second stage of separation, both the trading entity and the deposit bank would have to be separately capitalized—requiring capital buffers could effectively eliminate any risk of bank failure. By requiring that these two entities be partitioned clearly from one another, three key advantages emerge. First, separation eliminates banking groups incentive to engage in risk-taking behavior.[126] Historically, banks had "gamed the system" to manipulate the amount of capital[127] they held measured against their risk-weighted

123. *See* Tim Harford, *More equity, less risk*, FIN. TIMES (July 1, 2011), https://www.ft.com/content/5038a3de-a1f3-11e0-b485-00144feabdc0 ("The simplest way to reduce the risk of a future banking crisis is to force banks to hold more equity.").

124. Mark Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation,* 41 B.C. L. REV. 195, 200 (2000).

125. *Id.* at 201. Professor Charles Goodhart further draws on the perils of this toxic concoction, noting that "[l]iquidity and solvency are the heavenly twins of banking, frequently indistinguishable. An illiquid bank can rapidly become insolvent, and an insolvent bank illiquid." Matt Johnston, *Revisiting the Lehman Brothers Collapse*, MEDIUM (Feb. 1, 2018), https://medium.com/coinmonks/revisiting-the-lehman-brothers-collapse-fb18769d6cf8.

126. *See* FINANCIAL STABILITY BOARD, STRUCTURAL BANKING REFORMS: CROSS-BORDER CONSISTENCIES AND GLOBAL FINANCIAL STABILITY IMPLICATIONS; REPORT TO G20 LEADERS FOR THE NOVEMBER 2014 SUMMIT 1, 10 (2014), https://www.fsb.org/wp-content/uploads/r_141027.pdf?page_moved=1 ("Hence the separation measure in German and French law is motivated by the authorities' aims of preserving financial stability, protecting deposits and retail banking against risks arising from certain trading activities, removing conflicts of interest, and encouraging lending to the real economy. Belgium (not currently home to a G-SIB) has undertaken similar reforms.").

127. *See* Pam Martens & Russ Martens, *Treasury Reveals What J.P. Morgan Was Really Doing with London Whale Trades*, WALL ST. ON PARADE (Jun. 15, 2015), https://wallstreetonparade.com/2015/06/treasury-reveals-what-J.P. Morgan-was-really-doing-with-london-whale-trades/ (reporting that regulators turned their attention to opaque capital relief and undisclosed transactions after the London Whale, which increased showing of net capital holdings). The U.S. Treasury Office of Financial Research reported:

> To see how a bank can structure regulatory capital relief, let's look at a hypothetical bank required to hold capital equal to 8 percent of its total risk-weighted assets. A relatively safe asset held by a bank might be assigned a 100 percent risk weight, requiring 8 cents of capital for every dollar of the asset. A riskier loan is assigned a 750 percent risk weight, requiring 60 cents of capital for every dollar of the asset. A bank's riskiest assets are assigned a 1,250 percent risk weight, requiring one dollar of capital to back every dollar of the asset (8 percent times 1,250 percent = 100 percent).

JILL CETINA ET AL., OFF. OF FIN. RSCH., BRIEF SER. NO. 15-04, MORE TRANSPARENCY NEEDED FOR CAPITAL RELIEF TRADES 2 (2015), https://www.financialresearch.gov/briefs/files/OFRbrassets.[128] Returning to the London Whale trading scandal, J.P. Morgan's Iksil and Martin-Artajo opted to engage in a series of illegal trades that technically satisfied the CIO's internal risk model test for a balanced portfolio, yet it failed due to the long positions the traders took in a highly illiquid market.[129] Although the firm's management task force concluded that the internal oversight mechanisms were inadequate— such highly complex derivatives swaps, trades, and investments would be substantially more challenging with a separate trading entity required by the Liikanen approach.

Second, separation of the trading entity from the banking entity prevents losses incurred by the trading entity from trickling down to the taxpayer and the deposit insurance system. Liikanen endorses this proposition—noting that "[t]he Group proposes that proprietary trading and all assets or derivative positions incurred in the process of market-making, other than the activities exempted below, must be assigned to a separate legal entity, which can be an investment firm or a bank (henceforth the 'trading entity') within the banking group."[130] This eliminates the primary concern that banks that are "Too Big to Fail" will result in corporate debts becoming consumer debts. Taxpayer liability is curtailed by clearly separating the two entities. Third, the separation stifles any attempt at misallocating lending from deposit banks to other financial activities.[131]

C. Separation in Practice

"Separation," however, can be an amorphous term. Separation has been used to denote a separation between banking and commerce

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2015-04-bank-capital-reflief-trades.pdf.

128. *See* Carey L. Biron, *U.S. Regulators Facing Deadline On Key Rule To Rein In Wall Street*, MINTPRESS NEWS (Dec. 2, 2013), http://www.demos.org/news/us-regulators-facing-deadline-key-rule-rein-wall-street (taking a historical approach to evaluate both failed and successful regulatory reforms aimed at speculative trades).

129. DERIVATIVES RISKS AND ABUSES, *supra* note 2, at 9.

130. LIIKANEN REPORT, *supra* note 22, at v (emphasis omitted).

131. The Federal Reserve Board has described the intended scope and purpose of its own authority to approve certain activities as complementary to a financial holding company's financial activity in relatively cautious terms, as allowing individual FHCs "to engage . . . in activities that appear to be commercial if a meaningful connection exists between the proposed commercial activity and the FHC's financial activities and the proposed commercial activity would not pose undue risks to the safety and soundness of the FHC's affiliated depository institutions or the financial system." H.R. 10, 106th Cong. § 102 (as reported by H. Comm. on Banking & Fin. Servs., Jun. 15, 1999) (internal citations omitted). An earlier House Committee Report included a similar provision. *See* H.R. Rep. No. 106-74, pt. 1, at 5 (Mar. 23, 1999) (proposing various eligibility requirements for financial holding companies).

activities, a separation between investment and commercial banking, and a separation of banking from nonfinancial activities. This Note endorses a separation between specific investment activities (speculative trades) and nonbanking or commercial banking activities based upon a threshold valuation of a bank's assets and a weighted valuation of risk and liquidity. Separate investment activities can be divided into four categories: accounting separation, functional separation, legal separation, and economic separation—each of which would involve a distinct degree of separation from commercial banking activities.[132] Accounting separation, the lightest degree of intervention, would require that financial institutions create publicly available reports about the performance of their various business units.[133] Yet, this form of separation alone fails to resolve the issue; there would still be an incentive for banks to involve themselves in risky trading and over-leverage themselves.[134] Accounting separation would have no meaningful impact on intragroup transfers of subsidies by large banks; however, it would be one step closer to increased accountability of rogue traders.[135]

Functional separation, a second intermediate form of intervention, would allow banking groups to continue to provide services within one group with some of these activities relegated to "functional" subsidiaries.[136] Creating such a firewall is imperative. Though functional separation in the context of the European system presents more challenges than it does when applied to the US banking system, it is nevertheless an essential step.[137] Under no circumstance should a deposit-taking entity economically support a trading entity.

The passage of the Gramm Leach Bliley Act amended the Bank Holding Company Act to permit Bank Holding Companies (BHCs) to register as financial holding companies (FHCs)—a change in classification that broadened the scope of activities that the Bank could

132. *See European Commission Consultation Paper on Reforming the structure of the EU banking sector*, at 7 (May 16, 2013), https://ec.europa.eu/finance/consultations/2013/banking-structural-reform/docs/consultation-document_en.pdf (outlining divisions originally proposed by the European Commission; this Note elects to employ four of the six original forms of separation).

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *See id*. at 85 (proposing functional separation as a means of prudential regulation and defining the bounds of this separation: stating that such situation requires that "banking groups continue to provide a universal set of banking services within one group but [that] some of these activities would need to be provided by separate 'functional' subsidiaries.").

engage in with minimal oversight.[138] As a result, banks—now classified as FHCs—could engage in securities underwriting and dealing, insurance underwriting, and merchant banking activities.[139] In contrast, the European Commission's 2016 attempt at revamping the regulatory mechanisms resulted in a requirement that large non-EU banks establish an intermediate parent company, often referred to as the EU Intermediate Holding Company.[140] The Federal Reserve Board's foreign bank organization rules require non-US banks with US non-branch or agency assets of $50 billion to establish an intermediate holding company.[141]

The United States foreign bank organization's rules are considerably more rigid than the European Union's rules regulating corporate form. The European Union allows the parent company to be an operating company whereas the Foreign Bank Organization requires a series of measures to ensure the Bank meets liquidity and capital requirements.[142] It must be acknowledged that due to the European banking structure's flexibility, it may be easier to install a system similar to the Liikanen proposal throughout Europe compared to instituting such a system throughout the United States. Despite the hurdles posed by the US banking structure, deposit banks can still be successfully insulated from the risks of the trading entity if they were to be re-separated. Liikanen stipulates that:

> transfers of risks or funds from the deposit bank to the trading entity . . . would not be allowed to the extent that capital adequacy, including additional capital buffer requirements on top of the minimum capital requirements, would be

138. Arthur E. Wilmarth, *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 1006 (2011).

139. *Id*. at 1035. While the Federal Reserve is the regulatory body overseeing Financial Holding Companies, the SEC regulates the problematic broker-dealer subsidiaries behind crises like the residential mortgage-backed securities crisis. Therefore, the SEC is the appropriate regulatory body to oversee the stages of separation. *See generally* U.S. SECURITIES AND EXCHANGE COMMISSION: DIVISION OF TRADING AND MARKETS, GUIDE TO BROKER-DEALER REGISTRATION (2008) (discussing the Exchange Act's special provisions relating to brokerage and dealing activities of banks and purview over broker-dealers' activities).

140. *See The New EU Law on Intermediate Holding Companies for Third-Country Banking Groups*, SHEARMAN & STERLING (Mar. 26, 2019), https://www.shearman.com/perspectives/2019/03/the-new-eu-law-on-intermediate-holding-companies-for-third-country-banking-groups.

141. David H. Carpenter & M. Maureen Murphy, CONG. RESEARCH. SERV., R41298, THE "VOLCKER RULE": PROPOSALS TO LIMIT "SPECULATIVE" PROPRIETARY TRADING BY BANKS 9, (2010).

142. *Id.* at 2.

endangered.[143]

Such a requirement is imperative for revamping Volcker. The root of the banking crisis that Volcker sought to purge lies in the indistinct boundaries between deposit banks and trading entities. With a distinct separation between these two banking entities, Liikanen and his colleagues found that regulating the deposit bank and the trading entity could be easier for federal regulators and would permit "consolidated supervision."[144]

D. Dispensing with Ring-fencing as a Method for Isolation

Retail ring-fencing does not adequately prevent proprietary trading. Although the conceptual underpinnings of the Vickers report—involving distinct separation between banking and trading entities—should be directly applied to the United States banking structure, the specific ring-fencing measures would likely prove impossible to implement. Ring-fencing requires a UK bank to establish a separate legal entity within its corporate group to provide retail and commercial banking services in the UK.[145] Through subsidiarization, retail banking operations that pose minimal risk are insulated from riskier financial activities.[146] If these banks fail, as they did after the European Sovereign Debt Crisis and Residential Mortgage-Backed Securities Crisis, ring-fencing would at least ensure that retail banking services can be continuously provided by ring-fenced banks, with reduced bail-out costs for taxpayers since only investment banks would require bail-outs, and lay the groundwork for bail-ins as an effective resolution tool.[147]

This Note agrees that capital requirements are necessary to ensure that banks have enough liquid capital to repay their debts to consumers. Ring-fencing is another articulation of the *separation* doctrine set forth in Liikanen—providing a separate legal entity to carry out retail and commercial banking services. The United Kingdom's iteration focuses on insulating investment activities by creating a separate legal entity

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143. LIIKANEN REPORT, *supra* note 22, at 102.

144. *Id*.

145. *See* LEHMANN, *supra* note 26, at 11 (arguing ring-fencing causes banking groups to be "broken up into retail and wholesale/investment banking entities.").

146. VICKERS REPORT, *supra* note 24, at 10.

147. *See* Jianping Zhou et al., *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions*, at 6-10, SDN/12/03 (Apr. 24, 2012) (setting forth a clear formula for when bail-ins should be employed to "save" SIFIs).

that provides both retail and financial services.[148]

The Vickers Report expressly notes that banks cannot, "structure, arrange, or execute derivatives transactions, engage in proprietary trading, originate, trade, lend or make markets in securities, underwrite the sale of debt or equity securities or provide services to non-EEA customers."[149] Yet, this is a mere "suggestion" that banks maintain their autonomy over investment and wholesale divisions. The concept of ring-fencing parallels the United States' "swaps push out" requirement, wherein derivatives trading must be completely squared off from banking activities.[150]

The Vickers Report, proposed by the UK's Independent Commission on Banking, suggests that there should be secured exposure within every banking group of up to 50 percent of capital.[151] This Note proposes that the remodeled Volcker Rule adopt Vickers' capital requirements and specific language about risky activities with only the slight modification that these risky trading activities would be housed within the separate trading entity that is not necessarily ring-fenced. These activities include:

> b) any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation, except those associated with the provision of payments services where the regulator has deemed this appropriate; c) any service which would result in a trading book asset; d) any service which would result in a requirement to hold regulatory capital against market risk; e) the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and f) services relating to secondary markets activity including the purchase of loans or securities.[152]

Vickers sets forth several safeguards to ensure that ring-fenced banks are truly distinct entities. Ring-fenced banks are prohibited from engaging in deposit-taking, a practice of providing overdraft facilities to individuals and small and medium-sized organizations in the UK.[153]

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148. VICKERS REPORT, *supra* note 24, at 11.

149. Barnabas Reynolds, *The Vickers Report: What the Recommendations Mean for the Future of Banking in the UK*, HARV. L. SCH. F. ON CORP. GOVERNANCE, (Oct. 5, 2011) [hereinafter *Reynolds*], https://corpgov.law.harvard.edu/2011/10/25/the-vickers-report-what-the-recommendations-mean-for-the-future-of-banking-in-the-uk/.

150. *Id.*

151. *Id.*

152. VICKERS REPORT, *supra* note 24, at 52.

153. *Structural Reforms in Banking, supra* note 45, at 77.

These ring-fenced banks would be allowed to provide minimal credit services such as lending to small banks with little market power.[154] Ring-fenced banks are prevented from structuring, arranging, or executing derivatives transactions or engaging in "proprietary trading, [as to] originate, trade, lend or make markets in securities, underwrite the sale of debt or equity securities, or provide services to non-EEA customers."[155] Vickers does speak to aggregate exposure which takes an *ex-post* approach to regulating capital of banks that is deemed risky.[156] Vickers establishes that once ring-fenced, banks must maintain a standard aggregate unsecured exposure.[157] This exposure consists of the outstanding credit that has been extended to other entities.[158] The greater the credit extended, the higher the risk posed to the ring-fenced entity.[159] Vickers dictates that these ring-fenced banks not extend more than 25 percent of capital resources after certain deductions (the same limit that currently applies for third parties under the large exposures regime).[160] The *ex-post* approach fails to put banks on notice about the trades themselves.

Although Vickers' prohibitions are not characteristically different from those of Liikanen, Vickers retail ring-fencing provides a blanket prohibition on interactions between these two distinct types of banks.[161] In contrast, Liikanen focuses on specific resolution tools to mitigate risky financial behaviors—and chiefly separates speculative trading activities from investment activities.[162] Vickers does not advocate for

154. *See id.* at 77. Ring-fencing affects market behavior of small banks. The non-Morgan Stanley's and Goldman Sachs of the world have responded quite negatively. Even though ring-fencing does not actually separate small banks since they do not illustrate excessive risk exposure, they do feel spillover effects from large banks' response to ring-fencing. Large ring-fenced banks often acquire large market shares in mortgage markets by offering cheap mortgage. To keep up, small banks must increase the riskiness of their lending. In geographic areas wherein large banks exert considerable market power, smaller banks reduce their rates on high loan-to-value mortgages. These imprudent financial decisions have the potential to rekindle the circumstances leading to the financial crisis.

155. *See id*. (describing the types of activities that ring-fenced banks are prohibited from engaging in).

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. VICKERS REPORT, *supra* note 24 at 10–11; see also LIIKANEN REPORT, *supra* note 22, at 85 (noting that the UK Government proposed that smaller institutions be exempt from the ring-fencing requirement as part of a de minimis exemption. These smaller institutions are comprised of banks with less than £25bn in mandated deposits).

162. *See* LIIKANEN REPORT, *supra* note 22, at 107 ("Notably, the restriction of speculative risk-taking and the limitation of the use of guaranteed deposits to fund or subsidise significant

the separation of proprietary trading and other trading activities based upon the percent of assets for sale.[163] Therefore, Vickers' focus on *insulation* rather than *intervention* goes beyond the necessary scope for restraining speculative activities.[164]

The UK Government implicitly rejected one of the few *intervention* measures stipulated in Vickers.[165] UK ring-fenced retail banks are prohibited from lending to financial companies; this notion of "separation," reminiscent of the stages of separation proposed in Liikanen, was met with hesitancy by the UK Government. The UK Government Response noted that no suitable definition of "financial companies" existed, and therefore a definition would need to be created. Adopting Liikanen's clearly defined capital requirements and stated leverage ratios for what is and is not a "financial institution" mitigates any concern that the same issue would arise if Congress were to adopt a measure separating trading entities from deposit banks. Such a *de minimis* limit is clearly specified in Liikanen.[166]

If adopted, Vickers' ring-fencing would also apply to a wider scope of banks because capital requirements would not necessarily dictate which banks qualify as large enough to be insulated.[167] The absence of

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trading activities facilitate the supervision of the largest and most complex banks within a Single Supervisory Mechanism and facilitate the closer linking of deposit guarantee schemes by limiting the risks insured by those schemes.").

163. VICKERS REPORT, *supra* note 24 at 11.

164. *See* Reynolds, *supra* note 149 (noting that for "insulation," of ring-fenced banks, the Pensions Act 1995 would likely need to be amended—as ring-fenced banks would need to be shielded from responsibility for deficits in group pension schemes).

165. *See* Neil Baker, *Breaking the Banks*, INT'L BAR ASS'N (Sept. 8, 2016) (arguing that Vickers deemed complete insulation of these banks as an optimal solution to ensure that banks did not get a free ride and characterized Liikanen's intervening mechanisms as too permissive); *see also* Sudip Kar-Gupta & Steve Slater, *Banks told to boost capital and shield taxpayers,* REUTERS (April 11, 2011), https://www.reuters.com/article/uk-britain-banks/banks-told-to-boost-capital-and-shield-taxpayers-idUKTRE7377OY20110411. Bank share prices certainly strengthened on news that Vickers was not calling for a forced break-up of banks that were deemed too big to fail. But Vickers himself believes that the reforms outlined in his committee's report are "far-reaching" and "could be transformative." At the press launch of his findings, Vickers dismissed suggestions that banks were getting an easy ride. "I absolutely reject any notion that we bottled it," he said.

166. LIIKANEN REPORT, *supra* note 22, at 85.

167. *See* Barnabas Reynolds, *The Vickers Report and the Future of UK Banking*, HARV. L. SCH. F. ON CORP. GOVERNANCE, (Mar 29, 2012), https://corpgov.law.harvard.edu/2012/03/29/the-vickers-report-and-the-future-of-uk-banking/ ("The Vickers Commission had proposed that such banks would need to have primary loss absorbing capital equal to at least 17 percent across all their global operations. However, the UK government has stated that so long as such a bank can show that any non-UK operations do not pose a risk to UK financial stability, the requirement will not apply to those non-UK operations.").

such a *de minimis* standard is especially concerning.[168] Liikanen's threshold approach combined with its capital requirements on trading assets, bail-in mechanisms rather than bail-out mechanisms, and plans for strengthening banks' governance and control make it the ideal platform for US banking reform.

III. BAIL-INS BEFORE BAIL-OUT

Turning unsecured debt into bail-inable debt, bail-ins constitute a form of reorganization—reorganization, as opposed to liquidation. This failsafe leaves the institutions' assets alone while converting debt into alternative, more dilutable forms.[169] A bank bail-in requires a bank to use the money of its unsecured creditors to restructure their capital.[170] The bank then converts debt into equity to meet capital requirements.[171] Resolution proceedings can immediately provide relief to the bank during a bail-in, meaning expedience is not an issue during bail-ins.[172] Bail-outs require the government—rather than the bank—to bear the burden.[173]

Within days, the financial institution's value will be evaluated as it responds to the inquiries of foreign regulators.[174] Overnight, debt is converted to equity, subsidiary debt swaps take place, and a receiver takes over.[175] Within days to weeks, the government provides liquidity support and the bank institutes new governance.[176] Throughout the

168. Risky assets, more formally known as risk-weighted assets, determine the minimum amount of capital that must be held by banks or other financial institutions to reduce the risk of insolvency. *Id.* Systematically important banks and "large UK ring-fenced banks" are required to hold capital of core equity and bail-in subordinated debt of at least 17 percent of their risky assets, with a lower percent for smaller UK banks. *Id.*

169. *See* Joseph H. Sommer, *Why Bail-In? And How!*, 20 ECON. POL'Y REV. 207, 213 (2014) [hereinafter *Sommer*]. (describing the merits of reorganization processes as opposed to liquidation processes).

170. *Id.* at 227.

171. Edoardo Martino, *Subordinated Debt Under Bail-In Threat*, 2 UNIV. OF BOLOGNA L. REV. 252, 289 (2017) [hereinafter *Subordinated Debt*].

172. *See* Sommer, *supra* note 169, at 214 ("To preserve liquidity and confidence, megabank resolutions must be very fast. Certain parts of them are over with almost before they start.").

173. *See Subordinated Debt*, *supra* note 171, at 267 (discussing how the government currently bears the burden in bail-out regimes. Yet, in the Italian banking system, the bail-in system "shift[s] a part of the resolution burden from bank insiders to the banking system as a whole, via the National Resolution Fund, realizing a sort of 'private bail-out' intervention.").

174. *See* Sommer, *supra* note 169, at 217 (outlining how government regulators and clearinghouses, intermediaries between the reorganizing institution and the bank, will evaluate bank liquidity to ensure the potential for long-term stability after the bail-in proceeding terminates).

175. *Id.* at 219 tbl.1.

176. *Id.*

course of several months, the financial institution is restructured to position the bank to pay off its secured creditors, while simultaneously gaining access to public liquidity.[177] The financial institution also undergoes new securities registration and distribution.[178] At this point, the receivership ends.[179] The end of the receivership signals the end of the bail-in process. After the process concludes, restructuring continues. Liikanen suggests that a layer of subordinate bank debt be created—wherein banks are prohibited from holding subordinated bonds from other banks.[180] As a result, banks would be forced to issue these bonds, which transfers risk outside of the banking system.[181] Termed a "strict bail-in system," Liikanen's bail-in capital requirements would extend the bail-in process by staggering the maturity dates of these bonds.[182] This strategy ensures that there are no significant one-time refinancing costs that could lead to a bank run.[183] Because banks will not be permitted to hold their subordinated debt, non-SIBs are well-suited to assume the responsibility.[184] Specialized hedge funds, sovereign wealth funds, and life insurance companies can be effective administrators.[185]

In order to meet the enhanced capital ratios required to satisfy Liikanen's thresholds, it is suggested that "bail-in" subordinated debt be provided to these banks to help them meet their increased capital requirements.[186] Banks should be incentivized to avoid the quandary

177. *Id.*

178. *Id.*

179. *See id.* at 218 ("[The receiver] may replace management (if necessary), do some early transactions, and possibly alter the governance of the firm. The active part of the receivership could be over as soon as reliable private governance is in place: a few weeks. Or it could persist longer.").

180. Jan P. Krahnen, *Rescue by Regulation? Key Points of the Liikanen Report*, SAFE POL. CTR., at 1, 11 (White Paper Ser. No. 9, 2013) [hereinafter *Rescue by Regulation*].

181. *Id.* at 12.

182. *Id.* at 15.

183. *Id.*

184. *Id.* ("Life insurance companies, as well as sovereign wealth funds, pension funds, high-net-worth individuals and specialized hedge funds seem to fit this profile in particular."). This Note does not agree that high-net worth individuals would be well positioned within the US banking system to oversee the receivership or bail-in process as a whole. This Note does concur that Italian and French dignitaries may be satisfactorily responsible to monitor European banks' bail-ins. It, however, does *not* impute such faith in wealthy, relatively unrestrained individuals within the US system.

185. *Id.*

186. *See* Sommer, *supra* note 169, at 219 ("Bail-ins requires two things to succeed in full. First, there must be enough debt at the parent to credibly fill the consolidated capital shortfall, and the receiver must be willing to haircut it accordingly. This requires regulation, as discussed below. Second, bail-in must inspire confidence. For this, adequate capital is necessary, but not sufficient. A sufficient liquidity backstop is also necessary, as is the cooperation of foreign regulators. But even these are not sufficient.").

that Lehman Brothers had found itself in—being comprised of two thousand separate legally incorporated entities.[187] Discussing the Lehman Brothers' collapse, the most notable instance of when a bank that is "Too Big to Fail" fails itself, Senators questioned a series of financial and regulatory experts during a Senate Banking, Housing, and Urban Development hearing. One expert noted that the infamous bank's collapse highlighted the need for "an exploration of mechanisms such as so-called debt bail-in proposals that would help maintain firms as going concerns without requiring either governmental assistance or a formal resolution process."[188] Terming the imposition of "bail-in debt" as a "work [] in progress," the advisors noted that adopting bail-in debt instruments can "maximize cooperation and planning before a possible insolvency and, thus, [] maximize the chances that a distressed firm can be satisfactorily dealt with internationally."[189] Instituting measures for bail-in debts will permit standardized methods of ensuring that banks meet capital standards and do not overleverage. Senator Warner, addressing members of the Federal Reserve Board, noted politicians' frustration that there has been little traction to implement stricter restrictions on leverage:

> We have spoken quite a bit here about capital standards. Another piece—at least in my process of getting educated about the crisis—was the leverage rates. If I have heard once, I have heard dozens of times, you know, Canada made comments about the fact that their lack of problems because of their rates on—their restrictions on leverage. There was a proposal in the House bill to put a restriction on leverage. I believe the blended rate left it—or the conference report left it to you all.[190]

Bail-ins have the power to transfer the responsibility from taxpayers to depositors.[191] In other words, neither the government nor

187. Adam Davidson, *Lehman Brothers Thought You Were Dead*, N.Y. TIMES MAG. (Sept. 11, 2012), https://www.nytimes.com/2012/09/16/magazine/lehman-brothers-we-heard-you-were-dead.html.

188. *Continuing Oversight on International Cooperation to Modernize Financial Regulation: Hearing on S.111-720 Before the S. Subcomm. on Sec. & Int'l Trade & Fin. of the S. Comm. of Banking, Hous., & Urb. Affs.*, 111th Cong. 11 (2010) (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

189. *Id.*

190. *Id.* at 18 (statement of Sen. Mark Warner, Member, S. Subcomm. on Sec. & Int'l Trade & Fin.).

191. Randall D. Guynn & Patrick S. Kenadjian*, Structural Solutions: Blinded by Volcker, Vickers, Liikanen, Glass-Steagall and Narrow Banking*, *in* TOO BIG TO FAIL III: STRUCTURAL

the failed institutions will bear the risk; Rather, the depositors—whose debts are protected by the Federal Deposit Insurance Corporation—will absorb the losses collectively.[192] On a macro-scale, distributing this risk among the general population will invariably prevent banks and financial institutions from increasing the government's deficit and will allow banks and financial institutions who face bankruptcy to withdraw their deposits. Bail-outs must be wholly extinguished from any statutory framework for "rescuing" the big banks.[193] Bail-ins provide banks with an opportunity to rescue *themselves*, rather than rely on outside intervention.

Dodd-Frank prohibits bail-outs by requiring orderly liquidation—instead of government intervention—while minimally advocating for bail-ins.[194] The Act's bail-in mechanisms are partly modeled after the European bail-in system set forth during the Basel III international reforms.[195] Bail-ins, however, as they stand now, only apply to the parent company.[196] They must apply more broadly—as Liikanen's strict bail-in requirements instruct. Vickers provides that bail-ins should involve a layer of subordinate debt, "from which there can be no contagion amongst banks, [which] represents, by its very nature, a form of non-systemic risk."[197] All bail-in mechanisms specified in Dodd-Frank,

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192. *See* ALLEN N. BERGER ET AL., BANK BAIL-OUTS, BAIL-INS, OR NO REGULATORY INTERVENTION? A DYNAMIC MODEL AND EMPIRICAL TESTS OF OPTIMAL REGULATION*,* at 3 (2018) (using many complex mathematical models to illustrate that bail-ins sufficiently spread risk).

193. *See id.* ("However, bail-outs produce somewhat lower social welfare values than bail-ins if the costs of using and risking taxpayers' funds and transaction costs of raising and distributing these funds are incorporated in the social welfare function.")

194. *See id.* (creating statutory bail-ins that authorize the Federal Reserve, the FDIC and the Securities and Exchange Commission (SEC) to place bank holding companies and large non-bank holding companies in receivership in the event of bank failure)*; see also* David Branaccio & Janet Nguyen, *No more bail-outs: The lawmakers behind Dodd-Frank say that taxpayers won't foot the bill the next time a bank fails*, MARKETPLACE (Sept. 19, 2018) [hereinafter Dodd & Frank Remarks], https://www.marketplace.org/2018/09/19/no-more-bail-outs-lawmakers-behind-dodd-frank-say-taxpayers-won-t-foot-bill-next/ (quoting Sen. Chris Dodd and Rep. Barney Frank remarks on Dodd-Frank Act). The co-authors of the Dodd-Frank act clarify that while there is no exacting language within the Act itself that says bail-outs are banned, they are completely incompatible with the provisions included in the Volcker Rule. *Id.* When asked about whether another bank bail-out would be possible, Dodd noted, "[n]ot only politically could you not get away with what we were able to do in 2008, but legally you cannot do it." *Id.* Rather the Act requires that there be "orderly dismantling," instead of a bail-out. *Id.*

195. Sommer, *supra* note 169, at 224.

196. *See id.* at 207 (addressing how bail-ins "impair[] only the nonfinancial liabilities in the parent and preserve[] the financial liabilities in the subsidiaries. It therefore preserves the firm's liquidity and risk- shifting abilities.").

197. *Rescue by Regulation*, *supra* note 180, at 15.

including the FDIC's Single-Point-of-Entry approach,[198] or Chapter 11 bankruptcy, wield protection only if the parent company is deemed insolvent.[199] With the current bail-in provisions, the insolvent subsidiary still remains particularly vulnerable. This is easy if the subsidiary is solvent. Every dollar that flows from the parent's creditors to the solvent subsidiary will increase the value of the subsidiary by at least a dollar."[200]

The Act and this Note are both more concerned with the situation if a bank is rendered insolvent. Structural subordination, which Dodd-Frank provides for, only protects creditors if the insolvent parent recapitalizes the subsidiary.[201] Operating within the boundaries of the Bankruptcy Code, the Dodd-Frank bail-in resolution would require that the parent first pay creditors of the insolvent subsidiary, rather than recapitalize the subsidiary itself.[202] While it is understandable that creditors demand they be left in the same or better position than they would be in the event of bank liquidation,[203] the subsidiary may still be left unable to meet net-capital requirements, rendering the entire intervention-based approach futile.

There are two principal means of administering bail-in bonds. The first principle—the hierarchy principle—involves claims with "high seniority," which will incur lower losses.[204] The second principle—the equitable treatment principle—allocates expected losses to bail-inable creditors in a staggered manner wherein creditors of the same seniority incur the same loss.[205] Either approach will provide a valuable means for issuing bail-in bonds and particular selection of a method is beyond the scope of this Note. Yet, they must apply to both parent and subsidiary for the aforementioned reason—the subsidiary's default is still a potential outcome even after intervention.[206] Bail-in insolvency

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198. *See* THE CLEARING HOUSE ASSN., ENDING TOO-BIG-TO-FAIL": TITLE II OF THE DODD-FRANK ACT AND THE APPROACH OF "SINGLE POINT OF ENTRY" PRIVATE SECTOR RECAPITALIZATION OF A FAILED FINANCIAL COMPANY, 8–9, 34–38 (2013) (noting that supports of the SPOE approach argue that the FDIC will no longer have to heavily borrow from the Treasury if bail-ins were to be installed among SIFIs).

199. Sommer, *supra* note 169, at 227.

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. *See* Edoardo Martino, *The Bail-In Beyond Unpredictability: Creditors' Incentives and Market Discipline*, 21 EUR. BUS. ORG. L. R. 789, 814 (2020) (discussing the varied methods of administering bonds and their associated risk levels) [hereinafter *Bail-In Unpredictability*].

205. *Id.*

206. *Id.*

should not be merely a first step before bail-outs. Rather, Liikanen's express prohibition on bail-outs should be embraced[207]—doing away with the implied language inherent in Volcker's orderly liquidation process.[208] Likewise, Liikanen endorses bail-in instruments that apply to both parent and subsidiary, primarily concerned with maintaining the retail bank that is operating as the subsidiary and houses most individuals' assets.[209] The report suggests that "[b]anks should build up a sufficiently large layer of bail-inable debt that should be clearly defined, so that its position within the hierarchy of debt commitments in a bank's balance sheet is clear and investors understand the eventual treatment in case of resolution."[210]

Liikanen also suggests that bail-ins can be used as a compliance tool. If a bail-in debt instrument must be deployed, executives would receive lower bonuses or face individual financial consequences. It is suggested that "[b]ail-in instruments should also be used in remuneration schemes for top management so as best to align decision-making with longer-term performance in banks."[211] A regulatory structure akin to that of Liikanen must exist so that banks have a means of reckoning with the burden left by hefty financial liabilities—often ones created through rogue actors' proprietary trades. Under Liikanen's strict bail-in terms, only SIFIs with the resources to collect from creditors can avoid redistributing risk to unwitting consumers.

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207. *See* Erikki Liikanen, Governor, Bank of Fin, Chairman, High-level Expert Grp. on reforming the structure of the EU banking sector, seminar at the Bank of Italy: Too-Big-To-Fail and a reform of banking structures (Jun. 27, 2014) ("The regulatory initiative, which to date most directly *addresses the too-big-to-fail problem* and the assumption that systemically important banks will be bailed-out by the government, is the *recovery and resolution* regime. When successfully implemented, the new tools enable an orderly 'failure' of banks. The main tool will be the possibility to 'bail-in' bank debt holders to absorb losses. Substantial social costs can thus be avoided. Moreover, the new recovery and resolution tools, provided that they are credible, will *reduce the implicit government guarantee* and the *distortive risk-taking incentives* created by public bail-out expectations and artificially low funding costs.").

208. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C.). *See also*, Wex, *Dodd-Frank: Title II - Orderly Liquidation Authority*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/dodd-frank_title_ii_-_orderly_liquidation_authority ("Title II, the Orderly Liquidation provision of the Dodd-Frank Act, provides a process to quickly and efficiently liquidate a large, complex financial company that is close to failing. Title II provides an alternative to bankruptcy, in which the Federal Deposit Insurance Corporation (FDIC) is appointed as a receiver to carry out the liquidation and wind-up of the company.").

209. David G. Mayes, *Bank Resolutions in New Zealand and its Implications for Europe*, *in* CENTRAL BANKING AT A CROSSROADS: EUROPE AND BEYOND, 123, 130 (Charles Goodhart et al. eds., 2014).

210. Tom Burgis, *The Liikanen Report Decoded,* FIN. TIMES (Oct. 2, 2012), https://www.ft.com/content/0ff0b3a4-0c8a-11e2-a73c-00144feabdc0.

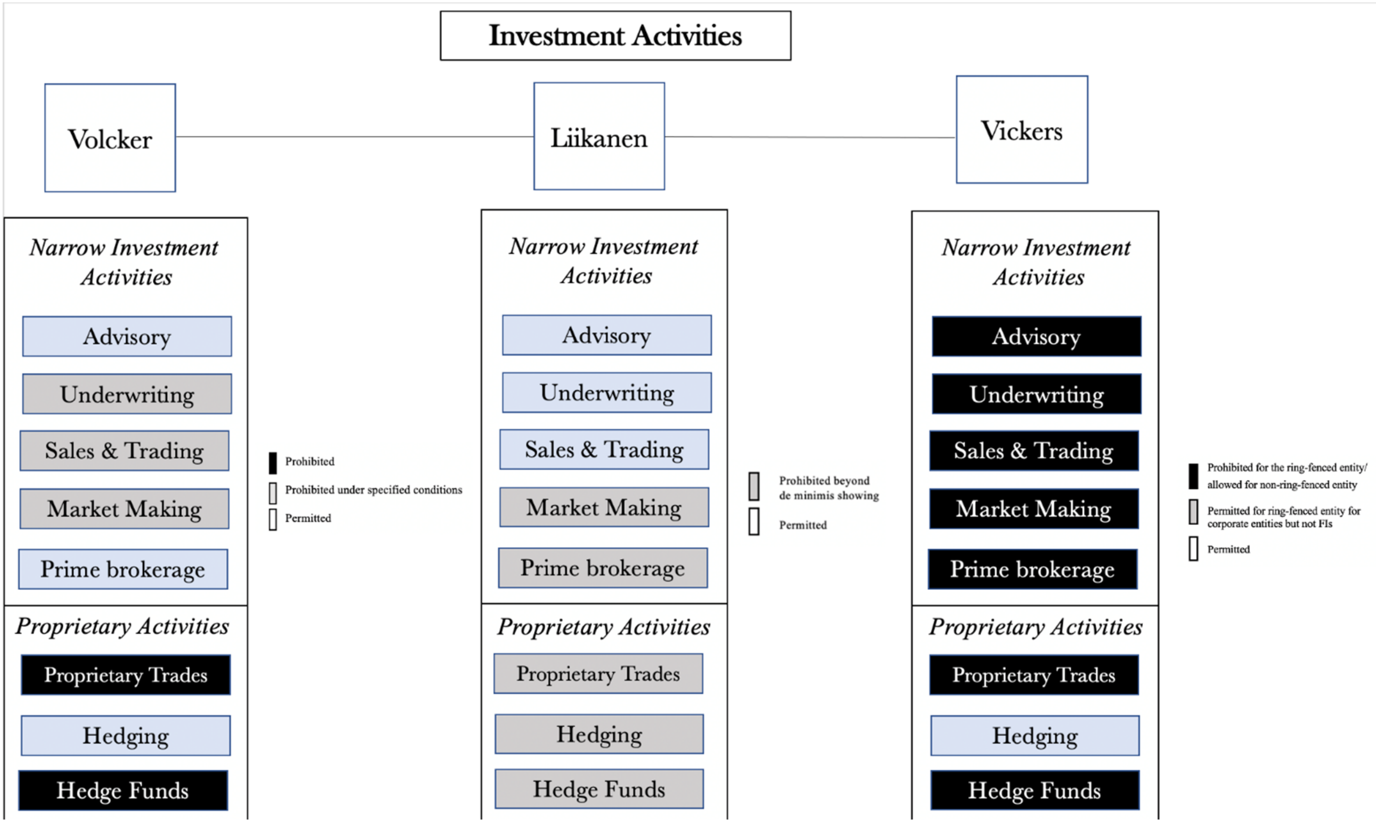
211. *Id.*

Under the current Volcker Rule, rogue traders will maintain the perverse incentive to pay back creditors before consumers. Conversely, the Liikanen framework puts an end to the ability for traders to set priorities for payment. Regulators will instead.[212]

Many countries have modified their banking laws to separate investment and commercial banking activities while maintaining a market-making exemption.[213] The Liikanen Report acknowledges that separating market-making from proprietary trading would not be a fruitful course of action, concluding that prohibition on such activities is imprudent.[214] This Note concurs with Liikanen's judgment. By requiring mandatory separation of high-risk trading activities—including proprietary trading, market-making, and undertaking unsecured exposures to hedge funds, SIVs and private equity investments—and permitting these activities to take place in a separately capitalized and ring-fenced legal entity, the US regulatory structure can ensure that market-making will not pose substantial risk.[215] Liikanen goes so far as to classify market-making as a trading activity, rather than as a proprietary trading activity—a classification that can only be made when globally significant institutions maintain an infrastructure for separating core banking activities from risky financial activities.[216] As seen in Figure 1, market-making is permitted under Volcker and Liikanen, but prohibited under Vickers. Ring-fenced entities, by their nature, are overly-limiting.[217] Liikanen's separation is compatible with the market-making exemption and would be the easiest to implement into the current legal framework for monitoring speculative trading.

212. *Structural Reforms in Banking*, *supra* note 45, at 79.
213. *Id.* at 80.
214. *Id.* at 78.
215. *Id.*
216. *Id.*
217. *See* LEHMANN, *supra* note 26, at 12.

FIGURE 1

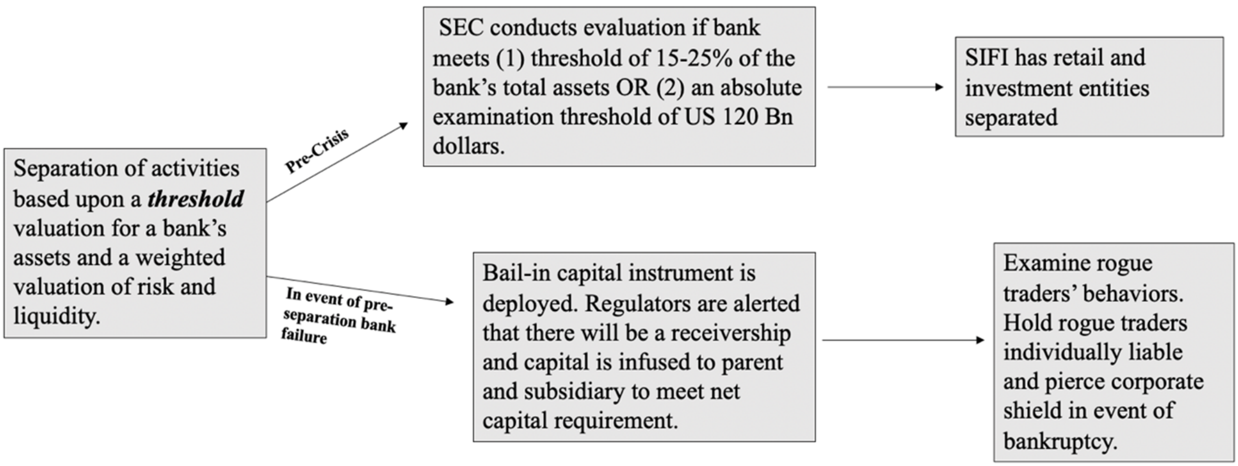


European countries with separate retail and investment entities have different interpretations of Liikanen's reticence to conclusively prohibit market-making, most requiring internal risk limits that are quantified into "tiers."[218] Vickers also evaluated whether the Volcker Rule's prohibition of proprietary trading is needed in a system in which there are ring-fenced entities.[219] Under Vickers, agencies would not have the authority to bail-out the banks. Ring-fenced entities, the entities that would ostensibly bail-out the banks would be prevented from doing so due to their separation. Bail-ins rather than bail-outs

218. *Id.* at 13.
219. *Id.* at 11.

within ring-fenced entities have the potential to render the market-making discussion moot. This Note proposes that these bail-in instruments be deployed in the event of bank-failure. While this failure would be unlikely in the proposed *separated* system, it should nonetheless be an intervention mechanism that is readily available for banks to implement (see Figure 2).

FIGURE 2



IV. CONTROLLING FOR ROGUE TRADERS

Solely regulating banks via external processes is not enough. In addition, internal controls must also be heightened to mitigate the types of rogue trading activities that led to crises like the London Whale. If separation of trading activities from deposit banking does not come to fruition, this Note endorses two primary means of course-correction. First, the Federal Deposit Insurance Corporation should re-evaluate whether the stock market can actually serve as a source of discipline for traders. Federal proposals isolating the stock market as the principal means of reigning in illicit bank behaviors emphasize the ability of shareholders to pressure bad bank managers to improve share price and lower cost of capital in the event of an illiquidity crisis.[220]

Second, banks carry minimal equity compared to other institutions

220. Simon Kwan, *Testing the Strong-Form of Market Discipline: The Effects of Public Market Signals on Bank Risk* 2-4 (Fed. Reserve Bank of S.F., Working Paper No. 2004-19).

due to the asymmetric structure of banks' assets and liabilities;[221] therefore, a lapse in judgment or purposeful evasion of standard trading practices can lead to a severe liquidity crisis. The continued reliance on the stock market as a source of market discipline may yield unintended effects on the behavior of depositors. As seen in *Brickner v. Federal Deposit Insurance Corp.*,[222] the Eighth Circuit noted that in the case of such a crisis, it is likely that a bank's depositors will want to withdraw their money, leading to a bank run.[223]

If banks remain relatively deregulated,[224] with no distinct separation between investment and commercial activities, the responsibility for managing risk must be spread between bank regulators, bank management, and bank shareholders. While many academics and banking professionals alike traditionally consider corporate officers to be fiduciaries, holding corporate officers responsible does not serve as much of a deterrence function as a regulator would hope. Additionally, corporate officers typically are not involved in rogue trades. The Board's investigation into the illegal trade or loss after the fact may not deter the behavior in the first place. In *Espinoza v. Dimon*, the Plaintiff shareholder alleged that J.P. Morgan adequately investigated only one of the two incidents in the London Whale fiasco.[225] The Board investigated (1) the underlying trading losses, which cost J.P. Morgan billions but allegedly did not examine (2) the misleading statements by Dimon and others.[226]

This Note finds that risk managers, who oversee these proprietary trades, should have their compensation deflated to typical investment banking salaries. A Senate report found that Marcis, Martin-Artajo, and Iksil were all compensated as investment bankers rather than as risk

221. *Basel III Capital and Liquidity Standards - FAQs, Moody's Analytics* (2013), https://www.moodysanalytics.com/-/media/article/2013/2013-18-10-basel-iii-capital-and-liquidity-standards-faq.pdf (noting that the Basel III accord raised the minimum Basel III capital requirements for banks from 2 percent in Basel II to 4.5 percent of common equity, calculated as a percentage of the bank's risk-weighted assets. An extra 2.5 percent buffer capital requirement also is embedded in Basel III's capital requirements—including 4.5 percent common equity requirement, plus 2.5 percent capital conservation buffer, plus 2.5 percent counter-cyclical capital buffer).

222. *See* Brickner v. Fed. Deposit Ins. Corp., 747 F.2d 1198, 1202 (8th Cir. 1984) (discussing bank depositors' chance to withdraw their deposits simultaneously in the event of a prospective market failure).

223. *See generally id.*

224. Deregulation describes the general reduction in government oversight over the banking industry and increased self-authority over internal policing within banks.]

225. Espinoza *ex rel.* J.P. Morgan Chase & Co. v. Dimon, 797 F.3d 229, 231 (2d Cir. 2015).]

226. *Id.* at 236.

managers.[227] The Report observed that "not only were the SCP employees compensated like Investment Bank employees, but they were compensated at levels that were at the top range of, or better than, the best Investment Bank employees."[228] Therefore, incentive-based compensation for risk managers who handle risky derivatives must be eliminated, destroying any desire for one of the factors that would lead to financial reward from influencing these individuals.[229] In *In re J.P. Morgan Chase & Co. Securities Litigation*, another case rifling with the London Whale trades, the Court noted that J.P Morgan had misrepresented the risk management activities of the Chief Investment Office and that "Dimon had 'secretly transformed the CIO from a risk management unit into a proprietary trading desk whose principal purpose was to engage in speculative, high-risk bets designed to generate profits."[230] Risk-taking is exactly what this proposed structural form seeks to limit. Rogue trades will be severely curtailed when the management required to execute these trades is incentivized to respond and report rather than to turn a blind eye.

V. ELIMINATING THE AMBIGUITIES

The Volcker Rule's ambiguities can be effectively eliminated through this proposal. The separation of proprietary trading from deposit banks makes distinguishing between 'proprietary trading' and 'trading account[s]' virtually pointless. The Volcker Rule expresses that, "proprietary trading under the Rule concerns 'engaging as a principal for the trading account of [a] banking entity,' and trading accounts refer to 'any account used for … taking positions in the securities and instruments described in the Act's definition of proprietary trading.'"[231]

This "purpose test" distinguishes between what is and is not a "trading account." Yet, the purpose test has been found to be extremely complex. For example, what constitutes "taking positions" and what are the "instruments" for selling that are prohibited? In contrast,

227. *Id.*

228. STAFF OF THE PERMANENT S. SUBCOMM. ON INVESTIGATIONS, 113TH CONG., REP. ON J.P. MORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 59 (Comm. Print 2013), http://www.hsgac.senate.gov/download/report-J.P. Morgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-; *see id.* at 9 (observing that the public first learned about the whale trades on April 6, 2012).

229. *See* Jill E. Fisch, *The Mess at Morgan: Risk, Incentives and Shareholder Empowerment*, 83 U. CIN. L. REV. 651, 677 (2015).

230. In re JP Morgan Chase & Co. Sec. Litig., 12 Civ. 3852, 2014 U.S. Dist. LEXIS 44050 at *8 (S.D.N.Y. Mar. 31, 2014) (citing Compl. ¶ 5).

231. 17 CFR § 255.3.

Liikanen's threshold-based inquiry navigates around such ambiguities by initially determining whether separation between proprietary trading activities and other activities is necessary. When discussing the Volcker Rule's intrinsic complexity, Democratic Senator Heidi Heitkamp stated, "it is my experience that when a rule's too complicated, there isn't much compliance, so it doesn't really get you what you need."[232] As evidenced by a considerable amount of complaints filed regarding the rule, those who are responsible for complying have historically been unable to understand how to line-draw between illicit proprietary trades, legal trades, and market-making.[233]

CONCLUSION

The London Whale, Subprime Mortgage Crisis, and European Sovereign Debt Crisis all shared two elements in common: banks that overleveraged and the comingling of retail and investment infrastructures. A lack of regulatory oversight enables these behaviors—spurring speculative trades and the need for government bail-outs, which proved costly to taxpayers following the 2008 financial crisis. Volcker does not prevent the occurrence of speculative trades. Likewise, its complexity has confused lawmakers and the public alike while providing traders with a route for skirting regulation. While Congress, and this Note, have considered Vickers' concept of ring-fencing and found it to be too limiting, legislative bodies have failed to consider a threshold-based approach that would require banks by law to maintain a minimal level of net capital and liquidity in the event of bank failure. This Proposal, after a careful consideration of the merits of Vickers, Volcker, and Liikanen finds that Liikanen's bail-in debt instruments and threshold separation of speculative trading from other financial activities coupled with increased restraints on rogue traders would vastly curtail illicit banking activities. The system is ripe for change. This framework provides fertile ground for increasing accountability for banks and the rogue traders within these institutions.

232. Rob Tricchinelli, *Volcker Rule Changes Likely as Focus Shifts to Regulators*, BLOOMBERG (Jun. 23, 2017), https://www.bna.com/volcker-rule-changes-n73014460637/.

233. *See* Michael Nester, *Reconciling the Volcker Rule with the Dodd-Frank Act's Objectives: How to Best Combat Systemic Risk*, 86 FORDHAM L. REV. 3069, 3079 (2018) ("The Financial Stability Oversight Council received more than 8000 comments on the rule in a thirty-day period before the NPRM, which is uncommonly high. This high comment activity continued into the post-NPRM period, when nearly 18,500 comments were given. This onerous promulgation left tremendous uncertainty about the Rule's scope, costs and benefits, and many of its provisions.").