The Expressive Synergies of the Volcker Rule

Onnig H. Dombalagian

Tulane University School of Law, odombala@tulane.edu

Follow this and additional works at: http://lawdigitalcommons.bc.edu/bclr

Part of the Administrative Law Commons, Antitrust and Trade Regulation Commons, Banking and Finance Law Commons, and the Consumer Protection Law Commons

Recommended Citation

THE EXPRESSIVE SYNERGIES OF THE VOLCKER RULE

ONNIG H. DOMBALAGIAN*

Abstract: In this Article, I propose an implementation of the Volcker Rule that balances the statutory mandate to promote the safety and soundness of U.S. banking organizations with the significant role that bank-affiliated dealers currently play as providers of liquidity in over-the-counter markets. The Volcker Rule restricts the proprietary trading activities of U.S. banks and their affiliates subject to exemptions for traditional banking activities and certain “client-oriented” activities. This Article draws upon the academic literature regarding expressive law, the history of federal banking legislation, and the text of the Dodd-Frank Act to argue that federal financial regulators have the discretion to implement the Rule’s exemption for “market-making-related activities” to realize synergies with Dodd-Frank’s initiatives in the regulation of over-the-counter markets. Specifically, I envision that the market making exemption could be implemented with a view to encouraging the provision of liquidity to competitive trading facilities. I further argue that such an implementation may well be essential to the vitality of the Volcker Rule, in light of the political forces aligned in favor of the Rule’s repeal.

Introduction

The Volcker Rule (the “Rule”)¹ is unquestionably one of the more controversial provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).² The Rule restricts U.S. depository institutions and their affiliates from engaging in proprietary trading, subject to certain enumerated exemptions, and limits

---

* © 2013, Onnig H. Dombalagian, George Denège Professor of Law, Tulane University Law School. I am extremely grateful to Roberta Karmel, Stephen F. Williams, Felix Chang, Stanislav Dolgopolov, Eric Pan, Erik Gerding, David Zaring, Saule Omarova, my colleagues Claire Dickerson and Adam Feibelman, the participants at the Brooklyn Law School Financial Scholars Roundtable, at the annual meetings of the Canadian Law and Economics Association, and in the Tulane Law School internal speaker series who offered comments on prior drafts of this Article. I would also like to extend enormous gratitude to my research assistant, Matthew Amoss, for assistance above and beyond the call of duty, and to my administrative assistant, Toni Mochetta. All errors are mine.


their sponsorship of and investment in hedge funds and other private funds. The Rule reflects the view of Paul Volcker, chairman emeritus of the Group of Thirty and former chairman of the Federal Reserve Board (FRB), that systemically important banking institutions should not undertake proprietary activities that entail high risks and pose serious conflicts of interest. Although scholars debate whether proprietary trading was the precipitating cause of the recent crisis, it is difficult to deny that speculative trading activity exacerbated losses in connection with the securitization and related derivatives activities that contributed to the recent collapse of the financial sector.

The Rule is often framed as a compromise between the segregation of commercial and investment banking established by the Glass-Steagall Act of 1933 and the permissive affiliations permitted by the Gramm-Leach-Bliley Act of 1999. Supporters and opponents of the Rule’s premise are exerting enormous pressure on federal financial regulators as they struggle to find a practicable implementation of its prohibitions and exemptions. Supporters of an aggressive implementation of the Rule generally contend that the U.S. government should never again be forced to cover losses sustained by financial institutions that result from morally hazardous speculative trading—thereby enabling such institutions to reap profits from aggressive trading activity while shifting losses to taxpayers. As argued by the Rule’s sponsors in

---

Congress, Senators Jeff Merkley and Carl Levin, banking entities should only engage in those kinds of proprietary trading that represent “client-oriented, risk-reducing, or other traditional banking activities that facilitate the formation and deployment of capital.”¹⁰

Supporters of a more lenient approach claim that an “incorrect” implementation of the Rule could result in “decreased liquidity, higher costs for issuers, reduced returns on investments and increased risk to corporations wishing to hedge their commercial activities.”¹¹ One industry study estimates that the impact of the Rule on issuers and investors in corporate bonds alone could cost up to $350 billion.¹² Even though final rules have yet to be adopted, banks are already beginning to suffer a significant loss of reputational and human capital.¹³ At least one rating agency has published negative rating outlooks on Goldman Sachs and Morgan Stanley in part “because of the potential adverse impact of the Rule under a stricter final rule.”¹⁴ Several financial institutions have begun to close or reassign their trading desks,¹⁵ and promi-

---


nent traders have defected to private funds or non-U.S. banks where they can continue their trading activities unabated.\(^{16}\)

The federal financial regulatory agencies charged with implementation of the Rule\(^{17}\) have jointly proposed a uniform set of regulations, which focuses predominantly on promoting the safety and soundness of banks and their affiliates.\(^{18}\) As I have argued elsewhere, this narrow approach is unwise.\(^{19}\) The safety and soundness of banks and their affiliates is separately addressed in Dodd-Frank’s enhancements to capital adequacy and leverage; implementing the Rule with such a parsimonious focus undermines its independent significance as a tool of financial regulation and invites pressure to relax the Rule’s prohibitions as bank balance sheets become healthier (the fate that befell the Glass-Steagall Act of 1933).\(^{20}\) Indeed, even as the reelection of President Barack Obama is likely to have eliminated the possibility of legislative repeal in the near term, lobbyists continue to exert pressure on the Agencies to weaken the Rule,\(^{21}\) and the financial services industry is exploring litigation as a tool for delaying its impact.\(^{22}\)

More consequentially, a better rounded implementation of the Rule could create an opportunity to achieve synergies with Dodd-Frank’s other objectives. To the extent that certain of the activities permitted under the Rule—such as “market-making-related activities”

---


\(^{17}\) Although many of the Rule’s provisions are self-executing, the federal financial regulators are required to engage in significant rulemaking to implement its provisions. 12 U.S.C. § 1851(b)(2)(B)(i) (Supp. IV 2010). The federal financial regulators—namely, the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“FRB” or the “Board”), the Federal Deposit Insurance Corporation (“FDIC”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”)—are hereinafter collectively referred to as the “Agencies.” “Commissions” refers to the SEC and the CFTC collectively.


\(^{19}\) Dombalagian, supra note 5 (manuscript at 28).

\(^{20}\) See infra notes 284–286 and accompanying text.


for over-the-counter financial instruments—are not comprehensively defined in federal financial legislation, the Rule offers the Agencies the ability to shape the structure of those markets through the Volcker Rule exemption. To be sure, the Rule does not give the Commissions (the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)) a broad mandate to flesh out a market structure for over-the-counter markets. The SEC’s views, however, have played a significant role in discovering norms that balance the interests of market makers, dealers, brokers, and investors in organized markets. The Agencies’ implementation of the Rule could play a similar expressive function in over-the-counter markets—beginning with the rules governing swap and security-based swap execution facilities under Dodd-Frank, and ultimately with respect to transactions in fixed-income securities and other financial instruments.

I argue that the Agencies should implement the Volcker Rule’s market-making-related activities exemption with a view to shaping the development of over-the-counter markets. Part I discusses the structure of the Rule and the relationship of its exemption for market-making-related activities to traditional market-maker regulation. Part II considers whether the Rule’s exemption for market-making-related activities has the expressive potential to shape market structure, even without recourse to effective enforcement tools. Part III proposes a specific approach to implementing the Rule’s market making exemption in a manner that complements the Commissions’ initiatives relating to over-the-counter markets—in particular, swaps and security-based swaps under Dodd-Frank. Part IV considers whether my proposal is consistent with the legislative history and judicial interpretation of analogous provisions of federal banking legislation.

I. THE VOLCKER RULE AND MARKET MAKING

This Part summarizes the structure of the Volcker Rule’s restrictions on proprietary trading and considers the meaning and interpreta-

24 See id. § 1851(b)(1) (not mentioning market structure among the expressly enumerated policies that the FSOC and Agencies are required to consider in implementing the Rule).
25 See infra notes 183–206 and accompanying text.
26 See infra notes 30–140 and accompanying text.
27 See infra notes 141–206 and accompanying text.
28 See infra notes 207–249 and accompanying text.
29 See infra notes 250–346 and accompanying text.
tion of the exemption for market-making-related activities.\textsuperscript{30} The core policy justifications for the Rule, as described in the statute and legislative history of the Dodd-Frank Act, are traditional concerns about the safety and soundness of banks and their affiliates (augmented by concerns about systemic risk to the financial stability of the United States) and the “subtle hazards” of permitting banks to affiliate with providers of other financial services.\textsuperscript{31} The Rule is often described as a compromise between the formal separation of investment and commercial banking activities enforced by the Glass-Steagall Act of 1933 and the liberalization of affiliations between depository institutions and other financial companies under the Gramm-Leach-Bliley Act of 1999.\textsuperscript{32}

Of all the provisions of the Rule, the exemption for market-making-related activities has perhaps drawn the most intense scrutiny.\textsuperscript{33} As described in Sections B and C below, the crux of the problem is that the Agencies have defined market making based primarily on the literal text of the statute and the business practices of market makers in organized markets, without drawing upon their experience with the regulation of market making or the specific market structure for any particular class of financial instruments to define market making qualitatively.\textsuperscript{34} The Agencies’ proposed implementation of the exemption has therefore made it difficult to anticipate how the role of banking entities as dealers in over-the-counter fixed-income and derivatives markets will evolve in

\textsuperscript{30} See infra notes 31–140 and accompanying text.


\textsuperscript{32} E.g. 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd) (“The purpose of the Volcker rule is to eliminate excessive risk-taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest.”); see infra notes 250–321 and accompanying text.


\textsuperscript{34} See infra notes 62–140 and accompanying text.
response to the Rule, and has led concerned parties on both sides of the issue to demand further refinement to the proposed rules.\textsuperscript{35}

This disconnect is not accidental; indeed, it reflects the longstanding difficulty of defining what “market making” means,\textsuperscript{36} whether on the facilities of an exchange or in the over-the-counter market. Market making has eluded definition because there is no definitive way to design a market structure that requires market intermediaries to provide a reasonable expectation of liquidity while protecting them from insolvency. Rather, market makers’ privileges and duties must evolve with the needs of investors and traders. Indeed, even as financial institutions lament that the Agencies should better appreciate the contribution that their affiliates make by providing liquidity to dealers and end-users of financial instruments, they offer no competing restrictive principle for defining trades that provide beneficial liquidity to the marketplace.\textsuperscript{37}

A. The Volcker Rule Summarized

The Volcker Rule subjects U.S. depository institutions and their affiliates to various restrictions on the scope of their trading and investment activities.\textsuperscript{38} As envisioned by the Financial Stability Oversight Council’s implementation study, the Rule’s ostensible purpose is to “promote and enhance the safety and soundness of banking entities,” to “reduce conflicts of interest” between supervised entities and their customers, and to “limit activities that have caused undue risk or loss” or that might reasonably be expected to cause such risk or loss in these entities.\textsuperscript{39} The Rule’s tone and approach, however, are essentially qualitative; for example, it permits only those proprietary trading activities that are “client-oriented,”\textsuperscript{40} and even then, only if the activities do not

\textsuperscript{35} Compare Coffee, supra note 33, at 1074 (discussing the loopholes for commercial banks under the Rule), with Oliver Wyman, supra note 12, at 2 (discussing the negative effects of the proprietary trading ban on the value of corporate bonds).

\textsuperscript{36} Merkley & Levin, supra note 10, at 543 (noting the difficulty of distinguishing market making from a firm’s proprietary trading).


\textsuperscript{38} 12 U.S.C. § 1851(d) (Supp. IV 2010) (providing for permitted activities and limitations).

\textsuperscript{39} FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 8 (2011); see 12 U.S.C. § 1851(b)(1).

themselves create material conflicts of interest or risks to the trading entity or the financial system as a whole.\footnote{12 U.S.C. § 1851(d)(2).}

The Rule is structured as a broad prohibition against proprietary trading, with exemptions for certain enumerated categories of trading activity, which are themselves restricted by certain statutory limitations. The Rule begins with the imperative that a “banking entity”\footnote{Id. § 1851(h)(1). “Banking entity,” for this purpose, is defined to include all insured depository institutions and their subsidiaries and affiliates. Id. The FRB is empowered to adopt “additional capital requirements for and additional quantitative limits with regard to” such activity if conducted by systemically important financial institutions (“SIFIs”) subject to FRB supervision. Id. § 1851(a)(2).} shall not “engage in proprietary trading” or “acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”\footnote{Id. § 1851(a)(1).} Proprietary trading, for these purposes, is expansively defined as “engaging as a principal for the trading account of the [relevant entity] in any transaction to purchase or sell, or otherwise acquire or dispose of,” various financial instruments.\footnote{12 U.S.C. § 1851(h)(4) (Supp. IV 2010). Specifically, the Rule covers any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule . . . determine. Id. § 1851(h)(6).} The definition of “trading account,” however, narrows the scope of the prohibition: as defined in the statute, a “trading account” includes “any account used for acquiring or taking positions . . . for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements).”\footnote{Id. § 1851(a)(1).}

The Rule then provides a series of exemptions for various trading activities or fund activities in which banking entities are permitted to engage.\footnote{12 U.S.C. § 1851(h)(4) (Supp. IV 2010). See id. § 1851(d) (providing exemptions for, among other things, market making and risk-related hedging activities).} Traditional bank securities activities, such as trading in U.S. government, municipal, agency- and government-sponsored enterprise securities, and permissible bank brokerage activity,\footnote{Id. § 1851(d)(1)(A), (D); see also 15 U.S.C.A. § 78c(a)(5)(C)(i), (iii) (West 2012) (permitting banks to engage in buying and selling government and municipal securities that are “exempted securities” under the Securities Exchange Act of 1934 (“the Exchange Act”) and to issue and sell asset-backed securities). The Rule also exempts proprietary}
or securitization of loans, are allowed.\textsuperscript{48} Securities, commodities, and swaps affiliates may additionally engage in brokerage, underwriting, or market-making-related activities,\textsuperscript{49} subject to registration and regulation by the appropriate federal financial regulator.\textsuperscript{50} Affiliates regulated as insurance companies may engage in state-regulated insurance activities.\textsuperscript{51} The Rule also permits the organization and offering of private equity or hedge funds, as well as the performance of certain services for such funds by the bank and its affiliates.\textsuperscript{52}

Beyond such activities, the Rule permits only a few additional categories of trading activity.\textsuperscript{53} Banking entities are permitted to enter into “risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings” resulting from otherwise permissible activities.\textsuperscript{54} Certain small business and public welfare investments and certain non-U.S. proprietary trading and fund activity undertaken by banking organizations not controlled by a U.S. banking entity are also permitted.\textsuperscript{55} Finally, the Rule allows the Agencies to permit other activity by rule, if such activity “would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”\textsuperscript{56} The Rule’s exemptions are further circumscribed by statutory limitations that address safety and soundness and conflicts of interest.\textsuperscript{57}

\textsuperscript{48} 12 U.S.C. § 1851(g)(2).
\textsuperscript{49} Id. § 1851(d)(1)(B).
\textsuperscript{50} 12 U.S.C. § 1851(d)(1)(B).
\textsuperscript{51} Id. § 1851(d)(1)(F).
\textsuperscript{52} Id. § 1851(d)(1)(G), (f).
\textsuperscript{53} Id. § 1851(d)(1)(C), (E), (J).
\textsuperscript{54} Id. § 1851(d)(1)(C).
\textsuperscript{55} Id. § 1851(d)(1)(E).
\textsuperscript{57} Id. § 1851(d)(2). The Rule not only prohibits, but also requires, the Agencies to limit or restrict by rule any transaction, class of transactions, or activity that would “involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties” that would “result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies” or “pose a threat to the safety and soundness of such banking entity” or “pose a threat to the financial stability of the United States.” Id.
The Rule also requires the Agencies to implement a systematic inspection and examination program, as discussed in Section C below. As part of such a program, compliance personnel at banking organizations must identify objective metrics that trigger subjective review of certain activities under an organization’s internal controls, policies, and procedures. Given the ease with which individual transactions can be reclassified, it will be difficult for the Agencies and for firms themselves to police a prohibition whose distinctions turn on qualitative considerations. The allocation of enforcement responsibilities to multiple Agencies—including the Commissions, which have limited resources and experience with the kind of iterative supervision bank regulators employ—further complicates coordinated action.

B. Regulation of Market Makers in Financial Markets

Perhaps the most hotly contested exemption from the Rule’s restrictions on proprietary trading is the exemption for market-making-related activities. Because the text of the Rule itself provides little guidance as to the contours of this exemption, the Agencies have sought to articulate a vision of how market-making-related activities may be distinguished from other types of dealing. Subsection 1 discusses how the concept of market making as a regulatory classification is most developed in the context of organized markets, such as ex-

58 Id. § 1851(e)(1); see infra notes 103–140 and accompanying text.
59 For example, under the Rule, the purpose or intent of the actor is relevant to determining whether a transaction is prohibited or exempted from the prohibition. As an example, the intent to profit from short-term price movements is prohibited, whereas the intent to mitigate risk or meet the near-term liquidity needs of customers is exempt. See 12 U.S.C. § 1851(d)(1)(B)–(C), (d)(2)(A).
60 See, e.g., Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1640–55 (2008) (describing how the securities industry successfully argued that the characterization of a repurchase agreement as a form of secured financing should depend “upon the intent of the parties,” rather than economic equivalence); Merkley & Levin, supra note 10, at 544 (relating the comments of one banker, who remarked that he could “find a way to say that virtually any trade we make is somehow related to serving our clients”).
61 See, e.g., SIFMA-ABA-TCH Letter, supra note 11, at 6 (discussing the inherent difficulty in organizing enforcement responsibilities among the Agencies); Letter from Paul A. Volcker to the Agencies 4–5 (Feb. 13, 2012) (No. OCC-2011–0014–0209) (discussing the challenge of enforcing the Rule’s restrictions).
62 See, e.g., Coffee, supra note 33, at 1074 (discussing the loopholes allowed for commercial banks under the Rule); Wilmarth, supra note 33, at 1028 (noting the problematic nature of the distinction between proprietary trading and market making).
changes, which rely on such specialized dealers to provide market participants with a reasonable expectation of liquidity. Many products—such as government and corporate debt, and individually tailored notes and derivatives—have not traditionally traded on such markets, but rather in bilateral “over-the-counter” transactions. Subsection 2 consequently discusses how market making outside the context of organized markets represents a quality of service—providing liquidity and exposure on demand—that is difficult to define or enforce by rule.

1. Organized Securities Markets

On organized markets, the term “market maker” generally refers to dealers who hold themselves out as willing to purchase and sell financial instruments on a regular or continuous basis, whether to market professionals or to the public generally. Such intermediaries typically trade in one or more assigned or allocated instruments (or classes of financial instruments) and receive an exclusive franchise, quoting privileges, compensation, or other regulatory privileges. In return,

---

64 See infra notes 67–88 and accompanying text.

65 For purposes of this Article, I use the term “over-the-counter” to refer to transactions that are not effected on a securities or futures exchange. Many over-the-counter transactions take place through electronic trading systems or other trading facilities, such as “swap execution facilities.” See infra notes 89–102 and accompanying text. Such facilities do not necessarily provide the same degree of centralization and are not subject to the same degree of regulatory oversight as exchanges.

66 See infra notes 89–102 and accompanying text.

67 See, e.g., 15 U.S.C.A. § 78c(a)(38) (West 2012) (defining “market maker” under the Exchange Act); 17 C.F.R. § 240.3b-8 (2012) (defining qualified over-the-counter and third market makers) for purposes of the FRB’s Regulation U, which governs margin requirements); see also Exchange Act Release No. 47,364, 68 Fed. Reg. 8686, 8688–90 (Feb. 24, 2003) (suggesting, in the context of distinguishing “traders” from “dealers,” that dealers generally provide liquidity services in transactions with investors, whereas market makers generally provide such services in transactions with other professionals); Morris Mendelson & Junius W. Peake, Intermediaries’ or Investors’: Whose Market Is It Anyway?, 19 J. Corp. L. 443, 470–71 (1994) (proposing a definition of market maker that includes “any person or firm which, in the regular course of its business, buys and sells securities from the public, attempting to make a profit from the differences between the purchase and sales prices,” regardless of whether it is required to register as a broker-dealer or to stand ready to make markets in selected or assigned securities during market hours).


69 See, e.g., NASDAQ Rule 4613, NASDAQ (Jan. 14, 2013), http://nasdaq.cchwallstreet.com (“For each security in which a member is registered as a Nasdaq Market Maker, the member shall be willing to buy and sell such security for its own account on a continuous basis and shall enter and maintain a two-sided quotation . . . .”).

70 Such compensation, depending on the jurisdiction in which the market is located, could consist of fees paid by the issuer of the financial instrument. See, e.g., Stanislav Dol-
such intermediaries generally commit to provide liquidity to the exchange’s participants as needed in order to maintain a fair and orderly market (the so-called “affirmative obligation”), and in some markets, agree not to trade for their own account when not necessary for that purpose (the so-called “negative obligation”). Importantly, such regulatory privileges exist not only because regulators consider market making activity to be less risky than proprietary trading, but also because concerns about financial responsibility and conflicts of interest must yield to the objective of facilitating continuous trading.

Regulators and the markets they regulate have long struggled to balance the market maker’s need to make a reasonable return in the face of adverse selection against the need to ensure that any benefits
gopolov, Linking the Securities Market Structure and Capital Formation: Incentives for Market Makers? 42–54 (Feb. 23, 2013) (unpublished manuscript), http://ssrn.com/abstract=2169601. Financial Industry Regulatory Authority (FINRA) Rule 5250 prohibits U.S. broker-dealers from receiving any payment or other consideration from an issuer for market making, but the SEC has approved rebate programs implemented by various securities exchanges. See Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Changes Relating to Market Maker Incentive Programs for Certain Exchange-Traded Products, 77 Fed. Reg. 42,052, 42,053 (July 17, 2012); FINRA Rule 5250, FINRA (Dec. 15, 2010), http://finra.compinet.com. 71 See, e.g., 15 U.S.C. § 78g(c)(3)(B), (d)(2)(C)(ii) (2006 & Supp. IV 2010) (excluding from federal margin requirements any credit extended, maintained, or arranged to or for a registered broker-dealer “to finance its activities as a market maker or an underwriter”); 17 C.F.R. § 240.11a1-5 (deeming transactions effected by New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) market makers to be consistent with Section 11(a)(1) of the Exchange Act); id. § 240.15c3-1(a)(6)(iii)(A) (establishing a lower net capital requirement for certain broker-dealers acting as a market maker or specialist); id. §§ 242.201(d)(2), 203(b)(2)(iii) (exempting short sales by market makers from the restrictions imposed by Regulation SHO, which regulates practices with respect to short sales). 72 George T. Simon & Kathryn M. Trkla, The Regulation of Specialists and Implications for the Future, 61 Bus. Law. 217, 224–25 (2005). The affirmative obligation to trade arises when there is a comparative lack of liquidity (thus requiring the market maker to take an unwanted inventory position), and the negative obligation arises when there is adequate liquidity provided by other market participants (notwithstanding the desirability of selling unwanted positions or profiting from transactions at the bid/ask spread). Id.


74 See, e.g., H.R. Rep. 103-76 (1993), reprinted in 1993 U.S.C.C.A.N. 1666, 1678 (reprinting an SEC comment that the market-making exception in Section 11(a)(1) of the Exchange Act was included because market making was considered “beneficial to the markets”).
provided to market makers are tied to their commitment to provide liquidity.\textsuperscript{75} At the most conceptual level, market makers have an incentive to avoid trading with “informed traders” and to seek out trading with “uninformed traders.” Market makers who sell to, or buy from, counterparties with superior knowledge of the financial instrument traded may routinely find themselves holding money-losing positions in inventory.\textsuperscript{76} Accordingly, they have an incentive to avoid informed traders, increase spreads, pay for less informed order flow, and pursue other strategies that compensate for this risk.\textsuperscript{77}

To combat these tendencies, organized markets historically imposed both affirmative and negative obligations on market makers, backed by calibrated market privileges, to maintain a “fair and orderly market.”\textsuperscript{78} Exchanges and organized markets use a variety of tools to reward and punish market makers based on the value of the liquidity they provide to the exchange’s other constituencies. For example, exchanges may employ statistical measures to assess the performance of their registered specialists and market makers\textsuperscript{79} and reallocate financial

\textsuperscript{75} See infra notes 183–206 and accompanying text.

\textsuperscript{76} Stanislav Dolgopolov, Insider Trading, Informed Trading, and Market Making: Liquidity of Securities Markets in the Zero-Sum Game, 3 WM. & MARY BUS. L. REV. 1, 12–21 (2012). In his analysis of various empirical studies regarding this issue, Stanislav Dolgopolov suggests that market makers are more sensitive to losses resulting from short-term informational advantages of public traders (e.g., due to technological or logistical “advantages in acquiring, processing, and aggregating public information”), rather than access to nonpublic information by insiders. \textit{Id}. As a result, sensitivity to adverse selection is not necessarily limited to equity securities and related financial instruments, but to any class of financial product if there are asymmetries with respect to access to information about or trends concerning the underlying instrument (e.g., interest rates, commodity prices, securities indices). \textit{See id.}

\textsuperscript{77} See, e.g., Harris, supra note 73, at 502–09, 519–20.


instruments or fine tune privileges among registered entities. Some exchanges, moreover, are experimenting with compensation structures that seek to improve the quality of execution. Regulators also consider the threat of market dominance by a dealer or collusion among dealers in illiquid or highly tailored financial instruments. Collusion allows dealers to set unfavorably wide spreads or seek other forms of excessive compensation. Although hard caps on the amount of markups or markdowns on securities are difficult to enforce, especially given the variety of markets in which equity products trade, the Financial Industry Regulatory Authority (FINRA) requires dominant market makers to establish a reasonable relationship between the price they charge customers and their contemporaneous cost of purchasing or selling a security. In addition, collusion among exchanges and market makers in organized markets has been the subject of various Department of Justice (DOJ) and SEC investigations.

To the extent that the governance of exchanges and organized markets has historically been dominated by their specialist or market making constituencies, the enforcement of such obligations has not

---

83 See, e.g., FINRA MANUAL, NASD IM-2440-1, supra note 82 (stating that “[n]o definitive answer can be given and no interpretation can be all-inclusive” with respect to the fairness of markups or spreads “for the obvious reason that what might be considered fair in one transaction could be unfair in another transaction because of different circumstances”).
84 NASD, supra note 82, at 2–3.
86 See Roberta S. Karmel, The Future of Corporate Governance Listing Requirements, 54 SMU L. REV. 325, 347–38 (2001) (asserting that “[t]o the extent market power was not curtailed by competition or regulation, mutual governance [of exchanges] gave specialist or market maker members of an exchange control of the price, quality, and range of services produced by the exchange”); see also John C. Coffee, Jr., Racing Towards the Top?: The Impact of
always been consistent. Tectonic changes in the role of exchange specialists or market makers usually occur only in the wake of major scandals. The history of specialist and market maker regulation in the U.S. equity markets thus provides an interesting parallel with the Volcker Rule. Because of the special advantages traditionally conferred on exchange specialists (e.g., exclusive access to the exchange’s order book with respect to their assigned securities), other constituencies that have a strong interest in the reputational integrity of the exchange, such as exchange brokers and customers, may often support efforts at constraining the specialists’ role.

2. Over-the-Counter Markets

The concept of market making, as a regulatory classification, is not well established for financial instruments that trade off-exchange. In their discussion of the characteristics that distinguish market making from proprietary trading, the Agencies describe market making as “an intermediation service,” in which the market maker “assum[es] the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy.” The Proposing Release characterizes such activity as “passively providing liquidity by submitting resting orders that interact with the orders of others,” whether by automated execution or by the rules of the organized market. The absence of organized trading for most over-the-counter debt and derivative instruments, however,
renders that definition unworkable as a tool for distinguishing market making as a subcategory of dealing.

Some commentators view the role of market makers in over-the-counter markets as including not only the provision of “liquidity and exposure,” but also an element of reputational integrity consistent with the service mission of the financial services industry. One scholar suggests that clients may expect firms holding themselves out as market makers to offer certain tacit promises, such as assurances that tailored or exotic products are not designed to benefit insiders or other parties at the client’s expense, and that the price and terms of instruments offered for sale efficiently serve the client’s needs. Many market makers, however, view themselves solely as counterparties, and not investment advisers with a fiduciary duty to act in the best interests of the client when engaged in market making. These differences in the perception of the role of a market maker make it difficult to give normative content to the term “customer.”

The focus of the Agencies’ analysis therefore largely rests upon a descriptive analysis of the business model of market makers, without considering the market structure obligations that typically distinguish market making from dealing. For example, the Agencies assert that successful market makers typically “demonstrate consistent profitability and low earnings volatility” by limiting the extent to which they are exposed to market movements and by initiating transactions with non-customers only to the extent that they facilitate customer transactions. Although this may be an accurate description of the strategy that market makers employ in practice, it does not reflect the value of the ser-


93 Thompson, supra note 92, at 344–47 (discussing how newer synthetic products have made clients more reliant on market makers).

94 See, e.g., Wall Street and the Financial Crisis—The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the Sen. Comm. on Homeland Sec. and Governmental Investigations, 111th Cong. 26–27 (2010) (recording the opinion of one Goldman Sachs executive that the duty of market makers is only to provide the bid-ask spread and fair market prices).

95 The Agencies attempt to address this “client-oriented” service aspect of the Rule by identifying certain “customer facing” metrics. See infra note 124. Moreover, the statutory limitation on transactions that “involve or result in a material conflict of interest” would seem to address more egregious transactions that seek to extract profits at a counterparty’s expense. See supra note 57.

vice provided by market makers to other market participants. As at least one commentator argues, there is a risk that market makers will adapt to the environment promoted by this analysis by trading only under circumstances when additional liquidity is unnecessary, and withdrawing from the market when additional liquidity might be helpful.97

More controversial are the regulators’ assertions about the role of market makers outside of an organized market. To say that the purpose of market making is “not to earn profits as a result of [price] movements” is a question of market design, not a question of the market maker’s business model.98 As the Proposing Release recognizes, although market makers (like all dealers) derive profits from the difference between the price at which they purchase and the price at which they are willing to sell a financial instrument, they may also profit (or sustain losses) from changes in their aggregate long or short position in the financial instrument.99 Distinguishing profit-taking from each of these sources, for the purpose of distinguishing market makers from non-market-maker dealers, is a matter of degree; the more illiquid the instrument, the more attuned a dealer will be to price movements with respect to its net long or short position.

Ironically, past efforts to regulate the conduct of such dealers have focused on limiting the ability of dealers to profit from spreads under the guise of business conduct or antifraud rules100—thus pushing them to assume greater inventory risk as well as adopt more efficient inventory management systems. For example, dealers in corporate debt securities or derivatives may hold themselves out as being willing to buy and sell particular financial instruments or classes of instruments, with no expectation of being able to liquidate the position within a reason-

98 Proposing Release, 76 Fed. Reg. at 68,960 (stating that the purpose of market making is not to earn profits from price movements).
99 Id. at 68,960 (recognizing that market makers will make at least some profit from price movements). Notwithstanding comments to the contrary, the Commissions have implemented Dodd-Frank’s definitions of “swap dealer” and “security-based swap dealer” with the understanding that all market makers are dealers, but that not all dealers are market makers. 17 C.F.R. §§ 1.3(ggg) (ii), 240.3a71-1 (2012) (defining the terms “swap dealer” and “security-based swap dealer” to include any person who “[m]akes a market” in swaps and security-based swaps); see Exchange Act Release No. 66,868, 77 Fed. Reg. 30,596, 30,599–601 (May 23, 2012) (summarizing comments suggesting a narrow definition of swap dealer).
able time period. Assuming that dealers must make a certain profit on such transactions in order to compensate for the risk of holding the position in inventory, their only recourse is to widen spreads. The National Association of Securities Dealers (NASD) nevertheless adopted guidelines that limit the spreads that dealers may charge in such transactions.

C. Proposed Implementation of the Market-Making-Related Activities Exemption

Consistent with the view of over-the-counter market making described above, the Agencies approach the implementation of the exemption for “market-making-related activities” solely from the perspective of containing risk and limiting interaction with noncustomers. First, the Agencies’ proposed rules define the scope of each of the exemptions with a particular emphasis on establishing rebuttable presumptions with respect to certain categories of transactions. Second, the Agencies propose quantitative metrics to be used by firms and their examiners to determine whether impermissible trading activity has occurred or is occurring. Finally, the Agencies require firms to implement internal controls and written policies and procedures, with high-level managerial accountability, both for the purpose of self-policing and facilitating ex post analysis.

1. Definition of Market-Making-Related Activities

The Volcker Rule’s exemption for “underwriting and market-making-related activities” in financial instruments, by its terms, is limited to activities “designed not to exceed the reasonably expected near

\[101\] See Seha M. Tinic, *The Economics of Liquidity Services*, 86 Q.J. Econ. 79, 81 (1972) (indicating that dealer specialists must hold larger positions for longer time periods to provide adequate liquidity to the market when dealing in inactive stock issues).

\[102\] FINRA Manual, NASD IM-2440-2 (2013), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3662. FINRA generally requires dealers in debt securities to calculate, and thus assess the fairness or excessiveness of, a mark-up or mark-down based on the prevailing market price of the security. IM 2440–2 presumes that the prevailing market price is the dealer’s contemporaneous cost (or the dealer’s contemporaneous proceeds), but permits dealers to consider contemporaneous transactions or quotations, prices of similar securities, or a price derived from economic models when the presumption is overcome (e.g., due to intervening changes in interest rates, credit quality, or other information). *Id.*

\[103\] See *infra* notes 106–119 and accompanying text.

\[104\] See *infra* notes 120–128 and accompanying text.

\[105\] See *infra* notes 129–140 and accompanying text.
term demands of clients, customers, or counterparties.”

As discussed above, the Rule covers the purchase and sale of (or acquisition or disposition of positions in) securities, futures, options, derivatives, or other financial instruments determined by the Agencies. To implement the definition of market-making-related activities, the Agencies have devised various qualitative criteria relating to the intent of the entity (or its trading desk), compliance with which would be monitored by the quantitative metrics and compliance program discussed in the following sections.

In the proposed rules, the Agencies limit eligibility for the exemption to those banking affiliates that are regulated as dealers with respect to the appropriate instrument. The affiliate, or the relevant trading desk of the affiliate, must also “hold[] itself out as being willing to buy and sell . . . the covered financial position for its own account on a regular or continuous basis.” Furthermore, its activities, as required by the statute, must not “exceed the reasonably expected near term demands of clients, customers or counterparties.” More controversially, the Agencies propose that such activities must be “designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable” to appreciation in the value of covered positions or the hedging of such positions. The compensation of persons performing the market-making-related activities must also be designed “not to reward proprietary risk-taking.”

Despite the repeated statutory references to the design of a trading desk’s activities, industry commenters criticize the proposed definitions for hard coding criteria or presumptions for distinguishing permissible and impermissible activities, particularly given that the Agencies have not tailored these definitions to reflect the variety of markets in which financial instruments trade. To characterize a transaction in a particular financial instrument as being motivated by the desire to reap a short-

---

107 Id. § 1851(h)(4); see supra notes 62–102 and accompanying text.
109 See id. at 68,947, Proposed Rule § _4(a)(2)(iv). The rules require, for example, that a bank affiliate (other than an entity engaged in business outside of the United States) relying on the exemption be registered as a dealer, a swap or security-based swap dealer, a government securities dealer, or a municipal securities dealer, depending on the instruments in which the entity deals. See id.
110 Id. § _4(b)(2)(ii).
111 Id. § _4(b)(2)(iii).
112 Id. § _4(b)(2)(v).
113 Id. at 68,948, Proposed Rule § _4(b)(2)(vii).
114 See, e.g., SIFMA-ABA-TCH Letter, supra note 11, at A-24 to -25.
term profit, as opposed to meeting the demands of a customer, client, or counterparty, might be deemed to depend on factors such as the availability of the instrument, the frequency with which it trades, the size of the entity’s transactions, and price volatility.\footnote{Id.}

The most contested element of the proposed definition, however, is the revenue tracing requirement. Although the Rule specifically targets profit-taking from short-term price movements,\footnote{See 12 U.S.C. § 1851(d) (1) (B), (h) (4) (Supp. IV 2010).} dealers will claim that, for many illiquid securities, it is impossible to distinguish profits from spreads, markups, and commissions, and profits from short-term price movements.\footnote{See, e.g., SIFMA-ABA-TCH Letter, supra note 11, at A-30 to -34, A-129 to -130 (asserting that the distinction between fee income, spreads, and price appreciation “falls apart in less liquid markets where, among other things, market makers often need to hold inventory”).} Finding a party willing to take the opposite side of a trade might take a significant period of time, during which the dealer is subject to the risk of both favorable and adverse price movements.\footnote{Duffie, supra note 97, at 19 (“Were the proposed rule to be implemented, market makers who absorb large demand and supply shocks into their inventories would experience a ‘deterioration’ in the proposed metrics for their market-making risk, and the associated threat of regulatory sanction. They would also be less inclined to absorb the associated risks given the likely sanctions for significant profits from price changes. Further, under the proposed rules for trader compensation, market making traders would have significantly lower incentives to accept trades involving significant increases in risk or profit.”).} Although the Agencies propose requiring firms to develop metrics for distinguishing revenues from spreads and revenues from price movements,\footnote{See infra notes 120–128 and accompanying text.} the utility of such daily measurements turns on the availability of enough contemporaneous (or reliable historical) data about market prices to draw meaningful distinctions—the less pre-trade and post-trade transparency a market exhibits, the less meaningful such measurements will be.

2. Measures of Market Making Activity

In addition to the design element, the Agencies propose certain quantitative recordkeeping and monthly reporting requirements on banking entities and their subsidiaries and affiliates that (on a consolidated basis) have trading assets and liabilities the gross sum of which is greater than or equal to $1 billion, with heightened requirements if the gross sum is greater than or equal to $5 billion.\footnote{Proposing Release, 76 Fed. Reg. 68,846, 68,956–57 (OCC et al. Nov. 7, 2011).} The statistics required of entities engaged in market-making-related activities are the
most detailed, and include various measures of risk management, revenue sources, revenue relative to risk, and customer-facing activity. The relevant entity or trading desk is required to compute such statistics and its compliance personnel are required to use the data to monitor compliance with the exemption pursuant to the firm’s internal controls and written policies and procedures.

Although the banking industry appears more receptive to the use of quantitative measurements, at least one commentator has expressed concern that the proposed metrics under the Volcker Rule (1) do nothing to encourage a duty similar to the affirmative obligation of market makers to supply liquidity when it is needed, and (2) further undermine the idea of a negative obligation to refrain from trading in instruments for which liquidity is not needed. For example, the use of metrics that measure revenue versus risk will discourage firms from facilitating customer transactions that expose the firm to significant proprietary risk; instead, such firms may prefer “cream skimming” transactions that reap

121 All banking entities and trading desks subject to Appendix A that engage in market-making-related activities are required to calculate “value at risk” (VaR) on a daily basis. *Id.* at 68,957. Those with over $5 billion in gross trading assets and liabilities must also calculate Stress VaR, VaR Exceedance, certain Risk Factor Sensitivities, and Risk and Position Limits (whether expressed as VaR or Risk Factor Sensitivities, or otherwise, such as net position limits) on a daily basis. *Id.* at 68,957–58.

122 All banking entities and trading desks subject to Appendix A that engage in market-making-related activities are required to calculate daily by trading unit Comprehensive Profit and Loss ("P/L") (and Attribution of Comprehensive P/L to separate sources of risk and revenue), as well as to calculate separately daily profits and losses from changes in market value of their underlying holdings (Portfolio P/L); from the spread charged between purchases and sales, whether by reference to prevailing market prices or appropriate proxies (Spread P/L); and Fee Income and Expense. *Id.* at 68,958–59. In this connection, entities or desks must also report daily the ratio of Spread P/L and Fee Income received to the amount paid out by the unit. *Id.* at 68,960.

123 All banking entities and trading desks subject to Appendix A that engage in market-making-related activities are required to calculate the volatility of Comprehensive P/L and the volatility of Portfolio P/L, as well as the respective ratios of P/L to volatility, on a 30-day, 60-day, and 90-day basis. *Id.* at 68,959. In addition, those with over $5 billion in gross trading assets and liabilities must also calculate Skewness and Kurtosis of P/L (with a view to monitoring the symmetry and prevalence of extreme deviations of profits and losses) as well as the number of unprofitable days (based on Comprehensive and Portfolio P/L) with the same frequency. *Id.* at 68,959.

124 All banking entities and trading desks subject to Appendix A that engage in market-making-related activities are required to calculate on a 30-day, 60-day, and 90-day basis the amount of risk associated with its inventory (as measured by each of its Risk Factor Sensitivities) that is turned over, the amount of time its trading assets and liabilities have been held, and the ratio of trades effected with customers and noncustomers (as identified by the firm’s compliance program). *Id.* at 68,959–60.

125 *Id.* at 68,957.

easy profits with little risk.\footnote{Id. (observing that a bank’s market making affiliate could cream-skim the market by limiting their activities to highly liquid securities that pose little market risk).} Likewise, metrics that focus on trading activity with clients, as opposed to other financial services firms, may inappropriately discount the value of the liquidity that wholesale dealers provide to facilitate client-oriented transactions by smaller dealers.\footnote{Id. (arguing that proposed criteria and metrics would “discourage the use of market making discretion” and “meeting a client’s demand for immediacy would be unattractively risky relative to the expected profit”).}

One can of course debate whether such forms of trading are or should be beyond the scope of the market making exemption, but to the extent that there exist socially valuable types of proprietary trading that present significant risks, there will be relentless pressure on the Agencies to view these statistics charitably. The utility of metrics that attempt to distinguish portfolio profits and losses from spread profits and losses and other sources of fee income is particularly problematic for all but the most liquid markets. To the extent that firms presumably have an incentive to maximize recorded and reported Spread Profit and Loss (“P/L”) and minimize Portfolio P/L, firms may stiffen resistance to the implementation of market structures that will encourage greater fungibility and provide greater pre-trade transparency (and thus less opportunity to manufacture their own estimates of prevailing spreads for purposes of these computations).

3. Compliance Program Requirement

The final piece of the Volcker Rule exemption is the requirement to establish an internal compliance program to ensure compliance with the exemption as appropriate for the particular entity.\footnote{Proposing Release, 76 Fed. Reg. 68,946, 68,955, Proposed Rule §§ .4(b)(2)(i), .20(a) (OCC et al. Nov. 7, 2011) (stating that compliance should be appropriate for the “size, scope and complexity of [its] activities and business structure”).} Among other elements, the compliance program must consist of (1) “written policies and procedures” regarding activities covered by the Rule, (2) “internal controls” reasonably designed to monitor and identify potential areas of noncompliance, (3) a “management framework” that presumably escalates potentially noncompliant activity as necessary for review and appropriate remedial action, (4) “independent testing” of the compliance program for effectiveness, (5) training, and (6) sufficient record-keeping to demonstrate compliance.\footnote{Id. at 68,853.}
Firms whose trading assets and liabilities equal or exceed $1 billion (or ten percent or more of its assets) are required to comply with additional compliance standards.\textsuperscript{131} The internal policies and procedures must contain detailed identification of trading accounts, trading units, and organizational structure; a description of the mission and strategy for each trading unit (including authorized activities, revenue sources, and identification of customers); and a description of risks and risk management processes, as well as hedging policies and procedures.\textsuperscript{132} The required internal controls, moreover, must not only ensure compliance by each trading unit with authorized risks, instruments, products, and risk limits, but also develop and implement additional quantitative measurements designed in accordance with the firm’s specific trading strategy.\textsuperscript{133} The policies and procedures must also explain how violations will be remedied.\textsuperscript{134}

All federal financial regulators have significant experience developing inspection and examination programs to ensure that firms establish, maintain, and update proper controls, policies, and procedures in light of the scope of their activities, as required by the Rule.\textsuperscript{135} The ability to take appropriate supervisory action in the face of evidence that the Rule has been violated—whether in the form of quantitative metrics or otherwise—will be more problematic. The Rule provides, for example, that the primary recourse for the Agencies, upon “reasonable cause to believe” that an entity has violated the Rule’s restrictions, is to order termination of the activity, after due notice and the opportunity for a hearing.\textsuperscript{136}

Some regulators are better equipped to implement this form of regulation than others.\textsuperscript{137} From the perspective of bank regulators, who are accustomed to continuous examination of their regulated entities’ business practices and have considerable discretion and resources to coerce compliance through the supervisory process, the implementa-

\textsuperscript{131} Id. at 68,963 app. C.
\textsuperscript{132} Id. at 68,964.
\textsuperscript{133} Id. at 68,965.
\textsuperscript{134} Id.
\textsuperscript{136} Id. § 1851(e)(2).
\textsuperscript{137} Cf. Eric J. Pan, Four Challenges to Financial Regulatory Reform, 55 Vill. L. Rev. 743, 756 (2010) (noting that the organization of a regulatory system must take into account “whether the arrangement of existing agencies suits their regulatory responsibilities” and “whether multiple agencies have adequate resources”).
tion of the Rule may seem relatively noncontroversial. The Commissions, which traditionally rely on administrative and judicial enforcement tools, will have to decide to what extent they intend to devote regulatory resources either to reviewing such reports or to taking appropriate enforcement action against banking entities under their supervision. This allocation of responsibility also raises important questions about the discretion of the Commissions to adopt rules that serve ancillary objectives.

II. The Volcker Rule and Its Expressive Potential

However effective the Rule may be in achieving its stated ends, the Rule’s prohibition nevertheless conveys an unmistakable discontent with the proprietary trading activities of banks. A more ambitious reading of the Rule could recognize the opportunity to build upon the experience gained from the Glass-Steagall Act of 1933 and the Gramm-Leach-Bliley Act of 1999 to improve the quality of proprietary trading services provided by financial services providers. Even if Congress may not have explicitly contemplated such a role for the Volcker Rule, the framers of the Rule clearly recognized the important public interest in preserving certain proprietary trading activities. Moreover, the structure of the Rule arguably authorizes the Agencies to influence the

---


139 See, e.g., Tamar Frankel, Regulating the Financial Markets by Examinations 26 (Bos. Univ. Sch. of Law, Working Paper No. 09-08, 2009), http://ssrn.com/abstract=1339913 (“Currently, a more significant portion of the SEC’s resources is devoted to enforcement by prosecution, including investigation of particular offenses. The Commission’s Office of Compliance is far smaller. As compared to the banking regulators, the SEC examination force is even smaller.”).

140 See infra notes 322–346 and accompanying text.

141 156 Cong. Rec. S5894 (daily ed. July 15, 2010) (statement of Sen. Jeffrey Merkley) (“While the intent of section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world and permit a broad array of low-risk, client-oriented financial services.”).

142 See infra notes 250–346 and accompanying text.

143 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd) (“The purpose of the Volcker rule is to eliminate excessive risk taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest.”).
nature of over-the-counter trading in the course of defining the scope of these statutory exemptions.\textsuperscript{144}

To this end, the Rule represents a unique opportunity for the Agencies to consider whether the Rule’s metrics and compliance procedures may be harnessed to influence norms for trading in over-the-counter instruments. Theorists of the expressive function of legislation have grappled with the significance of laws that effectively make statements without necessarily providing punitive damages or devoting significant resources to enforcement.\textsuperscript{145} As discussed below, such expressive laws can arguably help discover, establish, or change prevailing social norms in a manner that changes the behavior of members of a social sphere without the use of legal sanctions.\textsuperscript{146}

Section A discusses the different theories of expressive laws,\textsuperscript{147} whereas Section B analyzes how expressive laws might be employed in financial regulation.\textsuperscript{148} Finally, Section C asserts that an implementation of the Rule that helps to identify the trading preferences of different segments of the trading community could bring significant synergistic benefits to the structure of over-the-counter financial markets.\textsuperscript{149}

A. Theories of Expressive Law

Theorists of expressivism have sought to identify the mechanisms by which a statement of law, without more, can influence behavior.\textsuperscript{150} Perhaps the most straightforward theory, the focal point theory, is that some legal statements may establish a focal point for standardizing behavior.\textsuperscript{151} The focal point theory may apply in a situation where there is no established norm and the law or regulation provides a focal point

\textsuperscript{144} See infra notes 250–346 and accompanying text.

\textsuperscript{145} See infra notes 150–170 and accompanying text.

\textsuperscript{146} In borrowing the concept of expressivism, it is important to distinguish laws that seek to establish a “focal point for coordinating behavior” (as discussed in Part II.A below) from laws that have purely symbolic value without any expectation that they will necessarily change behavior. See infra notes 150–170 and accompanying text. As Cass Sunstein notes, the latter type of symbolic legislation—such as a prohibition against flag-burning—may actually encourage noncompliance by those who disagree with its meaning. See, e.g., Cass R. Sunstein, Social Norms and Social Roles, 96 COLUM. L. REV. 903, 965 (1996) (suggesting that governmental efforts to curb teenage smoking might “backfire and make smoking seem bold or glamorous”).

\textsuperscript{147} See infra notes 150–170 and accompanying text.

\textsuperscript{148} See infra notes 171–182 and accompanying text.

\textsuperscript{149} See infra notes 183–206 and accompanying text.

\textsuperscript{150} See infra notes 151–170 and accompanying text.

for the creation of a new norm.\textsuperscript{152} For example, in the absence of a rule that “all drivers must drive in the right lane,” or that “vehicles proceed through a four-way stop sign in counterclockwise order,” drivers may incur significant transaction costs in navigating traffic.\textsuperscript{153} By announcing a neutral standard that coordinates everyone’s expectations, the law solves the collective action problem in a manner that reduces everyone’s transaction costs.\textsuperscript{154}

More substantially, the focal point theory may also apply where a social norm already exists and the law attempts to alter the existing consensus, whether through the discovery of a new consensus norm or the imposition of an intensely held minority preference on an indifferent majority.\textsuperscript{155} Examples of such social norms include prohibitions against littering in the park or smoking in restaurants. In the absence of a legal statement, those opposed to littering or smoking must either expend significant resources in order to find and preserve litter/smoke-free environments, or suffer disutility from the offending conduct.\textsuperscript{156} The existence of a law, however, may have the effect of discouraging noncompliance and empowering supporters to demand that others come into compliance, thus conforming behavior to the new norm without the use of legal sanctions.\textsuperscript{157}

\textsuperscript{152} Joy Sabino Mullane, The Unlearning Curve: Tax-Based Congressional Regulation of Executive Compensation, 60 Cath. U. L. Rev. 1045, 1074 (2011) (arguing that “[Richard McAdams’] theory works in situations where coordination is needed and a norm has not yet been established”).

\textsuperscript{153} See McAdams, supra note 151, at 1684 (discussing transaction costs).

\textsuperscript{154} See id. at 1659.

\textsuperscript{155} Robert E. Scott, The Limits of Behavioral Theories of Law and Social Norms, 86 Va. L. Rev. 1603, 1615 (2000). Minority preferences may become norms through the private efforts of “norm entrepreneurs” (or “busybodies,” as critics such as Robert Scott may call them) that expend significant individual effort to establish and enforce them. Cass R. Sunstein, On the Expressive Function of Law, 144 U. Pa. L. Rev. 2021, 2030–31 (1996); see Scott, supra, at 1615.

\textsuperscript{156} See McAdams, supra note 151, at 1684 & n.84 (indicating, using smoking as an example, that transaction costs will deter bargaining when conflict arises only once between strangers due to time restraints and due to an inability to efficiently pay either party for the right to restrain from or for the right to engage in smoking); see also Alex Geisinger, A Group Identity Theory of Social Norms and Its Implications, 78 Tul. L. Rev. 605, 640 (2004) (describing the belief among public choice scholars that transaction costs “limit the ability of individual citizens to pursue regulation that satisfies their preferences”).

\textsuperscript{157} See McAdams, supra note 151, at 1685 (suggesting that a public smoking ban might empower nonsmokers to “cause a scene” to enforce their preference for smoke-free environments); Michael Ashley Stein, Under the Empirical Radar: An Initial Expressive Law Analysis of the ADA, 90 Va. L. Rev. 1151, 1173 (2004) (book review) (noting a law’s ability to alter behavior by changing an individual’s preferences, by inducing fear of “social sanctions,” or by inducing pressure upon individuals through “societal sanctions”).
Expressive laws that are intended to change social behavior within a community, however, will work only under certain conditions. First, members of the community must be sensitive to reputational utility, and in particular, the disutility that follows from violating a social norm established through consensus.\textsuperscript{158} For Richard McAdams, such reputational utility might take the form of a human desire to maintain or increase one's respect or esteem within a community relative to others by complying with social norms (whether by not littering in the park, or even calling out those who do), or conversely, to minimize shame resulting from noncompliance.\textsuperscript{159} Other theorists suggest that social norms may be internalized based on second-order preferences (a desire to obey the law or to follow the will of the majority) that trump first-order preferences (littering in the park).\textsuperscript{160}

Second, the norm must be sufficiently publicized that members of the community cannot claim to be unaware of its existence.\textsuperscript{161} Here, the role of law is most salient in discovering and publicizing such consensus. The law can serve, for example, as the "jolt necessary to create a new norm, or strengthen an old one,"\textsuperscript{162} both by virtue of the represen-

\textsuperscript{158} See Robert Cooter, \textit{Expressive Law and Economics}, 27 J. LEGAL STUD. 585, 588 (1998) (describing the individual benefits, including enhanced reputation, that may result when a person upholds a social norm); Richard H. McAdams, \textit{The Origin, Development, and Regulation of Norms}, 96 Mich. L. Rev. 338, 358 (1997) (describing three basic conditions for when an esteem-based norm may arise); Sunstein, \textit{supra} note 155, at 2032 (arguing that "[b]ehavior and choice are a product not only of other people's behavior, but also of the perceived judgments of other people, and those judgments have a great deal to do with—indeed they constitute—social norms," and suggesting that "[r]eputational utility is . . . produced by social norms, and [that] it may shift over time because it is likely to be endogenous to both existing information and to law").

\textsuperscript{159} See Alex Geisinger, \textit{A Belief Change Theory of Expressive Law}, 88 Iowa L. Rev. 35, 41 (2002) (discussing the law’s ability to "influence the probability of a behavior attracting second and third order sanctions," for example, by altering "the meaning of riding a motorcycle without a helmet from an exercise of 'freedom' to an act of high risk"); Stein, \textit{supra} note 157, at 1187–88 (defining first, second, and third order sanctions in the context of the Americans with Disabilities Act and the "fear of social condemnation").

\textsuperscript{160} See Peter H. Huang, \textit{Trust, Guilt, and Securities Regulation}, 151 U. Pa. L. Rev. 1059, 1087 (2003) (indicating that "[c]ommon knowledge of a law helps law coordinate expectations"); McAdams, \textit{supra} note 151, at 1666 (arguing that a sufficiently publicized legal expression often provides a strong focal point).

\textsuperscript{161} McAdams, \textit{supra} note 158, at 403.
tative processes through which laws are formulated and the administrative processes through which they are communicated to the public.\textsuperscript{163} In addition, there must be some probability that compliance and noncompliance with social norms can be detected or observed by members of the community.\textsuperscript{164} If the likelihood that other members of the community will detect a violation is low, the offending members’ expected reputational disutility may be insufficient to override the benefits of noncompliance.\textsuperscript{165}

Perhaps most importantly for our purposes, the new social norm must create a stable, welfare-enhancing equilibrium around which members of a community are able to coordinate their behavior.\textsuperscript{166} A well-grounded norm may grow stronger over time through the network effect of compliance. As more members of the community comply with a norm, norm enforcers will concentrate their persuasive activity on the increasingly smaller number of noncompliant members.\textsuperscript{167} By contrast, a norm that does not create such an equilibrium may never be firmly grounded.\textsuperscript{168} In some areas, such as the imposition of sanctions under criminal law, the idea of a stable equilibrium is often expressed in the language of moral credibility,\textsuperscript{169} whereas in others, it is largely a question whether the utility reaped by norm enforcers creates sufficient leverage to overpower resistance from norm violators who suffer corresponding disutility.\textsuperscript{170}

\begin{flushleft}

\textsuperscript{164} McAdams, \textit{supra} note 158, at 355–61 (discussing three criteria, including “an inherent risk that . . . behavior will be detected,” for “the pattern of disapproval” to create costs for the actor engaging in such behavior).

\textsuperscript{165} \textit{Id.}

\textsuperscript{166} Cooter, \textit{supra} note 158, at 593.

\textsuperscript{167} Sunstein, \textit{supra} note 146, at 909 (describing “norm bandwagons” and “norm cascades”).

\textsuperscript{168} \textit{See} Cooter, \textit{supra} note 158, at 586 (stating that the law’s expressive ability to alter the focal point of a particular behavior “can create or destroy a social norm without changing individual values”).

\textsuperscript{169} \textit{See} McAdams, \textit{supra} note 158, at 398 (indicating that criminal punishments serve both as punishments and as expressions of society’s moral view and condemnation of the sanctioned behavior).

\textsuperscript{170} \textit{Id.} at 358 (indicating that a norm will arise if the cost or benefits afforded by societal esteem outweigh the cost or benefits of engaging in a particular activity).
\end{flushleft}
B. Expressive Law and Financial Regulation

Several scholars have considered whether expressive readings of legislation or judicial decisions can successfully modify behavior in the realm of business or financial decision making. For example, one may argue that the principles-based regulation movement promoted by some scholars of financial regulation is a variant of expressivism. For such scholars, the role of the policymaker is to articulate “best practices” or “core principles,” which are developed and implemented primarily through ongoing information-sharing and guidance between the industry and the regulators, rather than through traditional regulatory enforcement mechanisms. In a similar vein, several scholars advocate mandatory disclosures that may shame regulated entities into compliance with non-mandatory norms. Still others view the sermonizing opinions of the Delaware courts as playing an expressive role in developing fiduciary standards for directors of public companies.

Generally, I doubt that financial legislation may play an expressive role in the same way that expressivist theorists have envisioned in other contexts. One question is whether it is possible to define a community

171 See, e.g., Cristie L. Ford, New Governance, Compliance, and Principles-Based Securities Regulation, 45 Am. Bus. L.J. 1, 38 (2008) (envisioning the role of a regulator in a principles-based and outcome-oriented regulation as “us[ing] its enhanced outcome-oriented analytical capacity to interrogate industry action, communicate results, provide ongoing guidance, and spur laggards with a view to effectuating its irreducibly public policy goals of safeguarding investors and promoting efficient capital markets,” even as it retains “[u]ltimate enforcement and coercive power”); James J. Park, The Competing Paradigms of Securities Regulation, 57 Duke L.J. 625, 671–72 (2007) (“Principles-based regulation requires the regulated to act as moral agents who assess whether their conduct conforms with the principles reflecting those values, not just whether their conduct violates a cost-effective rule.”).


that is capable of enforcing social norms through nonlegal rewards and sanctions.\textsuperscript{174} For example, despite the public hue and cry over excessive executive compensation, there is little evidence that the scorn of public shareholders (or nonshareholders, for that matter) affects the reputational utility of corporate executives.\textsuperscript{175} Executives, as other scholars have suggested, are if anything more likely to be sensitive to their social standing vis-à-vis their peers at public or private companies.\textsuperscript{176} As long as compensation reigns as the measure of esteem in this community, public finger-wagging may continue to be easily brushed off as envy of the “best and brightest.”\textsuperscript{177}

Another question to ponder is whether policymakers or regulators can be taken seriously as norm entrepreneurs.\textsuperscript{178} For example, legislators and regulators who seek to regulate corporate governance or executive compensation, in the view of corporate executives, have little experience in the business world (other than as lawyers) and do not appreciate the complexity and pressure of corporate decision making.\textsuperscript{179} Accordingly, their opinions as to the propriety of governance or compensation arrangements not only may appear to have no moral or common-sense basis, but also may be viewed as impeding the implementation of “useful devices and practices” and “discourag[ing] risk-

\textsuperscript{174} See Geisinger, \textit{supra} note 160, at 652 (arguing that the government has an extremely limited ability to act as a norm entrepreneur because, as an “outgroup source,” the government’s opining will generally be discounted by smaller normative groups).

\textsuperscript{175} See Mullane, \textit{supra} note 152, at 1077–78.

\textsuperscript{176} \textit{Id.} (arguing that recent executive compensation tax penalties failed to create normative attitudinal changes among highly paid executives as would be predicted by McAdams’s theory); \textit{see also} David I. Walker, \textit{The Challenge of Improving the Long-Term Focus of Executive Pay}, 51 B.C. L. \textit{Rev.} 435, 451–55 (2010) (discussing previous failed attempts to rein in executive compensation through tax penalties and securities disclosure regulations).


\textsuperscript{178} See McAdams, \textit{supra} note 151, at 1671–72 (discussing how regulators are actually implementing change and how this role encourages people seeking change to lobby regulators and policymakers).

taking by punishing negative results and reducing the rewards for success.”

In arguing that the Volcker Rule may serve an expressive function, this Article does not make the broad argument that the Rule crystallizes the public’s disdain for proprietary trading in a manner that will pressure the banking community to change its business model. “Making banking boring” has, to be sure, become a progressive mantra. Some policymakers and scholars are struggling to find ways to reorient the mindset of those who manage or control depository institutions, so that they avoid excessive risk-taking unrelated to the core business of insured retail deposit-taking and commercial lending (i.e., “narrow” or “utility” banking). Such a norm, broadly speaking, is not enforceable through private action alone. Even if “safety and soundness” and “avoidance of conflicts of interest” are worthy goals, they cannot be articulated, publicized, and detected with the clarity and consistency that is necessary to marshal the public to shun offenders.

First, it is unclear whether Congress or the Agencies possess the reputational authority within the financial community to articulate such a norm. To have meaning within the banking community, a norm must be forged based on something approximating a consensus view

---

180 Stephen M. Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 95 MINN. L. REV. 1779, 1787 (2011) (quoting Larry E. Ribstein, Bubble Laws, 40 Hous. L. REV. 77, 83 (2003)); see also Ramirez, supra note 179, at 381–82 (suggesting that “neither legislators nor judges are well suited to interpreting and integrating the best academic information on corporate governance” and that “[t]he current system of corporate governance law looks nothing like emerging corporate governance science”).


182 Proposals for banking reform in other jurisdictions tend to rely on legal separation of deposit-taking and proprietary traded entities, rather than a complete bar against affiliation. A proposal advanced by the UK Independent Commission on Banking would achieve this goal by requiring segregation of traditional banking and proprietary trading activities and imposing higher capital requirements on the former. INDEP. COMM’N ON BANKING, FINAL REPORT RECOMMENDATIONS 9–13 (2011) [hereinafter Vickers Report], available at http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf. Similarly, the Liikanen Report on reforming the European Union (EU) banking sector advocates segregation of proprietary trading activities (if they amount to a significant share of the bank’s business) into a separate investment banking affiliate within the bank holding company (“BHC”) structure that is subject to all the regulatory requirements (including capital adequacy and consolidated supervision) pertaining to EU financial institutions. HIGH-LEVEL EXPERT GRP. ON REFORMING THE STRUCTURE OF THE EU BANKING SECTOR, FINAL REPORT, at iii (2012) [hereinafter Liikanen Report], available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/liikanen-report/final_report_en.pdf; see also Arthur E. Wilmarth, Jr., Narrow Banking: An Overdue Reform That Could Solve the Too-Big-To-Fail Problem and Align U.S. and U.K. Regulation of Financial Conglomerates (Part II), 31 BANKING & FIN. SERVICES POL’Y REP., Apr. 2012, at 1, 1–2 (arguing that banks controlled by conglomerates should maintain only traditional banking operations).
within the banking community. Second, even if the Agencies were able to build on such a consensus view, both the Rule itself and the rules promulgated thereunder attest to the difficulty of defining the kind of conduct promoted, tolerated, or discouraged under the putative norm. Third, and perhaps most important, there is little reason to believe that members of the trading community themselves have sufficient incentive—whether reputational or commercial—to take specific action to enforce norms that undercut their profitability. Although “busybodies” may exist within the financial community, the isolated activity of a few gadflies is not likely to be sufficient to sustain a social norm.

C. Expressivism and Market Structure

An expressive implementation of the Rule’s exemption for market-making-related activities may nevertheless shape the structure of over-the-counter markets in a way that direct legislation (such as Title VII of Dodd-Frank) cannot. In particular, market structure—that is, the manner in which intermediaries in financial instruments deal with one another and with end users—is the product of competitive forces and the tension among different categories of market participants. Individual market participants take the primary role in negotiating the structures to address those needs, whether by participating directly in the establishment of trading rules or customs or directing trades to markets that hold out the promise of fair and orderly markets. Regulators nevertheless play a critical role in eliciting the information necessary to understand how markets work and how markets may better serve the interests of individual participants. Thus, the regulators may help generate norms around which market practices may coalesce.

The self-regulatory structure of U.S. securities and commodities markets may serve as a helpful, if imperfect, illustration of the role that regulators can play in the organic development of trading norms. The posture of Congress and the Commissions (the SEC and the CFTC) in such initiatives, including those relating to business conduct, frequently resembles that of a norm entrepreneur, rather than a rulemaker. Some commentators view self-regulatory organizations (“SROs”) as incrementally playing a quasi-governmental role and abandoning their representative character—particularly in light of the consolidation of business conduct and financial responsibility regulation in FINRA. See Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14 Stan. J.L. Bus. & Fin. 151, 159–70 (2008) (discussing the
the realm of sales practice and financial responsibility, for example, Congress has observed that attempts to proscribe unethical conduct at the legislative or agency level would require a “minute, detailed, and rigid regulation of business conduct by law” that would not keep pace with evolving practices in the marketplace.\textsuperscript{185} By contrast, federal financial regulators can often lend significant support to self-regulatory organizations (“SROs”) in identifying and implementing rules for the reciprocal benefit of their members or to “balance the interests of one class of members . . . against the often conflicting interests of another.”\textsuperscript{186}

One simple example of such expressive rulemaking is reflected in the attempts of various agencies to carve out exemptions for market making in the context of federal margin rules.\textsuperscript{187} The concept of market making, borrowed from the context of securities trading, was not directly apposite to open-outcry futures exchanges, in which floor traders provide significant liquidity to other market participants even though they have no obligation to post continuous quotations.\textsuperscript{188} Accordingly, without defining the term “market maker,” the Commissions

\textsuperscript{185} S. Rep. No. 75-1455, at 3 (1938).

\textsuperscript{186} Dombalagian, supra note 184, at 319–22 (describing a concept of “reciprocal” and “partitive” rules of an SRO). In a similar vein, in over-the-counter markets, regulators have sought indirectly to influence market structure by embellishing express fiduciary duties or imposing implied duties—such as the duty of best execution or the duty not to charge excessive or fraudulent markups—in a manner that constrains the trading discretion of market intermediaries acting as principals or agents. See, e.g., Roberta S. Karmel, \textit{Is the Shingle Theory Dead?}, 52 Wash. & Lee L. Rev. 1271, 1275–80 (1995) (describing such duties); David A. Lipton, \textit{Best Execution: The National Market System’s Missing Ingredient}, 57 Notre Dame L. Rev. 449, 458–59 (1982) (describing the “symbiotic relationship” between a best execution rule and national market mechanisms designed to integrate competing market centers).


\textsuperscript{188} See, e.g., Exchange Act § 3(a)(26), 15 U.S.C.A. § 78c(a)(38) (West 2012) (defining a market maker as someone who is willing to buy and sell on a “regular or continuous basis”).
permitted SROs to classify market participants as market makers based on a nonexclusive list of market-specific quantitative criteria.\(^{189}\)

The evolution of specialist trading on organized markets is another, perhaps more instructive example of how regulators influence market structure by articulating norms. The differentiated functions of the participants in an organized market—such as, specialist, market maker, floor trader, broker—and the rules that govern their respective obligations and privileges are the product of decades of evolution in market structure; these rules in many cases predate U.S. securities regulation.\(^{190}\) The SEC has used its influence periodically to adjust the balance of power among specialists and other exchange members as necessary to require specialists to provide (or withhold) liquidity in response to feedback from the trading community as to prevailing market conditions.\(^{191}\)

In 1934, policymakers held “strong conflicting views” as to whether to ban specialist trading outright; specialists, who acted as agents for the execution of public orders on the floor of the exchange, were perceived as abusing the instrumentalities of the market for their own speculative activities.\(^{192}\) Congress instead granted the newly created SEC authority to impose a “negative obligation” on specialists.\(^{193}\) The 1937 “Saperstein Interpretation” described a specialist’s negative obligation as “involv[ing] the exercise of judgment in appraising and

\(^{189}\) Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. at 53,153 (stating that exchanges or associations trading security futures may confer market maker status on a member based on the “percentage of its security futures trades on that exchange or association with persons other than registered market makers” or the percentage of the “exchange member’s revenue . . . derived from business activities or occupations from trading [in] listed financial-based derivatives”).

\(^{190}\) See, e.g., Seligman, supra note 87, at 74–76 (describing the development of and the roles in the NYSE before the creation of the SEC).

\(^{191}\) See, e.g., id. Joel Seligman has described, for example, the shift in allegiance of NYSE floor brokers and public broker-dealers in the 1930s away from the NYSE’s leadership—which tended to be dominated by specialists and floor traders—to the SEC’s proposed reforms as a means to restore the reputation of the NYSE. Id. Likewise, the posture of commission brokerage houses was also a key factor in the SEC’s efforts to reform the role of floor traders and specialists in the 1960s. Id. at 330–33.

\(^{192}\) See, e.g., id. at 144–49 (describing the legislative and regulatory battle behind contemporaneous proposals to segregate trading and brokerage activities more generally); Simon & Trkla, supra note 72, at 241–47, 316 (describing the legislative battle behind the drafting of the original text of Section 11(b)).

\(^{193}\) Exchange Act § 11(b), Former 15 U.S.C. § 78k(b) (1934) (“If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market.”), deleted by Securities Acts Amendments of 1975, § 6(2), Pub. L. No. 94-29, 89 Stat. 97, 111.
weighing the many variables constituting or influencing the market at the time,” and exhorted the importance of considering whether trades are “reasonably calculated to contribute to the maintenance of price continuity and to the minimizing of the effects of temporary disparity between supply and demand,” in light of “the immediate condition of the market and of the specialist’s book” and the “adequacy of the specialist’s position to the reasonably anticipated needs of the market.”

In the 1960s and 1970s, technology-enhanced competition from off-exchange market makers and regional exchanges and facilitated the diversion of trading activity—particularly, large institutional orders—away from the primary exchanges. In 1975, Congress granted the SEC more flexible authority to adopt both affirmative and negative obligations for specialists in order to induce the provision of greater liquidity while recognizing the strain placed on specialists by such competition. The SEC originally proposed to exercise this authority to enforce specialists’ affirmative and negative obligations under an SEC rule; it ultimately imposed a requirement on exchanges to enforce such obligations themselves, while retaining the authority to order an exchange to cancel or suspend a specialist’s registration if the specialist failed to carry out its obligations. The SEC did not dictate how com-

---


195 Seligman, supra note 87, at 486–97 (citing the rise of institutional block orders; market maker competition; the complexity of the order, clearance, transfer, and settlement process; and the rise of the Nasdaq automated quotation system as reasons for the migration of trading away from the primary exchanges).

196 Exchange Act § 11(b), 15 U.S.C. § 78k(b) (2006) (granting the SEC authority to promulgate rules governing the registration of exchange specialists “as necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to remove impediments to and perfect the mechanism of a national market system”); see also Simon & Trkla, supra note 72, at 317 (describing the amendments to Section 11(b) as “consistent with the theme . . . that competition may mitigate the need for regulation, balanced by the pragmatic view that competitive forces should be backstopped by the Commission’s oversight authority to ensure that true competition and its intended benefits occur”). Section 11A of the Exchange Act, added by the 1975 Amendments, set out more sharply defined policy objectives with respect to the national market system, including, among others, that “[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . an opportunity . . . for investors’ orders to be executed without the participation of a dealer.” 15 U.S.C.A § 78k-1(a)(1)(C)(v) (West 2012); see also Simon & Trkla, supra note 72, at 318 (describing this provision as essentially an extrapolation of the specialist’s negative obligation).

197 17 C.F.R. § 240.11b-1(a)(2)(ii)–(iii) (2012) (requiring every national securities exchange to adopt and enforce requirements “that a specialist engage in a course of dealings for his own account to assist in the maintenance, so far as practicable, of a fair and orderly market” and provisions “restricting his dealings so far as practicable to those reasonably
pliance with such obligations was to be measured or enforced and, according to Joel Seligman, “did not once invoke this procedure” during the seven years following adoption of the rule.\footnote{Seligman, supra note 87, at 342.}

Evolving market structure demands in the ensuing years forced the role of specialists (and the SEC’s interpretation of their obligations) in a different direction. As technology enabled exchanges and alternative trading systems to automate the matching of orders, the need for specialists to act as agents has diminished.\footnote{See, e.g., Stanislav Dolgopolov, Providing Liquidity in a High-Frequency World: Trading Obligations and Privileges of Market Makers and a Private Right of Action, 7 Brook. J. Corp. Fin. & Com. L. (forthcoming 2013) (manuscript at 60–61), http://ssrn.com/abstract=2032134 (describing how technical developments have led to exchange rules that are less favorable to specialists).} Many of these technological initiatives—such as the gradual development of the Nasdaq Stock Market over the last quarter century and the automation of the New York Stock Exchange (NYSE)—were in fact encouraged by the SEC.\footnote{See Onnig H. Dombalagian, Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System, 39 U. Rich. L. Rev. 1069, 1082–89 (2005) (describing the emergence of the national market system and the SEC’s role in its development).}

As a result, the relative informational advantages and other privileges of specialists, such as the ability to view orders before they enter the limit order book, have disappeared or been stripped.\footnote{Order Approving a Proposed Rule Change by New York Stock Exchange LLC to Create a New NYSE Market Model, Exchange Act Release No. 58,845, 73 Fed. Reg. 64,379, 64,379–80 (Oct. 24, 2008).} In response, exchanges have adopted quantitative metrics and initiatives for their specialists as a means to induce them to provide greater liquidity, while dropping the negative obligation imposed on specialists (who are now referred to as “designated market makers” on the NYSE).\footnote{Id.}

The analogy to SROs, of course, is imperfect: there is no SRO focused on developing trading norms for over-the-counter debt or derivatives markets.\footnote{See Dombalagian, supra note 184, at 348–52 (advocating for SRO regulation of specific products, especially in the over-the-counter derivatives market).} Nevertheless, such markets are highly interconnected,\footnote{See, e.g., Monica Billio et al., Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors, 104 J. Fin. Econ. 535, 536 (2012) (illustrating through various models how banks, broker-dealers, insurance companies, and hedge funds over the
expectations as to how markets should be structured. Throughout its involvement in market structure, the SEC staff has viewed its role as identifying the conflicting needs of different classes of market participants, articulating the appropriate mix of affirmative and negative obligations, and encouraging the development of market systems that eventually supplanted the most controversial aspects of specialization or market making. Critically, these initiatives were not attempts to adopt and enforce specific rules, but were intended to encourage SROs to adapt or build systems that channeled activity in (what the SEC perceived to be) a more efficient configuration. Moreover, the SEC’s initiatives were reactive to changes in the trading practices and preferences of emerging market constituencies, such as alternative trading systems and institutional investors.

III. TAPPING THE EXPRESSIVE SYNERGY: THE VOLCKER RULE AND MARKET STRUCTURE

In this Part, I propose an implementation of the Volcker Rule’s market making exemption that recognizes the service mission of market making—providing liquidity in financial instruments designed to meet the needs of counterparties as efficiently and economically as possible. If the Rule represents the need for a “rebalancing of incentives” in our financial system, the Rule and its prohibitions and exemptions could be interpreted in a manner that aspires to that aim. In particular, I believe that the Rule may achieve such a rebalancing in the structure of over-the-counter markets. To be clear, it would be inappropriate, in the absence of express congressional intent, to co-opt the Rule to create a full-throated system of affirmative and negative obligations for market makers in swaps and security-based swaps. The past decade “have become highly interrelated, increasing the channels through which shocks can propagate throughout the finance and insurance sectors”.


207 See infra notes 208–249 and accompanying text.

forcement mechanisms established by the Rule may nevertheless offer useful synergies that can be exploited to shape the structure of over-the-counter trading post-Dodd-Frank.

Section A shows that the metrics and internal controls used to enhance compliance with the market-making-related activities exemption could be designed to give nonbank market participants—nonbank market makers and dealers, and institutional or professional counterparties—greater leverage to negotiate for more competitive execution facilities. The collection (and limited publication) of statistics regarding participation in such facilities, execution quality offered through such facilities, and competitiveness with other trading participants would establish these metrics as aspirational goals for the banking entities that participate in such facilities. Moreover, Section B illustrates that nonbank constituencies might use these statistics as leverage when negotiating rule changes or seeking to eliminate barriers to access to such systems, particularly if the Commissions (the SEC and the CFTC) are prepared to consider certain market structures to be presumptively in compliance with the Volcker Rule exemption.

A. Incorporating Market Structure Considerations into Volcker Rule Metrics

To the extent that market making is best understood in the context of organized markets, one approach to implementing the market making exemption is to take into consideration the volume of trading that bank affiliates effect through the trading facilities available for a particular product. Although there is no express link between the Rule and the authority of the Commissions to regulate organized and over-the-counter markets, there is a natural synergy between the two Commissions’ authority to define market making and to define market structure. The manner in which market making is structured in over-the-counter derivatives markets is of particular importance because the Commissions must consider how market makers will function within the new regulatory regime for swaps and security-based swaps.

209 See infra notes 211–239 and accompanying text.
210 See infra notes 240–249 and accompanying text.
211 See infra notes 213–229 and accompanying text.
212 See infra notes 230–239 and accompanying text.
1. Case Study: The Title VII Regime for Swaps and Security-Based Swaps

Rulemaking relating to swap markets under Title VII of the Dodd-Frank Act serves as a concrete example of how an expressive reading of the Rule can directly shape the contours of market making in the over-the-counter market. The Commissions are required to oversee the development of new market structures for swaps and security-based swaps as part of the Title VII reform of the over-the-counter derivatives market. Dealers and certain major participants in security-based swaps (based on the size of their positions, substantial counterparty exposure, or leverage) are required to register with the SEC or the CFTC, as applicable, and to comply with capital, margin, business conduct, conflicts, position limit, recordkeeping, and reporting requirements. Title VII generally requires such swaps or security-based swaps to be cleared through a registered clearing facility (if eligible), to be traded through a swap execution facility (if available), and reported for public dissemination.

The provisions of Title VII governing swap intermediaries barely address the role of such intermediaries in market structure. Statutory terms such as “swap dealer” and “security-based swap dealer” suggest that there is a distinction between market making and dealing activity. For example, in defining the term “swap dealer,” the Commissions

---

213 With limited exceptions, Title VII of the Act classifies most over-the-counter derivatives transactions as swaps or security-based swaps. Commodity Exchange Act (CEA) of 1974 § 1a(47), 7 U.S.C. § 1a(47) (2006 & Supp. IV 2010) (defining “swap” to include most options and executory exchanges of payments on various financial or economic interests, subject to exclusions for traditional securities, futures, physically settled forwards, and security-based swaps); Exchange Act § 3(a)(68), 15 U.S.C.A. § 78c(a)(68) (West 2012) (defining “security-based swaps” to include all swaps based on a single security, a narrow-based index, or a credit event relating to a single issuer or narrow-based group of issuers).

214 For purposes of this Article, references to the term “swap” and any associated instruments, entities, intermediaries, or utilities include, unless otherwise noted, both CFTC-regulated swaps and SEC-regulated security-based swaps.

215 CEA § 4s, 7 U.S.C. § 6s (requiring swap participants to register with the CFTC and granting the CFTC the power to regulate swaps); Exchange Act § 15F, 15 U.S.C.A. § 78o-10 (providing for the registration and regulation of security-based swaps dealers and participants by the SEC).


217 CEA § 1(a)(49), 7 U.S.C. § 1a(49) (defining “swap dealer” to mean any person who “holds itself out as a dealer in swaps,” “makes a market in swaps,” “regularly enters into swaps with counterparties as an ordinary course of business for its own account,” or otherwise “engages in any activity causing the person to be commonly known in the trade as a dealer or...
sions observed that a market maker is one who “routinely,” rather than regularly or continuously, stands ready to enter into a swap at the request or demand of a counterparty. Title VII, however, does not build upon those distinctions in a meaningful way. Much of the regulation of swap dealers, for example, focuses on traditional financial responsibility and business conduct regulation. The Agencies, moreover, have made little effort to date to bridge the concept of market making in the Rule with Title VII.

The clearing and trade execution mandates of Dodd-Frank likewise do not contemplate a specific role for market makers as distinct from other dealers. The Commissions have crafted certain market structure rules in reliance on Title VII’s definition of “swap execution facility.” For example, to qualify as a swap execution facility, a trading facility must offer some “ability to execute or trade [swaps] by accepting bids and offers made by multiple participants” in order to promote

market maker in swaps”); see also Exchange Act § 3(a)(71), 15 U.S.C.A. § 78c(a)(71) (providing an analogous definition of “security-based swap dealer”).


routinely: (i) quoting bid or offer prices, rates or other financial terms for swaps on an exchange; (ii) responding to requests made directly, or indirectly through an interdealer broker, by potential counterparties for bid or offer prices, rates or other similar terms for bilaterally negotiated swaps; (iii) placing limit orders for swaps; or (iv) receiving compensation for acting in a market maker capacity on an organized exchange or trading system for swaps.

Id.

For example, market participants (whether or not affiliated with a bank) deemed to be dealers or major participants in swap or security-based swap markets must comply with information walls and business conduct rules modeled on existing SRO rules for securities and futures brokers and dealers. See generally CEA § 4s, 7 U.S.C. § 6s (2006 & Supp. IV 2010) (authorizing CFTC registration and regulation of swap dealers and major swap participants); Exchange Act § 15f, 15 U.S.C. § 78o-10 (West 2012) (authorizing SEC registration and regulation of security-based swap dealers and major security-based swap participants).

See Exchange Act Release No. 66,868, 77 Fed. Reg. at 30,618 n.272. As discussed above, the Commissions have merely required that an entity claiming the market-making-related activities exemption must register as a “swap dealer” with the CFTC or “security-based swap dealer” with the SEC “unless the person is exempt from registration or is engaged in a dealing business outside the U.S., and is subject to substantive regulation in the jurisdiction where the business is located.” Id.; see supra note 99.

See, e.g., CEA § 1a(49), 7 U.S.C. § 1a(49) (including in the definition of swap dealer any person who “holds itself out as a dealer in swaps” or “makes a market in swaps”).

Id. § 1a(50) (defining “swap execution facility” as a system that allows participants to execute swaps by accepting bids and offers).
price discovery. Under the proposed rules and interpretations, this statutory definition may generally be satisfied by an execution facility that offers a limit order book, the availability of multiple published quotations, or the availability of multiple participants willing to receive requests for quotes. There is no expectation, however, that particular market participants will provide liquidity to such systems on terms that are favorable to their users.

More problematically, derivatives clearinghouses may have “the greater part of the discretion” vis-à-vis the Commissions to decide what kinds of products are eligible for standardized clearance (and therefore standardized trading). Their owners, who are likely to be larger commercial banks or other swap intermediaries themselves, have an incentive to resist broad application of the clearing requirement: all things being equal, spreads on standardized products are likely to be narrower than spreads on bespoke products, and standardized products provide fewer opportunities for exotic terms that could allow the dealer to profit at the counterparty’s expense. Because the mandatory centralized execution requirement applies only to swaps eligible to

---


225 See 76 Fed. Reg. at 1240–41 (setting forth CFTC Proposed Rule 17 C.F.R. § 37.10, which provides what swaps must be made available for trading but does not regulate the terms).


227 Griffith, supra note 226, at 1193–1204. Similarly, they have resisted the requirement to trade through swap execution facilities (“SEFs”) to avoid the risk of adverse selection vis-à-vis better informed counterparties. See, e.g., Letter from the Foreign Exch. Comm. to the Dep’t of the Treasury (Nov. 30, 2010) (No. TREAS-DO-2010–0006–0015 (arguing that the mandates for “central clearing and trading through [SEFs] will have the potential unintended consequence of increasing systemic risk and possibly driving the market to other jurisdictions”).
be cleared, incentives to prevent the clearance of swaps will also indirectly discourage centralized trading. Moreover, because a swap execution facility (“SEF”) may be owned and controlled by an even smaller consortium of banking organizations, there is the further risk that such facilities will be designed to suppress centralized trading in favor of off-exchange, off-facility bilateral transactions.

2. Developing Volcker Rule Metrics That Relate to Swap Market Structure

A Volcker Rule compliance system that aims to improve the quality of market making services would consider a variety of factors in addition to the Agencies’ proposed revenue, risk, and customer-facing activity metrics. Such additional factors might include measures of the participation of banking entities in swap execution or other trading facilities, competitiveness of quotations and actual trades, and readiness to supply liquidity. Not only would such measures encourage centralization of trading and price discovery, but they would also promote the availability and use of standardized swap products, which are less susceptible to the kind of conflicts of interest that the Rule seeks to proscribe. Such standardized products, moreover, may have the added benefit of decreasing systemic risk if they can be liquidated more easily or if default is backstopped by a clearinghouse.

Although more elaborate statistics may be developed for these purposes, some simple examples will suffice. To the extent that it is desirable to centralize trading in SEFs, banking entities could be required to report the percentage of trades (or percentage of notional volume of


229 Proposed Regulation MC, for example, allows any participant in a security-based swap execution facility (together with its related persons) to own or exercise up to twenty percent of its voting interest. 75 Fed. Reg. 65,882, 65,931 (Oct. 26, 2010) (to be codified at 17 C.F.R. pt. 242); see also Rena S. Miller, Cong. Research Serv., R41715, Conflicts of Interest in Derivatives Clearing 11 (2011), http://assets.open CRS.com/rpts/R41715_20110322.pdf (citing concern that the Agencies “have not gone far enough in limiting dealers from gaining monopolistic control over clearinghouses, [SEFs], and exchanges”).

230 See Thompson, supra note 92, at 343–58 (evaluating the tools market regulators have at their disposal and how best to use them).

231 Scholars continue to debate the merits of central clearing of swaps and security-based swaps under Title VII. Compare, e.g., Adam J. Levitin, The Tenuous Case for Derivatives Clearinghouses, 101 Geo. L.J. 445, 461–63 (2013) (discussing clearinghouses’ ability to absorb risk), with Yesha Yedav, The Problematic Case of Clearinghouses in Complex Markets, 101 Geo. L.J. 387, 393–95 (2013) (arguing that clearinghouses will increase systemic risk because they bear the economic risk of the swap but not the legal tools to mitigate the risk).
trades) executed through SEFs relative to total trades eligible for trading through such facilities. A more detailed breakdown of such activity would classify execution facilities by the number of quoting participants as well as the degree of affiliation between the entity and the facility. Competitiveness could be measured by reference to the activity of such entities in individual SEFs. For example, regulators could require disclosure of the percentage of trades (or percentage of notional volume of trades) represented by an entity in each facility, and the notional-volume-weighted frequency at which the entity appears in the best displayed quote or offers the topping quote in such facility.

In this regard, it is important for regulators not just to devise metrics, but also to solicit comment from counterparties and end users as to what metrics would improve the quality of the services market makers provide in the over-the-counter market. For example, the Commissions could compel the publication of a limited subset of these statistics for purposes of facilitating evaluation of market maker services. The SEC has required exchanges, market centers, and broker-dealers to publish statistics about their execution quality. This, in turn, has created incentives for exchanges to incorporate such metrics into their regulation of specialists and market makers. Naturally, it would not be appropriate to require firms to publish the revenue and risk statistics that the Agencies have confidentially requested in the proposed rules. Aggregate statistics on market share, market competitiveness, and liquidity provision would go a long way, however, to helping the public understand how these markets function and how the quality of service may be improved.

Critics are likely to contend that the collection and publication of such statistics may create further confusion as to the scope of permissible market making activities and thereby undermine the effectiveness of internal controls. Moreover, incorporating market-specific statistics into the Rule’s enforcement program might be perceived as an infringement of the right of customers to choose the counterparty with whom and the facilities through which they enter into swaps and secu-

232 The collection and reporting of such data would mainly serve the expressive function described above. Regulators would propose them as guidelines for market making, and the trading community—including banking entities and nonbank constituencies—would latch on to the metrics that gave them the most leverage vis-à-vis bank dealers. See supra notes 171–182 and accompanying text (discussing the role of law in discovering and publicizing norms).


234 See supra notes 68–69.
Conversely, the Rule’s supporters may argue that some of the proposed statistics may encourage greater risk taking, to the extent that execution facilities foster greater competition among bank market making affiliates and between bank market making affiliates and other market makers.

These considerations, however, only underscore the importance of treating the additional proposed metrics as part of an ongoing information-gathering and norm-establishing process. The additional statistics I suggest are no more dispositive of whether a banking entity is in compliance with the Volcker Rule exemption than the statistics proposed by the Agencies. Such metrics, however, would create an atmosphere in which banking entities have an incentive to negotiate with nonbank constituencies—be they rival traders or customers—to sponsor and participate in execution facilities that offer some opportunity for competitive bidding. What is critical is that the Agencies signal to nonbank constituencies a willingness to address their market structure concerns within the context of the market-making-related activities exemption—consistent with the expressivist view that law can encourage the development of new norms by discovering and publicizing consensus views or intense minority preferences.

---

235 Certain end users of swaps—nonfinancial companies that use swaps to hedge or mitigate commercial risk—may elect not to clear transactions with other swap market participants. CEA § 2(h), 7 U.S.C. § 2(h) (A)–(B) (2006 & Supp. IV 2010) (swaps); Exchange Act § 3C(g) (1)–(2), 15 U.S.C.A. § 78c-3(g) (1)–(2) (West 2012) (security-based swaps). The clearing mandate nevertheless applies to swap dealers, major swap participants, and certain other financial companies (e.g., financial intermediaries and certain private funds or commodity pools). CEA § 2(h) (7)(c), 7 U.S.C. § 2(h) (7)(C); Exchange Act § 3C(g) (3), 15 U.S.C.A. § 78c-3(g) (3).

236 Some of the proposed factors might well be at odds with revenue and risk measures. For example, a banking entity that regularly charges wider spreads might report a better Spread P/L, but might not appear as competitive as firms that report leaner Spread P/Ls because they provide more liquidity when needed.

237 Cf. Whitehead, supra note 5, at 70 (suggesting that the Agencies implement the Rule narrowly at the outset, and introduce additional restrictions or prohibitions “over time, with additional data—and a clearer picture of the impact of the new regulation” so that banks and regulators have an opportunity “to assess the impact of the new requirements” and “to fine tune the detailed metrics that are likely to be used in separating proprietary from permissible activities”).

238 See supra notes 120–125 and accompanying text (discussing the Rule’s statistics requirements).

239 See supra notes 150–170 and accompanying text (describing the different expressivist theories).
B. Encouraging the Design of More Competitive Over-the-Counter Markets

The Volcker Rule, more broadly, could be implemented in a manner that favors the creation of trading facilities that address the imbalance between bank and nonbank trading activity. As Luigi Zingales has argued, one “beneficial side effect of the Glass-Steagall Act” was to fragment the banking sector and thereby foster “healthy competition between commercial banks and investment banks.” To the extent that a significant percentage of trading activity in financial instruments is concentrated in a handful of banks as a result of the dismantling of Glass-Steagall, an argument could be made that the Rule should seed larger market structure initiatives to encourage the growth of the nonbank financial sector.

A second step toward improving liquidity and price discovery would therefore be to signal a willingness to consider whether transactions executed in certain qualified execution facilities would presumptively satisfy the market-making-related activities exemption. In particular, the Commissions could work with market operators—not just for swaps, but for a variety of corporate debt and other over-the-counter instruments—to devise rules that enable nonbank financial companies (“NFCs”) to compete effectively with established banking organizations, notwithstanding their smaller size and lack of established customer or counterparty relationships. Such incentives may be necessary to induce the participation of smaller firms that may not wish to or may not be able to raise the capital necessary to compete with established commercial and investment banks.

One approach might be to encourage the development of trading rules—whether as part of the rules of a formal trading facility or as business conduct principles for an SRO charged with overseeing the over-the-counter market—that permit nonbank financial counterparties to step ahead of or share in transactions that would otherwise be executed by a banking affiliate. It might be excessive for such rules to require that execution facilities guarantee parity or precedence for

---

241 Id. at 52–65.
242 Whitehead, supra note 5, at 61–63. Naturally, increasing the amount of liquidity provided by nonbanks—particularly liquidity resulting from speculative trading by private hedge funds—could make it more difficult to monitor the amount of risk within the financial system. Id. at 61–68 (discussing risks from the outsourcing of credit risk by banks to hedge funds).
NFCs with respect to bank-affiliated dealers; the Commissions might nevertheless signal a willingness to allow banking entities presumptively to establish compliance with the Rule for transactions effected through qualifying markets that incorporate similar concepts.

Another approach would be to broaden opportunities for smaller NFCs to act as “quoting participants” in such systems. As one scholar has noted, many NFCs do not currently have the regulatory infrastructure, capital, access to liquidity, and relationships necessary to assume the market making function performed by bank affiliates. For such entities, a regulatory definition of “quoting participant” that considers the focus of their trading activity, rather than their potential to contribute significant liquidity, would ensure some degree of competitiveness. For example, a swap execution facility could deem an NFC to fulfill the “regular or continuous basis” element of the market-maker definition, as the Commissions have permitted in other contexts, by considering whether the member has effected a certain percentage of its trading activity through a specific facility, or by requiring that a large majority of such exchange member’s revenue is derived from trading a particular set of financial instruments through any such facility.

To complement these initiatives, the Agencies would do well to encourage the emergence of a critical mass of NFCs able to participate as quoting participants. One straightforward way to create such an independent, adequately capitalized investment banking sector capable of providing the kind of financial intermediation currently provided by commercial banks is to facilitate the divestiture of trading affiliates from bank holding companies (“BHCs”) (or in the case of BHCs that

243 Such rules would effectively function as the converse of rules that guarantee a specialist a proportion of each order when its quote is equal to the best price on the exchange. See Competitive Developments in the Options Markets, Exchange Act Release No. 49,175, 69 Fed. Reg. 6124, 6129 (Feb. 9, 2004).

244 See Whitehead, supra note 5, at 46. Shifting trading to nonbank financial companies (“NFCs”)—such as hedge funds—might result in less regulatory oversight of such activity. As Charles Whitehead notes, “even if proprietary trading is no longer located in banks, it may now be conducted by less-regulated entities that affect banks and banking activities.” Id.

245 See, e.g., Duffie, supra note 97, at 6. But see, e.g., Letter from Dennis Kelleher et al., Better Markets, Inc., to the Agencies 23 (Feb. 13, 2012), http://www.federalreserve.gov/SECRS/2012/February/20120221/R-1432/R-1432_021312_105537_519233431691_1.pdf (arguing that “it is irrational and baseless to assume that the revenue and profits from market making will be insufficient to attract capital and competition to that activity”); Transcript of CFTC Volcker Rule Roundtable 112–16 (May 31, 2012), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript053112.pdf (statement of John Parsons) (discounting the argument that nonbanks will not provide risk management services that banks will not be permitted to provide under the Rule).

246 See supra note 187–189 and accompanying text.
once were independent investment banks or insurance companies, to divest their depository institutions).\textsuperscript{247} From a regulatory perspective, therefore, regulators may wish to ensure that the path to “debanking” is free from obstacles\textsuperscript{248} and that capital, leverage, and other financial responsibility requirements applicable to such holding companies will take into account the cost of forgoing express federal assistance.\textsuperscript{249}

IV. THE VOLCKER RULE IN CONTEXT

Any implementation of the Volcker Rule is likely to face legal challenges.\textsuperscript{250} Industry participants, for example, are likely to cite the magnitude of the costs associated with the Rule, including both the compliance costs required by the Rule itself, as well as the indirect burden on end users of financial products and financial service providers resulting from lost trading opportunities or off-shore migration of trading activity, as a justification for reconsideration of any combination of final rules adopted by the Agencies.\textsuperscript{251} As compared to the proposed rules,

\textsuperscript{247} Of course, the Financial Stability Oversight Council (“FSOC”) retains the discretion to designate such investment banks or insurance companies as systemically important financial institutions (“SIFIs”) based on the extent and nature of their transactions and relationships with other SIFIs; their leverage, off-balance-sheet exposures, and importance to the economy; the nature, scope, size, scale, concentration, interconnectedness, and mix of their activities; and other risk-related factors. See 12 U.S.C. § 5323 (Supp. IV 2010) (confering authority on the FSOC to require supervision and regulation of certain NFCs). The FRB, moreover, may impose additional capital requirements and quantitative limits on the activities of such SIFIs. Id. § 1851(a)(2).

\textsuperscript{248} 12 U.S.C. § 5327. One key obstacle is Dodd-Frank’s “Hotel California” provision, which ensures that investment banks-turned-BHCs, such as Goldman Sachs and Morgan Stanley, will not escape supervision as SIFIs even if they divest their insured U.S. depository institutions. Id. (providing that any entity that was a BHC having total consolidated assets equal to or greater than $50 billion as of January 1, 2010 and that received financial assistance under the Troubled Asset Relief Program shall be treated as an FRB-supervised NFC). Clarifying how the FRB and the FSOC apply the Hotel California provision to investment banking units of financial holding companies and BHCs would be an effective signal as to whether such spinoffs will be encouraged or discouraged.

\textsuperscript{249} The loss of such access might increase the funding costs of entities that wish to become independent investment banks, but only to the extent that their creditors and counterparties believe that implicit federal assistance will not realistically be available to non-BHCs. One recent study suggests that SIFIs continue to enjoy significant subsidies (up to eighty basis points in funding costs) from such implicit guarantees, notwithstanding higher capital requirements and new liquidation regimes. Kenichi Ueda & Beatrice Weder di Mauro, Quantifying Structural Subsidy Values for Systemically Important Financial Institutions 1–5 (IMF Working Paper, No.12-128, 2012), http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf.

\textsuperscript{250} See supra notes 1–29 and accompanying text.

\textsuperscript{251} Cost/benefit challenges in the U.S. Court of Appeals for the D.C. Circuit have become an important focus of industry groups, such as the U.S. Chamber of Commerce and
the proposals I have advanced modestly increase direct compliance costs (by requiring banking organizations to maintain additional metrics), but significantly liberalize proprietary trading (particularly if one or more safe harbors may be created for qualifying trading facilities). Moreover, they encourage trading in more liquid standardized instruments cleared through a clearinghouse, which arguably promotes financial stability.\(^\text{252}\)

Nevertheless, one may challenge the proposal on the grounds that the Rule does not confer sufficient flexibility and discretion on the Agencies to develop an expressive implementation of its provisions that serve the additional policy objectives I have suggested. The Rule, like the Glass-Steagall Act of 1933, is ostensibly grounded in the twin mission of preserving the safety and soundness of individual banks and of avoiding the conflicts of interest between lending and traditional securities activities;\(^\text{253}\) the legislative history of the Rule, the Financial Stability Oversight Council’s study of proprietary trading, and the invocation of these purposes within the text of the Rule make this much clearer. Accordingly, this Part closely examines the structure of the Rule in the light of its antecedents—the Glass-Steagall Act of 1933 and the Gramm-Leach-Bliley Act of 1999—to find a basis for such a proposal.\(^\text{254}\)

By way of background, Glass-Steagall’s restrictions on proprietary trading by banks and bank affiliates were contained in four key provisions. Sections 16 and 21 (which remain in force today) generally prohibit the conduct of deposit taking and proprietary trading in most securities within the same business entity,\(^\text{255}\) whereas Sections 20 and 32

---

\(^{252}\) See supra note 231 and accompanying text (discussing this argument).


\(^{254}\) See infra notes 263–286 and accompanying text.

\(^{255}\) As amended, Section 16 of the Glass-Steagall Act provides that

\[\text{[t]he business of dealing in securities and stock by [a national banking association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers,}\]
formerly restricted affiliations and interlocking directorates between depository institutions and entities principally engaged in securities underwriting and dealing. Gramm-Leach-Bliley replaced the latter restrictions with a framework of “functional regulation,” under which entities engaged in underwriting, dealing, and other activities that are “financial in nature” could affiliate with certain “well managed” and “well capitalized” BHCs, subject to oversight by the appropriate functional regulator and with limited FRB supervision.

When reading the Volcker Rule against this history, three themes are notable. First, Section A shows that the Rule’s various exemptions were clearly designed to accommodate the positive externalities, as well as the risks and rewards, of proprietary trading by banks and banking affiliates. Second, Section B argues that the Rule confers significant administrative discretion on the Agencies to articulate how the scope of

and in no case for its own account, and the association shall not underwrite any issue of securities or stock.


[1] or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits.

Id. § 378(a)(1).

Although Section 16 refers specifically to national banks, the prohibitions of the Glass-Steagall Act were extended to state banks that are members of the Federal Reserve System by 12 U.S.C. § 330 (2006). The limitations and restrictions in Section 16 as to “dealing in, underwriting and purchasing for its own account” do not apply to certain U.S. government, agency, municipal, and government-sponsored enterprise securities, or to certain marketable corporate debt securities and Canadian government and municipal securities.

See id. § 24 (2006 & Supp. II 2008). Consistent with the practice of financial regulators, such activities are hereinafter referred to as “bank-eligible activities,” and all other activities prohibited by Section 16 are referred to as “bank-ineligible activities.”

More specifically, Section 20 formerly barred affiliations between banks and any entity “engaged principally in the issue, flotation, underwriting, public sale or distribution . . . of stocks, bonds, debentures, notes or other securities.” Banking Act of 1933, Pub. L. No. 73-66, § 20, 48 Stat. 162, 188–89 (formerly codified at 12 U.S.C. § 377) (repealed 1999). Section 32 prohibited any “officer or director” of a member bank from serving as an “officer, director, or manager” of any entity “engaged primarily in the business of purchasing, selling, or negotiating securities” except as permitted by the FRB. Id. § 32 (formerly codified at 12 U.S.C. § 77) (repealed 1999). Although the language in the two sections differs slightly—“engaged principally” in Section 20 versus “engaged primarily” in Section 32—the analysis in this Part focuses exclusively on the interpretation of the “engaged principally” restriction in Section 20.

See infra notes 262–286 and accompanying text.


See infra notes 262–286 and accompanying text.
permitted activities should be implemented as the financial industry and financial markets evolve. Third, Section C argues that the Rule preserves and reinforces the role and mission of federal securities and derivatives regulators in interpreting and enforcing its provisions consistent with the concept of “functional regulation.”

A. The Agencies Must Be Able to Consider More Than Safety and Soundness and Conflicts of Interest

Unlike Glass-Steagall, the Volcker Rule unquestionably permits the Agencies to consider factors other than safety and soundness and conflicts of interest when carrying out their rulemaking obligations. Courts reviewing the administration of Glass-Steagall have often treated these two goals as the exclusive focus of the separation of deposit-taking and dealing activities; despite advocacy by academic commentators and policymakers to broaden implementation of Glass-Steagall, courts have struck down interpretations that deviated from those stated mandates. As the legislative draftsmen behind the Rule note, however, the Rule exemptions are designed to permit the Agencies to consider the positive externalities of bank proprietary trading in addition to safety and soundness and conflicts of interest.

Discussions of the judicial interpretation of Glass-Steagall prohibitions typically begin with the U.S. Supreme Court’s 1971 decision in

---

260 See infra notes 287–321 and accompanying text.
261 See infra notes 322–346 and accompanying text.
262 12 U.S.C. § 1851(d) (1)(B)–(C) (providing market making and hedging exceptions).
263 For example, some scholars argued for Glass-Steagall reform on the grounds that its narrow focus on safety and soundness and the judicial preoccupation with “subtle hazards” did not permit regulators to consider other important policy objectives, such as efficient provision of services and the risks posed by undue concentration of resources. Robert S. Plotkin, What Meaning Does Glass-Steagall Have for Today’s Financial World?, 95 Banking L.J. 404, 411 (1978) (arguing that financial reform should focus on undue concentration of resources, unfair competition, and efficiency); James R. Smoot, Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of “Subtle Hazards” in Bank Regulation, 4 Geo. Mason L. Rev. 21, 22–23 (1995) (critiquing subtle hazards); see also infra notes 267–269 and accompanying text (discussing the U.S. Supreme Court’s use of the term “subtle hazards”).
265 See, e.g., Merkley & Levin, supra note 10, at 542–48. Senators Jeff Merkley and Carl Levin argue that these exemptions provide commercial banks with a better ability to serve clients than Glass-Steagall. Id. at 538–39 (“The Glass-Steagall Act’s separation was overinclusive because its ban on all securities activities at commercial banks swept in truly client-oriented activities that could be managed by developments in securities and banking law.”).
Investment Company Institute v. Camp. In Camp, the Court famously articulated the “apparent” policy reasons for prohibiting commercial banks from engaging in investment banking activities or affiliating with investment banks. In addition to the “obvious danger” that banks might imprudently invest their own assets in securities or other speculative investments, the Court noted the more “subtle hazards” that the bank’s “salesman’s interest” in the activities of its underwriting and dealing affiliates might “create new temptations” to engage in unsound lending activity or divert the facilities of commercial banking “into speculative operations” as a result of the aggressive and promotional character of the investment banking business.

The severity of Glass-Steagall’s prophylactic firewall led a number of scholars to question whether deeper motivations underlay the Act, beyond the twin concerns of safety and soundness and conflicts of interest. After all, the Act’s specific restriction on “securities” activities seemed somewhat out of place to the extent that many equally risky activities remained open to insured depository institutions after the Act’s passage. One scholar has suggested that the purpose of such a prohibition may have been to channel bank activity to underserved sectors of the economy. Other scholars have suggested that the bar may simply have been designed to subvent the investment banking industry, which was decimated by the Great Depression. The courts nevertheless clipped federal financial regulators’ limited attempts to extend the scope of Glass-Steagall beyond these two statutory purposes.

266 401 U.S. 617, 620 (1971).
267 Id. at 629–30.
268 Id. at 630–32.
269 Id. For example, an affiliation with a securities firm might create pressure on a bank to extend credit to its affiliates, to the companies whose shares were underwritten or dealt in by such affiliates, or to customers for the purpose of purchasing such securities. See id. at 632–33. The bank might also succumb to pressure to recommend such securities to bank depositors or to induce the public generally to invest in such securities in reliance on its reputation for “prudence and restraint.” Id. at 632.
271 See, e.g., Langevoort, supra note 270, at 680–83; Macey, supra note 270, at 11–13.
272 See Langevoort, supra note 270, at 691–98.
274 Citicorp, 839 F.2d at 68–69. For example, the FRB sought to interpret the “engaged principally” language to impose a market share limitation on the bank-ineligible activities of Section 20 affiliates. See Sec. Indus. Ass’n, 900 F.2d at 364. Although a bank’s market...
Unlike Glass-Steagall, the Volcker Rule invites the Agencies to balance the risks of proprietary trading against the public benefit of financial services. The Rule’s approach to delimiting the activities of entities affiliated with a bank, for example, is more nuanced than Glass-Steagall’s “engaged principally” test. First, the Rule focuses exclusively on the *intent, design, and nature* of the activities in which banking entities may engage, as opposed to the *quantitative impact* that such trading could have on the entity or its affiliates. Second, the Rule specifically considers the benefits provided to customers, clients, counterparties, and the financial markets, not just the “subtle hazards” posed to banks by their affiliation with other financial services providers.

The language of the Rule thus is distinguishable from Glass-Steagall in that it qualitatively defines the types of dealing activity in which a banking group may engage (e.g., underwriting, market making, and risk mitigating hedging) without specifically imposing any quantitative limitations on such activities. Indeed, other provisions of Dodd-Frank enhance the Agencies’ ability to regulate the quantitative impact of such trading. More significantly, the Rule gives the Agencies supplemental discretion to impose “additional capital requirements and quantitative limitations” regarding permitted activities to protect the safety and soundness of banking entities engaged in those activities.

---


276 See, e.g., Liikanen Report, supra note 182, at 84–85 (noting that the Rule, unlike Glass-Steagall, attempts to make “fine distinctions” between “proprietary” and “customer-driven” activities and between “high-risk” and “low-risk” activities).


278 Section 171 of Dodd-Frank both extends risk capital requirements to BHCs (for which capital adequacy was previously determined pursuant to FRB guidelines) and superimposes minimum leverage capital requirements (tier 1 capital to total assets) on existing capital requirements of depository institutions and BHCs. Id. § 5371. Similar requirements obtain with respect to holding companies of broker-dealers under Section 618 of Dodd-Frank. Id. § 1850a.

279 Id. § 1851(d)(3). Moreover, the Agencies possess similar authority to impose such capital requirements and quantitative limitations on systematically significant NFCs under FRB supervision. Id. § 1851(a) (2).
Finally, the nature of the Rule’s exemptions suggests that some consideration must be given to the value of the financial services provided by banking affiliates. The exemption for investments in small business investment companies, for example, is certainly one motivated by considerations of the public interest, as is the exemption for government securities (particularly to the extent that it continues to include mortgage-backed securities of government-sponsored enterprises such as Fannie Mae and Freddie Mac). Congress was, moreover, surely aware that the permitted activities are inherently risky and pose significant conflicts of interest. Otherwise, it would have been redundant to subject the exemptions to additional limitations on material conflicts and material exposures to high-risk assets or high-risk trading strategies.

If anything, a broader reading of the Rule may well be necessary, given the history of Glass-Steagall, if the Rule is to have any lasting significance. Enthusiasm for enforcing the Glass-Steagall firewall waned as confidence in financial responsibility and business conduct regulation improved and competition intensified among domestic and interna-

As a corollary, the Rule should be viewed as complementing, rather than supplementing, the Agencies’ initiatives to shore up domestic and international capital adequacy standards. Federal financial regulators have already undertaken a revision of the market risk capital requirements applicable to trading assets. Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890, 1890 (OCC et al. proposed Jan. 11, 2011) (to be codified at 12 C.F.R. pts. 3, 208, 225, & 325). Moreover, Basel III, an international regulatory standard for bank capital and stress testing, will introduce liquidity coverage ratios and stable funding ratios with a view to reducing the likelihood of further liquidity crises. See Basel Comm. on Banking Supervision, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring 1 (2010), available at http://www.bis.org/publ/bcbs188.pdf.

282 156 Cong. Rec. S5906 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd) (confirming Sen. Evan Bayh’s understanding that the market-making-related activities exemption “would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function” and without which “market makers would not be able to provide liquidity to markets”).
284 See, e.g., Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750, 68,755 (Dec. 30, 1996) (“Bank holding companies have demonstrated over the past nine years that they are able to manage the risks of investment banking, and section 20 subsidiaries operate as separately capitalized subsidiaries of a bank holding company, outside the control of any affiliated bank and therefore outside the protections of the federal safety net. Section 20 subsidiaries must register as broker-dealers and remain subject to the capital regulations of the Securities [&] Exchange Commission.”). But see Arthur E. Wilmarth, Jr., The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consoli-
tional commercial banks and between commercial banks and non-bank financial services firms. Enforcement of the Rule will likewise require the dedication of significant regulatory resources and may well fall into desuetude as regulatory budgets contract and safety and soundness concerns recede. The information-gathering and information-sharing apparatus required for implementation of the Rule, by contrast, can continue to help shape the evolution of the market structure of over-the-counter markets by helping regulators calibrate the role of market makers in a manner that improves the function of such markets.

B. Courts Should Defer to Agencies’ Interpretation of Activities Exemptions

The Volcker Rule should also be read to confer broad administrative discretion with respect to the meaning of terms such as “underwriting and market-making-related activities” and “risk-mitigating hedging activities,” as well as the variety of metrics employed to measure them. Notwithstanding the Court’s purposive reading of Glass-Steagall in Camp, as early as the 1980s scholars observed a shift toward greater judicial deference to the federal bank regulators’ deregulatory moves.
Such deference is particularly notable in the context of the “activity” analysis under Glass-Steagall, under which courts gave latitude to bank regulators to expand the type and quantity of permitted activities in bank-ineligible securities notwithstanding the significant jurisdictional implications. Congress has furthermore encouraged judicial deference to the federal financial regulators in recent years, both by crafting mechanisms for interagency resolution of disputed terms and by relying on joint rulemaking exercises among competing agencies.

Beginning in the 1980s, courts showed considerable deference to the FRB’s program of permitting commercial banks to compete with investment banks and mutual fund companies through increasingly narrow interpretation of the scope of prohibited activities. The change in courts’ attitudes was first observed in a 1981 Supreme Court case, Board of Governors v. Investment Company Institute (ICI), in which the Institute challenged a FRB regulation permitting BHCs and nonbanking subsidiaries to act as investment advisers to closed-end investment companies. In ICI, the Court deferred to the FRB’s reasonable determination of the appropriate method for restricting conflicts of interest between a bank and its affiliates. Scholars viewed the case as

288 See, e.g., Langevoort, supra note 270, at 718–19 (discussing the reasoning behind the Court’s decisions which strayed from Camp).


291 ICI, 450 U.S. at 48–50.

292 Id. at 64–68 (reframing Camp as a decision that “squarely relied on the literal language” of Glass-Steagall). The Court observed that, unlike an open-end investment company (i.e., a mutual fund), a closed-end investment company does not issue shares after its initial organization and does not redeem its shares; its shareholders must sell their shares in the marketplace. Id. at 51. Thus, a closed-end investment company need not “constantly issue securities to prevent the shrinkage of assets.” Id. The Court further noted that the regulation at issue prohibited banks from underwriting or selling the stock of a closed-end investment company and that it was therefore reasonable to conclude that an advising bank (1) would not be affiliated with an entity “constantly involved in the search for new capital to cover the redemption of other stock,” and (2) would not be subject to promotional pressure. Id. at 67. Accordingly, the Court deferred to the FRB’s reasonable interpretation that a bank could associate with a closed-end investment company without violating the policies underlying Glass-Steagall or the Bank Holding Company Act (“BHCA”). See id. at 64–68, 78 (distinguishing the Court’s holding in Camp, in which the mutual fund at issue was the functional equivalent of an open-end investment company).
heralding a shift away from the purposive analysis of “subtle hazards” in \textit{Camp} toward accommodation of administrative line drawing.\textsuperscript{293}

Throughout the 1980s and 1990s, even as courts continued to engage in a “plain meaning” analysis of the scope of bank-ineligible securities under Glass-Steagall,\textsuperscript{294} they increasingly deferred to the bank regulators’ determination that particular securities activities did not constitute “underwriting,” “dealing,” “distribution,” or “public sales” that were bank-ineligible under Section 16 or Section 20.\textsuperscript{295} For example, courts upheld administrative action permitting banks and their affiliates to participate in private placements,\textsuperscript{296} discount brokerage\textsuperscript{297} (even when coupled with investment advice),\textsuperscript{298} and best-efforts un-

\begin{footnotesize}
\textsuperscript{293} Langevoort, \textit{supra} note 270, at 701–04; Macey, \textit{supra} note 270, at 21–25 (discussing regulations and court decisions after \textit{Camp} and arguing that the power to administer Glass-Steagall switched to the regulatory authorities).

\textsuperscript{294} \textit{Bankers Trust I}, 468 U.S. at 139–40 (holding that commercial paper is a “security” under Glass-Steagall and that the FRB therefore could not permit a state commercial bank to enter into the business of selling third-party commercial paper).

\textsuperscript{295} Although Section 20 affiliates were permitted to engage in bank-ineligible activities, the analysis of bank-eligibility is nevertheless important because Section 20 affiliates could engage in bank-eligible activities without limitation. \textit{See supra} notes 255–256 and accompanying text.

\textsuperscript{296} In 1981, in \textit{Bankers Trust I}, the Supreme Court rejected the FRB’s determination that commercial paper is not a “security” for the purposes of Glass-Steagall. The Court reasoned that the FRB’s “functional analysis,” which focused on marketplace realities, was at odds with the Act’s plain meaning. \textit{Bankers Trust I}, 468 U.S. at 140–43. The Court further noted that the FRB’s failure to make an administrative determination as to whether Bankers Trust’s commercial paper placement program constituted underwriting rendered its legal arguments “post hoc rationalizations . . . entitled to little deference.” \textit{Id.} at 143–44. On remand, instead of relying on a narrow definition of “security,” the FRB determined that Bankers Trust’s activities did not constitute “underwriting,” drawing a distinction between private and public placement of commercial paper. \textit{Sec. Indus. Ass’n v. Bd. of Governors of the Fed. Reserve Sys. (Bankers Trust II)}, 807 F.2d 1052, 1054–55 (D.C. Cir. 1986), \textit{cert. denied} 483 U.S. 1005 (1987). Furthermore, the FRB found that Bankers Trust’s private placement program did not trigger the “subtle hazards” associated with public offerings. \textit{See id.} at 1066–70. On appeal, in \textit{Bankers Trust II}, the D.C. Circuit deferred to the FRB’s determination that Bankers Trust’s private placement of commercial paper did not constitute underwriting, distribution, or public sale of securities. \textit{See id.} at 1062–66; \textit{see also id.} at 1066 (concluding that the FRB’s distinction between private and public placement activities “mesh[e][d] well with the congressional goal of eliminating the ‘subtle hazards’ of conflicts of interest and abuse of fiduciary relationships in banking”); Smoot, \textit{supra} note 263, at 56–57 (describing how Bankers Trust modified its commercial paper program after the Court’s decision in \textit{Bankers Trust I}).


\end{footnotesize}
In these cases, courts relied on the regulators’ articulated justifications and operational controls for permitting such activities and rarely invoked “subtle hazards” as the sole basis for overturning administrative action.

Courts also permitted bank regulators to interpret Section 20’s “intrinsically ambiguous” language with a view to increasing the quantity of bank-ineligible activities in which an affiliate could engage without running afoul of the “engaged principally” requirement. For example, the FRB raised the cap on gross revenues from the bank-ineligible activities of Section 20 affiliates from 5% (beginning in 1987) up to 10% by 1990 and eventually 25% in 1996. In upholding a challenge to the 1998 Citigroup Order, the D.C. Circuit concluded that “[w]here a statute can reasonably be understood to invite an agency to draw a quantitative proportional line, it is rare that a court can reject the agency’s selection of one percentage over another.” By contrast, when the FRB sought to restrict the market share of Section 20 affiliates in connection with the relaxation of limitations

299 Bankers Trust New York Corp., 75 Fed. Res. Bull. 829, 835 (1989); see Bankers Trust II, 807 F.2d at 1054–55 (holding that the placing of commercial paper for clients was consistent with Glass-Steagall); see also Lori Anne Czepiel, Note, Best Efforts Underwriting: Does Glass Steagall Allow It?, 7 ANN. REV. BANKING L. 557, 558 (1988) (discussing the federal government’s leanings toward allowing commercial banks to conduct best efforts underwriting and arguing against it).

300 2 Michael P. Malloy, Banking Law and Regulation § 9.02C (2d ed. Supp. 2012-1); Smoot, supra note 263, at 77–79.


307 Indep. Cmty. Bankers, 195 F.3d at 36. The Independent Community Bankers of America questioned the FRB’s discretion to interpret the “engaged principally” requirement solely by reference to “a purely quantitative proportional line” capping revenue share from impermissible activities and “thereby to disregard other indicia of risk and/or the absolute level of sales volume.” Id.
on revenues, the D.C. Circuit in 1990, in *Securities Industry Association v. Board of Governors of the Federal Reserve System*, struck down the proposed market share limitations for lack of any grounding in the text of Section 20.\textsuperscript{308}

It is arguable, moreover, that since Gramm-Leach-Bliley, Congress has stacked the deck in favor of administrative resolution of the meaning of contested terms through interagency consultation and dispute resolution. As part of the major financial market reforms of the last fifteen years, Congress has required joint or coordinated rulemaking among federal financial regulators in a number of areas, including customer privacy,\textsuperscript{309} the regulation of single stock and narrow-based index futures,\textsuperscript{310} hybrid products,\textsuperscript{311} and swaps and security-based swaps,\textsuperscript{312} among other instruments. Moreover, perhaps in a bid to avoid jurisdictional disputes to be waged through proxies, Congress has created direct mechanisms by which federal agencies may challenge one another’s jurisdictional determinations, with judicial resolution offered only as a last resort.\textsuperscript{313}

The permitted activities exemptions of the Volcker Rule are drafted in a manner that compels administrative discretion. First, whereas Glass-

\textsuperscript{308} See *Sec. Indus. Ass’n*, 900 F.2d at 364.


\textsuperscript{311} 7 U.S.C. § 27d (2006) (imposing on the CFTC the requirement to consult with the FRB with respect to hybrid products that are “predominantly” banking products under 7 U.S.C. § 27c(b)); Exchange Act § 15(j), 15 U.S.C.A. § 78o(j) (imposing on the SEC the requirement to consult with the FRB in connection with the imposition of broker-dealer registration with respect to any “new hybrid product”).

\textsuperscript{312} See, e.g., 15 U.S.C. § 8302 (Supp. IV 2010) (discussing generally the allocation of authority and mutual consultation requirements between the Commissions with respect to swaps, security-based swaps, and relevant financial intermediaries).

\textsuperscript{313} To resolve certain specific interagency disputes between banking regulators and the SEC or the CFTC, Congress has directed courts to focus on the appropriateness of proposed rulemaking “in light of the history, purpose, and extent of regulation” under federal banking laws and federal securities or commodities law, “giving deference neither to the views of the Commission nor the Board.” 7 U.S.C. § 27d(c) (granting the FRB the authority to challenge CFTC rulemaking over hybrid products that are “predominantly” banking products under 7 U.S.C. § 27c(b)); 15 U.S.C.A. § 78o(j) (West 2012) (granting the FRB the authority to challenge the imposition of broker or dealer registration requirements with respect to any “new hybrid product”).
Steagall sought only to distinguish principal and agency trading, the Rule requires the Agencies to make more nuanced distinctions among types of proprietary trading—such as “dealing” versus “market making”\(^\text{314}\)—and relies on the Agencies’ expertise to determine the relevant criteria in the absence of any legislative history or established meaning for such terms.\(^\text{315}\) Similar efforts to classify or articulate the obligations of market professionals, particularly in the context of supervising the implementation of such classifications or obligations by organized markets or SROs, have been referred to the Agencies due to their special competence and have not been struck down as vague or overbroad.\(^\text{316}\)

In addition, the exemption’s latitudinous reach to activities “related” to market making implies even greater administrative deference.\(^\text{317}\) For example, the Supreme Court has held that the FRB’s pre-Gramm-Leach-Bliley authority to determine whether certain activities were “so closely related to banking . . . as to be a proper incident thereto” under § 4(c)(8) of the Bank Holding Company Act (BHCA) was “entitled to the greatest deference.”\(^\text{318}\) In interpreting § 4(c)(8),

\(^{314}\) See supra notes 62–102 and accompanying text (discussing the meaning of “market making”).


\(^{316}\) See, e.g., Shultz v. SEC, 614 F.2d 561, 571 (7th Cir. 1980) (upholding Chicago Board Options Exchange (CBOE) Rule 8.7 against a challenge for vagueness because the affirmative obligation it imposes on CBOE market makers “could not be fully spelled out in a series of specific prohibitions,” because a “market maker is a professional who has voluntarily assumed this delicately-balanced and often very profitable position,” and “[b]y registering as a specialist, he has agreed to act only within certain parameters according to calculations which require his sophisticated judgment”); Schonholtz v. Am. Stock Exch., 505 F.2d 699, 700 (2d Cir. 1974) (per curiam) (refusing to read into AMEX Rule 170, which states the affirmative duty of the specialist to “assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market,” an “obligation to insure a market in which float would be adequate” in the face of an inadequate float that allegedly persisted for two years); Cutner v. Fried, 373 F. Supp. 4, 8 (S.D.N.Y. 1974) (dismissing challenge to the adequacy of NYSE Rules governing specialists as required under Exchange Act Rule 11b-1(a)(2) on the ground that “determination of whether a rule governing specialists on the Exchange is adequate or inadequate raises issues calling for the exercise of judgmental factors which are within the special competence of the SEC and outside the conventional experience of judges and juries”).


\(^{318}\) ICI, 450 U.S. at 56 (interpreting § 4(c)(8) of the BHCA, 12 U.S.C. § 1843(c)(8)). The D.C. Circuit elaborated that § 4(c)(8) “commits it to the Board to apply a standard of such inherent imprecision . . . that a discretion of almost legislative scope was necessarily contemplated.” Ass’n of Data Processing Serv. Orgs. Inc. v. Bd. of Governors of the Fed. Reserve Sys., 745 F.2d 677, 697 (D.C. Cir. 1984).
the FRB reserved the right to consider “any . . . factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking.” Gramm-Leach-Bliley granted the FRB equally broad authority to identify activities that are “incidental” or “complementary” to a financial activity.

Second, to the extent that the Rule’s exemptions require an inquiry into whether transactions are designed to make markets, to meet “near term demands” of third parties, or with the intent “to profit from short-term price movements,” the quantitative inquiry compelled by such provisions—whether by virtue of simple line drawing or more sophisticated metrics—should rarely be disturbed by a court. Moreover, although judicial review of the arbitrary or capricious nature of SEC/CFTC cost-benefit analysis or the discriminatory or anticompetitive impact of proposed rulemaking remains appropriate, courts should be willing to recognize the difficulty of quantifying the externalities resulting from financial market activity, as discussed above.

C. Functional Regulation Should Permit Consideration of Market Structure

Courts should also respect the philosophy of “functional regulation” espoused in Gramm-Leach-Bliley, which confers authority on the primary financial regulatory agency of each banking affiliate to adopt rules implementing its restrictions. The Commissions (the SEC and the CFTC)—which have exclusive responsibility for regulating the activities of most securities and derivatives dealers within a banking organization under the Rule—traditionally view financial responsibility regulation as part of their overall obligation to ensure the integrity

321 See, e.g., Clement v. SEC, 674 F.2d 641, 646–47 (7th Cir. 1982) (vacating a proposed CBOE rule change and remanding to the SEC for consideration of the anticompetitive and discriminatory impact on market making activity).
323 12 U.S.C. § 1851(b)(2)(B)(i) (Supp. IV’2010). Other amendments to the BHCA, however, expand the authority of the FRB to undertake group-wide supervision of financial holding companies and their affiliates, notwithstanding functional regulation by the SEC, CFTC, OCC, FDIC, or state insurance regulators. Id. § 1844(c).
324 Id. § 1851(b)(2).
of financial markets and the protection of participants in those markets. As a result, the Commissions should enjoy a modicum of discretion to implement the Volcker Rule’s expressive directives in a manner that complements (and is consistent with) their other statutory obligations under Dodd-Frank and federal securities and commodities law.

The approach of the Rule with respect to the role of the Agencies builds upon the framework established by Gramm-Leach-Bliley. Although Gramm-Leach-Bliley is hailed for permitting banking groups to offer a range of financial services to their clients (e.g., commercial banking, investment banking, and insurance), argued its most significant achievement is balancing group-wide oversight of financial institutions against the need to ensure that subject matter regulators retain the authority to regulate the conduct of entities within their respective spheres of activity. Prior to Gramm-Leach-Bliley, the SEC and the federal banking regulators vied over the authority to regulate the securities activities of depository institutions, particularly with respect to sales practices and other business conduct. Although banks successfully rebuffed the SEC’s attempt to regulate the securities activities of depository institutions, Congress, nevertheless, took steps to reconcile disparities in regulation between banks conducting securities-related activities and brokerage firms.

---


327 A Section 20 affiliate of a bank that engaged in securities activities remained subject to Exchange Act registration as a broker-dealer. 12 C.F.R. § 225.200(a) (2012).

328 Am. Bankers Ass’n v. SEC, 804 F.2d 739, 743 (D.C. Cir. 1986) (vacating SEC Rule 3b-9). Under Rule 3b-9, the SEC proposed to narrow the scope of “banks” excluded from the definition of “broker” in Section 3(a)(5) of the Exchange Act, 15 U.S.C. § 78c(a)(5), so that the SEC could regulate depository institutions that earned “transaction-related compensation” from brokerage services, whether as an accommodation for existing banking customers or resulting from public solicitation. 17 C.F.R. § 240.3b-9 (2006).

329 For example, Congress conferred the authority to promulgate rules on all dealers in government and municipal securities (including both traditional securities firms and
Under Gramm-Leach-Bliley, the SEC and other federal and state financial regulators were given express authority to regulate most securities activities of bank affiliates. Banks were required to push out most of their securities and commodities activities to an appropriately registered broker-dealer affiliate. Although the FRB retained some recordkeeping and examination powers over such affiliates, the Commissions became responsible for regulating the activities of firms engaged in securities and commodities dealing respectively, while state insurance regulators remained responsible for regulating the activities of bank affiliates operating as insurance companies. Most notably, the FRB was not given the authority to impose capital requirements on such functionally regulated affiliates.

Dodd-Frank generally reinforces this principle of functional regulation by expanding it to derivatives-related activities, such as over-the-counter interest-rate swaps, currency swaps, credit-default swaps, and other instruments in which banks have commonly dealt. The Lincoln Amendment (also known as the “mini-Volcker Rule”) forces a U.S.-insured depository institution, in order to maintain eligibility for federal assistance, to push out all swaps activity (other than bona fide hedging activities and certain traditional bank activities) to a swaps bank divisions) on the Secretary of the Treasury and the Municipal Securities Rulemaking Board, respectively, with enforcement powers delegated to the dealer’s primary regulator. See 15 U.S.C.A. §§ 78c(a)(34), 78o-3, 78o-5 (West 2012). Congress also required bank regulators to adopt sales practice regulations for banks engaged in government securities dealing. See Government Securities Sales Practices, 62 Fed. Reg. 13,276, 13,276–77 (Mar. 19, 1997) (providing joint rulemaking by federal bank regulators adopting sale practice rules for banks dealing in government securities that are substantially similar to the National Association of Securities Dealers (NASD) Business Conduct and Suitability Rules).


12 U.S.C. § 1844(c)(1)–(2) (2006 & Supp. IV 2010). The FRB’s power to compel reports and conduct examinations of the functionally regulated subsidiaries of a BHC were enhanced by Section 604 of the Dodd-Frank Act.

Id. § 1844(c)(4).

Id. § 1844(c)(3).


The Lincoln Amendment permits banks to enter into hedging and other similar risk-mitigation activities directly related to the insured depository institution’s activities—which include interest rate, currency, and related index derivatives to hedge the bank’s lending and payment systems activities. Id. § 8305(d)(1). Banks are also permitted to engage in swaps activities related to their traditional role in underwriting U.S. government, agency, and municipal securities. Id. § 8305(d)(2). Moreover, the Lincoln Amendment permits banks to enter into credit-default swaps (e.g., on individual debt or asset-backed securities, or baskets of or indices based on a group of asset-backed securities) as long as
entity within a BHC under FRB supervision.\textsuperscript{337} This structure is similar to the proposals in the Vickers and Liikanen reports for UK and EU banking sector reform respectively.\textsuperscript{338} The consequence, however, is that regulation of most market making activity (other than traditional government securities activity) is housed in special purpose affiliates regulated by the Commissions.\textsuperscript{339}

The Volcker Rule, moreover, is structured as a coordinated rule-making of the Agencies, under which the Commissions have the exclusive authority to adopt rules governing those banking entities under their oversight.\textsuperscript{340} Although the Agencies must “jointly” adopt any regulations under the Rule with respect to insured depository institutions,\textsuperscript{341} the Commissions are each entitled exclusively to issue regulations with respect to banking entities for which they are the primary financial regulatory agency.\textsuperscript{342} This agency power is subject only to the requirement that they “consult and coordinate” with the federal banking agencies and each other, “as appropriate, for the purposes of assuring, to the greatest extent possible, that such regulations are comparable and provide for consistent application and implementation.”\textsuperscript{343} The purpose of such consultation is to avoid “providing advantages or imposing disadvantages to the companies affected” and “to protect the safety and soundness” of banking entities and FRB-supervised NFCs.\textsuperscript{344}

This allocation of functional responsibility raises two questions. Firstly, to what extent should the Commissions devote their comparatively scarce examination and enforcement resources to enforcing a Rule that has the ostensible purpose of protecting insured deposits at an affiliated depository institution for which the Agencies themselves are not responsible? Congress’s failure to appropriate sufficient funds

\textsuperscript{337} \textit{Id.} \S 8305(d)(3).

\textsuperscript{338} See supra note 182.

\textsuperscript{339} See supra note 182.

\textsuperscript{340} Although the FRB has rulemaking authority under the Rule with respect to insurance affiliates, the Rule maintains Gramm-Leach-Bliley’s deference to state insurance law, unless a particular law, regulation, or written guidance of the state is “insufficient to protect the safety and soundness of the banking entity or of the financial stability of the United States.” 12 U.S.C. \S 1851(d)(1)(F)(ii) (Supp. IV 2010).

\textsuperscript{341} \textit{Id.} \S 1851(b)(2)(B)(i)(I).

\textsuperscript{342} \textit{Id.} \S 1851(b)(2)(B)(i)(II)-(IV).

\textsuperscript{343} \textit{Id.} \S 1851(b)(2)(B)(ii).

\textsuperscript{344} \textit{Id.} \S 1851(b)(2)(B)(ii).
to the Commissions to enforce compliance would almost certainly render enforcement of the Rule ineffective with rules not critical to their mission.\textsuperscript{345} More saliently, to what extent should they have comparatively greater freedom to shape the contours of an exemption almost exclusively under their jurisdiction\textsuperscript{346} to advance their own regulatory mission? It could not violate the statutory requirement of “coordination, consistency, and comparability” in rulemaking if the Commissions chose to interpret the exemption for market-making-related activities to achieve a broader set of regulatory goals, including the role of ostensible “market makers” in the Title VII market structure.

The implications of the framework for functional regulation for interpreting the exemptions of the Rule are significant. Given this structure, it would be very odd to read the rule as solely concerned with safety and soundness or bank conflicts of interest. After all, why put “functional regulators” such as the SEC, the CFTC, and state insurance regulators—who are charged with ensuring that their registrants are able to satisfy the claims of customers, clients, and counterparties—in the position of policing brokerage, dealing, and underwriting activity under a Rule designed to protect the safety and soundness or the reputation of the insured depository institutions at the financial holding company’s core? If this delegation of authority to the Commissions has any meaning, the Commissions must be able to interpret the provisions relevant to their spheres of activity in a manner that creates positive externalities for the marketplace, as long as they do not jeopardize the safety and soundness of the core depository institutions.

**Conclusion**

It is difficult to predict whether the Volcker Rule will survive the political gamesmanship of the coming four years, let alone endure the tumultuous sixty-six years that Glass-Steagall reigned. The Agencies, and more specifically the Commissions, nevertheless have a window of

\textsuperscript{345} See, e.g., Barbara Black, *The SEC and the Foreign Corrupt Practices Act: Fighting Global Corruption Is Not Part of the SEC’s Mission*, 73 OHIO ST. L.J. 1093, 1117 (2012) (“The SEC has consistently, and with good reason, asserted that it has inadequate resources to address all the increased demands placed upon it, particularly by growth in the securities industry and by Dodd-Frank.”); Joel Seligman, Lecture, *Key Implications of the Dodd-Frank Act for Independent Regulatory Agencies*, 89 WASH. U. L. REV. 1, 16–17 (2011) (“The broader an agency’s jurisdiction, the more likely it is to lack the resources or focus to address all appropriate priorities.”).

\textsuperscript{346} With the exception of bank divisions regulated as government securities dealers or municipal securities dealers, the exemption applies exclusively to securities or derivatives dealers under SEC/CFTC oversight. 12 U.S.C. § 1851(b)(2)(B).
opportunity to empower participants in over-the-counter markets to use the Rule as leverage in negotiating the regulatory and operational structure of those markets over the next few years. An expressive implementation of the Rule’s market making exemption not only will help to differentiate the prospective roles of bank-affiliated dealers, nonbank financial companies, and end-users of financial instruments (and thus create constituencies with an interest in the survival of the exemption), but also may improve the long-term vitality and competitiveness of financial markets.