From: Green, Andrew (Merkley) [mailto:Andrew.Green@merkley.senate.gov]
Sent: Monday, July 18, 2011 12:33 PM
To: Henseler, Timothy; Davis, Julie Z.
Cc: Gellasch, Tyler (Levin)
Subject: Merkley-Levin Harvard Essay

Tim, Julie,

Please find attached an article by Senators Merkley and Levin soon to be published by the Harvard Journal of Legislation discussing the background, legislative history, and implementation considerations of the Merkley-Levin/Volcker Rule provisions.

Can you make sure your Volcker Team gets a copy? We hope they find it useful.

Best,

Andy

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Please consider the environment before printing.

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THE DODD-FRANK ACT RESTRICTIONS ON PROPRIETARY TRADING AND CONFLICTS OF INTEREST: NEW TOOLS TO ADDRESS EVOLVING THREATS

Senator Jeff Merkley* & Senator Carl Levin**

I. Introduction

Proprietary trading1 played a critical role in the recent global financial crisis and subsequent recession. The major global financial firms' proprietary trading losses contributed significantly to the freezing of global financial markets, helping to precipitate more than $17 trillion in investment losses and necessitating bailouts by governments all over the world.2 While a massive economic collapse was prevented, the subsequent recession was nonetheless extraordinarily severe, and the recovery has been slow.

Congress responded to this financial crisis by enacting the broadest financial reforms since the 1930s. These reforms, which constitute the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),3 seek to protect: (1) the U.S. economy from suffering another debilitating financial crisis; and (2) taxpayers from again being called upon to rescue failed financial firms. Critical to those efforts are the Merkley-

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1 Unless otherwise indicated, for the purposes of this Policy Essay, the term "proprietary trading" means the purchase or sale of financial instruments for the firm's own account, including investments in separate private funds managed or sponsored by the firm.


Levin provisions on proprietary trading and conflicts of interest, drafted by the Authors.4

This Policy Essay details why those restrictions are needed, outlines how they came into existence, and highlights some key issues for their successful implementation.

II. NEED FOR REFORM

The Merkley-Levin provisions seek to restore the spirit of regulations that followed the Great Depression. Although the need for reform was evident in the 1930s, the lessons of the Great Depression were forgotten over time, and the regulations that followed in its wake eroded. Decades of deregulation enabled banks to take the risks that precipitated the current financial crisis. Therefore, to understand the purposes of the Merkley-Levin provisions, it is necessary to review the history of post-Great Depression regulatory reform and subsequent regulatory repeal.

A. The Crash of 1929 and the Regulatory Response

President Franklin Roosevelt and the Congress responded to the last great financial crisis—the crash of 1929 and the subsequent Great Depression—by passing a series of laws establishing strong federal regulation of the banking and securities industries, including the Banking Act of 1933 (the “Glass-Steagall Act”),5 the Securities Act of 1933 (the “Securities Act”),6 and the Securities Exchange Act of 1934 (the “Exchange Act”).7

The Glass-Steagall Act instituted a number of significant banking reforms, primary among them: (1) the establishment of federal deposit insurance;8 and (2) the restriction of bank activities to create a separation between institutions engaged in commercial banking9 and those engaged in investment banking10 and trading.11 Establishing federal deposit insurance was

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4 The Authors introduced their initial legislative proposal on March 10, 2010. Protect Our Recovery Through Oversight of Proprietary Trading Act of 2010 (PROP Trading Act), S. 3098, 111th Cong. (2010). The original language was then modified during the Senate floor debate on financial regulatory reform, see infra Part III, and was ultimately included in the final reform package, Dodd-Frank Act §§ 619-21, 124 Stat. at 1620-32 (to be codified in scattered sections of 12, 15 U.S.C.).


9 In this Policy Essay, “commercial banking” refers to the business of taking deposits and extending credit.

10 In this Policy Essay, “investment banking” refers to securities underwriting, dealing, advising, and related activities.
viewed as necessary to protect depositors and to prevent the panic-induced
bank runs that had just ravaged the banking system.¹² Similarly, imposing
restrictions on bank activities was thought to be essential because com­
cmercial bank participation in investment banking and securities trading was
deemed a major cause of the financial collapse.¹³ In particular, banks had
been using their deposits to fund increasingly risky and complex financial
transactions.¹⁴ When the risks of those activities came to bear, the banks
rapidly lost their ability to pay back their depositors or meet their other obli­
gations.¹⁵ In order to effectively insulate the financial system from these
risks, the Glass-Steagall Act generally barred banks from engaging in the
investment banking business. The consequence was a near total separation
of commercial banks from firms that engaged in investment banking.¹⁶

While the Glass-Steagall Act focused on what banks can do, the Securi­
ties Act and the Exchange Act set out regulations for the investment banking
sector. Broadly speaking, the Securities Act sought to regulate new issu­
ances of securities. It prohibited the offer or sale of securities that were not
registered or that did not otherwise qualify for an exemption, and also pro­
vided for certain required disclosures by issuers.¹⁷ The Exchange Act, by
contrast, created new regulations for the secondary trading of securities, and
created a new agency, the Securities and Exchange Commission ("SEC"), to
oversee and police the financial markets.¹⁸

Collectively, these three new laws sought to restore confidence in the
U.S. financial system by limiting the risks, known and unknown, that were
borne by investors and depositors.

¹¹ Glass-Steagall Act §§ 16, 20, 21, 32, 48 Stat. at 184-85, 188-89, 194 (codified as
¹² Thomas A. Brooks, The Federal Deposit Insurance System: The Past and the Potential
¹³ Member banks of the [Federal Reserve] system have manipulated their deposit
accounts . . . releasing enormous funds of the banks to be thrown into the maestros
of stock speculation. . . I have often pointed to the absurdity of States and commu­
nities and the Nation enacting laws making it a criminal offense for a company of
gentlemen to sit around a table and wager at poker, or to go to a race track and bet on
a race, and then legalizing a system of pure gambling that menaces the entire com­
ercial and financial fabric of the Nation.
70 CONG. REC. 3206-07 (1929) (statement of Sen. Glass); see also John Kenneth Galbraith,
¹⁴ See Galbraith, supra note 13, at 43-65.
¹⁵ Steven L. Schwarz, Systemic Risk, 97 GEO. L.J. 193, 199-200 (2008); see also Simon
Johnson & James Kwak, 13 Bankers: The Wall Street Takeover and the Next Finan­
cial Meltdown 31 (2010).
B. Deregulation and Its Consequences

The Glass-Steagall Act's separation of commercial banking from investment banking remained in place for decades, protecting U.S. financial stability and providing a strong foundation for America's rapid post-war growth.\(^1\) However, market, technological, and ideological changes in the 1970s and 1980s began to wear down the strong wall it erected. The rise of competition from investment banking and other "shadow banking" firms\(^2\) put pressure on commercial bankers, who responded by seeking to engage in activities that had long been walled off.\(^3\) Meanwhile, the development of derivatives and securitization\(^4\) during the 1980s and 1990s gave both commercial and investment banks powerful new financial tools.\(^5\) These developments occurred against the backdrop of a deregulatory ideology that became increasingly dominant among financial regulators and lawmakers.\(^6\)

Nevertheless, some observers warned of the consequences of tearing down the wall between investment banking and commercial banking. For example, in 1987, as Congress considered whether to relax the protections of the Glass-Steagall Act, the Congressional Research Service issued a report that offered four key reasons to continue its restrictions:

1. Conflicts of interest characterize the granting of credit—lending—and the use of credit—investing—by the same entity and led to abuses [that started the Great Depression], which originally produced the Act.
2. Depository institutions possess enormous financial power by virtue of their control of other people's money; its extent must be

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\(^{22}\) For a brief description of securitization, see Arthur E. Wilmarth, Jr., The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis, 41 CONN. L. REV. 963, 984-91 (2009).


limited to ensure soundness and competition in the market for funds, whether loans or investments.

(3) Securities activities can be risky, leading to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as a result of securities losses.

(4) Depository institutions are supposed to be managed to limit risk. Their managers thus may not be conditioned to operate prudently in more speculative securities businesses. An example is the crash of the real estate investment trusts sponsored by bank holding companies a decade ago.25

Despite these warnings, the Comptroller of the Currency and the Federal Reserve Board led the steady weakening of the Act's protections.26 The multi-billion dollar bailout of the hedge fund Long-Term Capital Management in 1998, which the Federal Reserve Bank of New York organized to protect the nation's largest commercial and investment banks, should have been a powerful wake-up call regarding new risks in the financial system, in particular related to proprietary trading and relationships with private funds.27 Unfortunately, and in the face of some lawmakers' protests,28 the Financial Services Modernization Act of 1999 (the "Graham-Leach-Bliley Act") repealed the last remaining restrictions of the Glass-Steagall Act.29 These deregulatory steps allowed commercial banking groups to invest and trade in securities for their own accounts, as well as offer banking, securities, and insurance products under one corporate umbrella, placing them in direct competition with their even less-regulated investment banking competitors.30

26 For a timeline of legislative and regulatory changes in banking, see Century of Change, supra note 21. See also Omarova, supra note 25; Wilmarth, supra note 21; FIN. CRISIS INQUIRY COMMN, THE FINANCIAL CRISIS INQUIRY COMMISSION REPORT 33, 55-56 (Jan. 2011) [hereinafter FCIC REPORT], available at http://www.fcic.gov/report.
28 145 CONG. REC. 8,808-10, 28,343-44 (1999) (statements of Sen. Byron Dorgan (D-N.D.)).
30 Wilmarth, supra note 21, at 312-13, 316-36.
C. The Rise of Proprietary Trading: Large Firms, High Risk

Deregulation freed the commercial banks to compete with investment banks and securities firms, including through risky securities and derivatives trading businesses. As competition intensified, both commercial and investment banks grew dramatically.\(^\text{31}\) Using their large balance sheets, these firms amassed enormous proprietary trading positions in increasingly complex and risky assets.\(^\text{32}\) The following graph illustrates the dramatic increase in their trading accounts (which excludes positions held through private funds and longer-term positions)\(^\text{33}\) in the years leading up to the crisis:


\(^{33}\) In general, “trading account” refers to accounts on the firms’ books where assets are held for the near-term price appreciation of the asset. See Fed. Reserve Bd. of Governors, FR Y-9C, INSTRUCTIONS FOR PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS FOR BANK HOLDING COMPANIES GL-76 (2007). What constitutes trading account assets is not consistent across firms. Nor do firms’ reports distinguish between “pure” proprietary trading, which is targeted for prohibition by the Merkley-Levin provisions, and more client-oriented trading, such as underwriting or market-making, which is still permitted, subject to certain restrictions. See David Reilly, Goldman Shows Some Ankle, WALL ST. J., Jan. 12, 2011, http://online.wsj.com/article/SB10001424052748703791904576076144209948656.html. One significant source of risky proprietary trading involved securitization activities, especially resecuritizations. See FCIC REPORT, supra note 26, at 174-78, 188-212.
Proprietary trading benefited the nation's largest financial firms in a number of ways. The implicit taxpayer backing owing to the size, interconnectedness, and cross-border profiles of the firms gave them access to lower-cost funding,\textsuperscript{35} which permitted them to obtain substantial returns on relatively low-yield assets by amassing large portfolios and increasing their lev-

\textsuperscript{34} This graph is based on data from the firms' 10-K filings from years 2002-2007. The values presented are the value of trading account assets at the end of each fiscal year. All the firms listed had fiscal years that ended between November 30 and December 31.

\textsuperscript{35} Analysts have set forth how the largest, most systemically significant firms were able to borrow funds at relatively lower interest rates because creditors viewed them as "too big to fail." Lenders offered them advantageous rates on credit because they believed their risk of default was reduced; that is, the government would not permit them to fail. See DEAN BAKER & TRAVIS MACARTHUR, CTR. FOR ECON. AND POLICY RESEARCH, *THE VALUE OF THE "TOO BIG TO FAIL" BIG BANK SUBSIDY* (2009), *available at* http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf.
These returns were amplified by the use of increasingly complex products and increasingly complex and risky trading strategies.37

Indeed, the largest banks came to rely on proprietary trading for an increasingly large share of their revenues.38 Trading revenues at the largest banks had increased from under fifteen percent of net operating revenues in 2004 to nearly thirty percent at the start of the crisis. However, the same trading exposures left the banks highly vulnerable, and in the fourth quarter of 2007 losses from trading almost entirely offset positive net operating revenues from all other sources combined, with trading losses equaling nearly 250 percent of net operating revenue, devastating the capital bases of many firms.39

D. Proprietary Trading: Traders First, Clients Last

Proprietary trading offers financial firms with clients the additional temptation to magnify returns by taking advantage of their knowledge of investment activities of their clients.40 This temptation proved increasingly irresistible for the largest financial firms and their bonus-driven traders and executives.41 As one well-known investment advisor put it:

36 See, e.g., Report of Exam'nr Anton R. Valukas, supra note 32, at 59-62; D'Arusta, supra note 32; Acharya & Richardson, supra note 32, at 199-204; Wilmarth, supra note 22, at 1052-34; Cassidy, supra note 32, at 86-88. Indeed, many securitization transactions, in particular securitizations, would not have been possible absent firms' proprietary trading positions in the top tranches of those securities. As such, proprietary trading positions in these assets was a critical means through which many firms maintained their securitization deal flow. See Jake Bernstein & Jesse Eisinger, The 'Subsidy': How a Handful of Merrill Lynch Bankers Helped Blow Up Their Own Firm, PROPUBLICA (Dec. 22, 2010), http://www.propublica.org/article/the-subsidy-how-merrill-lynch-traders-helped-blow-up-their-own-firm. Risk-based capital rules for commercial banks and their modified application to investment banks played an important role in facilitating the growth of the trading account in this manner. See FCIC REPORT, supra note 26, at 49, 151.

37 See FCIC REPORT, supra note 26, at 190-95 (discussing the connection between certain securitization practices and proprietary trading); Erik Gerding, Deregulation Pas De Deux: Dual Regulatory Classes of Financial Institutions and the Path to Financial Crisis in Sweden and the United States, 15 NEXUS 135, 151-60 (2010). On how complexity in products and trading amplifies risk and returns, see generally SATYAJIT DAS, TRADERS, GUNS & MONEY: KNOWNS AND UNKNOWNS IN THE DAZZLING WORLD OF DERIVATIVES (2006). See also LOWENSTEIN, supra note 23, at 8-10.

38 See, e.g., Clive Horwood, Credit Suisse Rebuilds Its Model, EUROMONEY, July 2009, at 62, available at https://www.credit-suisse.com/investment_banking/doc/spotlight/euromoney_article1.pdf ("[Credit Suisse] was a leader in the areas where investment banks were making the most money — notably commercial mortgage-backed securitization, private-equity sponsors, leveraged finance and proprietary trading. The bad news was that, as the market began to turn in 2007, those were the very sectors that were most at risk.").


41 156 CONG. REC. S2691 (daily ed. Apr. 27, 2010) (April 23, 2010 Letter from John Reed, Former Chairman and CEO, Citigroup, to Senators Jeff Merkley & Carl Levin). See generally Annette Nazareth, Dir., S.E.C. Div. of Mkt. Regulation, Remarks before the SIA
Proprietary trading by banks has become by degrees over recent years an egregious conflict of interest with their clients. Most if not all banks that prop trade now gather information from their institutional clients and exploit it. In complete contrast, 30 years ago, Goldman Sachs, for example, would never, ever have traded against its clients. How quaint that scrupulousness now seems. Indeed, from, say, 1935 to 1980, any banker who suggested such behavior would have been fired as both unprincipled and a threat to the partners' money.42

Two notable ways in which banks put their proprietary trading interests ahead of their clients were (1) the creation and marketing of products to clients that were secretly designed to fail; and (2) the use of client trading information against the interests of those clients and others in the markets.

1. Designed to Fail

The rise of securitization tempted firms to engage in an egregious form of self-dealing: designing products to fail, selling them to unsuspecting clients, and making proprietary trading bets on the products' collapse.43 This practice has been analogized to a firm designing a car with faulty brakes and then purchasing a life insurance policy on the driver.44

A close look at one of these transactions involving a collateralized debt obligation ("CDO") created by Goldman Sachs reveals much about this conflict of interest.45 In September 2006, Goldman Sachs's executives real-

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45 Details of this transaction were highlighted by the Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, during its hearings and in its 639-page bipartisan
ized that the firm had a significant long exposure to mortgage-related securities. To reduce the firm's exposure, its traders began to sell or transfer to others the risk of loss from its mortgage-related positions, including by creating and selling to clients "synthetic" CDOs that Goldman Sachs designed to produce profits for the firm when the values of the CDOs declined in value.

One of the CDOs it designed was Hudson Mezzanine 2006-1 ("Hudson Mezzanine"). Hudson Mezzanine was a $2 billion synthetic CDO referencing mortgage securities with BBB and BBB- credit ratings. The transaction was structured as follows. Goldman Sachs first created a special purpose entity ("SPE") that was to be the legal issuer of Hudson's securities, which were to be purchased by investors. Goldman Sachs then used credit default swap ("CDS") trades to essentially transfer $2 billion of mortgage-related assets to the SPE, including $1.2 billion in assets from Goldman Sachs's own books that it saw as at risk of losing value and another $800 million in assets that the firm selected for the CDO.

As the sole holder of the short side of the CDS trades, Goldman Sachs was required to make regular payments to the SPE in exchange for a promise by the SPE to pay Goldman Sachs the full value of the referenced securities if they defaulted or incurred other credit problems. The CDS payments made by Goldman Sachs served as part of the cash flow for the CDO and enabled the SPE to make interest payments to the investors who purchased the CDO securities. The investors had also contributed cash when they purchased the Hudson securities.

As long as the referenced obligations retained value, the CDS payments from Goldman Sachs continued and the SPE made the promised interest payments to the investors. In the event of a widespread default on the referenced assets, however, Goldman Sachs would not only stop making CDS payments but would also recover the value of the SPE's assets. This is in contrast to some of the other major Wall Street firms who in the last years before the crisis expanded their proprietary trading exposures to the U.S. mortgage market.
payments, the SPE would have to stop making payments to the investors and instead make payments to Goldman Sachs, using the funds that had been provided by the investors. The CDO was a zero-sum game: either the investors or Goldman Sachs would be paid by the SPE, but not both. By taking 100 percent of the short side of the CDO, Goldman Sachs took a position diametrically opposed to that of the investors who had purchased the CDOs.

Not only had Goldman Sachs structured the deal, but the firm had also marketed and sold the CDOs to the investors. Goldman Sachs told potential investors that Goldman Sachs had “aligned incentives” with them, that the assets had been “sourced from the Street,” and that Hudson was not a “Balance Sheet CDO,” all of which were misleading characterizations. In addition, while Goldman Sachs told potential investors that it was the CDS party facing the CDO, it was market practice for one investment bank to serve as the intermediary between several Wall Street dealers and a CDO. Potential investors were not told that Goldman Sachs intended to keep 100 percent of the short side of the Hudson transaction and was making a proprietary bet that the referenced assets would decline in value.

Hudson Mezzanine and other similar transactions represent securities underwriting, derivatives dealing, and proprietary trading at their most conflicted. Goldman Sachs intentionally designed the product to take a proprietary trading position against the firm’s own risky exposure, and it then marketed the CDO it had designed to fail. Ultimately, this CDO alone allowed Goldman Sachs to earn a gross profit of $1.7 billion at the direct expense of the clients to whom it had sold the Hudson securities.

In testimony to the Senate Permanent Subcommittee on Investigations, Goldman Sachs executives claimed that when the firm did this deal it was merely “market-making” for clients. However, such an assertion defies the common understanding of the term. Goldman Sachs, pursuing its own self-interest, created a product so that it could obtain the short exposure it wanted and then sold the long exposure to clients. It not only bet against its clients; it loaded the dice.

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53 Role of Investment Banks Hearing, supra note 43, at 563 (Exhibit 87).
54 Id. at 235 (Exhibit 1A).
55 Id. at 566 (Exhibit 87) (Goldman Sachs pitch book representing that “[a]ssets [are] sourced from the Street. Hudson Mezzanine Funding is not a Balance Sheet CDO.”).
56 Id.; id. at 227-39 (Exhibit 1A).
57 Role of Investment Banks Hearing, supra note 43, at 134 (statement of Lloyd Blankfein, CEO and Chairman, Goldman Sachs Group, Inc.) (“in the context of market making, that is not a conflict.”).
Proprietary trading also tempted firms to engage in another abuse of their clients—using information from client trades either against those clients or others in the marketplace. A financial services firm that facilitates client trading will often learn information about or from its customers' trading that would present the firm with an advantage when trading for its own account.\(^{59}\) The desire to maximize that “edge” is the point of conflict between the firm’s role as a facilitator of client trading and its own self-interested role as a proprietary trading firm. A classic example of this type of conflict is “front running,” whereby a firm trades ahead of a pending client order to profit from the expected change in price resulting from the order,\(^{60}\) a practice that is already illegal under the federal securities laws.\(^{61}\)

Traditionally, regulators have viewed abuse of client order information narrowly, taking enforcement actions only against abuses such as front running in the same instrument as that ordered by the client or in options referencing that instrument.\(^{62}\) The federal securities laws typically offer little protection against firms improperly using client information in other ways, such as by trading in a similar or otherwise correlated product.\(^{63}\)

One recent example of more robust enforcement is the SEC’s recent settlement of a case against Merrill Lynch. The SEC settled an action it brought against the firm for allowing its proprietary traders to obtain information about its clients’ orders and to use that information to trade on the firm’s account.\(^{64}\) In that case, the SEC pursued its action notwithstanding the fact that the proprietary orders were executed after the client orders and therefore did not amount to a classic case of front running.\(^{65}\) Indeed, one trader at the firm characterized the strategy as follows: “I always like to do what the smart guys were doing.”\(^{66}\) In other words, the firm’s market making activities gave its proprietary traders the distinct marketplace advantage of actually knowing and being able to emulate what the “smart guys” were doing. While the SEC’s effort to crack down on this abuse may be an encouraging step towards attacking a recognized conflict of interest, it is unclear

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59 AUGAR, supra note 40, at 113 (noting the value to financial services firms of “the information they gain from looking at the flow going through their desk[,] The proprietary trading profits of the big investment banks are testimony to that.” (citation omitted)).


62 See, e.g., Nazareth, supra note 41.

63 AUGAR, supra note 40, at 113.


65 Id. at *6-10.

66 Id. at *8.
whether, without new authority, the SEC has sufficient tools to combat the growing conflicts of interest in proprietary trading.\[67\]

**E. Collapse and Bailout**

By the beginning of the financial crisis, the largest financial firms and their private funds had acquired—mostly with borrowed money—billions of dollars in proprietary trading positions.\[68\] In 2007, the markets underlying many of those assets—most notably, but not exclusively, mortgage-related securities—began to sour.\[69\] In July, two large hedge funds managed by Bear Stearns and specializing in mortgage-related securities collapsed suddenly, precipitating a bailout by the firm.\[70\] As markets called into question the value of similar mortgage-related and other risky holdings, firms with such holdings (including off-balance sheet funds and similar vehicles, which came back onto the balance sheet) were successively forced to write down their values and record losses.\[71\] The losses increasingly eroded the firms' capital positions, leading investors to question the firms' solvency and stability. By April 2008, the major Wall Street firms had suffered an estimated $230 billion in proprietary trading losses on what had come to be seen as "toxic" assets.\[72\]
The crisis intensified throughout the remainder of 2008, as the firms and their trading partners and clients each began to minimize business relationships with each other.73 The markets reached their nadir in September of 2008, when firms stopped lending to one another in the overnight market.74 By the end of 2008: (1) Bear Stearns75 and Merrill Lynch76 had failed; (2) Goldman Sachs77 and Morgan Stanley78 had converted to bank holding companies in order to gain access to emergency bailout funds;79 (3) UBS was rescued by the Swiss government;80 and (4) trillions of dollars in taxpayer-backed programs, along with certain accounting maneuvers,81 were

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74 See FCIC REPORT, supra note 26, at 358-60; see also Gorton, supra note 73.


76 See id.


78 See id. (approving the applications for Morgan Stanley, Morgan Stanley Capital Management L.L.C., and Morgan Stanley Domestic Holdings, Inc.).


81 DETERMINING THE FAIR VALUE OF A FINANCIAL ASSET WHEN THE MARKET FOR THAT ASSET IS NOT ACTIVE, Staff Position No. FAS 157-3 (Fin. Accounting Standards Bd. 2008); DETERMINING FAIR VALUE WHEN THE VOLUME AND LEVEL OF ACTIVITY FOR THE ASSET OR LIABILITY HAVE SIGNIFICANTLY DECREASED AND IDENTIFYING TRANSACTIONS THAT ARE NOT ORDERLY, Staff Position No. FAS 157-4 (Fin. Accounting Standards Bd. 2009); RECOGNITION AND PRESENTATION OF OTHER-T HAN-TEMPORARY IMPAIRMENTS, Staff Position Nos. 115-2, 124-2 (Fin. Accounting Standards Bd. 2009); see also Harry Huizinga & Luc Laeven, Accounting Discretion of Banks During a Financial Crisis 16-17, 21-22 (Int'l Monetary Fund, Working Paper No. 09/207, 2009), available at http://www.imf.org/external/pubs/ft/wp/2009/wp09207.pdf; Francesco Guerrera & Patrick Jenkins, Citi Puts $12.7bn Portfolio up for Sale, Fin. Times (Apr. 18, 2011), http://www.ft.com/cms/s/0/8c5fb104-69d0-11e0-89d0-00144feab49a.html#axzz1K0Cvdp5y ("In order to put the assets up for sale, Citi had to reverse an accounting manoeuvre performed during the crisis, when it moved them from its 'trading' book to its 'banking' book. Such a shift, which mirrored moves by other commercial banks, helped Citi to avoid suffering quarterly mark-to-market losses on those assets at the height of the turmoil. Before that move, the bank had suffered billions of
used to keep AIG, Bank of America, Citigroup, JPMorgan Chase, State Street, and the rest of the financial system from collapse.

Plummeting asset prices, the deterioration of world financial markets, and the collapse of leading institutions had generated global economic panic. Commercial banks' proprietary trading losses and write-downs alone totaled an estimated half a trillion dollars or more. To staunch the losses and protect the U.S. economy from further damage, Congress and the Executive Branch responded with a number of actions, including the creation and use of the Troubled Asset Relief Program ("TARP") and Federal Reserve emergency assistance programs.

With the creation of TARP in October 2008, Congress authorized the Treasury Department to spend up to $700 billion to prevent financial institutions from collapsing and further damaging the U.S. economy. TARP was originally intended to buy toxic proprietary trading assets from the balance sheets of the major financial institutions, but TARP funds were ultimately injected as direct equity investments in hundreds of banks under the Treasury Department's Capital Repurchase Program. The largest recipients of TARP funds included AIG, Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, PNC Financial Services, U.S. Bancorp, and Wells Fargo.

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82 Although only the nineteenth largest U.S. bank, State Street is a systemically critical financial institution owing to the $19 trillion in custodial assets it holds. When certain private funds were threatened with collapse, State Street deployed $2.5 billion to rescue them. It, however, subsequently required several billion in emergency bailouts, including $2 billion in TARP funds. Raj Date, Test Case on the Charles, CAMBRIDGE WINTER CTR. FOR FIN. INSTS. POLICY (June 12, 2010), http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/6/12_TEST_CASE_ON3HE_CHARLES_files/state%20street%20volcker%2006121O.pdf.


86 Turmoil in U.S. Credit Markets: Recent Actions Regarding Government-Sponsored Entities, Investment Banks, and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 110th Cong. 26 (2008) (statement of Henry Paulson, Secretary, Department of the Treasury); id. at 29 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors).


To provide additional emergency support to the U.S. financial system, the Federal Reserve aggressively expanded its balance sheet from about $900 billion at the beginning of 2008, to more than $2.4 trillion by December 2010.\textsuperscript{89} Using more than a dozen new and previously existing programs and through more than 21,000 individual transactions, the Federal Reserve provided trillions of dollars in assistance to U.S. and foreign financial institutions in an ultimately successful effort to promote liquidity and prevent a financial collapse.\textsuperscript{90} Such efforts were further enhanced by guarantees on trillions of dollars in assets extended by the Federal Deposit Insurance Corporation ("FDIC") and the Treasury Department to a range of institutions and markets.\textsuperscript{91}

Collectively, these government programs kept credit flowing to a wide range of financial and non-financial institutions in the United States and around the world as markets absorbed the losses from the toxic proprietary trading assets held by many large financial firms. By all estimates, they also amounted to the largest bailout of any financial system in history.\textsuperscript{92}

In many ways similar to the Great Crash of 1929\textsuperscript{93} and the collapse of the hedge fund Long-Term Capital Management in 1997,\textsuperscript{94} proprietary trading losses had once again played a central role in bringing the financial system to its knees. Yet even after taxpayers provided trillions of dollars in support to keep these firms alive, some have asserted that the firms did not need the support or that the collapse had little or nothing to do with proprietary trading.\textsuperscript{95} Those claims are belied not only by the history described above, but by significant TARP funds.


\textsuperscript{93} See \textit{Galbraith}, supra note 13, at 46-51, 56-65.

\textsuperscript{94} See \textit{Lowenstein}, supra note 23, at 163, 221-22 (detailing how the major Wall Street banks’ proprietary holdings exposed them to huge losses if Long-Term Capital Management collapsed).

\textsuperscript{95} See, e.g., Thomas Frommherz, \textit{Morgan Stanley Chairman John Mack Tells Fox Business Network that Finance Reform Will Be More Difficult Due to Healthcare Debate}, \textit{CEOWorld Mag.} (Mar. 23, 2010), http://ceoworld.biz/ceo/2010/03/23/morgan-stanley-chairman-john-
above but even by the firms' own regulatory filings. A review of the firms' disclosed trading revenues, profits, and losses demonstrates the significance of the proprietary trading losses. Studies have since confirmed the dramatic nature of losses properly understood to be proprietary trading losses.

III. FROM VOLCKER RULE TO MERKLEY-LEVIN PROVISIONS: A LEGISLATIVE HISTORY

Following the financial crisis of 2008, a number of leading experts began to recognize the need to restore certain limits to the activities of banks and major financial institutions. In January 2009, the Group of Thirty, chaired by former Federal Reserve Chairman Paul Volcker, released a broad financial reform proposal, calling for, inter alia, a prohibition on proprietary trading at banking institutions.

In the spring of 2009, Senator Merkley began to raise the issue with witnesses at Senate Banking Committee hearings investigating the causes and possible response to the financial crisis. He also began working with Chairman Volcker during the summer and fall of that year. The outgrowth of these efforts was a proposal for the Government Accountability Office ("GAO") to study the issue, which Senator Merkley intended to be a placeholder for the coming debate on restricting proprietary trading. It was

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96 See, e.g., Goldman Sachs Group, Inc., Annual Report (Form 10-K) 27 (Jan. 27, 2009) ("We have 'long' proprietary positions in a number of our businesses. These positions are accounted for at fair value, and the declines in the values of assets have had a direct and large negative impact on our earnings in fiscal 2008." (emphasis added)); Bank of America Corp., Annual Report (Form 10-K) 7 (Feb. 27, 2009) ("We have a large portfolio of assets held for sale at any time in connection with our 'originate to distribute' strategy. We also have large proprietary trading and investment positions in a number of our businesses. These positions are accounted for at fair value, and the declines in the values of assets had a direct and large negative impact on our earnings in 2008, as well as the earnings of Merrill Lynch. We may incur additional losses . . . . " (emphasis added)).


98 See FCIC Report, supra note 26, at 21; Report of Exam'r Anton R. Valukas, supra note 46.


included in Senate Banking Committee Chairman Chris Dodd’s (D-Conn.) legislative proposal introduced in November of 2009.102

Separately, the Permanent Subcommittee on Investigations, chaired by Senator Levin, had begun in late 2008 to investigate the financial crisis, examining transactions that raised concerns related to proprietary trading and conflicts of interest. The investigation eventually led to hearings in April 2010103 that presented some of the troubling transactions that inspired the Merkley-Levin reforms ultimately included in the Dodd-Frank Act.

The Obama administration’s initial financial regulatory reform proposal, which was released in June 2009, included only a limited discussion of proprietary trading.104 Indeed, the draft legislation that the Treasury Department sent to Congress in August 2009 did not include restrictions on either proprietary trading or conflicts of interest.105

In September 2009, the administration identified proprietary trading when listing priorities for future risk-based capital reforms to be negotiated at the Basel Committee on Banking Supervision.106 On November 10, 2009, Senator Dodd released his first comprehensive financial reform bill, which did not include any provision restricting proprietary trading or conflicts of interest but did contain a study of the issues requested by Senator Merkley.107 Several weeks later, the House of Representatives passed financial

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reform legislation, modeled in large part on the administration's proposal, which did not contain any statutory restrictions on proprietary trading. The prospects for including a restriction on proprietary trading in the final financial reform bill increased dramatically on January 21, 2010, when President Obama announced his support for a prohibition on proprietary trading, coining this set of restrictions the “Volcker Rule” after Chairman Volcker, its leading proponent. Chairman Volcker outlined his vision in testimony to the Senate Banking Committee on February 2, 2010, arguing that any effective financial reform bill needed to limit the risk and conflicts of interest associated with proprietary trading (including relationships with hedge funds and private equity funds). At the same hearing, Deputy Treasury Secretary Neal Wolin also testified in favor of the Volcker Rule. At a subsequent Senate Banking Committee hearing, former Citigroup Chairman John Reed and Massachusetts Institute of Technology Professor Simon Johnson offered additional support for the Volcker Rule. A range of financial industry leaders also spoke out in support of the proposal, including former Secretaries of the Treasury Michael Blumenthal, Nicholas Brady, Paul O'Neill, George Shultz, and John Snow, Federal Reserve Bank of Kansas City President Thomas Hoenig, former SEC chairman William Donaldson, and influential investors John Bogle and George Soros.

With an eye towards the coming Senate mark-up of the financial reform bill, the Treasury Department released a proposal to enact the Volcker Rule

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111 E.g., id. at 8-10, 53-56 (statement by Neal Wolin, Deputy Secretary, Department of the Treasury). Secretary Wolin's testimony also included a new proposal from the Treasury Department regarding restricting the size of financial institutions through limiting concentration in certain non-deposit lending markets, a provision that ultimately came to be § 622 of the Dodd-Frank Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 622, 24 Stat. 1376, 1632-34 (2010) (to be codified at 12 U.S.C. § 1852); Prohibiting Certain High-Risk Activities, supra note 110, at 55-56 (statement by Neal Wolin). Although initially referred to as part of the Volcker Rule, the Authors and others generally view it as a separate, albeit important, provision from that which most call the “Volcker Rule.”
This proposal would have authorized the federal banking regulators to write rules that would: (1) prohibit banks and bank holding companies (but not affiliates or subsidiaries) from engaging in proprietary trading and from managing or investing in private equity funds and hedge funds; (2) require additional capital charges and quantitative limits for similar activities at systemically significant nonbank financial firms; and (3) limit the bailout of hedge funds and private equity funds by banks. The prohibition on proprietary trading was not designed to be self-executing, but instead would have relied on the regulators to issue rules.

On March 10, 2010, the Authors, along with Senators Ted Kaufman (D-Del.), Sherrod Brown (D-Ohio), and Jeanne Shaheen (D-N.H.), introduced the Protect our Recovery through Oversight of Proprietary Trading Act ("PROP Trading Act"), a proposal representing a similar approach to the Volcker Rule. Senators Dianne Feinstein (D-Cal.), Bob Casey (D-Penn.), and Bill Nelson (D-Fla.) joined as early co-sponsors.

The Authors' language differed from that of the administration, however, in several respects. First, the PROP Trading Act would have made the restrictions statutory as opposed to regulatory. In the Authors' view, this would give the prohibition greater force if challenged in court. It also allowed the Authors and colleagues in Congress greater ability to shape the contours of the legislation, while recognizing that certain technical details would still need to be worked out in rulemaking. Second, the prohibition would have extended to all affiliates within the bank holding company group. Third, it would have covered all proprietary trading, not just those assets held in the undefined "trading book." Fourth, it would have included additional limitations (the "backstops" discussed below) to guard against permitted exceptions swallowing the rule. Finally, it would have prohibited sponsors of asset-backed securities from engaging in transactions

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115 Proprietary trading was defined as the purchase or sale of "stocks, bonds, options, commodities, derivatives, and other financial instruments" for the "trading book" of the firm and excluding "market making" and other activities "in facilitation of customer relationships," with terms such as "trading book" and "in facilitation of customer relationships" undefined. See Dep't of the Treasury, Amendment to the Bank Holding Company Act Regarding the Size of Institutions and the Scope of Bank Activities, TREASURY.GOV (2009), available at http://www.treasury.gov/initiatives/wsr/Documents/amend.final.-3-3-10.pdf.
116 See id.
117 See id.
119 Id. at sec. 2, § 6.
120 Id. at sec. 2, § 6(h)(2).
121 Id. at sec. 2, § 6(h)(1)(A).
122 Id. at sec. 2, § 6(e).
that would involve or result in a conflict of interest with the investor of the securities, which are often associated with proprietary trading.123

Upon introduction, the PROP Trading Act was endorsed by Chairman Volcker and a range of experts, reformers, and industry leaders, including former Citigroup Chairman John Reed, Nobel Prize-winning economist Joseph Stiglitz, former Labor Secretary Robert Reich, the Independent Community Bankers of America, and Americans for Financial Reform.124

On March 15, Chairman Dodd introduced a revised legislative package, which included a modified Volcker Rule, modeled on the Treasury Department's proposal but with an additional twist.125 Like the Treasury Department proposal, his bill would have directed regulators to issue a rulemaking to restrict proprietary trading126 and certain relationships with hedge funds and private equity funds.127 But, it also directed the Financial Stability Oversight Council ("FSOC") to conduct a study and recommend "modifications to the definitions, prohibitions, requirements, and limitations" that the regulators would be required to follow in conducting their rulemaking.128 The Congressional Research Service noted that allowing a regulatory body to conduct a study and, based upon that study, to make changes in the statutory criteria for the rulemaking introduced additional uncertainty into the rulemaking process.129

With minor changes,130 this text remained in the bill that passed the Senate Banking Committee and was included in the base text for legislative

123 Id. at sec. 3, § 27B (amending the Securities Act of 1933).
127 Id. at § 619(c).
128 Id. at § 619(g)(1)(A), (B).
129 M. MAUREEN MURPHY, CONG. RESEARCH SERV., EXTENT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S AUTHORITY TO MAKE RECOMMENDATIONS AND MODIFICATIONS IN THE PROHIBITIONS ON PROPRIETARY TRADING IN SECTION 619 OF S. 3217, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, REPORTED ON MARCH 22, 2010 BY THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS (Apr. 23, 2010) (stating that granting an executive branch agency the power to "modify" the statutory restrictions was novel, at best, and could lead to unintended and possibly adverse consequences).
debate on the Senate Floor. The section directing the GAO to conduct an independent study of proprietary trading also remained in the legislation.

The Authors were pleased with the progress achieved in the Banking Committee bill but believed that the PROP Trading Act still offered the stronger, sounder approach. Accordingly, on May 10, Senators Merkley and Levin, along with an eventual twenty-three co-sponsors, introduced a modified version of the PROP Trading Act as an amendment to the Senate financial reform base text. This Merkley-Levin amendment differed from the stand-alone PROP Trading Act in several ways. The most notable was that the self-executing prohibition on proprietary trading applied to a “trading account.” The amendment defined this term to focus the presumptive prohibition on proprietary trading in near-term holdings while also giving the regulators the authority (and the implicit directive) to sweep in “other accounts” of longer-term holdings in a careful way. This was intended to allow them to selectively apply the prohibitions to activities such as merchant banking without disturbing traditional, long-term extensions of credit by banks. The amendment also required regulators to conduct a study of the types of activities and investments in which banks are allowed to participate, a provision which was also added at that time and intended to target long-term proprietary trading activities no longer covered by the presumptive prohibition.

131 S. 3217, 111th Cong. § 619 (as amended by S. Amdt. 3739, 111th Cong. (2010), 156 Cong. Rec. S2814-973 (daily ed. Apr. 29, 2010), Apr. 29, 2010). The base text for Senate floor debate on financial reform was the Banking Committee proposal as amended by the Agriculture Committee’s derivatives proposal. For example, the base text included the controversial proposal by Agriculture Committee Chairman Blanche Lincoln (D-Ark.) to bar banks from engaging in any derivatives activities, whether or not those activities were proprietary trading or not. See id. at § 714.

132 Id. § 989 (as amended by S. Amdt. 3739, Apr. 29, 2010).

133 Senators Sherrod Brown, Edward Kaufman, Jeanne Shaheen, Dianne Feinstein, Bob Casey, Bill Nelson, Roland Burris (D-III.), Mark Begich (D-Alaska), Daniel Inouye (D-Haw.), Sheldon Whitehouse (D-R.I.), Claire McCaskill (D-Mo.), Mark Udall (D-Colo.), Barbara Mikulski (D-Md.), Bernard Sanders (I-Vt.), Tom Udall (D-N.M.), Jack Reed (D-R.I.), Richard Durbin (D-Ill.), Jim Webb (D-Va.), Tom Harkin (D-Iowa), Patty Murray (D-Wash.), John Kerry (D-Mass.), Barbara Boxer (D-Cal.), Russell Feingold (D-Wis.).


136 This applied equally to the presumptive capital charges and quantitative restrictions for systemically significant nonbank financial companies.


Following further negotiations, the Authors reintroduced the amendment with additional changes.\footnote{See S. Amdt. 4101, 111th Cong. (2010), 156 CONG. REC. S3935-38 (daily ed. May 18, 2010).} First, the revised amendment excluded from its coverage as a bank certain limited purpose trust companies that do not take ordinary deposits or function as regular banks where families and businesses keep their money.\footnote{Id. at sec. 619, § 13(h)(1), 156 CONG. REC. S3938 (daily ed. May 10, 2010).} Second, the revised language allowed banking entities to provide wealth management services for their clients through offering and managing funds.\footnote{See id. at sec. 619, § 13(d)(1)(G), 156 CONG. REC. S3935 (daily ed. May 10, 2010).} Finally, it extended the time period for divestiture of illiquid positions, addressing the risk that firms could be forced to conduct distressed sales in order to come into compliance with the Merkley-Levin provisions.\footnote{Id. at sec. 619, § 13(c)(2), 156 CONG. REC. S3936 (daily ed. May 10, 2010).}

With the support of Chairman Dodd, the Authors and their twenty-three co-sponsors worked to bring the amendment to a vote. The Authors offered to accept a vote that would require 60 votes to pass, even though at the time at least two Democratic Senators were expected to be in their home states due to primary elections. The Authors were informed, however, that the Senate Republican leadership declined to allow the amendment to be called up for a vote under any circumstances.

In response, on May 19, 2010, the Authors engaged in a parliamentary maneuver designed to ensure the Merkley-Levin amendment would receive a vote: they offered it as a second-degree amendment to an unrelated but pending amendment that happened to have been sponsored by Senator Sam Brownback (R-Kan.).\footnote{156 CONG. REC. S3961 (daily ed. May 19, 2010).} With this maneuver, the two amendments were linked together. The following day, cloture was invoked on the bill, making the Merkley-Levin amendment the next scheduled vote. Unfortunately, Senator Brownback withdrew his amendment, bringing down the second-degree Merkley-Levin amendment offered to it.\footnote{See id. at S4076-78 (daily ed. May 20, 2010) (statement by Sen. Reid (D-Nev.) and subsequent action).} No other amendments were considered after that, and the Senate subsequently passed the reform bill.\footnote{See id. at S4078 (daily ed. May 20, 2010). The financial reform bill passed 59-39.}

The House of Representatives and the Senate began preparing to convene a Conference Committee to resolve the differences between the two financial reform bills. Almost immediately, the Authors, with the support of Chairman Volcker, began working to include the Merkley-Levin language in the Conference Report. House Financial Services Committee Chairman Barney Frank (D-Mass.) and Chairman Dodd both worked with the Authors in the effort to include the Merkley-Levin provisions.\footnote{See Ryan Grim, Frank: ‘Conceptual Agreement’ Reached on Tougher Volcker Rule, HUFFINGTON POST (June 6, 2010), http://www.huffingtonpost.com/2010/06/10/frank-volcker-rule-deal_n_608277.html.} However, to secure its
inclusion in the Conference Report, some additional changes needed to be made to the Merkley-Levin Amendment. The final, slightly-amended Merkley-Levin provisions, which are discussed in greater detail below, were successfully incorporated into the Dodd-Frank Act.

To ensure that legislators, analysts, policymakers, and courts understand the provisions that were finally agreed to, the Authors offered into the Congressional Record prior to final adoption of the Conference Report in the Senate detailed explanations of how the Merkley-Levin provisions were intended to work, the main themes of which are reflected in this Policy Essay. Ultimately, the Conference Report was passed by the House of Representatives on June 30, 2010 and by the Senate on July 15, 2010. H.R. 4173 was signed into law by President Obama on July 21, 2010.

Once the provisions were enacted into law, the Authors, with the support of Chairman Volcker, turned to the task of ensuring that the provisions were implemented as intended, an effort that is still on-going.

IV. THE MERKLEY-LEVIN PROVISIONS: A MODERN GLASS-STEAGALL

The Volcker Rule, as embodied in the Merkley-Levin provisions, seeks to both protect the economy and taxpayers and refocus U.S. banks and other systemically significant financial firms on the business of serving their customers. The law was not intended simply to reinstate the Glass-Steagall Act’s separation between commercial banking and investment banking, which over time had become over- and under-inclusive. The Glass-Steagall Act’s separation was over-inclusive because its ban on all securities activities at commercial banks swept in truly client-oriented activities that could be

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151 156 CONG. REC. H5261, S5933 (daily ed. July 15, 2010).


managed by developments in securities and banking law. At the same time, the Glass-Steagall Act’s separation was under-inclusive because it did not account for the risks of modern derivatives trading, which had come to be a major driver of revenues (and conflicts of interest) at both commercial banks and investment banks. Nor did the Glass-Steagall Act address the risks arising from nonbank financial companies that had grown to become systemically significant. Thus, instead of simply restoring the Glass-Steagall Act, the Merkley-Levin provisions were designed to protect the financial system by targeting proprietary trading at banking entities and systemically significant nonbank financial companies, while allowing those firms to continue to engage in client-oriented, risk-reducing, or other traditional banking activities that facilitate the formation and deployment of capital.

To accomplish these objectives, the final Merkley-Levin provisions seek to: (1) prevent banks from engaging in the high-risk activities of proprietary trading and establishing certain relationships with hedge fund and private equity funds; (2) limit the risk created by such activities at systemically significant nonbank financial firms; and (3) limit conflicts of interest in proprietary trading and other trading-related activities.

This Part discusses the key components of the final Merkley-Levin provisions, codified as section 13 of the Bank Holding Company Act, and several on-going concerns related to their implementation.

A. Impermissible Activities: Broad Prohibitions

With respect to banks and their affiliates, the Merkley-Levin provisions of the Dodd-Frank Act establish the basic principle clearly: a “banking entity” shall not “engage in proprietary trading” or “acquire or retain . . . ownership interest[s] in or sponsor a hedge fund or private equity fund,” unless otherwise empowered to do so elsewhere in the section. This is a self-executing rule of law that establishes a clear and strong statutory prohibition on banks engaging in high-risk activities.

The law also limits the ability of systemically significant nonbank financial companies to take risky financial actions by subjecting the proprietary trading activities of such nonbank financial companies to heightened
capital charges and quantitative limits to be set forth by regulation. The capital requirements for and quantitative limits on such trading are not spelled out in the statute, but they are expected to follow the contours of the banking entity restrictions. Moreover, they are expected to become stricter as size, leverage, and other risk factors increase.

Because these prohibitions were written broadly to give regulators flexibility to address evolving financial conditions, implementation will require regulators to develop rules that bring clarity to certain areas.

An initial key issue in implementation of these provisions is determining who is covered by them. The term “banking entity” is defined broadly to include banks, their holding companies, and their affiliates. This broad definition recognizes that depositors, bond holders, and customers do not generally distinguish among the fates of a bank, its holding company, and its affiliates. With respect to nonbank financial firms, the provisions apply to the set of institutions identified by the FSOC as systemically significant nonbank financial companies, which are subject to oversight by the Federal Reserve as well as to the Merkley-Levin provisions.

Another key issue is determining what activities are restricted. Unlike the broad definition used generally in this Policy Essay and in the PROP Trading Act, the final Merkley-Levin provisions restrict a somewhat narrower range of “proprietary trading.” Specifically, the restrictions apply to “engaging as a principal for the trading account” of the firm in transactions to “purchase or sell, or otherwise acquire or dispose of” a wide range of traded financial products, including securities, derivatives, futures, and options.

“Trading account” is defined as any account used “principally 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)” and “any such other accounts” as the regulators determine are appropriate. For firms or subsidiar-

159 Dodd-Frank Act sec. 619 § 13(a)(2), 124 Stat. at 1620.
161 See id. at S5895 (daily ed. July 15, 2010); see also Letter from Sen. Tom Harkin to the Fin. Stability Oversight Council (Oct. 22, 2010), http://www.regulations.gov/#!documentDetail;D = FSOC-2010-0002-0040.1.
162 Dodd-Frank Act sec. 619, § 13(h)(1), 124 Stat. at 1629.
165 Id. at sec. 619, § 13(h)(4), 124 Stat. at 1630.
166 Id. at sec. 619, § 13(b)(6), 124 Stat. at 1630; see Letter from Robert Johnson, Dir. of Econ. Policy, Roosevelt Inst., to Fin. Stability Oversight Council (Nov. 4, 2010), http://www.regulations.gov/#/documentDetail;D = FSOC-2010-0002-1263.1.
ies that do not maintain a distinction between a trading account and an investment account, all accounts should be presumed to be trading accounts and covered by the restriction.\textsuperscript{167}

The intent behind limiting the self-executing prohibition to the “trading account” was, in part, to permit banks to continue the classic banking functions of managing their liquidity and extending credit through investment portfolios. By including a reference to “other accounts,” the trading account definition gives regulators the authority to make the detailed determinations of what types of longer-term positions should be covered within the prohibitions.\textsuperscript{168}

One of the major types of activities that the Merkley-Levin provisions prohibit is “bright line” proprietary trading. This subset of proprietary trading often occurs at special “proprietary trading desks” that deploy a firm’s capital in pursuit of short-term trading profits. These desks often trade with or use the services of sell-side analysts, brokers, and dealers and generally do not have obligations to customers.\textsuperscript{169} Its traders may be compensated in a manner commensurate with hedge fund managers and other managers of private pools of capital.\textsuperscript{170} Banking entities seeking to effect early compliance with the Dodd-Frank Act appear to have already begun to spin off these bright line proprietary trading desks.\textsuperscript{171}

In addition to restricting direct proprietary trading, the Merkley-Levin provisions restrict the types of relationships that banks may have with private funds. In general, the law provides that banking entities may not “acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”\textsuperscript{172} To “sponsor” a fund is to serve as a general partner, managing member, or trustee of the fund, select or control officers or employees, or share with the fund a common name.\textsuperscript{173} As with bright line proprietary trading, retaining an equity interest in or sponsoring a hedge fund or private equity fund, other than that which complies with permitted activities described below, is statutorily prohibited and will be subject to divestiture.\textsuperscript{174}

\begin{itemize}
  \item[\textsuperscript{168}] Tom Braithwaite, Volcker Takes Aim at Long-Term Investments, FIN. TIMES (Jan. 20, 2011), http://www.ft.com/cms/s/0/2a03c58c-242a-11e0-a89a-00144feab49a.html.
  \item[\textsuperscript{169}] FSOC STUDY, supra note 58, at 27-28.
  \item[\textsuperscript{170}] Id.
  \item[\textsuperscript{173}] Dodd-Frank Act sec. 619 § 13(b)(5), 124 Stat. at 1630 (to be codified at 12 U.S.C. § 1851).
  \item[\textsuperscript{174}] Dodd-Frank Act sec. 619 § 13(c)(2)-(3), 124 Stat. at 1622-23 (to be codified at 12 U.S.C. § 1851).
\end{itemize}
"Hedge fund" and "private equity fund" are collectively defined in broad terms to cover any investment vehicle that would be an investment company under the Investment Company Act of 1940 but is excluded from such coverage by the provisions of § 3(c)(1) or 3(c)(7) and "such similar funds" that the regulators determine are appropriate. For example, Commodity Futures Trading Commission Chairman Gary Gensler recently pointed to commodity pools as an appropriate vehicle to cover under the "similar funds" provision.

B. Permitted Activities: Limited Exceptions to the Broad Prohibitions

Despite the broad restrictions on proprietary trading discussed above, banking entities are permitted to engage in a range of customer-serving, risk-mitigating, and other traditional banking activities that may involve conduct otherwise banned by the provisions. Banking entities may: (1) act as market-makers and underwriters; (2) trade on behalf of customers; (3) trade in government securities; (4) mitigate their risks through hedging; (5) provide asset management services in hedge funds and private equity funds (including with de minimis "skin in the game" positions); and (6) invest in small business investment companies and public welfare entities. Similarly, the additional capital charges and quantitative limits intended to effect the Merkley-Levin restrictions for systemically significant nonbank financial companies are intended to be reduced to facilitate the firms' abilities to engage in permitted activities. Both banking entities and systemically significant nonbank financial companies shall, however, still be subject to such additional capital charges and quantitative limitations on permitted activities as the regulators determine necessary to protect the safety and soundness of the firms and the financial system.

Accordingly, establishing the contours of these permitted activities is essential for meaningful implementation of the Merkley-Levin provisions for both banking entities and systemically significant nonbank financial companies. The statutory language provides significant direction—for example, limiting market-making to "reasonably expected near term demands of

176 Commodity pools are investment vehicles formed for the purpose of trading in commodity interests, including futures contracts, commodity options or options on futures. NORA JORDAN ET AL., ADVISING PRIVATE FUNDS: A COMPREHENSIVE GUIDE TO REPRESENTING HEDGE FUNDS, PRIVATE EQUITY FUNDS AND THEIR ADVISERS § 4.19 (2011).
177 See Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Comments During Meeting of the Financial Stability Oversight Council (Jan. 18, 2011).
clients, customers, and counterparties—the Dodd-Frank Act Restrictions on Proprietary Trading but regulators must still flesh out the details. This will be a challenging process. In particular, the permitted activities covered by “market-making,” “risk-mitigating hedging,” and “organizing and offering” private funds, along with certain other aspects of firms’ permitted relationships with private funds, deserve special attention.

1. Market-Making

Market-making is a customer service whereby a firm provides its customers, clients, and counterparties with two-sided markets for speedy acquisition or disposition of financial instruments. Done properly, it is not a speculative enterprise, and revenues for the firm should largely arise from the provision of liquidity and not from the capital gain earned on the change in the price of instruments held in the firm’s accounts. Market-making can be, in some instances, difficult to distinguish from proprietary trading. Indeed, while some firms have dedicated proprietary trading desks that only deploy the firms’ capital in search of trading returns, many financial institutions engaged in proprietary trading through their client-related market-making operations.

A genuine market-maker will seek to make a two-sided market (buying when others will not buy and selling when others will not sell) and will seek to minimize the firm’s risk exposure from the acquired positions. A proprietary trading operation, in contrast, may trade with clients but not necessarily provide a steady two-sided market, especially in times of stress, and may also choose to accumulate larger inventories or engage in less hedging with a view towards earning returns from market appreciation of the product. Indeed, recent history demonstrates that the accumulation of positions in the trading account when client demand for the products has dried up poses significant risk to the financial entity and ultimately to the financial sys-

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183 William L. Silber, On the Nature of Trading; Do Speculators Leave Footprints?, J. PORTFOLIO MGMT., Summer 2003, at 64, 64-70; Letter from Ams. for Fin. Reform, supra note 182; Letter from William L. Silber, Professor of Fin. and Econ., Stern Sch. of Bus., N.Y. Univ., to the Fin. Stability Oversight Council (Nov. 2, 2010), http://www.regulations.gov/ #!documentDetail;D=FSOC-2010-0002-0185; Letter from Paul Volcker, supra note 156.
184 FSOC STUDY, supra note 58, at 18-19.
187 See Silber, On the Nature of Trading, supra note 183, at 70 n.3; see also FSOC STUDY, supra note 58, at 28-29.
It is for this reason that underwriting (including for securitizations) and market-making are “not to exceed the reasonably expected near term demands of clients, customers, or counterparties.”

Some firms and traders may seek to exploit the exception for “market-making” as an opportunity to make proprietary trades, especially if trader compensation incentivizes them to do so. As one banker reportedly explained, “I can find a way to say that virtually any trade we make is somehow related to serving our clients.” In fact, some may understand the term market-making to encompass any time a financial firm takes a position opposite a counterparty. On this understanding, every principal trade would be market-making. Such an interpretation would render the Dodd-Frank protections meaningless, and runs directly contrary to the language and intent of the Dodd-Frank Act.

To separate proprietary trading from market-making, regulators will need to collect trading data and deploy a wide range of quantitative and qualitative metrics. Much of the relevant information is already gathered or its collection will be mandated under other provisions of the Dodd-Frank Act, but “new, specifically-tailored regulatory and supervisory tools” will also be needed. The academic literature sets out some of the factors that should be the focus of these efforts, including the volume of trading, the size of the positions and inventory, whether and how the positions are hedged, the length of time that positions remains open, the volatility of profits and losses, and the intent of the trader. Trader compensation incentives can
also be indicative of whether traders are engaged in market-making (or risk-mitigating hedging) or proprietary trading.\footnote{198}

2. Risk-Mitigating Hedging

"Risk-mitigating hedging" is a permitted activity under the Merkley-Levin provisions in order to enable firms to reduce their risk through purchasing or selling assets, thereby creating the positions that offset the risks arising from other positions on the firm's books.\footnote{199} Market-making and underwriting, for example, can necessitate hedging positions. Banks also often use a range of hedging tools to manage interest rate risk and credit risk\footnote{200} from their lending portfolio.\footnote{201}

As with market-making, firms may seek to evade the broader restrictions on proprietary trading by purportedly relying on the risk-mitigating hedging exception.\footnote{202} For example, if a firm underwriting convertible bonds selectively hedges various dimensions of the exposures, by varying its hedges it can create proprietary trading positions of its own choosing.\footnote{203} To prohibit those types of evasions while still permitting risk-mitigating hedging, the regulators will need to ensure that the firms maintain clear identification of the specific assets and risks being hedged.\footnote{204} Firms will need to develop procedures to tag hedging positions, describe the "specific risks" being hedged, track the underlying assets being hedged, and initiate and monitor the unwinding or termination of hedges as the underlying risk is sold or resolved.\footnote{205} Rigorous use of quantitative metrics is also likely to be helpful in this context, in particular because the requirements of hedges will change over time as markets adjust and the firm's positions are successively off-loaded.\footnote{206}
The Merkley-Levin provisions permit banking entities to continue to organize and offer hedge funds and private equity funds as asset management services to their customers, subject to certain limitations. They also permit banking entities to seed funds by taking a significant initial interest in the fund on its start-up, which is reduced over time as investors come in. In addition, banking entities are allowed to maintain some “skin in the game” investments in funds organized and offered by the banking entity in order to align their interests in the funds with the funds’ investors. These “de minimis” investments are not permitted to total more than three percent of a banking entity’s Tier 1 capital, and are subject to heightened capital requirements and other restrictions.

The restrictions on investing in or sponsoring private funds are important to mitigate systemic risk and prevent evasion of the proprietary trading provisions. If a financial firm were able to structure its proprietary positions simply as an investment in a private fund, the prohibition on proprietary trading might be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue. The Authors remain concerned with the risks arising from the ability, even though limited, of banking entities to maintain relationships with private funds. In particular, the process of “seed­ing” new funds should be a place for regulators to closely guard against evasion of the protections.

Moreover, a financial institution that sponsors or manages a private fund may still incur significant risk even when its investment makes up only part of a fund. Recent history demonstrates that a financial firm will often feel compelled by reputational demands and relationship preservation to bail out clients in a failed fund that it managed or sponsored. These bailouts
may put the financial firms themselves at risk.\textsuperscript{214} Further, the potential for bailouts undermines market discipline in the asset management markets by advantaging bank-affiliated funds and also encourages the funds to take on more risk than may otherwise be prudent.\textsuperscript{215}

In the recent financial crisis, when funds suffered significant losses, some firms brought those off-balance sheet funds back onto their own balance sheets through asset purchases and guarantees (bailouts).\textsuperscript{216} In some cases, the firms that bailed out their funds ultimately relied on taxpayers to bail them out.\textsuperscript{217} It is precisely for this reason that the permitted activities in fund management and anti-bailout provisions are intended to be strictly defined and vigorously enforced.

Accordingly, the Merkley-Levin provisions also prohibit banking entities from bailing out, through lending, derivatives transactions, or asset purchases, their private funds and those they control.\textsuperscript{218} Systematically critical nonbank financial firms are intended to be assessed additional capital charges to account for similar risks.\textsuperscript{219}

A limited exception exists for “prime brokerage” services between the banking entity and a third-party-advised fund in a fund-of-funds relationship.\textsuperscript{220} Several criteria must be met for the banking entity to take advantage of this exception. Most notably, the statute requires the chief executive officer of firms taking advantage of this exception to certify that these services are not used directly or indirectly to bail out a fund advised by the firm.\textsuperscript{221} The Authors remain concerned that prime brokerage could expose banking entities and systemically significant nonbank financial companies to heightened risk, as evidenced during the crisis by the “run” on many financial institutions by their prime brokerage clients.\textsuperscript{222}

Market discipline should also be strengthened through the requirement that if a banking entity sells assets to a managed or controlled fund, it must

\begin{itemize}
\item \textsuperscript{214} Id.; see, e.g., Date, supra note 82.
\item \textsuperscript{216} See, e.g., FCIC REPORT, supra note 26, at 286 (detailing how the collapses of certain Bear Stearns funds led to the government-backed bailout of the firm itself); Date, supra note 82 (explaining how State Street Bank bailed out funds it managed, but then itself needed several emergency taxpayer-backed programs); see also Letter from Richard Trumpka, supra note 213.
\item \textsuperscript{217} See Date, supra note 82; see also FCIC REPORT, supra note 26, at 286.
\item \textsuperscript{219} Dodd-Frank Act § 13(d)(4), 124 Stat. at 1629 (to be codified at 12 U.S.C. § 1851).
\item \textsuperscript{221} Dodd-Frank Act sec. 619, § 13(d)(3), 124 Stat. at 1628 (to be codified at 12 U.S.C. § 1851); see also Letter from Paul Volcker, supra note 156 (on the importance of the “tone at the top” for effective implementation of § 619).
\item \textsuperscript{222} See FCIC REPORT, supra note 26, at 286.
\end{itemize}
do so on arms-length terms. Transparency and disclosure may also play an important part in ensuring compliance. This is an important area for regulators to closely monitor and vigorously apply the available anti-evasion tools.

C. Limitations on Permitted Activities: Backstops Ensuring that Permitted Activities Do Not Undermine the Broad Prohibitions

While the permitted activities are designed to ensure that firms can serve their clients, reduce risk, and allocate capital efficiently, they are still subject to significant limits. First, regulators have broad authority to set restrictions on the permitted activities and impose additional capital charges when firms engage in them. Second, four statutory “backstops” provide that none of these activities are allowed if they would involve or result in a material conflict of interest, leave the firm materially exposed to high-risk assets or high-risk trading strategies, threaten the safety and soundness of the firm, or threaten the financial stability of the United States.

The statutory backstops are designed to ensure that the permitted activities do not evolve to undermine the protections of the broad prohibitions. For example, the backstops against material conflicts of interest and high-risk trading strategies are designed to ensure that the permitted activity of trading in government securities does not come to threaten the firms, harm clients, or contaminate the government securities markets. Similarly, the backstop for activities that would result in exposure to high-risk assets is designed to ensure that underwriting, including securitization activities, and market-making do not lead to transactions that would endanger the firm or the financial system.

These backstops were intentionally drafted broadly to give regulators significant flexibility to craft rules that effectuate their purpose. Some char-

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224 See FSOC STUDY, supra note 58, at 70.
225 Dodd-Frank Act sec. 619, § 13(e), 124 Stat. at 1627-28 (to be codified at 12 U.S.C. § 1851); see also Letter from Dennis Kelleher, supra note 193; Letter from John Reed, supra note 163.
227 The backstop against material conflicts of interest is discussed in greater detail infra in Part IV.D.
acteristics that may be indicative of high-risk assets or high-risk trading strategies include the following:

- The introduction of new products with rapid growth;
- Assets or strategies that include embedded leverage;
- Past volatility of the asset or strategy;
- Total Value-at-Risk ("VaR") of the asset or strategy;
- Assets whose values cannot be externally priced or whose exposure cannot be quantified;
- Assets whose risk cannot be adequately mitigated by effective hedging; and
- The fact that application of capital and liquidity standards would not adequately account for the risk of an asset or trading strategy.230

Given the speed at which financial markets change, regulators should regularly update the criteria and their application.231 For example, the performance of VaR during the crisis and the potential for gaming of internal risk modeling and VaR itself suggests regulators should be cautious in placing great reliance on banks' existing risk metrics.232 The Office of Financial Research, established in the Dodd-Frank Act, may play an important role in advancing regulatory understanding in these areas.233

D. Conflicts of Interest

The Merkley-Levin provisions' broad restrictions on proprietary trading should significantly reduce the opportunities for conflicts of interest in trading. The provisions provide additional protections against conflicts of interest in trading through two means.234

First, the Merkley-Levin provisions prohibit underwriters, sponsors, and others who assemble asset-backed securities from engaging in transactions that involve or result in a material conflict of interest with an investor.

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230 FSOC Study, supra note 58, at 51.
231 See id.
233 Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 111th Cong. (2010) [hereinafter Implementation Hearing] (statement of Ben Bernanke, Chairman, Federal Reserve Board Of Governors) (noting that the Office of Financial Research could gather more detailed position data than is currently available for regulators, which may be the only way to identify systemic risks).”
of the securities. For example, it prohibits the sponsor of an asset-backed security from soliciting clients to buy a security while betting on the security's failure. Unlike in ordinary corporate finance, those who assemble and sell asset-backed securities select the underlying assets and design the security, such that they are exceptionally well-positioned to control whether a security is intended to succeed or fail. Because of this extraordinary control, such institutions should be expected to abide by heightened duties to their clients and not be able to benefit from the failure of a security they designed and marketed to clients.

These provisions are not intended to limit the ability of an underwriter to support the value of a security in the secondary market immediately following issuance by providing liquidity and a ready two-sided market for it. Nor do they prevent a firm from creating a synthetic asset-backed security, such as Hudson Mezzanine, provided the firm does not intend to hold the short position. A firm that underwrites an asset-backed security would run afoul of the provision, however, if it takes the short position in a synthetic asset-backed security that references the same assets it created because this results in the firm essentially betting against assets that it previously packaged. Even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has— or might in the future—bet against that asset will not cure the material conflict of interest.

The SEC has authority to define the contours of the rule so as to remove conflicts of interest from these transactions in a way that promotes the healthy functioning of our capital markets.

Second, as mentioned supra, the Merkley-Levin provisions also contain broad backstops on the permitted activities of proprietary trading. The backstop on material conflicts of interest ensures that the permitted activities do not undermine the broad prohibitions' efforts to rein in material conflicts of interest in trading. Specifically, the backstop prohibits activities that "involve or result in a material conflict of interest" even if those activities would otherwise be allowed as a permitted activity, such as market-making.


236 See Role of Investment Banks Hearing, supra note 43; supra Part II.D.1.


238 See supra Part II.D.1.


240 A disclosure that a firm "may" trade or take a position that is opposite an investor is insufficient to cure a conflict of interest, and in fact may be its own material misrepresentation if, at the time of the disclosure, the firm knows that it did or would take such a position. See SEC v. Cruzco, No. CV 06-4792 (C.D. Cal. Dec. 5, 2007).


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or hedging. The language is intentionally broad so as to give regulators the flexibility they need to address ethically dubious practices, both current and future. Remedies may include more rigorous restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm.

This backstop may be especially useful in reining in improper use of information about a client’s trading for the firm’s own benefit, including for the benefit of private funds organized and offered by the firm as a permitted activity. The Merkley-Levin provisions will also provide useful tools to address conflicts of interest in securities lending and other activities that are “complex, highly structured, or opaque; involve illiquid or hard-to-value instruments or assets; require the coordination of multiple internal groups...; [or] involve a significant asymmetry of information...or transactional data among participants.” As such, this backstop gives the regulators critical tools and, hopefully, the strong ethical mandate to address conflicts of interest across a range of trading activities within the coverage of the Merkley-Levin provisions.

V. REGULATORY FRAMEWORK

Regulators will have to give meaning to a number of technical terms through rulemaking and ensure on-going meaningful supervision of firms. To provide additional guidance on how to best implement the Merkley-Levin provisions, the statute directs the Financial Stability Oversight Council to prepare a study and recommendations to regulators on how to implement the provisions most effectively (the “FSOC Study”). The FSOC Study was released on January 18, 2011 and marks the first step towards effective implementation.

At the heart of the recommendations in the FSOC Study is a four-part supervisory framework designed to distinguish proprietary trading from permitted activities. The recommended framework consists of the following elements: (1) programmatic compliance systems by financial firms; (2) analysis and reporting of quantitative metrics to regulators; (3) regulatory review and oversight of trading operations; and (4) enforcement procedures for viola-

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243 Dodd-Frank Act sec. 619, § 13(d)(2)(A)(i), 124 Stat. at 1626 (to be codified at 12 U.S.C. § 1851) (providing that "a material conflict of interest" will be defined by rule-making under § 13(b)(2)).
244 On separation of functions as a solution to conflicts of interest, see ALGAR, supra note 40, at 217-20.
246 FSOC Study, supra note 58, at 49.
248 FSOC Study, supra note 58.
The four-part framework suggests that regulators should require firms to establish internal systems and procedures designed to ensure compliance with the Merkley-Levin provisions. The firms would need to use certain measures and metrics to evaluate their own activities, and their chief executive officers would need to certify the firms' compliance under their systems. Regulators would then review the firms' activities, as well as their policies and procedures, to identify compliance concerns and bring actions against firms found to be in violation.

The FSOC Study sets out important details regarding the compliance protocols that will assist firms and regulators in ensuring that firms stay within the confines of the rules. Of special importance is the required attestation by the chief executive that the firm is abiding by the rules. As Chairman Volcker has emphasized, the "tone at the top" is critical, and boards of directors, CEOs, and senior and relevant management are to be expected to take a leadership role in ensuring compliance and reestablishing strong ethical practices in the industry.

It is also critical that regulators "get into the weeds" as necessary to test for and enforce compliance. In order to identify, monitor, and evaluate market-making, risk-mitigating hedging, and other permissible trading activities, regulators will need detailed trading data and information of firms' market positions. At a minimum, regulators will need objective information such as the parties to a trade, the size of the trade, pricing information, the size of the parties' positions, how long those positions are held, and whether and how they are hedged. Regulators will need to collect and analyze this data across multiple asset classes. Further, the increase of high-speed, automated trading in recent years suggests that regulators will need to utilize automated systems to a great extent as well. The FSOC Study sets out a number of tests that will be useful in monitoring these activities, but it also notes that new tests will need to be developed.

These regulatory oversight efforts should supplement information provided by the firms themselves with information gathered from data warehouses already being established under the Dodd-Frank Act, new and existing trading and position data collections, and from data to be gathered...

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249 Id. at 3, 33-36.
250 Id. at 3, 43-46.
251 Id. at 3.
252 See id. at 33-36; Letter from Paul Volcker, supra note 156.
253 See, e.g., Implementation Hearing, supra note 233 (statement of Sen. Jack Reed).
254 FSOC Study, supra note 58, at 31.
256 See, e.g., Consolidated Audit Trail, Exchange Release No. 62174, 75 Fed. Reg. 32556 (proposed May 26, 2010) (to be codified at 17 C.F.R. § 242.613); Large Trader Reporting...
and analyzed by the Office of Financial Research created by the Dodd-Frank Act.\textsuperscript{258}

Of course, it will also be critical for Congress to provide on-going oversight to ensure that regulators are effectively and meaningfully implementing the intent of the statute and ensuring that the regulators are establishing sufficient protections for the nation's critical financial infrastructure.

VI. CONCLUSION

In 2008, the United States lived through the worst financial crisis in most Americans' memories, and millions of Americans, through no fault of their own, continue to pay the price. Some have depicted the near-collapse of the financial system as akin to a natural disaster that no one could have foreseen or prevented. To the contrary, however, poor policy choices and lax regulation led to unbridled proprietary trading and unchecked conflicts of interest that helped create the conditions that resulted in the crisis.

The Merkley-Levin reforms fundamentally reduce the risks created by proprietary trading and conflicts of interest in our financial system. If implemented correctly, the Authors expect the changes in our financial system will be profound.\textsuperscript{259} If our regulators can stand up on behalf of taxpayers and meet the challenge of implementing the Dodd-Frank Act properly, then our financial system, our economy, our federal budget, and, ultimately, our children and grandchildren will enjoy a safer, sounder, and more stable financial system, which can help drive our economy for decades to come.


\textsuperscript{259} See generally Letter from Joseph Stiglitz, supra note 163.