

February 2013

Systemic Risk and Dodd-Frank's Volcker Rule

Julie A.D. Manasfi

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SYSTEMIC RISK AND DODD-FRANK'S VOLCKER RULE

JULIE A.D. MANASFI*

ABSTRACT

With the recent global financial crisis starting in 2007, the issue of “systemic risk” has attracted much attention in our financial system. Some legislators have asserted that proprietary trading by banking entities, generally the trading of financial instruments for a banking entity’s own account, played a critical role in the recent global financial crisis. These sentiments parallel arguments that the practices of banks and their securities affiliates in the 1920s were partly responsible for the stock market crash of 1929 and subsequent Great Depression. At the heart of these assertions is the issue of whether combining the businesses of commercial banking and investment banking increases systemic risk.

The Banking Act of 1933 (Glass-Steagall Act) contains provisions that prohibit commercial banks from underwriting, promoting, or selling securities directly or through an affiliated brokerage firm, effectively erecting a wall between commercial banking and investment banking. That wall was gradually weakened and picked apart over the course of the next sixty years or so, finally coming down with the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), which repealed the last remaining restrictions of the Glass-Steagall Act’s wall. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) of 2010 makes the most sweeping regulatory changes in this area since the 1930s by re-erecting portions of Glass-Steagall’s wall. The Volcker rule, contained in the Dodd-Frank Act, restricts “banking entities” from engaging in proprietary trading, and from sponsoring, or acquiring or retaining certain ownership interests in, a hedge or private equity fund.

One of the policy justifications for these restrictions is that the prohibited activities increase systemic risk. The implicit contentions in this justification are that if the prohibited activities are too risky they could

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affect a bank's liquidity, causing the banking entity to (i) be unwilling or unable to extend credit to qualified borrowers or (ii) to fail, disrupting credit channels. Similarly, some fear that banking entities may also fail from exposure to failing hedge or private equity funds, further disrupting credit channels. Are these implicit contentions underlying the Volcker rule's enactment with respect to the policy rationale of systemic risk well founded? One way to attempt to answer that question is to look at whether the blending of commercial and investment banking really played a critical role in the recent recession and in the Great Depression, as some proponents of the Volcker rule and the Glass-Steagall Act contend.

Parts I and II of this Article will provide the background necessary for a discussion of these questions. Part I will discuss the concept of systemic risk in general and describe the Volcker rule and its origins. Part II will describe the history of systemic risk banking regulation in the United States. Part III of this Article asks the important question of whether the blending of commercial banking and investment banking produces the alleged harm: increased systemic risk. The Article considers the argument that blending played a role in the stock market crash of 1929. It also considers the argument that blending played a role in the financial crisis of 2007. Part III concludes that the claims that the walls contained in the Glass-Steagall Act and Volcker rule are needed to decrease systemic risk have not been necessarily proven or statistically supported. It seems that the Glass-Steagall wall was erected in 1933 to address conflicts of interest in the blending and to serve as a purported fix to the horrors of the Great Depression in the name of regulating systemic risk—a wall erected for more political than economic reasons in satisfying public outcry to do something, anything, about the disaster. Eugene White's bank failure statistics demonstrate not only that the blending may not increase systemic risk but that there may be diversification, complementarities, and economies of scope benefits to the blending.

The policy justifications of the Glass-Steagall and Volcker rule walls must be detangled. If the conflicts of interest are the main harm we are trying to address, it may make sense to consider other solutions such as additional disclosures and regulations that protect the public from such conflicts. If, however, the harm we are trying to address is truly systemic risk, this Article posits that we need a better understanding of systemic risk in a modern era of financial innovation before we erect the Volcker rule wall that may decrease economies of scope, diversification of risks and perhaps even global competitiveness. Perhaps doing something must wait for a better understanding of systemic risk and excessive risk-taking with respect to today's financial innovation and instruments. Once there, the Article posits that there must be some balancing of the synergies and global economic advantages created from the blending and systemic risk concerns.

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INTRODUCTION

With the recent global financial crisis starting in 2007, the issue of “systemic risk” has been front and center in our political discourse.¹ Some legislators have asserted that proprietary trading by banking entities, generally the trading of financial instruments for a banking entity’s own account, “played a critical role in the recent global financial crisis and subsequent recession.”² These sentiments parallel arguments that the practices of banks and their securities affiliates in the 1920s jeopardized the soundness of banks and were partly responsible for the stock market crash of 1929 and subsequent Great Depression.³ At the heart of these assertions is the issue of whether allowing banks to engage in the businesses of commercial banking *and* investment banking increases systemic risk.⁴ Commercial banking traditionally consists of making loans and taking deposits for the

¹ See, e.g., CONG. OVERSIGHT PANEL, 111TH CONG., SPEC. REP. ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY, at 22–23 (2009); James Bullard, Christopher J. Neely & David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RES. BANK OF ST. LOUIS REV. 403, 407 (2009); Ben S. Bernanke, Chairman, U.S. Fed. Reserve, Speech at the Federal Reserve Bank of Kansas City’s Annual Economic Symposium: Reducing Systemic Management in Financial Institutions (Aug. 22, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm> (stating the need to reduce systemic risk to promote and maintain stability in the financial system); Ben S. Bernanke, Chairman, U.S. Fed. Reserve, Speech at the Federal Deposit Insurance Corporation’s Forum on Mortgage Lending for Low and Moderate Income Households: Financial Regulation and Financial Stability (July 8, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080708a.htm> (discussing instability in the financial system and the Federal Reserve’s analysis that “allowing Bear Stearns to fail ... would likely have had extremely adverse implications for the financial system”); Ben S. Bernanke, Chairman, U.S. Fed. Reserve, Speech at the Federal Reserve Bank of Chicago’s Annual Conference on Bank Structure and Competition: Risk Management in Financial Institutions (May 15, 2008), available at http://www.federalreserve.gov/news_events/speech/bernanke20080515a.htm (describing the origins of the current financial turmoil, including subprime mortgages and failures in management of risk by large financial institutions).

² Senator Jeff Merkley & Senator Carl Levin, Policy Essay, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 515–16 (2011) [hereinafter Merkley & Levin]. For purposes of this Article, the term “proprietary trading” shall include the purchase and sale of financial instruments for the banking entity’s own account and investment in private funds managed or sponsored by the banking entity. *Id.* at 515 n.1.

³ *Id.* at 516–17; see also Eugene Nelson White, *Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks*, 23 EXPLORATIONS IN ECON. HIST. 33, 33 (1986) [hereinafter White, *Before the Glass-Steagall Act*].

⁴ Merkley & Levin, *supra* note 2, at 516–17.

net interest income.⁵ Investment banking generally consists of securities underwriting,⁶ dealing, trading, and other related activities⁷ for fee and commission income.⁸

The Banking Act of 1933 (Glass-Steagall Act) contained provisions that prohibited commercial banks from engaging in investment banking directly or through an affiliated brokerage firm, effectively erecting a wall between commercial banking and investment banking.⁹ That wall was gradually weakened and picked apart over the course of the next sixty years or so, finally coming down with the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), which repealed the last remaining restrictions of the Glass-Steagall Act's wall.¹⁰ The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) of 2010 makes the most sweeping regulatory changes in this area since the 1930s by re-erecting portions of Glass-Steagall's wall.¹¹ The Volcker rule, contained in the Dodd-Frank Act, restricts "banking entities" from engaging in proprietary trading, and from sponsoring, or acquiring or retaining certain ownership interests in, a hedge or private equity fund.¹²

⁵ See ARTHUR O'SULLIVAN & STEVEN M. SHEFFRIN, *ECONOMICS: PRINCIPLES IN ACTION* 511, 513–14 (2003).

⁶ The underwriting of securities issues involves guaranteeing a price at which the new equity or bond will sell.

⁷ Other related activities include brokerage, financing services, and securities handling, for example.

⁸ MICHEL FLEURIET, *INVESTMENT BANKING EXPLAINED: AN INSIDER'S GUIDE TO THE INDUSTRY* 42–43 (2008).

⁹ See Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162, 184–85, 188–89, 194 (1933) (codified as amended at 12 U.S.C. § 227 (2012)).

¹⁰ See Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999). Section 101 repealed sections 20 and 32 of the Glass-Steagall Act, which prohibited affiliations between commercial and investment banks. *Id.* Note that sections 16 and 32 of the Glass-Steagall Act, which prohibit what affiliates can do directly, are still in effect.

¹¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–21 (2010) (codified at 12 U.S.C. § 1851 (2012)).

¹² *Id.* "Banking entities" is "defined to include ... insured depository institutions, ... compan[ies] that control[] an insured depository institution or [companies] treated as a [Bank Holding Company] under the [Bank Holding Company Act (BHCA)], and any subsidiary or affiliate of those entities." *Understanding the New Financial Reform Legislation: The Dodd-Frank Wall Street Reform and Consumer Protection Act*, LEGAL UPDATE (Mayer Brown), July 2010, at 65 (July 2010) [hereinafter *Understanding the New Financial Reform Legislation*], available at <http://www.mayerbrown.com/files/Publication/1ec275f4-5618-4a63-9d383129010c06db/Presentation/PublicationAttachment/e42ecce-49ff-44b2-b37a-72b81d87fb79/Final-FSRE-Outlinev2.pdf>.

Thus, the prohibitions would apply to: FDIC-insured commercial banks, thrifts, and industrial loan companies (with an exception for

One of the policy justifications for these restrictions is that the prohibited activities increase systemic risk.¹³ The implicit contentions in this justification are that if the prohibited activities are too risky they could affect a bank's liquidity, causing the banking entity to be unable to extend credit to qualified borrowers or to fail, disrupting credit channels.¹⁴ Similarly, some individuals fear that banking entities may also fail from exposure to failing hedge or private equity funds, further disrupting credit channels.¹⁵

Are these implicit contentions underlying the Volcker rule's enactment with respect to the policy rationale of systemic risk well founded? One way to attempt to answer that question is to look at whether the blending of commercial and investment banking really played a critical role in the recent recession and in the Great Depression, as some proponents of the Volcker rule and the Glass-Steagall Act contend. Parts I and II of this Article will provide the background necessary for a discussion of these questions. Part I will discuss the concept of systemic risk in general and describe the Volcker rule and its origins. Part II will describe the relatively recent history of systemic risk banking regulation in the United States.

Part III of this Article asks the important question of whether the blending of commercial banking and investment banking produces the alleged harm: increased systemic risk. The Article considers the argument that blending played a role in the stock market crash of 1929.¹⁶ It also considers the argument that blending played a role in the financial crisis of 2007.¹⁷

insured depository institutions that function solely in a trust or fiduciary capacity)...; any company that controls those depository institutions, regardless of the depository institution's size; any non-U.S. bank (and any parent company) that has a US branch, agency, commercial lending company[,] or insured depository institution subsidiary; and any subsidiary of the foregoing entities.

Id. at 66.

¹³ See Merkley & Levin, *supra* note 2, at 538, 546.

¹⁴ See JOHN KAMBHU, TIL SCHUERMANN & KEVIN J. STIROH, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 291, HEDGE FUNDS, FINANCIAL INTERMEDIATION, AND SYSTEMIC RISK 11–12 (2007), http://www.ny.frb.org/research/staff_reports/sr291.pdf (discussing that collateralizing these exposures may not be sufficient to mitigate against this risk because collateral values may fall. However, recognizing that banks' current exposures are heavily collateralized and each bank has some interest in mitigating these risks.). *But see* Anne Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach*, 10 RICH. J. GLOBAL L. & BUS. 263, 294 (2010) (discussing how the failure of Amaranth "did not have a destabilizing effect because counterparties to these funds held sufficient collateral").

¹⁵ See KAMBHU, SCHUERMANN & STIROH, *supra* note 14, at 13 (citing Hyun Song Shin, *Risk and Liquidity in a System Context* (BIS, Working Paper No. 212, 2006)).

¹⁶ See discussion *infra* Part III.A.

¹⁷ See discussion *infra* Part III.B.

Part III concludes that the claims that the walls contained in the Glass-Steagall Act and Volcker rule are needed to decrease systemic risk have not been necessarily proven or statistically supported.¹⁸ It seems that the Glass-Steagall wall was erected in 1933 to address conflicts of interest in the blending and to serve as a purported fix to the horrors of the Great Depression in the name of regulating systemic risk¹⁹—a wall erected for more political than economic reasons in satisfying public outcry to do something, anything, about the disaster. Eugene White’s bank failure statistics demonstrate not only that the blending may not increase systemic risk, but that there may be diversification,²⁰ complementaries,²¹ and economies of scope benefits²² to the blending. The hearings and legislative history of both the Glass-Steagall Act and the Volcker rule emphasize the conflicts of interest with the blending as opposed to the systemic risk concerns.²³ Conflicts of interest might include, for example, banks making loans on preferential terms to customers who purchase securities underwritten by the bank, taking advantage of their knowledge of their clients’ investment activities, or taking advantage of their influence over their clients.²⁴

The policy justifications of the Glass-Steagall and Volcker rule walls must be detangled. If the conflicts of interest are the main harm we are trying to address, it may make sense to consider other solutions such as additional disclosures and regulations that protect the public from such conflicts. If, however, the harm we are trying to address is truly systemic risk, this Article posits that we need a better understanding of systemic risk in a modern era of financial innovation before we erect the Volcker

¹⁸ See discussion *infra* Part III.

¹⁹ See S. REP. NO. 73-1455, at 155–56 (1934).

²⁰ Diversification generally refers to reducing risk by investing in a variety of assets. O’SULLIVAN & SHEFFRIN, *supra* note 5, at 273–74. The idea is that a diversified portfolio will have less risk than the weighted average risk of its constituent assets. See *id.*

²¹ Generally, for a good to be a complementary good, its demand increases when the price of another good decreases. *Id.* at 88. An example often given is that usually the demand for hot dog buns will increase when the price of hot dogs is decreased so hot dog buns and hot dogs are complementary goods. See *id.* (utilizing the example of skis and ski boots to explain complementary goods).

²² Generally, “economies of scope” refers to the lowering average cost for a firm in producing two or more products. John C. Panzar & Robert D. Willig, *Economies of Scope*, 71 AM. ECON. REV. 268, 268 (1981). There can also be synergies between products such that offering a complete range of products gives the consumer a more desirable product offering than a single product would. *Id.*

²³ See S. REP. NO. 73-1455, at 113–14, 155–56, 185–86, 351–52, 362, 393 (1934); Merkley & Levin, *supra* note 2, at 532–33, 539.

²⁴ Merkley & Levin, *supra* note 2, at 522–23, 526.

rule wall that may decrease economies of scope, diversification of risks, and perhaps even global competitiveness. Perhaps doing *something* must wait for a better understanding of systemic risk and excessive risk-taking with respect to today's financial innovation and instruments. Once there, the Article posits that there must be some balancing of the synergies and global economic advantages created from the blending and systemic risk concerns. The Dodd-Frank Act requires more transparency and disclosures of systemically significant entities.²⁵ However, it also simultaneously erects the Volcker rule wall between commercial banking and investment banking.²⁶ The response to the recent recession must be nuanced. With more transparency comes more information to decide whether there *should* be a wall. It is important to consider that there may be a hefty cost to erecting the wall.

I. BACKGROUND: SYSTEMIC RISK AND DODD-FRANK'S VOLCKER RULE

A. Systemic Risk

There is no widely accepted uniform definition of systemic risk.²⁷ One way to define systemic risk is that it is the risk of collapse of an entire financial system or market "serious enough to quite probably have significant adverse effects on the real economy."²⁸ The "real economy" simply refers to the goods, services, and resources aspects of the economy as opposed to financial markets.²⁹

²⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 404, 124 Stat. 1376, 1571–74 (2010) (codified at 15 U.S.C. § 80b-4 (2012)).

²⁶ § 619, 124 Stat. at 1620–21.

²⁷ See Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1353 (2011) (recognizing "that the term 'systemic risk' has been used in various ways, sometimes inconsistently"); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 247–48 (2008). Alan Greenspan stated that the "very definition [of systemic risk] is still somewhat unsettled." George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17, 20–21 n.5 (1996) (quoting Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at a Research Conference on Risk Measurement and Systemic Risk (Nov. 16, 1995)).

²⁸ The G10 Report on Consolidation in the Financial Sector, at 126 (Jan. 2001), <http://www.bis.org/publ/gten05.pdf>; see also George G. Kaufman & Kenneth E. Scott, *What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, 7 THE INDEP. REV. 371, 371 (2003) (stating that "[s]ystemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by comovements (correlation) among most or all the parts") (emphasis omitted).

²⁹ *Real Economy Definition*, FIN. TIMES LEXICON, <http://lexicon.ft.com/Term?term=real-economy> (last visited Feb. 2, 2013).

Bank lending affects the real economy.³⁰ Banking entities are unique with respect to their place in our financial system. An expansion of bank deposits results in an increase of the money circulating in an economy.³¹ This is because when a bank receives a deposit, the bank may keep a portion of that deposit as reserves and loan out the rest. The borrower of that loan may deposit that borrowed money into a bank that keeps a portion of that deposit and loans out the rest. Therefore, changes in bank deposits change the amount of outstanding credit and the money supply. This concept is known as the credit multiplier.³² In this way, banking entities play a special role in the stability of the U.S. financial system and that is typically the reason given for why they have access to certain governmental subsidies like Federal Reserve credit, federal insurance, and emergency services.³³

Systemic risk involves a potential cascading failure in a system or market due to interlinkages and interdependencies.³⁴ The chain reaction that is

³⁰ Adam B. Ashcraft, *Are Banks Really Special? New Evidence from the FDIC-Induced Failure of Healthy Banks*, 95 AM. ECON. REV. 1712, 1728 (2005) (“This paper has developed evidence that healthy-bank failures have significant and apparently permanent effects on real economic activity. While there are important caveats to keep in mind concerning the interpretation of pro forma failed bank balance sheets, much of this effect can be explained by a severe contraction of bank lending.”); KAMBHU, SCHUERMAN & STIROH, *supra* note 14, at 10.

³¹ The concept is the credit multiplier.

[It] magnifies small changes in bank deposits into changes in the amount of outstanding credit and the money supply. For example, a bank receives a deposit of \$100,000, and the Reserve Requirement is 20%. The bank is thus required to keep \$20,000 in the form of reserves. The remaining \$80,000 becomes a loan, which is deposited in the borrower’s bank. When the borrower’s bank sets aside the \$16,000 required reserve out of the \$80,000, \$64,000 is available for another loan and another deposit, and so on. Carried out to its theoretical limit, the original deposit of \$100,000 could expand into a total of \$500,000 in deposits and \$400,000 in credit.

JOHN DOWNES & JORDAN E. GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* (8th ed. 2010). Example from BARBARA CASU ET AL., *INTRODUCTION TO BANKING* (2006).

³² CASU, *supra* note 31.

³³ See Paul Volcker, *Commentary on the Restrictions on Proprietary Trading by Insured Depository Institutions 1*, available at http://online.wsj.com/public/resources/documents/Volcker_Rule_Essay_2-13-12.pdf (stating that proprietary trading “does not justify the taxpayer subsidy implicit in routine access to Federal Reserve credit, deposit insurance or emergency support”).

³⁴ *Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation: Hearing Before the Subcomm. on Domestic Monetary Policy and Tech. of the H. Comm. on Fin. Servs.*, 111th Cong. 88 (2009) (testimony of John Taylor) (“[S]ystemic risk in the financial sector [is] a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.”); see also Schwarcz, *supra* note 27, at 200.

often looked at is a banking panic.³⁵ Banking panics historically have occurred when customers withdrew their deposits from a bank in fear that the bank would become insolvent, causing a chain reaction of runs on other banks.³⁶ The chain reaction may have occurred because other banks were owed money by the bank in trouble or simply because fear spread across the general populous.³⁷ It is thought that much of the Great Depression's economic damage was caused by bank runs.³⁸ Some scholars contend that the recent economic crisis of 2007–2010 was a run by investors, not on banks, but on the shadow banking system.³⁹ The term “shadow banking system” refers to the fact that financial institutions outside the traditional banking system, such as hedge funds and investment banks, have acted as intermediaries between investors and borrowers, and increasingly undertaken roles traditionally played by banks, including lending capital to U.S. businesses.⁴⁰ These intermediaries have included investment banks, hedge funds, and others that have expanded the liquidity in many global financial markets.⁴¹

Many think of very large institutions when they think of systemic significance. However, systemic risk does not only stem from being “too big

³⁵ See generally George G. Kaufman, *Banking and Currency Crisis and Systemic Risk: Lessons from Recent Events*, 24 *ECON. PERSPECTIVES*, FED. RESERVE BANK OF CHI., no. 3, at 9–11 (2000) (discussing banking crises).

³⁶ Gary Gorton, *Banking Panics and Business Cycles*, 40 *OXFORD ECON. PAPERS* 751, 751–54 (1988); Rajkamal Iyer & Manju Puri, *Understanding Bank Runs: The Importance of Depositor-Bank Relationships and Networks* 2, 9 (Nat'l Bureau of Econ. Research, Working Paper No. 14280, 2008), available at <http://www.nber.org/papers/w14280>.

³⁷ Gorton, *supra* note 36, at 751–55.

³⁸ Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 *AM. ECON. REV.* 257, 259–60 (1983).

³⁹ See Gary Gorton, Questions and Answers About the Financial Crisis Prepared for the U.S. Financial Crisis Inquiry Commission 2 (Feb. 20, 2010), available at <http://online.wsj.com/public/resources/documents/crisisqa0210.pdf>.

⁴⁰ Andrew W. Lo, *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Written Testimony for the House Oversight Committee Hearing on Hedge Funds* 4 (Nov. 13, 2008), available at <http://ssrn.com/abstract=1301217>. In the lending context, this role may consist of being an intermediary between investors and borrowers (i.e., funneling funds from the investor to the borrower). See *id.* The non-bank institution will thereby profit from fees and/or the difference in interest rates that it pays the investors and what it receives from the borrowers. This role may also consist of purchasing debt securities on the secondary market. These non-bank institutions may include hedge funds, investment banks, structured investment vehicles, and other non-bank entities. *Id.*

⁴¹ *Id.* (describing financial intermediaries); see also Roger Ferguson & David Laster, *Hedge Funds and Systemic Risk*, *FIN. STABILITY REV.*, Apr. 2007, at 45, 47–48, available at http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etud5_0407.pdf (explaining that hedge funds have contributed to market efficiency and financial stability by expanding liquidity and thereby lowering the cost of capital).

to fail” in terms of market share.⁴² The Dodd-Frank Act recently created the Financial Stability Oversight Council (FSOC), in part to identify, monitor, and respond to risks to the financial stability of the United States.⁴³ In designating certain “nonbank” financial companies to be supervised by the Federal Reserve’s board of governors, some characteristics that were considered were “the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;”⁴⁴ “the importance of the company as a source of credit ... and as a source of liquidity for the United States financial system;”⁴⁵ and the “interconnectedness ... of the company.”⁴⁶ Clearly, Congress felt that there were factors in determining systemic risk that needed to be looked at in addition to the size and scale of the activities of the company.⁴⁷ The International Monetary Fund also determined, in a recent G-20 commissioned study, that institutions that were interconnected, not just the largest institutions, could impair financial markets.⁴⁸ Professor Hal Scott stated in his testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on the Volcker rule that “the absolute size of an institution is not the predicate for systemic risk; it is rather the size of its debt, its derivatives positions, and the scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system.”⁴⁹ Therefore, while we certainly need more study on what actually causes systemic risk or a cascading failure, systemic risk in general can be thought of as a cascading failure, like dominoes, that affects the real economy.

⁴² See, e.g., Rivière, *supra* note 14, at 293 (“Indeed, the failure of LTCM, a hedge fund worth \$4 billion, posed a systemic risk because of its exposure to banks. On the other hand, the failure of Amaranth, which was worth more than double that of LTCM (\$9.5 billion), had no systemic impact.” (citing Rama Cont, Amal Moussa & Andreea Minca, *Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks* (Columbia Ctr. for Fin. Eng’g, Working Paper, 2009))).

⁴³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 111–112, 124 Stat. 1376, 1392–95 (2010) (codified at 12 U.S.C. § 5321 (2012)).

⁴⁴ § 113(a)(2)(C), 124 Stat. at 1398.

⁴⁵ § 113(a)(2)(D), 124 Stat. at 1398.

⁴⁶ § 113(a)(2)(G), 124 Stat. at 1398.

⁴⁷ This is evidenced by the multi-faceted approach to defining “nonbank financial companies” that will be supervised and regulated by the Federal Reserve Board of Governors. See § 102(a)(1)(4)(A)–(D), § 113, 124 Stat. at 1391–92, 1398–99.

⁴⁸ See Staff of the Int’l Monetary Fund & the Bank for Int’l Settlements, & the Secretariat of the Fin. Stability Board, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations, Report to the G-20 Finance Ministers and Central Bank Governors*, at 9 (Oct. 2009), <http://www.imf.org/external/np/g20/pdf/100109.pdf>.

⁴⁹ *Implications of the “Volcker Rules” for Financial Stability: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 51 (2010) (statement of Hal Scott, Nomura Professor of International Systems, Harvard Law School).

B. Dodd-Frank's Volcker Rule

The Volcker rule, in section 619 of the Dodd-Frank Act, generally restricts “banking entities”⁵⁰ from engaging in proprietary trading for the entity’s own account. This includes trading in any security, derivative, future, option, or any other security or financial instrument designated by the federal banking agencies, the Securities Exchange Commission (SEC), and the Commodities Futures Trading Commission (CFTC).⁵¹ “Trading” generally means acquiring or taking positions “principally for the purpose of selling in the near term”⁵² However, “instruments held for investment, as opposed to trading,” are not banned.⁵³

Notwithstanding the general prohibitions of the Volcker rule, there are significant exemptions. These “permitted activities” include transactions in U.S. government or agency obligations, certain market-making activities, certain risk-mitigating hedging activities, and certain transactions in securities and other instruments on behalf of customers.⁵⁴ There are also other exemptions for regulated insurance companies and offshore transactions.⁵⁵

The Volcker rule also prohibits banking entities from acquiring or retaining certain ownership interests in, or sponsoring,⁵⁶ a hedge fund or private

⁵⁰ See *supra* note 12.

⁵¹ § 619, 124 Stat. at 1620–21, 1630. “It does not apply to commodities such as precious or base metals, or energy or agricultural products, nor does it apply to foreign exchange or loans.” *Understanding the New Financial Reform Legislation*, *supra* note 12, at 66.

⁵² § 619, 124 Stat. at 1630.

⁵³ *Understanding the New Financial Reform Legislation*, *supra* note 12, at 66.

⁵⁴ § 619, 124 Stat. at 1624.

⁵⁵ For example, the Dodd-Frank Act exempts from the proprietary trading ban certain transactions in securities and other financial instruments by a regulated insurance company, or its affiliate. *Id.* at 1623–24.

The Dodd-Frank Act also exempts proprietary trading conducted by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, 12 U.S.C. § 1841, but only if the trading occurs “solely outside of the United States” and the banking entity is not directly or indirectly owned or controlled by a banking entity organized under US or state law.

Understanding the New Financial Reform Legislation, *supra* note 12, at 67 (citing Dodd-Frank Act, § 619, 124 Stat. at 1625–26). Another exemption permits a banking entity to make “[i]nvestments in ... small business investment companies,” certain “investments designed primarily to promote the public welfare,” and “investments that are qualified rehabilitation expenditures [related] to a qualified rehabilitated building or certified historic structure.” § 619, 124 Stat. at 1624.

⁵⁶ A banking entity “sponsors” a covered fund by:

(A) [serving] as a general partner, managing member, or trustee of [the] fund;

equity fund.⁵⁷ There are several exemptions from these restrictions as well. A banking entity can organize and offer a fund, and be its general partner or managing member if the banking entity provides investment advisory or other services, if the fund is organized in connection with those services and if the fund is offered only to customers of the banking entity.⁵⁸ In addition, the banking entity may only have a *de minimis* investment⁵⁹ in the fund, the banking entity may not enter into certain transactions with the fund, and the banking entity may not guarantee or insure the obligations or performance of a private fund.⁶⁰ The banking entity also may not share a name with the fund, and “no director or employee of a banking entity [may have] ... an interest in a private fund, except for any director or employee who is directly engaged in providing advisory services.”⁶¹ Finally, adequate

(B) ... select[ing] or ... control[ing] (or [having] employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of the fund; or

(C) [sharing] with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

§ 619, 124 Stat. at 1630.

⁵⁷ Covered funds include the following:

The ban on certain relationships with “hedge funds” and “private equity funds” applies to any fund that relies on either Section 3(c)(1) (the exemption for funds with less than 100 US beneficial owners) or 3(c)(7) (the exemption for funds with owners who meet the definition of “qualified purchasers,” principally institutions and individuals with large investment portfolios) of the ICA for its exemption from registration under that Act, and similar funds as are designated by the agencies. Private funds not ordinarily considered to be the market equivalent of hedge funds or private equity funds, but which rely on either 3(c)(1) or 3(c)(7), could be covered. For example, the ban may apply to collateralized debt obligations or other bank loan funds and securitization special purpose entities that rely on these exemptions, although the Dodd-Frank Act includes what appears to be a blanket exception for a banking entity’s sale or securitization of loans “in a manner otherwise permitted by law.”

Understanding the New Financial Reform Legislation, *supra* note 12, at 68.

⁵⁸ § 619(d)(1)(G)(ii), 124 Stat. at 1624–25.

⁵⁹ § 619(d)(1)(G)(iii), 124 Stat. at 1626. The *de minimis* investment provision permits a banking entity to make investments in covered funds under the fiduciary exemption for purposes of either “(i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or (ii) making a *de minimis* investment.” § 619, 124 Stat. at 1626–27. “A banking entity’s aggregate investment in all covered funds made pursuant to the *de minimis* investment authority must ‘be immaterial to the banking entity,’ a term to be defined by rule, and in any case may not exceed” certain limits. *Understanding the New Financial Reform Legislation*, *supra* note 12, at 70. There are separate restrictions with respect to seed funding investments. *See id.*

⁶⁰ § 619(d)(1)(G)(v), 124 Stat. at 1625.

⁶¹ *Understanding the New Financial Reform Legislation*, *supra* note 12, at 69.

disclosures must be provided in the offering documents stating “that the losses in a private fund are not borne by the banking entity.”⁶²

It is also important to note that the SEC and the CFTC may also exempt additional activities if they determine doing so “would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”⁶³ In addition, the exemptions from the Volcker rule proprietary trading ban and private fund restrictions will not apply if the transaction would involve a material conflict of interest or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.⁶⁴

Under the Dodd-Frank Act, the FSOC was to complete a study and make implementation recommendations so as to, among other things, “reduce conflicts of interest” and “limit activities that cause undue risk.”⁶⁵ It did so in January 2011.⁶⁶ Further, the SEC and the CFTC were required to consider the study and adopt rules with respect to the Volcker Rule within nine months of the completion of the FSOC’s study.⁶⁷ The Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and the SEC approved proposed rules in October 2011 and requested public comments that were due in February 2012.⁶⁸

The Volcker rule prohibitions would take effect on the earlier of twelve months after the date of issuance of final rules, or two years after the date of the Dodd-Frank Act’s enactment, July 21, 2012.⁶⁹ Therefore, banking entities and nonbank financial companies that are supervised by the FRB generally will have two years after the effective date, until July 21, 2014, to comply with the Volcker rule.⁷⁰ As this is being written, the OCC has stated

⁶² *Id.*

⁶³ *Id.* at 71.

⁶⁴ *Id.* at 71.

⁶⁵ *Id.* at 72.

⁶⁶ FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS (2011), <http://www.treasury.gov/initiatives/documents/volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>.

⁶⁷ *Understanding the New Financial Reform Legislation*, *supra* note 12, at 69.

⁶⁸ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011), <http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf>. The Commodities Futures Trading Commissions (CFTC) subsequently issued its own proposed rules. See Notice of Proposed Rulemaking, 77 Fed. Reg. 8332 (Feb. 14, 2012), <http://www.gpo.gov/fdsys/pkg/FR-2012-02-14/pdf/2012-935.pdf>.

⁶⁹ § 619, 124 Stat. at 1622–23.

⁷⁰ *Understanding the New Financial Reform Legislation*, *supra* note 12, at 73; see Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity

that “many of the largest national banks and their holding affiliates have shut down, or are in the process of winding down, exposures in trading books that appear most clearly to fall within the statutory definition of proprietary trading.”⁷¹

C. Policies Behind the Enactment of the Volcker Rule

One of the underlying policy considerations of the Volcker rule is that banking entities are different from other entities with respect to their place in our financial system.⁷² The monetary function of bank deposits is one of the main reasons why deposit-taking institutions are subject to heavier regulation than non-deposit-taking institutions.⁷³ The idea is that banking entities play a special role in the stability of the U.S. financial system and that is the reason why they have access to certain governmental subsidies like Federal Reserve credit, Federal Deposit Insurance, and emergency services.⁷⁴ Proponents of the Volcker rule argue that banking entities should therefore be prohibited from engaging in activities that are deemed too risky.⁷⁵

The implicit contention behind these restrictions with respect to the policy justification of systemic risk is that proprietary trading for the banking entity’s own account is too risky because it could cause the banking entity to fail or reduce the liquidity it provides to others, disrupting credit channels.⁷⁶

Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011) (to be codified at 12 C.F.R. pt. 225).

⁷¹ Letter from Thomas J. Curry, Comptroller of the Currency to Carolyn Maloney, U.S. Rep. for N.Y. 14th District (July 18, 2012), *available at* http://maloney.house.gov/sites/maloney.house.gov/files/documents/financial/20120718OCCResponseAR-M550U_20120718_161635.pdf. As reflected in public filings, institutions that are in this process of winding down such activities include Bank of America, Citibank, JPMorganChase, Morgan Stanley, PNC, and Wells Fargo; the OCC further states it cannot gauge the extent to which actions already taken fulfill the Volcker rule until there is a final rule adopted on the definition of proprietary trading. *Id.*

⁷² Please note that another main policy consideration behind the Volcker rule is the elimination of the conflicts of interest created by generating in blending the business of commercial and investment banking. This Article will focus on the systemic risk issue and not potential conflicts of interest.

⁷³ See *supra* notes 22–23 and accompanying text.

⁷⁴ *Id.*

⁷⁵ See Merkley & Levin, *supra* note 2, at 533; FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 66, at 1.

⁷⁶ See KAMBHU, SCHUERMANN & STIROH, *supra* note 14, at 11–12 (postulating that collateralization of these exposures may not be enough to mitigate against this risk because collateral values may fall, while recognizing that banks’ current exposures are heavily collateralized and each bank has some interest in mitigating these risks). *But see* Rivière, *supra* note 14, at 36 (stating the failure of Amaranth “did not have a destabilizing effect because counterparties to these funds held sufficient collateral”).

Similarly, if a hedge fund or private equity fund struggles or fails, a banking entity with exposure to that fund may also fail themselves or reduce liquidity they provide to others, further disrupting credit channels.⁷⁷ In addition, the limitation on investing in or sponsoring a hedge fund or private equity fund ensures that banking entities cannot circumvent the proprietary trading ban; this eliminates incentives for banks to bail out funds that they sponsor or in which they have significantly invested.⁷⁸

In January 2009, the Group of Thirty, under the leadership of a committee chaired by Paul Volcker, issued a report on financial reform aimed at global financial stability and “intended to be useful to policymakers in all the countries whose financial systems [were] disrupted in [the global financial crisis starting in 2007].”⁷⁹ The report states that market forces combined with responses to those forces have led to pressure for changes in the structure of financial systems.⁸⁰ The report also states that the implication is that “at least the very large and complex banking organizations that ... carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities.”⁸¹ The Group’s first recommendation was that large systemically important banking institutions be limited in high risk proprietary activities or those that present serious conflicts of interest.⁸² The Group also recommended that sponsorship and management of private pools of capital be limited.⁸³

Although the Volcker rule did not appear in the House version of the legislation that passed the House in December 2009 or in the original Senate version, adoption of the rule was endorsed by President Obama as part of

⁷⁷ See KAMBHU, SCHUERMANN & STIROH, *supra* note 14, at 13 (citing Hyun Song Shin, *Risk and Liquidity in a System Context* (BIS, Working Paper No. 212, 2006)).

⁷⁸ See FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 66, at 6.

⁷⁹ Group of Thirty Working Group on Financial Reform, *Financial Reform: A Framework for Financial Stability*, at 8 (2009), available at http://www.group30.org/rpt_03.shtml.

The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers. *History of the Group*, GROUP OF THIRTY, <http://www.group30.org/about.shtml> (last visited Feb. 2, 2013).

⁸⁰ Group of Thirty Working Group on Financial Reform, *supra* note 79, at 16.

⁸¹ *Id.*

⁸² *Id.* at 28.

⁸³ *Id.*

the administrative reform plan in early 2010.⁸⁴ The rule was included in the Senate bill in April 2010.⁸⁵ At this point in the legislative process, the rule was not debated in the Senate and was largely unchanged, passing in May 2010.⁸⁶ While a number of changes were made to the rule in the conference process, guidance was not provided as to motivation and application of the rule. In fact, many of the material details and definitions were left for the FSOC and the other federal banking agencies.

Senators Jeff Merkley and Carl Levin, who introduced the rule in Congress, wrote a policy essay published in 2011.⁸⁷ They contend that deregulation, taking down the Glass-Steagall wall, allowed banks to take risks that precipitated the 2007 financial crisis.⁸⁸ This contention will be addressed in Part III. The bulk of their essay focuses on abuses by banks that created and marketed products to clients that were secretly designed to fail and the use of client trading information against the interests of those clients and others in the markets.⁸⁹ Therefore, via the Volcker rule, they try to “restore the spirit of regulations that followed the Great Depression” (the Glass-Steagall wall).⁹⁰ Because it is the spirit of the Glass-Steagall wall that motivated the Volcker rule, this Article will now turn to the history of banking regulation in general, focusing on the expansion of bank services that led to the Glass-Steagall wall, the factors that led to the deconstruction of the Glass-Steagall wall, and the erection of the Volcker wall.

II. A HISTORICAL LOOK AT SYSTEMIC RISK AND BANKING LAWS IN THE U.S.

A. Early Regulators of State Chartered Banks—The First and Second Banks of the U.S.

Before 1791, the American banking system consisted mostly of unstable state chartered banks.⁹¹ Many state banks issued notes that were not backed

⁸⁴ See Kevin Drawbaugh, *White House Recommits to “Volcker Rule” Bank Trade Ban*, REUTERS (Feb. 23, 2010), <http://www.reuters.com/article/idUSTRE61L3UL20100224>.

⁸⁵ See Merkley & Levin, *supra* note 2, at 535–36.

⁸⁶ See *id.* at 536–37.

⁸⁷ *Id.* at 515.

⁸⁸ See *id.* at 516.

⁸⁹ *Id.* at 523, 525.

⁹⁰ *Id.* at 516.

⁹¹ This does not include the Bank of North America ratified in early 1781 but its charter was repealed in 1785 due to charges of favoritism of foreigners and unfair competition. 1 JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900)*, at 86–88 (2002) [hereinafter MARKHAM, *FINANCIAL HISTORY*].

by specie—gold or silver—redeemable at the bank’s office.⁹² This meant each bank had its own currency, which caused interregional issues.⁹³ In order to stabilize and improve the nation’s credit with respect to the debt from the Revolutionary War and to create a standard form of currency, the First Bank of the United States was chartered by Congress in 1791.⁹⁴ It was responsible for twenty percent of the currency supply while state banks accounted for the rest.⁹⁵ Restrictions on the bank stemmed from fears of concentrations of wealth in the hands of a few.⁹⁶ The Bank of the United States was prohibited, for example, “from investing in land or buildings and from dealing in goods, wares, merchandise, or commodities.”⁹⁷

After Alexander Hamilton, the bank’s champion, left the position of Secretary of the Treasury, the new Secretary of the Treasury advised that the government could raise money by selling its shares in the bank.⁹⁸ Congress agreed and the bank’s charter was allowed to expire in 1811.⁹⁹ Competing private banks resented the Bank of the United States and were able to prevent its charter renewal by the Congress in 1811.¹⁰⁰

The debt of the nation from the War of 1812 led to an increase in state banks’ notes and inflation skyrocketed because most state chartered banks suspended specie payments.¹⁰¹ As a result, Congress agreed to form the Second Bank of the United States in 1816.¹⁰² The Second Bank of the United States served as an early regulator of the wildcat banks, in that it held large quantities of other banks’ notes in reserve and could discipline banks that it was concerned were over-issuing notes with the threat of redeeming those

⁹² *Id.* at 168.

⁹³ *Id.* at 168–69.

⁹⁴ *Id.* at 75. A central banking system was quite controversial to some of the founding fathers. England had tried to place the colonies under the control of the Bank of England prior to the Revolutionary War. Some founding fathers were in favor of a central bank.

⁹⁵ *Id.* at 88–89; *The First Bank of the United States (1791–1811)*, AMERICAN HISTORY: FROM THE REVOLUTION TO RECONSTRUCTION AND BEYOND, [http://www.let.rug.nl/usa/essays/general/a-brief-history-of-central-banking/the-first-bank-of-the-united-states-\(1791-1811\).php](http://www.let.rug.nl/usa/essays/general/a-brief-history-of-central-banking/the-first-bank-of-the-united-states-(1791-1811).php) (last visited Feb. 2, 2013).

⁹⁶ Jerry W. Markham, *The Subprime Crisis—A Test Match for the Bankers: Glass-Steagall vs. Gramm-Leach-Bliley*, 12 U. PA. J. BUS. L. 1081, 1082 (2010) [hereinafter Markham, *The Subprime Crisis*].

⁹⁷ *Id.* at 1083.

⁹⁸ *First Bank of the United States*, <http://www.saylor.org/site/wp-content/uploads/2011/08/HIST312-5.1.3-First-Bank-of-the-United-States.pdf> (last visited Feb. 2, 2013).

⁹⁹ *Id.*

¹⁰⁰ Markham, *The Subprime Crisis*, *supra* note 96, at 1083.

¹⁰¹ See *Second Bank of the United States/Portrait Gallery*, U.S. HISTORY, <http://www.ushistory.org/tour/second-bank.htm> (last visited Feb. 2, 2013).

¹⁰² *Id.*

notes.¹⁰³ Andrew Jackson feared that a powerful private institution would be susceptible to corruption and refused to renew the bank's charter in 1832, pulling federal deposits from the bank.¹⁰⁴ The bank was crippled and its federal charter expired in 1836.¹⁰⁵ Also in 1836, President Jackson declared in the Specie Circular (Coinage Act) by executive order that the government would only accept gold or silver for payment of land, which caused runs on the banks and a wave of bank failures.¹⁰⁶

B. Informal Regulation—The Free Banking Era

The period from 1837 to the Civil War was known as the free banking era since there was no central bank and states controlled their own bank charters.¹⁰⁷ Banks could generally enter into the banking business by depositing government bonds with state auditors.¹⁰⁸ The government bonds were the collateral that backed their bank notes.¹⁰⁹ In addition, banks were generally required to redeem their notes on demand in specie.¹¹⁰ While there was no central bank, the Suffolk Bank played this role to a certain extent with respect to disciplining banks that were issuing too many notes, clearing payments, and exchanging notes. Also in 1853, the New York Clearinghouse Association was established and provided a way for banks to exchange notes and checks and settle accounts.¹¹¹ Many contend that this kind of free banking is instable and cite bank failures in Indiana, Wisconsin, and Minnesota during this era as evidence.¹¹²

¹⁰³ Markham, *The Subprime Crisis*, *supra* note 96, at 1084.

¹⁰⁴ See MARKHAM, FINANCIAL HISTORY, *supra* note 91, at 144.

¹⁰⁵ *Id.* at 146 (discussing how the Second Bank “failed in its effort to obtain a federal charter” but “was able to carry on its banking activities ... through a charter granted by Pennsylvania”). See generally Edwin J. Perkins, *Lost Opportunities for Compromise in the Bank War: A Reassessment of Jackson's Veto Message*, 61 BUS. HIST. REV. 531 (1987).

¹⁰⁶ See MARKHAM, FINANCIAL HISTORY, *supra* note 91, at 148.

¹⁰⁷ See MARKHAM, FINANCIAL HISTORY, *supra* note 91, at 170 (discussing specific examples of state regulation of bank charters during this period); see also Arthur J. Rolnick & Warren E. Weber, *New Evidence on the Free Banking Era*, 73 AM. ECON. REV. 1080, 1080 (1983) (describing the lack of regulation during this period and the attendant problems as “often cited as evidence that banking should be regulated”).

¹⁰⁸ See Hugh Rockoff, *The Free Banking Era: A Reexamination*, 6 J. MONEY, CREDIT & BANKING 141, 141 (1974).

¹⁰⁹ See *id.*; Rolnick & Weber, *supra* note 107, at 1083.

¹¹⁰ Rolnick & Weber, *supra* note 107, at 1083.

¹¹¹ *A History of Central Banking in the United States*, THE FEDERAL RESERVE BANK OF MINNEAPOLIS, http://www.minneapolisfed.org/community_education/student/central_bankinghistory/bank.cfm (last visited Feb. 2, 2013). See *id.* at 177.

¹¹² Rolnick & Weber, *supra* note 107, at 1084. Kam Hon Chu, *Is Free Banking More Prone to Bank Failures Than Regulated Banking?*, 16 CATO J., no. 1, Spring/Summer 1995, at 48.

C. The National Banking System, Federal Reserve Act and Stock Market Crash of 1929

The Civil War led to a “dual” banking system in which a bank could adopt a state charter, which would be regulated by state regulators, or a national charter, which would be regulated by the OCC.¹¹³ State banks could not issue their own notes that could serve as a circulating currency.¹¹⁴

With the need to finance the Civil War and multiple currencies in the form of state bank notes circulating, interest in a National Bank was renewed.¹¹⁵ The original National Banking Act of 1863¹¹⁶ was enacted with the main goal of creating a single national currency.¹¹⁷ It created national banks that were able to issue United States Treasury backed bank notes, which were printed by the government itself.¹¹⁸

The number of bank notes allowed to be issued was contingent upon the bank’s capital level deposited with the Comptroller of the Currency. To further regulate currency, the Act also placed a tax on notes issued by state and local banks, which effectively drove non-federally issued notes out of circulation.¹¹⁹ The National Banking Act of 1864 replaced the National Banking Act of 1863.¹²⁰ The new Act also established federally issued bank charters.¹²¹ The new federal chartering took banking regulation and authority away from corrupt state governments.¹²² Under the National Banking Act of 1864, a national bank’s role was to invest its funds in short-term, self-liquidating loans to finance goods in the process of production or exchange.¹²³ However, national banks had difficulty conducting such limited operations and surviving because they had to compete with state-chartered banks and trust companies.¹²⁴ They therefore took advantage of what some call a “loophole” in the law that permitted these banks to perform activities “incidental” but

¹¹³ Markham, *The Subprime Crisis*, *supra* note 96, at 1084 (citations omitted).

¹¹⁴ *Id.*

¹¹⁵ See Richard S. Grossman, *U.S. Banking History, Civil War to World War II*, EH.NET ENCYCLOPEDIA OF ECONOMIC AND BUSINESS HISTORY (Feb. 2, 2010, 6:21 PM), <http://eh.net/encyclopedia/article/grossman.banking.history.us.civil.war.wwii>.

¹¹⁶ National Banking Act of 1863, ch. 58, 12 Stat. 665.

¹¹⁷ Grossman, *supra* note 115.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ National Banking Act of 1864, ch. 106, 13 Stat. 99.

¹²¹ See Grossman, *supra* note 115.

¹²² *Id.*

¹²³ White, *Before the Glass-Steagall Act*, *supra* note 3, at 34.

¹²⁴ See *id.*

necessary to their operations.¹²⁵ Courts broadly interpreted this to mean the national banks could do what was not specifically prohibited by law.¹²⁶

The national banking system suffered from many bank panics, notably in 1873, 1893, and 1907.¹²⁷ These panics included a large number of depositors attempting to get their money, causing an otherwise solvent bank to fail.¹²⁸ Depositors at other banks would then follow suit, causing the panic to be system-wide.¹²⁹ After a bad panic in 1907, the nation again began to consider a central bank.¹³⁰ The Federal Reserve Act of 1913 created twelve private regional federal reserve banks and a Federal Reserve Board appointed by the President.¹³¹ It also created a single new United States currency.¹³² All nationally chartered banks were required to become members and to purchase specified non-transferable stock in their regional federal reserve bank.¹³³ They were also required to set aside a stipulated amount of noninterest-bearing reserves with their respective reserve bank.¹³⁴

D. The Rise of Commercial Banks Engaging in Investment Banking

In order to compete with state chartered banks, national commercial banks started to supply trust services to their customers, through affiliates.¹³⁵ World War I financing needs required many national banks to handle their first security issues in the form of bonds.¹³⁶ In addition to the financing needs of World War I, there was a decline for commercial loans, which left the banks looking for new income.¹³⁷ Once banks entered the securities business, they found commercial banking and investment banking to be complementary. Commercial banks had large numbers of customers to tap into for the purchase of the securities, so they were able to charge smaller commissions than

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ See Grossman, *supra* note 115.

¹²⁸ See *id.*

¹²⁹ *Id.*

¹³⁰ See *id.*

¹³¹ *Id.*

¹³² *Id.* (discussing an elastic currency as a means by which “components of the money supply (gold and silver certificates, national bank notes) [are] able to expand or contract particularly rapidly”).

¹³³ Federal Reserve Act of 1913, Pub. L. No. 63-43, § 2, 38 Stat. 251, 252, 257.

¹³⁴ § 2, 38 Stat. at 270–71.

¹³⁵ See White, *Before the Glass-Steagall Act*, *supra* note 3, at 34.

¹³⁶ See EMMANUEL N. ROUSSAKIS, COMMERCIAL BANKING IN AN ERA OF DEREGULATION 287 (3d ed. 1997); White, *Before the Glass-Steagall Act*, *supra* note 3, at 34.

¹³⁷ White, *Before the Glass-Steagall Act*, *supra* note 3, at 34–35.

investment bankers who had a smaller client base.¹³⁸ Because of the banks' distribution networks, they could obtain desirable participations in underwriting syndicates.¹³⁹ Banks could also use existing parent banks' offices to sell the securities.¹⁴⁰ In return, banks could take advantage of securities research staffs to analyze both purchases for the bank, and collateral.¹⁴¹

Given these advantages and the limited role prescribed for national banks in the National Banking Act of 1864, national banks began using affiliated trust companies to engage in securities businesses.¹⁴² For example, National City Company, an "investment affiliate" of National City Bank, was organized in 1911.¹⁴³ National City Bank's officers and shareholders owned, via trustees, all of the stock of the company in proportion to their ownership interest in the National City Bank.¹⁴⁴ This beneficial interest in the investment company was tied to the shares of the bank, in that sale of bank stock included the corresponding shares of the beneficial interest in the investment company.¹⁴⁵ This was evidenced by a stamp on the back of the bank shares stating that the beneficial interest in the company went with the bank shares.¹⁴⁶ Other banks carried an affiliate as an investment of the bank, or a holding company owned both the investment affiliate and the bank.¹⁴⁷

The investment banking done by affiliates of commercial banks grew. From 1927 to 1930, the level of participation in all bond issues by banks and banks' affiliates increased from 36.8 percent to 61.8 percent.¹⁴⁸ National City Company, for example, an affiliate of National City Bank, was not subject to the limitations of National City Bank and could therefore engage in any lawful business, including investing in shares of sixteen banks and trust companies and other businesses.

In 1911, U.S. Solicitor General Fredrick W. Lehman considered whether National City Bank's affiliation with National City Company violated banking

¹³⁸ *See id.* at 36.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 37.

¹⁴² *Id.* at 34.

¹⁴³ S. REP. NO. 73-1455, at 156 (1934).

¹⁴⁴ *Id.* at 158.

¹⁴⁵ *Id.*

¹⁴⁶ *See* Eugene N. White, *Banking Innovation in the 1920s: The Growth of National Banks' Financial Services*, 13 BUS. & ECON. HIST. 92, 93 (1984) [hereinafter White, *National Banks*].

¹⁴⁷ White, *Before the Glass-Steagall Act*, *supra* note 3, at 35 (describing the basic methods of organizing security affiliates).

¹⁴⁸ *Id.* at 37 (citing *Operation of the National & Federal Reserve Banking Systems: Hearings on S. Res. 71 Before a Subcomm. of the S. Comm. on Banking & Currency*, 71st Cong. (1931)).

laws. Lehman concluded that National City Company's investments in sixteen banks and trust companies caused concern that it was gaining control over banks. He thus found that National City's holding of bank stock did violate federal banking laws.¹⁴⁹ National City Company did not respond to the ruling and ultimately, President William Taft asked to handle the matter but did not pursue it.¹⁵⁰ A congressional subcommittee, the Pujo Committee, was formed two years later in 1913 to investigate Wall Street bankers and criticism of securities affiliates was reignited.¹⁵¹ Although the committee itself garnered press, there was no resulting legislation.¹⁵²

E. Erecting the Glass-Steagall Wall

Yet another investigation, the Pecora Investigation, was initiated almost twenty years later, on March 4, 1932, by the U.S. Senate Committee on Banking and Currency to investigate the causes of the 1929 stock market crash.¹⁵³ On October 24, 1929, "Black Thursday," the stock market lost around nine percent of its value by the end of the day.¹⁵⁴ Several bankers, including Charles E. Mitchell,¹⁵⁵ then president of the National City Bank of New York, used their financial resources to bid on large blocks of blue chip stocks at prices above the current market in an effort to halt the slide.¹⁵⁶ It worked temporarily, but by October 29, 1929, "Black Tuesday," the Dow had lost twelve percent more.¹⁵⁷ Some sources say that in total, "\$25 billion—some \$319 billion in today's dollars—was lost in the 1929 crash."¹⁵⁸ In addition, the market would not return to its pre-crash statistics until 1954.¹⁵⁹

¹⁴⁹ Markham, *The Subprime Crisis*, *supra* note 96, at 1086.

¹⁵⁰ 2 JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970)*, at 58 (2002).

¹⁵¹ *Id.*; *see also* Markham, *The Subprime Crisis*, *supra* note 96, at 1088.

¹⁵² *Id.*

¹⁵³ S. REP. NO. 73-1455, at 1. Ferdinand Pecora was the final chief counsel for the investigation. *See, e.g.*, Ron Chernow, Op-Ed., *Where Is Our Ferdinand Pecora?*, N.Y. TIMES, Jan. 6, 2009, at A25.

¹⁵⁴ Harold Bierman, Jr., *The 1929 Stock Market Crash*, EH.NET ENCYCLOPEDIA OF ECONOMIC AND BUSINESS HISTORY (Feb. 4, 2005, 4:13 PM), <http://eh.net/encyclopedia/article/Bierman.Crash>.

¹⁵⁵ In 1933, the Senate's Pecora Commission investigated Mitchell as its first witness for his part in tens of millions of dollars in losses, excessive pay and tax avoidance. JOHN N. INGHAM, *John Mitchell*, in 2 *BIOGRAPHICAL DICTIONARY OF AMERICAN BUSINESS LEADERS* 945 (1983).

¹⁵⁶ ROBERT GOLDSTON, *THE GREAT DEPRESSION: THE UNITED STATES IN THE THIRTIES* 38–39 (1968).

¹⁵⁷ Claire Suddath, *The Crash of 1929*, TIME (Oct. 29, 2008), <http://www.time.com/time/nation/article/0,8599,1854569,00.html>.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

Among other abuses, in its report the Pecora commission discussed “abuses arising out of the interrelationship of commercial and investment banking.”¹⁶⁰ The commission discussed investment banks that were affiliated with large commercial banks as a “prolific source of evil.”¹⁶¹ The report states that these affiliates were instrumentalities employed “to speculate in their own stock, to participate in market operations designed to manipulate the price of securities, and to conduct other operations in which commercial banks are forbidden by law to engage.”¹⁶² For example, the report goes on to detail National City Bank’s creation of its investment affiliate, National City Company. According to the report, the purpose of National City Company was to allow National City Bank “to make investments not within the scope of the bank’s power.”¹⁶³ One historian called the independence of City’s investment bank, National City Company, “a masterpiece of legal humor.”¹⁶⁴ The report further concluded that commercial banks breached fiduciary duties to depositors who sought “disinterested investment counsel” because commercial banks referred them to their affiliates.¹⁶⁵

The commission questioned Charles E. Mitchell, who was elected president of National City Bank in 1921 and chairman in 1929, for losses concerning potential conflicts of interest of the intersection between commercial banking and investment banking, excessive pay, and tax avoidance.¹⁶⁶ Senator Glass said of him: “Mitchell more than any 50 men is responsible for this stock crash.”¹⁶⁷ These hearings mostly identified problems with respect to conflicts of interest in blending commercial banking and investment banking and did not focus on systemic risk.¹⁶⁸

F. Deregulation: Gramm-Leach-Bliley

In the 1960s, banks began looking for new sources of income to compensate for inflation.¹⁶⁹ The then Comptroller of the Currency, James Saxon,

¹⁶⁰ See S. REP. NO. 73-1455, at 113 (1934).

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.* at 157.

¹⁶⁴ Allen Brinkely, *When Washington Took on Wall Street*, VANITY FAIR (June 2010), <http://www.vanityfair.com/business/features/2010/06/pecora-201006> (quoting popular historian Frederick Lewis Allen).

¹⁶⁵ S. REP. NO. 73-1455, at 157.

¹⁶⁶ See Brinkely, *supra* note 164.

¹⁶⁷ *Damnation of Mitchell*, TIME, Mar. 6, 1933, at 53.

¹⁶⁸ The relevant provisions of the Glass-Steagall Act appeared in the Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162, 184–85, 188–89, 194 (codified as amended at 12 U.S.C. §§ 24, 77, 377, 378(a) (2006)).

¹⁶⁹ See MARKHAM, FINANCIAL HISTORY, *supra* note 91, at 1095.

encouraged this by taking an expansive approach to the banking laws.¹⁷⁰ He permitted commercial banks and affiliates to engage in an expanding list and volume of securities activities.¹⁷¹ Some of these activities were prohibited by the courts¹⁷² but by the time the Gramm-Leach-Bliley Act was enacted in 1999, many felt that the Glass-Steagall wall had already come down.¹⁷³

In 1998, a year before Gramm-Leach-Bliley tore down Glass-Steagall's wall, Citicorp, a commercial bank holding company, merged with an insurance company to form a corporation that combined banking, securities, and insurance services. This merger was technically a violation of the Glass-Steagall Act and the Bank Holding Company Act of 1956 but the Federal Reserve granted Citicorp a temporary waiver. Subsequently, Gramm-Leach Bliley was enacted, tearing down Glass-Steagall's wall, removing the prohibition of commercial banks from entering into securities and insurance businesses.¹⁷⁴ The stated purpose of the Gramm-Leach-Bliley Act was to "enhance competition in the financial services industry by providing a ... framework for the affiliation of banks, security firms, insurance companies, and other financial service providers."¹⁷⁵

III. DOES THE BLENDING OF COMMERCIAL BANKING AND INVESTMENT BANKING PRODUCE THE ALLEGED HARM, INCREASED SYSTEMIC RISK?

Does the blending of commercial banking and investment banking produce the alleged harm, increased systemic risk? It is important to reiterate

¹⁷⁰ *Id.*

¹⁷¹ *See id.*

¹⁷² *See, e.g.,* *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 639 (1971) (holding that Saxon's authorization of the operation of commingled investment accounts by commercial banks violated the Glass-Steagall Act).

¹⁷³ For example, the FRB determined in 1982 that a bank could operate a discount brokerage subsidiary, and the Supreme Court upheld the decision. *See* *Secs. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 221 (1984). Also, section 16 of the Glass-Steagall Act allowed commercial banks to underwrite certain government securities and section 20 prohibited banks from affiliating with companies principally engaged in issuing, floating, underwriting, selling, or distributing ineligible securities. *Banking Act of 1933*, Pub. L. No. 73-66, §§ 16, 20, 48 Stat. 162, 184, 188-89. "Principally engaged" was defined by the Second Circuit Court of Appeals to be exceeding five to ten percent of the affiliates' gross revenue. *See* *Secs. Indus. Ass'n v. Bd. Of Governors of the Fed. Reserve Sys.*, 839 F.2d 47, 68-69 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

¹⁷⁴ Teveia R. Barnes, Commissioner, California Department of Financial Institutions, Remarks at 27th Annual Management & Directors Seminar (Dec. 12, 2012); *see also* LISSA LAMKIN BROOME & JERRY W. MARKHAM, *THE GRAMM-LEACH-BLILEY ACT: AN OVERVIEW 1* (2001) (identifying the merger as a motivating factor for the passage of GLBA).

¹⁷⁵ *See* *Gramm-Leach-Bliley Act*, Pub. L. No. 106-102, §§ 101, 103, 113 Stat. 1338, 1338 (1999).

that justifications for prohibiting blending usually rely on two separate rationales. One is that certain conflicts of interest injure the public. The other is that the blending increases systemic risk. This Article will focus on the latter, systemic risk, leaving possible solutions to the issues of conflicts of interest for another discussion.

A. *The Great Depression*

First, consider the assertions that the blending played a significant role in the stock market crash of 1929 and subsequent banking crisis. Much of the blame for the banking crisis after 1929 was put on commercial banks' investment banking activities through their bond departments and through affiliated securities firms.¹⁷⁶ Hearings on the bill that would become the Banking Act of 1933 uncovered abuses in the activities of the security affiliates.¹⁷⁷ Senator Glass stated: "[T]hese affiliates, I repeat, were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since."¹⁷⁸ It is difficult to tease out the role that the investment banking activities of commercial banks played in the crisis of 1929. Nevertheless, while the congressional hearings generated buzz about the blending's harm to the soundness of banks, most of the actual testimony in hearings convened in 1931 focused on the potential conflicts of interest in the blending as opposed to the potential for increased systemic risk.¹⁷⁹

It was also alleged that the blending may create liquidity issues for commercial banks because a bank would hold short-term demand deposits while being exposed to marketable securities with long-term maturities.¹⁸⁰ Securities, moreover, may have unanticipated losses because the market unexpectedly fluctuates. If the market turns down, a blended bank's assets values (securities for its own account) may decrease at the same time that the depositors will withdraw their funds and borrowers would default on the loans. In addition, it was thought that a bank may make investment decisions it would not otherwise make but for the blending, such as lending money or purchasing from a securities affiliate or certain customers on

¹⁷⁶ See Edward J. Kelly, III, *Legislative History of the Glass-Steagall Act*, in *DEREGULATING WALL STREET: COMMERCIAL BANK PENETRATION OF THE CORPORATE SECURITIES MARKET* 43 (Ingo Walter, ed., 1985).

¹⁷⁷ See William F. Shugart II, *A Public Choice Perspective of the Banking Act of 1933*, 7 *CATO J.* 595, 603 (1988).

¹⁷⁸ Kelly, *supra* note 176, at 53.

¹⁷⁹ Shugart, *supra* note 177, at 603.

¹⁸⁰ *Id.* at 595–96.

preferential terms.¹⁸¹ This too could affect a bank's liquidity, making it more susceptible to panics and failure.¹⁸²

These theories have not necessarily been borne out by the statistics. Looking at four different liquidity measures to determine the potential influence of securities affiliates on commercial banks, Eugene White stated that national banks' liquidity did not appear to have been weakened by the presence of an affiliated securities business.¹⁸³ On the contrary, White found a "significantly higher survival rate of banks with securities operations during the massive bank failures of 1930–1933."¹⁸⁴ He stated that "[w]hile 26.3% of all national banks failed in this period, only 6.5% of the 62 banks which had affiliates in 1929 and 7.6% of the 145 banks which conducted large operations through their bond departments closed their doors."¹⁸⁵ He does concede that this may be due to the size of these banks and their ability to achieve more diversification and economies of scale.¹⁸⁶ White also found, using data from 1931, the year when the largest number of banks with securities affiliates failed, that the presence of an affiliate appears to have reduced the probability of bank failure.¹⁸⁷ Friedman and Schwartz argue that banks would have failed at a much faster rate if the instability was due to the assets they had accumulated in the 1920s (securities).¹⁸⁸

William Shughart found further evidence against the culpability of blending in that it was the smaller, rural institutions that did not have much blending that accounted for the majority of bank failures throughout the 1920s and early 1930s.¹⁸⁹ In addressing the issue of whether the larger banks could have contributed to the collapse of the smaller banks in funneling worthless investment securities to the smaller banks, he stated that a competing explanation should be considered.¹⁹⁰ That potential competing explanation is that the smaller banks were hurt by the failing agricultural industry, highlighting that the default rate on agricultural loans was so high that many smaller banks would have failed anyway.¹⁹¹ In addition,

¹⁸¹ *Id.* at 596.

¹⁸² *See id.*

¹⁸³ *See White, Before the Glass-Steagall Act, supra* note 3, at 50.

¹⁸⁴ *Id.* at 40.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *See id.* at 41.

¹⁸⁸ *See* MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES: 1867–1960, at 354 (1963) (discussing the relative stability of the loans and investments of commercial banks at this time).

¹⁸⁹ Shughart, *supra* note 177, at 602.

¹⁹⁰ *Id.* at 602–03.

¹⁹¹ *Id.*

what about the argument that investment banking is too risky and might injure the banks? White found that while the securities affiliates' return was subject to a high degree of risk (as evidenced by the mean and standard deviation being higher than for the banks), this does not seem to have generated wider fluctuations in the banks' combined earnings.¹⁹²

Some authors even go so far as to suggest alternate explanations for the passage of the Glass-Steagall wall including the interests of investment banks in keeping commercial banks from their business, the interests of commercial banks in keeping investment banks from their business, and the interest of the U.S. Treasury in eliminating a competitor, private securities, for the purchase of the Treasury's securities by banks.¹⁹³

B. Did the Blending Play a Critical Role in the Financial Crisis of 2007?

Senators Merkley and Levin, the Volcker rule's drafters, state in their policy essay that "[p]roprietary trading [including investments in separate private funds managed or sponsored by the bank] played a *critical* role in the recent global financial crisis and subsequent recession."¹⁹⁴ They state that "the lessons of the Great Depression were forgotten over time" and that "deregulation enabled banks to take the risks that precipitated the current financial crisis."¹⁹⁵ They contend that the Glass-Steagall wall protected U.S. financial stability and that "similar to the Great Crash of 1929 ... proprietary trading losses had once again played a central role in bringing the financial system to its knees."¹⁹⁶ The Senators state that firms' disclosed proprietary trading revenues and losses demonstrate that those losses were significant.¹⁹⁷

The Senators are not alone in blaming proprietary trading for financial instability. As mentioned above, two years earlier in January 2009, the Group of Thirty, under the leadership of a committee chaired by Paul Volcker, issued a report on financial reform aimed at global financial stability and "intended to be useful to policymakers in all the countries whose financial systems [were] disrupted in [the global financial crisis starting in 2007]."¹⁹⁸ The group's first recommendation was that large systemically important banking institutions should be limited in their proprietary securities

¹⁹² See White, *Before the Glass-Steagall Act*, *supra* note 3, at 43–44.

¹⁹³ See Shughart, *supra* note 177, at 604–09; see also George J. Benston, *Why Did Congress Pass New Financial Services Law in the 1930's? An Alternative Opinion*, FED. RESERVE BANK OF ATLANTA ECON. REV. April 1982, at 7, 8–10.

¹⁹⁴ Merkley & Levin, *supra* note 2, at 515 (emphasis added) (internal citation omitted).

¹⁹⁵ *Id.* at 516.

¹⁹⁶ *Id.* at 530.

¹⁹⁷ *Id.* at 531.

¹⁹⁸ Group of Thirty Working Group on Financial Reform, *supra* note 79, at 8.

trading activities that present particularly high risks and serious conflicts of interest.¹⁹⁹ The group also recommended that sponsorship and management of private pools of capital be prohibited.²⁰⁰ While admitting that “there were many factors other than proprietary trading contributing to the breakdown of the financial markets,”²⁰¹ Paul Volcker stated in his commentary to the Volcker Rule that “losses within large trading positions were in fact a contributing factor for some of our most systemically important institutions.”²⁰²

Were Senators Merkely and Levin correct when they contended that the blending of commercial banking and investment banking played a “critical role” in the crisis of 2007 by allowing banks to purchase and sell financial instruments for their own account, and by allowing banks to invest in private funds managed or sponsored by the bank? In other words, was it the removal of the Glass-Steagall wall by the Gramm-Leach-Bliley Act in 1999 that led to the financial crisis in 2007? This debate has been fought over the front page of newspapers. For example, a front-page *New York Times* article pointed out that the “Gramm-Leach-Bliley Act ... removed barriers ... that had been instituted to reduce the risk of economic catastrophes.”²⁰³ Phil Gramm responded instead, fingering faulty monetary policy and mortgage lending.²⁰⁴

This Article posits that it has not been demonstrated that deregulation led to the financial crisis. In fact, deregulation, or the removal of the Glass-Steagall wall, may have allowed banks to achieve diversification, liquidity, complementaries, and global competitiveness. But instead of looking at the underlying causes of the excessive risk taking, legislators want to ban proprietary trading altogether, and with it lose the potential benefits. This Article argues that we must look at some of the more nuanced causes of the financial crisis and not just throw the baby, the potential benefits of deregulation, out with the bathwater, excessive risk taking.

Banks were in the business of mortgage-backed securities, which were blamed for much of the losses, well before the Gramm-Leach-Bliley Act took down the Glass-Steagall wall. In 1987, the OCC made a determination that the Glass-Steagall Act did not prevent a national bank from selling mortgage-backed securities and the Second Circuit upheld that determination.²⁰⁵ Part

¹⁹⁹ *Id.* at 28.

²⁰⁰ *Id.*

²⁰¹ Volcker, *supra* note 33, at 2.

²⁰² *Id.*

²⁰³ Eric Lipton & Stephen Labaton, *A Deregulator Looks Back, Unswayed*, N.Y. TIMES, Nov. 17, 2008, at A12.

²⁰⁴ Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

²⁰⁵ *Secs. Indus. Ass'n v. Clarke*, 885 F.2d 1034, 1052 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

of the Second Circuit's reasoning was that it recognized that the increased liquidity provided by such business would help banks as they fund long-term mortgage loans with short-term deposits.²⁰⁶

In addition to mortgage-backed securities, *subprime* mortgage lending and excessive risk taking is seen as a culprit in the financial crisis.²⁰⁷ Subprime lending is generally a loan to a borrower that is not creditworthy.²⁰⁸ It was not the lack of a wall between commercial and investment banking that made it possible for banks to enter the subprime mortgage market. In fact, the Community Reinvestment Act of 1977 (CRA) encouraged this kind of lending by making loaning to subprime areas a condition for receiving approval from bank regulators for bank mergers.²⁰⁹ These loans could be securitized, which meant banks had a way to move subprime loans off their balance sheets.²¹⁰ Note that the CRA required that these loans be made consistent with safe and sound practices, but that there was clearly incentive for excessive risk taking with the promise of a CRA credit reward.²¹¹ Banks also failed to perform due diligence with respect to the creditworthiness of borrowers, perhaps on the mistaken belief that a rising housing market would allow for refinancing and avoid foreclosures.²¹² In addition to failing to perform due diligence, banks may have taken excessive risks because of the failure of ratings agencies and risk assessment models to adequately capture the risks associated with certain modern financial instruments, such as credit default swaps²¹³ and securitized obligations.²¹⁴ Additional factors that some authors say may have contributed to

²⁰⁶ *Id.* at 1049.

²⁰⁷ See, e.g., PETER J. WALLISON, FINANCIAL CRISIS INQUIRY COMMISSION: DISSENTING STATEMENT 444 (2011).

²⁰⁸ *ComE-IN Background Definitions: Subprime Definition (based on borrower characteristics)*, FED. DEPOSIT INS. CORP. (July 13, 2007), <http://www.fdic.gov/about/comein/background.html>.

²⁰⁹ See Community Reinvestment Act of 1977, Pub. L. No. 95-128, § 802, 91 Stat. 1147 (codified at 12 U.S.C. § 2901 (2006)).

²¹⁰ See generally *id.* (noting that these provisions were meant to deal with lending discrimination toward low income borrowers).

²¹¹ See Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571, 1576–77; see also Community Reinvestment Act § 804(1) (encouraging banks to make loans consistent with safe and sound practices).

²¹² Markham, *supra* note 91, at 1133 (citing PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME (2008)).

²¹³ These swaps were exempt from regulation under the Commodity Exchange Act of 1936. Pub Law 74-675, 49 Stat. 1491, 1492 (1936).

²¹⁴ See Markham, *supra* note 91, at 1133, 1126 (discussing how “Super-Senior” tranches of subprime CDOs were often given triple-A ratings because of credit enhancement features, and therefore were given regulatory blessing of capital treatment on

the financial crisis include federal interest rate policies and mark-to-market accounting.²¹⁵ The Glass-Steagall wall would not have prevented incentivization for lenders to make subprime loans, failures in performing due diligence, and failures at measuring the credit risk of modern financial instruments.

There are clearly issues with banks engaging in proprietary trading. Namely, as Senators Merkley and Levin point out, proprietary trading banks that trade may gather information from their banking clients and exploit it.²¹⁶ This leads to a conflict of interest between the banks' motivations and their clients' motivations. The most egregious conflict of interest examples include designing products to fail, selling them to clients and then making trading bets on the products' collapse.²¹⁷ Proponents of the Volcker rule often focus on these conflict of interest rationales. If conflict of interest is the main harm we are trying to address, it may make more sense to consider other solutions such as additional disclosures and regulations that protect the public from such conflicts. Therefore, with respect to the argument that proprietary trading by banks increases systemic risk, this Article concludes that this has not been demonstrated. It seems that we should look at the incentives for excessive risk such as the failure of risk ratings and models and skewed incentives for bad business judgment before taking the drastic step of banning proprietary trading altogether.

CONCLUSION

The claims that the Glass-Steagall Act and Volcker rule walls are needed to decrease systemic risk have not been supported. We need to study systemic risks by gaining a deeper understanding of the links between financial intermediation, money, and credit flows. We need to gain

balance sheets, removing concern of undue risk from the banks perspective and explaining that risk assessment models failed to predict the subprime crisis).

²¹⁵ *Id.* at 1131–32 (“The effect of [17 consecutive interest rate increases] on the real estate market culminated in a financial crisis in 2007.”); *see also* Todd Davenport, *Fair Value: Few Fans, But Fewer Alternatives*, 173 AM. BANKER 1 (Mar. 24, 2008) (“The argument against fair value is a compelling one: volatile markets make securities valuation difficult and undermine investors’ confidence, forcing companies to mark down values, leading to greater illiquidity and further markdowns. The more the mark downs impair capital, the greater the loss of investor confidence, and the faster the churn of the self-reinforcing cycle.”).

²¹⁶ *See* Merkley & Levin, *supra* note 2, at 515.

²¹⁷ For example, Goldman Sachs designed CDOs to take a proprietary trading position against the firm’s own risky exposure and then marketed the CDO it had designed to fail. Goldman therefore earned profit at the direct expense of the client to whom it had sold the CDOs. *See Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. 4–5, 176 (2010).

a better understanding of excessive risk taking and the cause, incentives, and instrumentalities of such risk taking. The Glass-Steagall wall seemed to have been erected in 1933 to address conflicts of interest in the blending of commercial and investment banks and as a purported fix to the horrors of the Great Depression in the name of regulating systemic risk. White's statistics demonstrate not only that the blending may not increase systemic risk, but that there may be diversification, complementarities, and economies of scope benefits to the blending. Further, the financial crisis of 2007 was likely caused by failures in our financial system that reach beyond proprietary trading in general. If we are trying to correct potential conflicts of interest, why not regulate and require additional disclosures that protect the public from such conflicts of interest? If we are trying to reduce systemic risk, why not study excessive risk taking in general and regulate more precisely instead of banning proprietary trading by banks and systemically significant entities altogether?

This Article posits that we need a better understanding of systemic risk before we erect a wall that may decrease economies of scope and complementarities of these businesses. Leaving the industry without the wall may in fact, because of diversification, make banks less susceptible to failure. More importantly, a wall may put U.S. banks at a global competitive disadvantage. This Article posits that in the legislative histories of both the Glass-Steagall and the Volcker rule, legislators focus on conflicts of interest issues that can be solved in other ways, such as additional disclosures and regulations without the cost to diversification, economies of scope, and global competition. At the very least, whether the blending increases systemic risk needs more study. It seems that the Glass-Steagall wall and the Volcker rule wall have been more political than economic in satisfying public outcry to do something, anything, about the respective disasters.