# COMMENT LETTER ON IMPLEMENTATION OF THE "VOLCKER RULE"

## Public Input for the Study Regarding the Implementation of the Prohibition on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds

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Dear Members of the Financial Stability Oversight Council:

Americans for Financial Reform (AFR) welcomes this opportunity to provide comments regarding the Financial Stability Oversight's Council (FSOC) study to inform the implementation of the "Volcker Rule" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Sections 619 – 621). AFR is a coalition of over 250 national, state and local groups who are committed to reforming financial regulation and the financial industry to play a more constructive role in helping to provide jobs, incomes and safe savings vehicles for Americans and to avoid a repeat of the devastating financial instability and massive tax payer bank bailouts of recent years. As the over 5,000 comments from citizens urging the FSOC to implement a strong Volcker Rule have shown, this issue has high public visibility.

The Merkley–Levin/"Volcker Rule" provisions are among the most important sections of the Dodd-Frank Act with respect to creating a more sustainable financial system. They are designed to prohibit proprietary trading and other risky behaviors by banks, impose limits and higher capital charges on proprietary trading of non-bank financial firms, and prescribe significant limits on the ability of these institutions to invest in hedge funds and private equity funds in order to reduce the risks facing these banks and to induce them to engage in financial behavior more conducive to supporting the financial services needs of citizens and communities. We therefore support a robust implementation of the Merkley–Levin/Volcker Rule.

In light of recent financial history, the rationale for the Volcker Rule is compelling. The financial crisis we are currently experiencing resulted from the interactions of at least four factors that are at the heart of the Volcker Rule provisions:[1]

1. Banks and non-bank financial institutions risked their own capital to make large proprietary investments in complex and opaque financial instruments whose value was unknown and even unknowable when the financial crisis hit.

2. These proprietary investments were funded with short-term borrowing and backed up with questionable collateral that created dangerous interconnections with other banking institutions as well as

[1] See Jane D'Arista, "Statement before the Committee on Financial Services; Hearing on 'Systemic Regulation, Prudential Matters, Resolution Authority and Securitization,'" October 29, 2009. and "Leverage, Proprietary Trading and Funding Activities," SAFER Policy Brief #1, 2009. Also see further references to the literature below.



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with hedge funds, private equity funds and other elements of the "shadow banking system." This interconnection in turn led to runs, illiquidity and in some cases, insolvency of these institutions when market confidence evaporated. Taxpayer-funded rescue operations followed.

3. These proprietary trading strategies were made more complex by their reliance on opaque derivative products containing counter-party risks, such as credit default swaps (CDS). Such counter-party bets increased the complexity and opacity of interconnections so that when the crisis hit, the uncertainty created led to serious liquidity and even solvency problems for these systemically important financial institutions.

4. Actions and strategies by these financial institutions – such as the design, sale and shorting of securities packaged to fail - created significant conflicts of interest between banks and their customers, including possibly fraudulent behavior.

Considering this etiology of the current crisis, it is clear that proprietary trading funded by extensive short-term borrowing and other proprietary investments that are intertwined with hedge funds and private equity funds, and are in turn made more dangerous by opaque and complex counter-party bets, should be strictly limited or prohibited. This is precisely what the explicit statutory limitations in Sections 619-620 will accomplish. But the regulations implementing 619-620 must also be flexible enough to be relevant to new, similar kinds of dangers stemming from proprietary trading, high-risk products and strategies and conflicts of interest that could develop in the future. Future dangers are unlikely to be identical or even similar to those of the recent past and therefore require vigilance and an effective investigative and enforcement infrastructure. Fortunately, the law was written to give regulators that flexibility and authority.

*Question #1 Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to: (i) Promote and enhance the safety and soundness of banking entities; (ii) Protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities; etc.*

Our central message is that the regulatory authorities must signal a clear intention to strictly enforce the Merkley-Levin/Volcker Rule provisions, use the anti-evasion components of the law to the fullest extent possible, collect and utilize all the data needed to monitor and enforce the provisions, and impose appropriate but significant penalties should the rules be evaded. The need for serious intent, adequate data and strict enforcement stems from the strong possibilities for evasion that would otherwise result.[2] The danger of evasion – always present – is enhanced by the various exemptions contained in the Merkley/Levin provision, particularly the "permitted activities" of risk-mitigating hedging and market-making activities.

**Extensive data collection.** It is crucial to recognize that because these exemptions open up possibilities for evading the overarching intent to reduce bank risk, they also create an imperative for more extensive data collection and monitoring than otherwise would have been the case. As a result, the FSOC should recommend the collection and monitoring of real-time or daily data on trades, hedging strategies,

[2] See for example the article by Michael Lewis, based on interviews with bankers and former bankers that testify to the intentions of some to exploit ambiguities to evade the law. Michael Lewis, Wall Street Proprietary Trading Goes Under Cover. Bloomberg News. October 27, 2010.

counter-party relationships, among others (see below for more detail) for not only the bank and non-bank financial institutions that are directly subject to the Volcker provisions, but importantly also for the hedge funds and private equity funds in which these banks have "seed" and "de minimis" investments.

This level of data-monitoring and trading analysis will be essential to regulators' enforcement of provisions that must serve as backstops to the "permitted activities" exceptions in order to fully determine "high-risk products, activities and strategies" and general "conflicts of interest." The law states that, "No transaction, class of transactions, or activity may be deemed…permitted…if it (i) would involve or result in a material conflict of interest…(ii) would result, directly or indirectly in material exposure by the banking entity to high-risk assets or high-risk trading strategies…(iii) would pose a threat to the safety and soundness of such banking entity; or (iv) would pose a threat to the financial stability of the United States." (Dodd-Frank Act, Section 619(d)(2)(A)(i – iv).)

These provisions impose significant obligations on the regulatory authorities to gather and analyze the data they will need to implement this aspect of the law.

*Question #2: What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker rule?*

It is crucial that the FSOC study insist on rule-making and implementation procedures that guard against the danger that exemptions and exceptions will swallow the rules designed to eliminate high-risk proprietary trading in banks, and limit these activities in non-bank financial institutions. **To do this, the FSOC needs to promote strong definitions of key terms, recommend mechanisms for acquiring and analyzing meaningful trading information, and implement active and effective enforcement strategies**.

**Examinations.** We would like to see the FSOC study include an in-depth section describing how banks currently perform, book, *compensate*, report and classify proprietary trading. FSOC staff should use their full examination authority to observe for themselves how banks conduct proprietary trading and interact with their sponsored private funds. FSOC staff should also devote substantial investigative resources to the third main policy area in Sections 619-620, client conflicts of interests. We know that there are many ways in which the relatively new business model of proprietary trading mixed with client services serves to disadvantage clients[3]; the Rule's broad backstop prohibition on material conflicts-of-interests offers regulators an opportunity for a full investigation of bank business practices.

**Extensions.** The proprietary trading provisions contain the possibility of granting extensions to financial firms for the disposal of illiquid investments, and the implementation of rules governing seed investments in hedge and private equity funds. These extensions should be granted rarely, only after public comment, and then only after those applying for the extensions can demonstrate that they are not attempting to evade the provisions of the Rule.

**A two-tiered regulatory approach.** Given the possible complexities of indentifying and enforcing the restrictions on proprietary trading, the FSOC may want to consider implementing a two-tiered regulatory approach: On one level, perhaps implemented by the SEC and the CFTC, regulators should

[3] See, e.g., *New York Times* article series, "House Advantage," May – October 2010, at http://topics.nytimes.com/top/news/business/series/house_advantage_series/index.html



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monitor the trade by trade and position by position activities to identify illegal trading. On the other level, perhaps conducted by the Federal Reserve, FDIC and the OCC, regulators should evaluate policies and procedures and engage in portfolio-level reviews.

*Question #3: What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?*

The Merkley-Levin provisions generally prohibit insured depository institutions and their affiliates from "sponsoring" a hedge fund or private equity fund, and requires the regulators to impose extra capital charges and quantitative limits on systemically important non-bank financial firms for doing the same (though it would not prohibit banking organizations from providing advice to such funds). Section 619(a)(1)(B), Section 619(a)(2). This provision is designed to prevent banks from using their relations with hedge and equity funds from evading the prohibitions on proprietary trading, as well as to eliminate the possibility that banks will be put in the position, as they were during the recent crisis, of bailing out their associated hedge and private equity funds, which in turn placed the banks at risk and contributed to taxpayer bailouts. Fundamentally, banks should be offering leveraged funds as investment opportunities for their clients, not using these funds to carry out their own trading strategies for their own profit.

**The De Minimis and Seed Fund Exceptions.** Because the Act allows "De Minimis Investments" in hedge funds and private equity funds, the statutory restrictions must be carefully defined in the rulemaking process to make sure that these exceptions do not place banking entities at risk or provide major loopholes for risky proprietary trading. The amount of de minimis investment should be "immaterial" to the bank and, in any case, at most 3% of each fund following an initial period when banks could temporarily "seed" up to 100% of the capital of the fund (Section 619(d)(4)(B)(ii)(I)). Additionally, the aggregate interest in all such funds at any time can constitute at most 3% of the banks' Tier I capital (Section 619(d)(4)(B)(ii)(II)). However, because the banks have one year in which to fully fund the vehicles, regulators must ensure that banks do not use this one-year seeding period to evade the Volcker Rule by establishing private funds that are really conducting proprietary trading on behalf of the banks under the guise of seeding a private fund.

To help avoid this problem, regulators should consider phasing in limitations on the portion of a private fund that the bank may own. For example, regulators could require that at least 25% of the equity be owned by outside investors within three months of when the fund is launched, 50% of the equity be owned by outside investors with 6 months, so on and so forth.

We would also like to see the FSOC study list the averages and ranges of existing seed funds. The goal of a seed fund is merely to demonstrate the trading strategy for potential investors, not take large positions. In fact, it is our understanding that many hedge fund managers successfully seed funds with just $10 million. That sum is a far cry from the $3.9 billion that represents three percent of JP Morgan Chase's Tier 1 capital.[4] Because the legislative intent was to continue the industry practice of seeding funds, and 3 percent is a suggested maximum limit, we strongly recommend that the FSOC study pro-

[4] Daniel Inviglio, Dodd-Frank Bill's Volcker Rule a Win for Big Banks. *The Atlantic.* June 25, 2010.



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vide regulators with information about the industry standard amounts for seed funds so that they may write the seed fund maximum rules accordingly.

We also recommend that regulations implementing the 3% de minimus investment and seed fund exceptions should be written to prevent financial institutions from subverting the intent of the legislation by structuring off-balance sheet arrangements that technically comply with the 3% ownership limit while allowing them to retain more than an insignificant share of the risks and benefits of ownership.

Another danger is that banks will choose to bail out funds in which they hold investments, as happened during the recent crisis. State Street Bank bought securities for nearly $2.5 billion from one of its ailing funds, but then the bank relied on TARP and several other taxpayer-backed programs to stay afloat during the crisis.[5] Bear Stearns bailed out two of its funds for over $3 billion despite having only about $35 million invested in them. Ultimately, the firm collapsed.

To prevent this from happening again, the rules require that when investments in funds are made, there is a no-bailout pledge from the bank, so it is clear that banks will not come to the rescue of these funds and place their bank (and taxpayers) in jeopardy. However, a pledge without enforcement mechanisms will not be sufficient. The rules must be written to prohibit such bailouts, not simply call for bailout pledges on the part of the banks.

**Customer Disclosures.** The Act also requires banks to inform customers that there is no implicit promise of support for their funds. If the hedge fund fails, the investors bear the losses. This would be a major change from existing practice, in which investors are drawn to funds sponsored by well-capitalized banks because of such an implicit guarantee of a rescue if the fund fails. Banks also cross-sell products to major clients, so that allowing a client to experience a loss in one business line could threaten other business. Therefore, properly implemented, this disclosure requirement should result in fewer clients for bank-managed funds. The FSOC should consider a follow-up survey post-implementation of bank clients to determine not just how effectively banks are disclosing the bailout prohibition, but whether they are using other strategies to compel investments, such as threatening fee increases in other areas of bank business.

**Leverage.** Finally, the Act calls for significant capital charges for all investments in funds "…and the amount of the deduction shall increase commensurate with the leverage of the hedge fund and private equity fund." (Section 619(d)(4)(B)(iii)). It is clear from the foregoing that in order to implement this provision, the regulators must collect detailed information from all hedge funds and private equity funds in which banking entities have de minimis investments. For only by having detailed information on the funds' strategies can the regulators know the degree of leverage in the fund, including embedded leverage in financial instruments. Regulators will need extensive data on the hedge funds and private equity funds in which the banking entities invest, and particularly the degree of leverage of those funds, the strategies employed, the ownership interests, and the types of transactions between the

[5] Raj Date, "Test Case on the Charles; State Street and the Volcker Rule," June 12, 2010; Cambridge Winter.

funds and the banking entities. It is crucial that these considerations inform the "internal controls and recordkeeping, in order to insure compliance" with these rules (Section 619(d)(4)(e)(1)).[6]

*Question #4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the (following) definitions:*

This question requests input on the definition of fifteen terms. Here we focus on several of these:

**Trading account.**[7] "Trading account" should be interpreted broadly to cover all types of trading activities. All accounts other than an insured depository institution's long-term investment account (where long-term capital charges are already assessed) should presumed to be trading accounts until proven otherwise. The bill clearly gives regulators authority to designate other accounts as subject to the rule in the following provision: "any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodities Futures Trading Commission, by rule as provided in subsection (b)(2), may determine" (Section 619(h)(6)).

**A transaction "in connection with underwriting or market making related activities."**[8] "Market making-related" activities are those in which a firm provides liquidity to clients, customers, or counterparties, while simultaneously seeking to avoid any long or short exposures to the instruments it is trading. The goal of a market maker is to provide clients with buy and sell opportunities without incurring substantial risk. This goal of avoiding risk contrasts with the goal of proprietary trading, where firms seek to accumulate financial holdings and profit from changes in the value of the held financial instruments. If a firm allows a position on its books for more than a brief period of time, the activity ceases to be market-making and instead becomes a proprietary investment, which should only be permitted if it is a longer-term investment and assessed an appropriate capital charge. A firm is clearly acting as a market-maker only when it takes a long or short position for a relatively brief period of time and, during the holding period, takes appropriate steps to limit its exposure to price changes in the instrument, both up and down.[9]

a. Two-sided markets: Market-making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments.[10]

b. Revenues based on these trades should come primarily from bid-ask spreads and the provision of credit and not from capital gains earned on the change of prices of the assets. So, in order to qualify for this exemption, the banks should have to provide data on the acquisition and sales price of the assets, and the sources of revenue (fees, bid-ask spreads, interest rates, charged, etc.) If a firm writes derivatives contracts, then such activities should be either (1) held in the long term investment portfolio where it should have requisite capital and margin requirements or (2)

[6] On the central importance of "embedded leverage," risky bets resulting from derivatives and related positions tied to securities, see, The Counterparty Risk Management Policy Group (CRMPG), "Containing Systemic Risk: The Road to Reform," August 6, 2008, pp. 4, 17 – 38.

[7] See the discussion in the *Congressional Record,* July 15, 2010, pp. S5894 – S5899, which we have drawn on here.

[8] *ibid.*

[9] *ibid.*

[10] *ibid.*

traded away. Hedging such positions while keeping them in the trading accounts of the firm should not be allowed.

c. Metrics for gauging whether such trading is for market-making or for speculative purposes should be implemented. Market making for customers can be distinguished from holding speculative positions in assets by looking at a variety of data, but in general the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open and the volatility of profits and losses, among other factors.[11] Thus, FSOC should recommend that the appropriate regulators must have access to real time (or close to it) sequentially accurate data on, at least, the following: the parties to the trades; the size of the trade; the size of the trade; price at which trades occur; the size of the parties' positions; how long these positions are help; and whether and how they are hedged.

d. In addition, to identify proprietary trading relative to market making-related and risk mitigating activities, regulators should make use of income and bonus pool data for traders which will reflect the nature and types of activities which are generating incomes for the firm.[12] The regulators should be on the watch for unusually large incomes and bonuses being tied to trading activities of any type since these might create a prima facie case for the existence of significant amounts of proprietary trading.[13]

In general these data gathering processes can build on data already being gathered from data warehouses already being established under the law, from existing or new SEC and CFTC filings, and from elsewhere, including data to be gathered by the Office of Financial Research (OFR).

**Reasonably expected near term demands of clients, customers and counterparties.** This language creates two restrictions:

a. One is on the expected holding period of the assets or positions. Metrics for determining the holding period, such as a dated inventory approach, or other measures must be determined.

b. The other is the intent. In this regard, revenue should result primarily from fees charged and not from price changes from holding the assets and positions.

**Risk mitigating hedging activities.** "Risk mitigating hedging" activities are those in which firms take a position in order to reduce a specific financial exposure created by another position or holding. The goal of this activity is to reduce risk rather than be exposed to the change in the value of a financial instrument. The key is to scrutinize these activities to ensure that they actually reduce risk rather than enhance risk to attempt to generate profits for the firms. To implement this rule, data must be provided to ensure that the hedges apply to specific, identifiable assets, whether it be on an individual or aggregate basis. This language is designed to prevent general macro hedges that are really designed to

[11] See, for example, William L. Silber, "On the Nature of Trading; Do Speculators Leave Footprints?" *The Journal of Portfolio Management,* 2003, Vol. 29, issue 4, pp. 64 – 70.

[12] For estimates of the size of the contribution of trading to bank incomes see James Crotty, Gerald Epstein and Iren Levina, "Proprietary Trading is a Bigger Deal Than Many Bankers and Pundits Claim" SAFER Policy Brief #20, 2009.

[13] See James Crotty, "The Bonus-Driven 'Rainmaker' Financial Firm: How These Firms Enrich Top Employees, Destroy Shareholder Value and Create Systemic Financial Instability," Political Economy Research Institute (PERI), 2010, Working Paper Series, Number 209.

be open bets, rather than positions taken to hedge specific owned assets or incurred risks. This formulation is meant to focus banking entities on traditional hedges and prevent proprietary speculation under the guise of general "hedging."

**Purchase, sale acquisition, disposition of securities or other instruments 'on behalf of customers.'** Here, the holding of securities or other instruments and the taking on of positions should be hedged, of a short term nature, and the income to the firm from undertaking these activities should come from fees, and not from the fluctuations in prices of these instruments.

*Question #5. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should be taken into account as indicative that a transaction class of transactions or activity:*

*(i) would involve or result in a material conflict of interest between a banking entity (or a nonbank financial company supervised by the Board) and its clients customers or counterparties;*

*(ii) would result, directly or indirectly in a material exposure by a banking entity (or a nonbank financial company supervised by the Board) to high-risk assets or high-risk trading strategies;*

*(iii) would pose a threat to the safety and soundness of a banking entity (or a nonbank financial company supervised by the Board)?*

These are critical provisions, as they empower regulators to take independent steps to effectuate the two highest goals of the law: reducing bank risk and eliminating conflicts of interest. For example, regulations should prohibit firms from taking advantage of order flow information (popularly referred to as "front-running") for their own trading. Firms should also be prohibited from participating in the design and/or selling of products that they then short to earn a profit (eg. the ABACUS CDO created by Goldman Sachs in consultation with hedge fund Paulson & Co.)[14]

The study should provide a list identifying some prohibited assets and strategies and a set of principles and procedures for identifying others. The list should be gleaned from the rich experience of recent financial crises. (See also the answer to question 7 below).

**Monitoring of potentially fraudulent activities: risky 'strategies.'**[15] Enhanced commitments to supervision in order to deter potentially fraudulent activities will also be required to protect the safety and soundness of banking entities. Fraudulent behavior has been increasingly alleged and even evident in some of the securitization activities undertaken by financial institutions especially with respect to the mortgage backed securities and related products. The possibility of misrepresentation and fraud is now threatening not only the solvency of some of these institutions, but because of their interconnections with other bank and non-bank financial institutions, is taking on systemic importance.[16]

[14] Press Release: SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010) available at http://sec.gov/news/press/2010/2010-59.htm; "Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Senate Permanent Subcommittee on Investigations," 111th Cong. (2010)

[15] W.K. Black, *The Best Way to Rob a Bank is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*. University of Texas at Austin Press, 2005.

[16] See Yves Smith, "How The Banks Put the Economy Under Water," *New York Times,* October 31, 2010.

*Question #6. What factors and considerations should be taken into account in making recommendation on whether additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities or nonbank financial companies supervised by the Board engaged in activities permitted under the Volcker Rule?*

The same activities and principles identified above should be candidates for significantly enhanced capital charges and increased quantitative restrictions. Products which are not transparent and therefore cannot be properly priced or sold in a reasonable period of time, for example within a trading day, should have increased capital charges. Firms that engage in strategies that fund such investments with very short-term borrowing should be subject to stricter leverage limits, and be forced to hold larger liquidity reserves.

*Question #7. With respect to proprietary trading and hedge fund and private equity fund activities, which practices, types of transactions or corporate structures in general have historically accounted for or involved increased risks or may account for involve increased risks in the future?*

For example, it is well known that opaque structured products financed by short-term wholesale borrowing, such as repos, and complex chains of collateral used for borrowing, such as the process of "rehypothecation," led to massive liquidity and solvency problems for large banks when confidence evaporated during the recent crisis.[17] These examples suggest that the FSOC should recommend that regulators identify not only high-risk *products* (for example, structured products that cannot be quickly and accurately hedged or reliably priced that should be prohibited and or charged appropriately high capital requirements) but dangerous practices such as funding or facilitating the holding illiquid assets with very short-term liabilities such as repos or hypothecated securities, that are subject to unpredictable runs.

These problems are at the heart of the interconnections between banks, non-bank financial institutions and so-called "shadow banking" institutions such as hedge funds and private equity funds. This will be especially true to the extent that banks will be allowed to own, through de minimis investments, shares of these funds.

*Question #8. With respect to proprietary trading and hedge fund and private equity fund activities, what practices, policies or procedures have historically been utilized that may have mitigated or exacerbated risks or losses? What practices, policies or procedures might be useful in limiting undue risk or loss in the future.*

Prior to the last few decades, the United States experienced a 40-year history of a relatively stable banking and financial system following the Second World War as a result of the New Deal financial regulatory structure that was established.[18] This stability was partly due to a set of strict regulations, under the Glass-Steagall Act and related rules, that separated high-risk financial strategies from the core banking and finance institutions that have access to government support and that lie at the heart of the payments and finance system. The Merkley-Levin/Volcker Rule provisions attempt to restore – in modern form –

[17] For example see, Hyun Song Shin , "Financial intermediation and the post-crisis financial system" *Bank for International Settlements (BIS),* Monetary and Economic Department March 2010; and Jane D'Arista and Gerald Epstein, " Dodd-Frank and the Regulation of Dangerous Financial Interconnectedness," in *Will It Work; How Will We Know*, Roosevelt Institute, 2010; Gorton, Gary and Andrew Metrick, 2010. "Regulating the Shadow Banking System," Brookings Institution; Manmohan Singh and James Aitken, 2010, "The(Sizable) Role of Rehypothecation in the Shadow Banking System," IMF Working Paper, No. 172.

[18] See Demos, "A Brief History of Glass-Steagall," 2009. Congressional Oversight Panel, 2009. "A Special Report on Regulatory Reform."

some of these crucial protections. Since the full repeal of Glass-Steagall was just eleven years ago, speculation has become the core business model of our formerly solely commercial banks.

This experiment led to the bailouts of 2008. While most of the damage was sown by pure investment banks such as Morgan-Stanley, Bear Stearns, and Lehman Brothers and by the effectively unregulated insurance company, AIG, commercial banks played a crucial role as buyers and sellers of mortgage-backed securities, credit-default swaps, and other risky financial derivatives. Without the watering down and ultimate repeal of Glass-Steagall, the banks would have been barred from most of these activities. The market and appetite for derivatives would then have been far smaller, lowering the scale of the eventual meltdown.

However, the repeal of Glass-Steagall led to a major crisis in capitalism beyond the crisis on Wall Street, as banks that the nation felt compelled to safeguard were suddenly subject to the vagaries of massive speculation. The pre-bailout trend of increased reliance on trading revenue by the largest banks in America's history (the combined recipe for "Too Big (and Likely) to Fail" institutions) has actually worsened since the bailouts, with increased concentration and a total reliance on trading for bank revenue at the largest firms. AFR recognizes the inherent tension here: for banks to remain solvent during a (bank-sown) recession and credit crisis hangover, profits from trading – not lending – have become essential. The Volcker Rule's goals would cut into what is currently the sole category of profitable activity for our largest banks. However, the new law creates a new imperative for regulators: remember the reason for government support of banks; they are to be a credit intermediary for a well-functioning "real" economy. Inasmuch as our largest banks are functioning like investment banks, speculating for their own profit, they should be un-tethered from the government safety net and allowed to rise and fall on their own accord.

*Question #9. What factors and considerations should be taken into account in making recommendations to safeguard against evasion of the Volcker Rule?*

In addition to the data gathering and analysis imperatives that we have discussed several times above, the FSOC and relevant authorities must implement clear mechanisms for bringing enforcement actions and significant penalties when warranted. As a related matter, they should implement a broad array of investigative strategies, including, for example, empowering whistleblowers with significant protections to help identify violations of the Rules. Trades deemed to be illegal must be subject to clawback penalties affecting related profits and – importantly – trader compensation and bonuses.

In summary, the key is for the FSOC and its members to signal clearly from the very beginning of this implementation process that they intend to apply the Merkley-Levin/Volcker rules strictly and effectively and that evasion will not be tolerated. By so doing, the FSOC can make a significant contribution to the financial stability and overall economic health of the American economy.