Securities Regulation - Loss, Seligman and Paredes, 1.*The Changing Environment*

Securities Regulation - Loss, Seligman and Paredes
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Online trading, convenience of securities brokerage and investment advice, and most fundamentally, the stock market crash of 2008–2009 and the 2010 enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, have transformed the environment of securities broker-dealers. [1]

a. Online Brokerage

In 1999 the Commission published On-Line Brokerage: Keeping Apace of Cyberspace, which focused on this rapid evolution. The Report began:

> Recent advances in information technology—particularly the Internet—are revolutionizing commerce. The securities industry, most significantly on-line brokerage, is at the forefront of this revolution.
>
> Research reports estimate that last year's $415 billion in on-line brokerage assets will grow by more than sevenfold to $3 trillion in 2003. The 3.7 million on-line accounts open in 1997 have almost tripled to reach 9.7 million by the second quarter of this year. On-line trading volumes have increased dramatically over the last several years. According to one analyst, volume has increased from under 100,000 trades per day in the second quarter of 1996 to over half a million in the second quarter of 1999. The percentage of equity trades conducted on-line has grown to 15.9 percent of all equity trades in the first quarter of 1999.
>
> On-line brokerage has significantly changed the dynamics of the marketplace, causing one of the biggest shifts in individual investors' relationships with their brokers since the invention of the telephone. For the first time ever, investors can—from the comfort of their own homes—access a wealth of financial information on the same terms as market professionals, including breaking news developments and market data. In addition, on-line brokerage provides investors with tools to analyze this information, such as research reports, calculators, and portfolio analyzers. Finally, on-line brokerage enables investors to act quickly on this information. [2]

By the first quarter of 1999 almost one in six equity trades (15.91 percent) were estimated to take place on-line. [3]

One positive impact of on-line brokerage was a dramatic reduction in commission rates. The SEC Report, On-Line Brokerage, found that the average commission charged by the top ten on-line firms had decreased from $52.89 to $15.75 per trade between the first quarter of 1996 and 1998–1999. [4]

On-line investors also enjoyed a veritable cornucopia of data and investment opportunities according to the Commission Report:

> On-line investors can click onto a firm's website and, frequently at no charge, find market data, historical charts, securities analyses (e.g., analyst reports, industry reports, earnings estimates, comprehensive charge, news stories), stock and mutual fund screeners, asset allocators, mutual fund supermarket offerings, interactive calculators, and customizable home pages.
>
> On-line firms offer trading in equities, mutual funds, listed options, and fixed-income securities. Many on-line firms also offer access to IPOs, after-hours trading, and pre-opening trading. Investors can opt to have these services delivered not only to their personal computers, but via wireless communications as well (*e.g* ., pagers or personal digital assistants).
>
> Moreover, investors can access information on-line that was previously unavailable or difficult to obtain, such as information about hedge funds, proxy voting records, a mutual fund's investment record, daily price information about certain fixed-income securities, and information about corporate issuers. [5]

Notably the Commission Report anticipated continued significant growth in the number of on-line brokerage accounts and account assets. [6] However, it was uncertain that the future would unfold in a linear fashion:

> The big question is where does on-line brokerage go from here. Does it represent an evolutionary step or a revolutionary event? Is it merely the natural evolution of discount brokerage from a telephone-based technology platform to an Internet-based one? Or does it represent a revolution in the way brokerage will be conducted in the future? Will it be a necessary channel for every broker? Will technology drive the convergence of the business models of full-service and the more upscale on-line firms? [7]

This uncertainty was particularly significant for full service firms:

> The availability of on-line trading at reduced commission rates has forced full-service firms to reconsider the viability of their commission-based pricing models. These models traditionally bundle execution services and investment advice into one transaction fee. Several full-service firms are already moving from a commission-based pricing model to an asset management fee model for broker-assisted and on-line trading and/or competitively-priced on-line per trade commissions.
>
> As full-service firms go on-line, however, the most significant challenge they face is a potential *channel conflict* between their traditional method of distributing financial services—the registered representative—and their new distribution method—the Internet. Some full-service broker-dealers are seeing customers shift from trading through a registered representative to trading independently on-line. In the traditional full-service model, the customer typically develops a stronger relationship with the registered representative than with the firm itself. When a registered representative leaves the firm, he usually takes his *book* of clients with him. In the on-line model, however, the customer develops the stronger relationship with the firm itself, rather than with any registered representative. While some full-service firms have moved slowly in establishing an on-line presence because of potential channel conflicts, others have established an on-line presence to avoid having their customers transfer a portion of their assets elsewhere. [8]

For securities regulation, when on-line trading began, it raised a series of difficult issues including: (1) How will suitability rules apply on-line? [9] (2) What impact will on-line trading have on a broker's best execution duty?;

[10] (3) How will market data be affected by on-line brokerage?; [11] (4) Are on-line brokerage firms maintaining sufficient system capacity?; [12] and (5) What impact will on-line brokerage have on investor privacy? [13]

b. Convergence of Broker-Dealers and Investment Advisers

In March 2006 SEC Chair Christopher Cox announced that a study would be conducted to compare the levels of protection afforded retail investors of financial services providers under the Securities Exchange and Investment Adviser Acts. [14]

The LRN-Rand Center for Corporate Ethics, Law and Governance study [15] was published to provide the Commission a factual description of the current state of the investment adviser and brokerage industries for the SEC's evaluation of the legal and regulatory environment concerning investment professionals. The Study reported in part:

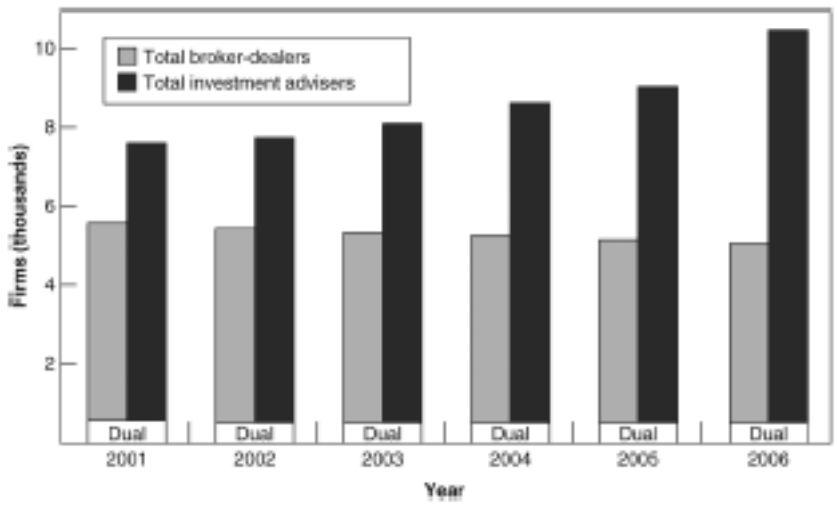
Number of Firms and Firm Size

A relatively small number of large firms provide a full range of services, are often affiliated with other financial service providers, and conduct an overwhelming proportion of the investment advisory and brokerage businesses. On the other end of the spectrum are a great number of relatively small firms that provide a limited range of either investment advisory or brokerage services, but they frequently report affiliations with firms providing complementary services.

Figure S.1 displays year-end industry snapshots of the number of brokerage and investment advisory firms from 2001 through 2006, as described in data we obtained from the SEC Division of Investment Management and from the Financial Industry Regulatory Authority (*FINRA*). During this time period, the following changes took place:

- The number of investment advisory firms in the Investment Adviser Registration Depository (*IARD*) database grew substantially, from 7,614 in 2001 to 10,484 in 2006, whereas the number of brokerage firms declined from 5,526 to 5,068.
- The number of brokerage firms in the Financial and Operational Combined Uniform Single (*FOCUS*) Report database declined from 5,526 to 5,068.
- The number of dual registrants (firms in both databases) in these data remained relatively constant (between 500 and 550 each year).
- The share of brokerage firms that were dually registered increased slightly, from 9.5 percent to 10.6 percent, while the share of investment advisory firms that were dually registered fell from 6.9 percent to 5.1 percent.

Figure S.1
Broker-Dealers, Investment Advisers, and Dually Registered Firms (2001–2006)



SOURCES: Brokerage-firm data from FOCUS reports. Investment advisory-firm data came from IARD. NOTE: Dual indicates firms listed in both databases.

Although some investment advisory firms are very large, most are rather small. Among investment advisory firms with individuals as clients at the end of 2006, more than half reported having no more than 10 employees. Only about one-fourth of these firms reported having more than 50 employees, and less than 8 percent reported having more than 100 employees. However, 69 investment advisory firms with individual clients reported that they employed more than 1,000 individuals each. Almost 40 percent of investment advisory firms reported that some of their employees were registered representatives of a brokerage firm.…

Among brokerage firms, distributions of assets and ownership equity are heavily skewed, with one group of firms being vastly larger than the rest. The mean of total assets reported in the fourth quarter of 2006 is more than $1 billion, but the median is less than $500,000. The difference between mean of ownership equity ($32 million) and the median ($340,000) is also quite striking.…

Most firms reported being engaged strictly as either an investment adviser or as a broker-dealer without any affiliations with those that provide the complementary service. Many others, however, were directly engaged in only one type of activity but were affiliated with a firm engaged in the other type. The remainder, a minority of firms, were directly engaged in both brokerage and advisory activities.…

Almost 95 percent of investment advisory firms with individual clients provide portfolio management for individuals or small businesses, with about 14 percent of those firms managing a wrap-fee program.… After portfolio management, the most frequently provided advisory service is financial planning, reported by about half of the firms. Almost 20 percent engage in pension consulting. More than 25 percent of investment advisory firms with individual clients reported being engaged in business activities other than advisory services, including broker-dealer (7 percent), registered representative of a broker-dealer (12 percent), and insurance agent or broker (12 percent). Our assessment of these data, in combination with other evidence, indicates the presence of substantial reporting error in the regulatory filings.

Among broker-dealers in the Central Registration Depository (*CRD*) database at the end of 2006, the most frequently reported business activities were mutual fund retailer (52 percent), retailing of

corporate-equity securities over the counter (50 percent), and private placement of securities (50 percent).… More than 20 percent of the brokerage firms reported being engaged in the investment advisory-service business. Overall, about 7 percent of total quarterly revenues of brokerage firms were reported for a fee category that included *but was not limited to* investment advisory-service fees. Even among firms that reported being engaged in investment advisory services, this share is just 8 percent. However, further inspection of the data indicates that investment advisory-service fees may have accounted for a large share of revenues at smaller firms.

Dual Activity and Affiliations

The number of firms dually registered in the FOCUS and IARD databases remained relatively constant at 500 to 550 from 2001 through 2006. However, the number of dually registered firms grew as a proportion of all brokerage firms, and these dually registered firms grew substantially in terms of mean reported revenues, expenses, and, generally, net incomes over the entire period. With respect to assets under management by these dually registered firms, the total amount in discretionary accounts increased slightly from 2001 to 2006, while the amount in nondiscretionary accounts increased by about 75 percent.

Firms that directly provide either investment advisory or brokerage activities but not both may be affiliated with firms that provide other financial services. Overall, almost one out of every four investment advisory firms with individual clients has a related person who is also an investment adviser, and this other adviser could, of course, engage in other business activities. Moreover, more than one out of every five advisers reported that a related person was a broker-dealer, municipal-securities dealer, or government-securities broker or dealer. About 17 percent reported that a related person was an insurance company or agency, and 11 percent reported that a related person was an investment company.

Among brokerage firms, more than 20 percent of registered firms in the fourth period of 2006 reported current or expected engagement in investment advisory services. Only about half of these firms are included in the contemporaneous IARD database. Many, but certainly not all, of the other half were confirmed to be state-registered investment advisers.… About 40 percent of broker-dealers either directly or indirectly control, are controlled by, or are under common control with a firm engaged in the securities or investment advisory business. About 8 percent of broker-dealers are directly or indirectly controlled by a bank holding company or other banking institution.

Firms reporting such affiliations play a disproportionately large role in the market. For example, investment advisory firms that report no direct engagement in brokerage activities but that a related person is a broker-dealer constitute less than 15 percent of all reporting firms but managed more than one-fourth of all accounts and almost two-thirds of all assets reported at the end of 2006.…

Investor Understanding

To assess the level of investor understanding about a range of issues, we administered a large-scale, national household survey and conducted six intensive focus-group discussions with both experienced and inexperienced investors.… Our analysis confirmed findings from previous studies and from our interviews with stakeholders: Investors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers.

About two-thirds of all survey respondents were classified as *experienced* investors (that is, they held investments outside of retirement accounts, had formal training in finance or investing, or held investments only with retirement accounts but answered positively to questions gauging their financial understanding). Of the 349 respondents who reported using a financial service provider, 73 percent seek professional assistance for advising, management, or planning, and 75 percent seek professional assistance for conducting stock-market or mutual fund transactions.

We presented respondents with a list of services and obligations and asked them to indicate which items applied to investment advisers, brokers, financial advisors or consultants, or financial planners. Their responses indicate that they view financial advisors and financial consultants as being more similar to investment advisers than to brokers in terms of services and duties. However, regardless of the type of service (advisory or brokerage) received from the individual professional, the most commonly cited titles are generic titles, such as *advisor, financial advisor,* or *financial consultant* . Focus-group participants shed further light on this confusion when they commented that the interchangeable titles and *we do it all* advertisements made it difficult to discern broker-dealers from investment advisers. [16]

These conclusions were adumbrated within the Study, which stated in part:

The Dividing Line Between Investment Advisers and Broker-Dealers

Because of the distinct regulatory structures of registration, disclosure, and legal duties placed on investment advisers and broker-dealers, the dividing line between those two categories has always been an important (though also an elusive) one. Under the 1940 act, registered brokers and dealers are excluded from the terms of the 1940 act so long as the following are true:

1. Any advice that the broker-dealer gives to clients is *solely incidental* to its business as a broker-dealer.
2. The broker-dealer does not receive any *special compensation* for rendering such advice.

The proscription on special compensation has traditionally meant that broker-dealers receive compensation from their brokerage clients in the form of commissions, markups, and markdowns on specific trades. In essence, then, investment advisers' business practice of charging a general fee, rather than broker-dealers' practice of charging transaction-specific fees, has evolved into one of the hallmark distinctions between investment advisers and broker-dealers. Although a broker-dealer could, in theory, charge a management fee and avoid being deemed an investment adviser by giving *solely incidental* investment advice, the judicial interpretation of solely incidental is fraught with ambiguity, and thus the mechanism by which broker-dealers and investment advisers charge clients for services has become a significant issue from a regulatory perspective. Consequently, over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that (at least under the regulatory regime) have historically been the province of investment advisers.

Simultaneously, investment advisers have also begun to enhance the scope of advisory activities they offer in a way that has not been part of the traditional norm. Some investment advisers, for example, may offer services that employ computerized trading programs and may take an active, discretionary management role over customer accounts. From the retail investor's prospective, these activities may not be obviously distinct from those in which brokers typically engage.

Adding further ambiguity to the mix is the emergence, also during the past 20 years, of a category of financial service provider known as *financial planners* . This field is itself highly professionalized, with a certification program that involves rigorous training and testing. Moreover, the financial planner is sometimes identified as an entity independent of either the broker-dealer or the investment adviser, offering *generalized advice* about a *general* financial plan for a client and not handling client accounts or executing transactions.… However, it is widely acknowledged that financial planners typically offer a range of services, which need not correspond with this description.…

In the 1990s, a number of other types of brokerage accounts, including *discount* brokerage accounts and *fee-based* accounts, further blurred the distinction between broker-dealers and investment advisers. The popularity of discount brokerage programs grew in the 1990s because they were

attractive to brokerage customers who wanted to trade securities at a lower commission rate and who did not want assistance from a registered representative. Full-service broker-dealers began to introduce discount brokerage accounts to compete with discount broker-dealers. However, they continued to offer full-service brokerage accounts that still included assistance from registered representatives, for a higher commission rate than that charged for discount brokerage accounts. There was concern that offering both discount and full-service brokerage accounts would require full-service accounts to come under the proscription of the 1940 Act. This concern arose because, with a two-tiered commission structure, the difference in commission rates between full-service and discount brokerage accounts could be viewed as special compensation in return for investment advice.

During this same period, fee-based brokerage programs were gaining popularity as well, in part as reaction to the 1995 Tully-Levitt report.… [17]

Fee-based brokerage accounts typically provide customers with a bundle of brokerage services for either a flat fee or a fee based on assets in the account. As with discount brokerage accounts, there was concern that the introduction of fee-based accounts would trigger the 1940 Act, due to violation of the special-compensation exemption.…

Limited Investor Understanding

Most of those interviewed agreed that whether a financial service professional is a broker-dealer or an investment adviser is indistinguishable to investors. Many interviewees reported believing that investors think that broker-dealers and investment advisers offer the same products and services. According to these interviewees, most investors do not know the differences between a broker-dealer and an investment adviser; nor do they know that their regulatory burdens may be different. The primary view was that most investors believe that the financial intermediary is acting in the investor's best interest.

Trends Blurring the Distinction Between Broker-Dealers and Investment Advisers

We asked participants for their views on past and future trends that shaped and will shape the industry and marketplace. Many interviewees said that they felt that two factors have encouraged brokerage houses to move away from transaction-based commissions and toward more asset-based fees: the decline in transaction fees and the results from the Tully report. As a result, they claim that broker-dealers expanded their form of compensation to include fee-based accounts. Many participants reported that they thought that offering such products and services meant that broker-dealers and investment advisers became less distinguishable from one another. They claimed that bundling of advice and sales by broker-dealers also added to investor confusion. Participants mentioned that the line between investment advisers and broker-dealers has become further blurred, as much of the recent marketing by broker-dealers focuses on the ongoing relationship between the broker and the investor and as brokers have adopted such titles as *financial advisor* and *financial manager* .

As for future trends, some participants noted that the baby-boom generation has been pouring money into the financial markets over the past 25 years. These participants expressed concern that, within the near future, large numbers of these people will be retiring, shifting a large amount of wealth out of corporate retirement plans and into the hands of individual investors. This issue is of primary concern to the regulators. These investors will face new challenges regarding managing their finances over the remainder of their lives, and most will need professional help doing so. Participants said that access to good financial information will be critical for those investors to make wise financial decisions.…

Assessment of the Current Regulatory Structure

The majority of those interviewed felt that the current regulatory scheme treats broker-dealers and investment advisers differently when, in practice, their role is essentially the same, especially from the

viewpoint of the individual investor. Most of these respondents felt that the recently vacated rule that exempts broker-dealers from the 1940 Act based on the form of compensation (asset-based fees) misses the mark. They argue that it is the services provided, rather than the form of compensation, that should trigger the type of regulation that applies. Most interviewees said that, if the services provided are the same, then the same rules should apply, because an investor's expectation will be the same.…

Compensation Structures of Investment Professionals

…

Broker Compensation. Across broker-dealer firms, compensation to individuals accounts for roughly 40 percent of a firm's cost structure.… [18] The literature reports a wide variety of compensation structures for brokers.…

Investment Advisers' Compensation . In the area of investment advisers' compensation, we found several academic articles. The economic and finance theory articles analyze the conflicts of interest inherent in the relationship between the investment adviser and the client. In these sorts of relationships, the investment adviser is the agent and the client is the principal. The client hires the investment adviser to act on his or her behalf, but the investment adviser's interests may not always coincide with those of the client. The client may not be able to perfectly monitor the principal. From the client's point of view, then, the important question is what kind of compensation structure best aligns the parties' interests. These articles generally report that a bonus-compensation structure, in which the adviser is paid a bonus (either a fixed sum or a percentage) if the portfolio return exceeds a predetermined benchmark, is the optimal contract from the client's point of view.

…

Types of Assistance That Respondents Would Like with Financial Matters

We asked all respondents, "what kind of professional assistance with financial matters would you find most helpful at this point in your life? " with the following options: asset management, college-saving planning, debt consolidation or management, developing a budget and saving plan, estate planning, executing stock or mutual fund transactions, general financial planning, investment advising, retirement planning, or other. A majority of respondents (62 percent) would like assistance with retirement planning. Many respondents would also like assistance with investment advising (41 percent), financial planning (38 percent), and estate planning (35 percent).

We replicated the analysis conditioning on age, education, income, geographic region, investment experience, and whether the respondent reported using a financial service provider. Across all groups, the most commonly selected option is *retirement planning* . Across all groups, the second most common is *investment advising* , except for respondents who live in the West region, respondents who do not have a college degree, respondents who did not report using a financial service provider, or respondents who are classified as inexperienced. For the first three of those groups, the second most commonly selected option is *general financial planning* . For the last group, those respondents classified as inexperienced, the second most commonly selected option is "developing a budget and savings plan. " [19]

The LRN-Rand study enhanced support for several specific provisions in the 2010 Dodd-Frank Act, which address broker-dealers and investment advisers. [20]

Section 913(g)(1) of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act adds a new §15(k) to the Securities Exchange Act to empower the Commission to adopt a standard of conduct for broker-dealers "when providing personalized investment advice about securities to a retail customer (and such other customers

as the Commission may by rule provide) [which would be the same] as the standard of conduct applicable to an investment adviser under Section 211 of the Investment Advisers Act of 1940. " [21]

As added by §913(g)(2) of the Dodd-Frank Act, §211(g)(1) of the Investment Advisers Act provides:

> The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under sections 206(1) and (2) of this Act when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term *customer* that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser. [22]

Section 913(h) of the Dodd-Frank Act also adds §15(m) to the Securities Exchange Act and §211(i) to the Investment Adviser Act to direct the Commission to harmonize enforcement of the standard of conduct applicable to a broker-dealer providing personalized investment advice about securities to a retail customer with the standard applicable to an investment adviser.

Sections 913(b) and (d) directs the SEC to conduct a study and report to Congressional oversight committees within six months after enactment an evaluation of:

> (1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards; and
>
> (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute. [23]

In January 2011 the SEC staff published Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The study was approved for release by the Commission, but the views were those of the staff and did not necessarily reflect the views of the Commission.

Two members of the Commission dissented from the staff study on the grounds that, among other things, the study had failed to conduct a cost-benefit analysis that justified itsrecommendations. [24]

The study explained in part:

Investment Advisers : Over 11,000 investment advisers are registered with the Commission. As of September 30, 2010, Commission-registered advisers managed more than $38 trillion for more than 14 million clients. In addition, there are more than 275,000 state-registered investment adviser representatives and more than 15,000 state-registered investment advisers. Approximately 5% of Commission-registered investment advisers are also registered as broker-dealers, and 22% have a related person that is a broker-dealer. Additionally, approximately 88% of investment adviser representatives are also registered representatives of broker-dealers. A majority of Commission-registered investment advisers reported that over half of their assets under management related to the accounts of individual clients. Most investment advisers charge their clients fees based on the percentage of assets under management, while others may charge hourly or fixed rates.

Broker-Dealers : The Commission and FINRA oversee approximately 5,100 broker-dealers. As of the end of 2009, FINRA-registered broker-dealers held over 109 million retail and institutional accounts. Approximately 18% of FINRA-registered broker-dealers also are registered as investment advisers with the Commission or a state. Most broker-dealers receive transaction-based compensation.…

…

Uniform Fiduciary Standard : Consistent with Congress's grant of authority in Section 913, the Staff recommends the consideration of rulemakings that would apply expressly and uniformly to both broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, a fiduciary standard no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2). In particular, the Staff recommends that the Commission exercise its rulemaking authority under Dodd-Frank Act Section 913(g), which permits the Commission to promulgate rules to provide that:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.…

The Staff notes that Section 913 explicitly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities does not, in and of itself, violate the uniform fiduciary standard of conduct applied to a broker-dealer. Section 913 also provides that the uniform fiduciary standard does not necessarily require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice.

The following recommendations suggest a path toward implementing a uniform fiduciary standard for investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers:

- *Standard of Conduct:* The Commission should exercise its rulemaking authority to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

  > the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and

> such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

Implementing the Uniform Fiduciary Standard : The Commission should engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: the duties of loyalty and care. In doing so, the Commission should identify specific examples of potentially relevant and common material conflicts of interest in order to facilitate a smooth transition to the new standard by broker-dealers and consistent interpretations by broker-dealers and investment advisers. The Staff is of the view that the existing guidance and precedent under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply.

- *Duty of Loyalty:* A uniform standard of conduct will obligate both investment advisers and broker-dealers to eliminate or disclose conflicts of interest. The Commission should prohibit certain conflicts and facilitate the provision of uniform, simple and clear disclosures to retail investors about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.
    - The Commission should consider which disclosures might be provided most effectively (a) in a general relationship guide akin to the new Form ADV Part 2A that advisers deliver at the time of entry into the retail customer relationship, and (b) in more specific disclosures at the time of providing investment advice (e.g., about certain transactions that the Commission believes raise particular customer protection concerns).
    - The Commission also should consider the utility and feasibility of a summary relationship disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services (e.g., whether its advice and related duties are limited in time or are ongoing).
    - The Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements.
- *Principal Trading:* The Commission should address through interpretive guidance and/or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.
- *Duty of Care:* The Commission should consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking and/or interpretive guidance. Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor.
- *Personalized Investment Advice About Securities:* The Commission should engage in rulemaking and/or issue interpretive guidance to explain what it means to provide "personalized investment advice about securities. "
- *Investor Education:* The Commission should consider additional investor education outreach as an important complement to the uniform fiduciary standard.…

Harmonization of Regulation : The Staff believes that a harmonization of regulation—where such harmonization adds meaningful investor protection—would offer several advantages, including that it would provide retail investors the same or substantially similar protections when obtaining the same or substantially similar services from investment advisers and broker-dealers. The following recommendations address certain other areas where investment adviser and broker-dealer laws and

regulations differ, and where the Commission should consider whether laws and regulations that apply to these functions should be harmonized for the benefit of retail investors:

- *Advertising and Other Communications:* The Commission should consider articulating consistent substantive advertising and customer communication rules and/or guidance for broker-dealers and investment advisers regarding the content of advertisements and other customer communications for similar services. In addition, the Commission should consider, at a minimum, harmonizing internal pre-use review requirements for investment adviser and broker-dealer advertisements or requiring investment advisers to designate employees to review and approve advertisements.
- *Use of Finders and Solicitors:* The Commission should review the use of finders and solicitors by investment advisers and broker-dealers and consider whether to provide additional guidance or harmonize existing regulatory requirements to address the status of finders and solicitors and their respective relevant disclosure requirements to assure that retail customers better understand the conflicts associated with the solicitor's and finder's receipt of compensation for sending a retail customer to an adviser or broker-dealer.
- *Supervision:* The Commission should review supervisory requirements for investment advisers and broker-dealers, with a focus on whether any harmonization would facilitate the examination and oversight of these entities (e.g., whether detailed supervisory structures would not be appropriate for a firm with a small number of employees) and consider whether to provide any additional guidance or engage in rulemaking.
- *Licensing and Registration of Firms:* The Commission should consider whether the disclosure requirements in Form ADV and Form BD should be harmonized where they address similar issues, so that regulators and retail investors have access to comparable information. The Commission also should consider whether investment advisers should be subject to a substantive review prior to registration.
- *Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers:* The Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.
- *Books and Records:* The Commission should consider whether to modify the Advisers Act books and records requirements, including by adding a general requirement to retain all communications and agreements (including electronic information and communications and agreements) related to an adviser's "business as such, " consistent with the standard applicable to broker-dealers. [25]

c. The 2008–2009 Stock Market Crash

The impact of the Dodd-Frank Act on the regulation of securities broker-dealers is broader than provisions addressing the convergence of securities broker-dealers and investment advisers. To appreciate the Act, analyzed in the next section, it is worth contextualizing the crisis that preceded it.

As early as 2007, the ongoing crisis in the housing and credit markets [26] galvanized Congressional and Department of Treasury initiatives to create a new regulatory structure with proposals for consolidation of regulatory agencies, an agency or agencies unequivocally in charge, and fewer areas of finance such as hedge funds largely outside of regulation altogether. [27]

Regulatory consolidation already had achieved a conspicuous success with the merger of the former National Association of Securities Dealers and the New York Stock Exchange broker-dealer regulation under a single new self-regulatory organization, the Financial Institutions Regulatory Authority. [28]

The Department of the Treasury published "Blueprint for a Modernized Financial Regulatory Structure " in March 2008. This Report proposed short term recommendations, intermediate term recommendations, and what it perceived to be an optimal regulatory framework for the United States insurance industry holding assets totaling $6 trillion at the end of 2006, the United States banking sector with total assets of $12.6 trillion, and the United States securities sector worth $12.4 trillion, as well as the United States commodities industry, among other cognate topics. [29]

The short term recommendations most significantly proposed:

*Modernization of the President's Working Group on Financial Markets to enhance its effectiveness as a coordinator of financial regulatory policy, primarily by (1) broadening its focus to include the entire financial sector, rather than financial markets; (2) facilitating better inter-agency coordination and communication in mitigating systemic risk to the financial system, enhancing market integrity, promoting consumer and investor protection, and supporting capital markets efficiency and competitiveness; and (3) expanding the Working Group membership, which then included the Secretary of the Treasury, who acted as Chair of the Group and the heads of the Federal Reserve Bank, the SEC, and CFTC, with the proposed addition of the heads of the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision. [30]

*A second short term proposal would create a new Mortgage Origination Commission to address the high levels of delinquencies, defaults, and foreclosures among subprime borrowers in 2007 and 2008 and develop uniform minimum licensing qualifications for state mortgage market participants.

The intermediate recommendations notably included:

*Within two years, phasing out the federal thrift charter and requiring thrifts to secure a national bank charter and closing the Office of Thrift Supervision.

*Creating a new system of federal regulation administered by the Federal Reserve to address payment and settlement systems.

*Establishing an optional federal charter for insurers which would solely be subject to federal regulation and supervision while continuing state insurance regulation for those insurers who did not elect to be regulated at the national level.

*Merging the SEC and CFTC, not only in the sense of a structural merger but a merger of regulatory philosophies. [31]

This alone was a breathtaking agenda, but there were even more ambitious proposals for an optimal long term regulatory structure. This proposed structure was inspired by the objectives based approach used in Australia and the Netherlands, [32] and ultimately would restructure the financial structure to:

*Transform the Federal Reserve into the Market Stability Regulator, continuing its role with respect to monetary policy and the provision of liquidity to the financial system and adding new responsibilities to supervise federal insured depository institutions, federal insurance institutions, and federal financial services providers. [33]

*Create a new Prudential Financial Regulatory Agency to supervise financial institutions with some type of explicit government guarantees including federal deposit insurance and state established insurance guarantee funds and assume the role of current federal prudential regulation now conducted by the Office of the Comptroller of the Currency and the Office of Thrift Supervision. [34]

*Create a new Conduct of Business Regulatory Agency to monitor business conduct regulation across all types of financial firms including federal insured depository institutions, federal insurance institutions, federal financial services providers and be responsible for consumer protection, business practices, standards for entry into the financial services industry and for sales and service practices. The new Agency would also address broker-dealers, hedge funds, private equity funds, venture capital funds, and mutual funds and would develop standards that address such topics as net capital, public disclosures, testing, training, fraud, and manipulation, and such duties to customers as best execution and suitability. [35]

*The SEC would be succeeded both by the new Conduct of Business Regulatory Agency and by a new Corporate Finance Regulator to assume the Commission's current responsibilities with respect to corporate disclosures, corporate governance, accounting, and similar issues. [36]

Publication of the Department of Treasury Report was overshadowed by the March 2008 collapse of Bear Stearns. [37]

On July 24, 2008, Chairman Cox delivered testimony on Reform of the Financial Regulatory System to the House Committee on Financial Services. He stated in part:

> When this Committee, and eventually the entire Congress and the President, devised the Gramm-Leach-Bliley Act in 1999, you—or rather we, since I was a member of the Commerce Committee, which then had jurisdiction over securities, and also of the Conference Committee—decided that the SEC would serve as a functional regulator with responsibility over broker-dealers, investment advisers, and mutual funds. And we decided that the federal banking regulators similarly would be functional regulators for banking activities. Under this approach, the securities-related activities would be pushed out of banks and savings associations and into broker-dealers and investment advisers where the SEC could examine them. This was a valiant attempt to reconcile the traditional model of regulation with the increasing interconnectedness of the securities and banking industries.
>
> After considering the very different aims and methods of banking regulators and securities regulators, Congress decided that the SEC would continue to be responsible for regulating broker-dealers that are the central entities in investment banks. The Federal Reserve Board was given consolidated oversight of holding companies that contain both broker-dealers and most types of insured depository institutions, while the SEC retained among other things the authority to regulate the net capital of those broker-dealers. But no explicit arrangement for regularly sharing information between the SEC and the Federal Reserve Board was established that took into account the desirability of viewing capital and liquidity on an entity-wide basis. Likewise, neither the Commission nor the Federal Reserve Board was authorized to exercise mandatory consolidated supervision over investment bank holding companies.
>
> Therefore, there is simply no provision in the law that requires investment bank holding companies to compute capital measures and maintain liquidity on a consolidated basis. Nor do the statutes explicitly provide for a consolidated supervisor that is knowledgeable in their core securities business, and that would be recognized for this purpose by international regulators.
>
> In 2004, the Commission adopted two regimes to fill this statutory gap. One provided group-wide supervision of holding companies that include broker-dealers based on the specific statutory authority in the Gramm-Leach-Bliley Act concerning voluntary consolidated supervision of investment bank holding companies. The other provided for voluntary consolidated supervision based on our authority over the regulated broker-dealer. Both regimes imposed similar requirements on the holding companies of broker-dealers.…

One characterization of the inadequacy of the Commission's consolidated supervised entity program was depicted in painful detail in a September 2008 Report from the SEC Office of Inspector General, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program. [38] The Report stated in part:

> During the week of March 10, 2008, rumors spread about liquidity problems at The Bear Stearns Companies, Inc. (*Bear Stearns*). As the rumors spread, Bear Stearns was unable to obtain secured financing from counterparties. This caused severe liquidity problems. As a result, on Friday, March

14, 2008, JP Morgan Chase & Co. (*JP Morgan*) provided Bear Stearns with emergency funding from the Federal Reserve Bank of New York (*FRBNY*). According to Congressional testimony, after the markets closed on March 14, 2008, it became apparent that the FRBNY's funding could not stop Bear Stearns' downward spiral. As a result, Bear Stearns concluded that it would need to file for bankruptcy protection on March 17, 2008, unless another firm purchased it. On Sunday March 16, 2008, (before the Asian markets opened), Bear Stearns' sale to JP Morgan was announced with financing support from the FRBNY. In May 2008, the sale was completed.…

Of the seven original CSE firms, the Commission exercised direct oversight over only five firms (Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers), which did not have a principal regulator. The Commission does not directly oversee Citigroup Inc. and JP Morgan because these firms have a principal regulator, the Federal Reserve.

The CSE program is a voluntary program that was created in 2004 by the Commission pursuant to rule amendments under the Securities Exchange Act of 1934. This program allows the Commission to supervise these broker-dealer holding companies on a consolidated basis. In this capacity, Commission supervision extends beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer to the holding company itself. The CSE program was designed to allow the Commission to monitor for financial or operational weakness in a CSE holding company or its unregulated affiliates that might place United States regulated broker-dealers and other regulated entities at risk.

A broker-dealer becomes a CSE by applying to the Commission for an exemption from computing capital using the Commission's standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision (if it does not already have a principal regulator). By obtaining an exemption from the standard net capital rule, the CSE firms' broker-dealers are permitted to compute net capital using an alternative method. The Commission designed the CSE program to be broadly consistent with the Federal Reserve's oversight of bank holding companies.…

Audit Conclusions and Results. The CSE program's mission (goal) provides in pertinent part as follows:

The regime is intended to allow the Commission to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including US and foreign-registered banks and broker-dealers, *or the broader financial system at risk* . [Emphasis added.]

Thus, it is undisputable that the CSE program failed to carry out its mission in its oversight of Bear Stearns because under the Commission and the CSE program's watch, Bear Stearns suffered significant financial weaknesses and the FRBNY needed to intervene during the week of March 10, 2008, to prevent significant harm to the broader financial system.

This audit was not intended to be a complete assessment of the multitude of events that led to Bear Stearns' collapse, and accordingly, does not purport to demonstrate any specific or direct connection between the failure of the CSE Program's oversight of Bear Stearns and Bear Stearns' collapse. However, we have identified serious deficiencies in the CSE program that warrant improvements. Overall, we found that there are significant questions about the adequacy of a number of CSE program requirements, as Bear Stearns was compliant with several of these requirements, but nonetheless collapsed. In addition, the audit found that [the Division of Trading and Markets (*TM*)] became aware of numerous potential red flags prior to Bear Stearns' collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain Basel II standards, but did not take actions to limit these risk factors.

In addition, the audit found that procedures and processes were not strictly adhered to, as for example, the Commission issued an order approving Bear Stearns to become a CSE prior to the completion of the inspection process. Further, the Division of Corporation Finance (*CF*) did not conduct Bear Stearns' most recent 10-K filing review in a timely manner.

The audit also identified numerous specific concerns with the Commission's oversight of the CSE program, some of which are summarized as follows:

(a) Bear Stearns was compliant with the CSE program's capital and liquidity requirements; however, its collapse raises questions about the adequacy of these requirements;

(b) Although TM was aware, prior to Bear Stearns becoming a CSE firm, that Bear Stearns' concentration of mortgage securities was increasing for several years and was beyond its internal limits, and that a portion of Bear Stearns' mortgage securities (e.g., adjustable rate mortgages) represented a significant concentration of market risk, TM did not make any efforts to limit Bear Stearns' mortgage securities concentration;

(c) Prior to the adoption of the rule amendments which created the CSE program, the broker-dealers affiliated with the CSE firms were required to either maintain:

- A debt-to-net capital ratio of less than 15 to 1 (after their first year of operation); or
- Have net capital not less than the greater of $250,000 or two percent of aggregate debit items computed in accordance with the *Formula for Determination of Reserve Requirements for Broker-Dealers.*

However, the CSE program did not require a leverage ratio limit for the CSE firms. Furthermore, despite TM being aware that Bear Stearns' leverage was high, TM made no efforts to require Bear Stearns to reduce its leverage, despite some authoritative sources describing a linkage between leverage and liquidity risk;

(d) TM became aware that risk management of mortgages at Bear Stearns had numerous shortcomings, including lack of expertise by risk managers in mortgage-backed securities at various times; lack of timely formal review of mortgage models; persistent understaffing; a proximity of risk managers to traders suggesting a lack of independence; turnover of key personnel during times of crisis; and the inability or unwillingness to update models to reflect changing circumstances. Notwithstanding this knowledge, TM missed opportunities to push Bear Stearns aggressively to address these identified concerns;

(e) There was no documentation of discussions between TM and Bear Stearns of scenarios involving a meltdown of mortgage market liquidity, accompanied by a fundamental deterioration of the mortgages themselves. TM appeared to identify the types of risks associated with these mortgages that evolved into the subprime mortgage crisis yet did not require Bear Stearns to reduce its exposure to subprime loans;

(f) Bear Stearns was not compliant with the spirit of certain Basel II standards and we did not find sufficient evidence that TM required Bear Stearns to comply with these standards;

(g) TM took no actions to assess Bear Stearns' Board of Directors' and senior officials' (e.g., the Chief Executive Officer) tolerance for risk although we found that this is a prudent and necessary oversight procedure;

(h) TM authorized (without an appropriate delegation of authority) the CSE firm's internal audit staff to perform critical audit work involving the risk management systems instead of the firms' external auditors as required by the rule that created the CSE program;

(i) In June 2007, two of Bear Stearns' managed hedge funds collapsed. Subsequent to this collapse, significant questions were raised about some of Bear Stearns' senior managements' lack of involvement in handling the crisis. However, TM did not reassess the communication strategy component of Bear Stearns' Contingency Funding Plan (*CFP*) after the collapse of the hedge funds, and very significant questions were once again raised about

some of Bear Stearns' managements' handling of the crisis during the week of March 10, 2008;

(j) The Commission issued four of the five Orders approving firms to use the alternative capital method, and thus become CSEs (including Bear Stearns) before the inspection process was completed; and

(k) CF did not conduct Bear Stearns' most recent 10-K filing review in a timely manner. The effect of this untimely review was that CF deprived investors of material information that they could have used to make well-informed investment decisions (i.e., whether to buy/sell Bear Stearns' securities). In addition, the information (e.g., Bear Stearns' exposure to subprime mortgages) could have been potentially beneficial to dispel the rumors that led to Bear Stearns' collapse. [39]

Simultaneous with the release of the damning SEC Inspector General report, the Commission terminated the CSE program. [40] The Release stated in part:

> Chairman Cox made the following statement:
>
> The last six months have made it abundantly clear that voluntary regulation does not work. When Congress passed the Gramm-Leach-Bliley Act, it created a significant regulatory gap by failing to give to the SEC or any agency the authority to regulate large investment bank holding companies, like Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.…
>
> As I have reported to the Congress multiple times in recent months, the CSE program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness.
>
> The Inspector General of the SEC today released a report on the CSE program's supervision of Bear Stearns, and that report validates and echoes the concerns I have expressed to Congress. The report's major findings are ultimately derivative of the lack of specific legal authority for the SEC or any other agency to act as the regulator of these large investment bank holding companies.
>
> With each of the major investment banks that had been part of the CSE program being reconstituted within a bank holding company, they will all be subject to statutory supervision by the Federal Reserve. Under the Bank Holding Company Act, the Federal Reserve has robust statutory authority to impose and enforce supervisory requirements on those entities. Thus, there is not currently a regulatory gap in this area.
>
> The CSE program within the Division of Trading and Markets will now be ending.
>
> Under the Memorandum of Understanding between the SEC and the Federal Reserve that was executed in July of this year, we will continue to work closely with the Fed, but focused even more clearly on our statutory obligation to regulate the broker-dealer subsidiaries of the banking conglomerates. The information from the bank holding company level that the SEC will continue to receive under the MOU will strengthen our ability to protect the customers of the broker-dealers and the integrity of the broker-dealer firms.… [41]

On September 7, 2008, Fannie Mae and Freddie Mac were placed in conservatorship. At the time they owned approximately 50 percent of residential mortgages, or approximate $4 trillion in mortgages. The United States ultimately would provide $145 billion to backstop Fannie Mae and Freddie Mac capital shortfalls. [42]

On September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection after the Department of Treasury indicated that emergency funding would not be available to stabilize the firm. [43]

The turmoil accelerated. The day after Lehman Brothers was allowed to fail the Department of Treasury orchestrated what was then an $85 billion rescue package for insurance giant AIG. [44]

On the same day Lehman Brothers failed, Bank of America acquired Merrill Lynch for $50 billion in an all stock deal. [45]

Breathtakingly, in six months, three of the five largest independent investment banks (Bear Stearns, Lehman, Merrill) were gone as independent entities. Within a few days, Goldman Sachs and Morgan Stanley converted from investment banks to commercial bank holding companies. Among other things, this meant that the Federal Reserve Bank of New York could extend credit "to provide increased liquidity support. " [46]

On October 3, 2008, Congress adopted a $700 billion financial bill, the Emergency Economic Stabilization Act of 2008, [47] a few days after the House of Representatives had initially defeated a similar bill. [48]

The Emergency Economic Stabilization Act of 2008 was most notable for its Troubled Assets Relief Program which can provide up to $700 billion "to restore liquidity and stability to the financial system of the United States. " [49]

The Department of Treasury soon announced a plan to invest $250 billion in selected banks. [50]

The size and scope of finance by the early 21st century was breathtaking. On September 1, 1929, the aggregate value of all securities listed on the New York Stock Exchange was approximately $90 billion. At year end 2006, the total assets of the United States securities sector equaled $12.4 trillion, the banking sector had assets of $12.6 trillion, and the United States insurance industry held assets totaling $6 trillion.

It was difficult to rationalize our current federal system of regulation that includes five separate federal depository institutions, specifically including the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration, as well as state banking regulation in each state. We are one of the few countries that separately regulate securities and commodities. Securities regulation, like banking, occurs both at the national and state level. Insurance regulation, in contrast, occurs solely at the state level.

On June 17, 2009 the Obama Administration Department of Treasury formally proposed its own approach. [51]

The key recommendations were: [52]

I. Promote Robust Supervision and Regulation of Financial Firms

A. Create a Financial Services Oversight Council

1. We propose the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (hereafter referred to as a *Tier 1 FHC*

[that is, Tier 1 Financial Holding Companies], and provide a forum for resolving jurisdictional disputes between regulators.

a. The membership of the Council should include

(i) the Secretary of the Treasury, who shall serve as the Chairman;

(ii) the Chairman of the Board of Governors of the Federal Reserve System;

(iii) the Director of the National Bank Supervisor;

(iv) the Director of the Consumer Financial Protection Agency;

(v) the Chairman of the SEC;

(vi) the Chairman of the CFTC;

(vii) the Chairman of the FDIC; and

(viii) the Director of the Federal Housing Finance Agency (*FHFA*).

b. The Council should be supported by a permanent, full-time expert staff at Treasury. The staff should be responsible for providing the Council with the information and resources it needs to fulfill its responsibilities.

2. Our legislation will propose to give the Council the authority to gather information from any financial firm and the responsibility for referring emerging risks to the attention of regulators with the authority to respond.

B. Implement Heightened Consolidated Supervision and Regulation of All Large, Interconnected Financial Firms

1. Any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed (Tier 1 FHC) should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution.

2. The Federal Reserve Board should have the authority and accountability for consolidated supervision and regulation of Tier 1 FHCs.

3. Our legislation will propose criteria that the Federal Reserve must consider in identifying Tier 1 FHCs.

4. The prudential standards for Tier 1 FHCs—including capital, liquidity and risk management standards— should be stricter and more conservative than those applicable to other financial firms to account for

the greater risks that their potential failure would impose on the financial system.

5. Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries—regulated and unregulated, U.S. and foreign. Functionally regulated and depository institution subsidiaries of a Tier 1 FHC should continue to be supervised and regulated primarily by their functional or bank regulator, as the case may be. The constraints that the Gramm-Leach-Bliley Act (*GLB* Act) introduced on the Federal Reserve's ability to require reports from, examine, or impose higher prudential requirements or more stringent activity restrictions on the functionally regulated or depository institution subsidiaries of FHCs should be removed.

6. Consolidated supervision of a Tier 1 FHC should be macroprudential in focus. That is, it should consider risk to the system as a whole.

7. The Federal Reserve, in consultation with Treasury and external experts, should propose recommendations by October 1, 2009 to better align its structure and governance with its authorities and responsibilities.

C. Strengthen Capital and Other Prudential Standards For All Banks and BHCs

1. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts that will conduct a fundamental reassessment of existing regulatory capital requirements for banks and BHCs, including new Tier 1 FHCs. The working group will issue a report with its conclusions by December 31, 2009.

2. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of the supervision of banks and BHCs. The working group will issue a report with its conclusions by October 1, 2009.

3. Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. In addition, we will support legislation requiring all public companies to hold non-binding shareholder resolutions on the compensation packages of senior executive officers, as well as new requirements to make compensation committees more independent.

4. Capital and management requirements for FHC status should not be limited to the subsidiary depository institution. All FHCs should be required to meet the capital and management requirements on a consolidated basis as well.

5. The accounting standard setters (the FASB, the IASB, and the SEC) should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both

fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.

6. Firewalls between banks and their affiliates should be strengthened to protect the federal safety net that supports banks and to better prevent spread of the subsidy inherent in the federal safety net to bank affiliates.

D. Close Loopholes in Bank Regulation

1. We propose the creation of a new federal government agency, the National Bank Supervisor (*NBS*), to conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks.

2. We propose to eliminate the federal thrift charter, but to preserve its interstate branching rules and apply them to state and national banks.

3. All companies that control an insured depository institution, however organized, should be subject to robust consolidated supervision and regulation at the federal level by the Federal Reserve and should be subject to the nonbanking activity restrictions of the BHC Act. The policy of separating banking from commerce should be re-affirmed and strengthened. We must close loopholes in the BHC Act for thrift holding companies, industrial loan companies, credit card banks, trust companies, and grandfathered *nonbank* banks.

E. Eliminate the SEC's Programs for Consolidated Supervision

The SEC has ended its Consolidated Supervised Entity Program, under which it had been the holding company supervisor for companies such as Lehman Brothers and Bear Stearns. We propose also eliminating the SEC's Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve.

F. Require Hedge Funds and Other Private Pools of Capital to Register

All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.

G. Reduce the Susceptibility of Money Market Mutual Funds (*MMF* s) to Runs

The SEC should move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs. The President's Working Group on Financial Markets should prepare a report assessing whether more fundamental changes are necessary to further reduce the MMF industry's susceptibility to runs, such as eliminating the ability of a MMF to use a stable net

asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources.

H. Enhance Oversight of the Insurance Sector

Our legislation will propose the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with six principles outlined in the body of the report.

I. Determine the Future Role of the Government Sponsored Enterprises (*GSE* s)

Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. We need to maintain the continued stability and strength of the GSEs during these difficult financial times. We will report to the Congress and the American public at the time of the President's 2011 Budget release.

II. Establish Comprehensive Regulation of Financial Markets

A. Strengthen Supervision and Regulation of Securitization Markets

1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.

2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.

3. The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (*ABS*).

4. The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process.

5. Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.

B. Create Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (*CDS*)

All OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market

manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

C. Harmonize Futures and Securities Regulation

The CFTC and the SEC should make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities.

D. Strengthen Oversight of Systemically Important Payment, Clearing and Settlement Systems and Related Activities

We propose that the Federal Reserve have the responsibility and authority to conduct oversight of systemically important payment, clearing and settlement systems, and activities of financial firms.

E. Strengthen Settlement Capabilities and Liquidity Resources of Systemically Important Payment, Clearing, and Settlement Systems

We propose that the Federal Reserve have authority to provide systemically important payment, clearing, and settlement systems access to Reserve Bank accounts, financial services, and the discount window.

III. Protect Consumers and Investors From Financial Abuse

A. Create a New Consumer Financial Protection Agency

1. We propose to create a single primary federal consumer protection supervisor to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.

2. The CFPA should have broad jurisdiction to protect consumers in consumer financial products and services such as credit, savings, and payment products.

3. The CFPA should be an independent agency with stable, robust funding.

4. The CFPA should have sole rule-making authority for consumer financial protection statutes, as well as the ability to fill gaps through rule-making.

5. The CFPA should have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes that it implements, including both insured depositories and the range of other firms not previously subject to comprehensive federal supervision, and it should work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.

6. The CFPA should pursue measures to promote effective regulation, including conducting periodic reviews of regulations, an outside advisory council, and coordination with the Council.

7. The CFPA's strong rules would serve as a floor, not a ceiling. The states should have the ability to adopt and enforce stricter laws for institutions of all types, regardless of charter, and to enforce federal law

concurrently with respect to institutions of all types, also regardless of charter.

8. The CFPA should coordinate enforcement efforts with the states.

9. The CFPA should have a wide variety of tools to enable it to perform its functions effectively.

10. The Federal Trade Commission should also be given better tools and additional resources to protect consumers.

B. Reform Consumer Protection

1. Transparency. We propose a new proactive approach to disclosure. The CFPA will be authorized to require that all disclosures and other communications with consumers be reasonable: balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties, and risks.

2. Simplicity. We propose that the regulator be authorized to define standards for *plain vanilla* products that are simpler and have straightforward pricing. The CFPA should be authorized to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.

3. Fairness. Where efforts to improve transparency and simplicity prove inadequate to prevent unfair treatment and abuse, we propose that the CFPA be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs. Moreover, we propose to authorize the Agency to impose appropriate duties of care on financial intermediaries.

4. Access. The Agency should enforce fair lending laws and the Community Reinvestment Act and otherwise seek to ensure that underserved consumers and communities have access to prudent financial services, lending, and investment.

C. Strengthen Investor Protection

1. The SEC should be given expanded authority to promote transparency in investor disclosures.

2. The SEC should be given new tools to increase fairness for investors by establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers.

3. Financial firms and public companies should be accountable to their clients and investors by expanding protections for whistleblowers, expanding sanctions available for enforcement, and requiring non-binding shareholder votes on executive pay plans.

4. Under the leadership of the Financial Services Oversight Council, we propose the establishment of a Financial Consumer Coordinating Council with a broad membership of federal and state consumer protection

agencies, and a permanent role for the SEC's Investor Advisory Committee.

5. Promote retirement security for all Americans by strengthening employment-based and private retirement plans and encouraging adequate savings.

IV. Provide the Government With the Tools It Needs to Manage Financial Crises

A. Create a Resolution Regime for Failing BHCs, Including Tier 1 FHCs

We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace) and be modeled on the existing resolution regime for inspired depository institutions under the Federal Deposit Insurance Act.

B. Amend the Federal Reserve's Emergency Lending Authority

We will propose legislation to amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of the Treasury for any extensions of credit by the Federal Reserve to individuals, partnerships, or corporations in "unusual and exigent circumstances. "

V. Raise International Regulatory Standards and Improve International Cooperation

A. Strengthen the International Capital Framework

We recommend that the Basel Committee on Banking Supervision (*BCBS*) continue to modify and improve Basel II by refining the risk weights applicable to the trading book and securitized products, introducing a supplemental leverage ratio, and improving the definition of capital by the end of 2009. We also urge the BCBS to complete an in-depth review of the Basel II framework to mitigate its procyclical effects.

B. Improve the Oversight of Global Financial Markets

We urge national authorities to promote the standardization and improved oversight of credit derivatives and other OTC derivative markets, in particular through the use of central counterparties, along the lines of the G-20 commitment, and to advance these goals through international coordination and cooperation.

C. Enhance Supervision of Internationally Active Financial Firms

We recommend that the Financial Stability Board (*FSB*) and national authorities implement G-20 commitments to strengthen arrangements for international cooperation on supervision of global financial firms through establishment and continued operational development of supervisory colleges.

D. Reform Crisis Prevention and Management Authorities and Procedures

We recommend that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009. We

further urge national authorities to improve information-sharing arrangements and implement the FSB principles for cross-border crisis management.

E. Strengthen the Financial Stability Board

We recommend that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009.

F. Strengthen Prudential Regulations

We recommend that the BCBS take steps to improve liquidity risk management standards for financial firms and that the FSB work with the Bank for International Settlements (*BIS*) and standard setters to develop macroprudential tools.

G. Expand the Scope of Regulation

1. Determine the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms.

2. We urge national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively.

H. Introduce Better Compensation Practices

In line with G-20 commitments, we urge each national authority to put guidelines in place to align compensation with long-term shareholder value and to promote compensation structures that do not provide incentives for excessive risk taking. We recommend that the BCBS expediently integrate the FSB principles on compensation into its risk management guidance by the end of 2009.

I. Promote Stronger Standards in the Prudential Regulation, Money Laundering/ Terrorist Financing, and Tax Information Exchange Areas

1. We urge the FSB to expeditiously establish and coordinate peer reviews to assess compliance and implementation of international regulatory standards, with priority attention on the international cooperation elements of prudential regulatory standards.

2. The United States will work to implement the updated International Cooperation Review Group (*ICRG*) peer review process and work with partners in the Financial Action Task Force (*FATF*) to address jurisdictions not complying with international antimoney laundering/ terrorist financing (*AML*/*CFT*) standards.

J. Improve Accounting Standards

1. We recommend that the accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009.

2. We recommend that the accounting standard setters improve accounting standards for loan loss provisioning by the end of 2009 that

would make it more forward looking, as long as the transparency of financial statements is not compromised.

3. We recommend that the accounting standard setters make substantial progress by the end of 2009 toward development of a single set of high quality global accounting standards.

K. Tighten Oversight of Credit Rating Agencies

We urge national authorities to enhance their regulatory regimes to effectively oversee credit rating agencies (*CRA* s), consistent with international standards and the G-20 Leaders' recommendations.

The Federal Reserve Board would become the sole regulator responsible for consolidated supervision and regulation of the largest financial holding companies: [53]

We propose that authority for supervision and regulation of Tier 1 FHCs be vested in the Federal Reserve Board, which is by statute the consolidated supervisor and regulator of all bank holding companies today. As a result of changes in corporate structure during the current crisis, the Federal Reserve already supervises and regulates all major U.S. commercial and investment banks on a firmwide basis. The Federal Reserve has by far the most experience and resources to handle consolidated supervision and regulation of Tier 1 FHCs.…

The ultimate responsibility for prudential standard-setting and supervision for Tier 1 FHCs must rest with a single regulator. The public has a right to expect that a clearly identifiable entity, not a committee of multiple agencies, will be answerable for setting standards that will protect the financial system and the public from risks posed by the potential failure of Tier 1 FHCs. Moreover, a committee that included regulators of specific types of financial institutions such as commercial banks or broker-dealers (functional regulators) may be less focused on systemic needs and more focused on the needs of the financial firms they regulate.

…

Diffusing responsibility among several regulators would weaken incentives for effective regulation in other ways. For example, it would weaken both the incentive for and the ability of the relevant agencies to act in a timely fashion—creating the risk that clearly ineffective standards remain in place for long periods.

The Federal Reserve should fundamentally adjust its current framework for supervising all BHCs in order to carry out its new responsibilities effectively with respect to Tier 1 FHCs. For example, the focus of BHC regulation would need to expand beyond the safety and soundness of the bank subsidiary to include the activities of the firm as a whole and the risks the firm might pose to the financial system. The Federal Reserve would also need to develop new supervisory approaches for activities that to date have not been significant activities for most BHCs. [54]

Under the proposal, hedge funds and other private pools of capital would be required to register.

In recent years, the United States has seen explosive growth in a variety of privately-owned investment funds, including hedge funds, private equity funds, and venture capital funds. Although some private investment funds that trade commodity derivatives must register with the CFTC, and many funds register voluntarily with the SEC, U.S. law generally does not require such funds to

> register with a federal financial regulator. At various points in the financial crisis, de-leveraging by hedge funds contributed to the strain on financial markets. Since these funds were not required to register with regulators, however, the government lacked reliable, comprehensive data with which to assess this sort of market activity. In addition to the need to gather information in order to assess potential systemic implications of the activity of hedge funds and other private pools of capital, it has also become clear that there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisers and the funds that they manage.
>
> Requiring the SEC registration of investment advisers to hedge funds and other private pools of capital would allow data to be collected that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes.
>
> We further propose that all investment funds advised by an SEC-registered investment adviser should be subject to recordkeeping requirements; requirements with respect to disclosures to investors, creditors, and counterparties; and regulatory reporting requirements. The SEC should conduct regular, periodic examinations of such funds to monitor compliance with these requirements. Some of those requirements may vary across the different types of private pools. The regulatory reporting requirements for such funds should require reporting on a confidential basis of the amount of assets under management, borrowings, off-balance sheet exposures, and other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability. The SEC should share the reports that it receives from the funds with the Federal Reserve. The Federal Reserve should determine whether any of the funds or fund families meets the Tier 1 FHC criteria. If so, those funds should be supervised and regulated as Tier 1 FHCs. [55]

The Obama Administration proposal focused also on the regulation of securitization markets:

> The financial crisis was triggered by a breakdown in credit underwriting standards in subprime and other residential mortgage markets. That breakdown was enabled by lax or nonexistent regulation of nonbank mortgage originators and brokers. But the breakdown also reflected a broad relaxation in market discipline on the credit quality of loans that originators intended to distribute to investors through securitizations rather than hold in their own loan portfolios.
>
> We propose several initiatives to address this breakdown in market discipline: changing the incentive structure of market participants; increasing transparency to allow for better due diligence; strengthening credit rating agency performance; and reducing the incentives for over-reliance on credit ratings.…
>
> The federal banking agencies should promulgate regulations that require loan originators or sponsors to retain five percent of the credit risk of securitized exposures. The regulations should prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these regulations. This is critical to prevent gaming of the system to undermine the economic tie between the originator and the issued ABS.
>
> The federal banking agencies should have authority to specify the permissible forms of required risk retention (for example, first loss position or pro rata vertical slice) and the minimum duration of the required risk retention. The agencies also should have authority to provide exceptions or adjustments to these requirements as needed in certain cases, including authority to raise or lower the five percent threshold and to provide exemptions from the *no hedging* requirement that are consistent with safety and soundness. The agencies should also have authority to apply the requirements to

securitization sponsors rather than loan originators in order to achieve the appropriate alignment of incentives contemplated by this proposal.…

The securitization process should provide appropriate incentives for participants to best serve the interests of their clients, the borrowers and investors. To do that, the compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process should be linked to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products.

For example, as proposed by Financial Accounting Standards Board (*FASB*), Generally Accepted Accounting Principles (*GAAP*) should be changed to eliminate the immediate recognition of gain on sale by originators at the inception of a securitization transaction and instead require originators to recognize income over time. [56]

OTC derivatives would be subject to new regulation.

To contain systemic risks, the Commodities Exchange Act (*CEA*) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (*CCP* s). To make these measures effective, regulators will need to require that CCPs impose robust margin requirements as well as other necessary risk controls and that customized OTC derivatives are not used solely as a means to avoid using a CCP. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared.

All OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision and regulation. Key elements of that robust regulatory regime must include conservative capital requirements (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. Counterparty risks associated with customized bilateral OTC derivatives transactions that should not be accepted by a CCP would be addressed by this robust regime covering derivative dealers. As noted above, regulatory capital requirements on OTC derivatives that are not centrally cleared also should be increased for all banks and BHCs.

The OTC derivatives markets should be made more transparent by amending the CEA and the securities laws to authorize the CFTC and the SEC, consistent with their respective missions, to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Certain of those requirements should be deemed to be satisfied by either clearing standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs and trade repositories should be required to, among other things, make aggregate data on open positions and trading volumes available to the public and make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC, SEC, and the institution's primary regulators.

Market efficiency and price transparency should be improved in derivatives markets by requiring the clearing of standardized contracts through regulated CCPs as discussed earlier and by moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives and by requiring development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. Furthermore, regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives. Competition between appropriately regulated OTC derivatives markets and

> regulated exchanges would make both sets of markets more efficient and thereby better serve end-users of derivatives.
>
> Market integrity concerns should be addressed by making whatever amendments to the CEA and the securities laws which are necessary to ensure that the CFTC and the SEC, consistent with their respective missions, have clear, unimpeded authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives. The CFTC also should have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. [57]

The Obama Administration proposal did not recommend merging the SEC and CFTC, but instead sought to better harmonize securities and commodities regulation. [58]

The proposed new Consumer Financial Protection Agency explicitly would not have authority for investment products and services already regulated by the SEC or CFTC. [59]

The Report did seek to harmonize broker-dealer and investment adviser regulation:

> …[I]nvestment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor's perspective.
>
> Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give *incidental advice* in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.
>
> From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing *incidental advice* appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same.
>
> The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary, but are not in the investors' best interest.
>
> New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:
>
> - requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;
> - providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and
> - prohibiting certain conflict of interests and sales practices that are contrary to the interest of investors.

The SEC should study the use of mandatory arbitration clauses in investor contracts.

Broker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes—and eliminating access to courts—may unjustifiably undermine investor interests. We recommend legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. The legislation should also provide that, before using such authority, the SEC would need to conduct a study on the use of mandatory arbitration clauses in these contracts. The study shall consider whether investors are harmed by being unable to obtain effective redress of legitimate grievances, as well as whether changes to arbitration are appropriate.…

Expand protections for whistleblowers.

The SEC should gain the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. Currently, the SEC has the authority to compensate sources in insider trading cases; that authority should be extended to compensate whistleblowers that bring well-documented evidence of fraudulent activity. We support the creation of this fund using monies that the SEC collects from enforcement actions that are not otherwise distributed to investors.

Expand sanctions available in enforcement actions and harmonize liability standards.

Improved sanctions would better enable the SEC to enforce the federal securities laws. We support the SEC in pursuing authority to impose collateral bars against regulated persons across all aspects of the industry rather than in a specific segment of the industry. The interrelationship among the securities activities under the SEC's jurisdiction, the similar grounds for exclusion from each, and the SEC's overarching responsibility to regulate these activities support the imposition of collateral bars. …

Require non-binding shareholder votes on executive compensation packages.

Public companies should be required to implement *say on pay* rules, which require shareholder votes on executive compensation packages. While such votes are non-binding, they provide a strong message to management and boards and serve to support a culture of performance, transparency, and accountability in executive compensation. Shareholders are often concerned about large corporate bonus plans in situations in which they, as the company's owners, have experienced losses. Currently, these decisions are often not directly reviewed by shareholders—leaving shareholders with limited rights to voice their concerns about compensation through an advisory vote.

To facilitate greater communication between shareholders and management over executive compensation, public companies should include on their proxies a nonbinding shareholder vote on executive compensation. Legislation that would authorize SEC *say on pay* rules for all public companies could help restore investor trust by promoting increased shareholder participation and increasing accountability of board members and corporate management. It would provide shareholders of all public U.S. companies with the same rights that are accorded to shareholders in many other countries. [60]

On January 21, 2010 President Obama went further and proposed adoption of the *Volcker Rule* to prohibit commercial banks from owning, investing, or sponsoring hedge funds, private equity funds, or proprietary trading operations for bank profits, unrelated to serving customers. Obama said in part:

For while the financial system is far stronger today than it was one year ago, it's still operating under the same rules that led to its near collapse. These are rules that allows firms to act contrary to the interests of customers; to conceal their exposure to debt through complex financial dealings; to benefit from taxpayer-insured deposits while making speculative investments; and to take on risks so vast that they posed threats to the entire system.

That's why we are seeking reforms to protect consumers; we intend to close loopholes that allowed big financial firms to trade risky financial products like credit defaults swaps and other derivatives without oversight; to identify system-wide risks that could cause a meltdown; to strengthen capital and liquidity requirements to make the system more stable; and to ensure that the failure of any large firm does not take the entire economy down with it. Never again will the American taxpayer be held hostage by a bank that is *too big to fail* ….

First, we should no longer allow banks to stray too far from their central mission of serving their customers. In recent years, too many financial firms have put taxpayer money at risk by operating hedge funds and private equity funds and making riskier investments to reap a quick reward. And these firms have taken these risks while benefiting from special financial privileges that are reserved only for banks.

Our government provides deposit insurance and other safeguards and guarantees to firms that operate banks. We do so because a stable and reliable banking system promotes sustained growth, and because we learned how dangerous the failure of that system can be during the Great Depression.

But these privileges were not created to bestow banks operating hedge funds or private equity funds with an unfair advantage. When banks benefit from the safety net that taxpayers provide—which includes lower-cost capital—it is not appropriate for them to turn around and use that cheap money to trade for profit. And that is especially true when this kind of trading often puts banks in direct conflict with their customers' interests.

The fact is, these kinds of trading operations can create enormous and costly risks, endangering the entire bank if things go wrong. We simply cannot accept a system in which hedge funds or private equity firms inside banks can place huge, risky bets that are subsidized by taxpayers and that could pose a conflict of interest. And we cannot accept a system in which shareholders make money on these operations if the bank wins but taxpayers foot the bill if the bank loses.

It's for these reasons that I'm proposing a simple and common-sense reform, which we're calling the *Volcker Rule* —after this tall guy behind me. Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, that's something they're free to do. Indeed, doing so—responsibly—is a good thing for the markets and the economy. But these firms should not be allowed to run these hedge funds and private equities funds while running a bank backed by the American people.

In addition, as part of our efforts to protect against future crises, I'm also proposing that we prevent the further consolidation of our financial system. There has long been a deposit cap in place to guard against too much risk being concentrated in a single bank. The same principle should apply to wider forms of funding employed by large financial institutions in today's economy. The American people will not be served by a financial system that comprises just a few massive firms. That's not good for consumers; it's not good for the economy. And through this policy, that is an outcome we will avoid. [61]

d. The Dodd-Frank Wall Street Reform and Consumer Protection Act

In July 2010 Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act on nearly party line votes, in the House with a 237-192 vote (with three Republicans in the majority) and the Senate by a 60-39 vote (with three Republicans, Senators Brown, Collins, and Snow, joining the majority). President Obama signed the Act into law on July 21, 2010, asserting: "Passing this law was no easy task. " [62]

The Dodd-Frank Act did little to restructure the existing financial regulatory agencies or departments. Only the Office of Thrift Supervision was terminated, with supervision of thrifts, primarily reallocated to the Office of the Currency (with respect to Federal Savings Associations) and the Federal Reserve Board (with respect to Federal Savings and Loan Holding Companies). [63]

Notably the SEC and CFTC were not amalgamated.

Throughout the Act, the SEC is defined to be the *primary financial regulatory agency* for each person or function already subject to its jurisdiction. [64]

The most important objective of the Dodd-Frank Act is to reduce systemic financial risk. That said, many have questioned whether the Act will in fact reduce systemic risk and have expressed concern that the Act will impose excessive regulation and may itself create new risks. Further, many provisions of the legislation are entirely unrelated to the causes of the financial crisis and the reduction of systemic risk.

Title I, The Financial Stability Act of 2010, establishes on the date of enactment the Financial Stability Oversight Council, §111(a), which includes the following voting members, each of whom has one vote on the Council:

> (A) the Secretary of the Treasury, who shall serve as Chairperson of the Council;
>
> (B) the Chairman of the Board of Governors;
>
> (C) the Comptroller of the Currency;
>
> (D) the Director of the Bureau [of Consumer Financial Protection];
>
> (E) the Chairman of the [Securities and Exchange] Commission;
>
> (F) the Chairperson of the [Federal Deposit Insurance] Corporation;
>
> (G) the Chairperson of the Commodity Futures Trading Commission;
>
> (H) the Director of the Federal Housing Finance Agency;
>
> (I) the Chairman of the National Credit Union Administration Board; and
>
> (J) an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise. [65]

There also are nonvoting advisory members, who include the Director of the Office of Financial Research, created in §§151–156 of the Dodd-Frank Act; the Director of the Federal Insurance Office, created in §502; a state insurance commissioner selected by the state insurance commissioners; a state banking supervisor; and a state securities commissioner, similarly selected by their peers. [66]

The Council meets at the call of the Chairperson or a majority of the members then serving, but not less than quarterly. [67]

Decisions normally are by majority vote of the voting members then serving. [68]

The Council's purposes and duties are defined broadly in §112(a):

(1) In General—The purposes of the Council are—

(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and

(C) to respond to emerging threats to the stability of the United States financial system.

(2) Duties—The Council shall, in accordance with this title—

(A) collect information from member agencies, other Federal and State financial regulatory agencies, the Federal Insurance Office and, if necessary to assess risks to the United States financial system, direct the Office of Financial Research to collect information from bank holding companies and nonbank financial companies;

(B) provide direction to, and request data and analyses from, the Office of Financial Research to support the work of the Council;

(C) monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;

(D) to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;

(E) facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions;

(F) recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies;

(G) identify gaps in regulation that could pose risks to the financial stability of the United States;

(H) require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or because of their activities pursuant to section 113;

(I) make recommendations to the Board of Governors concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors;

(J) identify systemically important financial market utilities and payment, clearing, and settlement activities (as that term is defined in title VIII);

(K) make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets;

(L) review and, as appropriate, may submit comments to the Commission and any standard-setting body with respect to an existing or proposed accounting principle, standard or procedure;

(M) provide a forum for—

(i) discussion and analysis of emerging market developments and financial regulatory issues; and

(ii) resolution of jurisdictional disputes among the members of the Council; and

(N) annually report to and testify before Congress on—

(i) the activities of the Council;

(ii) significant financial market and regulatory developments, including insurance and accounting regulations and standards, along with an assessment of those developments on the stability of the financial system;

(iii) potential emerging threats to the financial stability of the United States;

(iv) all determinations made under section 113 or title VIII, and the basis for such determinations;

(v) all recommendations made under section 119 and the result of such recommendations; and

(vi) recommendations—

(I) to enhance the integrity, efficiency, competitiveness and stability of United States financial markets;

(II) to promote market discipline; and

(III) to maintain investor confidence.

The emphasis in the Council's duties is on monitoring and deterrence rather than crisis management, which statutorily is delegated to the Federal Reserve Board and Federal Deposit Insurance Corporation. Through the enactment and Conference Report process, moreover, many provisions in the Act were compromised in order to ensure passage. Section 112(a)(2)(L), for example, limits the Council's role with respect to existing or proposed accounting principles, standard or procedures to review and comment, rather than a voting or veto role.

Section 113(a)(1) authorizes the Council on a vote of no fewer than 2/3 of the voting members then serving, including an affirmative vote of the Chairperson, to require that a *United States nonbank financial company* [69] be supervised by the Federal Reserve Board of Governors and subject to prudential standards as defined in §115 *if* "the Council determines that material financial distress at the U.S. nonbank financial company, or

the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States." [70]

This represents a significant, but uncertain, power for the Council. If exercised broadly, the powers of the Council will be concomitantly greater. If not exercised or exercised sparingly, the Council largely will focus on banks and bank holding companies.

Section 113(b) provides a similar approach to foreign nonbank financial companies. [71]

Section 113(c) authorizes the Federal Reserve to supervise the financial activities of any company incorporated or organized in the United States or abroad when the Council on a two-thirds vote determines that the Company's material financial distress of the company "would post a threat to the financial stability of the United States. " Section 113(c)(1)(B) requires a determination that "the company is organized or operates in such a manner as to evade the application of this title. " [72]

Section 115 authorizes the Council "in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions, " to make recommendations to the Federal Reserve "concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies…and large, interconnected bank holding companies. " [73] These recommendations may be more stringent than those that do not present similar risks. [74]

Enhanced prudential standards are a technique in the Dodd-Frank Act. Section 115(b) provides:

> The recommendations of the Council…may include—
>
> > (A) risk-based capital requirements;
> >
> > (B) leverage limits;
> >
> > (C) liquidity requirements;
> >
> > (D) resolution plan and credit exposure report requirements;
> >
> > (E) concentration limits;
> >
> > (F) a contingent capital requirement;
> >
> > (G) enhanced public disclosures;
> >
> > (H) short-term debt limits; and
> >
> > (I) overall risk management requirements. [75]

There will be considerable uncertainty as to how effective the Council will be until these prudential regulatory standards are developed, implemented, and sustained over time. To put it simply, the Council either will be a more effective coordinator of federal financial regulation or more narrowly focused, depending largely on its rulemaking, particularly concerning prudential regulatory standards. The Council may also prove to be too aggressive and far-reaching in its approach, such that even if it manages to reduce systemic risk the costs of doing so could outweigh the benefits. There is also the prospect that the Council, chaired as it is by the Secretary of Treasury, will have the effect of eroding, to at least some degree, the actual independence of agencies like the SEC.

Section 119 addresses a different type of challenge in the pre-Dodd-Frank Act regulatory structure, by empowering the Council to make recommendations to resolve a dispute among two or more of its members, when:

> (1) a member agency has a dispute with another member agency about the respective jurisdiction over a particular bank holding company, nonbank financial company, or financial activity or product (excluding matters for which another dispute mechanism specifically has been provided under title X);
>
> (2) the Council determines that the disputing agencies cannot, after a demonstrated good faith effort, resolve the dispute without the intervention of the Council; and
>
> (3) any of the member agencies involved in the dispute—
>
> > (A) provides all other disputants prior notice of the intent to request dispute resolution by the Council; and
> >
> > (B) requests in writing, not earlier than 14 days after providing the notice described in subparagraph (A), that the Council seek to resolve the dispute.

Recommendations under §119(c)(3) require an affirmative vote of two-thirds of the voting members of the Council then serving, but are not binding "on the Federal agencies that are parties to the dispute. "

The Council, in other words, may be seen as a mediator, not an arbitrator, although one cannot rule out that pressure will be brought to bear on certain members to bend toward the will of other Council members for the sake of showing consensus. How much effect this provision will have in reducing the disputes that have bedeviled the SEC and CFTC and depository regulatory institutions in resolving competing jurisdictions is uncertain. And whether the effect would prove, on net, to be beneficial or not is also uncertain. This heavily compromised provision may end up delivering far less than anticipated.

The Council similarly has advisory power under §120(a) to recommend to each primary financial regulatory agency:

> new or heightened standards and safeguards…for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.

This, however, is advice that could be difficult for a primary financial regulatory agency to ignore, and that thus could be the means of the gradual but meaningful erosion of the actual independence of independent agencies, including the SEC. If the Section 120 process has the effect of displacing the judgment of a primary financial regulatory agency with the judgment of the FSOC as an agency feels pressure to conform to the FSOC's advice, independent agencies will become less independent in practice. Section 120(c)(2) specifies:

> The primary financial regulatory agency shall impose the standards recommended by the Council in accordance with subsection (a), or similar standards that the Council deems acceptable, or shall

> explain in writing to the Council, not later than 90 days after the date on which the Council issues the recommendation, why the agency has determined not to follow the recommendation of the Council.

In a crisis the Federal Reserve Board and the FDIC become the operational executors of the Dodd-Frank Act's provisions to reduce systemic risk.

Upon an affirmative vote of two-thirds of the voting members of the Council then serving, §121 of the Dodd-Frank Act authorizes the Federal Reserve Board to take actions to mitigate risks posed by a covered bank holding company or nonbank financial company when such a company "poses a grave threat to the financial stability of the United States. " The Board is directed to:

> (1) limit the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
>
> (2) restrict the ability of the company to offer a financial product or products;
>
> (3) require the company to terminate one or more activities;
>
> (4) impose conditions on the manner in which the company conducts 1 or more activities; or
>
> (5) if the Board of Governors determines that the actions described in paragraphs (1) through (4) are inadequate to mitigate a threat to the financial stability of the United States in its recommendation, require the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities. [76]

Section 165 authorizes the Federal Reserve Board to establish more stringent prudential standards for nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets of $50 billion or more "[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions. " [77]

Significantly, §165(j) directs the Federal Reserve to require each covered bank holding company or each supervised nonbank financial company to maintain a debt to equity ratio of no more than 15 to 1, but the Federal Reserve Board only is required to do so, "upon a determination by the Council that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. Nothing in this paragraph shall apply to a Federal home loan bank. " [78]

Under §171(b)(7), the Federal banking agencies [79] generally are directed to develop capital requirements:

> applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity.…
>
> Such rules shall address, at a minimum, the risks arising from—
>
> > (i) significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse repurchase agreements;

(ii) concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid 2-way markets; and

(iii) concentrations in market share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly cease the activity.

Section 172(a) amends §10(b)(3) of the Federal Deposit Insurance Act [80] to authorize the FDIC to conduct special examinations of supervised nonbank financial companies, or bank holding companies as described in §165(a) of the Dodd-Frank Act.

Title II of the Dodd-Frank Act is in addition to the Financial Stability Oversight Council and Federal financial regulatory agencies. Title II vests both the FDIC generally with respect to *covered financial companies* , and the SIPC [81] with respect to a subset of financial companies that are *covered broker-dealers* [82] with orderly liquidation authority. [83] This orderly liquidation authority does not replace the Bankruptcy Code, but is applicable for nonbroker-dealer firms only upon triggering votes that the financial company should be liquidated under this authority.

The purpose of Title II is "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard, " although questions have been raised as to whether it will achieve that result in practice. [84] The FDIC is directed to exercise its authority "in the manner that best fulfills such purpose," so that:

(1) creditors and shareholders will bear the losses of the financial company;

(2) management responsible for the condition of the financial company will not be retained; and

(3) the Corporation and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility. [85]

For financial companies not involving broker-dealers, appointment of the FDIC as receiver begins with a recommendation of no fewer than two-thirds of the Federal Reserve Board of Governors [86] to the Secretary of Treasury. The Secretary (in consultation with the President) formally appoints the FDIC as a receiver [87] after determining that:

(1) the financial company is in default or in danger of default;

(2) the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States;

(3) no viable private sector alternative is available to prevent the default of the financial company;

(4) any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under this title is appropriate, given the impact that any action taken under this title would have on financial stability in the United States;

> (5) any action under section 204 would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company;
>
> (6) a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and
>
> (7) the company satisfies the definition of a financial company under section 201. [88]

Section 210(n) of the Dodd-Frank Act creates the Orderly Liquidation Fund to pay for actions authorized by Title II, including the orderly liquidation of financial companies. The Fund itself under §210(n)(4) is funded by obligations issued by the FDIC to the Secretary of the Treasury, who, in turn, under §210(n)(5)(D)–(E) can sell the obligations. For each covered financial company, maximum obligations limitations under §210(n)(6) may not exceed:

> (A) an amount that is equal to 10 percent of the total consolidated assets of the covered financial company, based on the most recent financial statement available, during the 30-day period immediately following the date of appointment of the Corporation as receiver (or a shorter time period if the Corporation has calculated the amount described under subparagraph (B)); and
>
> (B) the amount that is equal to 90 percent of the fair value of the total consolidated assets of each covered financial company that are available for repayment, after the time period described in subparagraph (A).

To access the Orderly Liquidation Fund, the FDIC under §210(n)(9)(A), must develop an orderly liquidation plan acceptable to the Secretary, and a mandatory repayment plan. [89]

Title II includes a *clawback* provision in §210(s) to empower the FDIC as receiver of a covered financial company to recover from any current or former senior executive or director "substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply. " [90]

Title XI of Dodd-Frank Act in §1101(a) authorizes the Federal Reserve Board to engage emergency lending programs "for the purpose of providing liquidity to the financial system. " Under §1104 both the FDIC and the Federal Reserve by votes of two-third of their then serving members must determine that a liquidity event exists that warrants use of a guarantee program as delineated in §1105. The maximum amount of debt permissible under §1105(c) is to be determined by the Secretary of the Treasury in consultation with the President. Section 1105(d) provides that Congress, using specified procedures, must adopt a joint resolution to provide an additional debt guarantee authority. Section 1105(e)(1) then provides: "The [FDIC] shall charge fees and other assessments to all participants in the program established pursuant to this section, in such amounts as are necessary to offset projected losses and administrative expenses, including amounts borrowed pursuant to paragraph (3) and such amounts shall be available to the [FDIC]. "

Section 619 of the Dodd-Frank Act amends §13 of the Bank Holding Company Act of 1956, [91] to establish a modified version of the Volcker Rule.

Specifically §13(a)(1) provides:

> Unless otherwise provided in this section, a banking entity shall not—

> (A) engage in proprietary trading; or
>
> (B) acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or a private equity fund.

Section 13(a)(2) solely is addressed to nonbank financial companies supervised by the Federal Reserve Board and provides:

> Any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund, except that permitted activities as described in subsection (d) shall not be subject to the additional capital and additional quantitative limits except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a banking entity.

This is not the Volcker Rule, but a specification of potential additional capital requirements. A former investment bank holding company that became a bank holding company such as Goldman Sachs does gain greater access to Federal Reserve Board support, but must comply with the Volcker Rule.

Section 13(b)(1) directs the Financial Stability Oversight Council to conduct a study and make recommendations to implement §13, focusing particularly on "the safety and soundness of banking entities " and "[protecting] taxpayers and consumers and [enforcing] financial stability by minimizing the risk that insured depository institutions [and their affiliates] will engage in unsafe and unsound activities. "

Section 13(b)(2) then directs the appropriate Federal banking agencies, the SEC, and the CFTC to consider the findings of this study and within nine months after its completion to engage in coordinated rulemaking and adopt rules to carry out §13.

In general under §13(c)(2):

> A banking entity or nonbank financial company supervised by the Board shall bring its activities and investments into compliance with the requirements of this section not later than 2 years after the date on which the requirements become effective pursuant to this section or 2 years after the date on which the entity or company becomes a nonbank financial company supervised by the Board. The Board may, by rule or order, extend this two-year period for not more than one year at a time, if, in the judgment of the Board, such an extension is consistent with the purposes of this section and would not be detrimental to the public interest. The extensions made by the Board under the preceding sentence may not exceed an aggregate of 3 years.

Section 13(c)(3) permits the Federal Reserve Board to extend the transition period for illiquid funds held by a banking entity.

Under §13(c)(5), the appropriate Federal banking agencies, the SEC and the CFTC "shall issue " rules to impose capital and other appropriate requirements on "any equity, partnership, or ownership interest in or sponsorship of a hedge fund or private equity fund by a banking entity. "

Several activities are permitted under §13(d)(1), including:

(A) The purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971…and obligations of any State or of any political subdivision thereof.

(B) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making-related activities, to the extent that any such activities permitted by this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.

(C) Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

(D) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) on behalf of customers.

(E) Investments in one or more small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958…, investments designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States…, or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

(F) The purchase, sale, acquisition, or disposition of securities and other instruments [and conditions] described in subsection (h)(4) by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company, provided that such activities by any affiliate are solely for the general account of the regulated insurance company.…

(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing [on specified conditions]…

(H) Proprietary trading conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c), provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.

(I) The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to paragraph (9) or (13) of section 4(c) solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.

(J) Such other activity as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission determine, by rule, as provided in

> subsection (b)(2), would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

Each of these permitted activities is limited by §13(d)(2)(A), which provides:

> No transaction, class of transactions, or activity may be deemed a permitted activity under paragraph (1) if the transaction, class of transactions, or activity—
>
> > (i) would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in subsection (b)(2)) between the banking entity and its clients, customers, or counterparties;
> >
> > (ii) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2));
> >
> > (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.

Section 13(d)(4) authorizes a banking entity to invest in a hedge fund or private equity fund that the bank organizes to (i) provide the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (ii) make a *de minimis* investment.

Significantly §13(d)(4)(B)(ii) requires that: “[n]ot withstanding any other provision of law, investments by a banking entity in a hedge fund or private equity fund shall—

> (I) not later than 1 year after the date of establishment of the fund, be reduced through redemption, sale or dilution to an amount that is not more than 3 percent of the total ownership interests of the fund;
>
> (II) be immaterial to the banking entity, as defined, by rule, pursuant to subsection (b)(2), but in no case may the aggregate of all the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.

Section 13(e) directs the relevant regulatory agency to adopt internal control and recordkeeping rules and to take steps to terminate any investment "in a manner that functions as an evasion of the requirements of this section. "

Section 13(f) generally prohibits banking entities that serve as an investment manager or investment adviser, or sponsors or organizes a hedge fund or other private equity fund to enter into a covered transaction as defined by §23A of the Federal Reserve Act (12 U.S.C. §371C) with the hedge fund or private equity fund.

Section 13(h)(2) defines a hedge fund or a private equity fund to coordinate with the Investment Company Act:

> The terms *hedge fund* and *private equity fund* mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940…, but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and

> Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.

Section 13(h) also defines the terms *banking entity* and *proprietary trading* , among other terms. [92]

As for the Volcker Rule itself, in January 2011, the Financial Stability Oversight Council, acting under §619 of the Dodd-Frank Act, published Study and Recommendations on Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds.

With respect to the Volcker Rule, the Council recommended to the other covered agencies the following actions:

> 1. Require banking entities to sell or wind down all impermissible proprietary trading desks.
> 2. Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness.
> 3. Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
> 4. Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
> 5. Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
> 6. Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
> 7. Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers.
> 8. Prohibit banking entities from engaging in transactions that would allow them to *bail out* a hedge fund or private equity fund.
> 9. Identify *similar funds* that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
> 10. Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds. [93]

The Study elaborated:

> In developing these rules, the study recommends that Agencies' rulemaking and implementation efforts be guided by five fundamental principles:
>
> 1. The regulations should prohibit improper proprietary trading activity using whatever combination of tools and methods are necessary to monitor and enforce compliance with the Volcker Rule.
> 2. The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate proprietary trading as new products and business practices emerge.
> 3. The regulations and supervision should be applied consistently across similar banking entities (e.g., large banks, hedge fund advisers, investment banks) and their affiliates to facilitate comparisons. The regulations and supervision should endeavor to provide banking entities with clarity about criteria for designating trading activity as impermissible proprietary trading.
> 4. The regulations and supervision should facilitate predictable valuations of outcomes so Agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity.

5. The regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary, e.g., cash and derivatives markets.…

To effectively apply and monitor these substantive tests, the Council recommends a four-part implementation and supervisory framework that would assist Agencies in identifying proprietary trading activities that must be eliminated, consisting of:

1. ***Programmatic compliance regime*** : The Council recommends that banking entities be required to develop robust internal controls and programmatic compliance regimes (that will include strong investment and risk oversight) designed to ensure that proprietary trading does not migrate into permitted activities. The compliance regime may require:
    - The establishment of internal policies and procedures to detect and eliminate proprietary trading;
    - The development and implementation of a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule policies and procedures;
    - The creation of recordkeeping and reporting systems to enable internal compliance reviews and supervisory examinations;
    - The implementation of independent testing of the compliance regime by a banking entity's internal audit department or by outside auditors, consultants or other qualified independent parties; and
    - Robust review of permitted activities to ensure that internal policies and procedures are being followed, combined with engagement by the Board of Directors and public attestation of compliance by the Chief Executive Officer (*CEO*).
2. ***Analysis and reporting of quantitative metrics*** : This study outlines four categories of metrics that banking entities could be required to analyze and report to Agencies to help identify impermissible proprietary trading, including:
    - Revenue-based metrics;
    - Revenue-to-risk metrics;
    - Inventory metrics; and
    - Customer-flow metrics.

    The use of appropriate metrics to identify possible proprietary trading should be important for management and supervisors to ensure compliance with the Volcker Rule. Although this study puts forth specific metrics that Agencies should consider for these purposes, Agencies may also consider other metrics they identify in the future.
3. ***Supervisory review and oversight*** : Agencies can engage in supervisory review and oversight of trading operations to review and test internal controls, monitor for potentially problematic trends or incidents, and investigate specific trading activity, including position-level data, where warranted.
4. ***Enforcement procedures for violations*** : If a violation is identified through the examination process, the statute requires that the activity be terminated and that the investment be liquidated. This remedy should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges, or monetary penalties. Also, it should not insulate proprietary trading from other applicable provisions of law. The statute also provides for an adjudication process, including notice and opportunity for hearing, which supervisors must develop as part of the implementation process.…

In addition to the restrictions on proprietary trading, the Volcker Rule generally prohibits banking entities from making investments in or sponsoring hedge funds or private equity funds that are

not connected to the provision of bona fide trust, fiduciary, or investment advisory services to its customers.

The purpose of this additional prohibition is to:

1. Ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule's restrictions on proprietary trading;
2. Confine the private fund activities of banking entities to customer-related services; and
3. Eliminate incentives and opportunities for banking entities to *bail out* funds that they sponsor, advise, or where they have a significant investment.

The Volcker Rule prohibits hedge fund and private equity fund sponsorship or investment by banking entities except in narrow circumstances. A banking entity is allowed to organize and offer a fund to its bona fide trust, fiduciary, and investment advisory customers. Further, banking entities are not permitted to invest in these types of funds beyond a specified *de minimis* amount in order to establish funds and attract unaffiliated investors in connection with its customer-related business.

The Volcker Rule relies on two commonly-used exclusions from the definition of the term *investment company* under section 3(c) of the Investment Company Act to define hedge funds and private equity funds. Although widely used by traditional hedge funds and private equity funds, these statutory exclusions were not designed to apply only to such funds. As such, they do not specifically address or closely relate to the activities or characteristics that are typically associated with hedge funds or private equity funds. In implementing the Volcker Rule, Agencies should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the *hedge fund* and *private equity fund* definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute.

The study makes recommendations in three areas below:

1. ***Customer requirement*** : The Volcker Rule requires that organized or sponsored funds only be offered to *customers* of a banking entity. The term *customer* is not defined in the statute. The study outlines factors that Agencies should consider in determining who is a customer and the necessary nature of that relationship.

2. ***Calculation of* de minimis *investment*** : The *de minimis* investment calculation applies both to restrict the exposure of a banking entity to 3% of any single fund and to limit the banking entity's aggregate exposure to 3% of Tier 1 capital. Agencies should consider calculating these limits in a manner that will require full accounting of the banking entity's risk and requiring ongoing monitoring of these limits through the life of the fund.

3. ***Monitoring compliance, attestation, and public reporting*** : Agencies should consider requiring banking entities to establish internal programmatic compliance regimes that will involve strong investment and risk oversight of permissible hedge fund and private equity fund activities with engagement by the Board of Directors and public attestation of the adequacy of such compliance regime by the CEO. In addition, in the limited instances in which a banking entity is permitted to invest in a hedge fund or private equity fund to facilitate customer-related business, Agencies should consider requirements for banking entities to disclose the nature and amount of any such investment. [94]

The Study relied on SEC Guidelines in developing its recommendations concerning the market making exception:

The Volcker Rule provides an explicit exception for market making-related activities but requires that they be "designed not to exceed the reasonably expected near term demands of clients, customers,

or counterparties. " To ensure that *market making* does not mask prohibited proprietary trading, Agencies should provide guidance that will assist banking entities in determining what constitutes prohibited trading activity, and will establish the basis for considering subsequent determinations as to whether a violation occurred. Accordingly, set forth below are some of the indicia of permitted market making that could be used to distinguish it from impermissible proprietary trading. To ensure full compliance with permitted activities, banking entities would likely need to change their business practices and implement comprehensive compliance programs.

The Council recommends that Agencies consider the SEC's guidance set forth in its 2008 Release, SEC Release No. 34-58775 (Oct. 14, 2008), which established indicia of bona fide market making in equity markets, including:

- Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- Making a comparable pattern of purchases and sales of a financial instrument in a manner that provides liquidity;
- Making continuous quotations that are at or near the market on both sides; and
- Providing widely accessible and broadly disseminated quotes.

In addition, the SEC has stated that, generally, market makers post quotes at a price above the national best bid and provide liquidity on the opposite side of the market. Demonstrating these indicia while conducting prohibited proprietary trading would be extremely challenging and will likely require banking entities to change their business practices on trading desks to conform to the Volcker Rule.

In its 2008 Release and a predecessor release, SEC Release No. 34-50103 (July 28, 2004), the SEC also discussed activities that would not be considered market making:

> Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception. Further, bona-fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with Rule 203(b)(1) [the short sale rule] by the other broker-dealer or customer. [95]

The Study also addressed material conflicts of interest:

> Under the Volcker Rule, permitted activities are prohibited if they involve or would result in a material conflict of interest. Indeed, such conflicts of interest were among the central concerns motivating the Volcker Rule's proprietary trading prohibition, and a companion provision, section 621 of the Dodd-Frank Act, which calls for SEC rulemaking on certain material conflicts of interest of the underwriter, placement agent, initial purchaser, or sponsor of an asset-backed securities transaction. In particular, there was concern that banking entities could actively trade against the positions of their customers, or could profit from betting against financial instruments the firm had assembled and sold to customers.

> Proprietary trading presents potentially serious conflicts of interest between a firm's activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer's order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer's portfolio of securities.
>
> Additionally, the combination of banking and trading may present particular conflicts of interest. Most notably, commercial banking operations acquire substantial amounts of nonpublic information about the financial condition of the companies to which they lend. Moreover, banking entities frequently advise corporate customers on debt and equity transactions and other corporate activities through which they accumulate nonpublic information. If information is transmitted from the lending and advising units of banking entities to trading operations, trading desks could use this inside information to make profitable trades, thus creating material distortions in the capital markets at customers' expense. Although firms instituted information barriers designed to prevent information flow between customer-serving activities and proprietary trading desks, the statute goes further with respect to banking entities and imposes a prohibition on proprietary trading.
>
> In imposing a prohibition on proprietary trading, the Volcker Rule directly cuts off a banking entity's opportunity to profit from conflicted proprietary trading, thereby protecting customers from financial injury arising from such conflicts. In implementing the Volcker Rule, Agencies should consider the extent to which the permitted activities present risks that banking entities will conduct transactions that place the banking entity's own interests ahead of its obligations to its customers and counterparties, and where such conflicts might arise, and what steps can be designed to prevent the banking entity from proceeding with the transaction in a manner contrary to those obligations.
>
> Agencies should consider all types of transactions, structures and roles in connection with permitted activities that pose a heightened risk for material conflicts of interest, including cases when the banking entity has a customer's business in two different areas and the transaction could adversely affect the customer or when the banking entity holds an informational advantage over its customers and positions itself to benefit financially from transactions that are financially harmful to customers. Agencies should also consider situations where the financial incentives associated with a banking entity's relationship with one customer might create circumstances under which particular benefits might accrue to the bank as a result of treating another customer less favorably. Agencies should also consider whether particular attention needs to be paid to situations when different departments or units have differing interests and incentives with respect to a customer. [96]

In addition, the Study addressed restrictions on bank investment in hedge funds and private equity funds:

> The recommendations set out in this study regarding investments in or sponsorship of hedge funds and private equity funds are advanced on the basis of three principles for implementation:
>
> > 1. Significant limits should be placed on the ability of banking entities to invest in hedge funds and private equity funds in order to reduce the risks banking entities face.
> >
> > 2. A banking entity is permitted to organize and offer, or invest in, a hedge fund or private equity fund in connection with the provision of bona fide trust, fiduciary or investment advisory services to its customers.

> 3. The relationships between banking entities and the hedge funds and private equity funds they organize and offer should not allow those funds to be used to circumvent the prohibition on proprietary trading.…

The Volcker Rule permits banking entities to take or retain a 3% or lower *de minimis* investment in a hedge fund or private equity fund that such entity organizes and offers, subject to certain conditions and limits. The amount of any *de minimis* investment should be *immaterial* to the bank and, in any case, at most represent up to 3% of each fund following an initial one-year *seeding* period during which banks can provide up to 100% of the capital of the fund.

Additionally, in no case can the aggregate of all of the interests of the banking entity in all such funds exceed 3% of the Tier 1 capital of the banking entity.

In addition, given the need to protect against risks with respect to even permissible hedge fund and private equity fund investments within the statutory limit, the Volcker Rule effectively requires Agencies to deduct the amount of these investments from the banking entity's capital. In addition, the statute requires that the deduction be increased commensurate with the leverage of the fund.

In providing a *de minimis* allowance for investments in hedge funds and private equity funds, the Volcker Rule permits banking entities to make certain limited investments in hedge funds and private equity funds while avoiding material conflicts of interest and any incentive or opportunity to *bail out* such funds. The proper implementation and enforcement of the Volcker Rule, which among other things seeks to align a banking entity's investments in a hedge fund or private equity fund with the interest of its customers, requires that the *de minimis* exemptions be connected to customer-related activities.

Because the Volcker Rule permits *de minimis* investments in hedge funds and private equity funds, Agencies should be careful to ensure that the statutory restrictions be carefully defined to ensure that these exceptions do not place banking entities at undue risk or provide loopholes for proprietary trading or other prohibited transactions. Agencies should consider rules that will:

- ***Avoid understating risk*** : Agencies should consider defining *investment* in a manner that will best capture the banking entity's true risk exposure.
    - *Invested vs. Committed:* In most private equity fund structures, investors commit to provide a certain amount of cash, which is called over time as the fund executes investments. Some commenters suggested that only the actual cash invested, rather than the commitment, should be counted in the 3% limit. Other observers argued that the cash commitment is a better measure of a banking entity's exposure, and therefore should be the amount included in the *de minimis* calculation.
    - *Carried interest:* Agencies should consider the proper treatment of carried interest for purposes of the *de minimis* calculation, including whether carried interest that remains in the fund, at the election of the party to whom it is allocated, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned.
    - *Synthetic Ownership Exposure:* Agencies should consider implementing the 3% *de minimis* investment and seed fund exceptions to prevent banking entities from subverting the intent of the legislation by structuring arrangements that technically comply with the 3% ownership limit while allowing banking entities to retain a synthetic or other interest in a fund, effectively exposing the banking entity to the risks and benefits of ownership otherwise prohibited under the Volcker Rule.
    - *Employee interests:* Agencies should consider whether investments by directors and employees engaged in providing services to the fund, together with other

> investors who may be affiliated with the bank (such as non-ERISA qualified employee deferred compensation plans) should be included in the 3% cap on a banking entity's investment in a hedge fund or private equity fund. [97]

In 2011 the Commission, Comptroller of the Currency, Federal Reserve Board, and FDIC jointly proposed for comment a complex rule to implement §619. [98] The proposal Release explained generally:

> In formulating the proposed rule, the Agencies have attempted to reflect the structure of section 13 of the BHC Act, which is to prohibit a banking entity from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting such entities to continue to provide client-oriented financial services. However, the delineation of what constitutes a prohibited or permitted activity under section 13 of the BHC Act often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice. The Agencies appreciate that while it is crucial that rules under section 13 of the BHC Act clearly define and implement its requirements, any rule must also preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 expressly protects and permits. These client-oriented financial services, which include underwriting, market making, and traditional asset management services, are important to the U.S. financial markets and the participants in those markets, and the Agencies have endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions.…
>
> In light of these larger challenges and goals, the Agencies' proposal takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the proposed rule includes a framework that: (i) clearly describes the key characteristics of both prohibited and permitted activities; (ii) requires banking entities to establish a comprehensive programmatic compliance regime designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the unique nature of a banking entity's businesses; and (iii) with respect to proprietary trading, requires certain banking entities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities.

In October 2013 the SEC, Office of the Comptroller of the Currency, FDIC, and Federal Reserve Board adopted final rules to implement the Volcker Rule, §13 of the Banking Holding Company (*BHC*) Act as added by §619 of the Dodd-Frank Act. [99]

The final Volcker Rule was highly controversial, generating more than 18,000 comment letters, and ultimately the Rules were significantly revised. At the SEC, the new rules were adopted by a 3-2 vote, reflecting the fact that many, not just those dissenting from the final rule, questioned the need for the Volcker Rule and whether any claimed benefits would in fact exceed the costs. Since its inception, the Volcker Rule has been subject to serious criticism as imposing undue costs, burdens, and uncertainty that can undercut the efficient and effective functioning of the financial system.

The core prohibition in §3(a) was virtually unchanged from the proposal: "Except as otherwise provided in this subpart, a banking entity may not engage in proprietary trading. *Proprietary trading* means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments. " But the 954-page adoption Release highlighted numerous changes from the earlier proposed Rules.

Section 3(b) of the proposal defined *trading account* :

> (1) *Trading account* means any account that is used by a banking entity to:
>
> > (i) Purchase or sell one or more financial instruments principally for the purpose of:
> >
> > > (A) Short-term resale;
> > >
> > > (B) Benefitting from actual or expected short-term price movements;
> > >
> > > (C) Realizing short-term arbitrage profits; or
> > >
> > > (D) Hedging one or more positions resulting from the purchases or sales of financial instruments described in paragraphs (b)(1)(i)(A), (B), or (C) of this section;
> >
> > (ii) Purchase or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule; or
> >
> > (iii) Purchase or sell one or more financial instruments for any purpose, if the banking entity:
> >
> > > (A) Is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or
> > >
> > > (B) Is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.
>
> (2) *Rebuttable presumption for certain purchases and sales* . The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section.

The definition of *trading account* was modified. The final Rule includes the proposed Rule approach to short-term, market risk rule and dealer trading accounts. The Agencies believed this approach was consistent "with both the language and intent of section 13 of the BHC Act. " [100]

The final Rule also included the proposed Rule's rebuttable presumption to determine when a covered financial position, by reason of its holding period is held with short term intent for purposes of the short term trading

account. In the final Rule, the Agencies found that 60 days is an appropriate cutoff for this presumption. [101] The adoption Release explained:

> The final rule provides three clarifying changes to the proposed rebuttable presumption. First, in response to comments, the final rule replaces the reference to an *account* that is presumed to be a trading account with the purchase or sale of a *financial instrument* . This change clarifies that the presumption only applies to the purchase or sale of a financial instrument that is held for fewer than 60 days, and not the entire account that is used to make the purchase or sale. Second, the final rule clarifies that basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk), are subject to the rebuttable presumption. Third, in order to maintain consistency with definitions used throughout the final rule, the references to *acquire* or *take* a financial position have been replaced with references to *purchase* or *sell* a financial instrument. [102]

Section 3(c)(1) defines *financial instrument* to mean:

> (i) A security, including an option on a security;
>
> (ii) A derivative, including an option on a derivative; or
>
> (iii) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.
>
> (2) A financial instrument does not include:
>
> (i) A loan;
>
> (ii) A commodity that is not:
>
> (A) An excluded commodity (other than foreign exchange or currency);
>
> (B) A derivative;
>
> (C) A contract of sale of a commodity for future delivery; or
>
> (D) An option on a contract of sale of a commodity for future delivery; or
>
> (iii) Foreign exchange or currency.

Section 3(d) provided nine exclusions from the definition of *proprietary trading* .

Sections 3(d)(1) and (2) exclude repurchase and reverse repurchase agreements and securities lending agreements. "To avoid evasion of the rule,…only the transactions pursuant to the repurchase agreement reverse repurchase agreement, or securities lending agreement are excluded. " [103]

Section 3(d)(3) as adopted modified the *liquidity management plan* exclusion:

> First, the liquidity management plan of the banking entity must be limited to securities (in keeping with the liquidity management requirements proposed by the Federal banking agencies) and specifically contemplate and authorize the particular securities to be used for liquidity management purposes; describe the amount, types, and risks of securities that are consistent with the entity's liquidity management; and the liquidity circumstances in which the particular securities may or must be used. Second, any purchase or sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-

> term arbitrage profits, or hedging a position taken for such short-term purposes. Third, the plan must require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to instruments the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements. Fourth, the plan must limit any securities purchased or sold for liquidity management purposes to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan. Fifth, the banking entity must incorporate into its compliance program internal controls, analysis and independent testing designed to ensure that activities undertaken for liquidity management purposes are conducted in accordance with the requirements of the final rule and the entity's liquidity management plan. Finally, the plan must be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Agency responsible for regulating the banking entity. [104]

The purpose of this exclusion is to ensure "that the banking entity has sufficient, readily-marketable assets available to meet its expected near-term liquidity needs. " [105] However:

> [t]he exclusion as adopted does not apply to activities undertaken with the stated purpose or effect of hedging aggregate risks incurred by the banking entity or its affiliates related to asset-liability mismatches or other general market risks to which the entity or affiliates may be exposed. Further, the exclusion does not apply to any trading activities that expose banking entities to substantial risk from fluctuations in market values, unrelated to the management of near-term funding needs, regardless of the stated purpose of the activities.

Section 3(d)(4) retained the exclusion for purchases and sales of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with its clearing activities, with two modifications:

> First, the final rule applies the exclusion to the purchase and sale of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with clearing financial instrument transactions. Second, in response to comments, the exclusion in the final rule is not limited to clearing agencies or derivatives clearing organizations that are subject to SEC or CFTC registration requirements and, instead, certain foreign clearing agencies and foreign derivatives clearing organizations will be permitted to rely on the exclusion if they are banking entities. [106]

Section 3(d)(6) provides that a purchase or sale of a financial instrument by a banking entity to satisfy an existing delivery obligation of the banking entity to its customers including a purchase or sale to prevent or close out a failure to deliver in connection with delivery, clearing or settlement activity is not proprietary activity, or a purchase or sale to satisfy an obligation of the banking entity in connection with a judicial, administrative, SRO, or arbitration proceeding. [107]

Section 3(d)(7) excludes "any purchase or sale of one or more financial instruments by a banking entity acting solely as agent, broker or custodian. " The final Rule was "modified to include activity solely as agent, broker, or custodian on behalf of an affiliate.…To the extent a banking entity acts in both a principal and agency capacity for a purchase or sale, it may only use this exclusion for the portion of the purchase or sale for which it is acting

as agent. The banking entity must use a separate exemption or exclusion, if applicable, to the extent it is acting in a principal capacity. " [108]

Section 3(d)(8) establishing an exclusion for a deferred compensation, stock bonus, profit sharing or pension plan of the banking entity "that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity " was broadened:

> While the proposed rule provided that the prohibition on covered fund activities and investments did not apply to certain instances where the banking entity acted through or on behalf of a pension or similar deferred compensation plan, no such similar treatment was given for proprietary trading.…
>
> … The Agencies believe that purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute.
>
> The Agencies note that if a banking entity engages in trading activity for an unaffiliated pension or similar deferred compensation plan, the trading activity of the banking entity would not be proprietary trading under the final rule to the extent the banking entity was acting solely as agent, broker, or custodian. [109]

Section 3(d)(9) excludes collecting and disposing of collateral in satisfaction of previously contracted debt from the definition of *proprietary trading* :

> The Agencies believe an exclusion for purchases and sales in satisfaction of debts previously contracted is necessary for banking entities to continue to lend to customers, because it allows banking entities to continue lending activity with the knowledge that they will not be penalized for recouping losses should a customer default.
>
> …
>
> As a result of this exclusion, banking entities, including SEC-registered broker-dealers, will be able to continue providing margin loans to their customers and may take possession of margined collateral following a customer's default or failure to meet a margin call under applicable regulatory requirements.

Section 4, the underwriting and market making exemptions, also was substantially revised from the proposal. The final Rule emphasizes the flexibility to recognize differences in underwriting activities across markets and asset classes. [110]

Section 4(a)(1) addresses permitted underwriting activities and exempts a banking entity's underwriting activities conducted in accordance with §4(a) from the proprietary trading prohibition in §3(d).

Section 4(a)(2) delineates five requirements that are required to satisfy §4(a)(1):

> The underwriting activities of a banking entity are permitted under paragraph (a)(1) of this section only if:
>
> (i) The banking entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution;
>
> (ii) The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and

reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (a) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

(B) Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:

(*1*) Amount, types, and risk of its underwriting position;

(*2*) Level of exposures to relevant risk factors arising from its underwriting position; and

(*3*) Period of time a security may be held;

(C) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(D) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval;

(iv) The compensation arrangements of persons performing the activities described in paragraph (a) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(v) The banking entity is licensed or registered to engage in the activity described in paragraph (a) of this section in accordance with applicable law.

The adoption Release explained about §4(a):

Importantly, for purposes of establishing an underwriting position in reliance on the underwriting exemption, a trading desk may only engage in activities that are related to a particular distribution of securities for which the banking entity is acting as an underwriter. Activities that may be permitted under the underwriting exemption include stabilization activities, syndicate shorting and aftermarket short covering, holding an unsold allotment when market conditions may make it impractical to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so, and helping the issuer mitigate its risk exposure arising from the distribution of its securities (*e.g* ., entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders). [111]

With respect to §4(a)(2)(ii), the adoption Release clarified with respect to unsold allotments:

> Under this requirement, a trading desk must have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution. Such reasonable expectation may be based on factors such as current market conditions and prior experience with similar offerings of securities.… [112]

The general requirement to make reasonable efforts to sell or reduce the underwriting position applies to the entirety of the trading desk's underwriting position. [113]

Compensation arrangements are consistent with §4(a)(2)(iv) when "[a] banking entity [takes] into account revenues resulting from movements in the price of securities that the banking entity underwriters to the extent that such revenues reflect the effectiveness with which personnel have management underwriting risk. The banking entity should provide compensation incentives that primarily reward client revenues and effective client services, not prohibited proprietary trading. For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the underwriting exemption. " [114]

Section 4(a)(2)(v) has different implications for domestic and international banking entities:

> … [T]his provision will require a U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.
>
> …
>
> The Agencies have determined that, for purposes of the underwriting exemption, rather than require a banking entity engaged in the business of a securities dealer outside the United States to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration provisions if required under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). In response to comments, the final rule recognizes that certain foreign jurisdictions may not provide for substantive regulation of dealing businesses. The Agencies do not believe it is necessary to preclude banking entities from engaging in underwriting activities in such foreign jurisdictions to achieve the goals of section 13 of the BHC Act because these banking entities would continue to be subject to other requirements of the underwriting exemption. [115]

The proposed definition of *distribution* is based on the definition of that term in Regulation M.

Section 4(a)(3) provides:

> For purposes of paragraph (a) of this section, a *distribution* of securities means:
>
> (i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

The adoption Release explained:

> This requirement is substantially similar to the proposed rule, but with five key refinements. First, to address commenters' confusion about whether the underwriting exemption applies on a transaction-by-transaction basis, the phrase *purchase or sale* has been modified to instead refer to the trading desk's *underwriting position* . Second, to balance this more aggregated position-based approach, the final rule specifies that the trading desk is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed. Third, the Agencies have made important modifications to the definition of *distribution* to better capture the various types of private and registered offerings a banking entity may be asked to underwrite by an issuer or selling security holder. Fourth, the definition of *underwriter* has been refined to clarify that both members of the underwriting syndicate and selling group members may qualify as underwriters for purposes of this exemption. Finally, the word *solely* has been removed to clarify that a broader scope of activities conducted in connection with underwriting (*e.g.* , stabilization activities) are permitted under this exemption. [116]

The term *distribution* also removed an earlier requirement to consider the magnitude of an offering. "After considering comments, the Agencies have determined that the requirement to have special selling efforts and selling methods is sufficient to distinguish between permissible securities offerings and prohibited proprietary trading, and the additional magnitude factor is not needed to further this objective. As proposed, the Agencies will rely on the same factors considered under Regulation M to analyze the presence of special selling efforts and selling methods. " [117]

Section 4(a)(4) defines *underwriter* to mean:

> (i) A person who has agreed with an issuer or selling security holder to:
>
> > (A) Purchase securities from the issuer or selling security holder for distribution;
> >
> > (B) Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or
> >
> > (C) Manage a distribution of securities for or on behalf of the issuer or selling security holder; or
>
> (ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

The adoption Release explained:

> … [E]ngaging in the following activities may indicate that a banking entity is acting as an underwriter under [§4(a)(4)] as part of a distribution of securities:
>
> - Assisting an issuer in capital-raising;
> - Performing due diligence;

- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery. [118]

Separately the term *issuer* is defined consistent with §2(a)(4) of the Securities Act, and *selling security holder* was defined in §4(a)(5) consistent with the definition in Regulation M.

The market making exemption in §4(b) is reticulate:

(1) *Permitted market making-related activities* . The prohibition contained in [§3(a)] does not apply to a banking entity's market making-related activities conducted in accordance with paragraph (b) of this section.

(2) *Requirements* . The market making-related activities of a banking entity are permitted under paragraph (b)(1) of this section only if:

(i) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(ii) The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on:

(A) The liquidity, maturity, and depth of the market for the relevant types of financial instrument(s); and

(B) Demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section;

(B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

(C) Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by paragraph (b)(2)(ii) of this section, on:

(*1*) The amount, types, and risks of its market-maker inventory;

(*2*) The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;

(*3*) The level of exposures to relevant risk factors arising from its financial exposure; and

(*4*) The period of time a financial instrument may be held;

(D) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(E) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of paragraph (b) of this section, and independent review of such demonstrable analysis and approval;

(iv) To the extent that any limit identified pursuant to paragraph (b)(2)(iii)(C) of this section is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;

(v) The compensation arrangements of persons performing the activities described in paragraph (b) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(vi) The banking entity is licensed or registered to engage in activity described in paragraph (b) of this section in accordance with applicable law.

Section 4(b) was substantially modified from the earlier proposal. The adoption Release explained:

> Based on the many detailed comments provided, the Agencies have made substantive refinements to the market-making exemption that the Agencies believe will reduce the likelihood that the rule, as implemented, will negatively impact the ability of banking entities to engage in the types of market

making-related activities permitted under the statute and, therefore, will continue to promote the benefits to investors and other market participants described above, including greater market liquidity, narrower bid-ask spreads, reduced price concessions and price impact, lower volatility, and reduced counterparty search costs, thus reducing the cost of capital. For instance, the final market-making exemption does not require a trade-by-trade analysis, which was a significant source of concern from commenters who represented, among other things, that a trade-by-trade analysis could have a chilling effect on individual traders' willingness to engage in market-making activities. Rather, the final rule has been crafted around the overall market making-related activities of individual trading desks, with various requirements that these activities be demonstrably related to satisfying reasonably expected near term customer demands and other market-making activities. The Agencies believe that applying certain requirements to the aggregate risk exposure of a trading desk, along with the requirement to establish risk and inventory limits to routinize a trading desk's compliance with the near term customer demand requirement, will reduce negative potential impacts on individual traders' decision-making process in the normal course of market making. In addition, in response to a large number of comments expressing concern that the proposed market-making exemption would restrict or prohibit market making-related activities in less liquid markets, the Agencies are clarifying that the application of certain requirements in the final rule, such as the frequency of required quoting and the near term demand requirement, will account for the liquidity, maturity, and depth of the market for a given type of financial instruments. Thus, banking entities will be able to continue to engage in market making-related activities across markets and asset classes. [119]

In §4(b) the term *trading desk* means:

the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed. The geographic location of individual traders is not dispositive for purposes of the analysis of whether the traders may comprise a single trading desk. For instance, a trading desk making markets in U.S. investment grade telecom corporate credits may use trading personnel in both New York (to trade U.S. dollar-denominated bonds issued by U.S.-incorporated telecom companies) and London (to trade Euro-denominated bonds issued by the same type of companies). This approach allows more effective management of risks of trading activity by requiring the establishment of limits, management oversight, and accountability at the level where trading activity actually occurs. It also allows banking entities to tailor the limits and procedures to the type of instruments traded and markets served by each trading desk.…

… [A] trading desk may manage a financial exposure that includes positions in different affiliated legal entities. Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. Using the previous example, the U.S. investment grade telecom corporate credit trading desk may include traders working for or booking into a broker-dealer entity (for corporate bond trades), a security-based swap dealer entity (for single-name CDS trades), and/or a swap dealer entity (for index CDS or interest rate swap hedges). To clarify this issue, the definition of *trading desk* specifically provides that the desk can buy or sell financial instruments "for the trading account of a banking entity or an affiliate thereof. " Thus, a trading desk need not be constrained to a single legal entity, although it is permissible for a trading desk to only trade for a single legal entity. A trading desk booking positions in different affiliated legal entities must have records that identify all positions included in the trading desk's financial exposure and where such positions are held, as discussed below. [120]

The adoption Release amplified the meaning of several terms in §4(b). Under §4(b)(2)(i):

> [T]he standard of *routinely* standing ready to purchase and sell one or more types of financial instruments will be interpreted to account for differences across markets and asset classes. In addition, this requirement provides that a trading desk must be willing and available to provide quotations and transact in the particular types of financial instruments in commercially reasonable amounts and throughout market cycles. Thus, a trading desk's activities would not meet the terms of the market-making exemption if, for example, the trading desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular, intermittent basis. [121]

The adoption Release elaborated on the concept of *routinely standing ready to buy or sell* with considerable precision:

> For instance, a trading desk that is a market maker in liquid equity securities generally should engage in very regular or continuous quoting and trading activities on both sides of the market. In less liquid markets, a trading desk should engage in regular quoting activity across the relevant type(s) of financial instruments, although such quoting may be less frequent than in liquid equity markets. Consistent with the CFTC's and SEC's interpretation of market making in swaps and security-based swaps for purposes of the definitions of *swap dealer* and *security-based swap dealer* , *routinely* in the swap market context means that the trading desk should stand ready to enter into swaps or security-based swaps at the request or demand of a counterparty more frequently than occasionally. The Agencies note that a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or it may routinely stand ready to enter into derivatives on either side of the market and then enter into one or more offsetting positions in the derivatives market or another market, particularly in the case of relatively less liquid derivatives. While a trading desk may respond to requests to trade certain products, such as custom swaps, even if it does not normally quote in the particular product, the trading desk should hedge against the resulting exposure in accordance with its financial exposure and hedging limits. Further, the Agencies continue to recognize that market makers in highly illiquid markets may trade only intermittently or at the request of particular customers, which is sometimes referred to as trading by appointment. A trading desk's block positioning activity would also meet the terms of this requirement provided that, from time to time, the desk engages in block trades (*i.e* ., trades of a large quantity or with a high dollar value) with customers. [122]

The market making activity is evaluated both in terms of *market making inventory* and overall *financial exposure* .

Section 4(b)(5) defines *market making inventory* to mean "all of the positions in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section, that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions. "

The covered financial instruments must be identified in the trading desk's compliance program under §4(b)(2)(iii)(A). Consistent with the *supplementary information* to the Rule, the term *inventory* means "both the retention of financial instruments (*e.g.* , securities) and, in the context of derivative trading, the risk exposures arising out of market-making related activities. " [123] Under §4(b)(2)(ii), "the market-making inventory of a trading desk [are

required to] be designed not to exceed on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties."

Under §4(b)(4), *financial exposure* is defined to mean "the aggregate risks of one or more financial instruments and any associates loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities. "

The concept of *financial exposure* :

> is broader in scope than market-maker inventory and reflects the aggregate risks of the financial instruments (as well as any associated loans, spot commodities, or spot foreign exchange or currency) the trading desk manages as part of its market making-related activities. Thus, a trading desk's financial exposure will take into account a trading desk's positions in instruments for which it does not act as a market maker, but which are established as part of its market making-related activities, which includes risk mitigation and hedging. For instance, a trading desk that acts as a market maker in Euro-denominated corporate bonds may, in addition to Euro-denominated bonds, enter into credit default swap transactions on individual European corporate bond issuers or an index of European corporate bond issuers in order to hedge its exposure arising from its corporate bond inventory, in accordance with its documented hedging policies and procedures. Though only the corporate bonds would be considered as part of the trading desk's market-maker inventory, its overall financial exposure would also include the credit default swaps used for hedging purposes. [124]

Under the definition in §4(b)(4):

> … the term aggregate does not imply that a long exposure in one instrument can be combined with a short exposure in a similar or related instrument to yield a total exposure of zero. Instead, such a combination may reduce a trading desk's economic exposure to certain risk factors that are common to both instruments, but it would still retain any basis risk between those financial instruments or potentially generate a new risk exposure in the case of purposeful hedging.
>
> With respect to the frequency with which a trading desk should determine its financial exposure and the amount, types, and risks of the financial instruments in its market-maker inventory, a trading desk's financial exposure and market-maker inventory should be evaluated and monitored at a frequency that is appropriate for the trading desk's trading strategies and the characteristics of the financial instruments the desk trades, including historical intraday volatility.… [125]

The use of the word *types* of financial instruments in §4(b)(2)(i) also must be related to a trading desk's "authorized market-making inventory and its authorized financial exposure ":

> Thus, the types of financial instruments for which the desk routinely stands ready to buy and sell should compose a significant portion of its overall financial exposure. The only other financial instruments contributing to the trading desk's overall financial exposure should be those designed to hedge or mitigate the risk of the financial instruments for which the trading desk is making a market. It would not be consistent with the market-making exemption for a trading desk to hold only positions in, or be exposed to, financial instruments for which the trading desk is not a market maker.
>
> A trading desk's routine presence in the market for a particular type of financial instrument would not, on its own, be sufficient grounds for relying on the market-making exemption. This is because the

> frequency at which a trading desk is active in a particular market would not, on its own, distinguish between permitted market making-related activity and impermissible proprietary trading. [126]

In §4(b)(2)(i) commercially reasonable amounts means that a trading desk "generally must be willing to quote and trade in sizes requested by other market participants. " [127]

Under §4(b)(2)(ii), the concept of *near term demands of customers* :

> focuses on a trading desk's positions in financial instruments for which it acts as market maker. These positions of a trading desk are more directly related to the demands of customers than positions in financial instruments used for risk management purposes, but in which the trading desk does not make a market.… [A] position or exposure that is included in a trading desk's market-maker inventory will remain in its market-maker inventory for as long as the position or exposure is managed by the trading desk. As a result, the trading desk must continue to account for that position or exposure, together with other positions and exposures in its market-maker inventory, in determining whether the amount, types, and risks of its market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.
>
> While the near term customer demand requirement directly applies only to the trading desk's market-maker inventory, this does not mean a trading desk may establish other positions, outside its market-maker inventory, that exceed what is needed to manage the risks of the trading desk's market making-related activities and inventory. Instead, a trading desk must have limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its aggregate financial exposure that are based on the factors set forth in the near term customer demand requirement, as well as other relevant considerations regarding the nature and amount of the trading desk's market making-related activities. A banking entity must establish, implement, maintain, and enforce a limit structure, as well as other compliance program elements (*e.g* ., those specifying the instruments a trading desk trades as a market maker or may use for risk management purposes and providing for specific risk management procedures), for each trading desk that are designed to prevent the trading desk from engaging in trading activity that is unrelated to making a market in a particular type of financial instrument or managing the risks associated with making a market in that type of financial instrument. [128]

Sections 4(b)(2)(ii)(A)–(B) employ two factors to assess compliance with this standard: (A) liquidity, maturity and depth of the market for the relevant type of financial instrument; and (B) demonstrable analysis of historical customer demand, current inventory and market and other factors for financial instruments in which the trading desk makes a market:

> For purposes of this provision, *demonstrable analysis* means that the analysis for determining the amount, types, and risks of financial instruments a trading desk may manage in its market-maker inventory, in accordance with the near term demand requirement, must be based on factors that can be demonstrated in a way that makes the analysis reviewable. This may include, among other things, the normal trading records of the trading desk and market information that is readily available and retrievable. If the analysis cannot be supported by the banking entity's books and records and available market data, on their own, then the other factors utilized must be identified and documented and the analysis of those factors together with the facts gathered from the trading and market records must be identified in a way that makes it possible to test the analysis. [129]

A banking entity is not required to conduct the demonstrable analysis under §4(b)(2)(B) on an instrument-by-instrument basis. [130]

Section 4(b)(3) defines the terms *client* , *customer* , and *counterparty* :

> For purposes of paragraph (b) of this section, the terms *client, customer* and *counterparty* , on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that:
>
> (i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with [§20(d)(1)] of subpart D, unless:
>
> > (A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of paragraph (b)(2) of this section; or
> >
> > (B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

The adoption Release explained with respect to these definitions:

> [F]or purposes of the analysis supporting the market-maker inventory held to meet the reasonably expected near-term demands of clients, customer and counterparties, a client, customer, or counterparty of the trading desk does not include a trading desk or other organizational unit of another entity if that entity has $50 billion or more in total trading assets and liabilities, measured in accordance with [§20(d)(1)] unless the trading desk documents how and why such trading desk or other organizational unit should be treated as a customer or the transactions are conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants. [131]

The final Rule does not prohibit a trading desk from relying on the market-making exemption to engage in interdealer trading related to facilitating permissible trading with a trading desk's clients, customers or counterparties. [132]

A trading desk, however, would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage or other trading that is not in response to client, customer or counterparty demands. [133] This point is nuanced:

> For example, a trading desk would not be permitted to engage in general statistical arbitrage trading between instruments that have some degree of correlation but where neither instrument has the capability of being exchanged, converted, or exercised for or into the other instrument. A trading desk may, however, act as market maker to a customer engaged in a statistical arbitrage trading strategy. Furthermore as suggested by some commenters, trading activity used by a market maker to maintain a price relationship that is expected and relied upon by clients, customers, and counterparties

> is permitted as it is related to the demands of clients, customers, or counterparties because the relevant instrument has the capability of being exchanged, converted, or exercised for or into another instrument. [134]

Section 4(b)(2)(iii) requires each banking entity to establish an appropriate risk management framework for each trading desk relying on the §4(b) market making exemption consistent with Subpart D of the Volcker Rule:

> This includes not only the techniques and strategies that a trading desk may use to manage its risk exposures, but also the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposures consistent with its required limits, which are discussed in more detail below. While the Agencies do not expect a trading desk to hedge all of the risks that arise from its market making-related activities, the Agencies do expect each trading desk to take appropriate steps consistent with market-making activities to contain and limit risk exposures (such as by unwinding unneeded positions) and to follow reasonable procedures to monitor the trading desk's risk exposures (*i.e* ., its financial exposure) and hedge risks of its financial exposure to remain within its relevant risk limits. [135]

The adoption Release further stated:

> To control and limit the amount and types of financial instruments and risks that a trading desk may hold in connection with its market making-related activities, a banking entity must establish, implement, maintain, and enforce reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing specific limits on a trading desk's market-maker inventory, risk management positions, and financial exposure. In particular, the compliance program must establish limits for each trading desk, based on the nature and amount of its market making-related activities (including the factors prescribed by the near term customer demand requirement), on the amount, types, and risks of its market-maker inventory, the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes, the level of exposures to relevant risk factors arising from its financial exposure, and the period of time a financial instrument may be held. The limits would be set, as appropriate, and supported by an analysis for specific types of financial instruments, levels of risk, and duration of holdings, which would also be required by the compliance appendix. [136]

Section 5 permits risk-mitigation hedging activities. The final Rule characterized this as a "multi-faceted approach " and contains several modifications to the proposed Rule.

Section 5(a) provides an exemption for specified risk-mitigating hedging activities that satisfy the requirements of §5(b) and the documentation requirement of §5(c).

Section 5(b)(1) establishes a requirement for an internal compliance program consistent with Subpart D similar to that in §4. Section 5(b)(1)(iii) requires that a hedge could be correlated "(negatively, when sign is considered) " to the risk being hedged:

> However, the Agencies recognize that some effective hedging activities, such as deep out-of-the-money puts and calls, may not…exhibit a strong linear correlation to the risks being hedged and also that correlation over a period of time between two financial positions does not necessarily mean one position will in fact reduce or mitigate a risk of the other. Rather, the Agencies expect the banking

> entity to undertake a correlation analysis that will, in many but not all instances, provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce. It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods. Rather, the nature and extent of the correlation analysis undertaken would be dependent on the facts and circumstances of the hedge and the underlying risks targeted. If correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation. [137]

Hedging may occur across affiliates under the hedging exemption. [138]

Under §5(b)(2)(ii) "at its inception " or when any adjustment is made to a hedging activity the banking entity must be able to demonstrate a correlation between a hedge and a specific identifiable risk that the hedge is designed to significantly reduce or significantly mitigate, "including market risk,…commodity price risk, basis risk, or similar risks. "

Risk-mitigating hedging activities may relate either to individual or aggregated positions; hedging activity may arise from identified positions of one or more trading desks as long as they are demonstrable. [139] The adoption Release paraphrases §5(b)(2)(iv):

> Specifically, the final rule requires, among other things: that the banking entity has a robust compliance program reasonably designed to ensure compliance with the exemption; that each hedge is subject to continuing review, monitoring and management designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time related to the hedging activity and the underlying positions, contracts, or other holdings of the banking entity; and that the banking entity meet a documentation requirement for hedges not established by the trading desk responsible for the underlying position or for hedges effected through a financial instrument, technique or strategy that is not specifically identified in the trading desk's written policies and procedures. The Agencies believe this approach addresses concerns that a banking entity could use the hedging exemption to conduct proprietary activity at one desk as a theoretical hedge for proprietary trading at another desk in a manner consistent with the statute. Further, the Agencies believe the adopted exemption allows banking entities to engage in hedging of aggregated positions while helping to ensure that such hedging activities are truly risk-mitigating. [140]

The final Rule, like the proposal, is intended to permit dynamic hedging. [141]

The final Rule does not prohibit anticipatory hedging and goes further than the proposed Rule in eliminating the requirement that the hedge be established "slightly " before the banking entity is exposed to the underlying risk. [142]

As with §4, §5(b)(3) prohibits "compensation arrangements of persons performing risk-mitigating hedging activities " when they are designed to reward or incentivize prohibited proprietary trading. [143]

Section 5(c) substantially retains the proposed requirement for enhanced documentation for hedging activity under the §5 hedging exemption:

> The final rule clarifies that a banking entity must prepare enhanced documentation if a trading desk establishes a hedging position and is not the trading desk that established the underlying positions,

> contracts, or other holdings. The final rule also requires enhanced documentation for hedges established to hedge aggregated positions across two or more desks.…
>
> The final rule adds to the proposal by requiring enhanced documentation for hedges established by the specific trading desk establishing or directly responsible for the underlying positions, contracts, or other holdings, the risks of which the purchases or sales are designed to reduce, if the hedge is effected through a financial instrument, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures as a product, instrument, exposure, technique, or strategy that the trading desk may use for hedging.…
>
> … In order to reduce the burden of the documentation requirement while still giving effect to the rule's purpose, the final rule requires limited documentation for hedging activity that is subject to a documentation requirement, consisting of: (1) the specific, identifiable risk(s) of the identified positions, contracts, or other holdings that the purchase or sale is designed to reduce; (2) the specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and (3) the trading desk or other business unit that is establishing and responsible for the hedge transaction. As in the proposal, this documentation must be established contemporaneously with the hedging transaction. Documentation would be contemporaneous if it is completed reasonably promptly after a trade is executed. The banking entity is required to retain records for no less than 5 years (or such longer period as may be required under other law) in a form that allows the banking entity to promptly produce such records to the Agency on request. [144]

Section 6 is based on §13(d)(1) of the Bank Holding Company Act and exempts from the §3(a) prohibition any proprietary trading in: (a) specified domestic government obligations; and (b) foreign government obligations by (1) specified affiliates of foreign banking entities in the United States, and (2) specified foreign affiliates of a United States banking entity.

Sections 6(a) and (b) will permit proprietary trading by a covered banking entity in specified domestic and foreign government securities. [145] This exemption does not include proprietary hedging in derivatives of these government securities or multilateral development bank obligations.

Section 6(c) exempts from §3(a) trading on behalf of customers when the banking entity does not have or retains beneficial ownership of the financial instruments. [146] "The final rule, like the proposed rule, permits transactions in any financial instrument, including derivatives such as foreign exchange forwards, so long as those transactions are on behalf of customers." [147]

A banking entity may act as a riskless principal when the entity receives a purchase or sell order from a customer. [148]

Section 6(d) exempts specified trading by a regulated insurance company whether conducted through a general or separate account established by the insurance company. [149] As in the statute, "an affiliate of an insurance company may not rely on this exemption for activity in any account of the affiliate (unless it, too, meets the definition of an insurance company). An affiliate may rely on the exemption to the limited extent that the affiliate is acting solely for the account of the insurance company." [150]

Section 6(e) of the final Rule amplifies §13(d)(1)(H) of the Bank Holding Company Act and permits specified foreign banking entities to engage in proprietary trading that occurs solely outside the United States:

> The final rule specifically recognizes that, for purposes of the exemption for trading activity of a foreign banking entity, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank that operates or controls that branch,

agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.…

… [T]he final rule provides that a foreign banking entity generally may engage in trading activity under the exemption with U.S. entities, provided the transaction is with the foreign operations of an unaffiliated U.S. firm (whether or not the U.S. firm is a banking entity subject to section 13 of the BHC Act) and does not involve any personnel of the U.S. entity that are in the United States and involved in the arrangement, negotiation, or execution of the transaction. The Agencies have also exercised their exemptive authority under section 13(d)(1)(J) to allow foreign banking entities to engage in a transaction that is either through an unaffiliated market intermediary and executed anonymously on an exchange or similar trading facility (regardless of whether the ultimate counterparty is a U.S. entity or not) or is executed with a U.S. entity that is an unaffiliated market intermediary acting as principal, provided in either case that the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty. [151]

However, the adoption Release continues:

Under the final rule, the exemption in no way exempts the U.S. or foreign operations of the U.S. banking entities from having to comply with the restrictions and limitations of section 13. Thus, the U.S. and foreign operations of a U.S. banking entity that is engaged in permissible market making-related activities or other permitted activities may engage in those transactions with a foreign banking entity that is engaged in proprietary trading in accordance with the exemption under [§6(e)] of the final rule. Importantly, the final rule does *not* impose a duty on the foreign banking entity or the U.S. banking entity to ensure that its counterparty is conducting its activity in conformance with section 13 of the BHC Act and the final rule. Rather, that burden is at all times on each party subject to section 13 to ensure that it is conducting its activities in accordance with section 13 and this implementing rule.

The final rule also permits, pursuant to section 13(d)(1)(J), a foreign banking entity to trade through an unaffiliated market intermediary if the trade is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization.…

The final rule does not allow a foreign banking entity to trade with a broader range of U.S. entities under the exemption because the Agencies are concerned such an approach may result in adverse competitive impacts between U.S. banking entities and foreign banking entities with respect to their trading in the United States, which could harm the safety and soundness of banking entities and U.S. financial stability. [152]

Section 7, originally §8 of the proposed Rule, implements §13(d)(2) of the Bank Holding Company Act and provides limitations on permitted proprietary activities, specified in §7(a):

(a) No transaction, class of transactions, or activity may be deemed permissible under [§§4 through 6] if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customer, or counterparties;

> (2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
>
> (3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Section 7(b)(1) defines *material conflict of interest* to mean:

> a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

Under §7(b)(2), a transaction with a material conflict may occur if there is (i) timely and effective disclosure and (ii) an information barrier.

The information barrier concept as articulated in §7(b)(2)(ii) provides that the banking entity:

> Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty. [153]

For the purposes of §7, a *high risk asset* and *high risk trading strategy* are defined in §7(c). *High risk* means that the asset or strategy will "significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. " [154]

Covered Fund Activities are addressed in §§10–15 of Subpart C.

Under §10(a) a banking entity may not, as principal, directly or indirectly acquire any ownership interest in or sponsor a covered fund.

Section 10(b) defines the term *covered fund* to mean an investment company as defined in §§3(c)(1) and 3(c)(7) of the Investment Company Act, and specified commodity pools under §1a(10) of the Commodity Exchange Act.

The final Rule definition of covered fund combines the definitions of *hedge fund* and *private equity fund* into a single definition. This is consistent with §13(h)(2) of the Bank Holding Company Act. [155]

In §10(c), the Rule excludes from the definition of *covered fund* : (1) foreign public funds; [156] (2) wholly-owned subsidiaries; (3) joint ventures; (4) acquisition vehicles; (5) foreign pension or retirement funds; (6) insurance company separate accounts; (7) bank owned life insurance; (8) loan securitizations; (9) qualified asset-backed commercial paper conduits; (10) qualifying covered bonds; (11) SBICs and public welfare investment funds;

(12) registered investment companies and excluded entities; [157] (13) issuers in conjunction with the FDIC's receivership or conservatorship operations; and (14) other excluded issuers. [158]

The Agencies declined to exclude from the definition of *covered fund* financial market utilities, venture capital funds, credit funds, cash management vehicles, or cash collateral pools. [159]

Under §10(d)(6)(i), *ownership interest* in a covered fund means any equity, partnership or other similar interest:

> (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, as well as any derivative of such an interest. This definition focused on the attributes of the interest and whether it provided a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. [160]

An *ownership interest* does not include a *restricted profit interest* , defined in §10(d)(6)(ii) as an interest:

> held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as:
>
> (A) The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;
>
> (B) All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;
>
> (C) Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits of [§12] of this subpart; and
>
> (D) The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.

As with the proposed Rule, §§11 and 13(d)(1)(G) of the Bank Holding Company Act under §11(a) of the final Rule, a banking entity is *not* prohibited:

> from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee, or commodity pool operator of the covered fund

and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing, only if:

(1) The banking entity (or an affiliate thereof) provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(2) The covered fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;

(3) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under [§12] of this subpart;

(4) The banking entity and its affiliates comply with the requirements of [§14] of this subpart;

(5) The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(6) The covered fund, for corporate, marketing, promotional, or other purposes:

> (i) Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and
>
> (ii) Does not use the word *bank* in its name;

(7) No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

(8) The banking entity:

> (i) Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):
>
> > (A) That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate ";
> >
> > (B) That such investor should read the fund offering documents before investing in the covered fund;
> >
> > (C) That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity " (unless that happens to be the case); and

(D) The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and

(ii) Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, as provided in section 13(b)(2) of the BHC Act, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.

The adoption Release generalized:

> The final rule reflects this view in that it permits a banking entity to invest in or sponsor a covered fund in connection with organizing and offering the fund, which may involve activities that are not prohibited by section 13. Under the final rule, a banking entity that serves as an investment adviser to a covered fund (including a subadviser), for example, may permissibly invest in the covered fund to the extent the banking entity complies with the requirements of section 13(d)(1)(G) of the Act. An entity that serves only as investment adviser, without making an investment or conducting any activity covered by the prohibition in section 13(a), would not be covered by the prohibition in section 13(a) and thus would not need to rely on section 13(d)(1)(G) and [§11] of the final rule to conduct that investment advisory activity. [161]

Section 11(b) specifies that a banking entity is not prohibited from acquiring or retaining an ownership interest in an issuing entity of asset-backed securities. [162]

Section 11(c) provides that the §10(a) prohibition does not apply to a banking entity's underwriting activities or market making of a covered fund under specified conditions. [163]

Section 12 is the pivotal *covered fund* provision which, consistent with §13(d)(4) of the Bank Holding Company Act, generally limits an investment by a bank entity and its affiliates in any covered fund to no more than "3 percent of the total number or value of the outstanding ownership interests of the fund. " [164]

Under §12(a)(iii), there also is an aggregate limit of a banking entity investment in covered funds:

> The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this section may not exceed 3 percent of the tier 1 capital of the banking entity, as provided under paragraph (c) of this section, and shall be calculated as of the last day of each calendar quarter. [165]

For the purposes of determining the aggregate funds limitation, the final Rule requires that the value of investments be calculated on a historical cost basis. [166]

Tier 1 capital is a banking law concept which here is applied consistent with the banking entity's Tier 1 capital as of the last date of the most recent calendar quarter that has ended as reported to the relevant Federal banking agency. [167]

Under §12(a)(i), a banking entity may acquire and hold all the ownership interests in a covered fund for the purpose of establishing the fund and providing the fund with sufficient initial equity to permit the fund to attract unaffiliated investors. There is a seeding period of one year for covered funds. [168]

Similar to proposed §13, §13 of the final Rule provides additional exemptions from the §10(a) prohibition on banking entity ownership in a covered fund for (a) risk mitigating by a banking entity in connection with a compensation arrangement with a bank or affiliate employee that directly provides investment advisors, commodity advisors, or other services to the covered fund; (b) specified ownership interests by a foreign banking entity in a sponsorship of a covered fund when "the principal risks of covered fund investments and sponsorship by foreign bank entities permitted under the foreign funds exemption occur and remain solely outside the United States "; [169] and (c) the acquisition or retention by an insurance company or an affiliate of any ownership interest in or sponsorship of a covered fund.

Section 14 prohibits specified *covered transactions* , as defined by §23A of the Federal Reserve Act, by a banking entity that serves directly or indirectly as the investment manager, investment adviser, commodity trader, or sponsor to a covered fund under §11 of the Rule. Section 14(a)(2) authorizes a banking entity to (i) acquire or retain any ownership interest in accordance with §§11, 12, or 13 of the Rule, and (ii) enter into any prime brokerage transaction in which a covered fund managed, sponsored, or advised by a banking entity that has taken an ownership interest if:

> (A) The banking entity is in compliance with each of the limitations set forth in [§11] with respect to a covered fund organized and offered by such banking entity (or an affiliate thereof);
>
> (B) The chief executive officer (or equivalent officer) of the banking entity certifies in writing annually to [Agency] (with a duty to update the certification if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; and
>
> (C) The Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

Section 15(a) echoes earlier limitations under the Volcker Rule and makes them applicable to covered fund activities:

> (a) No transaction, class of transactions, or activity may be deemed permissible under [§§11 to 13] if the transaction, class of transactions, or activity would:
>
> > (1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
> >
> > (2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
> >
> > (3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

The Volcker Rule concludes with Compliance Program Requirements in Subpart D, §20 and Appendices A and B, and §21, which requires prompt termination of an investment by a banking entity when the bank becomes aware of a violation of §13 of the Bank Holding Company Act.

The Compliance Program requirements are tiered to the size, complexity, and type of activity conducted by the banking entity.

> Specifically, the final rule allows banking entities with total assets below $10 billion to fold compliance measures into their existing compliance program in a manner that addresses the types and amounts of activities the entity conducts.… Similar to the proposal, the final rule requires that a banking entity that conducts no activity subject to section 13 of the BHC Act is not required to develop any compliance program until it begins conducting activities subject to section 13. The final rule further modifies the proposal by requiring that a banking entity with total assets greater than $10 billion but less than $50 billion is generally required to establish a compliance program suited to its activities which includes the six elements described in the final rule. Additionally, the final rule requires that the largest and most active banking entities, with total assets above $50 billion, or that are subject to the quantitative measurements requirement due to the size of their trading assets and liabilities, adopt an enhanced compliance program that addresses the six elements described in the rule plus a number of more detailed requirements described in Appendix B. [170]

The tier requirements are delineated in §§20(c) to (f) and Appendix B.

The six core elements of the Compliance Program Requirements are outlined in §20(b):

> *Contents of compliance program* . Except as provided in paragraph (f) of this section, the compliance program required by paragraph (a) of this section, at a minimum, shall include:
>
> (1) Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities subject to subpart B (including those permitted under [§§3 to 6] of subpart B), including setting, monitoring and managing required limits set out in [§§4 and 5], and activities and investments with respect to a covered fund subject to subpart C (including those permitted under [§§11 through 14] of subpart C) conducted by the banking entity to ensure that all activities and investments conducted by the banking entity that are subject to section 13 of the BHC Act and this part comply with section 13 of the BHC Act and this part;
>
> (2) A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and this part and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;
>
> (3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention;
>
> (4) Independent testing and audit of effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;
>
> (5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
>
> (6) Records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a banking entity must promptly provide to [Agency] upon request and retain for a period of no less than 5 years or such longer period as required by [Agency].

A short time later the SEC, OCC, Federal Reserve Board, CFTC, and FDIC each adopted an Interim Rule to permit banking entities to retain investments in pooled investment vehicles that invested their offering proceeds primarily in securities issues by community banking organizations of the type grandfathered under §171 of Dodd-Frank. [171]

In other words, the Volcker Rule, as adopted, limits banks and bank holding companies from much proprietary trading and participating in private equity funds above the three percent *de minimis* threshold. The different treatment of nonbank financial companies creates uncertainty as to the impact of this provision. A bank or bank holding company apparently can reconstitute some or all of its assets in a separate nonbank entity or be subject to new regulation standards but not the Volcker Rule. In a formal sense this may be logical—a nonbank entity does not receive FDIC guarantees (although it may receive SIPC guarantees). But this approach begs the question: If the Volcker Rule, as modified, is intended to reduce systemic risk, is this the wisest way to do so? One criticism of the Volcker Rule is that it will ultimately reduce market-making activity and thus introduce new risks to the system by contributing to a reduction in liquidity.

Section 956(a)(1) of the Dodd-Frank Act is another provision that the supporters of the legislation intended to reduce risk-taking. Section 956(a)(1) requires the appropriate Federal regulators, including the SEC, within nine months of the enactment of the Dodd-Frank Act to prescribe regulations or guidelines that require each covered financial institution, including registered broker-dealers and investment advisers:

> to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements offered by such covered financial institutions sufficient to determine whether the compensation structure—
>
> > (A) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
> >
> > (B) could lead to material financial loss to the covered financial institution.

However, §956(a)(2) provides: "Nothing in this section shall be construed as requiring the reporting of the actual compensation of particular individuals. " Section 956(f) excepts from this requirement covered financial institutions with assets of less than $1 billion.

Section 956(b) empowers the appropriate Federal regulators not later than nine months after enactment of the Dodd-Frank Act to jointly prescribe regulations or guidelines that:

> prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions—
>
> > (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or
> >
> > (2) that could lead to material financial loss to the covered financial institution.

In 2011, the SEC (on a 3-2 basis) in conjunction with the Office of the Comptroller, the Federal Reserve, the FDIC, the Treasury's Office of Thrift Supervision, the National Credit Union Administration, and the Federal Housing Finance Agency, acting under §956 of the Dodd-Frank Act, proposed rules to require the reporting of incentive-based compensation arrangements in a covered financial institution and to prohibit such arrangements when they provide excessive compensation or could expose the institution to inappropriate risks that could lead to a material financial loss. [172] The joint proposal Release stated in part:

The Agencies have elected to propose rules, rather than guidelines, in order to establish general requirements applicable to the incentive-based compensation arrangements of all covered financial institutions (Proposed Rule). The Proposed Rule would supplement existing rules, guidance, and ongoing supervisory efforts of the Agencies.

The Proposed Rule has the following components:

- The Proposed Rule would prohibit incentive-based compensation arrangements at a covered financial institution that encourage executive officers, employees, directors, or principal shareholders (covered persons) to expose the institution to inappropriate risks by providing the covered person excessive compensation.… [C]onsistent with the directive of section 956, the Agencies propose to use standards comparable to those developed under section 39 of the FDIA for purposes of determining whether incentive-based compensation is excessive in a particular case.
- The Proposed Rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss. The Agencies propose to adopt standards for determining whether an incentive-based compensation arrangement may encourage inappropriate risk-taking that are consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies (*Banking Agency Guidance*) adopted by the Federal banking agencies. The Proposed Rule would also require deferral of a portion of incentive-based compensation for executive officers of larger covered financial institutions. The Proposed Rule would also require that, at larger covered financial institutions, the board of directors or a committee of such a board identify those covered persons (other than executive officers) that have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. The Proposed Rule would require that the board of directors, or a committee thereof, of the institution approve the incentive-based compensation arrangement for such individuals, and maintain documentation of such approval. The term *larger covered financial institution* for the Federal banking agencies and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more.…
- In connection with these restrictions, the Proposed Rule would require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation to help ensure compliance with these requirements and prohibitions.
- The Proposed Rule also would require covered financial institutions to provide certain information to their appropriate Federal regulator(s) concerning their incentive-based compensation arrangements for covered persons. [173]

The foregoing discussion covers key statutory provisions of the Dodd-Frank Act. Commission rules implementing the Dodd-Frank Act are addressed throughout the various volumes of this text.

Footnotes

1 Cf. GAO, On-Line Trading: Better Investor Protection Needed on Brokers' Web Sites (GAO/GGD-00-43 May 2000); From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage

Industry (Off. of N.Y. State Att'y Gen., Investor Protection & Sec. Bureau & Internet Bureau 1999). See also citations supra at 29 n.67 par. 2.

Cf. Smith, Rethinking a Broker's Legal Obligations to Its Customers—The Dramshop Cases, 30 Sec. Reg. L.J. 51 (2002); Ramirez, The Professional Obligation of Securities Brokers under Federal Law: An Antidote for Bubbles?, 70 U. Cin. L. Rev. 527 (2002); Polkes & Fini, Recent Trends in Securities and Derivatives Litigation: The Second Circuit and the New York Appellate Division Address Scope of Duties and Effect of Disclosure by Broker-Dealers, 31 Sec. Reg. L.J. 273 (2003); Black & Gross, Economic Suicide: The Collision of Ethics and Risk in Securities Law, 64 U. Pitt. L. Rev. 483 (2003); Facciolo, When Deference Becomes Abdication: Immunizing Widespread Broker-Dealer Practices from Judicial Review Through the Possibility of SEC Oversight, 73 Miss. L.J. 1 (2003); Minnerop, Clearing Arrangements, 58 Bus. Law. 917 (2003); Zinser, Why *Best Execution* Is in Your *Best* Interest, 36 Rev. Sec. & Commodities Reg. 113 (2003); Choi, A Framework for the Regulation of Securities Market Intermediaries, 1 Berkeley Bus. L.J. 45 (2004); McGonigle, Hall & Goldstein, Risk Management for Broker-Dealers, 38 Rev. Sec. & Commodities Reg. 1 (2005); Uhlenhop, Critical Elements of an Effective Supervisory Structure, 38 Rev. Sec. & Commodities Reg. 173 (2005); Taylor & Cuadrado, The Future of Fee-Based Brokerage Programs, 40 Rev. Sec. & Commodities Reg. 247 (2007); Black, Are Retail Investors Better Off Today?, 2 Brook. J. Corp. Fin. & Com. L. 303 (2008); Macey, Miller, O'Hara & Rosenberg, Helping Law Catch up to Markets: Applying Broker-Dealer Law to Subprime Mortgages, 34 J. Corp. L. 789 (2009); SEC's Walter Urges *Harmonization* of Regulations for Finance Professionals, 41 Sec. Reg. & L. Rep. (BNA) 854 (2009); FINRA VP Says Congress Needs to Fix Gaps between B-D, IA Regulation, 42 Sec. Reg. & L. Rep. (BNA) 183 (2010); Schapiro: Firms Targeted in Exam Sweep; SEC Integrating Exams for Brokers, Advisers, 42 id. 172 ("I believe that securities professionals, whether broker-dealers or investment advisers, should be subject to equivalent regulatory requirements "); Walter, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization, 35 Iowa Corp. L. 1 (2009); Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 Bus. Law. 395 (2010); Black, Punishing Bad Broker-Dealers, 8 Brook. J. Corp. Fin. & Com. L. 23 (2013); Branson, A Changing Mosaic in SEC Regulation and Enforcement: Broker-Dealers and Investment Advisers, 82 U. Cin. L. Rev. 523 (2013); Nelson, Broker-Dealer, A Fiduciary by Any Other Name?, 20 Fordham J. Corp. & Fin. L. 637 (2015).

2 The Commission Report at 1.

At 11–12, the N.Y. Att'y Gen. Report added:

> Electronic brokerage actually predates individual investors' access to the Internet. In the mid-1980s, a number of broker-dealers offered customers software and direct dial-up access that permitted them to submit orders via their personal computers. In the early 1990s, several broker-dealers gave customers the ability to enter orders through private computer networks. In 1995, broker-dealers introduced the first systems that allowed customers to submit orders through the Internet. Approximately 160 broker-dealers now offer on-line trading. In less than five years, on-line brokerage has become an important channel for conducting retail brokerage transactions.…
>
> According to a survey on U.S. equity ownership by the Investment Company Institute (*ICI*) and the Securities Industry Association (*SIA*), investors who trade equities on-line tend to be younger and more affluent than those who use traditional full-service firms. On-line investors have a median age of 41, median household income of $73,800, and median household financial assets of $229,000. They are more often college-educated than other investors. The typical on-line investor has $127,600 invested in equities. The ICI and SIA estimated that only 11 percent of individual trading equities in 1998 (or five percent of all equity owners) traded on-line. In the 1999 Annual SIA Investor Survey, 18 percent of investors responded that they used the Internet to buy or sell securities in 1999, up from 10 percent in 1998.

3 CS First Boston, On-Line Trading Quarterly: 1st Quarter 1999, June 1999 at 4, quoted in SEC On-Line Brokerage: Keeping Apace of Cyberspace 14 (1999). "On-line trading accounts for an even higher percentage

of overall equity and options trades by retail investors. Piper Jaffray estimates that on-line firms processed 37 percent of all retail trades in equities and options in 1998." Id. at 15.

4 Id. at 15–16.

5 Id. at 15–17.

6 Id. at 17:

> Forrester Research predicts that by 2003, 9.7 million U.S. households will manage more than $3 trillion in 20.4 million on-line accounts. Jupiter Communications estimates that by 2003, 20.3 million households will trade on-line and also puts total on-line account assets at more than $3 trillion. According to the 1999 SIA Investor Survey, 28 percent of respondents stated that they were either very or somewhat likely to begin using the Internet to trade securities in the next 12 months.
>
> One securities analyst described what he perceives to be the five sources of on-line market growth today: (1) traditional mutual fund investors investing incremental income in stocks; (2) employees who previously let employers invest for them now investing for themselves; (3) new investors in the market favoring on-line firms; (4) investors transferring their accounts from full-service firms; and (5) investors who open on-line accounts while maintaining their full-service accounts.

7 Id. at 18.

8 Id. at 19–20.

9 Id. at 32–34; see discussion infra ch. 9.C.3. The SEC Report, On-Line Brokerage: Keeping Apace of Cyberspace (1999) recommended that the Commission work with the SROs to consider the issues raised by the following scenarios:

> 1. AN ON-LINE BROKER-DEALER PROVIDES ONLY ORDER EXECUTION SERVICES TO ITS CUSTOMERS
>
> This activity should not require a customer-specific suitability review, assuming that the firm acts purely as an order taker. This scenario is substantially similar to when the investor contacts a discount firm by telephone to execute a particular trade. The only difference is the *medium* by which the order is communicated to the firm. A firm's suitability obligation does not depend on whether a trade is executed on-line or otherwise.
>
> 2. AN ON-LINE BROKER-DEALER PROVIDES ORDER EXECUTION SERVICES AND ALLOWS ITS CUSTOMERS TO PULL INFORMATION FROM ITS *VIRTUAL LIBRARY* (WHICH CONTAINS RESEARCH REPORTS, MARKET COMMENTARY, AND NEWS). THIS VIRTUAL LIBRARY APPEARS THE SAME TO EVERY CUSTOMER.
>
> This type of activity should not trigger customer-specific suitability requirements. However, the broader reasonable basis suitability standard would apply in this context. In other words, the firm must have a reasonable basis for believing the research reports and market commentary are plausible and that the investments or strategies discussed therein may be appropriate for at least some of its customers.
>
> 3. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE CUSTOMER HAS THE ABILITY TO PERSONALIZE WHAT SHE SEES EACH TIME SHE GOES TO THE ON-LINE FIRM'S WEBSITE. THE CUSTOMER'S PERSONALIZED WEBPAGE TRACKS QUOTES IN SPECIFIED STOCKS, AND PROVIDES ALERTS ABOUT RESEARCH IN SUCH STOCKS OR THE SECTOR

THEY ARE IN. THE CUSTOMER ALSO IDENTIFIES HERSELF AS A PARTICULAR TYPE OF INVESTOR (*E.G* ., CONSERVATIVE, GROWTH, SPECULATIVE).

Resolving this scenario requires a more difficult determination. On the one hand, the customer has personalized the website, with no intervention from the firm. If the investor had not identified herself as a particular type of investor, no customer-specific suitability requirement should be triggered by this scenario. If, however, the customer does identify herself as a particular type of investor, the firm is on notice that the customer is following stocks that may be inappropriate for her if she has indicated a very low risk tolerance. This difference between how the investor identifies herself and how she customizes her webpage may trigger a firm's suitability obligation. As a good business practice, the firm would probably want to advise the customer (in writing and prior to executing any transactions) that risky stocks are not consistent with a conservative investment strategy.

4. THE ON-LINE BROKER-DEALER CLASSIFIES ITS CUSTOMERS INTO DIFFERENT CATEGORIES BASED ON FACTORS SUCH AS ACCOUNT BALANCE, SECURITIES HOLDINGS, AND FREQUENCY OF TRADING ACTIVITY. THE FIRM DIRECTS DIFFERENT INFORMATION TO CUSTOMERS IN EACH CATEGORY.

This scenario may require more facts to determine whether the firm has a suitability obligation. One relevant factor is how finely the firm segments investors and personalizes the information they see. If a firm makes individualized recommendations to the customer based on information it has collected about that customer, the firm would have a customer-specific suitability obligation. Firms would most likely not have suitability obligations if customers select certain investment categories and request to receive information appropriate for that category.

5. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE ON-LINE BROKER-DEALER PUSHES SELECTED INFORMATION TO THE CUSTOMER BASED ON OBSERVATIONS THAT THE FIRM HAS MADE OF THE USER WHILE SHE WAS ON-LINE. FOR EXAMPLE, AN ON-LINE BROKER-DEALER SEES THAT SHE TENDS TO PURCHASE SHARES OF BLUE-CHIP COMPANIES AFTER THEIR STOCK PRICES HAVE FALLEN AND SENDS AN E-MAIL TO HER WHEN THE STOCK PRICE OF A SIMILAR BLUE-CHIP COMPANY HAS FALLEN.

At this point on the continuum, the firm now has a customer-specific suitability obligation. While the process may be somewhat mechanized, the firm is now tailoring particular securities to her.

6. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE ON-LINE BROKER-DEALER HELPS THE CUSTOMER MANAGE HER PORTFOLIO ON-LINE, EITHER BY PROVIDING BENCHMARKS THAT HER PORTFOLIO SHOULD MEET OR BY ADVISING ON THE CUSTOMER'S ASSET ALLOCATION FOR HER PORTFOLIO.

An "asset allocation calculator, " where an investor enters basic information and the calculator provides a suggested asset mix (68% in stocks, 20% in bonds, and 12% in cash, for example), is usually akin to a generalized recommendation and in those situations the firm should not have to make a customer-specific suitability determination. As always, the reasonable basis suitability standard should apply.

Now let us assume that after entering all of her investment assets into the "asset allocation calculator, " she is alerted that she has too much common stock in her portfolio and should consider selling her blue-chip company shares and buying a municipality's industrial development bonds. This would be viewed as a personalized recommendation regarding specific securities, triggering a customer-specific suitability obligation.

7. A FULL-SERVICE BROKER-DEALER ALLOWS CUSTOMERS TO ENTER ORDERS ON-LINE OR THROUGH A REGISTERED REPRESENTATIVE. THE REGISTERED REPRESENTATIVE

RECOMMENDS A PURCHASE IN A SPECIFIC STOCK TO A CUSTOMER OVER THE TELEPHONE. THE CUSTOMER THEN ENTERS THE ORDER ON-LINE IN THE EVENING.

In this scenario, the firm has a customer-specific suitability obligation. The registered representative made a personalized recommendation to a customer. The more difficult issue for a firm will be how to monitor a broker's off-line recommendations to its customers for suitability when the customer enters the order on-line.

10 SEC, On-Line Brokerage: Keeping Apace of Cyberspace 35–40; see discussion of Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266 (3d Cir. en banc 1998), *cert. denied sub nom* . Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Kravitz, 525 U.S. 811.

The Commission Report generalized:

The duty of best execution requires a broker-dealer to seek the most advantageous terms reasonably available under the circumstances for a customer's transaction. The duty originally derived from agency law principles and fiduciary obligations. Subsequently, it was incorporated into SRO rules. In addition, judicial and Commission decisions have established that a broker-dealer's failure to perform its best execution obligation may form the basis for an action under the antifraud provisions of the federal securities laws.…

One of the Commission's main concerns regarding best execution has been that internalization and inducements for order flow could cause automated routing decisions to be made for reasons other than a customer's best interest. The Commission also has struggled over the years with how to reconcile its policy goal of having broker-dealers achieve best execution on an individualized basis with the practical reality of firms automatically routing aggregated retail order flow to a particular market center.…

Subsequently, the Commission has found that internalization and inducements for order flow could be reconciled with the broker-dealer's duty of best execution as long as the broker-dealer conducts a *regular and rigorous* evaluation of the execution quality of the different markets trading a security.

The Commission's most detailed pronouncement regarding a broker-dealer's best execution obligations came in the 1996 Order Handling Rules Adopting Release. In this release, the Commission emphasized the importance of price improvement opportunities in determining best execution. Specifically, the Commission stated that broker-dealers must modify their best execution evaluations to consider price improvement opportunities that become *reasonably available.* Perhaps most significantly, the Commission stated that internalizing or routing order flow for execution at the national best bid or offer (*NBBO*) would not necessarily satisfy a broker-dealer's duty of best execution for retail-sized orders in listed and over-the-counter (*OTC*) securities.

Accordingly, the Commission stated that a broker-dealer's regular and rigorous evaluation should include the extent to which directed order flow would be afforded better terms if executed in a market offering price improvement opportunities. As part of that evaluation, a broker-dealer must take into account material differences that exist among the price improvement opportunities offered in different markets. In addition, the broker-dealer must consider whether different markets are more suitable for certain types of orders or particular securities.

The Commission reiterated this point in its 1997 Report on the Practice of Preferencing. In concluding that preferencing arrangements were not necessarily inconsistent with a broker-dealer's best execution obligations, the Commission again stressed that firms automatically routing orders

to a particular exchange must regularly and rigorously evaluate execution quality in the various markets trading the security.…

Generally, under the Display Rule a customer order that improves the NBBO must be reflected in the quote. The Display Rule and the adoption of sixteenths have dramatically narrowed spreads and affected the quoted depth at the NBBO. The Order Handling Rules and technological advancements also have increased significantly the percentage of trading volume handled by alternative trading systems (*ATS* s), particularly in the Nasdaq market.

Broker-dealers also have developed sophisticated software that attempts to reduce best execution to an algorithm. These algorithms dictate customer order routing on an order-by-order basis. Several on-line firms are marketing order-by-order routing to active traders. The active trading segment is a very lucrative one for on-line brokerages. While the largest on-line firms do not yet provide direct access or order-by-order routing capabilities, several do compete for the active trader segment by offering features such as Nasdaq Level II quotes and faster connections through dedicated trading websites.

If the trend of commoditizing order routing technologies continues, on-line brokerages will almost certainly adopt these new technologies for use by the average customer. How will these technologies impact the duty of best execution? For example:

- If an on-line firm facilitates its customers ability to route orders to the market of their choice, does this alter the on-line firm's best execution obligation? If so, what, if any, residual best execution obligation would the on-line firm retain? Would the answer depend upon whether (1) the firm provides access to all the markets trading a particular security, or (2) the quality of disclosure provided regarding execution quality on different market centers? In such instances, what information should on-line firms disclose to customers? How would the widespread application of such services impact the markets?
- If on-line firms adopt technology that permits them to perform order-by-order routing of customer orders, how will this technology affect, if at all, the way they fulfill their best execution obligations? How will the traditional best execution factors apply in such an environment? What is the potential impact of order-by-order routing on the markets?
- For on-line investors, what are the potential advantages and disadvantages of order-by-order routing compared to the current practice of aggregate routing of retail order flow?

Id. at 35–40. Payment for order flow; the Order Handling Rules and Nasdaq are discussed supra ch. 7.D.2.c.

11 Id. at 46–57.

12 SEC, On-Line Brokerage: Keeping Apace of Cyberspace 58–66.

13 Id. at 87–97. See discussion infra ch. 13.F.

14 Sec. Ex. Act Rel. 53,406, 87 SEC Dock. 1385 (2006). Cf. Fausti, A Fiduciary Duty for All?, 12 Duq. Bus. L.J. 183 (2010); Ketchum Calls for One Fiduciary Standard, Says FINRA May Have Role in Enforcement, 42 Sec. Reg. & L. Rep. (BNA) 2210 (2010); Langevoort, Brokers as Fiduciaries, 71 U. Pitt. L. Rev. 439 (2010). See also Frankel, The Regulation of Brokers, Dealers, Advisers and Financial Planners, 30 Rev. Banking & Fin. L. 123 (2010-2011); cf. Aikin & Fausti, Fiduciary: A Historically Significant Standard, 30 id. 155 (2010–2011); Bullard, The Fiduciary Study: A Triumph of Substance over Form?, 30 id. 171 (2010–2011); Dibadj, Brokers, Fiduciaries and a Beginning, 30 id. 205 (2010–2011); Zambrowicz, Investment Adviser Regulation Post-Madoff: A Brave New World, 6 J. Bus. & Tech. L. 373 (2011); Laby, Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries, 87 Wash. L. Rev. 707 (2012); Wrona, The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection, 68 Bus. Law. 1 (2012); Black, Curbing Broker-Dealers' Abusive Sales Practices: Does Professor Jensen's Integrity Framework Offer a Better Approach?, 48 Wake Forest L. Rev. 771 (2013); Black, Punishing Bad Brokers: Self-Regulation and FINRA Sanctions, 8 Brook. J. Corp. Fin. & Com. L. 23

(2013); Watts, SEC Cracks Down on Unregistered Broker-Dealers in Private Offerings, 42 Sec. Reg. L.J. 69 (2014); Wink, Paulovic & Shaw, Dually Registered Brokers and Advisers, 46 Rev. Sec. & Commodities Reg. 191 (2013); Cybersecurity and Financial Firms: Bracing for the Regulatory Onslaught, 46 Sec. Reg. & L. Rep. (BNA) 779 (2014); Sanders, Resolving the Conflict between Fiduciary Duties and Socially Responsible Investing, 35 Pace L. Rev. 535 (2014); Bai, Broker-Dealers, Institutional Investors and Fiduciary Duty: Much Ado about Nothing?, 5 Wm. & Mary Bus. L. Rev. 55 (2014); Schwarcz, The Governance Structure of Shadow Banking: Rethinking Assumptions about Limited Liability, 90 Notre Dame L. Rev. 1 (2014).

15 Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008).

16 Id. at xviii–xxiv.

17 See supra ch. 7.D.3.

18 The Report elaborated:

> A common source of compensation is payout, the amount that a broker receives from total revenue that he or she generated for the firm. The payout percentage depends on the type of relationship between the firm and the broker, the level of production, the products involved, and the broker's rank in the firm. Firms can have 10 or more different payout levels. In general, payouts are structured to increase incrementally as production increases (Oberlin and Powers, 2003). However, Schaeffer (2001) noted that payout can also involve a fixed percentage.
>
> Clark (2003) found that, as the relationship between the broker and the firm becomes more independent and remote, the payout increases: Large brokerage firms pay out 35 to 50 percent, independent broker-dealers 80 to 95 percent, and clearing firms 100 percent. Tibergien and Clark (2002) found that integrated firms pay out 25 to 40 percent and independent broker-dealers 60 to 90 percent, with the average independent broker-dealer's payout being 82 percent. Furthermore, as professionals gain experience, they progress to arrangements with higher payouts.
>
> Horowitz (2004) explained one brokerage firm's payout structure as follows: monthly, 20 percent of the first $9,000 and 50 percent of anything above $9,000. There are other incentives, such as incentives that promote fee-based accounts: The firm charged its brokers $15 for a stock or option trade made outside a fee-based program and put 1 to 2 percent of the production of brokers who derived at least 50 percent of their annual production from fees into an investment plan that vests after five years.
>
> Even within a firm, compensation structures may vary depending on location. Cowan (2002) reports that, in the branches of a major brokerage firm, broker pay was 100 percent based on production. For the call center-based brokers of the same firm, pay was structured as a base salary and a bonus, which is a function of service skills, production, and net asset inflow.

19 Id. at 15–17, 20–21, 31–32, 116–117.

See also Staff Given Four Months to Develop Policy Advice Flowing from Rand Study, 40 Sec. Reg. & L. Rep. (BNA) 41 (2008).

20 See FINRA VP Says Congress Needs to Fix Gaps between B-D, IA Regulation, 42 Sec. Reg. & L. Rep. (BNA) 183 (2010); Schapiro, Firms Targeted in Exam Sweep: SEC Integrating Exams for Brokers, Advisers, 42 id. 172 ("I believe that securities professionals, whether broker-dealers or investment advisers, should be subject to equivalent regulatory requirements "); Walter, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization, 35 J. Corp. L. 1 (2009); Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 Bus. Law. 395 (2010).

21 Section 15(k)(2) also provides that a broker-dealer who sells only proprietary or other limited range of products obtain the consent or acknowledgment of the customer.

Section 15(l) more generally then empowers the SEC to:

> (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and
>
> (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.

22 Section 211(g)(2) defines a *retail customer* to mean:

> a natural person, or the legal representative of such natural person, who—
>
> (A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and
>
> (B) uses such advice primarily for personal, family, or household purposes.

23 In detail, §913(c) delineates 14 considerations that the Commission should take into account in conducting this Study. These include:

> (5) the regulatory, examination, and enforcement resources devoted to, and activities of, the Commission, the States, and a national securities association to enforce the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and

persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including—

> (A) the effectiveness of the examinations of brokers, dealers, and investment advisers in determining compliance with regulations;
>
> (B) the frequency of the examinations; and
>
> (C) the length of time of the examinations;

(6) the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers;

(7) the specific instances related to the provision of personalized investment advice about securities in which—

> (A) the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of brokers and dealers; and
>
> (B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers;

(8) the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail customers;…

(10) the potential impact of eliminating the broker and dealer exclusion from the definition of *investment adviser* under section 202(a)(11)(C) of the Investment Advisers Act of 1940.…

(11) the varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers;

(12) the potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers

relating to their obligations to retail customers regarding the provision of investment advice, including any potential impact on—

(A) protection from fraud;

(B) access to personalized investment advice, and recommendations about securities to retail customers; or

(C) the availability of such advice and recommendations;

(13) the potential additional costs and expenses to—

(A) retail customers regarding and the potential impact on the profitability of their investment decisions; and

(B) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations, including duty of care, to retail customers.

Section 913(f) provides the SEC rulemaking authority to address: the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers. The Commission shall consider the findings, conclusions, and recommendations of the study required under subsection (b).

Separately §917 directs the Commission within two years of enactment of the Dodd-Frank Act to conduct a study of the existing level of financial literacy among retail investors. The resulting Study Regarding Financial Literacy Among Investors was published in 2012 and is available on the SEC Web site at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

In July 2010 the Commission requested public comments on the effectiveness of the existing standards of care for broker-dealers, investment advisers and associated persons when providing personalized investment advice as requested by §913 of the Dodd-Frank Act. Inv. Adv. Act Rel. 3058, 98 SEC Dock. 3431 (2010).

In August 2010 FINRA wrote the Commission to "strongly support " a uniform standard for broker-dealers and investment advisers when providing personalized investment advice to retail customers. Letter to Elizabeth M. Murphy, Secretary, SEC, from Marc Menchel, Exec. V. P. and General Counsel, FINRA, Re: File No. 4-606, Study Regarding Obligations of Brokers, Dealers and Investment Advisers (Aug. 25, 2010). Many others, however, were and have been critical, concerned that a uniform standard would, among other things, decrease investors' access to the services of broker-dealers and increase the costs that investors pay for such services.

Separately FINRA Chair and CEO Richard Ketchum wrote Elizabeth Murphy in November 2010 with respect to the Commission's Study on Enhancing Investment Adviser Examinations required by §914 of the Dodd-Frank Act, which stated in part:

FINRA believes that

- For years, the Commission has had insufficient resources to devote to investment adviser examinations. Given the Commission's new responsibilities under Dodd-Frank and its

> many other programs, Commission resources alone are unlikely to be sufficient to improve the frequency of these examinations;
> - A practical solution to the resource problem is for the Commission to have the authority to approve one or more SROs for the investment adviser industry;
> - The standards set forth in Sections 15A and 19 of the Exchange Act establish an SRO regime that is transparent, publicly accountable, and operated in the public interest. We recommend a similar approach for an investment adviser SRO. Ongoing and comprehensive Commission oversight will be a critical component;
> - The governance structure of every investment adviser SRO should be designed to prevent undue industry influence and ensure appropriate staff independence. Public representatives should form a majority of any governing body. Members of the investment adviser industry should be allocated a number of the remaining seats, to ensure adequate industry representation. If FINRA were to seek authorization as an investment adviser SRO, we would create a separate affiliate, with its own Board of Governors, to ensure that the SRO establishes programs appropriate to the adviser industry; and
> - An investment adviser SRO should implement regulatory oversight that is tailored to the particular characteristics of the investment adviser business.

Id. at 2–3. On the other hand, others expressed significant concerns about the prospect of an investment adviser SRO; FINRA's perspective did not reflect a consensus view.

24 See Kathleen L. Casey & Troy A. Paredes, Commissioners, U.S. Sec. & Exch. Comm'n, Statement Regarding Study on Investment Advisers and Broker-Dealers (Jan. 21, 2001), available on the Commission's Web site at https://www.sec.gov/news/speech/2011/spch012211klctap.htm.

In March 2015, Chair White testified on Examining the SEC's Agenda, Operations and FY 2016 Budget Request (Mar. 24, 2015) and stated:

> After significant study and consideration, I believe that broker-dealers and investment advisers should be subject to a uniform fiduciary standard of conduct when providing personalized securities advice to retail investors. As set forth in Section 913, the financial professional giving advice to a retail client should be required to provide advice that is in the client's best interests, without regard to the financial or other interests of the financial professional.
>
> In proposing a uniform fiduciary standard, there are many challenges. At this juncture, I will just mention three of them. The first is how to define the standard. My initial view is that the standard should be codified, principles-based, and rooted in the fiduciary duty applicable to investment advisers. A second challenge, which was expressly contemplated by Section 913 of the Dodd-Frank Act, is to provide clear guidance on what the standard would require, and how current business practices can or cannot continue under the standard—importantly, for both broker-dealers and investment advisers. A third challenge is providing for the meaningful application, examination, and consistent enforcement of a uniform fiduciary standard. Without effective examination and enforcement, a uniform fiduciary standard could be mere words on a page. Central to this challenge is extending our examination coverage for registered investment advisers.

Id. at 9.

25 Id. at iii, v–ix.

In July 2011, SIFMA supported the establishment of a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers, but strongly opposed simply imposing on broker-dealers the existing Advisers Act standard and its associated

case law, guidance and legal precedent. SIFMA E-mail to SEC Chair Mary Schapiro Re: Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act; File No. 4-604 (July 14, 2011).

In September 2011, the House Financial Services Committee Chairman introduced the Investment Adviser Oversight Act of 2011, which required each registered investment adviser and each investment adviser subject to a state authority under §203A to be a member of a registered national investment adviser association, with specified exceptions, most notably for investment advisers that have assets under management 90 percent or more from (A) registered investment companies; (B) not *U.S. persons* as defined in Rule 902(k) of Regulation S ; (C) clients that in aggregate own less than $25 million in investments; (D)–(E) entities defined in §§3(c)(10) and (11) of the 1940 Act ; (F) the *private funds* as defined in §202(a)(29) of the Advisers Act ; and (G) *venture capital funds* as defined in §203(*l*) of the Advisers Act.

In September 2011, FINRA Chair Richard Ketchum urged that FINRA should be the SRO for investment advisers, a stance of which many were and have been critical. Ketchum stated, in part:

> The SEC oversees more than 11,000 investment advisers, but in 2010 conducted only 1,083 exams of those firms due to lack of resources. As such … "the average registered adviser could expect to be examined less than once every 11 years. "
>
> While the SEC examines only about 9 percent of investment advisers each year, 55 percent of broker-dealers are examined each year by the SEC and FINRA. As the SEC's study states, “the Commission's and the Commodity Futures Trading Commission's experiences with SROs support the view that an SRO can augment government oversight programs through more frequent examinations.”
>
> The frequency of SEC investment adviser examinations has declined 50 percent since 2004.

Testimony of Richard G. Ketchum before House Comm. on Fin. Serv., Subcomm. on Capital Markets & Gov't Sponsored Enter., 112th Cong., 1st Sess. (2011).

Cf. Boston Consulting Group, Investment Adviser Oversight Study (Dec. 15, 2011), found that 81 percent of surveyed investment advisers preferred enhanced SEC examination to 19 percent support for FINRA examination and enforcement. Seventy-five percent of the same advisers preferred a new IA SRO to FINRA. See also SEC Oversight of Advisers Less Costly Than Creation of SRO, New Study Finds, 44 Sec. Reg. & L. Rep. (BNA) 13 (2012); Groups Ask SEC to Extend Advisers Act Fiduciary Duty to Brokers, 44 id. 705 (2012) (including AARP and the Consumer Federation of America).

See also FINRA Cost Estimates for Its Oversight of IAs Steep Drop from Other Findings, 44 Sec. Reg. & L. Rep. (BNA) 911 (2012) (FINRA estimates $150 to $155 million in contrast to BCG estimate of $460 to 510 million); House Members Unveil Bipartisan Bill to Create SRO for Investment Advisers, 44 id. 857. But see BCG Refutes FINRA's Cost Estimates for Oversight of Investment Advisers, 44 Sec. Reg. & L. Rep. (BNA) 1017 (2012).

See also Bachus Says He Is Open to Addressing Concerns in Investment Adviser SRO Bill, 44 Sec. Reg. & L. Rep. (BNA) 1152 (2012).

The Financial Stability Oversight Council, 2012 Ann. Rep. at 76, reported:

> As of year-end 2011, there were 4,679 domestic- and foreign-owned BDs operating in the United States. Coinciding with a sharp decline in leverage within the industry, assets held within the U.S. BD industry fell sharply to $4.8 trillion at 2012:Q1—a decline of 25 percent since 2007.…
>
> The U.S. BD sector is relatively concentrated; at year-end 2011, 60 percent of industry assets were held by the top 10 BDs, the largest of which are affiliated with foreign banks and domestic BHCs.

> By contrast, the top 10 independent BDs represented only 6 percent of industry assets. In late 2011, the third largest independent BD, MF Global, filed for bankruptcy.

The Financial Stability Oversight Council 2014 Ann. Rep. at 71, reported:

> As of the fourth quarter of 2013, there were 4,378 domestic and foreign-owned securities broker-dealers registered with the SEC. The U.S. broker-dealer sector remains relatively concentrated, with about 60 percent of industry assets held by the top 10 broker-dealers at the end of 2013, the largest of which are affiliated with domestic BHCs or foreign banks. Aggregate annual revenues of broker-dealers increased by approximately 3.4 percent in 2013 to $71.2 billion, with increases in all categories, except in trading and other revenues related to the securities business.…
>
> Assets held within the U.S. broker-dealer industry declined modestly in 2013 to $4.6 trillion.…

In contrast, United States assets under management for private equity increased to $2 trillion in 2013, id. at 84, and to $2.6 trillion for hedge funds. Id. at 85.

These figures, of course, are updated each year as the Financial Stability Oversight Council issues new annual reports.

See also Bill for SRO Oversight of Advisers Will Not Advance Without Consensus, Bachus Says, 44 Sec. Reg. & L. Rep. (BNA) 1492 (2012) ("Unfortunately, there is no consensus.… "); Waters Re-Introduces Bill to Fund SEC's Adviser Oversight through User Fees, 45 Sec. Reg. & L. Rep. (BNA) 705 (2013); Walter Calls on Congress to Act Now to Ensure Advisers Adequately Examined, 45 id. 706.

Cf. FINRA Report on Conflicts of Interest (Oct. 2013), focusing solely on broker-dealer conflicts in three critical areas:

- → enterprise-level frameworks to identify and manage conflicts of interest;
- → approaches to handling conflicts of interest in manufacturing and distributing new financial products; and
- → approaches to compensating their associated persons, particularly those acting as brokers for private clients.

The Report concluded with an Appendix at 37–38, summarizing examples of conflict-related disclosure requirements and prohibitions:

Mandated Disclosures	Prohibitions
Firm's Interest in the Security Recommended—Exchange Act Rules 15c1-5 and 15c1-6 generally require written disclosure to a customer if a broker-dealer has any control, affiliation, or interest in a security it is offering or in the issuer of the security.	**Restrictions on the Purchase and Sale of IPOs**—FINRA Rule 5130 generally prohibits firms and their associated persons from purchasing a new issue for any account in which the firm or an associated person has an interest, except in accordance with the rule's conditions.
Disclosure and Consent When Trading on a Net Basis with Customers—FINRA Rule 2124 requires transaction-by-transaction disclosure and written consent for net trades involving non-institutional customers. Net trades with institutional customers are subject to different consent requirements. For these purposes, a net trade is a principal transaction in which, for example, a market maker, after having received an order to buy a security, purchases the security from another broker-dealer or customer and then sells it to the customer at a different price.	**Prohibition on Certain Market Activities**—SEC Regulation M generally prohibits underwriters, broker-dealers, issuers and other persons participating in a distribution from bidding for or purchasing the offered security during a certain restricted period, or inducing another person to do so. Regulation M also regulates various market activities in connection with an offering and requires that firms notify FINRA or the market where certain bids are to be posted. FINRA Rule 5190 sets forth Regulation M notification requirements for firms.

Disclosure of Control Relationship with Issuer—If a firm controls, is controlled by, or is under common control with an issuer of a security, FINRA Rule 2262 requires disclosure to the customer prior to commencing a transaction in the security.

Disclosure of Participation or Interest in Primary or Secondary Offering—FINRA Rule 2269 generally requires written disclosure to customers for trades in any security in which the firm is participating in the distribution or is otherwise financially interested.

Disclosure of Financial Condition upon Customer Request—FINRA Rule 2261 requires disclosure of the information in its most recent balance sheet.

Public Offerings of Securities with Conflicts of Interest—FINRA Rule 5121 prohibits participation in an offering unless certain conditions are met, including prominent prospectus disclosure of the conflict.

Trading Ahead of Research Reports—FINRA Rule 5280 prohibits firms from using non-public advance knowledge of a research report to change its inventory position in a security or derivative of a security.

Research Analysts and Research Reports—Among other things, NASD Rule 2711 and Incorporated NYSE Rule 472 restricts the activities of and the relationships between a firm's research analysts and its investment bankers and personal trading by research analysts in the stocks that they cover.

Influencing or Rewarding Employees of Others—FINRA Rule 3220 prohibits firms from giving anything worth more than $100 annually to employees of other firms where the payment is made because of the employer's business.

Brokerage Rewarding Fund Sales—NASD Rule 2830(k) prohibits a firm from favoring the sale of a fund because of brokerage business that has been or may be directed to the firm.

Borrowing From or Lending to Customers—FINRA Rule 3240 prohibits these arrangements unless strict conditions are met.

Trading Ahead of Customers—FINRA Rule 5320 generally prohibits firms from trading ahead of a customer order for the firm's own account.

In 2013, the Commission sought data and other information "in particular quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers. " Sec. Ex. Act Rel. 69,013, 105 SEC Dock. 3092 (2013).

26 In 2007, the housing bubble perceptibly began to burst.

In August 2007 Countrywide, the largest United States mortgage originator, drew down $11.5 billion from bank backup lines. Keoun, Countrywide Taps $11.5 Billion Credit Line from Banks, www.bloomberg.com (Aug. 16, 2007); El Boghdady, No. 1 Home Lender Taps $11.5 Billion Line of Credit, www.washingtonpost.com (Aug. 17, 2007).

In October Merrill Lynch recognized a $2.3 billion loss and its CEO, Stan O'Neal, resigned. Ellis, O'Neal Out at Merrill, www.money.cnn.com (Oct. 31, 2007); Merrill CEO *Mistakes* Led to Huge Write-Downs, www.cnbc.com (Oct. 24, 2007).

In November Citigroup wrote down $11 billion on top of $5.9 billion in October and its CEO Chuck Prince resigned. Siew, Citi Losses Expose Tip of Billion-Dollar Iceberg, www.reuters.com (Nov. 5, 2007); Embattled Citigroup CEO Resigns, www.cbsnews.com (Nov. 5, 2007).

Congress particularly focused on subprime mortgages and the crisis in housing. In July 2008 the Housing and Economic Recovery Act, Pub. L. No. 110-289, 122 Stat. 2654, was adopted, authorizing the United States government to have broad discretion to provide financial support to Fannie Mae and Freddie Mac.

By 2008 several leading investment and commercial banks were subject to SEC and State Attorney General lawsuits concerning Auction Rate Securities. In 2008 the Commission, NASAA, and New York Attorney General Cuomo regulated settlements with Citigroup to redeem $7.3 billion in illiquid ARS and pay a $100

million penalty. Citigroup to Buy Back Billions of ARS in Deals with SEC, State Regulators, 40 Sec. Reg. & L. Rep. (BNA) 1249 (2008).

There were several other similar settlements. Wachovia Becomes Fifth Bank to Settle with States in ARS Probe, Cuomo Reports, 40 id. 1309 (two units of Wachovia agreed to repay investors more than $8.5 billion and to pay a $50 million penalty); see also Citigroup, UBS Agree to Pay Record $30 Billion in ARS Settlement, 40 id. 2049; Wachovia, Citi to Return $4.7B to Investors in Calif. ARS Settlement, 41 id. 625; Citigroup, Wachovia to Pay $880 Million to Settle Mich. ARS Dispute, 41 id. 728; SEC, Cuomo Announce Final Settlements in 2008 Auction Rate Securities Disputes, 41 Sec. Reg. & L. Rep. (BNA) 1070 (2009) (total buybacks of $56 billion of illiquid auction rate securities at par from retail investors and $522.5 million in penalties).

One memoir to date by a key participant in the response to the 2008–2009 meltdown is by Timothy Geithner, Stress Test: Reflections on Financial Crises (2014). In this book, the former New York Fed President and later Secretary of Treasury captures the sense of overwhelming crisis that engulfed many financial regulators, the White House, Congress, and several banks and other financial institutions as the economy all but spun out of control.

From Geithner's perspective, which, it is important to note, is just his personal perspective and not necessarily the definitive word on the subjects he covers in his book, the SEC was unable to address the dysfunction in the major investment banks, including Bear Stearns and Lehman Brothers, and unable to address money market reform. In the final chapter, Geithner offered his personal reflections with which many make take issue:

> In a crisis, when confidence vanishes and risk-taking stops, government measures that further discourage risk-taking further depress confidence and spur runs. And when private demand withers, government austerity only intensifies the problem. What's needed to avoid a vicious cycle in which the financial system and the broader economy drag each other down are counterintuitive remedies: more private credit, more government borrowing, more confidence even if the mess was created by excessive confidence. Unfortunately, the only way for crisis responders to stop a financial panic is to remove the incentives for panic, which means preventing messy collapses of systemic firms, assuring creditors of financial institutions that their loans will be repaid, and generally reducing uncertainty in financial markets. In these severe cases, government needs to lean against the forces of gloom, borrowing more, spending more, and exposing taxpayers to more short-term risk—even if it looks profligate and immoral, even if it seems to reward incompetence and venality, even if it fuels perceptions of an out-of-control, money-spewing, bailout-crazed Big Government.
>
> That's why we stood behind so many mismanaged firms….
>
> Financial crises can't be reliably anticipated or preempted, because human interactions are inherently unpredictable. But there is a lot that can be done in advance to make crises less damaging. These can be divided into *safeguards* that help reduce the likelihood and severity of crises, and *emergency authorities* that help policymakers limit the damage when crises erupt. The goal should not be to prevent the failure of firms that take on too much risk, but to make the system

> safe for their failure, to prevent their failures from unleashing panics that lead to crashes, to avoid the extreme crises that can lead to depressions when they spiral out of control.

Id. at 493–524.

Early in 2011 the National Commission on the Causes of the Financial and Economic Crisis in the United States published its final report, entitled The Financial Crisis Inquiry Report (2011). The significance of the Report was reduced for four different reasons:

(1) Unlike the 1930s Pecora hearings, which preceded the New Deal Federal Securities Law, the Financial Crisis Inquiry Report was published after the enactment of the Dodd-Frank Act.
(2) The Report was divided along political lines with all six Democrats signing the majority report (chair Phil Angelides, Brooksley Born, Byron Georgiou, Bob Graham, Heather Murren and John Thompson) and all four Republicans (vice chair Bill Thomas, Keith Hennessey, Douglas Holtz-Eakin, and Peter Wallison) dissenting.
(3) The Report made no policy recommendations.
(4) The style of the majority report was chronological, rather than topical, which made the document harder to follow.

Notwithstanding these limitations, the Report did offer a view on the causes of the financial crisis. However, the Report itself has come in for criticism and reflects only the perspective of those who wrote it. The Majority

Report has been strongly criticized, and there were two dissents to the Report that deserve considerable attention for their analysis of the causes of the financial crisis.

The Majority Report drew several conclusions:

• We conclude this financial crisis was avoidable.

…

• We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.

…

• We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.

…

• We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.

…

• We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.

…

• We conclude there was a systemic breakdown in accountability and ethics.

…

• We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.

…

• We conclude over-the-counter derivatives contributed significantly to this crisis.

…

• We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction.

Id. at xi–xxv.

It is worth repeating that many disagree with much of the Majority Report, and it is not understood to be the definitive word on the causes of the financial crisis.

The Majority Report itself was over 400 pages. The Report offers one take on financial markets, especially the debt and mortgage markets (Chapter 1, urging "There were warning signs, " Id. at 3; Chapters 6, 7, pages 175–176, 213–221; Chapter 14, pages 390–402); shadow banking (Chapter 2, pages 295–296, focusing on largely unregulated commercial paper and repo markets); Fannie Mae and Freddie Mac (esp. pages 38–42, 65, 122–124, 178–187, 230, Chapter 17); securitization (esp. pages 42–45, 68–70, 102–103); derivatives (esp. pages 45–51, 298–301, 363–365); collateralized debt obligations (esp. pages 127–134, 145–150, 191–202, 223–224, 262–265); banking regulation (esp. pages 52–56, 72–79, 99–100, 111–116, 170–173, 204–206, 292–308); subprime lending (esp. Chapter 5, pages 88–92); credit rating agencies (esp. pages 118–122, 146–150, 206–212, 221–223, 242–243); money market funds (esp. pages 356–360); Bear Stearns (esp. pages 134–137, Chapter 15); Lehman (esp. pages 176–178, Chapter 18); Citigroup (esp. pages 137–139, 256, 260–

262, 302–304, 379–382); AIG (esp. pages 139–142, 265–278, Chapter 19, pages 376–379); Goldman Sachs (esp. pages 142–146, 235–238); Merrill Lynch (esp. pages 202–204, 256–259, 382–386).

In the Majority Report, the statements by Federal Reserve Chairman Bernanke provided the most significant new information. The report explains at 339 and 354:

> Fed Chairman Bernanke told the FCIC that government officials understood a Lehman bankruptcy would be catastrophic:
>
> > We never had any doubt about that. It was going to have huge impacts on funding markets. It would create a huge loss of confidence in other financial firms. It would create pressure on Merrill and Morgan Stanley, if not Goldman, which it eventually did. It would probably bring the short-term money markets into crisis, which we didn't fully anticipate; but, of course, in the end it did bring the commercial paper market and the money market mutual funds under pressure. So there was never any doubt in our minds that it would be a calamity, catastrophe, and that, you know, we should do everything we could to save it….
>
> Fed. Chairman Ben Bernanke told the FCIC, "As a scholar of the Great Depression, I honestly believe that September and October of 2008 were the worst financial crises in global history, including the Great Depression. If you look at the firms that came under pressure in that period… only one…was not at serious risk of failure…So out of maybe the 13, 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two. "

With respect to the SEC, see pages 150–155, 169–170, 282–283, 296–298, the Majority Report said:

> The Securities and Exchange Commission's poor oversight of the five largest investment banks failed to restrict their risky activities and did not require them to hold adequate capital or liquidity for their activities, contributing to the failure or need for government bailouts of all five of the supervised investment banks during the financial crisis.

Id. at 155. See also Chapter 15.

The Majority Report also concluded, at 187:

> The Securities and Exchange Commission failed to adequately enforce its disclosure requirements governing mortgage securities, exempted some sales of such securities from its review, and preempted sales from applying state law to them, thereby failing in its core mission to protect investors.

Three of the four Republicans (Thomas, Hennessey, Holtz-Eakin) signed a dissenting statement, urging a narrower approach than the Majority Report, stating in part:

> During the course of the Commission's hearings and investigations, we heard frequent arguments that there was a single cause of the crisis. For some it was international capital flows or monetary policy; for others, housing policy; and for still others, it was insufficient regulation of an ambiguously

> defined shadow banking sector, or unregulated over-the-counter derivatives, or the greed of those in the financial sector and the political influence they had in Washington.
>
> In each case, these arguments, when used as single-cause explanations, are too simplistic because they are incomplete. While some of these factors were essential contributors to the crisis, each is insufficient as a standalone explanation.
>
> The majority's approach to explaining the crisis suffers from the opposite problem—it is too broad. Not everything that went wrong during the financial crisis caused the crisis, and while some causes were essential, others had only a minor impact. Not every regulatory change related to housing or the financial system prior to the crisis was a cause. The majority's almost 550-page report is more an account of bad events than a focused explanation of what happened and why. When everything is important, nothing is.
>
> As an example, non-credit derivatives did not in any meaningful way cause or contribute to the financial crisis. Neither the Community Reinvestment Act nor removal of the Glass-Steagall firewall was a significant cause. The crisis can be explained without resorting to these factors.
>
> We also reject as too simplistic the hypothesis that too little regulation caused the crisis, as well as its opposite, that too much regulation caused the crisis. We question this metric for determining the effectiveness of regulation. The *amount* of financial regulation should reflect the need to address particular failures in the financial system. For example, high-risk, nontraditional mortgage lending by nonbank lenders flourished in the 2000s and did tremendous damage in an ineffectively regulated environment, contributing to the financial crisis. Poorly designed government housing policies distorted market outcomes and contributed to the creation of unsound mortgages as well. Countrywide's irresponsible lending and AIG's failure were in part attributable to ineffective regulation and supervision, while Fannie Mae and Freddie Mac's failures were the result of policymakers using the power of government to blend public purpose with private gains and then socializing the losses. Both the "too little government " and "too much government " approaches are too broad-brush to explain the crisis.

Id. at 414.

The Thomas, Hennessey, Holtz-Eakin dissent identified ten essential causes of the financial and economic crisis: (1) credit bubbles; (2) housing bubbles; (3) nontraditional mortgages; (4) credit ratings and securitization; (5) financial institutions' concentrated correlated risk; (6) leverage and liquidity risk; (7) risk of contagion; (8) common shock; (9) financial shock and panic; and (10) financial crisis causes economic crisis.

The remaining Republican dissenter, Peter Wallison, in contrast, believed:

> that the *sine qua non* of the financial crisis was U.S. government housing policy, which led to the creation of 27 million subprime and other risky loans—half of all mortgages in the United States—which were ready to default as soon as the massive 1997–2007 housing bubble began to deflate. If the U.S. government had not chosen this policy path—fostering the growth of a bubble of unprecedented size and an equally unprecedented number of weak and high risk residential mortgages—the great financial crisis of 2008 would never have occurred.

Id. at 444.

In Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), the Senate Permanent Subcomm. on Investigations conducted case studies of four root causes of the financial crisis. The majority

staff Report, with which some have taken issue, focused in part on what it termed "high risk lending, " regulatory failures, "inflated credit ratings, " and "investment bank abuses. " Id. at 2–11.

See also House Panel Approves Seven Bills; Three to Axe Reform Act Sections, 43 Sec. Reg. & L. Rep. (BNA) 964 (2011) (House Financial Services Capital Markets Subcommittee adopted bills which, among other things, would repeal Dodd-Frank provisions that private equity funds register with the SEC and exempt legitimate end-users from derivatives regulation); Experts Say Missed Dodd-Frank Deadlines Increasingly Common; Lawmakers Accept It, 43 id. 965; GOP Lawmakers Take First Legislative Steps to Restructure New Consumer Bureau, 43 id. 967.

See also Kerr, The Financial Meltdown of 2008 and the Government's Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup and General Motors, 85 St. John's L. Rev. 49 (2011); Symposium: Is Financial Reform Too Big to Fail? Emerging from the Financial Crisis with the Help of Increased Consumer Protection and Corporate Responsibility, 60 Am. U. L. Rev. 1265 (2011); Gordon & Muller, Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund, 28 Yale J. on Reg. 151 (2011). Financial Services Leaders, Report Give Dodd-Frank Failing Grade at One-Year Mark, 43 Sec. Reg. & L. Rep. (BNA) 1458 (2011) ("According to the committee, approximately 62 percent of the more than 385 rules required by Dodd-Frank have yet to be proposed, and only 21 rules have been finalized "); Regulators Need More Data on Volcker Rule, GAO Says, Drawing Fire from Merkley, Levin, 43 id. 1459; Valley, 8 Berkeley Bus. L.J. 107 (2011); McDonnell, Don't Panic! Defending Cowardly Interventions during and after a Financial Crisis, 116 Penn. St. L. Rev. 1 (2011); Thompson, Market Makers and Vampire Squid: Regulating Securities Markets after the Financial Meltdown, 89 Wash. U. L. Rev. 323 (2011); Prentice, Moral Equilibrium: Stock Brokers and the Limits of Disclosure, 2011 Wis. L. Rev. 1059; Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 Iowa J. Corp. L. 265 (2012); Gubler, Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run, 63 Ala. L. Rev. 221 (2012); Lubben & Woo, Reconceptualizing *Lehman* , 49 Tex. Int'l L.J. 297 (2014); Ponchione, Tarbert & Miller, Private Equity Funds and the Volcker Rule, 47 Rev. Sec. & Commodities Reg. 171 (2014); Stewart & Eavis, Revisiting the Lehman Brothers Bailout That Never Was, N.Y. Times, Sept. 30, 2014 at A1; Gohari & Woody, The New Global Financial Regulatory Order: Can Macroprudential Regulation Prevent Another Global Financial Disaster?, 40 Iowa J. Corp. L. 403 (2015).

In 2014, the Bipartisan Policy Center published Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture. In 2015, the Volcker Alliance published Reshaping the Financial Regulatory System: Long Delayed, Now Crucial.

27 See, e.g., Edmund Andrews & Stephen Labaton, Split Is Forming over Regulation of Wall Street, N.Y. Times, Mar. 23, 2008 at 1; Damian Paletta & Kara Scannell, Washington Revisits Financial Regulation, Wall St. J., Mar. 21, 2008, at A6; Treasury Will Issue Comprehensive Plan to Overhaul Financial Regulatory System, 40 Sec. Reg. & L. Rep. (BNA) 186 (2008). See generally, GAO, Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure (GAO-05-61 Oct. 2004).

Cf. Coffee & Sale, Redesigning the SEC: Does the SEC Have a Better Idea?, 95 Va. L. Rev. 707 (2009).

See also Johnson, Things Fall Apart: Regulating the Credit Default Swap Commons, 82 U. Colo. L. Rev. 167 (2011); Rao & Clark, Changing Landscape of Swap Regulation, 44 Rev. Sec. & Commodities Reg. 97 (2011). Cf. A. Blinder, After the Music Stopped (2013); Alden, *Primum Non Nocere* : The Impact of Dodd-Frank on Silicon Valley, 8 Berkeley Bus. L.J. 107 (2011); McDonnell, Don't Panic! Defending Cowardly Interventions during and after a Financial Crisis, 116 Penn. St. L. Rev. 1 (2011); Thompson, Market Makers and Vampire Squid: Regulating Securities Markets after the Financial Meltdown, 89 Wash. U. L. Rev. 323 (2011); Prentice, Moral Equilibrium: Stock Brokers and the Limits of Disclosure, 2011 Wis. L. Rev. 1059; Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 Iowa J. Corp. L. 265 (2012); Gubler, Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run, 63 Ala. L. Rev. 221 (2012); Horton, When Does a Non-Bank Financial Company Pose a "Systemic Risk "? A Proposal for Clarifying Dodd-Frank, 37 Iowa J. Corp. L. 815 (2012); Yadav, The Problematic Case of Clearinghouses in Complex Markets, 101 Geo. L.J. 387 (2013); Litvak, Defensive Management: Does the Sarbanes-Oxley Act

Discourage Corporate Risktaking?, 2014 U. Ill. L. Rev. 1663; Merrill & Merrill, Dodd-Frank Orderly Liquidation: Too Big for the Constitution?, 163 U. Pa. L. Rev. 165 (2014); Kirk, Superior Supererogation: Why Credit Default Swaps Are Securities under the Investment Company Act of 1940, 6 Wm. & Mary Bus. L. Rev. 237 (2015); Shill, Boilerplate Shock: Sovereign Debt Contracts as Incubators of Systemic Risk, 89 Tul. L. Rev. 751(2015).

28 See supra ch. 7.A.1.c. Simultaneously, a major initiative of the then-current SEC had been a move toward harmonizing SEC accounting standards with international standards, a step that potentially could lead to a form of international securities regulation. See SEC Weighs Easing Overseas Investing, Wall St. J., Mar. 25, 2008, at A2; supra generally ch. 2.D.3.b.

Less conspicuous has been the expansion of exemptions under state regulation of securities issuance which has moved state law toward a role that is of lessened practical significance with respect to securities offerings, particularly by national or international firms. See supra ch. 1.B.

29 Department of Treasury, Blueprint for a Modernized Financial Regulatory Structure 165 (Mar. 2008), citing the text.

30 Id. at 5–6, 75–77. See generally Seligman, The SEC in a Time of Discontinuity, 95 Va. L. Rev. 667 (2009).

31 Id. at 6–7, 78–83. To effectuate this merger, the Report most significantly recommended: (1) tasking the President's Working Group with drafting overarching regulatory principles focusing on investor protection, market integrity, and overall financial system risk reduction; (2) harmonizing securities and commodities rules involving margin, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, the SRO rulemaking approval process, and the agency's funding mechanism, with harmonization being achieved by a joint CFTC-SEC staff task force with equal agency representation and a requirement to harmonize specified differences; and (3) harmonizing the regulation of broker-dealers and investment advisers, among other things to create an SRO for investment advisers similar to that of broker-dealers. Id. at 11–13, 106–126. The SEC, it was recommended, also should use its exemptive authority to adopt core principles to apply to securities clearing agencies and exchanges modeled after the core principles adopted for futures exchanges and clearing agencies under the Commodities Futures Modernization Act.

It was further recommended to permit all clearing agencies and market SROs to self-certify most rulemakings that would become effective upon filing with the SEC retaining its right to abrogate the rulemaking later.

32 Id. at 13–14, 137–146.

33 Id. at 15–17, 146–156.

34 Id. at 17–19, 157–170.

35 Id. at 19–21, 170–180. There would remain a role for self-regulatory organizations. The standards developed by the Conduct of Business Regulatory Agency would apply to both nationally chartered and state chartered firms.

36 Id. at 21.

There was reason for considerable skepticism that the proposed long-term optimal regulatory structure could ever be adopted in the form proposed. This optimal solution likely achieved the improbable outcome of uniting often competitive industries and regulators in common opposition. Moreover, while the proposal was over 200 pages long, the serious detailed policy analysis to support many specific proposals was not produced. For example, the Report was not sophisticated or nuanced with respect to why there are different regulatory approaches followed by different agencies or for different industries or why virtually none of these different approaches should be retained. At page 116 of the Report, there is the observation: "In general, margin is a very different concept in the futures and securities worlds. " This was a rare recognition that differences existed, but the Report did not follow through and analyze why. Differences in customers, differences in

technology, differences in intermediaries, and differences in internationalization are contextual factors that may well require differences in regulation.

There are powerful advantages to a focused agency such as the Securities and Exchange Commission or more recently the Public Company Accounting Oversight Board.

In 1934, there was a strong preference of those who sought the most effective federal securities regulation that the Federal Trade Commission, which initially enforced the Securities Act of 1933, remain the federal securities regulator. The attitude of the New Deal champions was captured by Ferdinand Pecora, who led the legendary Stock Exchange Practices hearings that were popularly known as the Pecora Hearings and led to the New Deal federal securities laws, who urged that the new securities laws "will be a good or bad law, depending upon the men who administer it. " The FTC in 1934 was very sympathetic to far-reaching securities regulation and included among its members James Landis who championed continuing the FTC as the federal securities regulator. Only later would Landis revise his view and come to believe that an agency like the SEC with a narrow jurisdiction had advantages in providing administrative expertise that an agency with a broad jurisdiction, like the FTC, lacked. Joel Seligman, The Transformation of Wall Street 97, 100 (3d ed. 2003).

More recent experience has amplified this point. The broader an agency's jurisdiction, the more likely it is to not have the resources or focus to address all appropriate priorities. A significant illustration of this involved the SEC during the late 1990s. Given a challenging political context and inadequate budget, the Commission's ongoing review of periodic disclosure documents such as Form 10-Ks badly deteriorated. On the other hand, it is important to recognize that an agency's jurisdiction can reach too far and its regulation and oversight can become too aggressive and heavy-handed, sometimes proving to be counterproductive as measured against the very goals the agency has set out to achieve. A more expansive jurisdiction and a more demanding regulatory regime is not always optimal.

In October 2002 a staff report of the Senate Governmental Affairs Committee, for example, found that in FY 2001 the Division of Corporation Finance was able to complete a full review of only 2,280 of 14,600 Form 10-K annual reports, roughly 16 percent, far short of the Division's stated goal to review every company's annual report at least once every three years. "Of more than 17,300 public companies, approximately 9200 or 53%, have not had their Form 10-Ks reviewed in the past three years. " Enron, then a notorious example of staff neglect, had last received a partial review of its Form 10-K annual report in 1997 and had been last subject to a full review in 1991. II Staff Report to Senate Comm. on Gov't Affairs, Financial Oversight of Enron: The SEC and Private Sector Watchdogs 13, 31–32 (Oct. 8, 2002). The argument can be made that had the SEC had the resources to have run the Division of Corporation Finance at more appropriate levels, the PCAOB might not have been needed. On the other hand, a regulator can always claim to need more resources. A key question is what does a regulator do with the resources it has.

The creation of the PCAOB, however, ensured that there would be one federal agency solely responsible for audit quality. The Board, unlike the SEC of the 1990s, had a narrow and focused agenda and did not have to balance using resources for audit review with a broad array of other potential priorities such as market regulation, broker-dealer and investment adviser regulation, new securities offerings, municipal and governmental securities dealers, and enforcement. The first SEC Chair, Joseph Kennedy, memorably observed in 1935 that "I'd hate to go out of here thinking that I had just made some changes in accounting practices. " Seligman, The Transformation of Wall Street, at 116–117. It is reasonable to assume that no one at the PCAOB has ever derogated improving auditing practices.

This point should not be overstated. The narrower an agency's agenda, the less likely it will be to galvanize White House or Congressional support for its budget and administrative priorities. A well-focused agency runs the risk of being lost in the alphabet of federal agencies, subject, like the SEC too often has been, to a boom and bust cycle of budgetary and legislative support with effective support most likely only in times of crisis. That

said, a bigger budget is not always the answer. If the agency is not setting the proper priorities or is not using its resources efficiently and effectively, then perhaps a greater budget is not warranted.

The challenge is to find the right balance between expertise, which is a consequential virtue of a well run regulatory agency, and effectiveness, which often can be better achieved by reducing the number of responsible agencies and increasing resources for each. There is no algebraic formula to achieve this balance.

A quite different reason for the maintenance of separate federal regulatory agencies is less inspiring, but no less powerful. The politics of Congress and the agencies themselves tend to fortify inertia. In the wake of the October 19, 1987 stock market crash, the Report of the Presidential Task Force on Market Mechanisms argued that "the markets for stocks, stock index futures and stock options—are in fact one market " and accordingly "one agency must have the authority to coordinate a few but critical intermarket regulatory issues, monitor intermarket activities and mediate intermarket concerns. " Report of the Presidential Task Force on Market Mechanisms 55, 59 (1988). The Report concluded that the Federal Reserve Board "is well qualified to fill the role of intermarket agency. " Id. at 69.

Within one month, this proposal was effectively dead. Federal Reserve Board Chair Alan Greenspan testified that he "seriously [questioned] this recommendation ":

> To be effective, an oversight authority must have considerable expertise in the market subject to regulation, something that the CFTC and SEC have developed over time. Moreover, were the Federal Reserve to be given a dominant role in securities market regulation, there would be a presumption by many that the federal safety net applicable to depository institutions was being extended to these markets and the Federal Reserve stood ready to jump in whenever a securities firm or clearing corporation was in difficulty.

Black Monday, The Stock Market Crash of October 19, 1987, Hearings before Senate Comm. on Banking, Hous. & Urban Affairs, 100th Cong., 2d Sess. 98–99 (1988).

37 See, e.g., Fear of Regulating, N.Y. Times, Apr. 3, 2008 at A26 ("the blueprint was mostly developed before the current financial crisis and accordingly came across as outdated ").

Soon after the Bear Stearns failure, SEC Chair Christopher Cox wrote the Chair of the Basel Committee on Banking Supervision and its working group on liquidity about the Commission's conclusions to that date regarding Bear Stearns. See SEC Press Rel. 2008-48 (Mar. 20, 2008). Cox stated in part:

> …[T]he conclusion to which these data point is that the fate of Bear Stearns was the result of a lack of confidence, not a lack of capital. When the tumult began last week, and at all times until its agreement to be acquired byJP Morgan Chase during the weekend, the firm had a capital cushion well above what is required to meet supervisory standards calculated using the Basel II standard.
>
> Specifically, even at the time of its sale on Sunday, Bear Stearns' capital, and its broker-dealers' capital, exceeded supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity—not inadequate capital—caused Bear's demise.… Bear Stearns' registered broker-dealers were comfortably in compliance with the SEC's net capital requirements, and in addition Bear Stearns' capital exceeded relevant supervisory standards at the holding company level. Specifically, throughout the week of March 10 until the closing of the JP Morgan Chase transaction on Sunday March 16, Bear Stearns had a capital ratio of well in excess of the 10% level used by the Federal Reserve Board in its *well-capitalized* standard.
>
> …[T]he holding company had a pool of high quality, highly liquid assets of over $18 billion as of the morning of March 11. This was consistent with what the SEC had seen over the preceding weeks,

during which SEC staff—both on-site and at headquarters—monitored the capital and liquidity positions of all the CSEs, in the case of Bear Stearns on a daily basis.

In accordance with customary industry practice, Bear Stearns relied day-to-day on its ability to obtain short-term financing through borrowing on a secured basis. Beginning late Monday, March 10, and increasingly through the week, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. Notwithstanding that Bear Stearns continued to have high quality collateral to provide as security for borrowings, market counterparties became less willing to enter into collateralized funding arrangements with Bear Stearns. This resulted in a crisis of confidence late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms.

This unwillingness to fund on a secured basis placed enormous stress on the liquidity of the firm. On Tuesday, March 11, the holding company liquidity pool declined from $18.1 billion to $11.5 billion. This improved on Wednesday, March 12, when Bear Stearns' liquidity pool increased by $900 million to a total of $12.4 billion. On Thursday, March 13, however, Bear Stearns' liquidity pool fell sharply, and continued to fall on Friday. The market rumors about Bear Stearns liquidity problems became self-fulfilling. On Sunday, March 16, Bear Stearns entered into the transaction with JP Morgan Chase. These events illustrate just how critical not just capital, but liquidity is to the viability of financial firms and how the evaporation of market confidence can lead to liquidity being impaired.

In late June 2008 a *Wall Street Journal* article summarized criticism of Chairman Cox for his low key leadership during the Bear Stearns crisis. Scannell & Craig, SEC Chief under Fire as Fed Seeks Bigger Wall Street Role, Wall St. J., June 23, 2008, at A1.

See also Cox Says Agency Making Multi-Prong Response to Market Turmoil, 40 Sec. Reg. & L. Rep. (BNA) 231 (2008); Sirri Says CSE's Models, Risk Controls Failed during Turmoil, 40 id. 237; FDIC's Bair Calls for Greater Transparency for Structured Products, Criticizes Agencies, 40 id. 312; CFTC's Chilton Extols Oversight Based on Principles, Says SEC *Cumbersome* , 40 id. 332; SEC, CFTC Formally Agree to Protocol for Enhanced Regulatory Cooperation, 40 id. 390; New York Fed Announces Modifications, Terms for Primary Dealer Lending Facility, 40 id. 437; Need for U.S. Financial Reg Reform Urgent, Scott, Others Contend at Summit, 40 id. 484; Treasury Plan Would Harm Investors, State Securities Regulators, CFA Argue, 40 id. 522; Sirri Sees Coming Focus on Markets' Bid to Boost Liquidity, 40 id. 785; DOJ Charges Two Bear Stearns Managers with Securities, Wire Fraud, 40 id. 957; Fed, SEC Nearing Agreement on Closer Regulatory Cooperation, 40 id. 959; cf. Nazareth: U.S. Decades behind in Reform, Says Distinction of Futures, Securities Key, 40 id. 853. Cf. Dodd, Shelby Tell Fed., SEC to Hold Off on Agreement to Share More Oversight, 40 id. 1039.

The SEC and Fed subsequently did formalize an MOU to coordinate exams and share information about investment banks in an effort to reduce systematic risk to the financial system. Fed, SEC Memorandum of Understanding Cements Information-Sharing Agreement, 40 id. 1065.

Cf. Schumer Outlines Reform Plan, Calls for Contemplating Single Regulator, 40 id. 1878; Lukken Outlines New Oversight Regime with Three Agencies, Principles-Centric, 40 id. 1908; Collins' Bill Seeks Regulation of CDSs, Investment-Bank Holding Companies, 40 id. 1930; Basel Committee Unveils Plan to Alter Capital Rules in Wake of Financial Crisis, 40 id. 1938; Paulson Says Regulatory Reforms Should Include Hedge Fund Registration, 40 id. 1947; NASAA Asserts Five *Principles* Policymakers Should Heed in Reform Debate, 40 id. 1959.

38 Report No. 446-A 2008. On the adoption of the Consolidated Supervisory Entity Program, see infra ch. 8.A.3.d.(ii).

39 Id. at iv–xi.

The Report amplified this critique of the SEC's CSE's process:

> The CSE application process includes TM reviewing a firm's application (for an exemption from the net capital rule) and makes a recommendation to the Commission. Approval of the firm's application is contingent on the firm agreeing to group-wide Commission supervision of the consolidated entity (including unregulated affiliates), if the firm does not already have a principal regulator. In addition, CSE firms must agree to:
>
> - Maintain and document an internal risk management control system for the affiliate group;
> - Calculate a group-wide capital adequacy measure consistent with the international standards adopted by the Basel Committee on Banking Supervision (*Basel Standards*). The CSEs are required to maintain an overall Basel capital ratio of not less than the Federal Reserve's 10 percent *well-capitalized* standard for bank holding companies. The CSE must notify the Commission (e.g., file an Early Warning Notice) if the 10 percent capital ratio is or is likely to be violated, or if tentative net capital of the broker-dealer falls below $5 billion;
> - Maintain sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding is not available for a period of at least one year. Another premise of this liquidity planning is that any assets held in a regulated entity are unavailable for use outside of the entity to deal with weakness elsewhere in the holding company structure, based on the assumption that during the stress event, including a tightening of market liquidity, regulators in the U.S. and relevant foreign jurisdictions would not permit a withdrawal of capital;
> - Consent to Commission examination [inspection] of the books and records of the ultimate holding company [i.e., the consolidated entity] and its affiliates, where those affiliates do not have principal regulators;
> - Regularly report on the financial and operational condition of the holding company, and make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operations risks within the ultimate holding company and its material affiliates; and
> - Make available [examination] inspection reports of principal regulators for those affiliates that are not subject to Commission [examination] inspection.
>
> The firms agreed to consolidated supervision because of the preferential capital treatment under the alternative method and international requirements. The European Union's (*EU*) Conglomerates Directive required that affiliates of U.S. registered broker-dealers demonstrate that they were subject to consolidated supervision by a U.S. regulator or face significant restrictions on their European operations.…
>
> According to Bear Stearns' data, it exceeded the required capital amounts at the holding company and broker-dealer level the entire time it was in the CSE program, including during the week of March 10, 2008. Although Bear Stearns was compliant with the capital requirements, there are serious questions about whether the capital requirement amounts were adequate. For instance,

some individuals have speculated that Bear Stearns would not have collapsed if it had more capital than was required by the CSE program. In fact, a former Director of TM has stated:

> The losses incurred by Bear Stearns and other large broker-dealers were not caused by *rumors* or a *crisis of confidence* , but rather by inadequate net capital and the lack of constraints on the incurring of debt.

…

The fact that Bear Stearns collapsed while it was compliant with the CSE program's capital requirements raises serious questions about the adequacy of the CSE program's capital ratio requirements.…

Bear Stearns initiated a plan in November 2006 to increase its liquidity levels and in fact (according to TM data), it significantly increased its liquidity levels from May 2007 until it suddenly collapsed during one week in March 2008. According to the Commission, Bear Stearns collapsed because it experienced a liquidity crisis when it lost its secured financing. The collapse of Bear Stearns thus indicates that the CSE program's liquidity guidelines (implementing the spirit of pillar 2 of Basel II) are inadequate in two respects. First, the time horizon over which a liquidity crisis unfolds is likely to be significantly less than the one-year period. Second, secured lending facilities are not automatically available in times of stress.

Bear Stearns' liquidity planning indicates that Bear Stearns was well aware of these impractical aspects of the CSE program's approach to liquidity more than a year before it failed.…

In November 2006, Bear Stearns also undertook efforts to line up *committed* secured lending facilities. The fact that Bear Stearns made a special effort to line up committed secured lending facilities indicates that Bear Stearns did not think that such facilities would automatically be available in a stressed environment.…

To summarize, TM was aware that risk management of mortgages at Bear Stearns had numerous shortcomings, including lack of expertise by risk managers in mortgage-backed securities at various times; lack of timely formal review of mortgage models; persistent understaffing; a proximity of risk managers to traders suggesting lack of independence; turnover of key personnel during times of crisis; and an inability or unwillingness to update models quickly enough to keep up with changing circumstances. In 2006, TM missed an opportunity to push Bear Stearns aggressively to add expertise in mortgage modeling to the risk management staff, to review mortgage models in a timely manner, to add incorporate default rates into mortgage modeling, and to make sure that mortgage risk management could function efficiently in a stressed environment.

Id. at 3–23.

40 See Chairman Cox Announces End of Consolidated Supervised Entities Program, SEC Press Rel. 2008-230 (Sept. 26, 2008).

41 See also Labaton, Agency's '04 Rule Let Banks Pile up New Debt, and Risk, N.Y. Times, Oct. 3, 2008, at A1; SEC Ends Voluntary Program for Supervising Major Wall Street Firms' Capital and Liquidity, 40 Sec. Reg. & L. Rep. (BNA) 1532 (2008); Markey Demands Answers from SEC over Failures Cited in Recent IG Report, 40 id. 1587.

42 $145 Billion and Counting, www.online.wsj.com (May 11, 2010); Keith, Panel Examines Fannie Mae, Freddie Mac Collapse, www.npr.org (May 26, 2010).

43 Lehman Brothers Holdings Files Ch. 11 Petition after Gov't Denies Funding, 40 Sec. Reg. & L. Rep. (BNA) 1476 (2008). At the time Lehman was the fourth largest investment bank in the United States, with more than

25,000 employees. Three days later SIPC placed Lehman in SIPA liquidation. To Ease Accounts Transfer to Barclays, SIPC to Place Lehman in SIPA Liquidation, 40 id. 1477.

44 40 id. 1476. See also Fed Again Invokes Emergency Powers with $37.8 Billion in New Loans to AIG, 40 id. 1643. Subsequently this would grow to approximately $182 billion. Troubled Asset Relief Program: Status of Government Assistance Provided to AIG (GAO-09-975) Sept. 2009 at 47.

45 Bank of America Buys Merrill Lynch; Experts See More Concentrated Section, 40 id. 1480.

46 Goldman, Morgan Become Banks in Radical Change to Face of Wall Street, 40 id. 1534.

47 122 Stat. 3765, 110th Cong., 2d Sess.

48 Financial Bailout Package Signed into Law, Though Doubts Remain about Effectiveness, 40 id. 1581.

49 §2(1).

Under the Act, a Financial Stability Oversight Board was established, §104, whose membership included (1) the Chair of the Federal Reserve System, (2) the Secretary of Treasury, (3) the Director of the Federal Housing Finance Agency, (4) the Chair of the SEC, and (5) the Secretary of Housing and Urban Development. §104(b).

Under §111 any financial institution that sells troubled assets to the Treasury under this Act is subject to executive compensation requirements in §111(b) and (c). These include:

> (b) Direct Purchases
>
> (1) In general—Where the Secretary determines that the purposes of this Act are best met through direct purchases of troubled assets from an individual financial institution where no bidding process or market prices are available, and the Secretary receives a meaningful equity or debt position in the financial institution as a result of the transaction, the Secretary shall require that the financial institution meet appropriate standards for executive compensation and corporate governance. The standards required under this subsection shall be effective for the duration of the period that the Secretary holds an equity or debt position in the financial institution.
>
> (2) Criteria—The standards required under this subsection shall include—
>
> (A) limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution;
>
> (B) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and
>
> (C) a prohibition on the financial institution making any golden parachute payment to its senior executive officer during the period that the Secretary holds an equity or debt position in the financial institution.
>
> (3) Definition—For purposes of this section, the term *senior executive officer* means an individual who is one of the top 5 highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and any regulations issued thereunder, and non-public company counterparts.
>
> (c) Auction Purchases—Where the Secretary determines that the purposes of this Act are best met through auction purchases of troubled assets, and only where such purchases per financial institution in the aggregate exceed $300,000,000 (including direct purchases), the Secretary shall prohibit, for such financial institution, any new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. The Secretary shall issue guidance to carry out this paragraph not later

> than 2 months after the date of enactment of this Act, and such guidance shall be effective upon issuance.

Under §302, §162(m) of the Internal Revenue Code was amended by adding a new paragraph which provided in part:

> (5) Special Rule for Application to Employers Participating in the Troubled Assets Relief Program—
>
> (A) In General—In the case of an applicable employer, no deduction shall be allowed under this chapter—
>
> (i) in the case of executive remuneration for any applicable taxable year which is attributable to services performed by a covered executive during such applicable taxable year, to the extent that the amount of such remuneration exceeds $500,000, or
>
> (ii) in the case of deferred deduction executive remuneration for any taxable year for services performed during any applicable taxable year by a covered executive, to the extent that the amount of such remuneration exceeds $500,000 reduced (but not below zero) by the sum of—
>
> (I) the executive remuneration for such applicable taxable year, plus
>
> (II) the portion of the deferred deduction executive remuneration for such services which was taken into account under this clause in a preceding taxable year.

Regarding executive compensation generally, see supra ch. 2.D.2.k.

Section 132 authorized the SEC to suspend mark-to-market accounting, specifically the application of FASB Statement No. 157.

Section 133 directed the Commission within 90 days after enactment of this statute:

> …in consultation with the Board and the Secretary, [to] conduct a study on mark-to-market accounting standards as provided in Statement Number 157 of the Financial Accounting Standards Board, as such standards are applicable to financial institutions, including depository institutions. Such a study shall consider at a minimum—
>
> > (1) the effects of such accounting standards on a financial institution's balance sheet;
> >
> > (2) the impacts of such accounting on bank failures in 2008;
> >
> > (3) the impact of such standards on the quality of financial information available to investors;
> >
> > (4) the process by the Financial Accounting Standards Board in developing accounting standards;
> >
> > (5) the advisability and feasibility of modifications to such standards; and
> >
> > (6) alternative accounting standards to those provided in such Statement Number 157.

50 Treasury Already Looking to Next Phase As It Unveils $250B Bank Equity Buying Plan, 40 id. 1677. See also Treasury Office to Manage $700 Billion Rescue Plan Pushes to Build Operations, 40 id. 1687; Executive

Compensation, Governance Rules for Capital Purchase Program Are Released, 40 id. 1694; Fed Introduces Another Liquidity Program to Support Strained Money Market Funds, 40 id. 1744.

Cf. GAO Faults Treasury's Implementation of $700 Billion Financial Rescue Program, 40 Sec. Reg. & L. Rep. (BNA) 1988 (2008); GAO, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (GAO-09-216 Jan. 2009); Accountability for the Troubled Asset Relief Program: The Second Report for the Congressional Oversight Panel (Jan. 9, 2009).

51 Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation (2009).

52 See id. at 10–18.

53 Notably the Financial Services Oversight Council "should replace the President's Working Group on Financial Markets and have additional authorities and responsibilities with respect to systemic risk and coordination of financial regulation. " It was proposed that the council should:

> - facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemakings, examinations, reporting requirements, and enforcement actions;
> - provide a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies; and
> - identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks.

Id. at 20–21.

54 Id. at 22.

The approach to regulation of Tier I FHCs would significantly change. Where earlier their diversification was seen as a justification for looser capital, liquidity, and risk management standards, the Report stressed:

> Tier I FHCs should be subject to heightened supervision and regulation because of the greater risks their potential failure would pose to the financial system.…
>
> Capital Requirements. Capital requirements for Tier I FHCs should reflect the large negative externalities associated with the financial distress, rapid deleveraging, or disorderly failure of each firm and should, therefore, be strict enough to be effective under extremely stressful economic and financial conditions. Tier I FHCs should be required to have enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed economic times. In addition to regulatory capital ratios, the Federal Reserve should evaluate a Tier 1 FHC's capital strength using supervisory assessments, including assessments of capital adequacy under severe stress scenarios and assessments of the firm's capital planning practices, and market-based indicators of the firm's credit quality.
>
> Prompt Corrective Action. Tier 1 FHCs should be subject to a prompt corrective action regime that would require the firm or its supervisor to take corrective actions as the firm's regulatory capital levels decline, similar to the existing prompt corrective action regime for insured depository institutions established under the Federal Deposit Insurance Corporation Improvement Act (*FDICIA*).
>
> Liquidity Standards. The Federal Reserve should impose rigorous liquidity risk requirements on Tier 1 FHCs that recognize the potential negative impact that the financial distress, rapid deleveraging, or disorderly failure of each firm would have on the financial system. The Federal

> Reserve should put in place a robust process for continuously monitoring the liquidity risk profiles of these institutions and their liquidity risk management processes.…
>
> Overall Risk Management. Supervisory expectations regarding Tier 1 FHCs' risk-management practices must be in proportion to the risk, complexity, and scope of their operations. These firms should be able to identify firm-wide risk concentrations (credit, business lines, liquidity, and other) and establish appropriate limits and controls around these concentrations. In order to credibly measure and monitor risk concentrations, Tier 1 FHCs must be able to identify aggregate exposures quickly on a firm-wide basis.
>
> Market Discipline and Disclosure. To support market evaluation of a Tier 1 FHC's risk profile, capital adequacy, and risk management capabilities, such firms should be required to make enhanced public disclosures.
>
> Restrictions on Nonfinancial Activities. Tier 1 FHCs that do not control insured depository institutions should be subject to the full range of prudential regulations and supervisory guidance applicable to BHCs. In addition, the long-standing wall between banking and commerce—which has served our economy well—should be extended to apply to this new class of financial firm. Accordingly, each Tier 1 FHC also should be required to comply with the nonfinancial activity restrictions of the BHC Act, regardless of whether it controls an insured depository institution. We propose that a Tier 1 FHC that has not been previously subject to the BHC Act should be given five years to conform to the existing activity restrictions imposed on FHCs by the BHC Act.
>
> Rapid Resolution Plans. The Federal Reserve also should require each Tier 1 FHC to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress. Such a requirement would create incentives for the firm to better monitor and simplify its organizational structure and would better prepare the government, as well as the firm's investors, creditors, and counterparties, in the event that the firm collapsed. The Federal Reserve should review the adequacy of each firm's plan regularly.

Id. at 24–25.

55 Id. at 37–38.

56 Id. at 44–45.

57 Id. at 47–48.

58 Id. at 49–51:

> …While differences exist between securities and futures markets, many differences in regulation between the markets are no longer justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.
>
> Many of the instruments traded on the commodity and securities exchanges and in the over-the-counter markets have attributes that may place the instrument within the purview of both regulatory agencies. One result of this jurisdictional overlap has been that economically equivalent instruments may be regulated by two agencies operating under different and sometimes conflicting regulatory philosophies and statutes. For example, many financial options and futures products are similar (and, indeed, the returns to one often can be replicated with the other). Under the current federal regulatory structure, however, options on a security are regulated by the SEC, whereas futures contracts on the same underlying security are regulated jointly by the CFTC and SEC.
>
> In many instances the result of these overlapping yet different regulatory authorities has been numerous and protracted legal disputes about whether particular products should be regulated as futures or securities. These disputes have consumed significant agency resources that otherwise

could have been devoted to the furtherance of the agency's mission. Uncertainty regarding how an instrument will be regulated has impeded and delayed the launch of exchange-traded equity, equity index, and credit event products, as litigation sorted out whether a particular product should be regulated as a futures contract or as a security. Eliminating jurisdictional uncertainties and ensuring that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction, would remove impediments to product innovation.

Arbitrary jurisdictional distinctions also have unnecessarily limited competition between markets and exchanges. Under existing law, financial instruments with similar characteristics may be forced to trade on different exchanges that are subject to different regulatory regimes. Harmonizing the regulatory regimes would remove such distinctions and permit a broader range of instruments to trade on any regulated exchange. Permitting direct competition between exchanges also would help ensure that plans to bring OTC derivatives trading onto regulated exchanges or regulated transparent electronic trading systems would promote rather than retard competition. Greater competition would make these markets more efficient, which would benefit users of the markets, including investors and risk managers.

Pursuant to the CEA, the CFTC currently employs a *principles-based approach* to regulation of exchanges, clearing organizations, and intermediaries, while pursuant to the securities laws; the SEC employs a *rules-based approach* . Efforts at harmonization should seek to build a common foundation for market regulation through agreement by the two agencies on principles of regulation that are significantly more precise than the CEA's current *core principles* . The new principles need to be sufficiently precise so that market practices that violate those principles can be readily identified and subjected to enforcement actions by regulators. At the same time, they should be sufficiently flexible to allow for innovations by market participants that are consistent with the principles. For example, the CFTC has indicated that it is willing to recommend adopting as core principles for clearing organizations' key elements of international standards for central counterparty clearing organizations (the CPSS-IOSCO standards), which are considerably more precise than the current CEA core principles for CFTC regulated clearing organizations.

Harmonization of substantive futures and securities regulation for economically equivalent instruments also should require the development of consistent procedures for reviewing and approving proposals for new products and rulemakings by self-regulatory organizations (*SRO* s). Here again, the agencies should strike a balance between their existing approaches. The SEC should recommend requirements to respond more expeditiously to proposals for new products and SRO rule changes and should recommend expansion of the types of filings that should be deemed effective upon filing, while the CFTC should recommend requiring prior approval for more types of rules and allowing it appropriate and reasonable time for approving rules that require prior approval.

The harmonization of futures and securities laws for economically equivalent instruments would not require eliminating or modifying provisions relating to futures and options contracts on agricultural, energy, and other physical commodity products. There are important protections related to these markets which must be maintained and in certain circumstances enhanced in applicable law and regulation.

We recommend that the CFTC and the SEC complete a report to Congress by September 30, 2009 that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to statutes and regulations that would eliminate the differences. If the two agencies cannot reach agreement on such explanations and recommendations by September 30, 2009, their differences should be referred to the new Financial

> Services Oversight Council. The Council should be required to address such differences and report its recommendations to Congress within six months of its formation.

59 Id. at 55–56.

60 Id. at 71–73.

61 See Statement of Paul A. Volcker before Senate Comm. on Banking, Hous. & Urban Affairs (Feb. 2, 2010):

> The basic point is that there has been, and remains, a strong public interest in providing a *safety net* —in particular, deposit insurance and the provision of liquidity in emergencies—for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.

See also S. Johnson & J. Kwak, 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown (2010); H. Paulson, On the Brink: Inside the Race to Stop the Collapse of the Global Financial System (2010); Cunningham & Zaring, The Three or Four Approaches to Financial Regulation: A Cautionary Analysis against Exuberance in Crisis Response, 78 Geo. Wash. L. Rev. 39 (2009); Kulpa, Minimal Deterrence: The Market Impact, Legal Fallout, and Impending Regulation of Credit Default Swaps, 5 J. L. Econ. & Policy 291 (2009); Treasury's Proprietary Trading Language Targets All Financial Firms for Restrictions, 42 Sec. Reg. & L. Rep. (BNA) 389 (2010); Bernanke Says Ban on Proprietary Trading Appropriate if Regulators Allowed Discretion, 42 id. 346; White House Seeks Tough Limits on Size, Trading Activities of Large Financial Firms, 42 Sec. Reg. & L. Rep. (BNA) 117 (2010); cf. Addleman, The Impact of Dodd-Frank on Public Companies, 38 Sec. Reg. L.J. 181 (2010); Hill, Who Were the Villains in the Subpoena Crisis, and Why It Matters, 4 Entrepren. Bus. L.J. 323 (2010); Shadab, Guilty by Association? Regulating Credit Default Swaps, 4 Entrepren. Bus. L.J. 407 (2010); Siems, Convergence in Corporate Governance: A Leximetric Approach, 35 Iowa J. Corp. L. 729 (2010); Gray, Chandis & Echemendia, Striking the Right Balance: Public versus Private Enforcement Laws—What Will We Learn from this Financial Meltdown?, 60 Syracuse L. Rev. 449 (2010); Symposium on Lessons of the Financial Crisis: Implications for Regulatory Reform, 43 Creighton L. Rev. 275 (2010); cf. Symposium: Examining Government Reform in the Wake of the Financial Crisis, 5 J. Bus. & Tech. L. 183 (2010); Symposium: Regulatory Reform and the Future of the U.S. Financial System: An Examination of the Dodd-Frank Regulation, 7 N.Y.U. J. L. & Bus. 427 (2011); see also Symposium: From Wall Street to Main Street: The Future of Financial Regulation, 15 Chapman L. Rev. 257 (2011); Chertok, A Comprehensive Guide to Title IV of the Dodd-Frank Act and the Rules Promulgated Thereunder, 12 U.C. Davis Bus. L.J. 125 (2012); Chertok, The Rise of the Dodd-Frank Act: How Dodd-Frank Will Likely Impact Private Equity Real Estate, 16 U. Pa. J. Bus. L. 97 (2013); Patrikis, The *Systemically* Important Newbank Company: A Mythical Beast, 45 Sec. Reg. & L. Rep. (BNA) 17 (2013).

In January 2013 the GAO, in Financial Regulatory Reform: Regulators Have Faced Challenges Finalizing Key Reforms and Unaddressed Areas Pose Potential Risks (GAO-13-195, Jan. 2013), reported that for the more than 80 provisions of the Dodd-Frank Act for which the SEC is responsible, as of December 2012 the Commission had proposed or finalized rulemakings for at least 70 of those provisions. Id. at 23. SEC Chair Walter further noted that the Commission has finalized 17 of the 20 required studies under the Act. Id. at 44.

Nonetheless the pace of rule implementation under Dodd-Frank has been slow.

The GAO Report described several causes for the slow pace of implementation, including: (1) the requirement to coordinate rule adoption with other domestic and foreign regulators, id. at 25–26; (2) large volumes of comment letters (for example, 19,000 comment letters to the proposed proprietary trading rules), id. at 27–28; and (3) the need to establish new regulatory bodies or offices as predicate to certain rule makings. Id. at 28–

30. In September 2014, the Bipartisan Policy Center published Responding to Systemic Risk: Restoring the Balance, which criticized specific provisions of the Dodd-Frank Act.

In February 2016, the GAO issued a report entitled, "Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness " (GAO-16-175), offering an assessment of the regulatory structure with a focus on areas of fragmentation and overlap.

The GAO issued a December 2016 report addressing aspects of the regulatory rulemaking process by agencies responsible for implementing Dodd-Frank, including cost-benefit analysis, the degree to which such agencies have coordinated, and the impacts of the legislation on so-called Systemically Important Financial Institutions and swaps. See GAO, Dodd-Frank Regulations: Agencies' Efforts to Analyze and Coordinate Their Recent Final Rules (GAO-17-188) (Dec. 2016).

On April 21, 2017 the president issued a Presidential Memorandum for the Secretary of the Treasury directing the Secretary to review the FSOC designation process under Dodd-Frank and provide a written report to the president. See https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury. On the same day, the president also issued a Presidential Memorandum for the Secretary of the Treasury directing the Secretary to review orderly liquidation authority under Dodd-Frank and provide a written report to the president. See https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury-0. The FSOC report that the Treasury produced is available on its web site at https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf ; and the report produced on order liquidation authority is available at https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf.

62 See whitehouse.gov/blog2010/J7/21_President_Obama_Signs_WallStreetReform_noeasytask.

In May 2018, President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act into law. In the eyes of some, this is seen as an unfortunate rolling back of the Dodd-Frank Act. In the eyes of others, it is seen as an appropriate scaling and tailoring of the Dodd-Frank Act, legislation that in this view reflected dramatic overregulation. Indicating the reach and purpose of the Economic Growth, Regulatory Relief, and Consumer Protection Act, Title I is titled "Improving Consumer Access to Mortgage Credit "; Title II is titled "Regulatory Relief and Protecting Consumer Access to Credit "; Title III is titled "Protections for Veterans, Consumers, and Homeowners "; Title IV is titled "Tailoring Regulations for Certain Bank Holding Companies "; Title V is titled "Encouraging Capital Formation "; and Title VI is titled "Protections for Student Borrowers. "

Title V falls under the SEC and the federal securities laws. We will address the legislative changes further where each substantive statutory provision is covered in the text. The following offers a high-level summary:

Section 501 of the Act amends the Securities Act to exempt from state securities offering registration requirements securities that have been qualified for trading in the national market system and listed or authorized for listing on a national securities exchange.

Section 502 of the Act requires the SEC staff to submit to the Senate Banking Committee a report on the risks and benefits of algorithmic trading in U.S. capital markets. The report is due within 18 months of the enactment of the Act.

Section 503 of the Act provides that the SEC will review the findings and recommendations of the Government-Business Forum on Small Business Capital Formation and issue a public statement disclosing the action, if any, that the Commission intends to take regarding the findings and recommendations.

Section 504 of the Act provides that a *qualifying venture capital fund* that has no more than 250 investors will be deemed not to be an *investment company* under the Investment Company Act. A *qualifying venture capital fund* means a "venture capital fund that has not more than $10,000,000 in aggregate capital contributions and uncalled committed capital, with such dollar amount to be indexed for inflation once every 5 years by the

Commission, beginning from a measurement made by the Commission on a date selected by the Commission, rounded to the nearest $1,000,000. "

Section 505 of the Act provides for a credit to national securities exchanges and national securities associations that in the past had paid fees and assessments to the Commission that exceeded what was required to be paid under Section 31 of the Exchange Act. The credit will be offset against future fees and assessments.

Section 506 of the Act amends the Investment Company Act to apply the Investment Company Act to investment companies created under the laws of Puerto Rico, the U.S. Virgin Islands, or any other U.S. possession.

Section 507 of the Act directs the SEC to revise Rule 701 under the Securities Act to increase from $5,000,000 to $10,000,000 the aggregate sales price or amount of securities sold pursuant to compensatory benefit plans during a 12-month period in excess of which the issuer must deliver additional disclosures to investors.

Section 508 of the Act expands the availability of so-called Regulation A+ to companies reporting under section 13 or 15(d) of the Securities Exchange Act.

Section 509 of the Act directs the SEC to revise its rules to allow a closed-end company that is registered as an investment company to use the same offering and proxy rules as are available to other issuers that are required to report under the Exchange Act.

63 Title III, The Enhancing Financial Institution Safety and Soundness Act of 2010, also transfers residual functions of the Office of Thrift Supervision to the FDIC, see §312(b), and abolishes the Office of Thrift Supervision 90 days after the transfer date, §313, which itself is one year after enactment of the Dodd-Frank Act. §311.

Conforming amendments were made in §376 of the Dodd-Frank Act to Securities Exchange Act §§3(a)(34)(A), (B), (C), (D), (E), (F), (G), (H), 15C(g)(1), and 23(b)(1).

64 Specifically under §2(12)(B) the SEC is defined to be the *primary financial regulatory agency* with respect to:

> (i) any broker or dealer that is registered with the Commission under the Securities Exchange Act of 1934, with respect to the activities of the broker or dealer that require the broker or dealer to be registered under that Act;
>
> (ii) any investment company that is registered with the Commission under the Investment Company Act of 1940, with respect to the activities of the investment company that require the investment company to be registered under that Act;

> (iii) any investment adviser that is registered with the Commission under the Investment Advisers Act of 1940, with respect to the investment advisory activities of such company and activities that are incidental to such advisory activities;
>
> (iv) any clearing agency registered with the Commission under the Securities Exchange Act of 1934, with respect to the activities of the clearing agency that require the agency to be registered under such Act;
>
> (v) any nationally recognized statistical rating organization registered with the Commission under the Securities Exchange Act of 1934,…;
>
> (vi) any transfer agent registered with the Commission under the Securities Exchange Act of 1934;
>
> (vii) any exchange registered as a national securities exchange with the Commission under the Securities Exchange Act of 1934;
>
> (viii) any national securities association registered with the Commission under the Securities Exchange Act of 1934;
>
> (ix) any securities information processor registered with the Commission under the Securities Exchange Act of 1934;
>
> (x) the Municipal Securities Rulemaking Board established under the Securities Exchange Act of 1934;
>
> (xi) the Public Company Accounting Oversight Board established under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7211 *et seq.*);
>
> (xii) the Securities Investor Protection Corporation established under the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa *et seq.*); and
>
> (xiii) any security-based swap execution facility, security-based swap data repository, security-based swap dealer or major security-based swap participant registered with the Commission under the Securities Exchange Act of 1934, with respect to the security-based swap activities of the person that require such person to be registered under such Act.

Similarly, securities terms such as *broker* , *dealer* , and *investment adviser* are defined in Dodd-Frank with the same meanings as in the relevant Federal securities laws. §2(15).

65 §111(b)(1). The independent member of the Council serves for a six year term, the other nonvoting members for two year terms. See §111(c)(1).

66 §111(b)(2).

67 §111(e).

68 §111(f).

69 Section 102(a)(4) defines a *U.S. nonbank financial company* to mean:

> a company (other than a bank holding company, a Farm Credit System institution chartered and subject to the provisions of the Farm Credit Act of 1971…, or a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), security-based swap execution facility, or security-based swap data repository registered with the Commission, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company),

swap execution facility or a swap data repository registered with the Commodity Futures Trading Commission), that is—

(i) incorporated or organized under the laws of the Unites States or any State; and

(ii) predominantly engaged in financial activities, as defined in paragraph (6).

Section 102(a)(6) defines a company to be *predominantly engaged in financial activities* if:

(A) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the company; or

(B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the company.

Section 102(b) authorizes the Federal Reserve Board of Governors to establish by regulation the requirements to determine if a company is predominantly engaged in financial activities.

See generally Lee, Lyons & Ray, Regulation and Resolution of Systemically Significant Financial Companies under the Dodd-Frank Act, 26 Rev. Bank & Fin. Serv. 101 (2010).

70 Section 113(a)(2) elaborates the considerations that the Council must consider in nature this determination. These include §113(a)(2)(D), "the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system. "

71 See definition of a *foreign nonbank financial company* in §102(a)(4)(D)

72 Section 113(c)(3) specifies that a company subject to this antievasion provision may establish an intermediate holding company under which its financial activities may be conducted in compliance with regulation or guidance from the Federal Reserve Board of Governors.

Section 113(c) defines financial activities in §113(c)(5) and excludes nonfinancial activities from Federal Reserve supervision in §113(c)(6).

Section 113(d) provides a reevaluation and rescission process.

Section 113(e) details a notice and opportunity for hearing procedure before a final determination.

There is an emergency exception in §113(f) and a requirement for the Council to consult with the primary financial regulation agency, if there is one, for each nonbank financial company or subsidiary being considered for supervision under §113(a), (b), or (e).

Judicial review is limited to 30 days after the receipt of a notice of final determination under §113(h).

Section 114 specifies a registration procedure for a nonbank financial company to be supervised by the Federal Reserve under §113.

73 *Bank holding company* has the same meaning in Title I of the Dodd-Frank Act as it does in §2 of the Bank Holding Company Act of 1956.

In 2013 the Federal Reserve Board, acting under §113 and other provisions of the Dodd-Frank Act, defined the terms: (1) *predominantly engaged in financial activities* , and (2) *significant nonbank financial company* . FRS Reg. PP; Docket No. R-1405 (May 6, 2013). The Release states in part:

> The Dodd-Frank Act established the Council, which, among other authorities and duties, may subject a *nonbank financial company* to supervision by the board and consolidated prudential standards if the Council determines that material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to the financial stability of the United States. Nonbank financial companies that are designated by the Council under section 113 of the Dodd-Frank Act are referred to as *nonbank financial companies supervised by the Board* .
>
> The authority of the Council to subject a nonbank financial company to consolidated prudential supervision by the Board is an important component of recent legislative and regulatory changes designed to address gaps and weaknesses in the financial regulatory system that became evident during the financial crisis. These gaps often allowed financial firms whose failure could pose substantial risks to the financial stability of the United States to avoid prudential, consolidated supervision.
>
> Title I of the Dodd-Frank Act defines a *nonbank financial company* to include both a U.S. nonbank financial company and a foreign nonbank financial company. The statute, in turn, defines a *U.S. nonbank financial company* as a company (other than a bank holding company and certain other specified types of entities) that is (i) incorporated or organized under the laws of the United States or any State; and (ii) *predominantly engaged in financial activities* ….
>
> For purposes of Title I of the Dodd-Frank Act, a company is considered to be *predominantly engaged* in financial activities if either (i) the annual gross revenues derived by the Company and all of its subsidiaries from financial activities, as well as from the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represents 85 percent or more of the consolidated assets of the company….
>
> Section 165(d)(2) of the Dodd-Frank Act also requires nonbank financial companies supervised by the board and bank holding companies with total consolidated assets of $50 billion or more to disclose the nature and extent of (i) the company's credit exposure to other significant nonbank financial companies and significant bank holding companies; and (ii) the credit exposure of such significant entities to the company. The terms *significant nonbank financial company* and *significant bank holding company* are used in section 113 of the Dodd-Frank Act as well, which specifies that the Council must consider the extent and nature of a nonbank company's transactions and relationships with other *significant nonbank financial companies* and *significant bank holding companies* , among other factors, in determining whether to designate a nonbank financial company for supervision by the board. The Act does not define the terms *significant*

> *nonbank financial company* or *significant bank holding company* , but instead directs the board to define those terms by rule.

Id. at 1–3.

Under 12 C.F.R. §242.4(a) :

A *significant nonbank financial company* means:

> (1) Any nonbank financial company supervised by the Board; and
>
> (2) Any other nonbank financial company that had $50 billion or more in total consolidated assets (as determined in accordance with applicable accounting standards) as of the end of its most recently completed fiscal year.

12 C.F.R. §242.2 separately defines a *U.S. nonbank financial company* to mean a company that:

> (1) Is incorporated or organized under the laws of the United States or any State;
>
> (2) Is predominantly engaged in financial activities as defined in §242.3 of this part; and
>
> (3) Is not—
>
> > (i) A bank holding company;
> >
> > (ii) A Farm Credit System institution chartered and subject to the provisions of the Farm Credit Act of 1971…;
> >
> > (iii) A national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), security-based swap execution facility, or security-based swap data repository that, in each case, is registered with the Securities and Exchange Commission as such; or
> >
> > (iv) A board of trade designated as a contract market (or parent thereof), a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company), a swap execution facility, or a swap data repository that, in each case, is registered with the Commodity Futures Trading Commission as such.

12 C.F.R. §243.3 then defines the term *predominantly engaged in financial activities* to mean:

> (1) The consolidated annual gross financial revenues of the company in either of its two most recently completed fiscal years represent 85 percent or more of the company's consolidated annual gross revenues (as determined in accordance with applicable accounting standards) in that fiscal year;
>
> (2) The consolidated total financial assets of the company as of the end of either of its two most recently completed fiscal years represent 85 percent or more of the company's consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of that fiscal year; or
>
> (3) The Council, with respect to the definition of a nonbank financial company for purposes of Title I of the Dodd-Frank Act (other than with respect to the definition of a significant nonbank financial

company), or the Board, with respect to the definition of a significant nonbank financial company, determines, based on all the facts and circumstances, that—

> (i) The consolidated annual gross financial revenues of the company represent 85 percent or more of the company's consolidated annual gross revenues; or
>
> (ii) The consolidated total financial assets of the company represent 85 percent or more of the company's consolidated total assets….

Appendix A to 12 C.F.R. §242 then provides a detailed description of financial activities for purposes of Title I of the Dodd-Frank Act, which includes:

> (c) Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940).
>
> (d) Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.
>
> (e) Underwriting, dealing in, or making a market in securities….
>
> (6) *Financial and investment advisory activities* . Acting as investment or financial advisor to any person, including (without, in any way, limiting the foregoing):
>
> (i) Serving as investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940)…to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;
>
> (ii) Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies;
>
> (iii) Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structuring, financial transactions and similar transactions, and conducting financial feasibility studies;
>
> (iv) Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments;
>
> (v) Providing educational courses, and instructional materials to consumers on individual financial management matters; and
>
> (vi) Providing tax-planning and tax-preparation services to any person.
>
> (7) *Agency transactional services for customer investments* .
>
> (i) *Securities brokerage* . Providing securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services, and incidental activities (including related securities credit activities and custodial services).
>
> (ii) *Riskless principal transactions* . Buying and selling in the secondary market all types of securities on the order of customers as a "riskless principal " to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a

> customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer.
>
> (ii) *Private placement services* . Acting as agent for the private placement of securities in accordance with the requirements of the Securities Act of 1933…and the rules of the Securities and Exchange Commission.
>
> (8) *Investment transactions as principal* .
>
> (i) *Underwriting and dealing in government obligations and money market instruments* . Underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 U.S.C. 24 and 335, including banker's acceptances and certificates of deposit.
>
> …
>
> (16) *Securities exchange* . Owning shares on a securities exchange.

74 §115(a)(1)(A).

75 Section 115(c) directs the Council to study "the feasibility, benefits, costs and structure of a contingent capital requirement for nonbank financial companies…and bank holding companies described in subsection (a). "

Section 115(d) further authorizes the Council to make recommendations to the Federal Reserve Board concerning the requirement that each company described in §115(a) report periodically to the Council, the Federal Reserve Board and the FDIC "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure. "

The Council also is authorized to make recommendations to the Federal Reserve Board concerning each company described in §115(a) the advisability of requiring credit exposure reports, see §115(d)(2); concentration limits, see §§115(e), 165; enforced public disclosures, see §115(f); and short term debt limits, see §115(g).

For bank holding companies with total consolidated assets of $50 billion or more or nonbank financial companies supervised by the Federal Reserve Board, the Council may require certified reports addressing the company’s financial condition; systems for monitoring and controlling financial, operating and other risks; transactions with any subsidiary that is a depository institution; and the extent to which the activities and operations of the company could, under adverse circumstances, have the potential to disrupt the overall financial stability of the United States. §116(a).

Section 161 authorizes the Federal Reserve Board to require each nonbank financial company supervised by the Board and any of its subsidiaries to submit reports to the Board as to:

> (A) the financial condition of the company or subsidiary, systems of the company or subsidiary for monitoring and controlling financial, operating, and other risks, and the extent to which the activities and operations of the company or subsidiary pose a threat to the financial stability of the United States; and
>
> (B) compliance by the company or subsidiary with the requirements of this title.

§161(a)(1).

Section 161(b) authorizes the Federal Reserve Board to examine any supervised nonbank financial company.

Section 162 addresses enforcement, with subsection (a) specifying that the Federal Reserve Board will treat supervised nonbank financial companies "in the same manner and to the same extent as if the

company were a bank holding company " and subsection (b) authorizing the Federal Reserve Board to make recommendations to the primary financial regulatory agency.

Under §163, nonbank financial companies similarly are treated as bank holding companies for acquisition and subject to specified provisions of the Bank Holding Company Act of 1956.

The Federal Reserve Board may exempt specified types and classes of U.S. or foreign nonbank financial companies from Federal supervision.

In December 2010 the Basel Committee. on Banking Supervision published Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems raising the minimum common equity requirement from 2 to 7 percent (including a 2.5 capital conservation buffer), as a key technique to strengthen global capital standards. The new standards are to be phased in between 2013 and January 1, 2019. See also Basel Comm. on Banking Supervision, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 2010); Symposium: Financial Regulatory Reform in the Wake of the Dodd-Frank Act, 97 Cornell L. Rev. 967 (2012); Symposium: Reshaping Capital Markets & Institutions: Twenty Years On, 90 Tex. L. Rev. 1597 (2012).

In 2014, the Federal Reserve Board adopted Regulation XX to implement §622 of the Dodd-Frank Act. Federal Reserve Sys., Regulation XX, Docket No. R-1489, Concentration Limits on Large Financial Companies. The Federal Reserve System adoption Release explained:

> Under section 622 of the Dodd-Frank Act, a financial company is prohibited from consummating a covered acquisition if the ratio of the resulting financial company's liabilities to the aggregate consolidated liabilities of all financial companies exceeds 10 percent. Consistent with section 622, the proposed rule defined a *financial company* as a company that is an insured depository institution; a bank holding company, a foreign bank or company that is treated as a bank holding company for purposes of the Bank Holding Company Act, a savings and loan holding company, any other company that controls an insured depository institution, and a nonbank financial company designated by the Council for supervision by the Board.… Companies that are not affiliated with an insured depository institution, such as stand-alone broker-dealers or insurance companies, are not subject to the concentration limit unless they have been designated by the Council for supervision by the Board.

Id. at 6–7.

In MetLife v. Financial Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2016), the court overturned the Council's designation of MetLife as a systemically important nonbank financial institution subject to heightened supervision under the Dodd-Frank Act. The court faulted the Council's analysis, concluding that the Council's decision to designate MetLife as systemically important was arbitrary and capricious in violation of the Administrative Procedure Act. Among other things, the court reasoned:

> There is no doubt that FSOC refused to consider the costs of its Final Determination to MetLife, and purposefully so.…MetLife alleges in Count VII that FSOC was arbitrary and capricious in taking this position.…The costs to MetLife are "important aspect[s] of the problem " in MetLife's view, and FSOC was therefore obligated to consider them.…
>
> The Complaint alleges more specifically that it was arbitrary and capricious to weaken the very company that was meant to be fortified by new regulation.…Yet that is what FSOC allegedly did, by foisting "billions of dollars " of regulatory costs on MetLife under the auspices of safeguarding it. …To avoid suffering this loss, MetLife argues that it would have to raise prices and withdraw from

certain markets, thereby reducing consumer choice and competition.…Neither is a rational result, according to MetLife.

FSOC rejoins that Dodd-Frank does not require a cost-benefit analysis, something that an agency need not undertake absent congressional command.…FSOC points out that adjacent provisions in Dodd–Frank do require such analysis. *See, e.g.,* 12 U.S.C. §5493(d)(7)(A)(i)(IV) (requiring "a cost-benefit analysis " of a certification program for financial counselors); *id.* §5512(b)(2)(A)(i) (requiring CFPB to consider the "potential benefits and costs to consumers and covered [companies] " of proposed consumer protection regulations). FSOC urges the Court not to imply a requirement "to consider costs that has elsewhere, and so often, been expressly granted " by Congress.…Should the Court disagree, FSOC argues that its interpretation of the statute merits Chevron deference.

Just last term, the Supreme Court decided *Michigan v. Environmental Protection Agency,* —— U.S. ——, 135 S. Ct. 2699, 192 L.Ed.2d 674 (2015), where it entertained a challenge to certain regulations under the Clean Air Act. That statute empowers EPA to regulate power plants only if "regulation is appropriate and necessary. " 42 U.S.C. §7412(n)(1)(A). Having estimated some $9.6 billion per year in regulatory costs, EPA had nonetheless refused to consider cost in its calculus. *Michigan,* 135 S. Ct. at 2705–06. The Court invalidated EPA's rule on the grounds that it misinterpreted the statue, even under the deferential rubric of *Chevron* .

The Court first observed that "agency action is lawful only if it rests 'on a consideration of the relevant factors.' " *Id.* at 2706 (quoting *State Farm,* 463 U.S. at 43, 103 S.Ct. 2856) (internal quotation marks omitted). The Court then turned to the statutory text, noting that "'appropriate' is 'the classic broad and all-encompassing term that naturally and traditionally includes consideration of all the relevant factors.' " *Id.* at 2707 (citing *White Stallion Energy Ctr., LLC v. EPA,* 748 F.3d 1222, 1266 (D.C. Cir. 2014) (Kavanaugh, J., concurring in part and dissenting in part)). Although the term leaves some discretion, "an agency may not 'entirely fai[l] to consider an important aspect of the problem' when deciding whether regulation is appropriate. " *Michigan,* 135 S. Ct. at 2707 (citing *State Farm,* 463 U.S. at 43, 103 S. Ct. 2856).

The Court easily concluded that cost was an important aspect of the problem. *Id.* at 2707 ("One would not say that it is even rational, never mind 'appropriate,' to impose billions of dollars in economic costs in return for a few dollars in health or environmental benefits. "). To the contrary, cost-benefit analysis is a central part of the administrative process:

> Agencies have long treated cost as a centrally relevant factor when deciding whether to regulate. Consideration of cost reflects the understanding that reasonable regulation ordinarily requires paying attention to the advantages *and* the disadvantages of agency decisions. It also reflects the reality that "too much wasteful expenditure devoted to one problem may well mean considerably fewer resources available to deal effectively with other (perhaps more serious) problems. " *Entergy Corp. v. Riverkeeper, Inc.,* 556 U.S. 208, 233, 129 S. Ct. 1498, 173 L.Ed.2d 369 (2009) (Breyer, J., concurring in part and dissenting in part). Against the backdrop of this established administrative practice, it is unreasonable to read an instruction to an administrative agency to determine whether "regulation is appropriate and necessary " as an invitation to ignore cost.

Id. at 2707–08.24 In the end, cost must be balanced against benefit because "[n]o regulation is 'appropriate' if it does significantly more harm than good. " *Id.* at 2707.

"Appropriate " is also the touchstone of the catch-all factor in Dodd-Frank Section 113. *See* 12 U.S.C. §5323(a)(2)(K). Notwithstanding this facial similarity between Dodd-Frank and the Clean Air

Act, however, Dodd-Frank only requires FSOC to consider appropriate "risk-related " factors. *Id.* That distinction is addressed below.

FSOC cites *Michigan* and *Whitman* for the combined proposition that "[w]here a statute 'expressly directs [an agency] to regulate on the basis of a factor that on its face does not include cost, [it] normally should not be read as implicitly allowing the Agency to consider cost anyway.' " ….The quote is accurate, but FSOC omits the next two sentences from *Michigan* :

> That principle has no application here. "Appropriate and necessary " is a far more comprehensive criterion than "requisite to protect the public health "; read fairly and in context, as we have explained, the term plainly subsumes consideration of cost.

135 S. Ct. at 2709. The same textual hook in 12 U.S.C. §5323(a)(2)(K) ("appropriate ") would thus require FSOC to consider the cost of designating a company for enhanced supervision, provided that cost is a "risk-related " factor.

FSOC points to adjacent terms in Dodd-Frank that expressly mention cost.…But the *Michigan* Court considered and rejected the same argument. *See* 135 S. Ct. at 2709 ("It is unreasonable to infer that, by expressly making cost relevant to other decisions, the Act implicitly makes cost irrelevant to the appropriateness of regulating power plants. ").

Assuming that cost is "appropriate " to consider, the question remains whether it is "risk-related. " 12 U.S.C. §5323(a)(2)(K). FSOC argues that the "potential cost to a designated company cannot properly be considered a 'risk-related' factor, because it is unrelated to the question posed by the statutory standard: whether the company's 'distress…could pose a threat to the financial stability of the United States.' "…But that is not the only question posed by the statutory standard. According to FSOC, several of the considerations in 12 U.S.C. §5323(a)(2) "seek to assess the vulnerability of a nonbank financial company to financial distress. " 12 C.F.R. §1310 App. A.II.d.1. FSOC's *ejusdem generis* argument is thus belied by its own Guidance; the "risk " in §5323(a)(2)(K) must refer both to the risk of destabilizing the market and the risk of distress in the first place. FSOC never responded to MetLife's allegation…or its argument…that imposing billions of dollars in cost could actually make MetLife more vulnerable to distress. Because FSOC refused to consider cost as part of its calculus, it is impossible to know whether its designation "does significantly more harm than good. " *Michigan,* 135 S. Ct. at 2707. That renders the Final Determination arbitrary and capricious.

Finally, FSOC argues that the only relevant cost is that of designation itself, not of the ensuing prudential standards.…In other words, even if cost is a "risk-related factor, " it should only be considered later, when it can be discerned (under the yet-unwritten prudential standards). *See id.* (arguing that "the designation itself [is] the only agency action properly at issue here " and that the Court should not consider "possible future costs from 'the imposition of enhanced prudential standards' ") ….The *Michigan* dissent made the same argument, but it was rejected by the majority:

> This line of reasoning contradicts the foundational principle of administrative law that a court may uphold agency action only on the grounds that the agency invoked when it took the action. *SEC v. Chenery Corp.,* 318 U.S. 80, 87, 63 S. Ct. 454, 87 L. Ed. 626 (1943). When it deemed regulation of power plants appropriate, EPA said that cost was irrelevant to that determination—not that cost-benefit analysis would be deferred until later. Much less did it say (what the dissent now concludes) that the consideration

> of cost at subsequent stages will ensure that the costs are not disproportionate to the benefits. What it said is that cost is irrelevant to the decision to regulate.

135 S. Ct. at 2710.

FSOC, too, has made the decision to regulate—by designating MetLife. That decision intentionally refused to consider the cost of regulation, a consideration that is essential to reasoned rulemaking. *Cf. id.* at 2707 ("Consideration of cost reflects the understanding that reasonable regulation ordinarily requires paying attention to the advantages *and* the disadvantages of agency decisions. ") (emphasis in original). In light of *Michigan* and of Dodd-Frank's command to consider all "appropriate " risk-related factors, 12 U.S.C. §5323(a)(2)(K), FSOC's position is at odds with the law and its designation of MetLife must be rescinded.

Id. at 239-242.

76 Notice and hearing procedures are specified in §121(b).

Section 123 requires the Department of the Treasury to carry out a study of the economic impact of possible financial services regulatory limitations intended to reduce systemic risk.

Separately an Office of Financial Research within the Department of the Treasury is established by Subtitle B of Title 1, §§151–156. The core purpose of the Office of Financial Research is to support the Financial Stability Oversight Council. §153(a)(1). The Director of the Office is a Presidential appointment, §152(b)(1), with sole discretion in the manner in which he or she fulfills responsibilities under the subtitle. §152(b)(5). There is a form of self-funding to support the Office, see §155(d), and the Director of the Office has subpoena power to compel data requested under specified provisions of the Subtitle. §153(f).

In September 2011 the FDIC adopted an Interim Final Rule requiring specified insured depository institutions to submit contingent plans for the resolution of the institutions in the event of their failure. See 12 CFR Pt. 360, RIN 3064-AD59 (2011).

Too Big to Fail: The Path to a Solution: A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center (May 2013), proposed an alternative to the Orderly Liquidation Authority (*OLA*) in Title II of the Dodd-Frank Act, employing a single-point-of-entry recapitalization strategy. Id. at 8–15.

The Bipartisan Policy Center was founded in 2007 by former Senate Majority Leader Howard Baker, Tom Daschle, Bob Dole, and George Mitchell.

Charles Plosser, President of the Federal Reserve of Philadelphia, was an early supporter of this approach. See Plosser, Can We End Too Big to Fail?, 4th Ann. Simon N.Y. Conf., Reform at a Crossroads: Economic Transformation in the Year Ahead (May 9, 2013).

77 More stringent prudential standards can be tailored on an individual company basis. See §165(a)(2)(A). Specified subsections in §165 parallel those in §115.

In addition §165 specifically prohibits private rights of action to challenge resolution plans and credit exposure reports, see §165(d), and directs the Federal Reserve Board to require each covered publicly traded supervised nonbank financial company bank holding company to establish a risk committee, §165(h), and to be subject to an annual stress test administered by the Fed, §165(i)(1), and itself to conduct semiannual stress tests.

Section 166 directs the Federal Reserve Board to adopt regulations to provide for the early remediation of financial distress by a supervised nonbank financial company or covered bank holding company described in §165(a), "except nothing in this subsection authorizes the provision of financial assistance from the Federal Government. " §166(a).

78 Off-balance sheet activities are taken into account in computing capital requirements. §165(k).

The Act also imposes in §165(e) concentration limits of 25 percent of capital stock and surplus.

79 Section 2(10)(A) defines the term *federal banking agency* to mean the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, and the FDIC.

80 12 U.S.C. §1820(b)(3).

81 See ch. 8.B.5. A *covered financial company* means a financial company for which a determination has been made under §203(b) and a *covered financial company* is defined in §201(8).

82 Section 201(7) defines a *covered broker or dealer* to mean a *financial company* that is a broker-dealer that is registered with the SEC under §15(b) and a member of SIPC.

83 Orderly liquidations that result in appointment of the FDIC as receiver are subject to expedited judicial review under §202 and are not subject to the Bankruptcy Code. §202(c). Section 216, however, directs the Federal Reserve to conduct a study regarding the resolution of financial companies under Chapter 7 or 11 of the Bankruptcy Code, specifically including:

> (A) the effectiveness of chapter 7 and chapter 11 of the Bankruptcy Code in facilitating the orderly resolution or reorganization of systemic financial companies;
>
> (B) whether a special financial resolution court or panel of special masters or judges should be established to oversee cases involving financial companies to provide for the resolution of such companies under the Bankruptcy Code, in a manner that minimizes adverse impacts on financial markets without creating moral hazard;
>
> (C) whether amendments to the Bankruptcy Code should be adopted to enhance the ability of the Code to resolve financial companies in a manner that minimizes adverse impacts on financial markets without creating moral hazard;
>
> (D) whether amendments should be made to the Bankruptcy Code, the Federal Deposit Insurance Act, and other insolvency laws to address the manner in which qualified financial contracts of financial companies are treated; and
>
> (E) the implications, challenges, and benefits to creating a new chapter or subchapter of the Bankruptcy Code to deal with financial companies.

The Federal Reserve completed its Study on the Resolution of Financial Companies under the Bankruptcy Code in July 2011, a copy of which is available at http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf.

Cf. Horton, How Dodd-Frank's Orderly Liquidation Authority for Financial Companies Violates Article III of the United States Constitution, 36 Iowa J. Corp. L. 869 (2011); Petrasic, Volcker Rule Proposal Highlights Regulatory Challenges to Implementation, 43 Sec. Reg. & L. Rep. (BNA) 2365 (2011); Rock, Shareholder Eugenics in the Public Corporation, 97 Cornell L. Rev. 849 (2012).

84 §204(a).

85 Ibid.

Section 206 specifies mandatory terms and conditions for all orderly liquidations:

> In taking action under this title, the Corporation shall—
>
> (1) determine that such action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company;
>
> (2) ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid;
>
> (3) ensure that unsecured creditors bear losses in accordance with the priority of claim provisions in section 210;
>
> (4) ensure that management responsible for the failed condition of the covered financial company is removed (if such management has not already been removed at the time at which the Corporation is appointed receiver);
>
> (5) ensure that the members of the board of directors (or body performing similar functions) responsible for the failed condition of the covered financial company are removed, if such members have not already been removed at the time the Corporation is appointed as receiver; and
>
> (6) not take an equity interest in or become a shareholder of any covered financial company or any covered subsidiary.

86 §203(a)(1).

87 §202(a)(1)(A)(i).

88 §203(b).

Section 201(10) defines a *financial company* to mean any company that:

> (A) is incorporated or organized under any provision of Federal law or the laws of any State;
>
> (B) is—
>
> > (i) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a));
> >
> > (ii) a nonbank financial company supervised by the Board of Governors;
> >
> > (iii) any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956 …other than a company described in clause (i) or (ii); or
> >
> > (iv) any subsidiary of any company described in any of clauses (i) through (iii) that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956 …(other than a subsidiary that is an insured depository institution or an insurance company); and
>
> (C) is not a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended…, a governmental entity, or a regulated entity, as defined

> under section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.

89 §210(n)(9)(B).

The powers and duties of the FDIC are delineated in §210. These include the power to operate the covered financial company during liquidation, §210(a)(1)(B), and merger or transfer assets and liabilities, §210(a)(1)(G).

The Dodd-Frank Act includes §210(o), an assessment provision, that will charge one or more risk-based assessments to each bank holding company with total consolidated assets of $50 billion and nonbank financial companies supervised by the Federal Reserve "if such assessments are necessary to pay in full the obligations issued by the [FDIC] to the [Treasury]…within 60 months of the date of issuance of such obligations. "

90 More broadly, §213 authorizes the Federal Reserve or FDIC to issue minimum two year bar orders against a senior executive or director of a covered financial company for violation of laws or regulations; cease or desist orders; Federal agency conditions imposed by written agreements; unsafe or unsound practices; or acts, omissions or practices which constitute a breach of fiduciary duty. §213(b)(1).

Sections 213(b)(2)–(3) limit applicability of §213 to instances where the Federal Reserve or FDIC determines that:

> (2) by reason of the violation, practice, or breach described in any subparagraph of paragraph (1), such senior executive or director has received financial gain or other benefit by reason of such violation, practice, or breach and such violation, practice, or breach contributed to the failure of the company; and
>
> (3) such violation, practice, or breach—
>
> > (A) involves personal dishonesty on the part of such senior executive or director; or
> >
> > (B) demonstrates willful or continuing disregard by such senior executive or director for the safety or soundness of such company.

91 12 U.S.C. §§1841 et seq. Cf. Tarbert & Radetsky, The Volcker Rule and the Future of Private Equity, 27 Rev. Banking & Fin. Serv. 43 (2011); Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 Iowa J. Corp. L. 265 (2012); Dombalagian, The Expressive Synergies of the Volcker Rule, 54 B.C. L. Rev. 469 (2013); Long, Dumont, Chianese & Richard, The Final Volcker Rule: Highlights and Principal Differences from the Proposal, 42 Sec. Reg. L.J. 161 (2014).

92 Section 989 of the Dodd-Frank Act directs the Comptroller General within 15 months after enactment to conduct a study of the risks and conflicts associated with proprietary trading, including an evaluation of:

> (A) whether proprietary trading presents a material systemic risk to the stability of the United States financial system, and if so, the costs and benefits of options for mitigating such systemic risk;
>
> (B) whether proprietary trading presents material risks to the safety and soundness of the covered entities that engage in such activities, and if so, the costs and benefits of options for mitigating such risks;
>
> (C) whether proprietary trading presents material conflicts of interest between covered entities that engage in proprietary trading and the clients of the institutions who use the firm to execute trades

> or who rely on the firm to manage assets, and if so, the costs and benefits of options for mitigating such conflicts of interest;
>
> (D) whether adequate disclosure regarding the risks and conflicts of proprietary trading is provided to the depositors, trading and asset management clients, and investors of covered entities that engage in proprietary trading, and if not, the costs and benefits of options for the improvement of such disclosure; and
>
> (E) whether the banking, securities, and commodities regulators of institutions that engage in proprietary trading have in place adequate systems and controls to monitor and contain any risks and conflicts of interest related to proprietary trading, and if not, the costs and benefits of options for the improvement of such systems and controls.

93 Study and Recommendations on Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds at 3.

94 Id. at 4–7.

95 Id. at 28–29.

96 Id. at 48–49.

97 Id. at 60, 65–67.

98 Sec. Ex. Act Rel. 65,545, 102 SEC Dock. 603 (proposal) (2011).

99 BHCA-1, 79 Fed. Reg. 5536 (2013) (adoption).

100 Id. at 5548.

101 Id. at 5550.

102 Id. at 5550.

103 Id. at 5554.

104 Id. at 5555.

105 Id. at 5554.

106 Id. at 5556. See also §3(d)(5) excluding clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility.

107 Id. at 5557–5558.

108 Id. at 5558.

109 Id. at 5559.

110 Id. at 5560.

111 Id. at 5568.

112 Id. at 5570.

113 Id. at 5572.

114 Id. at 5574.

115 Id. at 5574–5575.

116 Id. at 5564.

117 Id. at 5565–5566.

118 Id. at 5567.

119 Id. at 5584.

120 Id. at 5592. See also id. at 5596.

121 Id. at 5589.

122 Id. at 5595–5596.

123 Id. at 5592.

124 Id.

125 Id. at 5593–5594.

126 Id. at 5596.

127 Id. at 5597.

128 Id. at 5605.

129 Id. See also id. at 5609–5611.

130 Id. at 5611.

131 Id. at 5606–5607.

132 Id. at 5609.

133 Id. at 5609.

134 Id. at 5608–5609.

135 Id. at 5613.

136 Id. at 5615. See generally id. at 5616.

137 Id. at 5631.

138 Id.

139 Id. at 5634.

140 Id.

141 Id. at 5636.

142 Id. at 5637.

143 Id. at 5637–5638.

144 Id. at 5639.

145 See generally id. at 5642–5646.

146 See §6(c)(1)(ii).

147 79 Fed. Reg. at 5648.

148 See §6(c)(2).

149 See §6(d)(1).

150 79 Fed. Reg. at 5651.

151 Id. at 5656.

152 Id. at 5656–5658.

153 See generally id. at 5662–5665.

154 Id. at 5665–5666.

155 Id. at 5670.

156 Id. at 5672–5673.

157 id. at 5676–5677.

158 See generally id. at 5677–5789.

159 See id. at 5699–5706.

160 Id. at 5705.

161 Id. at 5715. See generally id. at 5716–5722.

162 See id. at 5720–5722.

163 Id. at 5721–5723.

164 See §12(a)(ii)(A). See generally 79 Fed. Reg. at 5725–5728.

165 See generally 79 Fed. Reg. at 5728–5729.

166 Id. at 5729.

167 Id. at 5734–5735.

168 Id. at 5736.

169 Id. at 5740.

170 Id. at 5750.

171 BHCA-2, 79 Fed. Reg. 5223 (2014) (adoption). See also Bumpy Phase-In Seen for Volcker Rule Despite Extended Compliance Deadlines, 45 Sec. Reg. & L. Rep. 2277 (2013); Divided SEC Adopts Volcker Rule; Dissenting Members Call for Reproposal, 45 id. 2278; Federal Reserve Sys., FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule (Dec. 19, 2013).

In December 2014, the Federal Reserve Board extended the conformance period under §13 of the Bank Holding Company Act for all banking entities to conform investment in and with relationships with legacy covered funds for one year until July 21, 2016. The Board also indicated its intention next year to grant a final one-year extension until July 21, 2017.

The Commission staff has issued Responses to Frequently Asked Questions Regarding the Commission's Rule under Section 13 of the Bank Holding Company Act, commonly referred to as the Volcker Rule. The FAQs are available on the Commission Web site at https://www.sec.gov/divisions/marketreg/faq-volcker-rule-section13.htm. They are updated from time-to time.

Section 622 of the Dodd-Frank Act directs the Federal Reserve Board to establish a financial sector concentration limit that generally prohibits a financial company (including bank holding companies and nonbank financial companies supervised by the Federal Reserve Board) from merging, consolidating with, or acquiring another company if the resulting company's liabilities upon consummation would exceed 10 percent of the aggregate liabilities of all financial companies. See generally Federal Res. Sys., 12 C.F.R. Part 251, Reg. XX, Docket No. R-1489, RIN 7100-AE, Concentration Limits on Large Financial Companies (Rule adoption 2014).

In 2016, the staff of the Federal Reserve Board issued a working paper analyzing the effects of the Volcker Rule on market making during periods of stress, a copy of which is available on the Federal Reserve Board's Web site at https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf.

In 2016, the Federal Reserve Board of Governors extended the conformance period for the Volcker Rule until July 21, 2017, for the covered funds provisions of the rule insofar as they relate to investments in covered funds made before the implementing rules were adopted. The order is available on the Federal Reserve Board Web's site at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160707a1.pdf.

In June 2018, the SEC, along with the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Commodity Futures Trading Commission, proposed amendments to the Volcker Rule. BHCA-3 (2018). The proposing release summarizes as follows:

> The Agencies seek to address a number of targeted areas for potential revision in this proposal. First, the Agencies are proposing to tailor the application of the rule based on the size and scope

of a banking entity's trading activities. In particular, the Agencies aim to further reduce compliance obligations for small and mid-sized firms that do not have large trading operations and therefore reduce costs and uncertainty faced by smaller and mid-size firms in complying with the final rule, relative to their amount of trading activity. In the experience of the Agencies since adoption of the 2013 final rule, the costs and uncertainty faced by smaller and mid-sized firms in complying with the 2013 final rule can be disproportionately high relative to the amount of trading activity typically undertaken by these firms.

In addition to tailoring the application of the rule, the Agencies also seek to streamline and clarify for all banking entities certain definitions and requirements related to the proprietary trading prohibition and limitations on covered fund activities and investments. In particular, this proposal seeks to codify or otherwise addresses matters currently addressed by staff responses to Frequently Asked Questions (FAQs). Additionally, the Agencies are seeking in this proposal to reduce metrics reporting, recordkeeping, and compliance program requirements for all banking entities and expand tailoring to make the scale of compliance activity required by the rule commensurate with a banking entity's size and level of trading activity.

In tailoring these proposed changes to the 2013 final rule, the Agencies note the following statutory limitations to the permitted proprietary trading and covered fund activities, which are incorporated in the 2013 final rule and have not been changed in the proposed rule. These statutory limitations provide that such permitted activities must not: (1) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (2) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (3) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

…

To better tailor the application of the rule, the proposal would establish three categories of banking entities based on their level of trading activity. The first category would include banking entities with "significant trading assets and liabilities, " defined as those banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) equal to or exceeding $10 billion. These banking entities, which generally have large trading operations, would be required to comply with the most extensive set of requirements under the proposal.

The second category would include banking entities with "moderate trading assets and liabilities, " defined as those banking entities that do not have significant trading assets and liabilities or limited trading assets and liabilities. Banking entities with moderate trading assets and liabilities are those entities that, together with their affiliates and subsidiaries, have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) less than $10 billion, but above the threshold described below for banking entities with limited trading assets and liabilities. These banking entities would be subject to reduced compliance requirements and a more tailored approach in light of their smaller and less complex trading activities.

The third category includes banking entities with "limited trading assets and liabilities, " defined as those banking entities that have, together with their affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) less than $1 billion. This $1 billion threshold would be based on the worldwide trading assets and liabilities of a banking entity and all of its affiliates. With respect to a foreign banking organization ("FBO ") and its subsidiaries, the $1

billion threshold would be based on worldwide consolidated trading assets and liabilities, and would not be limited to its combined U.S. operations.

The proposal would establish a presumption of compliance for all banking entities with limited trading assets and liabilities. Banking entities operating pursuant to this proposed presumption of compliance would have no obligation to demonstrate compliance with subparts B and C of the proposal on an ongoing basis. If, however, upon examination or audit, the relevant Agency determines that the banking entity has engaged in proprietary trading or covered fund activities that are prohibited under subpart B or subpart C, such Agency may exercise its authority to rebut the presumption of compliance and require the banking entity to comply with the requirements of the rule applicable to banking entities that have moderate trading assets and liabilities. The purpose of this presumption of compliance would be to further reduce compliance costs for small and mid-size banks that either do not engage in the types of activities subject to section 13 of the BHC Act or engage in such activities only on a limited scale.

The proposal also includes a reservation of authority that would allow an Agency to require a banking entity with limited or moderate trading assets and liabilities to apply any of the more extensive requirements that would otherwise apply if the banking entity had significant or moderate trading assets and liabilities, if the Agency determines that the size or complexity of the banking entity's trading or investment activities, or the risk of evasion, warrants such treatment.

…

Subpart B of the 2013 final rule implements the statutory prohibition on proprietary trading and the various exemptions to this prohibition included in the statute. Section __.3 of the 2013 final rule contains the core prohibition on proprietary trading and defines a number of related terms. The proposal would make several changes to §.3 of the 2013 final rule. Notably, the proposal would revise, in a manner consistent with the statute, the definition of "trading account " in order to increase clarity regarding the positions included in the definition. The definition of "trading account " is a threshold definition that tells a banking entity whether the purchase or sale of a financial instrument is subject to the restrictions and requirements of section 13 of the BHC Act and the 2013 final rule in the first instance.

In the 2013 final rule, the Agencies defined the statutory term "trading account " to include three prongs. The first prong includes any account that is used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position (the "short-term intent prong "). For purposes of this part of the definition, the 2013 final rule also contains a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for the trading account if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase (or sale). The second prong covers trading positions that are both covered positions and trading positions for purposes of the Federal banking agencies' market risk capital rules, as well as hedges of covered positions (the "market risk capital prong "). The third prong covers any account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer that is licensed or registered, or required to be licensed or registered, as a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such (the "dealer prong ").

In the experience of the Agencies, determining whether or not positions fall into the short-term intent prong of the trading account definition has often proved unclear and subjective, and, consequently, may result in ambiguity or added costs and delays. For this reason, the proposal would remove the short-term intent prong from the 2013 final rule's definition of trading account and eliminate the associated rebuttable presumption, and would also modify the definition of

trading account as described below to include other accounts described in the statutory definition of "trading account. "

The remaining two prongs of the trading account definition in the 2013 final rule, the market risk capital prong and the dealer prong, generally would remain unchanged because, in the experience of the Agencies, interpretation of both prongs has been relatively straightforward and clear in practice for most banking entities. The proposal would, however, modify the market risk capital prong to cover the trading positions of FBOs subject to similar requirements in the applicable foreign jurisdiction. The Agencies are proposing this modification for FBOs to take into account the different frameworks and supervisors FBOs may have in their home countries. Specifically, the proposal would modify the market risk capital prong to apply to FBOs that are subject to capital requirements under a market risk framework established by their respective home country supervisors, provided the market risk framework is consistent with the market risk framework published by the Basel Committee on Banking Supervision, as amended. The Agencies expect that this standard, similar to the current market risk capital prong referencing the U.S. market risk capital rules, would include trading account activities of FBOs consistent with the statutory trading account requirements. The Agencies believe the proposed approach would be an appropriate interpretation of the statutory trading account definition. The Agencies likewise believe that application of the market risk capital prong to FBOs as described herein would be relatively straightforward and clear in practice.

In addition, the Agencies are proposing two changes related to the trading account definition that are intended to replace the short-term intent prong. These changes include: (i) the addition of an accounting prong and (ii) a presumption of compliance with the prohibition on proprietary trading for trading desks that are not subject to the market risk capital prong or the dealer prong, based on a prescribed profit and loss threshold. Under the proposed accounting prong, a trading desk that buys or sells a financial instrument (as defined in the 2013 final rule and unchanged by the proposal) that is recorded at fair value on a recurring basis under applicable accounting standards would be doing so for the "trading account " of the banking entity. Financial instruments that would be covered by the proposed accounting prong generally include, but are not limited to, derivatives, trading securities, and available-for-sale securities. For example, a security that is classified as "trading " under U.S. generally accepted accounting principles ("GAAP ") would be included in the proposal's definition of "trading account " under the proposed approach because it is recorded at fair value.

The proposed presumption of compliance, which would apply at the trading desk level, would provide that each trading desk that purchases or sells financial instruments for a trading account pursuant to the accounting prong may calculate the net gain or loss on the trading desk's portfolio of financial instruments each business day, reflecting realized and unrealized gains and losses since the previous business day, based on the banking entity's fair value for such financial instruments.

If the sum of the absolute values of the daily net gain and loss figures for the preceding 90-calendar-day period does not exceed $25 million, the activities of the trading desk would be presumed to be in compliance with the prohibition on proprietary trading, and the banking entity would have no obligation to demonstrate that such trading desk's activity complies with the rule on an ongoing basis. If this calculation exceeds the $25 million threshold, the banking entity would have to demonstrate compliance with section 13 of the BHC Act and the implementing regulations. …The Agencies are also proposing to include a reservation of authority to address any positions that may be incorrectly scoped into or out of the definition.

Section __.3 of the 2013 final rule also details various exclusions from the definition of proprietary trading for certain purchases and sales of financial instruments that generally do not involve the requisite short-term trading intent under the statute. The proposal would make several changes

to these exclusions. First, the proposal would clarify and expand the scope of the financial instruments covered in the liquidity management exclusion. Second, it would add an exclusion from the definition of proprietary trading for transactions made to correct errors made in connection with customer-driven or other permissible transactions.

Section __.4 of the 2013 final rule implements the statutory exemptions for underwriting and market making-related activities. The proposal would make several changes to this section intended to improve the practical application of these exemptions. In particular, the proposal would establish a presumption that trading within internally set risk limits satisfies the requirement that permitted underwriting and market making-related activities must be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties ("RENTD "). The Agencies believe this presumption would allow for a clearer application of these exemptions, and would provide banking entities with more flexibility and certainty in conducting permissible underwriting and market making-related activities. In addition, the proposal would make the exemptions' compliance program requirements applicable only to banking entities with significant trading assets and liabilities.

The proposal would also modify the 2013 final rule's implementation of the statutory exemption for permitted risk-mitigating hedging activities in §__.5, by reducing restrictions on the eligibility of an activity to qualify as a permitted risk-mitigating hedging activity. For banking entities with moderate or limited trading assets and liabilities, the proposal would remove all requirements under the 2013 final rule except the requirement that hedging activity be designed to reduce or otherwise mitigate one or more specific, identifiable risks arising in connection with and related to one or more identified positions, contracts, or other holdings and that the hedging activity be recalibrated to maintain compliance with the rule. For banking entities with significant trading assets and liabilities, the proposal would maintain many of the 2013 final rule's requirements, including the requirement that the hedging activity be designed to reduce or otherwise mitigate one or more specific, identifiable risks. The proposal would, however, eliminate the current requirement that the hedging activity "demonstrably reduces " or otherwise "significantly mitigates " risk, reduce documentation requirements associated with risk mitigating hedging transactions that are conducted by one desk to hedge positions at another desk with pre-approved types of instruments within pre-set hedging limits, and eliminate the 2013 final rule's correlation analysis requirement. These foregoing changes are intended to reduce costs and uncertainty and improve the utility of the hedging exemption.

Section __.6(e) of the proposal would remove certain requirements of the 2013 final rule implementing the statutory exemption for trading by a foreign banking entity that occurs solely outside of the United States. In particular, the proposal would modify the requirement that any personnel of the banking entity or any of its affiliates that arrange, negotiate, or execute such purchase or sale not be located in the United States. It also would (1) remove the requirement that no financing for the banking entity's purchase or sale be provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any state, and (2) eliminate certain limitations on a foreign banking entity's ability to enter into transactions with U.S. counterparty.

The proposal would retain the other requirements of §__.6(e) of the 2013 final rule, including the requirement that the banking entity engaging as principal in the purchase or sale (including relevant personnel) not be located in the United States or organized under the laws of the United States or of any State, that the banking entity not book a transaction to a U.S. affiliate or branch, and that the banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State. Taken as a whole, the proposed amendments to this exemption seek to reduce the impact of the 2013 final rule on foreign banking entities' operations outside of the United States

by focusing on where the trading of these banking entities as principal occurs, where the trading decision is made, and whether the risk of the transaction is borne outside the United States.

…

Subpart C of the 2013 final rule implements the statutory prohibition on directly or indirectly acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section __.10 of the 2013 final rule defines the scope of the prohibition on the acquisition and retention of ownership interests in, and certain relationships with, a covered fund, and provides the definition of "covered fund. " The Agencies request comment on a number of potential modifications to this section.

Section __.11(c) of the 2013 final rule outlines the requirements that apply when a banking entity engages in underwriting or market making-related activities with respect to a covered fund. The proposal would modify these requirements with respect to covered fund ownership interests for third-party covered funds to generally allow for the same types of activities as are permitted for other financial instruments. The proposal would also make changes to §.13(a) of the 2013 final rule to expand a banking entity's ability to engage in hedging activities involving an ownership interest in a covered fund.

…

Subpart D of the 2013 final rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the 2013 final rule.

As in the 2013 final rule, the proposal would provide that a banking entity that does not engage in proprietary trading activities (other than trading in U.S. government or agency obligations, obligations of specified government-sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments. To further enhance compliance efficiencies, the proposal would reduce compliance requirements for most banking entities and expand tailoring of the requirements based on the banking entity categories previously described in this Supplementary Information section.

Under the proposal, a banking entity with significant trading assets and liabilities would be required to establish a six-pillar compliance programs commensurate with the size, scope, and complexity of its activities and business structure that meets six specific requirements already included in the 2013 final rule. These requirements include (1) written policies and procedures reasonably designed to document, describe, monitor and limit trading activities and covered fund activities and investments conducted by the banking entity; (2) a system of internal controls; (3) a management framework that, among other things, includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the rule or by management as requiring attention; (4) independent testing and audits; (5) training for certain personnel; and (6) recordkeeping requirements. Certain additional documentation requirements for covered funds would also apply to banking entities with significant trading assets and liabilities. Because the proposal would eliminate Appendix B of the 2013 final rule, which requires large banking entities and banking entities engaged in significant trading activities to have a separate compliance program that complies with certain enhanced minimum standards, the

proposed rule would essentially permit a banking entity with significant trading assets and liabilities to integrate compliance programs meeting these requirements into its existing compliance regime.

Under the proposal, a banking entity with moderate trading assets and liabilities would be required to include in its existing compliance policies and procedures appropriate references to the requirements of section 13 of the BHC Act and the implementing rules as appropriate given the activities, size, scope, and complexity of the banking entity.

The proposal would also include in subpart D the specifications for the presumption of compliance noted above that would apply for banking entities with limited trading assets and liabilities.

The proposal would eliminate Appendix B of the 2013 final rule, which specifies enhanced minimum standards for compliance programs of large banking entities and banking entities engaged in significant trading activities. The proposal would, however, maintain the 2013 final rule's CEO attestation requirement, and would apply it to all banking entities with significant trading assets and liabilities and moderate trading assets and liabilities.

…

As part of adopting the 2013 final rule, the Agencies committed to reviewing and assessing the quantitative measurements data ("metrics ") for their effectiveness in monitoring covered trading activities for compliance with section 13 of the BHC Act and the implementing regulations. Since that time and as part of implementing the 2013 final rule, the Agencies have reviewed the metrics submitted by the banking entities and considered whether all of the quantitative measurements are useful for all asset classes and markets, as well as for all of the trading activities subject to the metrics requirement, or whether modifications are appropriate.

In the proposal, the Agencies aim to better align the effectiveness of the metrics data with its associated value in monitoring compliance. To that end, the proposal would streamline the metrics reporting and recordkeeping requirements by tailoring the requirements based on a banking entity's size and level of trading activity, completely eliminating particular metrics based on experience working with the data, and adding a limited set of new metrics. The proposal also would provide certain firms with additional time to report metrics to the Agencies, beyond the current deadlines set forth in Appendix A of the 2013 final rule. The Agencies solicit comment regarding whether a single point of collection among the Agencies for metrics would be more effective.

…

As noted, the proposal would define three different categories of banking entities based on thresholds of trading assets and liabilities, in order to improve compliance efficiencies for all banking entities generally and further reduce compliance costs for firms that have little or no activity subject to the prohibitions and restrictions of section 13 of the BHC Act.

The first category would include any banking entity with significant trading assets and liabilities, defined under the proposal to mean a banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities (excluding trading assets and liabilities involving obligations of, or guaranteed by, the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four previous calendar quarters, equals or exceeds $10 billion. The Agencies believe that this threshold would capture a significant portion of the trading assets and liabilities in the U.S. banking system, but would reduce burdens for smaller, less complex banking entities. The Agencies estimate that approximately 95 percent of the trading assets and liabilities in the U.S. banking system are currently held by those banking entities that would have significant trading assets and liabilities under the proposal. Under the proposal, the most stringent compliance requirements would apply to these banking entities, which generally have large trading operations. For example, as described in the relevant sections of

this Supplementary Information section below, the proposal would require banking entities with significant trading assets and liabilities to comply with a greater set of requirements than other banking entities to meet the conditions of the exemptions for permitted underwriting and market making-related activities and risk-mitigating hedging activities. In addition, the proposal would require these banking entities to maintain a six-pillar compliance program (*i.e.* , written policies and procedures, internal controls, management framework, independent testing, training, and records), commensurate with the size, scope, and complexity of their activities and business structure, which the banking entities could integrate into their existing compliance regime.

The second category would include any banking entity with moderate trading assets and liabilities, defined as a banking entity that does not have significant trading assets and liabilities or limited trading assets and liabilities (described below). These banking entities, together with their affiliates and subsidiaries, generally have trading assets and liabilities (excluding obligations of or guaranteed by the United States or any agency of the United States) of $1 billion or more but less than $10 billion. As with the threshold described above for firms with significant trading assets and liabilities, the Agencies believe that the proposed threshold for firms with moderate trading assets and liabilities would appropriately cover a significant percentage of trading activities in the United States. The Agencies estimate that approximately 98 percent of the trading assets and liabilities in the U.S. banking system are currently held by those firms that would have trading assets and liabilities of $1 billion or more, including firms with both significant and moderate trading assets and liabilities. Relative to banking entities with significant trading assets and liabilities, banking entities with moderate trading assets and liabilities would be subject to reduced requirements and a tailored approach in light of their smaller portfolio of trading activity. For example, the proposal would require banking entities with moderate trading assets and liabilities to comply with a more tailored set of requirements under the underwriting, market-making, and risk-mitigating hedging exemptions, as compared to the requirements applicable to banking entities with significant trading assets and liabilities. In addition, these firms would be subject to a simplified compliance program requirement, which would allow the banking entity to comply with the applicable requirements by updating existing policies and procedures. The Agencies believe these changes could substantially reduce the costs of compliance for banking entities that do not have significant trading assets and liabilities.

The third category would include any banking entity with limited trading assets and liabilities, defined under the proposal to mean a banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities (excluding trading assets and liabilities involving obligations of, or guaranteed by, the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four previous calendar quarters, is less than $1 billion. While entities with less than $1 billion in trading assets and liabilities engage in some activities covered by section 13 of the BHC Act and the implementing rules, as noted above, these activities constitute a relatively small percentage of the trading assets and liabilities in the U.S. banking system. In light of the relatively small scale of activities engaged in by such firms, the Agencies are proposing to provide significant tailoring of requirements for such firms. Under the proposal, a banking entity with limited trading assets and liabilities would be presumed to be in compliance with subpart B and subpart C of the implementing regulations and would have no affirmative obligation to demonstrate compliance with subpart B and subpart C on an ongoing basis. If, upon examination or audit, the relevant Agency determines that the banking entity has engaged in covered trading activities or covered fund activities that are otherwise prohibited under subpart B or subpart C, such Agency may exercise its authority to rebut the presumption of compliance and require the banking entity to demonstrate compliance with the requirements of the rule applicable to a banking entity with moderate trading assets and liabilities. Additionally, as noted below, the relevant Agency would retain its authority to require a banking entity to apply

any compliance requirements that would otherwise apply if the banking entity had moderate or significant trading assets and liabilities if such Agency determines that the size or complexity of the banking entity's trading or investment activities, or the risk of evasion, does not warrant a presumption of compliance.

The purpose of this proposed presumed compliance provision would be to significantly reduce compliance program obligations for small and mid-size banking entities that do not engage on a large scale in activities subject to the proposal. Based on data from the December 31, 2017, reporting period, all but approximately 40 top-tier banking entities would be eligible for presumed compliance.

The proposal would apply the 2013 final rule's CEO attestation requirement for all banking entities with significant or moderate trading assets and liabilities. Furthermore, all banking entities would remain subject to the covered fund provisions of the 2013 final rule, with some modifications described further below, including to the applicable compliance program requirements based on the trading assets and liabilities of the banking entity. As under the 2013 final rule, banking entities that do not engage in covered funds activities or proprietary trading would not be required to establish a compliance program unless or until prior to becoming engaged in such activities or making such investments.

The proposal also includes a reservation of authority that would allow an Agency to require a banking entity with limited or moderate trading assets and liabilities to apply any of the more extensive requirements that would otherwise apply if the banking entity had moderate or significant trading assets and liabilities, if the Agency determines that the size or complexity of the banking entity's trading or investment activities, or the risk of evasion, warrants such treatment.

The proposal seeks to tailor requirements based on a relatively simple, straightforward, and objective measure connected to the activities subject to section 13 of the BHC Act. Therefore, the Agencies are proposing thresholds that are based on the trading activities of a banking entity, and are considered on a consolidated basis with its affiliates and subsidiaries. In addition, many of the requirements that the proposal would apply on a tailored basis to banking entities based on these thresholds relate to the statutory prohibition on proprietary trading and the associated exemptions, such as for permitted underwriting, market making, and risk-mitigating hedging activities. In general, this approach would seek to apply requirements commensurate with the size and complexity of a banking entity's trading activities.

Under this approach, banking entities with the largest trading activity (banking entities with significant trading assets and liabilities) would be subject to the most extensive requirements. These firms are currently subject to reporting requirements under Appendix A of the 2013 final rule due to the fact that they engage in the most trading activity subject to section 13 of the BHC Act and the implementing regulations. Banking entities with moderate trading activities and liabilities would be subject to more tailored requirements, commensurate with the smaller scale of their trading activities. These firms are generally subject to the Federal banking agencies' market risk capital rules (like banking entities with significant trading assets and liabilities) and engage in some level of trading activity that is subject to the requirements of section 13 of the BHC Act, but not to the same degree as firms with significant trading assets and liabilities. Banking entities with limited trading assets and liabilities would be subject to significantly reduced requirements in recognition of the relatively small scale of covered activities in which they engage, and in order to reduce compliance costs associated with activities that are less likely to be relevant for these firms. The Agencies request comment regarding all aspects of the proposed approach to tailoring application of the rule.…

172 Sec. Ex. Act Rel. 64,140, 100 SEC Dock. 2593 (2011) (proposal).

173 Id. at 2597–2598.

In JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses (Majority and Minority Staff Report, Senate Permanent Subcomm. on Investigations, Comm. on Homeland Sec. & Gov't Affairs, 113th Congress, 1st Sess. 2013), Senate Staff issued its analysis of a major loss at a large financial institution. The Comptroller of the Currency and JPMorgan Chase, W.A. (AA-EC-13-01 (2013-001) and AA-EC-13-04 (2013-002)), subsequently reached consent settlements with JPMorgan under which the bank agreed to create a Board Compliance Committee; develop a comprehensive action plan to achieve compliance with the substantive requirements of the Consent Order; submit a written plan to ensure that the Board has appropriate oversight and governance of covered trading; submit a written plan to ensure appropriate risk management and control functions for covered trading; submit an acceptable written plan to ensure that appropriate valuation controls are in place for covered trading; submit an acceptable written plan to ensure that internal audit programs adequately address covered trading; and submit an acceptable written plan to ensure appropriate control over market risk and price risk models of the Bank. The Bank also is required to ensure that appropriate customer due diligence policies, procedures and processes are developed and to develop a program to ensure under 12 C.F.R. §21.11 timely and appropriate review of Suspicious Activity Alerts and timely filing of Suspicious Activities Reports. New products and securities are required to be subject to senior level compliance review and approval.

In GAO, Financial Regulatory Reforms: Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act (GAO-13-180, Jan. 2013), the Government Accountability Office reported:

> The 2007–2009 financial crisis, like past financial crises, was associated with not only a steep decline in output but also the most severe economic downturn since the Great Depression of the 1930s.… [I]n the aftermath of past U.S. and foreign financial crises, output falls (from peak to trough) an average of over 9 percent and the associated recession lasts about 2 years on average. …The U.S. economy entered a recession in December 2007, a few months after the start of the financial crisis. Between December 2007 and the end of the recession in June 2009, U.S. real gross domestic product (*GDP*) fell from $13.3 trillion to $12.7 trillion (in 2005 dollars), or by nearly 5 percent.… [R]eal GDP did not regain its prerecession level until the third quarter of 2011.…
>
> Research suggests that U.S. output losses associated with the 2007–2009 financial crisis could range from several trillion to over $10 trillion.…
>
> According to the Federal Reserve's Survey of Consumer Finances, median household net worth fell by $49,100 per family, or by nearly 39 percent, between 2007 and 2010. The survey found that this decline appeared to be driven most strongly by a broad collapse in home prices. Another major component of net worth that declined was the value of household financial assets, such as stocks and mutual funds. Economists we spoke with noted that precrisis asset prices may have reflected unsustainably high (or *bubble*) valuations and it may not be appropriate to consider the full amount of the overall decline in net worth as a loss associated with the crisis. Nevertheless, dramatic declines in net worth, combined with an uncertain economic outlook and reduced job security, can cause consumers to reduce spending. Reduced consumption, all else equal, further reduces aggregate demand and real GDP.
>
> As we reported in June 2012, decreases in home prices played a central role in the crisis and home prices continue to be well below their peak nationwide. According to CoreLogic's Home Price Index, home prices across the country fell nearly 29 percent between their peak in April 2006 and the end of the recession in June 2009.… This decline followed a 10-year period of significant home price growth, with the index more than doubling between April 1996 and 2006. Since 2009, home prices have fluctuated.
>
> Similarly, we also reported that homeowners have lost substantial equity in their homes, because home values have declined faster than home mortgage debt.… [H]ouseholds collectively lost

about $9.1 trillion (in constant 2011 dollars) in national home equity between 2005 and 2011, in part because of the decline in home prices.… [B]etween 2006 and 2007, the steep decline in home values left homeowners collectively holding home mortgage debt in excess of the equity in their homes. This is the first time that aggregate home mortgage debt exceeded home equity since the data were kept in 1945. As of December 2011, national home equity was approximately $3.7 trillion less than total home mortgage debt.

Id. at 12, 15, 20–21.

The report also calculated the funding cost of the Dodd-Frank Act:

Table 3: Summary of 10 Federal Entities' Reported Funding Resources Associated with Implementation of the Dodd-Frank Act, 2010 through 2013 (dollars in millions)

Agency/ Entity	2010	2011	2012	2010–2012 Total	2013 Projections
FSOC	$0.0	$2.9	$6.0	$8.9	$8.7
OFRa	0.0	11.3	39.5	50.8	78.1
CFPB	9.2	123.3	299.8	432.3	447.7
Federal Reserve	7.3	62.7	93.1	163.1	Not Available
CFTC	0.0	15.4	21.9	37.3	80.0
SEC	0.0	23.5	39.5	63.0	129.0
FDIC	2.3	19.9	38.1	60.3	Not Available
FHFA	0.0	2.2	2.1	4.3	2.1
OCC	0.0	34.9	235.0	269.9	Not Available
Treasury	0.0	5.6	9.2	14.8	9.4

Id. at 61.