

# Study

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## Financial Reform in the U.S.: A Critical Survey of Dodd-Frank and What is Needed for Europe

### Abstract

We review the major provisions of Dodd-Frank, focusing on the monitoring of systemic risk, the limitation on proprietary trading, the regulation of the hedge fund industry, credit rating agencies, and the rules applicable to derivative trading. We compare these provisions with the recent regulatory changes in the EU, and critically assess the potential impact of Dodd-Frank.

# Financial Reform in the U.S.: A Critical Survey of Dodd-Frank and What is Needed for Europe

Raphaële Chappe\*, Willi Semmler†

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## Abstract

We review the major provisions of Dodd-Frank, focusing on the monitoring of systemic risk, the limitation on proprietary trading, the regulation of the hedge fund industry, credit rating agencies, and the rules applicable to derivative trading. We compare these provisions with the recent regulatory changes in the EU, and critically assess the potential impact of Dodd-Frank.

## 1 Introduction

The past few decades were marked by the major deregulation of financial markets in the U.S. There were various major deregulatory initiatives, such as the repeal of Glass Steagall (the Depression-era strict separation between commercial banking and investment banking) in November 1999<sup>1</sup>; the deregulation of OTC (over-the-counter) derivatives, with the Commodity Futures Modernization Act of 2000 (CFMA), which provided that over-the-counter derivatives (privately-negotiated instruments traded outside of an exchange platform) would continue to be substantially unregulated; and the growth of the hedge fund industry in the absence of any regulatory framework, with limited supervision, and no obligation to disclose balance sheets, income statements, positions, or leverage. The rationale for unregulated markets was to preserve the competitiveness of U.S. firms, and a triumph of free-market ideology.

In the aftermath of the 2007-2008 financial crisis, the Dodd-Frank Act signed into law by President Obama on July 21, 2010 was a U.S. regulatory overhaul

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<sup>1</sup>With the Gramm Leach Bliley Financial Modernization Act.

designed to address the issues uncovered in the financial crisis.<sup>2</sup> The Act specifically targets the securitization and mortgage industries. There is a prohibition of financial incentives for subprime loans, of mortgage pre-payment penalties, and the requirement of additional disclosures on mortgages (and specifically variable rate mortgages). In order to better align the interests of financial institutions that sell securitized products and the investors that purchase them, institutions will be required to retain at least 5% of credit risk. New disclosure requirements also ensure that issuers disclose more information regarding the quality of the underlying assets.

There are other key provisions in the Act, all designed to prevent a meltdown of the sort that recently occurred – the major themes being controlling systemic risk, reducing excessive growth and complexity in financial markets, and creating more transparency with respect to hedge funds and derivatives. In this paper we provide an overview of Dodd-Frank regarding the monitoring of systemic risk (Section 2), the future of proprietary trading within investment banks (Section 3), the regulation of the hedge fund industry (Section 4), the regulation of derivatives (Section 5), and the regulation of credit rating agencies (Section 6). This survey engages in a comparison between the U.S. and EU regulatory frameworks, and attempts to assess how international markets will respond to these regulatory changes. Finally, the paper reflects upon whether Dodd-Frank can eliminate the conditions that created the 2007-2008 financial crisis, and assesses the link between a successful financial reform and the restructuring of an entire power dynamic in Wall Street and Washington (Section 7). The paper concludes with a critical assessment of the effectiveness of Dodd-Frank.

## 2 The Monitoring of Systemic Risk

### 2.1 The Financial Stability Oversight Council

Prior to Dodd-Frank, no single regulator had responsibility for monitoring systemic risk. For the first time in U.S. history, Dodd-Frank specifically contemplates the mitigation of systemic risk as a regulatory objective. To the extent that different types of financial firms operate across different markets and are regulated differently, Dodd-Frank specifically contemplates the creation of a regulatory agency designed to look after the stability of the financial system as a whole, the Financial Stability Oversight Council (“FSOC”).<sup>3</sup>

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<sup>2</sup>An evaluation of the recent financial reform from the perspective of financial theory can be found in Semmler (2011).

<sup>3</sup>The FSOC comprises ten voting members: the Secretary of the Treasury, who serves as the Chairperson, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise that is appointed by the President and confirmed by the Senate for a six-year term. There are in addition five nonvoting members: the Director of the OFR, the Director of the Federal Insurance Office,

The FSOC has a statutory mandate to identify risks to the stability of the financial system. It must report to Congress annually, with the Chairperson testifying on the FSOC’s activities and emerging threats to financial stability. The FSOC may also report to Congress on specific topics, as is deemed appropriate.

In the EU, there is the added issue of the inherent fragmentation of any comprehensive macro-prudential analysis due to the presence of multiple jurisdiction and regulators. The EU recognized the need to address these issues and monitor systemic risk with the creation of a European Systemic Risk Board (ESRB), established as from January 2011.<sup>4</sup> The ESRB’s task is to enable macro-prudential oversight of the financial system in Europe, monitor and assess systemic risk, and enhance the financial system’s resilience to shocks.

## 2.2 Prudential Regulation

The FSOC has authority to require (with a 2/3 vote) that the Federal Reserve regulate a “nonbank financial company” if it is perceived as systemically relevant and poses a threat to the financial stability of the U.S. in light of the firm’s financial distress or its nature, size, scale, concentration, interconnectedness, or mix of activities. We note that such a decision is subject to procedural protections and rights of appeal. A nonbank financial company is a company that is incorporated or organized in the U.S., and “predominantly engaged in financial activities”.<sup>5</sup>

We note that the Federal Reserve is to automatically regulate any bank holding company with \$50 billion or more in assets that received funding under the TARP program and subsequently sold its bank. This essentially prevents firms that have received benefits under TARP to seek to avoid supervision through a divestiture (also referred to as the “Hotel California” provision – “you can never leave”).

The prudential regulation regime is intended to minimize systemic risk by subjecting systemically-relevant institutions to enhanced regulatory standards. Further, Dodd-Frank requires that enhanced prudential standards established by the Federal Reserve for nonbank financial companies also apply to any bank holding company with assets of \$50 billion or more. While all bank holding companies are already under the regulatory supervision of the Federal Reserve, large interconnected bank holding companies are thus automatically deemed to carry systemic risk and to be subject to specific regulatory scrutiny. In

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a state insurance commissioner selected by the state insurance commissioners, a state banking supervisor chosen by the state banking supervisors, and a state securities commissioner designated by the state securities supervisors.

<sup>4</sup>Regulation (EU) No 1092/2010 Of The European Parliament And of The Council of November 24, 2010.

<sup>5</sup>For this purpose, Dodd Frank specifically defines that a firm is predominantly engaged in financial activities if (a) The company derives 85% or more of its consolidated annual gross revenues from activities that are financial in nature and, if applicable, from the ownership or control of insured depository institutions; or (b) 85% or more of the consolidated assets of the company are related to activities that are financial in nature and, if applicable, to the ownership or control of one or more insured depository institutions.

essence this is designed to close whatever gaps in supervision may exist between financial institutions and minimize opportunities for regulatory arbitrage. All institutions that might pose a threat to the financial sector are to be subject to the same enhanced regulatory oversight.

A key consequence for financial firms is the ability of the FSOC to designate an “activity” (i.e., a product or practice) as having systemic relevance, and placing the firm under special regulatory supervision of the Federal Reserve. Indeed, the designation of particular business sectors or practices of nonbank financial companies as deserving of special supervision by the Federal Reserve is one of the key functions of the FSOC.

Dodd-Frank indicates that the enhanced prudential standards might be tailored to particular institutions, but provides limited substantive requirements regarding what these enhanced prudential standards should consist of. There is a capital limitation on the total credit exposure of any firm to another at 25% of the firm’s capital and surplus, or such lower amount as the Federal Reserve may establish. There are also limitations on M&A activities, requiring Federal Reserve approval for the purchase of more than 5% of the shares of a bank, and a general “concentration limit” on the financial sector preventing any financial company from conducting a merger or acquisition that would result in the company accounting for more than 10% of the liabilities of the financial sector. There are also limitations on director interlocks among banking firms, and a cap on nationwide bank deposits that can be held by a single banking organization.

Other than that, the Federal Reserve will exercise its discretion in the development of prudential standards. According to the law firm Skadden Arps, some enhanced regulatory standards might include risk-based capital and leverage, liquidity, risk management, resolution plan, credit exposure and concentration limit requirements (Skadden Arps, 2010: 12). The Federal Reserve is also authorized (though not required) to impose requirements related to contingent capital, enhanced public disclosure, short-term debt limits and anything else it deems appropriate. Dodd-Frank also provides for annual “stress tests”.

## **2.3 Receivership and Orderly Liquidation Authority**

Dodd-Frank creates an orderly liquidation mechanism to unwind failing systemically significant financial companies. The FSOC has the authority to approve, with a 2/3 vote, a Federal Reserve decision to restrict the ability of a firm to offer a particular financial product or require a large, complex company to divest some of its holdings, terminate some of its activities, or change the manner in which it is doing business. This is to be exercised as a last resort, and only if the company poses a grave threat to the financial stability of the U.S.

Further, the Federal Reserve was given the mandate to promote uniform risk-management standards for systemically important financial market utilities and systemically important payment, clearing, and settlement activities conducted by financial institutions.

## 2.4 Emergency Lending

Dodd-Frank requires that the Federal Reserve, in consultation with the Treasury Secretary, establish policies and procedures to provide liquidity to the financial system but not provide aid to a single insolvent company. Any emergency loan would be granted with the approval of the Treasury Secretary.

## 2.5 Data Gathering and Information Sharing

The FSOC can request data and analyses from the newly created Office of Financial Research (OFR) housed within Treasury. The FSOC also has the authority to direct the OFR to collect systemically relevant information from individual financial companies, including the extent to which the financial company participates in a specific financial activity or financial market. The FSOC has a duty to facilitate information sharing amongst member agencies.<sup>6</sup> Access to comprehensive information is facilitated by the increased transparency and data-gathering measures in Dodd-Frank, which should allow the regulator to consider the financial system as a whole and aggregate information across institutions to develop systemic scenario analyses. There are data collection and publication requirements for hedge funds and derivatives markets (refer to Sections 4 and 5).

In the EU, the ESRB's access to data is guaranteed by the creation of a general obligation on the part of European Supervisory Authorities, national central banks and member states to provide to the ESRB all needed information needed for the macro-prudential analysis.<sup>7</sup> The ESRB is to receive assistance from the European Central Bank (ECB) regarding the "necessary analytical, statistical, logistical and administrative support".<sup>8</sup> It appears that for this purpose the ECB is "optimizing its existing capabilities and infrastructure in the areas of financial stability monitoring, macro-economic analysis and the collection of statistical information, to the benefit of the ESRB".<sup>9</sup> The ESRB has recently published a list of ECB, European Banking Authority and ESMA datasets it will use.<sup>10</sup> The ECB datasets include financial institutions balance sheets, interest rate statistics, investment fund statistics, securitization statistics, selected monetary, financial institutions and market statistics, and consolidated banking data. The European Banking Authority datasets include, for a sample of large banking groups, solvency indicators (e.g. Tier 1 capital ratio), credit risk and asset quality indicators, earnings risks indicators, balance sheet structure, growth rates, liquidity coverage ratios, and net stable funding ratios. The ESMA datasets include a breakdown of financial instruments traded in the EU, number of instruments admitted and issued by market, and number of new instruments issued by Member States.

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<sup>6</sup>Member agencies are agencies represented by a voting member of the FSOC.

<sup>7</sup>Regulation (EU) No 1092/2010 Of The European Parliament And of The Council of November 24, 2010.

<sup>8</sup>See Constâncio (2010). See also Recital 10 of Regulation (EU) No 1096/2010.

<sup>9</sup>Id.

<sup>10</sup>ESRB (2011a).

## 2.6 The Measure of Systemic Risk And Financial Sector Consolidation

### 2.6.1 Reform of Systemic Risk in the US

Some of the factors that the FSOC may consider in identifying whether a financial firm is a potential threat to the financial sector and should be subject to prudential regulation may include:<sup>11</sup>

- The size of the company, amount and nature of the financial assets of the company;
- The balance-sheet composition, the extent of leverage, the amount and types of liabilities of the company, and the reliance on short term funding;
- The interconnectedness of the company: the extent and nature of the interactions and relationships with other financial firms;
- The importance of the company as a source of liquidity and credit for the U.S. financial system;
- The extent to which the company manages (rather than own) assets;
- The nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
- The degree to which the company is regulated by financial regulatory agencies (including, if an entity is foreign, the company's home country regulator);
- Any other risk-related factors.

Beyond these general guidelines, we note that there are no specific criteria to be used by the FSOC to determine that an institution presents systemic risk, and no formal measures of systemic risk.

After Bank of America purchased Merrill Lynch, and Bear Stearns was bought out by JP Morgan, financial markets emerged from the 2007-2008 financial crisis with an even higher degree of consolidation. There has been a noted increase in the size of the largest banks in the U.S. The largest six bank holding companies in the U.S. had assets valued at 64% of GDP at the end of the third quarter of 2010, as compared with just 55% at the end of 2006 and 17.1% in 1995 (see Johnson and Kwak, 2010). The assets of all the major banks have also increased as a percentage of GDP. For example, the assets of JP Morgan Chase are 14.5% of GDP in 2010, as opposed to 4.1% (for Chase Manhattan) in 1995. The assets of Goldman Sachs account for around 6.2% of GDP as opposed to 1.3% in 1995. Hence the largest banks account for an

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<sup>11</sup>Skadden Arps (2010).

increasing share of the economy, potentially increasing the vulnerability of the financial system to the collapse of a single institution.

Treasury Secretary Tim Geithner, as chair of the FSOC, has released a report titled “Study of the Effects of Size and Complexity of Financial Institutions on Capital Market Efficiency and Economic Growth” in January 2011 (Geithner, 2011). This report specifically assesses the costs and benefits of potentially limiting the size of banks and other financial institutions. Highlighting the potential benefits of economies of scale, the report’s conclusion is that no particular limitation regarding the size and concentration of financial institutions was needed beyond the implementation of the “concentration limit”:

“This study will not make recommendations regarding limits on the maximum size of banks, bank holding companies, and other large financial institutions.” (Geithner, 2011: 13)

Further, the Geithner report also addresses the issue of functional diversification and organization complexity. While acknowledging that increased diversification and organizational complexity may be a factor of systemic risk, as institutions become more complex to manage and more interconnected, the report concludes that “more research on these topics could be helpful”, and that “this study will not make specific recommendations on the structure of limits to diversification or organizational complexity.” (Geithner, 2011: 18).

It thus seems, unfortunately, that the FSOC is not taking Dodd-Frank seriously when it comes to analyzing systemic risk. The Geithner report evidences no serious attempt to assess the evidence of increasing size and complexity of the major U.S. banks. The assumption that consolidation in the banking industry is leading to economies of scale is left unchallenged, and no effort is made to consider the issue of “too big to fail” seriously. No specific guidelines have been developed to measure the extent to which bank size, bank organization, and the variety of financial activities conducted within the same institution (and more specifically the combination of banking and other financial activities) leads to increased levels of risk at the systemic level. This is quite unfortunate.

## **2.6.2 Reform of Systemic Risk in Europe**

In the EU, there is specific statutory guidance regarding the measure of systemic and the identification of institutions that may be systemically relevant:

“The key criteria helping to identify the systemic importance of markets and institutions are size (the volume of financial services provided by the individual component of the financial system), substitutability (the extent to which other components of the system can provide the same services in the event of failure) and interconnectedness (linkages with other components of the system). An assessment based on those three criteria should be supplemented by a reference to financial vulnerabilities and the capacity of the institutional framework to deal with financial failures and should consider



a wide range of additional factors such as, inter alia, the complexity of specific structures and business models, the degree of financial autonomy, intensity and scope of supervision, transparency of financial arrangements and linkages that may affect the overall risk of institutions.”<sup>12</sup>

With the planned implementation of the ESRB, the European Parliament’s Committee on Economic and Monetary Affairs requested a report on “Defining and Measuring Systemic risk” (Eijffinger, 2009). The report highlights the conceptual issues of systemic risk, and focuses on the measurement of systemic risk as broken down into two components: the detection of early warning indicators for asset bubbles, and the individual institutions’ contribution to systemic risk. The report summarizes the recent literature on these topics, without concluding on a single approach. Early warning indicators for asset bubbles include indicators (as well as joint indicators) and noise-to-signal ratios based on credit variables, equity prices and property prices (Borio and Drehmann, 2009), as well as real-time financial and real variables for European and OECD countries (including the global private credit gap) with dynamic update of optimal threshold (Alessi and Detken, 2009). With respect to the contribution of individual firms to systemic risk, this report highlights the work of Acharya et al. (2009), which focuses on the method of Marginal Expected Shortfall (MES) as used in VaR approaches, and the Systemic Expected Shortfall (SES). MES measures the loss in case returns go below a certain distribution percentile. SES is similar to MES but takes leverage and risk-taking into account. The task for the ESRB, as identified in the report, is to gather specific data on financial institutions so as to properly measure SES. Another highlighted approach is that of Hart and Zingales (2009), mainly the use of market-based Credit Default Swap (CDS) prices as an indicator of default for systemic institutions and as a trigger for regulatory action. The main limitation here is that the approach does not indicate which entities are systemically relevant. Finally, one measure of interconnectedness is CoVar, see Adrian and Brunnermeier (2009).

The report does not conclude on the desirability of any single method, but rather their combined use:

“The abovementioned measures of systemic risk contribution can complement each other: the methods of Acharya et al. and Adrian and Brunnermeier can be used to determine which institutions are possibly a threat to systemic stability (including their network effects), while the measure of Hart and Zingales can be employed to determine when this threat may materialize so regulators can take timely prudential action.” (Eijffinger, 2009: 7)

These approaches are not exhaustive and only a “characterization of the measures necessary to gauge systemic risk properly” (Eijffinger, 2009: 7). The report advocates the use of a “broad set of systemic risk measures”, different

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<sup>12</sup>Regulation (EU) No 1092/2010 Of The European Parliament And of The Council of November 24, 2010.

indicators with appropriate weights. The final recommendation for the report is that European macro-prudential regulation should be approached as a signal extraction problem to be solved by Bayesian updating.

The ESRB has recently recommended that national supervisory authorities intensify their monitoring of EU credit institutions to prevent them from accumulating excessive funding risks in US dollars.<sup>13</sup> In particular, the ESRB suggest to closely monitor maturity mismatches, funding concentrations, and the use of U.S. dollar currency swaps.

## **2.7 Conclusion**

Both the U.S. and the EU have seen the creation of regulatory authorities charged with the specific task of monitoring of systemic risk, and access to large datasets. We have yet to see what exact systems the FSOC and ESRB will develop to build a comprehensive consolidated systemic risk database. While there is some ongoing discussion around the exact measure of systemic risk, we also have yet to see when and how the FSOC and the ESRB will raise systemic risk concerns. For the time being, unfortunately it does not seem that the FSOC is actively considering the issue of large financial institutions potentially being too large to fail.

# **3 The Future of Proprietary Trading**

## **3.1 Minimum Regulatory Capital Guidelines in Dodd-Frank**

Dodd-Frank avoids establishing substantive (quantitative) regulatory capital guidelines. There are two main provisions related to regulatory capital. First, bank holding companies are required to hold the same leverage profile and risk-based capital as other insured depository institutions (the so-called “Collins Amendment”, introduced by Susan Collins and included in the Act). This in essence creates some kind of benchmark for regulatory capital based on Basel I standards, even for those large banks that have adopted the Basel II approach. Another general guideline that the Federal Reserve is to attempt to adopt counter-cyclical capital requirements, so that the amount of capital to be maintained increases during economic booms and decreases during recessions. Other than these provisions, Dodd-Frank is relatively silent on the issue of regulatory capital. Instead, the approach is to minimize risk-taking on the part of financial institutions by restricting the amount of proprietary trading undertaken.

## **3.2 The Volcker Rule**

Why the focus on proprietary trading? Proprietary trading desks can be thought of as internal hedge funds within the bank, and proprietary trading refers to the

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<sup>13</sup>See ESRB (2011b).

use of the firm’s own capital to actively trade financial assets, as opposed to traditional investment banking fee-based activities, such as underwriting and consulting. The rise of proprietary trading within investment banks was accompanied by an increase in the risk profile of financial institutions. Indeed, proprietary trading is more volatile than the traditional investment banking fee-based activities, giving rise to more volatile returns and increased responsiveness to market swings. For example, in 2007 the “Trading and Principal Investments” division of Goldman Sachs accounted for \$13.3 billion of the \$17.6 billion of the firm’s pre-tax earnings. Yet in 2008, in the midst of the financial crisis, the division generated a loss of \$2.75 billion (when the firm generated pre-tax earnings of \$2.34 billion). Proprietary trading is also more capital-intensive in nature (as compared with the traditional fee-based underwriting and consulting businesses, or even market-making activities), and requires intense use of the firm’s own capital to fund both liquid and illiquid positions. Lacking a wide deposit base, which provides abundant and cheap funding to commercial banks, investment banks instead turned to other sources of borrowing such as short-term secured loans from repo markets. Leverage ratios of the major investment banks increased to roughly 35-to-1 and even 40-to-1 before the 2007-2008 crisis, allowing investment banks to turn high profits with minimal capital, but increasing their vulnerability to market swings. For all these reasons, proprietary trading was perceived as partly responsible for the 2007-2008 financial crisis.

Dodd-Frank significantly restricts proprietary operations undertaken by commercial banks (banks regulated by the Federal Reserve, rather than securities firm regulated by the SEC), the so-called “Volcker rule” (Dodd-Frank Title VI). The approach is to prohibit proprietary trading only insofar as it exceeds a limit set as a percentage of Tier 1 capital. Specifically, banks can place up to 3 percent of their Tier 1 capital in hedge fund and proprietary trading investments, and are prohibited from holding more than 3 percent of the total ownership interest of any private equity investment or hedge fund.<sup>14</sup> The limitation applies to U.S. banking organizations (regardless of where the trading activities are conducted), and also to proprietary trading activities conducted in the U.S. (or outside the U.S. to the extent they involve the offering of securities to any U.S. resident) by non-U.S. banking organizations.

Proprietary trading is defined as:

“engaging as a principal for the trading account of [a] banking entity or [systemically important nonbank financial company] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule . . . determine.”<sup>15</sup>

<sup>14</sup>This of course falls short of a complete disallowance (which would have been equivalent to restoring Glass-Steagall).

<sup>15</sup>Dodd-Frank § 1851(h)(4).

For this purpose, Dodd-Frank defines “trading account” as:

“any account used for acquiring or taking positions in the securities and instruments described in [the definition of proprietary trading] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule [...] determine.”<sup>16</sup>

Note that “intent to resell”, rather than actual liquidation of a position, can bring a banking entity within the definition of trading account. The Volcker Rule’s supplemental commentary provides that the part of the trading account definition that targets covered financial positions designed to profit from short-term price movements “does not require the resale of the position; rather, it requires only an intent to engage in any form of transaction on a short-term basis (including a transaction separate from, but related to, the initial acquisition of the position) for the purpose of benefitting from a short-term movement in the price of the underlying position.”<sup>17</sup> In addition, the Volcker Rule’s supplemental commentary provides for a rebuttable presumption that any account used to acquire or take a covered financial position that is held for sixty days or less is a “trading account”, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes.<sup>18</sup>

There are some notable exceptions to this ban. There is a list of permitted activities, including investments in U.S. government securities, transactions made in connection with underwriting or market-making related activities, transactions on behalf of customers, and “risk-mitigating hedging activities” in connection with individual or aggregated holdings of the banking entity.<sup>19</sup> Additional activities may be permitted to the extent they promote and protect the safety and soundness of the banking organization and financial stability of the U.S. Permitted activities are not allowed if they would result in a material conflict of interest, result in material exposure to high-risk assets or high-risk trading strategies, pose a threat to safety and soundness of the banking entity, or pose a threat to financial stability.

Regarding the market-making exception, one very big problem is that it is very difficult to distinguish permissible market-making activities from proprietary trading. Many law firms have highlighted this issue (or opportunity) to their clients.<sup>20</sup> On January 18, 2011, the FSOC issued a report on the implementation of the Volcker rule (FSOC, 2011). This report identified the challenge inherent in implementing the Volcker rule associated with the fact that classes of permitted activities may be difficult to distinguish from prohibited proprietary trading. Market-making activities are allowed only to the extent that they are

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<sup>16</sup>Dodd-Frank § 1851(h)(6).

<sup>17</sup>See Federal Register / Vol. 76, No. 215: 68857-58.

<sup>18</sup>See Federal Register / Vol. 76, No. 215: 68856.

<sup>19</sup>Dodd-Frank § 619.

<sup>20</sup>See for example Shearman & Sterling (2011).

“designed not to exceed the reasonably expected near term demands of clients, customers or counterparties”.<sup>21</sup> The difficulty here is that whether a particular market position constitutes inventory booked by the firm in its capacity as a market-maker, or whether the position is a proprietary investment for the firm, appears to rest upon a very subjective element, i.e. mainly whether the position was entered into with or without the intent to meet the reasonably expected near term demands of customer. An additional element that would allow to distinguish between proprietary trading and market making activities is the level of risk-taking involved. Yet as the FSOC report points out, there is a continuous spectrum of risk-taking levels in trading activities, suggesting that there is no clear-cut distinction between proprietary trading and market making, but a gradual transition.

At one end of the spectrum are activities in which the market-maker assumes very little risk, for example securing commitments from both the buyer and the seller before purchasing the financial instrument. As per the report, “riskless form of market-making is limited in practice to highly active and liquid markets that are characterized by a consistent, large and diverse pool of willing buyers and sellers.” (FSOC, 2011: 19). At the other end of the spectrum are activities where the market-maker commits capital and takes on more risk, in the absence of a ready counterpart on the other side of the transaction. Until such counterpart exists, the position remains on the market-maker’s balance sheet, which carries some level of risk: “This activity is especially complex in illiquid markets or in a liquid market where an order is very large, as a market-maker may be required to assume significant market risk between the time that the large order is purchased and sold back into the market.” (FSOC, 2011: 19). Hence whether a trade contains market-making or proprietary-trading elements would seem to depend on the associated risk-level, which is a function, amongst other things, of the size and liquidity of the market.

As a result, it is theoretically possible that banking entities conceal proprietary trading activities within larger market-making operations. For this reason, the FSOC highlights that the implementation of the Volcker rule will be challenging:

Key to implementing the Volcker Rule is the creation of rules that prevent prohibited proprietary trading activities from occurring throughout a banking entity – not just within certain business units. Absent robust rules and protections, banking entities may have the opportunity to migrate existing proprietary trading activities from the standalone business units that are presently recognized as “proprietary trading operations” into more mainstream “sales and trading” or other operations that otherwise engage in permitted activities. (FSOC, 2011: 17).

Some commentators, such as Michael Lewis, have suggested that this is already happening and that big banks, such as Goldman Sachs, Morgan Stanley and

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<sup>21</sup>Dodd-Frank § 619.

JP Morgan, are not truly abandoning proprietary trading. Instead, they are shutting down units called “proprietary trading” and shifting the activity onto trading desks that deal with clients. For example, it is indeed possible to hide proprietary positions within market-making activities by arguing that a particular position was entered into to provide liquidity to a customer who wanted to sell. In order to keep the position, a trader can offer the position at a slightly higher price than the market commands, and therefore will be unable to unload the position (See Lewis, 2010).

Another issue is that the exact scope of the other exceptions to the Volcker rule. There is enough ambiguity to allow banks to get away with a lot, if they can interpret the rules as they see fit. Will investments in funds that mostly trade government securities (for example fixed income arbitrage funds) be allowed? What is the scope of trades done “on behalf of customers”? What types of activities will constitute “risk-mitigating hedging activities”? This scope of this latter exception is particularly ambiguous, as potentially many banking activities can be characterized as “risk-mitigating hedging”.

There is in the EU no consensus to implement a rule similar to the Volcker rule. However, the ESRB has been actively monitoring firms with proprietary trading operations. For instance, the ESRB has recently asked proprietary trading firm with “high-frequency” trading operations to disclose trading strategies and details about computer algorithms (see Financial Times, 2011). Meanwhile, fifteen of the largest proprietary trading firms are setting up a European lobby group, the FIA European Principal Traders Association.

### **3.3 Conclusion**

The U.S. approach is to minimize risk-taking on the part of financial institutions by restricting the amount of proprietary trading undertaken by commercial banks. There is some concern as to whether the approach is realistic, given the complexity of some of the implementation issues (for example the exact scope of the permitted activities, and more specifically, the distinction between market-making and proprietary trading). There is no equivalent to the Volcker rule in the EU, but it is reasonable to assume that the existence of proprietary trading operations will be a factor in the ESRB determination of systemic risk.

## **4 The Regulation of the Hedge Fund Industry**

### **4.1 Registration Requirement, Recordkeeping and Reporting Obligations**

Prior to Dodd-Frank many investment advisers were not registered with the SEC, relying on various exemptions to registration granted pursuant to the Advisers Act. There are now registration requirements for investment advisers to private funds with assets under management of \$150 million or more. Hedge fund managers will have to register with the SEC and disclose infor-

mation regarding the fund. This includes basic organizational and operational information, assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading practices, valuation policies and practices of the fund, types of assets held, side arrangements or side letters (whereby certain investors in a fund obtain more favorable rights or entitlements than other investors), and trading practices. The SEC will make this information available to the Federal Reserve and the FSOC, to facilitate the monitoring of systemic risk. Further, the SEC and the FSOC may request any additional information relevant to assessing systemic risk.

The mandatory reporting should eliminate the issue of biases and distorted data associated with self-reporting. Hedge funds will also have to have assets audited by public accountants, which should reduce risk of fraud.

All of this information is to be held in confidentiality, and as such is exempt from disclosure to the general public. Dodd-Frank also protects from public disclosure any “proprietary information” of the investment adviser (which would protect a fund’s trading strategies and algorithms). However, to the extent these new recordkeeping and reporting requirements may give the SEC and other government agencies access to highly detailed and confidential information regarding a private fund’s positions, clients and trading strategies, there is potentially a heightened risk of accidental disclosure of confidential information (see concern on that issue in Skadden Arps, 2010: 40).

Note that Dodd-Frank registration requirement does not apply to foreign fund managers with no place of business in the U.S. However, the foreign exemption is relatively narrow in that the fund manager must have less than 15 clients (investors) in the U.S., and aggregate assets under management attributable to U.S. clients of less than \$25 million (or some higher amount, as deemed appropriate by the SEC). Unless the SEC significantly increases this \$25 million threshold, Dodd-Frank limits the ability of foreign hedge funds to raise funds in the U.S. without registering with the SEC.

In the EU, the proposed legislation on hedge funds is the Alternative Investment Fund Managers Directive. The European Parliament voted on a final text of the Directive on November 11, 2010, and member states have until July 22, 2013 to transpose the Directive into their national legislation. The Directive applies to alternative investment funds (AIF) and their EU domiciled managers (AIFMs). AIFs with assets under management above the threshold of 100 million EUR, or 500 million EUR in case of AIFs with no leverage and a lock-in period (no redemption rights) of 5 years or more, will need to be authorized by the home Member State competent authority and subject to ongoing requirements. There are information reporting requirements (annually) regarding the main instruments traded, the fund’s principal exposures and asset concentrations, the fund’s liquidity and risk management, arrangements for the valuation and safe-keeping of assets, audit arrangements, and the use of leverage. The AIF’s risk management function must set a maximum leverage level for the fund. The maximum level of leverage must take into account a variety of considerations: the type of AIF, the investment strategy, borrowing sources, the need to limit the exposure to any one counterparty, the scale of activity in

various markets, and the asset liability ratio.

The Directive also imposes capital requirements on AIFs: a minimum of EUR 300,000 for internally managed AIFs, and EUR 125,000 for externally managed AIFs. If the value of the portfolio being managed exceeds EUR 250 million, the funds will be subject to an additional capital requirement equal to 0.02% of the asset value in excess of EUR 250 million.

## 4.2 Hedge Funds and Systemic Risk

Though the hedge fund industry played no significant role in the 2008 financial crisis, there is the potential for hedge fund failures to destabilize the economy because of the size of the industry. Dodd-Frank has acknowledged this threat in that it specifically contemplates that the SEC be empowered to collect systemic risk data from the hedge fund industry. Yet it is unclear what measures would be taken if funds were identified as posing a threat to the stability of markets (because of size, leverage, possible liquidation spirals, etc.). It is unclear as a technical matter whether hedge funds are within the scope of the mandatory orderly liquidation mechanism described in Section 2. The law firm Skadden Arps is of the opinion that it is possible that the enhanced regulatory powers of the Federal Reserve could be used to regulate large private funds, especially highly-leveraged hedge funds (see Skadden Arps, 2010: 41).

In the EU, the Directive is more specifically focused on systemic risk implications of leverage:

Given that it is possible for an AIFM to employ leverage and, under certain conditions, to contribute to the build up of systemic risk or disorderly markets, special requirements should be imposed on AIFMs employing leverage. The information needed to detect, monitor and respond to those risks has not been collected in a consistent way throughout the Union, and shared across Member States so as to identify potential sources of risk to the stability of financial markets in the Union. To remedy that situation, special requirements should apply to AIFMs which employ leverage on a substantial basis at the level of the AIF. Such AIFMs should be required to disclose information regarding the overall level of leverage employed, the leverage arising from borrowing of cash or securities and the leverage arising from positions held in derivatives, the reuse of assets and the main sources of leverage in their AIFs.” (Directive, paragraph 49)

The Directive specifically provides that relevant information gathered by competent authorities should be shared with other authorities in the EU, with the European Securities and Market Authority (ESMA) and with the ESRB so as to facilitate a collective analysis of the impact of the leverage as well as a common response. The ESMA, based on advice of the ESRB, may impose specific leverage limits on AIFs.



### 4.3 Conclusion

There are similar transparency and disclosure requirements in the U.S. and the EU, with a focus on regulating the activities of fund managers rather than the funds themselves, which makes sense given that managers are responsible for all key investment decisions. One key difference is that unlike the EU Directive, Dodd-Frank does not provide for minimum capital requirements, and does not require specific leverage limits to be set by fund managers as part of their risk management. Further, the approach is quite different regarding the potential systemic risk implications of the hedge fund industry. The EU Directive very explicitly provides for a regulation of fund leverage. Dodd-Frank does not explicitly contemplate whether the hedge fund industry is within the scope of enhanced regulatory supervision.

## 5 The Regulation of Derivatives

In September 2009, at the G-20 Pittsburgh Summit, the G-20 leaders agreed that all standardized derivative contracts should be cleared through central counterparties by the end of 2012, that all non-centrally cleared derivatives should be subject to higher capital requirements, and that trading on exchanges or electronic trading platforms should be promoted. The G-20 leaders also agreed that information should be reported to trade repositories to provide transparency regarding OTC derivative transactions.

These objectives have been achieved both in the U.S. and in the EU. Dodd-Frank provides the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with authority to regulate over-the-counter derivatives (Dodd-Frank Title VII). This is a departure from the prior regulatory treatment of derivatives.<sup>22</sup> With Dodd-Frank, regulation of the OTC derivatives market is now divided between “swaps”, to be regulated by the CFTC, and “security-based swaps”, to be regulated by the SEC. “Security-based swap” are defined as swaps based on, among other things, a narrow-based security index or a single security or loan, including in each case any interest therein or the value thereof.

Both swap dealers and “Major Swap Participants” must register with the CFTC or the SEC, and satisfy capital and margin requirements (to be established by the CFTC or the SEC). Swap dealers are essentially the liquidity providers in the markets. “Major Swap Participants” are entities that maintain a substantial position in swaps, or create substantial counterparty exposure that could affect the stability of the financial market, or are financial entities that are highly leveraged relative to the amount of their capital. In substance, “Major Swap Participants” are those non-dealers whose swap activities might create systemic risk. Virtually all non-dealer business is conducted by large financial

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<sup>22</sup>While the CFTC was the regulator of commodity exchanges and commodity derivatives, it did not have oversight of the vast majority of privately negotiated OTC contract (Congress had passed the Commodity Futures Modernization Act of 2000 to deregulate the OTC market). Further, the SEC had no specific requirements for derivative operations of dealer firms.

institutions, and we should expect all the major players (banks, investment banks and other sophisticated market participants) potentially to qualify as “Major Swap Participants”.

With Dodd-Frank there are new clearing, trading and reporting requirements in the U.S., reviewed below. This new regulatory framework is very consistent with what is happening in Europe. The EU Commission has proposed a draft regulation to that effect, known as the European Market Infrastructure Regulation (the “EMIR”). The Regulation covers all areas of the OTC derivatives market – interest rates, credit, equity, foreign exchange and commodities.

## 5.1 Clearing Requirements

Derivatives are to be centrally cleared through clearinghouses, Designated Clearing Organizations (DCOs).<sup>23</sup> Further, the SEC and the CFTC are to pre-approve contracts before DCOs can clear them. Swaps must be cleared if they are of a type that the CFTC or the SEC determines must be cleared, and several factors are to be considered in this determination: the existence of significant notional exposures, trading liquidity, pricing data, the availability of operational infrastructure to clear the contract, and systemic risk considerations. Alternatively, DCOs may submit types of swaps to the SEC and CFTC to determine whether the clearing requirement should apply.

The role of a clearinghouse is to act as a counterparty for all participants, centralizing the market and allowing for a risk management system to be put in place at the clearinghouse level, thereby obviating the need for market participants to ascertain the credit-worthiness of each counterparty. Once it accepts the transaction and the parties post appropriate margins, the clearinghouse interposes itself between the parties to a derivative contract. Legally, the substitution of the clearinghouse requires a “novation” (the bilateral contract is novated when all duties and obligation under a contract are transferred to a new party) so as to enable the clearinghouse to become the counterparty to each side of the transaction.

There are exceptions for the clearing requirement, but they are limited. There is a end user exemption for swap counterparties that are not financial entities, and are using swaps to hedge risk. The rationale for this appears to be that end-users may not pose the same level of risk to the market as financial entities. For this purpose, a financial entity means a swap dealer, a “Major Swap Participant”, a hedge fund, or a person predominantly engaged in activities that are in the business of banking of otherwise financial in nature. If one of the counterparties to the swap is an end user that is not a financial entity and is hedging its own commercial risk, a swap is exempt from the clearing and exchange trading requirements. The end user may still elect to have the swap cleared and traded on an exchange.

The SEC and CFTC have been tasked with setting the standards for the organizational and business conduct of DCOs, including requirements regarding

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<sup>23</sup>Dodd-Frank §§ 723 & 763.

collateral for cleared swaps. Dodd-Frank also specifically stipulates that a registered DCO is not required to accept the credit risk of another DCO. The SEC and CFTC will have the ability to decide whether or not large banks regulated by the Federal Reserve should be prevented from owning DCOs. It appears that the position of the CFTC is that such large banks should not be allowed to both own DCOs and carry out trades through it.

These measures are similar to developments in Europe. The EMIR also requires the clearing of standardized OTC derivatives through central clearing counterparties (CCPs), the European equivalent of DCOs. There are provisions regarding the regulation of CCPs – it is proposed that CCPs be required to demonstrate that they are managed properly and maintain adequate liquidity levels (with access to liquidity through the central bank or a reliable commercial bank). Clearing an OTC derivative contract through a CCP usually will also involve the posting of collaterals, and it is expected that posted margins will cover 99% of risk exposure. There is no specific regulatory provision related to whether large banks should be able to own CCPs, but CCPs will have to disclose the identity of their shareholders.

There is no mandatory clearing for all OTC derivatives in the EU. Rather, clearing applies either because a competent regulatory authority in a Member State authorizes the CCP to clear a class of derivatives, or because the ESMA, on its own initiative and in consultation with the ESRB, identifies OTC derivatives that should be subject to the clearing obligation. Some specific criteria to determine whether a contract should be cleared includes systemic risk considerations, the liquidity of the contracts proposed for clearing, whether the CCP is able to handle the trading volume, and the level of required client protection.

The EMIR includes a clearing exemption for non-financial counterparties similar to the end-user exemption in Dodd-Frank. One difference, though, appears to be that under the EMIR, non-financial entities must also be deemed to not be systemically important. There is no such requirement regarding end-users, although potentially an end-user that maintains a substantial position in swaps that could affect the stability of the financial market may be characterized as a “Major Swap Participant”.

## 5.2 Trading and Data Reporting Requirements

Any swap subject to the clearing requirement will have to be traded on an exchange or on alternative venues called “Swap Execution Facilities” (SEF). In the case of swaps, trading will have to be conducted on a board of trade designated as a contract market (a “Designated Contract Market”) or a SEF. In the case of a security-based swap, trading will have to be conducted on a national securities exchange or a security-based SEF. A SEF is a “a trading system or platform in which multiple participants have the ability to execute or trade by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce”. Swap execution facilities are derivative-trading platforms. Currently, many firms are applying to run these platforms and become SEFs. For example, IntercontinentalExchange, which already op-

erates leading regulated exchanges, trading platforms and clearinghouses for various markets (agricultural, credit, currency, emissions, energy and equity index), announced its intention to become a SEF. This move is not surprising to the extent IntercontinentalExchange is already a major clearinghouse for credit default swaps. Other entities have also applied to become SEFs, for instance Tradeweb, MarketAxess and Bloomberg (New York Times, 2010). The first trading venue in the U.S. to facilitate the execution of an electronic interest-rate swap that was then processed by a central clearinghouse was Tradeweb, an online derivatives marketplace (Wall Street Journal, 2010).

There are now data collection and publication requirements to improve market transparency. The CFTC or SEC are to determine the appropriate manner to disclose real-time public reporting after execution of swap transaction and pricing data.<sup>24</sup> Here real-time public reporting means that the reporting of data relating to a swap transaction must occur as soon as is technologically practicable. There is no ‘end-user’ reporting exemption and all uncleared swaps must be reported to a registered trade repository, a registered entity that collects and maintains records of transactions.

Similarly, in the EU the EMIR encourages the use of electronic facilities to confirm the terms of an OTC derivative. The Markets in Financial Instruments Directive (“MiFID”) deals with electronic trading requirements. The EMIR also introduces a reporting obligation for OTC derivatives. The aim is to increase transparency by mandating that OTC derivative trades be reported to various central data centres known as trade repositories, which will be required to publish positions, by classes of derivatives. The newly created European Securities and Markets Authority (ESMA) is tasked with supervising these trade repositories.

### 5.3 Industry Implementation in the U.S.

Dodd-Frank thus provides for very ambitious changes and a comprehensive reform of the OTC derivatives market. From a technological point of view, all the major banks have been working to implement new trading platform and systems for their derivatives business. Meanwhile, the SEC and the CFTC have been working jointly to develop guidelines regarding margin and capital requirements, business conduct, reporting and recordkeeping requirements. Yet it has been suggested that the timeframe for implementation and compliance with these rules is unclear.<sup>25</sup> Key final rules are expected early 2012 (not yet finalized as of the date of writing). It is expected that mandatory clearing requirements will become effective some time by the end of the year. CFTC Commissioner Scott O’Malia has predicted that the first mandatory clearing determinations should begin in the third quarter of 2012.

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<sup>24</sup>Dodd-Frank § 727.

<sup>25</sup>Nazareth and Rosenberg (2001).

## 5.4 Conclusion

Dodd-Frank and the EMIR provide for very similar rules on key issue regarding the regulation of derivatives, which should reduce opportunities for regulatory arbitrage with respect to the OTC derivative business. This convergence is the result of close transatlantic cooperation, as evidenced in a joint statement from the CFTC Chairman Gary Gensler, and Commissioner Barnier, where both reaffirmed their determination to cooperate so as not to “create new space for regulatory arbitrage.” (Barnier and Gensler, 2010).

# 6 The Regulation of Credit Rating Agencies

## 6.1 Enhanced Regulatory Oversight

Dodd-Frank greatly expands the SEC’s oversight and enforcement powers, and has created an Office of Credit Ratings at the SEC with expertise and authority over CRAs. This office has the authority to conduct periodic compliance audits. The SEC also has authority to deregister CRAs for providing bad ratings over time. In the EU, CRAs have been a recent target for criticism in Europe because of their role in the euro crisis (for example Standard & Poor’s downgrade of Greek bonds in April 2010). The European Securities and Market Authority (ESMA) was established on January 1, 2011 and will be given general competence regarding matters related to the registration and ongoing supervision of registered credit rating agencies. The European Regulation on Credit Rating Agencies (ERCRA) has been in force since December 2010 and will become effective across the EU. This Regulation was amended in May 2011, to adapt to the creation of ESMA.<sup>26</sup>

## 6.2 Improved Rating Process and Disclosure

Under Dodd-Frank there are new disclosure requirements designed to improve the rating process through enhanced controls and greater transparency, and new rules regarding methodologies. CRAs must submit annual compliance reports to the SEC and establish internal controls to ensure compliance with rating policies. CRAs must apply qualification standards to credit analysts, who are required to pass qualifying exams and have continuing education.

CRAs are required to use standard forms to publicly disclose their rating methodologies. This includes a description of issuer data considered in the rating process, as well as any additional information that the SEC may require. In addition, issuers and underwriters of asset-backed securities must disclose the findings of any third-party due diligence. CRAs are also required to periodically disclose information assessing the degree of accuracy of its prior credit ratings (after the fact).

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<sup>26</sup>For more details, see the European Commission Press Release, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1355>.

In the EU the ERCRA also requires that CRAs disclose their methodologies and underlying assumptions made in producing ratings. Issuers will be required to disclose specific information on structured finance products on an ongoing basis.

### **6.3 Independence**

There are measures in Dodd-Frank to reduce conflicts of interest, and strengthen the ratings' independence. CRAs must maintain an independent board of directors (at least half the members of CRA boards must have no financial stake in credit ratings), prevent marketing considerations from influencing ratings, evaluate potential conflicts of interest related to former employees (especially when that employee goes to work for an underwriter or security issuer), prohibit compliance officers from working on ratings, methodologies or sales. To further strengthen independence, there are also restrictions on the ability of rating agencies to provide services other than credit ratings.

In the EU, there are also similar provisions designed to strengthen CRA independence. There are limitations on analysts leaving CRAs to work for entities they rated. If a large shareholder of a CRA (more than 10% ownership of capital or voting rights) has a financial interest in an entity, the CRA will be prohibited from rating the entity. Issuers would also have to rotate every three years between the agencies that rate them. Complex structured finance instruments would require ratings from two different CRAs. CRAs will also have to be more transparent regarding their pricing policy and the fees they receive.

Finally, the Capital Requirements Directive of July 2011 proposes measures to reduce reliance on ratings by encouraging banks to conduct their own internal credit opinions, specifically for purposes of regulatory capital requirements.

### **6.4 Accountability and Expert Liability**

Dodd-Frank makes it easier for investors to bring civil lawsuits against rating agencies. Prior to Dodd-Frank, CRAs were exempted from liability for inaccurate ratings (arguing, amongst other things, that ratings were protected by the First Amendment), unless there was evidence of actual knowledge of a false rating on the part of the CRA (or that the rating lacked basis in fact). There are now new expert liability rules exposing CRAs to expert liability if they consent to the inclusion of a credit rating in a registration statement. In order to avoid liability, CRAs must be able to show they had reasonable grounds to believe (and conducted a reasonable investigation to that effect) that the included credit rating was accurate.

In the EU, under the Market Abuse Directive the prohibition on market manipulation may apply to CRAs if it can be established that a CRA knew or ought to have known that its rating was false or misleading. The ERCRA also contains provisions designed to make CRAs more accountable for their ratings. A CRA should be liable in case it infringes, intentionally or with gross

negligence, the ERCRA, thereby causing damage to an investor having relied on the rating that followed such infringement. It is contemplated that investors could bring their civil liability claims before national courts. The burden of proof, as in the U.S., will be on the CRA to establish that the rating was reached with appropriate care.

## 6.5 Conclusion

We note here the key similarity here between the U.S. and the EU approaches, mainly the focus on transparency (the requirement that CRAs disclose detail regarding their credit assessment methodology), CRA independence, and a stated intent to make CRAs more accountable for inaccurate ratings, with the possibility to challenge CRAs for negligent ratings. It is as of yet unclear the extent to which investors would be successful in court, either in the U.S. and in the EU. Finally, the EU is more focused than the U.S. on minimizing credit institutions' reliance on CRA ratings.

## 7 Banking Power and Politics

Whether Dodd-Frank is likely to have much bite depends on whether it is properly addressing the conditions that created the 2007-2008 financial crisis. A safer financial sector in the U.S. would require that big, powerful banks that are "too big to fail" be reduced in size; that the financial system be significantly deleveraged; and that the incentive structures created by high leverage and the asymmetry of bonuses (high bonuses in good years, with the shareholders and government picking up the losses in bad years, creating an incentive for high volatility in returns) be eliminated. Unfortunately, the track record of the U.S. government is not particularly impressive in terms of addressing these issues.

As we have already discussed, the financial sector emerged from the financial crisis with a higher degree of concentration, and the U.S. government (the FSOC) has neglected to put size constraint on the banks. Commercial banks (including Goldman Sachs and Morgan Stanley since they converted to Bank Holding Companies) do have to comply with regulatory capital requirements, but there are no leverage limitations on the part of the hedge fund industry. Though we should expect less instability and more transparency in the derivative markets, with the clearing and data reporting requirement, there is still much leverage in the system. If the Obama administration originally intended to take advantage of the crisis (and sense of public outrage) to wring concessions from the bankers, such as the scale back of bonuses, it did not succeed in this respect. Dodd-Frank leaves the compensation structure of the bankers unchanged – banks are still fully sovereign in the determination of executive bonuses.

Johnson and Kwak (2010) ask the very pertinent question of why the U.S. government was unable to get real political leverage over the major banks in spite of the near-collapse of the financial system, and growing public concern

over Wall Street (e.g. the Occupy movement). Their answer is that the political influence of the financial sector is simply too great:

“When the government did rescue the financial system, it did so on terms that were favorable to the banks. What “we’re all in this together” really meant was that the major banks were already entrenched at the heart of the political system, and the government had decided it needed the banks at least as much as the banks needed the government. So long as the political establishment remained captive to the idea that America needs big, sophisticated, risk-seeking, highly profitable banks, they had the upper hand in any negotiation. Politicians may come and go, but Goldman Sachs remains.” (Johnson and Kwak, 2010: 6).

Johnson and Kwak (2010) well describes how the Wall Street banks are one of the most powerful political forces in Washington. In the past decades, Wall Street has exercised a tremendous political influence (with lobbying, campaign contributions, and top banking executives assuming key positions in the White House and in the Treasury Department) that helped create the laissez-faire environment that led to the recent financial crisis. Johnson and Kwak (2010) argue that if the basic conditions of the financial system do not change, if the financial lobby remains influential in Washington, and the few massive powerful banks continue business as usual, it is unlikely that Dodd-Frank will accomplish much. The financial reform cannot be successful unless the entire power dynamic in Wall Street and Washington is changed, and the banking oligarchy is challenged. Challenging the banking oligopoly could possibly be achieved with the application of U.S. anti-trust law. For example, in 1982 the Sherman Act was applied to dismantle AT&T into one long-distance company and seven regional “Bell” companies. There is no reason the Sherman Act could not be applied to break up the big banks, if there was political will on the part of the administration.

## 8 Conclusion

The Dodd-Frank reform places many new constraints on Wall Street – in this paper we have focused on the major changes. There are clearly welcome developments. The derivative clearing and publication requirements should improve market stability and transparency. The stricter regulation of CRAs, the improved rating process and disclosure, are all positive changes. Yet we can outline some reservations regarding the effectiveness of the new Dodd-Frank framework. One approach in Dodd-Frank is to minimize risk-taking on the part of financial institutions by restricting proprietary trading. The approach in itself has some merit – there is no doubt that the rise of proprietary trading within investment banks was accompanied by an increase in the risk profile of financial institutions, and in that sense, we can expect that a limit on proprietary trading would reduce risk and volatility. However, it is unclear that the Volcker rule will lead investment banks to return to a “boring banking” business model – to



focus on traditional investment banking fee-based activities, or low-risk market-making activities. As we have described, the current wording of the Volcker rule is complex, and there is some ambiguity regarding the exact scope of the permitted activities, and more specifically, the distinction between market-making activities and proprietary trading. This means that the implementation of the Volcker rule can be jeopardized to the extent the banks “hide” risk and proprietary trading in their market-making divisions (and we can expect banks to continue to seek risk, to the extent there are still incentives to do so and the compensation structure is still one-sided). A complete separation of investment banking and commercial banking (i.e. a return to Glass-Steagall) would have been a more clear-cut and enforceable provision.

Further, there is still potentially much risk in the financial system, with high levels of leverage in the hedge fund industry, and a high concentration of financial assets in the hands of bigger-than-ever banking institutions. Dodd-Frank does provide for the specific monitoring of systemic risk and enhanced regulatory supervision designed to prevent a global financial meltdown, but there are many challenges. Unlike the ESRB in Europe, the FSOC has not really indicated how it would measure systemic risk (which is still a difficult task, at a theoretical level). It is also unclear the extent to which the FSOC would actually rely on these enhanced supervisory measures in a preventive manner. The FSOC has already declined to address the issue of the size and complexity of financial institutions.

Technical fixes of specific mechanisms and financial products to solve specific problems that led to the 2008 crisis (e.g. by specifically addressing practices in the mortgage industry or in securitization) is necessary, but not sufficient in itself to prevent another market meltdown. The next financial crisis would likely take on a new form, originate in different sectors and products. With the bleak employment situation in the U.S., and the size of the student loan market (total student debt of \$867 billion, approximately 21% of which is delinquent), some people predict that student debt is the next bursting bubble (Washington Post, 2012). Other possible bubbles include social media Web 2.0 (with Facebook, Zynga, and LinkedIn enjoying billion dollar valuations that may well exceed fundamentals), or gold and precious metals (such as uranium or graphite). One could also conceive of the collapse of large hedge funds potentially leading to liquidity spirals and major market disruptions. But of course, we can only speculate as to what would be the sources of a new crisis.

One can only deplore that Dodd-Frank has not been more focused on the deep roots of the recent financial crisis. A safer financial sector in the U.S. would require smaller banks, a deleveraging of financial markets (and potentially the hedge fund industry), and a compensation structure which does not create incentives for volatility. Further, a reform of the current financial culture<sup>27</sup>, and the power system in place, remain a critical priority.

This said, many tough rules are attempted to be introduced in the U.S.

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<sup>27</sup>For an overview of the history of financial culture in the U.S., and the rise of a culture of reckless risk-taking, see Chappe, Nell and Semmler (2012).

through Dodd-Frank, including the Volcker rule. Some of them may not be final, some of them may never be enacted or enforced, some of them may not bite, but it is still a beginning, and those new laws can be claimed to be enforced by reform-friendly groups. On the other hand, Europe has only just started a serious attempt of a regulatory financial reform. The EMIR is still only a draft regulation. The Alternative Investment Fund Managers Directive will only come into effect on July 22, 2013. There is no equivalent to the Volcker rule in the EU, or any attempt to separate investment and commercial banking (although it is reasonable to assume that the existence of proprietary trading operations conducted by deposit-taking institutions could be a factor in the ESRB determination of systemic risk). It remains to be seen how exactly the ESRB will raise systemic risk concerns, whether it will exercise scrutiny over the risk profile of financial institutions, and whether it will effectively cooperate with national supervisory authorities. It might take an EU banking crisis to make the EU financial reform the topic of the day.

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