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Significance of the Volcker Rule

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**Eliminating Conflicts of Interests in Banks:
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Abstract

Public policy has been focused on controlling the conflicts of interests in banks for the last 85 years with limited success. Banks have a unique place in the economy as intermediaries between investors and companies that allow them to obtain significant private, proprietary information. Public policy is focused on trying to ensure that banks do not misuse this information to their own benefit to the detriment of their clients. This is a tough task.

In this paper, we exploit a unique data set that allows us to observe the information banks receive and what they do with it. When banks are hired as financial advisers, they become temporary insiders and they are required to report all transactions in their client firms' stock to the SEC. Using this unique data set, we analyze the kind of information banks acquire about their clients as part of their financial intermediary and advisory roles. Our data show that this information is highly valuable to banks, specifically, that they have been able to earn more than 25% returns above market, from proprietary trades on this information. Furthermore, since relaxation of the Glass-Steagall restrictions which had prohibited commercial banks from engaging in investment banking activities, this return on investment rose to a whopping 40%.

The Volcker Rule was enacted to aid in reducing systemic risks in the banking system, and among other purposes, to eliminate conflicts of interest that arise when banks profit at the expense of their clients. We demonstrate that an added benefit of enforcement of the Volcker Rule's prohibition on proprietary trading would be to eliminate these temptations to trade on material, non-public information for their benefit and their clients' detriment. We thus argue that not only should the Volcker Rule remain intact, it should be vigorously enforced.

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Eliminating Conflicts of Interests in Banks: The Significance of the Volcker Rule

In the banking sector, severe conflicts of interest can arise when, in the process of fulfilling their financial intermediary and adviser roles, bank executives become aware of opportunities to enter transactions for their own benefit that may also be detrimental to their banking clients. Examples of banking conflicts include marketing and sale of banking products such as new securities and bank loans created with knowledge of material, non-public adverse information about their client firms. Conflicts also permeated the role of banks in the FX manipulation,¹ LIBOR manipulation,² the Enron³ and Madoff⁴ scandals, and banks' huge trading losses such as the London Whale trade.⁵

The original motivation for the Glass-Steagall Act, which restricted banks from underwriting new securities, was in part to control these potential conflicts, specifically to prevent banks from using the material, non-public, adverse information they acquire from the normal banking activities in underwriting new securities. For instance, if banks realize that a particular client is in danger of financial distress, they have an incentive to arrange for a new security sale to the public and use the proceeds of those sales to pay off the bank loans.

The gradual weakening and subsequent repeal of most provisions of the Glass-Steagall Act in 1999 allowed commercial banks to acquire investment banking subsidiaries, to grow substantially in size, and to access even more information through more diverse banking activities.⁶ At the same time, proprietary trading became a major source of revenue for the

¹ Large, international banks in different parts of the world colluded for at least a decade to rig exchange rates by front-running client orders and rigging FOREX benchmark to gain financial benefits. See Philip Augar, *How the forex scandal happened*, BBC NEWS (May 20, 2015), <http://www.bbc.com/news/business-30003693>; Matt Levine, *Banks Manipulate Foreign Exchange in Ways You Can't Teach*, BLOOMBERG VIEW (Nov. 12, 2014, 7:15 PM), <https://www.bloomberg.com/view/articles/2014-11-12/banks-manipulated-foreign-exchange-in-ways-you-can-t-teach>.

² The *Wall Street Journal* ran a story in April 2008 claiming some banks understated their borrowing costs. Two years later, it turned out that there was indeed a collusion among the banks for the purpose of having LIBOR-related portfolios and making financial gains from these portfolios. Carrick Mollenkamp, *Bankers Cast Doubt on Key Rate Amid Crisis*, WALL ST. J. (Apr. 16, 2008, 12:01 AM), <http://online.wsj.com/article/SB120831164167818299.html>.

³ Top management of Enron overstated financial performance by repackaging bank loans to appear as Enron's profits. Enron's bankruptcy swept away billions of dollars from investors' pockets and forced the Congress to pass SOX. See *Enron Fast Facts*, CNN (Apr. 27, 2017, 3:39 PM), <http://www.cnn.com/2013/07/02/us/enron-fast-facts/index.html>; *The Fall of Enron*, BLOOMBERG BUSINESSWEEK (Dec. 17, 2001, 12:00 AM), <https://www.bloomberg.com/news/articles/2001-12-16/the-fall-of-enron>.

⁴ Banks enabled Bernie Madoff to create and perpetuate a Ponzi scheme that lasted for several years. See Stephanie Yang, *5 Years Ago Bernie Madoff Was Sentenced to 150 Years In Prison – Here's How His Scheme Worked*, BUSINESS INSIDER (Jul. 1, 2014, 6:54 PM), <http://www.businessinsider.com/how-bernie-madoffs-ponzi-scheme-worked-2014-7>.

⁵ Even though not a fraud, this case is an example of bad risk management and its consequences on financial markets and investors. See, Patricia Hurtado, *The London Whale*, BLOOMBERG QUICKTAKE (Feb. 23, 2016, 10:04 PM), <https://www.bloomberg.com/quicktake/the-london-whale>.

⁶ See Heather Long, *What the heck is the controversial Glass-Steagall Act?*, CNN MONEY (Oct. 14, 2015, 1:57 PM), <http://money.cnn.com/2015/10/14/investing/democratic-debate-what-is-glass-steagall-act/index.html>; ; Julia Maues,

banks.⁷ To prevent potential conflicts of interests that came from proprietary trading while acquiring material, non-public information about their clients, the SEC required so-called Chinese Walls, which refers to complete separation of personnel, decision-making and compensation between investment banking and commercial banking.

The subsequent financial crisis of 2008 exposed another glaring weakness of banking in the post-Glass-Steagall era. Banks had grown too big, too risky and too interconnected, many surpassing trillions of dollars in assets, interbank loans and liabilities on and off balance sheet. The sheer size, risk and interconnectedness of banking alone raised concerns about systemically important and too-big-to-fail banks. After numerous attempts to bring back Glass-Steagall failed, Congress attempted to contain banking systemic banking risk by passing the Volcker rule to prohibit proprietary trading, and enacting consumer protection and other ring-fencing and fire-wall provisions in the Dodd-Frank Act.⁸ The stated purpose of the Volcker Rule is as follows:

- (1) to reduce risks to the financial system by limiting the ability of banks to engage in activities other than socially valuable core banking activities;
- (2) to protect taxpayers and reduce moral hazard by removing explicit and implicit government guarantees for high-risk activities outside of the core business of banking; and
- (3) to eliminate any conflict of interest that arises from banks engaging in activities from which their profits are earned at the expense of their customers or clients.⁹

To test the potential importance of the Volcker Rule, we would need to know the amount of profits banks make from using proprietary adverse information about their clients. However, the source of the proprietary information banks use to execute their proprietary trading programs is typically confidential. Furthermore, banks do not disclose where and how they obtain this confidential information, which helps them create billions of dollars of profits every year.

In this paper we investigate one possible source of this information. Specifically, we investigate the importance of the private information banks acquire as part of their financial intermediary and financial advisory role for their client firms. Banks often attain insider trading status and become subject to insider trading reporting requirements and trading restrictions when they are hired to provide financial advice to their client firms. When banks become temporary

Banking Act of 1933 (Glass-Steagall), FEDERAL RESERVE BANK OF ST. LOUIS (Nov. 22, 2013), https://www.federalreservehistory.org/essays/glass_steagall_act.

⁷See, e.g., Imogen Rose-Smith, *The End of Proprietary Trading May Hit Banks' Profits but Help Their Stock Prices*, INSTITUTIONAL INVESTOR (Dec. 30, 2010), <http://www.institutionalinvestor.com/Article/2741999/Markets-Regulation/The-End-of-Proprietary-Trading-May-Hit-Banks-Profits-But-Help-Their-Stock-Prices.html#.WVPm-YTytaQ>.

⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 STAT 1376 (2010).

⁹ See 21st Century Glass-Steagall Act of 2017, H.R. 2585, 115th Congress (2017), <https://www.congress.gov/bill/115th-congress/house-bill/2585/text?q=%7B%22search%22%3A%5B%22congressId%3A115+AND+billStatus%3A%5C%22Introduced%5C%22%22%5D%7D&r=8>.

insiders,¹⁰ they must also report all of these trades executed on Forms 3, 4, and 5 alongside other legal insiders.

Using this insider trading database, we demonstrate that banks can and do access important, private, material information about their clients and appear to trade on this information. On average, the inside information that banks acquire and trade on is highly valuable, allowing the banks to earn more on 25% on their proprietary trades. Furthermore, we find that relaxation and elimination of the Glass-Steagall restrictions allowed the banks to trade more frequently and earn greater amount of abnormal profits. Since 2002, banks tend to trade and earn more than 40% abnormal profits from adverse information about their client firms. Consequently, we demonstrate that an added benefit of enforcement of the Volcker Rule would be to eliminate the incentives to trade on material, non-public information about their clients by eliminating proprietary trading by banks. Thus, we argue that enforcing the Volcker Rule would also help contain some the current conflicts of interest in the banking system resulting from the elimination of Glass-Steagall restrictions.

To address these issues, this paper is organized as follows. Part I presents a brief history of the Glass-Steagall Act and the repeal of most of the statute. Part II follows with a discussion of the resurgence of conflicts of interest in the wake of the partial repeal of Glass-Steagall, the ineffectiveness of Chinese Walls to adequately address conflicts, and the continuing conflicts inherent in proprietary trading. In Part III, we analyze the Volcker Rule, enacted in response to the 2008 financial crisis, which addresses conflicts of interest by restricting proprietary trading. We then present our empirical analysis in Part IV which provides evidence that conflicts of interest are alive and well, and highlights the need for regulation to decrease conflicts of interest and strong enforcement of the Volcker Rule. Recommendations and concluding remarks follow.

I. The Glass-Steagall Legislation: A Brief History

Buttressed by skyrocketing unemployment, plummeting stock valuations, evidence of securities manipulation and outright fraud, the Great Depression served as the motivating force for the foundational legislation of the securities, finance and banking industries. Acts such as the Securities Act of 1933¹¹ and the Exchange Act of 1934 (the '34 Act)¹² have become the cornerstone of the world-leading U.S. financial system. One such cornerstone act, known as the Glass-Steagall Act,¹³ has been gradually tore down by market forces even though the problems it aimed to remedy still exist today.

The Glass-Steagall Act prohibited commercial banks from engaging in either investment banking or nonbanking activities in an effort to both limit unsafe speculation by banks with

¹⁰ See *Dirks v. SEC*, 463 U.S. 646 (1983) wherein the Court discussed the concept of the temporary insider.

¹¹ Securities Act of 1933, Ch. 38, title I, Sec. 1, 48 STAT. 74 (1933).

¹² Securities Exchange Act of 1934, Ch. 404, title I, Sec. 1, 48 STAT. 881 (1934).

¹³ Banking Act of 1933, Pub. L. No. 73-66, 48 STAT 162 (1933).

consumer's funds as well as prevent self-dealing and conflicts of interest.¹⁴ Commercial banks could not affiliate with investment banks.¹⁵ Commercial banks could not deal in, underwrite or distribute non-government securities and they were restricted in holding only investment-grade securities for themselves.¹⁶

The gradual weakening and subsequent partial repeal of Glass-Steagall in 1999 by the Gramm-Leach-Bliley Act¹⁷ allowed commercial banks to merge with investment banks, allowing these financial conglomerates to grow in size substantially and investment activities to grow in importance to commercial banks. Such increased importance breeds conflicts of interest though; to prevent these conflicts from negatively affecting consumers, the SEC mandated the creation of so-called "Chinese Walls" within the firms, which refers to complete separation of personnel, decision-making and compensation between conflicted departments.

The subsequent financial crisis of 2008 highlighted the shortcomings of these Chinese Walls. Although somewhat effective, they did not adequately replace Glass-Steagall's now-removed conflict of interest protections. In 2010, after numerous attempts to reinstate Glass-Steagall failed, Congress attempted to remedy the conflicts of interest inherent in universal banking by passing the Volcker Rule, as well as enacting other consumer protections and ring-fencing and fire-wall provisions in the Dodd-Frank Act.¹⁸

Before the Glass-Steagall legislation and the accompanying financial and securities reforms, there was little federal regulation of the banking industry.¹⁹ The Office of Comptroller of the Currency was not created until 1864 and then only had authority over national banks, which many were not.²⁰ Market forces kept commercial banks from expanding into investment banking.²¹ Savings and loans (S&L) institutions largely focused on long-term securities and mortgages as well as taking small deposit amounts.²²

After the Civil War, the U.S. banking system extended a divide between commercial and investment banking.²³ Trust companies were able to substantially engage in both industries though; causing state chartered banks to lobby for this freedom and national banks to set up securities affiliates.²⁴ Fueled by the WWI bond effort, commercial banks participation in

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ The Gramm–Leach–Bliley Act (GLBA), also known as the Financial Services Modernization Act of 1999, (Pub.L. 106–102, 113 STAT. 1338 (1999)).

¹⁸ See Christoph Kumpan & Partrick C. Leyens, *Conflicts of Interest of Financial Intermediaries: Towards a Global Common Core in Conflicts of Interest Regulation*, 4 EUR. CO. FIN. L. REV. 72, 74 (2008) (noting that financial intermediaries "serve as a device for securing capital market stability").

¹⁹ James R. Barth et al., *Bank Regulation in the United States*, 56 CESifo Econ. Studies 112 (2010).

²⁰ *Id.* at 4.

²¹ *Id.*

²² *Id.*

²³ Michelle Clark Neely, *Commercial & Investment Banking: Should This Divorce be Saved?*, THE REGIONAL ECONOMIST (April 1995), <https://www.stlouisfed.org/publications/regional-economist/april-1995/commercial--investment-banking-should-this-divorce-be-saved>.

²⁴ *Id.*

securities grew even greater and more investment banks were created to satisfy demand.²⁵ By 1930, commercial banks participated in 61% of new bond issuances.²⁶

Then came the Great Depression. Following the stock market crash in 1929 and through 1933, U.S. GDP fell by 30%, unemployment soared to 25%, the stock market dropped 80% and over 7,000 banks failed.²⁷ Bank depositors lost almost \$400 million, the equivalent of over \$5.6 billion in 2017 dollars.²⁸ Public outrage was at a fever and with the 1929 stock market crash as the opening bell of the Great Depression, banks were in their crosshairs.

A. Legislative History

1. *The Pecora Commission*

Appointed as chief counsel to the U.S. Senate's Committee on Banking and Currency, New York District Attorney Ferdinand Pecora led a media-frenzied Congressional inquiry of Wall Street.²⁹ In what Senator Carter Glass referred to as a "circus," Pecora questioned Wall Street executives for over a year, most famously Charles Mitchell, the head of National City Bank (now Citi Bank), and Jack P. Morgan.³⁰

The hearings, taken at the height of the Great Depression and alongside the infamous mandatory four-day banking holiday, uncovered actions of the bankers that built on existing public outrage. A Chase National Bank executive had shorted his company's stock and National City Bank packaged failed loans as securities and sold them off to unknowing investors.³¹ Charles Mitchell sold discounted stocks to a family member to avoid paying taxes.³² The J.P. Morgan Bank maintained a "preferred list" of powerful businessmen whom it would provide

²⁵ *Id.*

²⁶ *Id.* The 1927 McFadden Act added fire to commercial banks' expansion by loosening practice and affiliate restrictions of commercial banks, for example, allowing the creation of subsidiaries solely to hold risky assets. Gary Richardson et al., *McFadden Act of 1927*, FED. RESERVE HISTORY, https://www.federalreservehistory.org/essays/mcfadden_act (last visited July 7 2017).

²⁷ David C. Wheelock, *The Great Depression: An Overview*, FED. RESERVE BANK OF ST. LOUIS, <https://www.stlouisfed.org/~media/Files/PDFs/Great-Depression/the-great-depression-wheelock-overview.pdf> (last visited July 7, 2017).

²⁸ See James Lardner, *A Brief History of the Glass-Steagall Act*, DEMOS 1 (Nov. 10, 2009), <http://www.demos.org/publication/brief-history-glass-steagall-act>. Assuming the annual inflation rate was 3.05% from 1929 to 2017.

²⁹ Bill Moyer, *Bill Moyer's Journal Transcript Part II*, PBS, <http://www.pbs.org/moyers/journal/04242009/transcript1.html> (last visited July 9, 2017).

³⁰ Gilbert King, *The Man Who Busted the 'Banksters'*, SMITHSONIAN MAG. (Nov. 29, 2011), <http://www.smithsonianmag.com/history/the-man-who-busted-the-banksters-932416/>. In a publicity stunt attempting to capitalize on the circus atmosphere, a Ringling Bros. press agent brought in Lya Graf, the world's smallest woman and perched her on the lap of J.P. Morgan. *Id.*

³¹ Lardner, *supra* note 28.

³² Senate Historical Office, *Subcommittee on Senate Resolutions 84 and 234 (The Pecora Committee)*, U.S. S., , <https://www.senate.gov/artandhistory/history/common/investigations/Pecora.html> (last visited July 9, 2017). In almost poetic fashion, Charles "Sunshine" Mitchell, who entered the Pecora hearings surrounded by throngs of attorneys and support staff, exited ten days later abandoned and alone. He resigned shortly thereafter. Michael A. Perino, *Ferdinand Pecora: The Hellhound of Wall Street*, FACULTY PUBLICATIONS 85, 18-19 (2011), http://scholarship.law.stjohns.edu/faculty_publications/85.

favors for and offer securities at below market prices.³³ Jack Morgan paid no income tax in 1921, 1922 or 1923.³⁴ The population was so outraged, the term “bankster,” a play on “gangster,” is believed to have been coined by *Time Magazine* as a result.³⁵

The populist outrage stirred up by the Pecora Commission compelled Congress and the President to action. In his inaugural address (which took place during the Pecora Commission), President Roosevelt stated the “[p]ractices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men” and “[t]he money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths.”³⁶ As one of FDR’s first signed legislative acts, the Glass-Steagall Act³⁷ ushered in the New Deal era.

2. *Jacksonian and Technocratic Motivators*

Before the Pecora Commission catalyzed reform, there was hearty debate and resistance surrounding what would eventually become known as Glass-Steagall. This debate was led by democratic senator Carter Glass.³⁸ In a clash of traditional Jacksonian, progressive and populist political theories and the then-new technocratic belief of government as macroeconomic managers, Glass-Steagall marked a shift in political discourse;³⁹ a shift from the morally grounded, democratic distrust of centralized power championed by individuals such as Supreme Court Justice Louis Brandeis, to a view that reform should be focused on maximizing economic productivity, agnostic to the fears of Brandeis.⁴⁰ Both views blamed “banker barons” for the

³³ Bonnie James, *It’s Past Time for a New Pecora Commission*, 39 EXEC. INTEL.REV. 12, 12 (2012). This preferred list contained multiple presidents, treasury secretaries, chairman of both the democrat and republican national committees and many other politicians. Alexander Tabarrok, *The Separation of Commercial and Investment Banking: The Morgans vs. The Rockefellers*, 1 Q. J. AUSTRIAN ECON. 1, 3 (1998).

³⁴ James, *supra* note 33, at 15. Chase National Bank voluntarily separated their investment and commercial banking practices in ear933; likely easing industry pushback to Glass-Steagall. K. Sabeel Rahman, *Democracy and Productivity: The Glass-Steagall Act and the Shifting Discourse of Financial Regulation*, 24 J. POL’Y HIST. 612, 618 (2012).

³⁵ Kate Phillips, *Financial Inquiries and the Pecora Legacy*, N.Y. TIMES (May 6, 2009), https://thecaucus.blogs.nytimes.com/2009/05/06/financial-inquiries-and-the-pecora-legacy/?_r=0; *See also Business: Bankster Jailed*, TIME (Sept. 5, 1932).

<http://content.time.com/time/magazine/article/0,9171,744304,00.html>.

³⁶ President Franklin D. Roosevelt, Inaugural Address (Mar. 4, 1933), <http://www.presidency.ucsb.edu/ws/?pid=14473>.

³⁷ Banking Act of 1933, Pub. L. No. 73-66, 48 STAT 162 (1933).

³⁸ Rahman, *supra* note 34, at 617. Glass was known as an “Unreconstructed Rebel,” having come from Lynchburg, Virginia. David Page, *A Brief Biograph of the Man Who Shaped the Federal Reserve Act*, FED. RESERVE BANK OF MINNEAPOLIS (Dec. 1997), <https://www.minneapolisfed.org/publications/the-region/carter-glass>.

³⁹ Rahman, *supra* note 34, at 615. Many commentators mistakenly view the Jacksonian line of thought as the impetus of Glass-Steagall. *Id.* at 620, 625. A comparison of the 1933 Securities Act and Glass-Steagall highlights this shift. While the Securities Act is motivated by the Brandesian disclosure and accountability model, the Banking Act centers on substantive economic value maximization. *See id.* at 621.

⁴⁰ *See id.* at 620. Ironically, the newly minted productivity-enhancing justification for reform Glass-Steagall was argued upon likely played a major role in its eventual demise. As discussed *infra*, Glass-Steagall was weakened over time by arguments that to do so would increase the productivity of the banking industry. *See id.* at 615. Although there is no consensus among scholars as to the motivating intent of Congress in enacting Glass-Steagall, the existence of both schools of thought in the debate is largely undisputed. *See* Jerry W, Markham, *The Subprime*

Great Depression but for differing reasons. The Jacksonian/Brandeis camp believed that the “curse of bigness” placed too much power in the hands of too few, impeding the democratic process.⁴¹ Glass on the other hand believed that artificial stimulation of stock prices by bankers was the cause of the Great Depression⁴² and that removal of conflicts of interest would serve to curb this artificial stimulation in the future.⁴³

The conflicting Jacksonian and Glass camps as well as the populist underpinnings of the Pecora commission create confusion as to the goals of and motivators for Glass-Steagall. The statute states three purposes:

- 1) To provide for safer and more effective use of bank assets
- 2) To limit stock market speculation.
- 3) To prevent self-dealing and conflicts of interest.⁴⁴

As the Court elaborated in *Investment Co. Institute v. Camp*, Congress was concerned with the “promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice.”⁴⁵ The interests of the commercial and investment banker could often be in conflict. The commercial banker was entrusted with government insured funds while the investment banker often looked to sell securities, which could be purchased with those funds.

These official considerations interwove the old Jacksonian fears and the new technocratic view. By creating a firewall between commercial and investment banking, Glass-Steagall simultaneously acknowledged the fear of banking as inherently dangerous but economically vital by separating the liquidity risk of commercial banks from the market volatility of investment banks. It also removed the conflicts of interest that were believed to have led to artificial stimulation of stock prices by requiring separate investment and commercial bankers and separate entities.⁴⁶

B. Glass-Steagall

Glass-Steagall is found in Sections 16, 20, 21 and 32 of the much broader Banking Act of 1933.⁴⁷ Coming in as a part of FDR’s New Deal and alongside the 1933 Securities Act and the

Crisis: - A Test Match for the Bankers: Glass-Steagall vs. Gramm-Leach Bliley, 12 U. PENN. J. BUS. L. 1081, 1092 (2010).

⁴¹ Rahman, *supra* note 34, at 620.

⁴² *Id.* at 623. Glass was a believer in the “Real Bills Doctrine,” the belief that the central bank of a country should only provide enough capital for legitimate commerce needs and not for speculation. Oonagh McDonald, *The Repeal of the Glass Steagall Act: Myth and Reality*, CATO INSTITUTE (Nov. 16, 2016), <https://www.cato.org/publications/policy-analysis/repeal-glass-steagall-act-myth-reality>.

⁴³ See Rahman, *supra* note 34, at 623-24. Glass also believed that the Brandesian, decentralized banking system was incapable of meeting the needs of the modern American economy. *Id.* at 622.

⁴⁴ Banking Act of 1933, Pub. L. No. 73-66, 48 STAT 162 (1933).

⁴⁵ *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 663 (1971).

⁴⁶ Whatever the stated or actual goals of Congress were in enacting Glass-Steagall, the evidence relied upon was largely anecdotal. There was and is little evidence that investment bank affiliates were a danger to banks. [“see” cite to the evidence used by Congress?]

⁴⁷ Banking Act of 1933, Pub. L. No. 73-66, 48 STAT 162 (1933); DAVID H. CARPENTER AT AL., CONG. RESEARCH SERV., R.44349, THE GLASS-STEAGALL ACT: A LEGAL AND POLICY ANALYSIS 13 (2016).

'34 Act, the Banking Act of 1933 also established Federal Deposit Insurance, increased Federal Reserve oversight over national banks, created the Federal Open Market Committee (FOMC) and introduced Regulation Q's predecessor, which outlawed the payment of interest rates on checking accounts and gave the Federal Reserve the power to set caps on interest paid on other deposits.⁴⁸

1. Section 16

Section 16 limits national, commercial banks to exercising "all such incidental powers as shall be necessary to carry on the business of banking."⁴⁹ It also outlaws underwriting and limits dealing in investment securities to non-recourse brokerage activities on behalf of clients.⁵⁰ These prohibitions were never an impenetrable firewall completely separating investment and commercial banking though. Section 16 granted the OCC the power to allow banks to trade up to 15% of their capital stock and 25% of their surplus funds for their own account; up to the lesser of 10% or \$100,000 in any one security.⁵¹ Section 16 also contained a carve-out for "bank-eligible securities," at the time obligations of the United States, the States or any political subdivision of either.⁵²

2. Section 20

Section 20 outlawed commercial, member bank affiliates to "engage[d] principally in the issue, flotation, underwriting, public sale, or distribution . . . securities."⁵³ Violations resulted in ongoing fines and eventual discontinuation of privileges granted to banks through the Federal Reserve System.⁵⁴

3. Section 21

As the inverse to Section 20, Section 21 made it illegal for investment banks to engage in deposit taking.⁵⁵ Qualifying deposits were only demand deposits; those "subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor."⁵⁶

⁴⁸ Julia Maues, *Banking Act of 1933 (Glass-Steagall)*, FED. RESERVE HISTORY (Nov 22, 2013), <http://www.federalreservehistory.org/Events/DetailView/25>. Although Glass was the driving force behind Glass-Steagall, the then chairman of the House Banking and Currency Committee, Henry Steagall agreed to sponsor the bill if the creation of deposit insurance was included. *Id.* Glass was opposed to the creation of deposit insurance. Michael Perino, *What FDR Hated About Glass-Steagall*, BLOOMBERGVIEW (June 14, 2013), <https://www.bloomberg.com/view/articles/2013-06-14/what-fdr-hated-about-glass-steagall>.

⁴⁹ Banking Act of 1933 § 16.

⁵⁰ *Id.*

⁵¹ *Id.* Banks were given one year to come into compliance with Glass-Steagall. *Id.*

⁵² *Id.*

⁵³ Banking Act of 1933 § 20. Sections 20's "principally engaged" language left enough ambiguity that banks occasionally acquired affiliates engaged in some prohibited activities, but not enough to make them prohibited. By 2000 there were 51 of these "Section 20 Affiliates."

⁵⁴ *Id.*

⁵⁵ Banking Act of 1933 § 21.

⁵⁶ *Id.* Section 30 also contained a prohibition on any entity or person from taking demand deposits unless subject to Federal Reserve or OCC oversight. Banking Act of 1933 § 30.

4. Section 32

Section 32 banned officers and directors of commercial, Federal Reserve member banks from being an officer, director or manager of an “organization engaged primarily in the securities business. . . .”⁵⁷ It also largely disallowed member banks from dealing with non-member banks that would be in violation of this section if they were a member without prior Federal Reserve permission.

C. The Gradual Erosion of Glass-Steagall

Glass-Steagall’s divide began to erode almost immediately after its enactment. Competitive forces between investment and commercial banks and from international banks as well as regulatory arbitrage and turf battles caused regulators, legislators and the judiciary to alter the Act without evidence that the underlying problems the Act aimed to solve were no longer present and without (and sometimes against) evidence of legislative intent.

1. Immediate Loopholes

Because Glass-Steagall put no legal restrictions on activities conducted by entities that owned commercial banks, Bank Holding Companies (BHCs) were immediately utilized as a loophole to the Act’s restrictions.⁵⁸ By incorporating under a BHC, banks could enjoy much of the benefits of being an investment bank without running afoul of Glass Steagall but also creating the relationships and conflicts the Act aimed to remedy.⁵⁹ By 1938, numerous Senators (including Senator Glass) and President Franklin D. Roosevelt called for their further regulation or prohibition of BHCs.⁶⁰ This regulation did not come about until the 1956 Bank Holding Company Act, which, among other things, limited the nonbanking companies a BHC could own to “those closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto. . . .”⁶¹ But the 1956 Act did not eliminate the loophole completely. One major exemption to the BHC activity restriction was the “one-bank” holding company exemption. This exemption allowed BHCs with only one bank to associate with commercial businesses; a product of the political power of local bankers.⁶² This exemption was so utilized

⁵⁷ Banking Act of 1933 § 32. Although the intent was not to break up “too-big-to-fail” banks, it had that immediate effect. JP Morgan spun off Morgan Stanley as a stand-alone investment banking entity shortly after its passing. CARPENTER, ET AL., *supra* note 47, at 8.

⁵⁸ Saule T. Omarova & Tahyar E. Margaret, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulations in the United States*, 31 REVIEW OF BANKING & FINANCIAL LAW 113, 121 (2012).

⁵⁹ *See id.*

⁶⁰ *Glass Moves to End Bank Holding Firms*, CHICAGO DAILY TRIBUNE (Jan. 25, 1938), <http://archives.chicagotribune.com/1938/01/25/page/21/article/glass-moves-to-end-bank-holding-firms>. The Federal Reserve had spoken out against Bank Holding Company’s as early as 1927. Omarova & Margaret, *supra* note 58, at 132-33.

⁶¹ Bank Holding Company Act, 12 U.S.C. § 1841, et seq. (2017).

⁶² *See Omarova & Margaret, supra* note 58, at 138.

that by 1969, one-bank holding companies represented 43% of all bank deposits in the U.S.⁶³ Evidencing that the fears that lead to Glass Steagall’s initial enactment still existed, the 1970 amendments to the Bank Holding Company Act finally closed this loophole.⁶⁴

In an effort to clarify the regulatory definition of a “bank,” the 1970 amendments also narrowed who qualified as a bank to those who both: 1) accepted demand deposits and 2) made commercial loans.⁶⁵ This created the “nonbank bank” where a business looking very much like a bank would restrict either of one of the two above qualifications to be deemed a bank and avoid BHCA regulations.⁶⁶ The high interest rate environment of the 1980s led commercial business to begin to take advantage of the nonbank bank model. Companies such as Sears, J.C. Penney, Merrill Lynch and Aetna Life and Casualty Company acquired nonbank banks and, thus, had direct access to the relatively inexpensive retail deposit as a source of funding.⁶⁷ The 1987 Competitive Equality in Banking Act closed this loophole by expanding the definition of a “bank” to include all insured banks; although some exceptions remained.⁶⁸

2. Market Competition

Outside competitors encroaching on commercial banking activities often led to the loosening of Glass-Steagall based regulations. As lightly regulated nonbanks competed with banks, their unequal treatment not only seemed unjustified, but the stricter regulator often loosened their policies to stem the exit of constituent entities to the more lucrative form despite no evidence or legislative signal that the risks the Act was originally aimed at mitigating no longer existed.

In response to increasing interest rates and asset/liability maturity mismatch in the savings and loan (S&L) industry, in 1982, after 118 S&L institutions failed and 752 merged, 418 S&L institutions with assets of \$220 billion were still insolvent.⁶⁹ This insolvency and subsequent government bailouts led to a revision of the S&L regulatory regime and to regulators loosening their restraint on the sector; increasing competition between S&L institutions and banks.⁷⁰

⁶³ *Id.* at 142 (quoting Carl A. Sax & Marcus H. Sloan III, *The Bank Holding Company Amendments of 1970*, 39 GEO. WASH. L. REV. 1200, 1201 (1970)).

⁶⁴ See Omarova & Margaret, *supra* note 58, at 146. In Congressional hearings leading up to the amendment, the Federal Reserve Board noted that “there [was] less need for concern of preferential treatment in extending credit where no commercial loans [were] involved.” *Id.* at 148.

⁶⁵ *Id.* at 147-48.

⁶⁶ *Id.* at 150.

⁶⁷ *Id.* at 152.

⁶⁸ Stephen K. Huber, *The Competitive Equality Banking Act of 1987: An Analysis and Critical Commentary*, 105 BANKING L.J. 284, 309 (1988).

⁶⁹ See Fed. Deposit Ins. Corp., *History of the Eighties – Lessons for the Future, Vol. 1, Ch. 4, The Savings and Loan Crisis and Its Relationship to Banking*, FED. DEPOSIT INS. CORP. 168-69, https://www.fdic.gov/bank/historical/history/167_188.pdf (last visited July 9, 2017). The ordeal is sometimes referred to as the “S&L Debacle.” *Id.*

⁷⁰ Fed. Deposit Ins. Corp., *supra* note 69, at 184.

To stave off further failures, in 1982, regulators lowered net worth requirements from 5% to 3%.⁷¹ This lowering along with a twenty-year phase-in rule for the net worth requirements and a five-year averaging rule for a deposit base meant that a new entrant could leverage just \$2 million in capital into \$1.3 billion in assets.⁷² In July of 1982, S&Ls were allowed to amortize goodwill in mergers over forty years, instead of the ten years allowed previously, taking the regulators off the hook for what would be otherwise insolvent banks and grossly overstating the actual value of otherwise insolvent institutions.⁷³

S&Ls grew rapidly after these changes. From 1983 through 1985, S&L assets grew at a rate double that of the commercial banks.⁷⁴ These assets moved more and more from the traditional S&L market of home mortgage financing into investments such as equities, casinos, windmill farms, ski resorts, junk bonds and arbitrage schemes; the commercial mortgage sector being a concentrated area of expansion.⁷⁵

Expansion of the S&L industry affected the competitiveness and profitability of banks in a multitude of ways. Both sectors directly competed for depositors' funds, increasing their costs of capital; of which S&Ls needed less.⁷⁶ Inexperienced and unskilled S&L institutions, flush with cash and unrestricted in their practices, also competed with commercial banks in issuing loans; often at unfavorable rates.⁷⁷ The S&Ls ability to take equity positions further disadvantaged commercial banks here.

As S&Ls were moving in on commercial real estate lending, disintermediation increased the competitive pressure on commercial banks. Through the 1970s and 1980s, the growth of the commercial paper markets meant that large corporate clients could attract more favorable lending rates from public sources as compared to commercial bank lending. Until its demise in March of 1986, Regulation Q exacerbated this competitive difference in favor of investment banks.⁷⁸ Regulation Q placed an upper bound on the interest rates banks could pay on demand deposit accounts, making unrestricted securities accounts much more attractive to customers throughout the inflationary 1970s.⁷⁹

⁷¹ Fed. Reserve Bank of S.F., *FRBSF Weekly Letter*, FED. RESERVE BANK OF ST. LOUIS 2 (Jan. 11, 1985), https://fraser.stlouisfed.org/files/docs/historical/frbsf/frbsf_let/frbsf_let_19850111.pdf.

⁷² Fed. Deposit Ins. Corp., *supra* note 69, at 173. The regulators' choice to switch between Regulatory Accounting Principles (RAP) and Generally Accepted Accounting Principles (GAAP) when one was more lenient than the other further eased restrictions on S&L institutions. *Id.* at 173.

⁷³ Fed. Reserve Bank of S.F., *FRBSF Weekly Letter*, FED. RESERVE BANK OF ST. LOUIS 2 (Dec. 21, 1984), https://fraser.stlouisfed.org/files/docs/historical/frbsf/frbsf_let/frbsf_let_19841221.pdf.

Relaxation of investor control limits also were lifted in an effort to attract new capital to the industry. Fed. Deposit Ins. Corp., *supra* note 69, at 175.

⁷⁴ Fed. Deposit Ins. Corp., *supra* note 69, at 178.

⁷⁵ *Id.* at 179.

⁷⁶ *See id.* at 181.

⁷⁷ *See id.*

⁷⁸ *See* R. Alton Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*, FED. RESERVE BANK OF ST. LOUIS 22 (Feb. 1986), https://files.stlouisfed.org/files/htdocs/publications/review/86/02/Requiem_Feb1986.pdf.

⁷⁹ *Id.*

Competitive pressures from abroad, most notably Europe, Japan and Canada, played a role in spurring the expansion of banking powers over time.⁸⁰ These foreign institutions could often operate more broadly in the U.S, than domestic banks, putting the domestic banks at a competitive disadvantage.⁸¹

3. *Regulatory Changes*

Regulatory turf battles, driven by both domestic and international competitive marketplace forces and political dealings among, for the most part, the Federal Reserve Board (FRB) as the regulator of bank holding companies and state banks that are a member of the Federal Reserve System,⁸² Office of Comptroller of the Currency (OCC) as the regulator of national banks, U.S. federal branches of foreign banks and federally chartered thrift institutions,⁸³ and the Securities Exchange Commission (SEC), which regulates brokers, dealers, clearing agencies, mutual funds and investment advisers⁸⁴ greatly contributed to the erosion of the Glass-Steagall commercial-investment bank barrier.

In 1937, the FRB introduced Regulation F, which provided rules for bank-run common-trust funds, pooled funds of small trusts held and administered by a bank as one and exempt from the reporting requirements of the otherwise applicable Investment Company Act Of 1940.⁸⁵ The SEC originally refrained from combatting this expansion because the FRB limited common-trust funds to when they were not used solely as a device for collective investment.⁸⁶ After a 1962 statutory shift in power, the OCC amended Regulation F with Regulation 9, eliminating this FRB limitation and the SEC finally pushed back on this infringement of their regulatory territory.⁸⁷ But by this point in time, the regulatory power of the OCC had expanded and the Glass-Steagall separation eroded. In *Investment Co. Institute v. Camp*, the Court ruled that this expansion of power was outlawed by Glass-Steagall when it was used to both pool trust funds and manage those funds.⁸⁸ Banks could manage client's funds and pool client's funds, just not do both in conjunction with each other.⁸⁹

In 1963, the OCC expanded its powers into the realm of insurance, a regulatory field largely left to the purview of the states, by interpreting Glass-Steagall's Section 92, which allowed national banks to act as insurance agents in any place with a population no greater than 5,000, applied whenever a bank branch is located in such a populace, regardless of the location

⁸⁰ See WILLIAM D. JACKSON, CONG. RESEARCH SERV., IB87061, GLASS-STEAGALL ACT: COMMERCIAL VS. INVESTMENT BANKING1(1987).

⁸¹ *Id.*

⁸² MARK JICKLING & EDWARD V. MURPHY, CONG. RESEARCH SERV., R43087, WHO REGULATES WHOM? AN OVERVIEW OF U.S. FINANCIAL SUPERVISION23 (2010). The Dodd Frank Act expanded the FRB's power to other institution types but such a discussion is beyond the scope of this historical recounting.

⁸³ *Id.*

⁸⁴ *Id.* at 24.

⁸⁵ *Regulation of Bank-Operated Collective Investment Funds. Judicial or Legislative Resolution of an Administrative Controversy?*, 73 YALE L.J. 1249, 1250-51 (1964).

⁸⁶ *Id.* at 1251.

⁸⁷ *Id.* at 1251-52.

⁸⁸ *Inv. Co. Inst.*, 401 U.S. 617.

⁸⁹ *Id.* at 624-25.

of the bank headquarters.⁹⁰ The OCC took this further in 1986, through a letter with regard to an expanding bank stating that “while the bank or bank branch must be located in a small town, it can sell insurance to persons and businesses located outside that town.”⁹¹

In the 1970s and ‘80s, regulators’ language marked a shift away from maintaining the Glass-Steagall wall to a debate over the proper regulatory regime. While still justifying their interpretations in under Glass-Steagall and the BHCA of 1963, the scope of permissible activities was clearly growing. FRB Chair Paul Volcker wrote “[a]s the Board as a whole has repeatedly urged, the plain and desirable remedy to this legal and substantive morass is a fresh congressional mandate.”⁹² According to Justice Blackmun, “The Court’s opinion and judgments here, it seems to me, are based more on what is deemed appropriate and desirable national banking policy than on what is a necessary judicial construction of the Glass-Steagall Act.”⁹³

In 1972, the FRB amended Regulation Y to include “serving as investment adviser . . . to an investment company” so “so closely related to banking . . . as to be a proper incident thereto” and therefore a permissible BHC affiliate activity.⁹⁴ Although past FRB regulations, such as Regulation F were hinged on Investment Company exemptions; here the FRB explicitly and squarely walked into the SEC’s realm of investment adviser regulation.

In 1957, the OCC allowed banks to profit from brokerage transactions provided on behalf of their customers only.⁹⁵ In 1982 the OCC expanded this interpretation to allow national banks to offer discount brokerage services to both customers and non-customers.⁹⁶ Once again, a bank regulator broke from their past self-defined limits on what it meant to be a “bank” and strayed into the realm of securities.

In 1983, the FRB enlarged its regulatory reach by including retail securities brokerages, engaged solely in the buying and selling of securities on behalf of clients without giving investment advice as “so closely related to banking . . . as to be a proper incident thereto.”⁹⁷ In affirming this interpretation, the Supreme Court ruled that Schwab had no “salesman’s stake,” something akin to a conflict of interest, because their profits relied solely on the volume of trades and not whether specific shares were traded.⁹⁸

⁹⁰ OFFICE OF THE COMPTROLLER OF THE CURRENCY, NO. 753-4, INTERPRETIVE RULING AND RELEVANT CASES <https://www.occ.gov/static/interpretations-and-precedents/nov/753-4.pdf> (last visited July 9, 2017).

⁹¹ *Indep. Ins. Agents of Am., Inc. v. Ludwig*, 997 F.2d 958 (D.C. Cir. 1993).

⁹² *J.P. Morgan & Co.*, 73 Fed. Res. Bull. 473, at 506 (F.R.B. 1987).

⁹³ *Inv. Co. Inst.*, 401 U.S. 617

⁹⁴ Fed. Deposit Ins. Corp., *FDIC Law, Regulations, Related Acts: 7500 – FRB Regulations*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/regulations/laws/rules/7500-3900.html> (last visited July 9 2017).

⁹⁵ Philip Wallach, *Policy Erosion and Policy Maintenance: The Case of Glass-Steagall* PRINCETON UNIVERSITY 17 (Nov. 24, 2008), https://lpa.princeton.edu/sites/default/files/Wallach_LEGS_Paper.pdf.

⁹⁶ See Intuit Inc. Electronic Fin. Services Council, *Promoting Efficient Arrangements Between Portals and Online Brokers*, SECURITIES AND EXCHANGE COMMISSION 6 (June 2000), <https://www.sec.gov/pdf/intuifescpaper.pdf>.

⁹⁷ See *Sec. Indus. Ass'n v. Bd. of Governors of Fed. Reserve Sys.*, 468 U.S. 207, 221 (1984).

⁹⁸ See *id.*

In what some saw as an apparent conflict with the legislative text, the FRB ruled in 1986 that a commercial bank could derive up to 5% of its gross revenues from investment banking.⁹⁹ In 1996, this limit was raised to 25%; virtually rendering Glass-Steagall's wall moot.¹⁰⁰

Numerous other erosions Glass-Steagall on the regulatory level took place over time. The OCC allowed banks to become members of security and commodity exchanges; engage in securities lending, individual retirement account (IRA) management, private placement of securities, brokering and dealing in options and futures on foreign currency and other financial products, holding certain securities for hedging purposes and general obligation municipal bond underwriting, dealing, and holding.¹⁰¹ The FRB list of nonbanking activities "closely related to banking," contained in Regulation Y, grew so long it became known as the "laundry list."¹⁰²

4. Partial Repeal of Glass Steagall: The Gramm-Leach-Bliley Act

The erosion of what was left of Glass-Steagall's divide picked up speed in the 1990s. By 1999, 70% of banks offered insurance products.¹⁰³ In 1998, Citigroup Bank and Travelers Insurance proposed what at the time was the largest corporate merger; creating the largest financial institution ever, in blatant violation of Glass-Steagall.¹⁰⁴ No regulator staged complete resistance to the merger though; only threatened requiring possible divestitures. After these threats, Citi and Travelers joined an already existing movement and strongly lobbied for a repeal of Glass-Steagall.¹⁰⁵ It came about in the Financial Modernization Act of 1999, commonly known as the Gramm-Leach-Bliley Act (GLBA) in November of 1999.¹⁰⁶

The GLBA, signed into law by President Bill Clinton, was enacted with the intention of promoting the benefits of financial integration while still safeguarding the soundness of the financial system; this final part an acknowledgement of the continuing risks Glass-Steagall aimed to remedy.¹⁰⁷ An obituary style news story described Glass-Steagall's demise at the hands

⁹⁹ MATTHEW SHERMAN, CENTER FOR ECONOMIC AND POLICY RESEARCH, A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES, 9 (2009).

¹⁰⁰ *Id.*

¹⁰¹ CARPENTER AT AL., *supra* note 47, 13.

¹⁰² Notice of Proposal and Request for Comments, 12 C.F.R. § 225 (Aug. 28,

1996)<https://www.federalreserve.gov/boarddocs/press/boardacts/1996/19960828/r-0935a.pdf>.

¹⁰³ Markham, *supra* note 36, at 1102. Alan Greenspan, the Chairman of the Federal Reserve, openly championed the demise of Glass-Steagall because he believed it would negatively affect the United States' position in the financial world. His views did recognize that the conflicts of interest Glass-Steagall aimed to remove still existed though. He believed a bank's banking and securities activities needed to be kept at arms-length in any future legislation. Hugh Vickery, *Greenspan warns Congress of Glass-Steagall*, UNITED PRESS INTERNATIONAL (Nov. 18, 1987), <http://www.upi.com/Archives/1987/11/18/Greenspan-warns-Congress-of-Glass-Steagall/1253564210000/>.

¹⁰⁴ Lardner, *supra* note 27, at 2.

¹⁰⁵ *Id.*

¹⁰⁶ Banking Act of 1933, Pub. L. No. 73-66, 48 STAT 162 (1933). Lardner, *supra* note 27, at 2. Citi and Travelers merged shortly after GLBA but separated when Travelers was spun off in 2002. Keisha Lamothe, *Travelers Buys Back Its Red Umbrella*, CNN MONEY (Feb. 13, 2007), <http://money.cnn.com/2007/02/13/news/companies/citigroup/?postversion=2007021314>. Gramm had been introducing variants of the GLBA since before 1995. After leaving government, Gramm went to work for UBS AG. Lardner, *supra* note 27, at 3.

¹⁰⁷ See Joe Mahon, *Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley*, FEDERAL RESERVE HISTORY (Nov. 12, 1999), <http://www.federalreservehistory.org/Events/DetailView/53>.

of GLBA as being “at the hands of marketplace changes and political compromise.”¹⁰⁸ President Clinton called the now-removed Glass-Steagall divide “antiquated walls.”¹⁰⁹ Senate Banking Committee Chairman Phil Gramm cited “stability and growth” as the reason for GLBA.¹¹⁰

GLBA aimed to allow US-based banks to operate as universal banks. To do this, GLBA created the Financial Holding Company (FHC), an evolution of the BHC that allowed commercial and investment banks to now be owned by the same holding company.¹¹¹ Cross-marketing restrictions prevent banks from marketing the products and services of other entities within the holding company.¹¹² GLBA also eliminated the commercial/investment bank affiliation restrictions contained in Sections 20 and 32 of the GSA.¹¹³ A national bank can now engage in financial activities through a subsidiary so long as the financial subsidiary does not exceed the lesser of \$50 billion or 45% of the bank’s assets.¹¹⁴ State member banks can control a subsidiary engaging in all the activities allowed a subsidiary of a national bank and, with FDIC approval, can also engage as principals in numerous activities not allowed to be conducted by national banks.¹¹⁵

GLBA did not eliminate Glass-Steagall completely though. Section 16’s and 21’s restriction on activities carried on within subsidiaries largely remained.¹¹⁶ National banks still cannot engage in insurance underwriting, merchant banking, insurance company portfolio investments, real estate development, and real estate investment.¹¹⁷ Along with this internal divide, GLBA also attempted to account for at least some of the conflicts of interest that could arise under this new structure. Reminiscent of how Glass-Steagall aimed to prevent investment bank arms from capitalizing on the knowledge commercial bank arms had about consumer’s funds; personal information of consumers can only pass from banking subsidiaries (or be shared with third parties) if the consumer is advised of the practices and has the option to opt-out of some sharing of personal information.¹¹⁸ These Glass-Steagall remnants are almost wholly ineffective though.

¹⁰⁸ Dean Anason, *Clinton Enacts Glass-Steagall Repeal*, AMERICAN BANKER (Nov. 15, 1999), <https://www.americanbanker.com/opinion/flashback-the-day-glass-steagall-died>.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ Mahon, *supra* note 104.

¹¹² *Id.*

¹¹³ Fed. Fin. Inst. Examination Council, *Financial Services Modernization Act – Gramm-Leach-Bliley – Summary of Provisions*, FED. FIN. INST. EXAMINATION COUNCIL, https://www.ffiec.gov/exam/InfoBase/documents/02-con-g-l-b_summary_of_provisions-010416.pdf (last visited July 9, 2017).

¹¹⁴ Source?

¹¹⁵ Abdullah Al Mamun et al., *the Impact of the Gramm-Leach-Bliley Act on the Financial Services Industry*, 28 J. ECON. & FIN. 333, 335 (2004).

¹¹⁶ CARPENTER AT AL., *supra* note 47, at 16.

¹¹⁷ Fed. Fin. Inst. Examination Council, *Financial Services Modernization Act – Gramm-Leach-Bliley – Summary of Provisions*, FED. FIN. INST. EXAMINATION COUNCIL, https://www.ffiec.gov/exam/InfoBase/documents/02-con-g-l-b_summary_of_provisions-010416.pdf (last visited April 4, 2017).

¹¹⁸ Electronic Privacy Info. Ctr., *The Gramm-Leach-Bliley Act*, ELECTRONIC PRIVACY INFO. CTR., <https://epic.org/privacy/glba/> (last visited July 9, 2017). GLBA’s privacy clauses were also heavily influenced by a wider trend of data security both in the US and abroad. *Id.*

II. The GLBA and the Resurgence of Conflicts of Interest

As discussed above, Glass-Steagall was gradually eroded by market forces, resulting in the enactment of the GLBA, despite the continued existence of conflicts of interests. The GLBA does nothing to address these conflicts. In the absence of Glass-Steagall, it thus becomes critical that other regulations address this legislative gap.

Even if bank subsidiaries are separate legal entities, formal and informal institutional connections raise the risk of conflicts being acted upon to the detriment of the consumer. When different financial services are offered within one parent company, the institution consequently possesses more private or inside information. Obtaining more information provides greater opportunity for a firm to use to this information among different departments in ways conflicting with the best interests of clients, thereby “creating material distortions in the capital markets at the customers’ expense.”¹¹⁹ For example, a conflict of interest arises when an investment bank subsidiary considers underwriting an entity to which the commercial banking subsidiary has extended a loan. Further, if the banking entity’s lending unit has inside knowledge about the bankruptcy likelihood of that customer, it can then encourage its underwriting department to sell that customer’s bonds to the unsuspecting public in order to pay off the loan.¹²⁰ The bank transfers the risk of the loan from its balance sheet to the market and simultaneously, earns an underwriting fee. In general, the universal banking structure allows an institution to engage in fewer due diligence efforts and underwrite lower-quality issuers.¹²¹

As the recent financial crisis demonstrated, when extreme or ubiquitous conflicts of interest are exploited, they can have significant economic implications. Dictated by an impartial or an “underhanded” source, conflicted transactions inhibit the efficient functioning of the capital markets, manipulate the optimal allocation of resources, and create “for those institutions involved[,] . . . a false level of profitability which is not sustainable in the long term under true market conditions.”¹²²

The public operates in the securities markets under the reasonable expectation that everyone is playing by the same rules. When firms that abuse conflicts or fail to play by the rules are left unpunished by law enforcement, investors feel that they are being cheated¹²³ in their investment, and in turn, the public’s confidence in that firm and in the overall capital markets decreases.¹²⁴ When investors are uncertain about the quality of their investment, they incur additional due diligence expenses, or in the alternative, are forced to trust that there is no conflict

¹¹⁹ FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC), STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 49 (2011).

¹²⁰ This transfer of information from the loan department to the underwriting department is known as an information flow. Andrew Crocket et al., *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* GENEVA REPORTS ON THE WORLD ECONOMY 5 (2003).

¹²¹ Greg Hebb, *Conflict of Interest in Chartered Bank Security Underwritings: Evidence from Canadian Bond Performance*, 15 INT’L RES. J. FIN. ECON. 124, 125 (2008).

¹²² HARRY MCVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL: REGULATING CONFLICTS OF INTEREST, 30 (1993).

¹²³ *Id.* at 740, 742, 746–47.

¹²⁴ Mirjana Radovic, *Measures for Preventing and Managing Conflicts of Interest in Investment Firms* in PRIVATE LAW REFORM IN SOUTHEAST EUROPE 232, 233 (Mirko Vasilijevic et al, eds., 2010).

or cheating occurring because the costs of detecting it are so high.¹²⁵ Both scenarios raise transaction costs.

Another case of market failure stems from the banks' key roles in addressing information asymmetry and rational ignorance between purchasers and offerors of securities. Investors often do not have the skill or information or the capital invested to justify an in-depth exploration of a securities offering. This asymmetry is heightened when the securities at issue are complicated, highly-structured, or backed by opaque, illiquid assets.¹²⁶ The role of the universal bank, as investment adviser, is to possess the necessary skill and knowledge to investigate the securities as well as spread the costs across numerous investors. Generally, when information asymmetry persists, transactions are tainted with adverse selection¹²⁷ and moral hazard.¹²⁸ By providing the buyer with information and the necessary assurance about the quality of the asset or security that they are purchasing from the seller, banks help to remove this information asymmetry but when conflicts of interest exist; banks acting as investment and commercial banks may have conflicting interests; leading them to give less than ideal investment advice to purchasers.¹²⁹

A. The Failure of Chinese Walls

With the passage of GLBA, Chinese Walls – defined as “a regulatory mechanism aimed at stopping the flow of material information from one department in a conglomerate to another and resolving the legal problems associated with conflicts of interest and duty generally”¹³⁰ – became important tools to prevent internal and external flows of material, non-public information. Chinese Walls have been described as essential to the continued survival of multi-service financial entities,¹³¹ and are also thought to prevent conflict abuse and insider trading by creating a separation among conflicted activities or market participants in financial conglomerates. Unfortunately, evidence shows these Walls alone to be ineffective.

¹²⁵ Norman S. Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 Mich J. Int'l L. 91, 94 (1988).

¹²⁶ FSOC, *supra* note 120, at 49. The CDOs and derivatives sold before the meltdown have these defining characteristics. *See id.*

¹²⁷ Adverse selection occurs before the transaction is executed and can be simply defined as a situation “when parties who are the most likely to produce an undesirable (adverse) outcome for a financial contract are most likely to enter the contract and thus be selected . . . Clearly, minimizing the adverse selection problem so that capital flows to productive uses requires that investors have the information to screen out good from bad investments.” Crocket ET AL., *supra* note 121, at 2–3.

¹²⁸ Moral hazard occurs after the transaction is executed because the firm “has incentives . . . to undertake investment in unprofitable projects that increase the firm's” wealth. Both adverse selection and moral hazard problems can be avoided when investors make decisions based on a comprehensive and accurate set of data points about their investment, which is generally achieved with the assistance of an underwriter or adviser. *Id.*

¹²⁹ The Jacksonian fears of big business that partially motivated Glass-Steagall also intersect with economic principles and substantiate the need to regulate conflicts of interest. Conflicted transactions are considered unfair because they involve the “illegitimate redistribution of wealth.” Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 746 (1978).

¹³⁰ McVEA, *supra* note 123, at 8.

¹³¹ *See, e.g.*, Harry McVea, *Financial Conglomerates and Conflicts of Interest: Resolving a Regulatory Dilemma*, 47 N. IR. LEGAL Q. 239, 243–44 (1996) (“Indeed, it may be no exaggeration to say that Chinese Walls are the linchpin of the financial conglomerate regulatory system, since the operation of the diversified institution would be severely impeded if the Wall mechanism were not widely permitted”).

1. *Development of Chinese Walls*

The use of Chinese Walls in financial firms has been traced back to the 1960s. Before the now-iconic insider trading case of *In re Cady, Roberts & Co.*,¹³² it was thought that a trustee for an investment account should make its investment decisions by rooting out information from all files and personnel across departments within the financial institution,¹³³ and that any information possessed by the financial institution should be used to make investment decisions benefiting the trust's beneficiaries.¹³⁴ *Cady, Roberts* involved the use of inside information that came to the defendant investment manager from an outsider.¹³⁵ The language of the decision, however, appeared to limit a trustee's use of material, non-public information, regardless of its source, in managing investments.¹³⁶

The 1968 case of *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹³⁷ brought about the widespread use of Chinese Walls in financial firms. Merrill Lynch was the managing underwriter of a potential public offering of debentures by Douglas Aircraft.¹³⁸ In its capacity as underwriter, Merrill Lynch learned that Douglas was planning to publicly disclose its revised earnings projections for the upcoming fiscal year, which would show substantially reduced figures.¹³⁹ Merrill Lynch's underwriting department tipped the firm's sales department, which in turn shared the information with clients.¹⁴⁰ Based on this shared information, numerous clients sold their Douglas stock before Douglas publicly disclosed their revised projections.¹⁴¹ Merrill Lynch eventually settled the case with the SEC. The terms of the settlement included a requirement that the firm adopt a policy that "prohibits disclosure by any member of the Underwriting Division of material information obtained from a corporation . . . , and not disclosed to the investing public."¹⁴²

Following *Merrill Lynch*, more financial firms voluntarily adopted internal policies that sought to prohibit information flows between commercial lending or underwriting activities (private-side) and trading or sales activities (public-side).¹⁴³ The SEC Order in *Merrill Lynch*, however, did not confer any legal effect on Chinese Walls, and the SEC emphasized that it could not anticipate whether adopting a policy like the one in *Merrill Lynch* would insulate a financial firm from any liability.¹⁴⁴

¹³² *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

¹³³ Leo Herzel & Dale E. Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73, 76-77 (1978).

¹³⁴ Edward S. Herman & Carl F. Safanda, *The Commercial Bank Trust Department and the "Wall,"* 14 BOS. C. INDUS. & COM. L. REV. 21, 24 (1972).

¹³⁵ *In re Cady, Roberts & Co.*, 40 SEC at 907-08.

¹³⁶ *Id.* at 908-912.

¹³⁷ *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 SEC 933 (1968).

¹³⁸ *Id.* at 935.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *See id.* at 936.

¹⁴² *Id.* at 938.

¹⁴³ Herzel & Colling, *supra* note 134, at 79-80.

¹⁴⁴ *In re Merrill Lynch, Pierce, Fenner & Smith*, Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629, at 83,350 (SEC1968).

Chinese Walls kept their non-mandated status until the late 1980s; in 1988, in the wake of numerous violations of the SEC’s anti-fraud provisions,¹⁴⁵ Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (the ITSFEA),¹⁴⁶ which revised the ’34 Act and the Investment Advisers Act to require that certain financial institutions adopt Chinese Walls.¹⁴⁷ Section 15(g) of the ’34 Act provides that:

Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker’s or dealer’s business, to prevent the misuse in violation of this chapter, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.¹⁴⁸

Section 204 of the Investment Advisers Act contains a similar requirement for investment advisers.¹⁴⁹ A financial entity that has in place adequate Chinese Walls may also avoid liability for activities that would otherwise could be considered breaches of the SEC’s anti-fraud provisions: for example, a firm subject to SEC Rule 14e-3 may still carry on arbitrage activity if it has a Chinese Wall preventing the arbitrage department from learning material, non-public information from the M&A department.¹⁵⁰ Broker-dealers and investment advisers may also face civil penalties for “knowingly or recklessly fail[ing] to establish, maintain, or enforce” these required policies or procedures.¹⁵¹

Although statutory Chinese Wall requirements grew out of insider trading concerns, recently greater emphasis has been placed on the potential effectiveness of Chinese Walls in addressing analysts’ conflicts of interest. In the wake of the Enron and WorldCom scandals, much blame for the financial fallout was placed on conflicts of interest among securities analysts. This blame was not without basis: financial regulators’ enforcement actions involving conflicts of interest between research and investment banking divisions of firms resulted in a

¹⁴⁵ FERRARA, *infra* note 200, at § 9.03.

¹⁴⁶ P.L. 100-704, codified in a number of provisions of the federal securities laws.

¹⁴⁷ Christopher M. Gorman, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?*, 9 FORDHAM J. CORP. & FIN. L. 475, 494 (2004).

¹⁴⁸ 15 U.S.C. § 78o(g) (2017). Note that this provision was originally Section 15(f) of the Securities Exchange Act

¹⁴⁹ 15 U.S.C. § 204.

¹⁵⁰ In addition, an entity that trades securities while another sector of the entity possesses “material, non-public information” can avoid Rule 10b5-1 liability if it demonstrates that the individuals making the investment decision on behalf of the entity to buy/sell shares was not aware of the material nonpublic information and implemented Chinese Walls.

¹⁵¹ Securities Exchange Act, 15 U.S.C. § 78U-1(b)(1)(B) (2017).

\$1.2 billion “global settlement”¹⁵² in 2003 among regulators and ten major investment firms.¹⁵³ The actions that gave rise to the settlements alleged that the accused firms to have created or maintained inappropriate influence of investment bankers over research analysts, thereby causing research analysts to experience pressure from conflicting interests.¹⁵⁴

In response, Congress included in the Sarbanes-Oxley Act¹⁵⁵ specific provisions with the goal of reducing such conflicts of interest and thereby, restoring confidence in the accuracy and integrity of analysts’ research reports. The new Section 15D(a)(3), which was added to the ’34 Act, reflected the concern that investment banks failed to maintain Chinese Walls between retail brokerage and underwriting.¹⁵⁶ Specifically, the section requires the SEC or self-regulatory organizations (SROs), such as National Association of Securities Dealers (NASD), to promulgate rules to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.¹⁵⁷ Pursuant to the mandate from Congress, the NASD and New York Securities Exchange (NYSE) promulgated rules that were approved by the SEC in 2003, and further elaborated in 2007.¹⁵⁸

¹⁵² In addition to monetary penalties and other requirements, the settlement terms provided that the firms were to comply with the following policies and procedures:

- Physically separate research and investment banking departments;
- Separate reporting structures for analysts and investment bankers;
- Budget and compensation decisions for the research and investment banking departments would be decided independently;
- No solicitation of investment banking business by analysts;
- No analyst participation in investment banking road shows;
- Limits on communication between analysts and investment bankers;
- Other firewalls designed to limit interaction between investment banking and research departments “except in specifically designated circumstances.”

Fin. Indus. Regulatory Auth., *Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking*, FIN. INDUS. REGULATORY AUTH. (Apr. 28, 2003), <http://www.finra.org/Newsroom/NewsReleases/2003/p002909>.

¹⁵³ *Id.* The financial regulators involved included the SEC, NYSE, NASD, North American Securities Administrators Association (NASAA), and state Attorneys General. *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ Pub. L. No. 107-204, 116 STAT. 745 (July 30, 2002).

¹⁵⁶ See COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SEN. REP. 107-205, 107TH CONG. 4 (2d Sess. 2002) (citing March 5, 2002 testimony of Dean Joel Seligman, who recommended congressional consideration of the adequacy of current Chinese Walls and whether securities firms that underwrite should be separated from retail brokerage, and stating the need for rules “reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information”).

¹⁵⁷ 15 U.S.C. § 78o-6(a)(3) (2017); See Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1077 (2003) (stating that, in the Sarbanes-Oxley Act, Congress explicitly identified a variety of structural safeguards to establish more effective Chinese walls to insulate analysts from investment banking influence); S. J. Hilgers, *Under the Influence: Analyzing Wall Street Research Analyst Conflicts of Interest and the Responses Designed to Induce Impartiality*, 31 SEC. REG. L.J. 427, 451 (2003) (maintaining that Chinese Walls have been legislatively codified through the enactment of . . . the Sarbanes-Oxley Act of 2002”).

¹⁵⁸ See Section II.A.2, *infra*.

2. *The Components of Chinese Walls*

Chinese Walls aim to stem the flow of material, nonpublic information. Although no clear definition of “material” information exists,¹⁵⁹ certain types of sensitive financial information are most likely material.¹⁶⁰ Mainly, information which – if disclosed publicly – would reasonably impact stock prices,¹⁶¹ or information which would be a significant factor in an investment decision if known,¹⁶² is likely to be material information. Examples include non-public information about financial results, future earnings projections, risk of default or serious liquidity issues, or changes in management. “All traders are not required to have equal information before trading,”¹⁶³ however, and an investor is not forbidden from trading on information that it “derived from publicly available information.”¹⁶⁴ The same policy would likely apply to the information that Chinese Walls are meant to block – non-public conclusions derived from publicly available information would pass through.

The statute does not detail what specific amalgamation of procedures and policies would constitute a Chinese Wall, although – as described further below – some guidance is provided by the House Report accompanying the Chinese Wall requirement, the SEC, NYSE and NASD. Ideally, a Chinese Wall prevents one agent within a multi-service financial conglomerate to be in the position of responding to multiple principals in one transaction.¹⁶⁵ As suggested above, a Chinese Wall should divide, both physically¹⁶⁶ and functionally,¹⁶⁷ a financial conglomerate’s public-side divisions, such as the trading and sales desk, market-makers and associated-research analyst departments, from the firm’s private-side divisions, like the firm’s investment banking and advisory departments.¹⁶⁸ Compartmentalization of divisions occurs through the use of system-wide compliance policies, procedures, and structural arrangements in addition to oversight and review mechanisms that systematically identify risk-areas.

¹⁵⁹ 2 MICHAEL B. SNYDER, HR SERIES COMPENSATION AND BENEFITS § 11:211 (2011).

¹⁶⁰ See Tower C. Snow, Jr. et al., *The Return of Insider Trading and Related Developments Under Rule 10b-5*, in *THE ART OF COUNSELING DIRECTORS, OFFICERS & INSIDERS: HOW WHEN AND WHAT TO DISCLOSE* 131, 154–55 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1083, 1998); Cindy A. Schipani & H. Nejat Seyhun, *Defining “Material Non-Public,” What Should Constitute Illegal Insider Information?*, 21 *FORDHAM J. OF CORP. & FIN. L.* 327 (2016).

¹⁶¹ 3 ROBERT B. HUGHES, *LEGAL COMPLIANCE CHECKUPS: BUSINESS Clients* app. 23- 3 (2009).

¹⁶² See Herzel & Colling, *supra* note 134, at 83.

¹⁶³ See *Dirks v. SEC*, 463 U.S. 646, 657 (1983).

¹⁶⁴ Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 *HASTINGS L.J.* 881, 883 (2010).

¹⁶⁵ “Whether the Chinese Wall is sufficient to reconcile conflicting duties owed under the general law is uncertain . . . [but] the courts, if asked to rule on the issue, would find that in most circumstances an effective Chinese Wall is sufficient . . . [I]f a Wall approach were not endorsed, the very raison d’être of conglomeration (purportedly efficiencies) would be thwarted.” *MCVEA, supra* note 123, at 169–70.

¹⁶⁶ Carlos E. Mèndez-Peñate, *The Bank “Chinese Wall”*: *Resolving and Contending with the Conflicts of Duties*, 93 *BANKING L.J.* 674, 699-700 (1976) (demonstrating that the implausible result of eliminating Chinese Walls would require complete divestment of some financial service firms’ activities)

¹⁶⁷ See Sheldon I. Goldfarb, *Chinese Wall Policies and Procedures*, at 809, 813 (PLI Corporate Law & Practice, Course Handbook Ser. No. 692, 1990). Functional separations attempt to avoid the intermingling of bank departments that possess private information by separating tasks and activities in which staff from each department engage. *Id.*

¹⁶⁸ See *id.*

The characteristics of a firm's Chinese Wall depend on various factors, and there is no one-size-fits-all.¹⁶⁹ The SEC's Division of Market Regulation has suggested that at a minimum, a Chinese Wall should "include review of employee and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of inter-departmental communication by the firm's compliance department, and procedures concerning proprietary trading when the firm is in possession of material, non-public information."¹⁷⁰ A firm may erect a Chinese Wall by internally distributing a policy statement outlining the purpose and basic provisions of the information barriers.¹⁷¹ According to the House Report accompanying the ITSFEA, examples of barriers include "restraining access to files likely to contain material, nonpublic information; providing continuing education programs concerning insider trading regulations; restricting or monitoring trading in securities about which firm employees possess material, nonpublic information; and diligently monitoring trading for firm or individual accounts."¹⁷² Other barriers might include using codes to disguise the identity of target corporations (in the mergers-and-acquisitions context) and restricting access to electronic databases containing sensitive information.¹⁷³ An independent compliance department may review trades and activities to ensure adherence to the policy statement.¹⁷⁴

The exceptions to the lack of statutory guidance on designing Chinese Walls are the rules promulgated pursuant to Section 15D(a)(3) of the Sarbanes-Oxley Act.¹⁷⁵ The Financial Industry Regulatory Authority (FINRA) requires that its members adopt various policies and procedures aimed at curbing the flow of information and communication between its research and trading departments.¹⁷⁶ It also enforces rules designed by NYSE and NASD that place substantial restrictions on interactions between the investment banking and research departments of their members. Some of these requirements include the pre-approval of research reports by supervising analysts, limitations on pre-publication review of reports by non-research personnel,

¹⁶⁹ See Herzel & Colling, *supra* note 134, at 88; MCVEA, *supra* note 123, at 122–23; SECURITIES AND EXCHANGE COMMISSION, BROKER–DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION: A REPORT BY THE DIVISION OF MARKET REGULATION 3, 11 (1990) [hereinafter SEC REPORT] (“[N]o two systems are alike, ranging from very tight centralized control of information and review to little or no review or follow-up . . . [F]irm procedures designed to control the flow of information between investment banking and proprietary trading (risk arbitrage, market making and block trading) lack consistency.”); Larry L. Varn, *The Multi–Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code*, 63 NEB. L. REV. 197, 212 (1984) (“There is no particular uniformity in the precise manner in which either securities firms or other multi–service financial institutions have implemented their particular procedures for dealing with inside information possessed by one of the firm’s departments”).

¹⁷⁰ SEC REPORT, *supra* note 170, at 21.

¹⁷¹ See Mèndez-Peñate, *supra* note 167, at 685. The statement may include procedures that should be followed by persons responsible for private information. Herzel & Colling, *supra* note 134, at 88.

¹⁷² A.A. SOMMER, JR., FEDERAL SECURITIES ACT OF 1934 § 5C.08 (Matthew Bender, Rev. Ed.)

¹⁷³ See Harry J. Weiss, *Outline for Enforcement Session: SEC and SRO Enforcement Developments*, in COPING WITH BROKER/DEALER REGULATION AND ENFORCEMENT 2008, at 49, 135 (PLI Corporate Law & Practice, Course Handbook Ser. No. 1701, 2008).

¹⁷⁴ See 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 6:274 (2d ed. 2011) (discussing Chinese Walls procedures ordered by a recent bankruptcy court decision). Personnel responsible for private information may be required to sign a letter acknowledging they are aware of the restrictions. *Id.*

¹⁷⁵ Pub. L. No. 107-204, 116 STAT. 745 (July 30, 2002).

¹⁷⁶ FINRA Rule 5280 Last Amended Apr. 20, 2009.

establishing an analyst compensation review committee, establishing “quiet periods” where analysts employed by the manager of an IPO are prohibited from reporting on the issuer until a certain period after the offering date, and – with limited exceptions – prohibitions on analyst participation in “pitch meetings” and “road shows.”¹⁷⁷

3. *Limitations of the Chinese Wall*

A Chinese Wall cannot be completely impenetrable. As courts and commentators have noted, “[t]ransactions, at times can require that a Wall be breached due to the necessary interaction of departments within a multiservice firm.”¹⁷⁸ High-ranking executives, in particular, must be allowed to cross the firm’s Chinese Walls to perform their corporate duties.¹⁷⁹ According to the court in *Board of Trustees of Aftra Retirement Fund v. JP Morgan Chase Bank*,¹⁸⁰ “[t]he [Chinese Wall] doctrine does not require total separation of fiduciary and commercial functions within a bank, nor does it prohibit joint marketing and servicing of customers,” and that directors and officers of a firm are aware of transactions on both sides of the Chinese Wall does not change its effectiveness.¹⁸¹

Directors and officers are often not involved in the individual trades performed by public-side department managers;¹⁸² however, there have been reported cases – such as the *Aftra* case – where senior management had specific knowledge of and involvement in public-side department activities.¹⁸³ Public-side department employees, and the senior executives who supervise them, have no fiduciary duty to seek out inside information for the benefit of the managed investment accounts,¹⁸⁴ but maximizing profits through increased brokerage and performance fees provides a strong incentive to exploit such information.¹⁸⁵

In its 1990 report following a review of various brokerage firms’ Chinese Walls, the SEC stated that “generally [Chinese Wall] systems are well conceived and conscientiously executed.”¹⁸⁶ Some commentators have opined that Chinese Walls are the most effective solution

¹⁷⁷ NYSE Rules 344, 472 (Apr. 7, 2008) ; NASD Rules 1050 (Sept 25, 2015). Even more restrictive amendments have been proposed. Notice of Filing of Proposed Rules Changes to Amend NYSE Rules 473 and 344, and NASD Rules 1050 and 2711, Exchange Act Release No. 55072, 2007 WL 966930 (Jan. 9, 2007).

¹⁷⁸ Norman S. Poser, *Conflicts of Interest Within Securities Firms*, 16 BROOK. J. INT’L L. 111, 114 (1990) [hereinafter Poser, *Conflicts*] (citing SEC v. First Boston Corp, Fed. Sec. L. Rep. at 93, 466 (S.D.N.Y. March 5, 1986), in which the court found a “legitimate” breach between the corporate finance and research division of the firm).

¹⁷⁹ See Mèndez-Peñate, *supra* note 167, at 685.; Theodore A. Levine et al., *An Overview of Compliance Policies and Procedures for Multiservice Financial Institutions*, at 731, 762–63 (PLI Corporate Law & Practice, Course Handbook Ser. No. 692, 1990). Others allowed to cross the barrier include lawyers, accountants, and appropriate research personnel. *Id.*

¹⁸⁰ 806 F. Supp. 2d 662 (S.D.N.Y. 2011).

¹⁸¹ *Id.* at 676.

¹⁸² See Herzel & Colling, *supra* note 134, at 92 n.54.

¹⁸³ See Louise Story, *JPMorgan Accused of Breaking Its Duty to Clients*, N.Y. TIMES (Apr. 10, 2011), http://www.nytimes.com/2011/04/11/business/economy/11bank.html?pagewanted=all&_r=0.

¹⁸⁴ See Herzel & Colling, *supra* note 134, at 86–87.

¹⁸⁵ See Steven R. Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611, 633–44 (1977)

¹⁸⁶ SEC REPORT, *supra* note 170, at 27.

to curbing information flow in multi-service financial firms.¹⁸⁷ Others are more skeptical – particularly given the evidence that information leaks and conflicted transactions occur frequently in firms that ostensibly have Chinese Walls in place.

There are numerous instances of non-public information concerning prospective tender offers and other corporate changes that has leaked from the investment banking or mergers-and-acquisitions departments of multiservice securities firms, either to outsiders or to other departments of these firms. Most of the known cases involve the flow of information to outsiders, however. In *SEC v. Contorinis*,¹⁸⁸ for example, the managing director at the investment bank Jeffries received a tip about an acquisition from a UBC banker and traded on the basis of that tip on behalf of a Jeffries fund that he co-managed.¹⁸⁹ Sometimes the Walls are breached by the people hired to maintain them. And in one recent proceeding, a JPMorgan employee – ironically, one who worked in JPMorgan’s Conflicts Office – passed along material, nonpublic information about planned acquisitions to a friend.¹⁹⁰

In January 2011, the SEC brought an administrative action against Merrill Lynch, alleging that the bank's market makers leaked institutional customer order information to its proprietary traders, who then proceeded to trade on the basis of that information and on behalf of Merrill Lynch.¹⁹¹ According to the SEC, the proprietary trading desk was located on Merrill's equity trading floor, where traders received and executed orders for the firm's institutional customers, and the proprietary traders were able to see and hear information pertaining to the market makers' customer orders – that is, Merrill Lynch failed to “establish policies and procedures reasonably designed to prevent the [proprietary] traders from obtaining institutional customer order information.”¹⁹² Although Merrill Lynch neither admitted to nor denied the SEC’s allegations, it agreed to pay a civil penalty of \$10 million.¹⁹³

Some have argued that Chinese Walls are ineffective due to an inherent conflict which arises from agency law in the context of multi-service firms – a discrepancy exists between a financial agent’s duty to maintain Chinese Walls and their fiduciary duty to their clients, as well as their clients’ expectations.¹⁹⁴ A Chinese Wall withholds information from a department of the firm that could use the information to benefit its customers. In contrast, customers expect that their broker-dealers will be their loyal representatives and serve their interests foremost. A

¹⁸⁷ See Herzel & Colling, *supra* note 134.

¹⁸⁸ *SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014).

¹⁸⁹ *Id.* at 298-300.

¹⁹⁰ See *FINRA v. David Michael Gutman & Chris John Tyndall*, Disciplinary Proceeding No. 2012033227402 (Dec. 31, 2013); *FINRA v. Chris John Tyndall*, Disciplinary Proceeding No. 2012033227402 (Jan. 15, 2014).

¹⁹¹ *Merrill Lynch, Pierce, Fenner & Smith*, 2011 WL 231575 (Jan. 25, 2011).

¹⁹² *Id.*

¹⁹³ See *id.*

¹⁹⁴ See, e.g., Leonard Chazen, *Reinforcing The Chinese Wall: A Response*, 51 N.Y.U. L. REV. 552 (1984) (discussing the conflicting financial institution duties of confidentiality and investment disclosure); Martin Lipton & Robert B. Mazur, *The Chinese Wall: A Reply to Chazen*, 51 N.Y.U. L. REV. 579 (1976) [hereinafter Lipton & Mazur, *Reply*] (arguing that Chinese Wall provisions that fail to disallow security recommendations and restricted lists for tainted securities are inadequate protections against the conflicting duties of brokerage firms); Bevis Longstreth, *Fiduciaries, Capital Markets and Regulation: The Current Challenge*, 7 ANN. REV. BANKING L. 237, 248–49 (1988) (discussing the conflicting duties arising from individuals in a firm possessing material non-public information).

Chinese Wall may run counter to these expectations. For example, investment bankers may know that a firm is restating its earnings because of accounting fraud. A Chinese Wall will keep this information from retail traders, however, who may continue to recommend this company's stock. The broker-dealer will still have to remain silent if a client wishes to purchase the security. Customers' expectations of being informed of all information available to the broker-dealer is entirely reasonable because an agent owes its principal a duty to disclose all relevant information that the agent knows regarding the transaction. Therefore, a broker-dealer's interest in respecting its Chinese Wall to avoid liability for insider trading will conflict with the customer's interest in being fully informed about all material facts affecting the transaction.

More importantly, broker-dealers generally lack sufficient incentives to establish and maintain Chinese Walls. Proving that a firm failed to maintain a Chinese Wall, or that it breached its Wall, is a difficult task. Government resources, as usual, are a factor – the SEC suffers from a shortage of staff to properly oversee implementation of Chinese Walls by firms. Moreover, according to Martin Lipton and Robert Mazur, “[t]he difficulty of discovering misuse of inside information is, of course, the greatest shortcoming of the Chinese Wall approach.”¹⁹⁵ Detection of trades on material nonpublic information may have become more difficult as trading speeds and volumes have increased.¹⁹⁶ Instead of detecting the apparent violation of information barriers, regulators focus on detecting “irregular” or “suspicious” trading activity¹⁹⁷ by looking at the timing of trades, from which they infer the use of non-public information and perhaps also the failure of information barriers.

Even if the misuse of nonpublic information could be detected, however, it would pose challenges for regulators. In particular, suspicious trading may be the result of benign rationales, including coincidence or the superior trading skill or intellect of the traders involved, rather than failing information barriers. Disproving these benign explanations can be extraordinarily difficult, especially because direct evidence of information flows is seldom available, and regulators must therefore rely on circumstantial evidence to prove wrongdoing.¹⁹⁸ Such evidence

¹⁹⁵ Martin Lipton & Robert Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 494 (1975) [hereinafter Lipton & Mazur, *Solution*].

¹⁹⁶ *Insider Trading: Tipping the Scales*, THE ECONOMIST (Oct. 15, 2011), <http://www.economist.com/node/21532280> (noting that “[d]etection [of insider trading] is also getting harder. Investors are able to trade more quickly and in greater volumes than ever before”).

¹⁹⁷ See Ben Protess & Michael J. De La Merced, *S.E.C.*, *Suspecting Insider Trading, Freezes Account Over Heinz Buyout*, N.Y. TIMES DEALBOOK (Feb. 15, 2013, 8:52 PM), <https://dealbook.nytimes.com/2013/02/15/s-e-c-acts-on-suspicious-heinz-trading> (quoting the head of the SEC’s market abuse unit as saying, “Irregular and highly suspicious options trading immediately in front of a merger or acquisition announcement is a serious red flag that traders may be improperly acting on confidential nonpublic information”).

¹⁹⁸ See Melissa Maleske, *An Insider Falls*, INSIDE COUNSEL 28-29 (Aug. 2012) (discussing the use of circumstantial evidence to prove insider trading cases and the difficulty of proving “a circumstantial case”). The primary exception to the use of circumstantial evidence involves wire-tap evidence, which proved vital in the high profile convictions of hedge fund manager Raj Rajaratnam and former corporate director Rajat Gupta. See Chad Bray et al., *Insider Case Lands Big Catch*, WALL ST. J. (June 15, 2012, 7:55 PM), <https://www.wsj.com/articles/SB10001424052702303822204577468470878668722> (referring to prosecutors’ view of wiretapped phone conversations as “the most important pieces of evidence that Mr. Gupta shared confidential information . . . with Mr. Rajaratnam”). However, wire-tap evidence must be planned in advance because of the need for judicial approval.

is less likely than direct evidence to discredit benign explanations for suspicious trading, and may lack teeth in court.

Because violations of Chinese Walls are difficult to detect, the expected gain of maintaining Chinese Walls (or the expected loss from breaching or failing to maintain Chinese Walls) is low. Moreover, there are costs to maintaining Chinese Walls: these barriers to information flows reduce economic synergies gained through the universal banking structure, thereby raising the cost of financial services. On the flip side, there may be huge economic gains to be derived from allowing information to flow between the private-side and public-side of a multi-service bank.¹⁹⁹ Thus, as Professor McVea has noted, “[g]iven that the Wall is largely dependent upon self-enforcement in an arena where self-interest is so prevalent it would seem unrealistic to assume at all times and in all circumstances, that the Wall would be completely effective.”²⁰⁰ Although a Chinese Wall might successfully halt information flows when the conflict spans between two clients, such as trading on insider information for another client, it is less likely to be effective when the conflict arises between a client and the firm’s interest. The issue of self-interest makes it unlikely that a firm can act objectively in that precarious situation.²⁰¹ As mentioned previously, directors and officers are usually conscious of facts on both sides of the Wall, which could potentially increase the severity of a conflict of interest.

Thus, as the crisis highlights, internal information barriers are generally inadequate at stopping information flows, and they do not curb conflict abuse when the bank itself is one of the principals.

4. Ineffectiveness of Chinese Walls: Empirical Evidence

Empirical research supports the notion that Chinese Walls are generally ineffective and allow material, nonpublic information to flow through. Studies in the mergers-and-acquisitions context suggest that firms continue to trade in the stock of target companies while advising the bidders in these transactions.²⁰² For example, a study by Professor Bodaruk and colleagues finds that the retail branches of investment banks often took positions in firms that were targets of

¹⁹⁹ See also RALPH C. FERRARA, FERRARA ON INSIDER TRADING & THE WALL § 9.01 (“Material, nonpublic information is extremely valuable to those who possess it because the market price does not yet reflect the new information; thus, the potential (and temptation) for profit is great”).

²⁰⁰ MCVEA, *supra* note 123, at 214. See also Poser, *supra* note 179, at 114 (stating that Chinese Walls are a “fake”).

²⁰¹ See McVea, *supra* note 123, at 253–55, 259. According to McVea,

[t]he highly sensitive nature of the duties owed under the general law, would suggest that it is inappropriate to try and reconcile the conglomerate’s conflicting and potentially conflicting interests and obligations by way of a Chinese Wall. The conglomerate ought simply to suffer the commercial disadvantages which flow from being a fiduciary in this context.

Id. at 254–55.

²⁰² See Narasimhan Jegadeesh & Yue Tang, Institutional Trades Around Takeover Announcements: Skills vs. Inside Information 23–24 (Dec. 2010) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568859 (finding that financial conglomerates use non-public information garnered from their M&A clients for the benefit of some of their brokerage clients). See also H. Nejat Seyhun, *Insider Trading & The Effectiveness of Chinese Walls in Securities Firms*, 4 J. OF L., ECON. & POLICY 369 (2008) (finding evidence that non-public information obtained by multi-service securities firms through having their employees serve on corporate boards is used by them in their trading activities).

acquisitions after negotiations had started – but the investment banking (advisory) branches of said banks were already representing the targets in an advisory capacity during the targets' negotiations with potential acquirers.²⁰³ Furthermore, these investments yielded abnormally high returns – of almost 4% per month – for these investment banks.²⁰⁴ From this, the authors conclude that the investment banks were likely trading on privileged, private information gathered by the advisory branch in its retail operations.²⁰⁵ In the mergers-and-acquisitions context, advisers know the proposed bidder and target companies prior to the public disclosure of this information, which allowed firms to profit by taking stakes in the target company before its price increase at the announcement of the deal.

Chinese Walls do not appear to fare well in the lending context either. Studies find evidence that firms use nonpublic information about companies for which they have acted as lenders to trade in the stock of those companies.²⁰⁶ In this context, multi-service firms will possess non-public information about the borrower, including information about the likelihood of default; this information may enable firms to trade against the borrower in equities or derivatives markets, and to profit on the borrower's expected reduction in value. For example, Professors Viral Acharya and Timothy Johnson find that the trading desks of multi-service financial firms obtain material, non-public information about the financial health of corporate borrowers from the firms' lending units.²⁰⁷ They use this information to trade in credit default swaps, which are financial instruments that derive their value in part on the occurrence of a particular "credit event" in an underlying security.²⁰⁸ The authors of another study note "that information spillover from the lending division to the equity division does not necessarily diminish the opportunities for financial conglomerates to capitalize their information advantage through proprietary trading because they can time the release of analyst forecasts and proprietary trading."²⁰⁹

According to the empirical evidence, Chinese Walls have not only been ineffective in preventing trades on improperly leaked information – they have also failed to prevent firms from bowing to conflicts of interest and violating the duties owed clients by providing biased, detrimental advice to their clients in the mergers-and-acquisitions context. Professor Bodaruk and colleagues find, for example, that conflicted advisers on mergers and acquisitions deals provide biased advice to bidders, leading to inferior deal outcomes for their clients relative to

²⁰³ Andriy Bodaruk et al., *Investment Banks as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989, 5020-24 (2009).

²⁰⁴ *Id.* at 5023.

²⁰⁵ *Id.* at 5024.

²⁰⁶ See, e.g., Victoria Ivashina & Zheng Sun, *Institutional Stock Trading on Loan Market Information*, 100 J. FIN. ECON. 284 (2011) (finding that institutional investors, including financial conglomerates, trade using non-public information garnered from participating in discussions by borrowers to amend their loan agreements); Massimo Massa & Zahid Rehman, *Information Flows within Financial Conglomerates: Evidence from the Banks–Mutual Funds Relation*, 89 J. FIN. ECON. 288 (2008) (finding that financial conglomerates' asset managers trade using non-public information from the firms' lending divisions).

²⁰⁷ Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110, 112–13 (2007).

²⁰⁸ *Id.* at 116.

²⁰⁹ Ting Chen & Xiumin Martin, *Do Bank–Affiliated Analysts Benefit from Lending Relationships?* 49 J. ACCT. RES. 633, 638 (2011).

clients of un-conflicted financial conglomerates.²¹⁰ That is, where the multi-service firm advises the bidder in a merger-and-acquisition deal while it holds a stake in the target, its client is more likely to pay a higher premium for the target relative to deals in which its adviser is not conflicted. Consistent with the adviser's self-interest, where the adviser is conflicted, its client is more likely to complete the deal than otherwise and is more likely to overpay for the target compared to deals in which the adviser faces no conflict of interest.²¹¹

5. *Afra v. JPMorgan Chase*

*Board of Trustees of Aftra Retirement Fund v. JPMorgan Chase Bank, N.A.*²¹² was a class-action suit brought by Aftra Retirement Fund ("Aftra") against JPMorgan Chase Bank (JPMC Bank) with respect to their investments in Sigma Finance, a structured investment vehicle (SIV).²¹³ In late 2008, Sigma was in trouble financially and its board determined that Sigma should be placed in receivership. As it lacked liquidity, Sigma sought financing from JPMC Bank in the form of repo agreements rather than the traditional commercial paper and term notes. Recognizing that Sigma was about to go insolvent, JPMC Bank's investment banking division outlined services that it would provide to Sigma such that it would profit from the unwinding of Sigma and other similar shadow banking entities.²¹⁴ Through various repo agreement plans totaling nearly \$13.5 billion, from February to August of 2008,²¹⁵ JPM Bank's investment banking division carefully chose collateral that gave it the best prospect of profit in the event of a Sigma default.²¹⁶

In June 2007, Aftra used JPMC Bank's securities lending services to gain access to \$500 million in collateral from borrowers of its securities; Aftra then authorized JPMC Bank's asset management division to invest the collateral in Sigma's secured medium term notes (MTN).²¹⁷ These MTNs allowed Sigma to retain the right to transfer specific assets to repo lenders, rendering those assets unavailable to MTN holders if Sigma defaulted.²¹⁸ After Sigma entered receivership, Aftra recovered about six cents on the dollar for its MTNs.²¹⁹ Meanwhile, JPMC Bank allegedly profited in the amount of \$1.9 billion.²²⁰ In sum, JPMC Bank had invested in securities of Sigma on behalf of Aftra, while simultaneously investing on its own account in

²¹⁰ Bodaruk et al., *supra* note 204, at 4990.

²¹¹ *Id.* at 5016–24.

²¹² *Bd. of Trs. of Aftra Ret. Fund v. JPMorgan Chase Bank*, 806 F. Supp. 2d 662 (S.D.N.Y. 2011).

²¹³ Sindhu Sundar, *JPMorgan Pays \$150M to Settle Pension Funds' ERISA Claims*, LAW360 (March 16, 2012, 10:54 PM), <https://www.law360.com/articles/320376/jpmorgan-pays-150m-to-settle-pension-funds-erisa-claims>.

²¹⁴ *See Aftra*, 806 F. Supp. 2d at 671–72. These services included advising Sigma note-holders on unwinding its portfolios, identifying Sigma assets that would be attractive purchases for JPMC, and protecting JPMC's own monetary interests. *Id.*

²¹⁵ *Id.* at 675–76. Note that the repo agreements were executed after JPMC executives recognized Sigma was near bankruptcy. *Id.*

²¹⁶ *Id.* at 675.

²¹⁷ *Id.* at 670.

²¹⁸ *Id.* at 670–71. JPMC's Asset Management division knew of the repo lender's superior claim to Sigma's assets vis-à-vis noteholders at least six weeks prior to Sigma's collapse. *Id.* at 677.

²¹⁹ *Id.* at 671.

²²⁰ *Id.* at 678. Note that at the time of Sigma's default, JPMC faced a nearly \$383 million loss on the collateral; JPMC Bank argued that its business decision to maintain possession of the collateral over a period of years (resulting in substantial asset appreciation) has no bearing on Aftra's claim. *Id.*

Sigma on the basis of the knowledge that Sigma was in dire financial straits. When Sigma became insolvent, Aftra suffered enormous losses while JPMC Bank profited.

Aftra brought suit, claiming that JPMC Bank breached its fiduciary duty under the Employee Retirement Income Security Act (ERISA). To bring a breach-of-fiduciary claim under ERISA, the plaintiff must allege 1) that defendant was a fiduciary who 2) was acting within his capacity as a fiduciary and 3) breached his fiduciary duty.²²¹ What ultimately came before the Southern District Court of New York was JPMC Bank's motion for summary judgment with respect to Aftra's claims for breach of duty of loyalty and duty to disclose.²²² Prior caselaw suggested that JPMC Bank's conduct could constitute a breach of fiduciary duty under ERISA; however, the court found that JPMC Bank did not violate its duties of loyalty or disclosure, thus granting JPMC Bank's summary judgment motion.²²³

The court determined, as a matter of law, "JPMC was not acting in a fiduciary capacity when it extended repo financing to Sigma," or when JPMC Bank issued a default notice to Sigma, thereby seizing Sigma's collateral.²²⁴ The duty of loyalty claim was of particular importance to the court's analysis, and it failed because JPMC Bank was acting in its capacity as creditor of Sigma, not as a fiduciary of Aftra, when the repo agreements were made and the default order issued.²²⁵ The court also cited the congressional intent of the Gramm-Leach-Bliley Act in support of its argument, noting that its passage reflected a calculated tradeoff between increasing capital formation and aligning financial services firms' bottom lines with the success of their clients' investments.²²⁶

Importantly, the court acknowledged that prior case law would have suggested a contrary result; however, the court explained that earlier courts "could not have predicted the scale of modern-day multi-service financial institutions, the scope of services they would be permitted to offer simultaneously, and the information barriers they would be required by law to erect in order to avoid liability for insider trading and related conflicts-of-interest."²²⁷ The Chinese Wall was not alleged to have "leaked," according to the court. Rather, it ensured that individuals on either side of it - those investing for asset management clients on one side and those investing for the firm on the other - made "independent decisions and shared no non-public information about Sigma."²²⁸ In addition to preventing the spread of non-public information, the information barrier prevented the financial conglomerate's commercial relationships from "influencing the advice

²²¹ *In re Morgan Stanley ERISA Litigation*, 696 F. Supp. 2d 345, 353 (S.D.N.Y. 2009) (denying defendant's motion to dismiss because allegations were sufficient to state a claim for breach of fiduciary duty to avoid conflicts of interest, to prudently manage plan assets, and to disclose material information to the plan). Implied in this statute is the requirement that trustee fiduciaries act completely independent of conflicting personal interests. *See Dabney v. Chase Nat. Bank of New York*, 196 F.2d 668, 670 (2d Cir. 1952).

²²² *Aftra*, 806 F. Supp. 2d at 666.

²²³ *Id.*

²²⁴ *Id.* at 677.

²²⁵ *See id.*

²²⁶ *Id.* at 678.

²²⁷ *Id.* at 688.

²²⁸ *Id.* at 688–89, n.149 (citation omitted) (internal quotation marks omitted).

and decisions made by the fiduciary in its fiduciary capacity.”²²⁹ Treating the information barrier as conceptually carving the financial conglomerate into multiple, distinct firms, the court reasoned that the firm violated no duty to avoid conflicts of interest - because it faced no conflict of interest.²³⁰

The failure of Chinese Walls, enacted in response to insider trading scandals and largely to remedy conflicts of interest between broker-dealers and their investment bank departments,²³¹ also demonstrate the need for increased enforcement of the Volcker Rule’s conflict of interest protections. Evidence shows that market forces and informal connections between departments make these Walls permeable.

B. The Proprietary Trade

Yet another demonstration of conflicts of interest allowed by Glass-Steagall’s repeal, the universal banking environment created by GLBA heightens one of the longest-standing concerns about Wall Street: whether a banking entity handles money for its own account with the same level of care as the money of its clients. The unfolding of the events leading up to the financial crisis shed light on a particularly perverse conflict of interest that arises when an institution is able to widely trade on its own account or proprietary trade (“prop trade”) as it is known in the industry. Such trading, as defined in § 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd–Frank Act”), involves “actively retaining principal positions and risks in excess of reasonably expected near–term customer demand.”²³²

Prop trades are often excessively large positions in highly volatile markets, which explains the immense profits they generate for the bank, but these positions also leave firms exposed to exceptionally large losses – it has been equated with casino gambling and hedge fund activity.²³³ Prop trading revenues at the largest firms increased from under fifteen percent of net operating revenues in 2004 to almost thirty percent in 2007.²³⁴

Prop trading can be distinguished from market–making on the grounds that firms earn profits without changes in the value of the underlying instrument when market–making, whereas firms earn profits based upon changes in the value of the underlying instruments when prop trading. Similarly, risk–mitigating hedging activities can be differentiated from prop trading in

²²⁹ *Id.* at 689 (citation omitted) (internal quotation marks omitted).

²³⁰ *See id.*

²³¹ Chinese Walls first came into being in 1968 in a settlement between the SEC and Merrill Lynch. Christopher M. Gorman, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?*, 9 *FORDHAM J. CORP. & FIN. L.* 475, 483 (2004). The SEC and Congress formally mandated their widespread use as a part of the Sarbanes-Oxley Act; a legislative response to widespread accounting abuses. *See id.* at 475.

²³² 12 U.S.C.A. § 1851 (2017).

²³³ Jeff Merkley & Carl Levin, *The Dodd Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 *HARV. J. ON LEGIS.* 515, 522 (2011).

²³⁴ *Id.*

that the former is designed to lower exposure to risk from actual positions. In contrast, prop trading tends to expose firms to more risk.²³⁵

Prop trading can engender serious conflicts of interest within a financial conglomerate because it allows a firm to take a “directional view,” which is a position that diverges or is at direct odds with a customers’ interest in a transaction.²³⁶ The firm’s position is often based on information known only internally within the firm. Leading up to the financial crisis, the prop trading desks at the world’s leading banks were involved in an incredible amount of trading in structured products. These instruments created perverse conflicts because the bank would create and market them to investors, and simultaneously prop trade against the customers’ interest in these securities.

In this typical scenario, the structured product was either a bundle of: (1) subprime mortgage asset-backed security tranches and a referencing derivative, which is called a collateralized debt obligation (“CDO”)²³⁷ or (2) credit default swaps (“CDS”), which is called a synthetic collateralized debt obligation (“synthetic CDO”).²³⁸ Despite the CDO and synthetic CDO’s composition or reference of low investment grade subprime mortgage-backed securities, these portfolios were typically rated AAA by the credit rating agencies.

The bank would both sponsor and underwrite the structured instrument, which means it would select the underlying assets, design the securities, market them to investors with the AAA rating and manage them during their lifetime. These activities enabled the firm to be exceptionally well-positioned to know whether a particular instrument had been created to succeed or fail and subsequently, would trade on that information.²³⁹ For example, a firm would short a product, if it was designed to fail, even though it was simultaneously selling its securities long to investors.²⁴⁰ Therefore, prior to the sale to an investor, a typical CDO security was conflicted. In the words of U.S. Senators Merkley and Levin, a bank “not only bet against its clients; it loaded the dice.”²⁴¹

²³⁵ Jeff Merkley & Carl Levin, *Making the Dodd–Frank Act Restrictions on Proprietary Trading and Conflicts of Interest Work*, ROOSEVELT INSTITUTE 31 (2011), <http://rooseveltinstitute.atendesigngroup.com/%5Bmenu-trail-parents-raw%5D/making-dodd-frank-act-restrictions-proprietary-trading-and-conflicts-intere>.

²³⁶ FSOC, *supra* note 120, at 48.

²³⁷ With a standard CDO, an investor’s return is derived from tranches of cash flows produced by a portfolio of fixed-income assets like mortgages; with a CDO-squared, investors receive payments derived from the tranches of CDOs, typically the lowest investment grade (BBB to A). The referencing derivative is called a credit default swap (“CDS”).

²³⁸ A synthetic CDO is an instrument that derives its revenue streams from credit default swaps (“CDS”) that reference a particular CDO. CDOs, CDO-squareds, and synthetic CDOs are usually held in a special purpose vehicle (“SPV”).

²³⁹ Merkley & Levin, *supra* note 236, at 550.

²⁴⁰ Complaint, SEC v. Stoker, 873 F.Supp. 2d 605 (S.D.N.Y. 2012) (No. 11-CV-7388) 2011 WL 4965844.

²⁴¹ Merkley & Levin, *supra* note 236, at 525. For example, Goldman Sachs allowed a favored client, a hedge fund, who wanted to bet against the mortgage market to help select the assets in the CDO and then sold the securities to unwitting investors but failed to tell those investors that “the cards were stacked against them.” Letter from Jeff Merkley & Carl Levin, to Elizabeth Murphy, Secretary of Securities and Exchange Commission, *Proposed Rule to Prohibit Conflicts of Interest in Asset-Backed Securitizations 2* (Jan. 12, 2012) (file no. S7-38-11).

The conflict here is clear: while brokers sold customers securities that were underwritten and issued by affiliates, the bank was making prop trades or bets against the assets of the vehicle to further its own economic interests. The prospectus of the CDO security did not usually explicitly disclose to investors that the issuing bank had a role in the selection of the assets, that their affiliated–prop trading desks were taking the short–position or that the assets in these portfolios were almost certain to fail, and were inherently risky and unsuitable for almost any investor.²⁴² Moreover, the complicated and opaque nature of the security heightened the information asymmetry between the bank and the long–position investors, and thus, the severity of the conflict. Starting in 2009, legislators recognized that, for the protection of investors and the overall financial system, banks must be prevented from executing trades in structured products riddled with such acute conflict.

III. The Volcker Rule as a Solution to Existing Conflicts of Interest

In response to the 2008 financial crisis, the U.S. enacted a watershed reform of the financial industry, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd–Frank Act”).²⁴³ Sections 619 and 621 of the Act specifically limit the conflicted trade²⁴⁴ – the prop trade – that contributed to the collapse of the international economy and are collectively referred to as the Volcker Rule after its original proposer—former Federal Reserve Chairman Paul Volcker.²⁴⁵

In January 2009, the Group of Thirty,²⁴⁶ under the leadership of a committee chaired by Paul Volcker, issued a report on financial reform aimed at global financial stability and “intended to be useful to policymakers in all the countries whose financial systems [were] disrupted in [the global financial crisis starting in 2007].”²⁴⁷ The report states that market forces combined with responses to those forces had led to pressure for changes in the structure of financial systems.²⁴⁸ The report also states that the implication is that “at least the very large and complex banking organizations that ... carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities.”²⁴⁹ The Group’s first recommendation was to limit the extent to which large systemically important banking institutions could participate in activities that present serious conflicts of interest.²⁵⁰

²⁴² See Complaint, 873 F. Supp. 2d 605 (S.D.N.Y. 2012) (No. 11-CV-7388) 2011 WL 4965844.

²⁴³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010)

²⁴⁴ 12 U.S.C.A § 1851 (2017); 15 U.S.C. § 77a (2017)

²⁴⁵ See 12 U.S.C. § 1851.

²⁴⁶ The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.

About the Group of Thirty, GROUP OF THIRTY, <http://www.group30.org/about> (last visited July 9, 2017).

²⁴⁷ Group of Thirty Working Group on Financial Reform, *Financial Reform: A Framework for Financial Stability*, GROUP OF THIRTY 8 (2009), http://www.group30.org/rpt_03.shtml.

²⁴⁸ *Id.* at 16.

²⁴⁹ *Id.*

²⁵⁰ *Id.* at 28.

Although the Volcker Rule did not appear in the version of the legislation that passed the House in December 2009 or in the original Senate version, adoption of the rule was endorsed by President Obama as part of the administrative reform plan in early 2010. The rule was included in the Senate bill in April 2010. At this point in the legislative process, the rule was not debated in the Senate and was largely unchanged, passing in May 2010. Although a number of changes were made to the rule in the conference process, guidance was not provided as to motivation and application of the rule. In fact, many of the material details and definitions were left for the FSOC and the other federal banking agencies to determine.

According to Senators Jeff Merkley and Carl Levin, who introduced the rule in Congress, deregulation – in particular, the GLBA – allowed banks to take risks that precipitated the 2007 financial crisis. Deregulation allowed conflicted banks to create and market products to clients that were secretly designed to fail and use client trading information against the interests of those clients and others in the markets. The Volcker Rule is an attempt “restore the spirit of regulations that followed the Great Depression” – that is, the Glass-Steagall Wall.²⁵¹

Although the Dodd–Frank Act allows for future radical changes in the financial industry such as the ability for the SEC to impose fiduciary duties on broker–dealers and require more stringent disclosures, Congress’ most radical reform was the fairly broad ban on prop trading and trading in asset–backed securities embodied in the Volcker Rule.²⁵² While designed to prohibit banks, that take in FDIC-insured funds from engaging in risky trading for their own accounts, this reform is also structured to serve double-duty as a conflict of interest protection.

Section 619 generally prohibits universal banks from prop trading, except in a limited number of securities and situations including trading in government obligations and market–making; however, even permitted activities and transactions are subject to prohibition if they “would involve or result in a material conflict of interest . . . between the banking entity and its clients. . . .”²⁵³ The text of § 619 is broad in its scope, but according to Senators Merkley and Levin, this was intentional. The language was intended to provide flexibility to banking regulators in addressing both present and future morally suspect financial activities.²⁵⁴ Section 621 essentially prevents banks from executing any transaction within one year after the date of the first closing of the sale of an asset–backed security that would involve a material conflict of interest with any investor.²⁵⁵

The United States is the first, and potentially only country, to enact such a severe deconglomerating measure in response to the crisis – at least on the surface. The ban attempts to remove the conflict of the crisis described above by removing one of the principals in the transaction, the prop trading desk. In doing so, the bank no longer faces the threat of being divided between itself over its customers—or in actuality, being loyal to itself over its customers.

²⁵¹ *Id.*

²⁵² Merkley & Levin, *supra* note 236, at 31.

²⁵³ 12 U.S.C.A. § 1851 (2017).

²⁵⁴ Merkley & Levin, *supra* note 236, at 551.

²⁵⁵ Under Rule 127B, a material conflict of interest is found to be material under a 2–prong test.

In total, the Volcker Rule was expected to force many banking entities to spin-off their prop trading desks, essentially deconglomerate.²⁵⁶ According to one scholar, “[t]he Volcker Rule, in effect, was motivated by a desire to return to a traditional banking model—to create a regulatory divide, much like the Glass– Steagall Act before its repeal in 1999”²⁵⁷ As noted by Senators Merkley and Levin, harsh provisions were viewed as necessary in order “(1) to separate federal support for the banking system from speculative trading activity with the banking entity’s own capital; (2) to reduce potential conflicts of interest between a banking entity and its customers; and (3) to reduce risk to banking entities and nonbanking financial companies designated for supervision by the Federal Reserve Board.”²⁵⁸ The first purpose was highlighted by President Obama in his speech supporting a draft of the Act. “[W]e should no longer allow banks to stray too far from their central mission of serving their customers. . . . 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.”²⁵⁹

The Volcker Rule’s departure from the conflict device that has been so-heavily relied upon by U.S. regulators since the inception of the universal bank can be attributed in part to Volcker’s position on the ineffectiveness of information barriers and internal compliance policies. The former Federal Reserve Chairman said:

“When the bank . . . is trading for its own account, it will almost inevitably find itself consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank Even with best efforts of board and management, so-called Chinese Walls can [not] remain impermeable against the pressures to seek maximum profit and personal remuneration.”²⁶⁰

Considering the severity of conflict abuse leading up to the crisis and its impact on the global economy, Congress’ general position was that it could no longer rely upon the prudence of executives at mega-banks to manage the build-up of risk and conflicts surrounding their bottom lines. This disposition also explains § 620 of the Act, which specifically directs

²⁵⁶ Justin Baer, *Morgan Stanley to Spin off Prop Trading Desk*, FINANCIAL TIMES (Jan 10, 2011), <https://www.ft.com/content/6c285214-1cfc-11e0-8c86-00144feab49a?mhq5j=e3>; see also Luke Jeffs & Douwe Miedma, *Bank Prop Trading Is Dead, Long Live Delta One*, REUTERS (Sept. 21, 2011), <http://www.reuters.com/article/us-banks-trading-idUSTRE78K4TK20110921?symbol=JPM>.

²⁵⁷ Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 HARV. BUS. L. R. 39, 42–43, 66 (2011).

²⁵⁸ Merkley & Levin, *supra* note 236, at 539; AMERICAN BANKRUPTCY INSTITUTE, Legislative Highlights, 30–AUG. AM. BANKR. INST. J. 8, 82 (2011).

²⁵⁹ Press Release, President Barack Obama, Remands by the President on Financial Reform, (Jan. 21, 2010), <https://obamawhitehouse.archives.gov/the-press-office/remarks-president-financial-reform>.

²⁶⁰ S. REP. NO. 111–176, at 91 (2010). “The Chinese Wall is especially vulnerable where employees deal on their own accounts, or for their employers’ accounts (whether to meet over-optimistic targets or as a response to corporate policy).” MCV EA, *supra* note 123, at 252.

regulators to consider whether any other banking activities should be restricted in order to protect the safety and soundness of the financial system.²⁶¹

Congress had not completely passed over its “primary tools” of Chinese Walls and disclosure, however. For example, if a statutorily permitted activity of § 619 is found to pose a material conflict of interest, the bank may continue with it if:

(1) the entity makes clear, timely and effective disclosure and in a manner that that provides the client an opportunity to negate any adverse effect created by the conflict; or

(2) the entity has information barriers that prevent the conflict of interest from involving or resulting in a materially adverse effect on a client. However, an entity cannot rely an information barrier if it knows or reasonably should have known that even with the barrier, a materially adverse effect may result and in that case, timely and effective disclosure of the conflict would be required to “cleanse” the conflict.²⁶²

These exemptions, however, have come under criticism for contradicting the underlying purpose of the Volcker Rule. By allowing banks to disclose conflicts of interest, even with respect to the statutorily permitted activities, the security could still pose a substantial threat to the investor. An investor may not fully appreciate the underlying conflict because they do not have access to all of the firm’s knowledge and trading strategy. Information barriers also do not remove the risk from the institution, and the exemption as structured in the statute is thought by some to leave too much discretion in the hands of the bank.²⁶³ Additionally, the Volcker Rule has been critiqued for being over-simplified in its proscription. Banks will find alternative routes to arbitrage the Rule and execute the same trades,²⁶⁴ and, “[t]his new round of financial engineering . . . may further increase the level of unnecessary complexity in the financial markets and thus make effective regulation even more difficult to achieve.”²⁶⁵

IV. The Empirical Evidence of the Continuing Problem of Conflicts of Interest

In this section we empirically investigate the profitability of trading by banks and other insiders. Banks typically acquire insider trading status on a temporary basis when they are hired as investment advisers. As a result, they are subject insider trading reporting requirements and trading restrictions.

²⁶¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 629, 124 Stat. 1376-2223 (2010).

²⁶² *Id.*

²⁶³ David Arkuch & Bartlett Naylor, Letter to Secy. Tim Geithner et al, Re: Prohibitions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, SEC 44 (Feb. 13, 2012), <https://www.sec.gov/comments/s7-41-11/s74111-296.pdf>.

²⁶⁴ “Banking activities may still be affected by proprietary trading— an end-run around the Volcker Rules’ divide—but now through the banks’ reliance on risk out-sourcing to hedge funds and the hedge fund industry.” Whitehead, *supra* note 258, at 70.

²⁶⁵ Omarova & Margaret, *supra* note 58, at 93.

To test our hypothesis, we obtained stock price information from the Center for Research in Security Prices (CRSP). The insider trading data comes from the union of the Thomson Reuters Insider Filing Data Feed (1996 to 2016) and backward extensions using archived annual purchases from the National Archives (1975 to 1995), (collectively, the combined “Insider Trading Database”). Our sample includes U.S. common stocks (CRSP share codes of 10 or 11) that are covered by all three databases. The time period is from January 1975 through December 2016. We restrict attention to this interval due to the availability of insider trading data, which first became available in January of 1975. We include observations beginning only from the time when the firms first appear in the combined Insider Trading Database. We adjust stock returns for delisting using the CRSP delisting file.²⁶⁶ Our final dataset has over 20,000 unique CUSIPs and over 3,500,000 observations.

The combined Insider Trading Database includes all trades reported to the SEC-Ownership Reporting System. The data contains all open market purchases and sales by officers and directors, executives and investment advisers of publicly traded firms. Top executives are limited to officer and director (‘OD’), officer, director, and beneficial owner (‘H’), chairman of the board (‘CB’), CEO (‘CEO’), CFO (‘CFO’), controlling person (CP), general partner (GP), and president (P). Investment bankers are coded with ‘IA.’ Officers are defined as all other officers. Large shareholders with an officer title are included in the sample. Outside large shareholders (‘SH’) and outside beneficial owner of more than 10% of a class security (‘B’) are excluded.

Shares acquired through the exercise of options, stock awards, and trades with corporations are excluded. The final sample is limited to firms for which stock return data are available in CRSP. Finally, in order to deal with potential misreports and incorrect outliers, three filters are used. On the insider transaction date, (1) the insider transaction price must be less than twice the closing price of the stock, (2) the number of shares of the insider transactions will be less than the daily volume of trade of the stock, and (3) the number of shares of the insider transaction will be less than the outstanding number of shares for the stock.²⁶⁷

We measure the profitability of insider trades starting from the insider trade date. We measure abnormal stock return behavior using the cumulative market-adjusted abnormal daily stock returns (CAR) starting from the trade date (date 0) for a period of T days:

$$CAR_{i,T} = \sum_{t=0}^T H_{i,t} (r_{i,t} - r_{m,t}),$$

where $H_{i,t}$ takes the value 1 for insider purchases and -1 for insider sales. Thus, we define an insider purchase to be abnormally profitable if the stock price outperforms the general stock market after the purchase. Similarly, we define an insider sale to be abnormally profitable if the stock price underperforms the general stock market after the sale. The variable $r_{i,t}$ is the cum-dividend return to stock i for day t , and $r_{m,t}$ is the cum-dividend return to the CRSP equally-weighted portfolio of all New York Stock Exchange, American Stock Exchange and NASDAQ

²⁶⁶ We follow the procedure used in Tyler Shumway, *The Delisting Bias in CRSP Data*, 52 J. Fin. 327 (1997).

²⁶⁷ Qualitative results do not change if these filters are not enforced. Results are available from the authors upon request.

stocks for day t . We examine the profitability of insider trades for $T=10, 20, 50, 100, 150, 200$ and 250 days following insiders' transactions.

To focus on insider transactions that are likely to be based on material, non-public information, we first require that the abnormal profitability (CAR) of insiders' transactions exceed 5% by day 10, 20, 50, 100, 150, 200 and 250. Summary statistics of the data for the period 1975-2016 are shown in Table 1.

Table 1**Summary Statistics of Insider Trades for 1975-2016 Period**

This table provides summary statistics of insider trades by officers, top executives and investment bankers. Panel A provides number of trades, average number of shares purchased, and average number of shares sold by officers, executives and investment advisers in NYSE, AMEX and NASDAQ. Pre-SOX period includes the time frame of January 1, 1975 to August 31, 2002 and post-SOX period includes the time frame of September 1, 2002 to December 31, 2016.

Panel A: Number of Insiders' Trades

	Number of Purchases	Number of Sales	Number of Total Transactions
Pre-SOX			
Officers	462,394	707,381	1,169,775
Executives	160,882	285,133	446,015
Investment Bankers	323	283	606
Post-SOX			
Officers	197,923	1,102,325	1,300,248
Executives	104,512	744,529	849,041
Investment Bankers	628	336	964
Total	926,662	2,839,987	3,766,649

Panel B: Insiders' Trades by Insider Relationship

	Average Number of Shares Purchased	Average Number of Shares Sold	Total Shares Purchased-Sold (Millions)
Pre-SOX			
Officers	3,694.66	8,790.65	4,321.92 - 10,283.08
Top Executives	3,913.58	13,039.08	1,745.52 - 5,815.63
Investment Bankers	6,096.60	6,355.66	3.69 - 3.85
Post-SOX			
Officers	4,179.65	12,764.91	5,434.58 - 16,597.55
Top Executives	1,904.37	8,052.33	1,616.89 - 6,836.76
Investment Bankers	1,908.28	13,277.45	1.84 - 12.80
Total			13,124.44 - 39,549.67

Table 1 displays the number of trades, average number of shares purchased, and average number of shares sold by relationship. This table provides information about insider trades for all three insider groups. We also separate the analysis period as pre-SOX and post-SOX. Pre-SOX period includes the time frame of January 1, 1975 to August 31, 2002 and post-SOX period includes the time frame of September 1, 2002 to December 31, 2016. The number of trades in the post-SOX era is somewhat higher than the number of trades in the pre-SOX era, for all three groups of insiders even though the pre-SOX period contains more than 27 years of data while the post-SOX period contains about 13 years of data.

Our data base is quite large, containing about 3.7 million insider trades from 1975 to 2016. The total number of shares sold is about 40 billion while the total number of shares purchased is about 13 billion over this time period. Insiders on average tend to sell more shares than they purchase because they receive a significant number of shares as part of executive compensation.

Table 2**Insiders' Abnormal Profits in Firms between 1975 and 2016**

This table provides the average abnormal market-adjusted returns (CAR) of insider trades in 10, 20, 50, 100, 150, 200, 250-day horizons. The market-adjusted abnormal return for each trade is computed as,

$$CAR_{i,T} = \sum_{t=0}^T H_{i,t} (r_{i,t} - r_{m,t})$$

where $r_{i,t}$ is the with- dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The t -statistics are in parentheses. Estimates that are statistically significant at the 5% level or better are in bold.

	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers	2,470,023	0.54% (5.61)	0.79% (5.81)	1.55% (7.21)	2.39% (7.85)	2.89% (7.71)	3.39% (7.82)	4.16% (8.59)
Top Executives	1,295,056	0.70% (6.78)	1.02% (6.94)	1.84% (7.90)	2.94% (8.87)	3.74% (9.18)	4.36% (9.25)	5.10% (9.67)
Investment Advisers	1,570	5.01% (3.11)	6.00% (2.63)	3.42% (0.94)	9.82% (1.92)	7.03% (1.12)	9.20% (1.27)	11.43% (1.41)
All Insiders	3,766,649	0.60% (6.22)	0.87% (6.41)	1.65% (7.66)	2.58% (8.46)	3.18% (8.47)	3.73% (8.57)	4.48% (9.23)

Table 2 displays insiders' abnormal profits for the overall sample period for officers, top executives, investment advisers and also for all insiders. Our database contains approximately 2.5 million transactions by officers and 1.3 million transactions by top executives. The number of transactions by investment bankers is 1,570.

As shown in Table 2, the abnormal market adjusted returns of all officers and top executives are positive and statistically significant for all analysis horizons. The evidence shows that all three groups of insiders as well the overall sample of all insiders engaged in profitable trading. Abnormal returns for officers' trades rise to more than 4%, while the abnormal returns of top executives rise to more than 5% for the one-year holding period (250 trading days). For shorter holding period, abnormal returns remain at or below one percent for the first 20 trading days (about one calendar month).

The abnormal profits of investment advisers are also positive and larger, rising to about 6% by day 20. Moreover, these abnormal profits attain statistical significance even for short-term horizons (up to 20 days). A longer horizon analysis provide larger positive abnormal returns for the investment bankers (about 11%), but not significantly different from zero due to the smaller sample size.

Typically, insiders tend to trade on long-lived information in order to avoid legal liability. Our evidence in table 2 is consistent with this observation for officers and top executives. However, the large and immediate profitability of trading by investment banks by day ten goes against this observation. This finding suggests that the investment bankers may be less concerned about legal liability and they tend to trade on short-lived information as well.

Table 3

Insiders' Abnormal Profits in All Firms between 1975 and 2016, grouped by volume of trading.

This table provides the average abnormal market-adjusted returns (CAR) of insider trades by volume of trading in 10, 20, 50, 100, 150, 200, 250-day horizons. Small volume is less than or equal to 10,000 shares while larger volume exceeds 10,000 shares of trades. The market-adjusted abnormal return for each trade is computed as,

$$CAR_{i,T} = \sum_{t=0}^T H_{i,t} (r_{i,t} - r_{m,t})$$

where $r_{i,t}$ is the with- dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The t -statistics are in parentheses. Estimates that are statistically significant at the 5% level or better are in bold.

	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers-Small Volume	2,071,274	0.51% (5.56)	0.74% (5.62)	1.40% (6.77)	2.15% (7.32)	2.56% (7.10)	2.95% (7.07)	3.66% (7.85)
Officers-Larger Volume	398,749	0.67% (5.39)	1.07% (6.14)	2.32% (8.40)	3.68% (9.39)	4.61% (9.59)	5.69% (10.22)	6.80% (10.92)
Top Executives-Small Volume	1,059,740	0.67% (6.48)	0.95% (6.46)	1.66% (7.09)	2.64% (7.95)	3.36% (8.24)	3.86% (8.19)	4.50% (8.53)
Top Executives- Larger Volume	235,316	0.84% (6.80)	1.34% (7.68)	2.69% (9.74)	4.31% (11.02)	5.48% (11.37)	6.65% (11.92)	7.86% (12.58)
Investment Advisers-Small Volume	1,328	5.60% (3.03)	6.64% (2.54)	3.00% (0.72)	9.69% (1.65)	6.05% (0.84)	7.88% (0.95)	8.96% (0.96)
Investment Advisers - Larger Volume	242	1.70% (1.38)	2.41% (1.38)	5.78% (2.09)	10.55% (2.70)	12.55% (2.63)	16.59% (3.01)	25.35% (4.11)

We next examine the volume of trading. If insiders understand the implications of the private information they have and do not worry about the legal consequences of their trading, we would expect them to trade greater number of shares when they have more valuable information. Our evidence is shown in Table 3, which displays insiders' abnormal profits for the overall period grouped by small and large volume trades. We define small trading volume as less than or equal to 10,000 shares; and large trading volume as more than 10,000 shares.

Our evidence is consistent with the inference that insiders understand the value of their information and they are not overly concerned about legal consequences of their trading. For officers, abnormal profits rise from 3.7% to 6.8% when insiders trade less than 10,000 share to more than 10,000 shares. For top executives, abnormal profits rise from 4.5% to 7.9% for the two groups. However, the most dramatic effect of trading volume can be observed from the trades of investment bankers. When the investment banks trade small volumes, abnormal return after one year equals about 9%, which does not attain statistical significance. For larger volumes of more than 10,000 shares, banks' abnormal return rise to a whopping 25.4%, and they are statistically significant at the 1% level.

Table 3 shows another interesting pattern for investment banks. When they trade smaller volumes, their abnormal returns attain statistical significance in ten days. When they trade larger volumes, their abnormal returns attain statistical significance only around 50 days and remains statistically significant for a one-year holding period. This finding is consistent with the inference that investment bankers are not too concerned about the legal consequences of small volume of trading but they may be more concerned about large volume of trading. As a result, they may use large volumes of trading only to exploit long-lived information.

Table 4

Insiders' Abnormal Profits in Firms between 1975 and 2016 for larger volume trades only.

This table provides the average abnormal market-adjusted returns (CAR) of insider trades by volume of trading in 10, 20, 50, 100, 150, 200, 250-day horizons. Small Volume is less than or equal to 10,000 shares while larger volume exceeds 10,000 shares of trades. The market-adjusted abnormal return for each trade is computed as

$$CAR_{i,T} = \sum_{t=0}^T H_{i,t} (r_{i,t} - r_{m,t})$$

where $r_{i,t}$ is the with- dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The t -statistics are in parentheses. Estimates that are statistically significant at the 5% level or better are in bold.

	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers- Sales	324,251	0.16% (1.20)	0.43% (2.29)	1.68% (5.63)	3.21% (7.62)	4.22% (8.16)	5.42% (9.07)	6.62% (9.93)
Officers-Purchases	74,498	2.97% (17.17)	3.99% (15.86)	5.22% (12.42)	5.79% (9.36)	6.43% (8.39)	6.96% (7.81)	7.61% (7.62)
Top Executives-Sales	198,168	0.30% (2.46)	0.63% (3.66)	1.79% (6.57)	3.53% (9.19)	4.69% (9.97)	5.83% (10.71)	7.10% (11.67)
Top Executives- Purchases	37,148	3.93% (15.49)	5.41% (14.83)	7.82% (13.13)	8.80% (10.01)	9.99% (9.17)	11.34% (8.97)	12.20% (8.60)
Investment Advisers-Sales	166	2.73% (1.75)	3.46% (1.57)	8.49% (2.44)	12.19% (2.48)	17.39% (2.89)	26.45% (3.80)	36.37% (4.68)
Investment Advisers – Purchases	76	-0.53% (-0.29)	0.13% (0.05)	-0.04% (-0.01)	7.04% (1.240)	2.31% (0.33)	-3.74% (-0.46)	2.67% (0.3)

Next, we investigate profitability of sales and purchases separately. To focus more narrowly on information events, we also restrict our sample to large volume of trading only. Our evidence is shown in Table 4.

For both officers and top executives, both sales and purchases display abnormal profitability. For officers, abnormal profitability equals about 6.6% and 7.6%, for sales and purchases, respectively. For top executives, abnormal profitability equals about 7.1% and 12.2%, for sales and purchases, respectively. Hence, for both officers and top executives, purchases tend to be somewhat more profitable than sales.

For investment bankers, this pattern is reversed. When investment bankers sell a large volume of shares, abnormal profitability rises to 36.4%, which is very large and highly significant. When investment bankers buy a large volume of shares, abnormal profitability rises only to 2.7%, which is not significant. Thus, our evidence indicates that investment banker tend to trade and profit more on adverse, material, non-public information. This finding suggests that the bankers may be hired to help with some developing problems with the client firms. As a result of this, they learn about the developing problems and the data suggests they trade on this information.

If investment bankers trade on material, non-public adverse information about their client firms, the banks may help disseminate this adverse material information mire publicly and lead to further negative consequences for their clients. Thus, this kind of proprietary trading can be detrimental to the bankers' client firms. Thus it becomes important to enforce the Volcker Rule to prohibit this kind of proprietary trading. The Volcker Rule can help reduce the conflicts of interest between the banks and their client firms.

Finally, we investigate whether the profitability of proprietary trading by the bankers has changed over time. For this purpose, we focus on the post-SOX period (2002 to 2016) only. These results are shown in Table 5.

Our evidence shows that if anything, the abnormal profitability of the proprietary trading by the banks has increased during the most recent period. The one-year abnormal profits during the 2002 to 2016 period exceed 40% for large sales by the banks. This amount is both large and statistically significant at the 1% level. This evidence is consistent with the inference that gradual elimination of the Glass-Steagall requirements has provided the banks with greater latitude to trade even more profitably at the expense of their client firms.

Table 5

Insiders' Abnormal Profits in Firms between 2002 and 2016 (Post-SOX) for larger volume trades only.

This table provides the average abnormal market-adjusted returns (CAR) of insider trades for large volume of trading (more than 10,000 shares) in 10, 20, 50, 100, 150, 200, 250-day horizons. The market-adjusted abnormal return for each trade is computed as

$$CAR_{i,T} = \sum_{t=0}^T H_{i,t} (r_{i,t} - r_{m,t})$$

where $r_{i,t}$ is the with- dividend return to stock i on day t and $r_{m,t}$ is the with-dividend return to an equally weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks on day t . The parameter H is equal to one if the insider trade is a purchase and negative one if it is a sale. The t -statistics are in parentheses. Estimates that are statistically significant at the 5% level or better are in bold.

	Number of Observations	10-days	20-days	50-days	100-days	150-days	200-days	250-days
Officers- Sales	163,314	0.23% (1.83)	0.36% (2.02)	0.83% (2.94)	1.23% (3.07)	1.22% (2.49)	1.58% (2.79)	1.81% (2.86)
Officers-Purchases	25,331	4.89% (17.88)	5.52% (13.28)	5.80% (8.30)	7.27% (7.25)	8.78% (7.13)	9.94% (6.97)	10.98% (6.88)
Top Executives-Sales	103,658	0.33% (3.04)	0.30% (1.97)	0.66% (2.73)	1.17% (3.40)	1.27% (3.03)	1.60% (3.29)	1.64% (3.02)
Top Executives- Purchases	14,694	5.70% (17.44)	6.60% (13.37)	7.97% (9.71)	9.65% (8.16)	11.53% (7.91)	13.29% (7.88)	15.40% (8.16)
Investment Advisers-Sales	104	3.07% (1.31)	3.44% (1.03)	9.60% (1.83)	13.15% (1.77)	22.51% (2.47)	32.84% (3.13)	40.32% (3.43)
Investment Advisers - Purchases	41	1.16% (0.63)	2.63% (1.01)	1.14% (0.28)	5.16% (0.89)	-3.20% (-0.45)	-1.65% (-0.20)	0.97% (0.11)

Recommendations and Conclusion

In this paper we investigate whether the Volcker Rule has the potential to reduce or eliminate the potential conflicts of interest between the banks and their client firms. In general, the type of information banks use to trade is confidential. Consequently, it is not possible to test the potential contribution of the Volcker Rule.

We overcome these difficulties by exploiting a unique data set that contains banks' proprietary trades when they attain temporary insider status in their client firms. Banks attain insider trading status and become subject to insider trading reporting requirements and trading restrictions when they are hired to provide financial advice to their clients. They report these trades on Forms 3, 4, and 5, alongside other insiders. Using empirical data reported by the banks themselves, we demonstrate that banks can and do access important, private, material information about their clients and the data suggests they trade on this information. Hence, our evidence is designed to uncover the importance of the private information banks acquire as part of their intermediary and advisory role.

On average, we find that the inside information that banks acquire and trade on is highly valuable, allowing the banks to earn more on 25% on their proprietary trades. Furthermore, we find that relaxation and elimination of the Glass-Steagall restrictions allowed the banks to trade more frequently and earn greater amount of abnormal profits. Since 2002, banks tend to trade and earn more than 40% abnormal profits from adverse information about their client firms. The nature of the information that the banks trade on is adverse (negative) information about their client firms. Hence, our empirical evidence demonstrates that banks profit using adverse information about their client firms, exactly as envisioned by the Volcker Rule.

Consequently, we demonstrate that an added benefit of implementation of the Volcker Rule would be to eliminate the incentives to trade on material, non-public information about their clients that benefit the banks to the detriment of their clients, by eliminating proprietary trading by banks. Thus, we argue that implementing the Volcker Rule would also help contain some the current conflicts of interest present in the banking system introduced by the elimination of Glass-Steagall restrictions.

In spite of these benefits, the future of Volcker Rule is uncertain at this time. Recent legislative agenda introduced by the Trump administration is directed at repealing Dodd-Frank and eliminating the Volcker Rule altogether, instead of implementing it. The Financial CHOICE Act, passed in the House in June 2017, includes a repeal of the Volcker Rule in its effort to “[c]reat[e] [h]ope and [o]pportunity for [i]nvestors, [c]onsumers and [e]ntrepreneurs.”²⁶⁸ House Financial Services Committee Chairman Jeb Hensarling claimed the repeal would pave way for “economic growth for all; bank bailouts for none.”²⁶⁹ Yet our evidence indicates that instead of repealing, implementing Volcker Rule expeditiously would

²⁶⁸ The Financial CHOICE Act, H.R. 10, 110th Cong. (2017); The Financial Choice Act Executive Summary, House Committee on Financial Services, https://financialservices.house.gov/uploadedfiles/financial_choice_act_executive_summary_final.pdf (last visited on July 16, 2017).

²⁶⁹ Geoff Bennett, House Passed Bill Aimed at Reversing Dodd-Frank Financial Regulations (June 8, 2017), <http://www.npr.org/2017/06/08/532036374/house-passes-bill-aimed-at-reversing-dodd-frank-financial-regulations>.

have the added benefit of reducing the conflicts of interest in banks. Based on our evidence, we recommend that Volcker Rule be implemented.