

The Volcker Rule and Regulations of Scope

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Regulations of Scope

A key objective of bank regulation since the financial crisis of 2007-2009 has been to reduce risk. Banks have been required to hold more risk-weighted capital, to operate within new restrictions on leverage and liquidity, and to pass newly introduced stress tests.

The Volcker Rule, section 619 of the Dodd-Frank Act, is another of these new bank regulations, but is best understood as a *regulation of scope*. Rather than restrict risk directly, the Volcker Rule restricts banks from particular holdings and activities. Broadly speaking, the rule prohibits banks from proprietary trading in most securities and derivatives and severely limits banks' connections to hedge funds and private equity funds.

Regulations of scope have a long history. National banks, first chartered at the time of the Civil War, were prohibited from managing trusts, making mortgage loans, and underwriting corporate securities. Mortgage loans on farmland were permitted only from 1913, in a political compromise to pass the Federal Reserve Act.

At about the same time, national banks began to create affiliates—with the tacit approval of regulators—to conduct businesses that were otherwise prohibited to them. The National City Bank, for example, the ancestor of Citigroup, used such affiliates to become the preeminent universal bank of its time.

Through the stock market crash of 1929, the Great Depression, and the Banking Crisis of 1933, securities affiliates of national banks were—without compelling evidence⁵¹—blamed for the troubles of

⁵¹ See, for example, Benston (1990).

the time. Furthermore, Carter Glass, an extremely influential U.S. senator on the Committee on Banking and Currency, had long believed that banks should have nothing to do with “speculative” markets for stocks and corporate bonds. The result was the most famous regulation of scope, the separation of commercial and investment banking, by the Glass-Steagall Act of 1933.⁵²

Securities markets remained subdued through the 1940s, but as activity picked up in the 1950s, banks once again pushed to become universal banks. A cat and mouse game ensued, with banks working around the rules and with counteractive legislation like the Bank Holding Company Acts of 1956 and 1970.

Eventually, however, as banks lost business both to nonbanking financial institutions in the United States and to foreign universal banks, regulators gradually loosened the restrictions of Glass-Steagall. In 1999, when banks were for all practical purposes already back in the securities businesses, Congress and President Clinton, with overwhelming bipartisan support, repealed Glass-Steagall.

The Volcker Rule, passed in the wake of the financial crisis of 2007-2009, is thus the latest iteration of regulations of scope.

Dodd-Frank and Supporting Rulemaking⁵³

Dodd-Frank lists a number of objectives of the Volcker Rule: promoting the safety and soundness of banks and the financial

⁵² While deposit insurance was introduced at the same time, the separation of commercial and investment banking was not proposed to allay fears of moral hazard arising from deposit insurance. Deposit insurance was added as a political necessity late in the life of a bill that had been years in the making. In fact, until just before its passage, both Senator Glass and President Roosevelt opposed deposit insurance.

⁵³ This section is neither intended nor appropriate as a legal guide to compliance with the rule.

system; limiting the benefits of deposit insurance and Federal Reserve liquidity facilities to regulated entities; and reducing conflicts of interest between banks and their clients.

To achieve these objectives, the Volcker Rule generally prohibits banks from proprietary trading of securities and derivatives and from investing in or sponsoring hedge funds or private equity funds.

At the same time, the rule includes a number of broad exclusions to allow banks to fulfill some of their functions as financial intermediaries, including the following: trading of securities sold by the U.S. government, U.S. agencies, government-sponsored entities (GSEs, e.g., Fannie Mae and Freddie Mac), and municipal obligations; underwriting and market-making activities; hedging; and trading on behalf of customers.

Despite such exclusions, however, “backstop prohibitions” outlaw transactions that result in any of the following: a material conflict of interest between a bank and its customers, clients, or counterparties; material exposure to high-risk assets or trading strategies; a threat to the safety and soundness of the banking entity; or a threat to the financial stability of the United States.

Rulemaking to implement the Volcker Rule started with a public comment period followed by recommendations by the Financial Stability Oversight Council (FSOC) in January 2011.

Between late 2011 and early 2012, proposed rules for public comment were released by the five regulators with jurisdiction: the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Commodity and Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC).

The proposed rules were long and complex, and attracted more than 18,000 comment letters. The regulatory agencies went back to work and, in December 2013, jointly released the final rules.

To understand why the rules are long and complex, consider the ban on proprietary trading.⁵⁴ A short list of explicitly exempted securities (e.g., U.S. Treasuries) and explicitly exempted transactions (e.g., securities lending) are recognized as outside the realm of the Volcker Rule.

All other trades are essentially assumed to be proprietary and forbidden, unless they can be justified as part of one of the broad permitted activities (e.g., market-making) and can be shown not to violate a backstop prohibition (e.g., conflicts of interest or exposure to high-risk assets and trading strategies).

Justifying that a trade belongs to a permitted category, however, is difficult and subjective. With respect to market-making, for example, some of the criteria are: “routinely stands ready to purchase and sell;” “willing and available to quote, purchase, and sell... in commercially reasonable amounts... throughout market cycles... appropriate for the liquidity, maturity, and depth of the market;” “not exceeding on an ongoing basis, the reasonably expected near-term demands of clients, customers, and counterparties.”⁵⁵

The backstop prohibitions are similarly hard to interpret. Trades may not “result in the bank’s interest being materially adverse to the interests of its client, customer, or counterparty.” Similarly, high-risk assets and trading strategies “significantly increase the likelihood... of a substantial loss... or pose a threat to the financial stability of the United States.”⁵⁶

⁵⁴ See Davis Polk (2013) for details.

⁵⁵ Davis Polk (2013), p. 6.

⁵⁶ Davis Polk (2013), p. 16.

A particular problem with the backstop prohibitions is that any losses incurred might be used as *ex post* evidence that undue risks had been taken. Along these lines, after a large loss at Credit Suisse in March 2016, a U.S. senator wrote the chairs of all the regulatory agencies:

“To put it very simply, how can the American public have confidence that banking organizations are complying with the Volcker Rule when this type of massive loss can occur?”⁵⁷

Precisely because it is so difficult to demonstrate that a trade is permitted, the rules require that banks establish compliance programs to justify all of their trades, at the level of a trading desk, in a consistent way. The rules are quite detailed about the attributes of these compliance programs, including the specification of seven quantitative metrics to be used in the process.⁵⁸

The rules with respect to restricting connections with hedge funds and private equity funds are also complex, from defining exactly what it means to be a “covered fund” under the rules to exactly what it means to invest in or sponsor such a fund.⁵⁹ Furthermore, any investments and sponsorships allowed under these tests are still subject to the backup prohibitions.

The complexities of compliance are further multiplied by the fact that five regulatory agencies have jurisdiction over any aspect of the rules.

⁵⁷ Merkley (2016).

⁵⁸ Davis Polk (2013), pp. 17-23.

⁵⁹ Davis Polk (2014).

The CHOICE Act

The CHOICE Act proposes to repeal the Volcker Rule in its entirety. The arguments given by the proposal in favor of repeal are the following:⁶⁰

- Banks' proprietary trading and investments or sponsorship of hedge funds and private equity funds played no significant role in the crisis.
- It is not clear how the Volcker Rule makes the financial system less risky.
- The Volcker Rule inhibits market-making by banks, which, in turn, reduces liquidity available in financial markets.
- The Volcker Rule imposes costs not only on the largest Wall Street banks, but also on smaller, community banks that need to demonstrate that they are not engaged in proprietary trading.

Policy Analysis

Why Regulate Risk-Taking at Banks?

There are two reasons to believe that banks, without constraints, will take on too much risk relative to what is optimal for their creditors, customers, and the broader financial system.

First, the government provides an underpriced safety net in the form of deposit insurance, access to Federal Reserve liquidity facilities and, for the biggest banks, an implicit too-big-to-fail guarantee. The long-standing policy of undercharging banks for this safety net may increase the availability of credit and support economic growth, but it also incentivizes banks to take on too much risk.

⁶⁰ House Committee on Financial Services (2016), pp. 81-86.

Second, even without an underpriced safety net, individual banks do not bear the costs to others of a general financial crisis that may be caused or exacerbated by their own failure. In other words, these banks do not internalize systemic risk costs arising from excessive risk-taking or leverage. This, too, implies that banks may take on too much risk.⁶¹

While the best solution might be to charge banks appropriately for their reliance on the safety net and for their contribution to systemic spillovers, this approach has never found general acceptance.⁶²

Instead, heading into the 2007-2009 crisis, risk-taking was regulated directly through bank examinations and risk-weighted capital requirements.

Regulatory Failures and Post-Crisis Responses

For the most part, the 2007-2009 crisis erupted not from the commercial banking system but rather from mortgage companies, government-sponsored enterprises (i.e., Fannie Mae and Freddie Mac), investment banks, nonbank subsidiaries, and vehicles of bank holding companies.

Nevertheless, banking supervision and regulation did fail in the sense that the government felt obliged in the fall of 2008 to save too-big-to-fail banks. Wachovia was to have received government assistance and be sold to Citigroup, although, in the end, Wells Fargo purchased Wachovia with the stimulant of newly instituted tax breaks. Most spectacularly, however, Citigroup was bailed out

⁶¹ See Acharya, Pedersen, Philippon and Richardson (2017).

⁶² One exception is the Dodd-Frank Act's imposition on SIFIs of a capital surcharge, which may be interpreted as a charge for their systemic impact. See Acharya, Pedersen, Philippon and Richardson (2013) for a discussion of how to charge for systemic risk costs.

by the government with a combination of capital injections and guarantees.

In response to the crisis, risk-weighted capital requirements, which had proved too low, were increased. At the same time, however, there was a recognition that this sort of capital requirement could not stand on its own.⁶³

First, a firm with adequate capital might fail in a general crisis because its funding was too susceptible to runs—that is, over-reliant on repo, wholesale funding, etc. The failure of Northern Rock, a British Bank, was probably the best example of this.⁶⁴

Despite the high quality of its mortgage portfolio, it could not roll over its short-term funding nor securitize its assets through the general crisis. In any case, the regulatory response here was to introduce liquidity ratios that limit the extent of such funding.

Second, regulators might easily set some risk weights too low, as had been the case during the crisis for mortgage-backed securities and, in Europe, for bonds of “peripheral” governments, like Greece. Even worse, the effect of such errors will always be magnified by banks’ loading up on precisely those assets with mistakenly low risk weights.

Third, banks manage to circumvent the risk weights through regulatory arbitrage. In the crisis of 2007-2009, this took forms ranging from setting up and guaranteeing off-balance-sheet vehicles to reducing underwriting standards on mortgages with set risk weights.

One response to concerns about risk weights was a leverage ratio, a minimum level of capital relative to total, rather than risk-weighted

⁶³ See Acharya and Richardson (2012).

⁶⁴ See Tuckman (2016). While Bear Stearns and Lehman Brothers are often cited as examples, it is arguable that funders ran because these firms were insolvent.

assets. In this way, leverage cannot get too high, even for assets with erroneously assigned risk weights.

Another response was to subject banks to stress tests that would detect risks not captured by other regulatory and internal risk models.⁶⁵ Furthermore, by varying stress scenarios relatively frequently and without much advance notice, regulators can respond quickly to perceived changes in the riskiness of particular asset classes and bank positions.⁶⁶

Is the Volcker Rule a Reasonable Way to Reduce Risk-Taking at Banks?

Supporters of the CHOICE Act correctly note that neither banks' proprietary trading nor their connections with hedge funds and private equity funds played a significant role in the crisis of 2007–2009.⁶⁷ The more important question, however, is whether the Volcker Rule is a useful tool for reducing the likelihood and minimizing the damage of future crises.

The difficulty of defending the Volcker Rule as a means of regulating risk-taking, however, is that Volcker Rule prohibitions are not

⁶⁵ A fundamental problem remains unresolved. Capital regulation is ill-suited to deal with certain kinds of activities, like carry trades and financial guaranty insurance. These activities generate small gains with high probability and large losses—likely systemic—with low probability. Regulators should, therefore, require banks to hold sufficient capital to cover losses against these low probability events. Unfortunately, however, this policy would require banks to hold too much capital relative to the set of overwhelmingly likely outcomes. See Kashyap, Rajan, and Stein (2008).

⁶⁶ Banks have objected to the flexibility of stress tests to the extent that it becomes difficult to make a forward-looking business plan that will be consistent with regulatory constraints.

⁶⁷ The crisis was very much related to large, complex financial institutions' manufacturing securitized products and retaining tail risk that was systemic in nature and inadequately capitalized. See Acharya, Cooley, Richardson and Walter (2009, 2011).

closely aligned with risk. Here are some illustrations of this proposition:

- Consider three similar bank business lines that are treated differently by the Volcker Rule: making and trading corporate loans (permitted), buying and trading corporate bonds for the account of the bank (forbidden), and investing in a private equity fund that makes corporate loans (forbidden except in very small size).
- A trading strategy that buys some stocks and shorts others is probably safer than making corporate loans, but the Volcker Rule prohibits the former and permits the latter. There is a robust debate around whether banking businesses are more volatile (and more illiquid) than trading activities.⁶⁸
- A market-maker in corporate bonds, facing interest rate risk and credit risk, may hedge both risks, one but not the other, neither, or may even overhedge to take on additional risk. When does permitted customer business become forbidden proprietary trading?
- A junk-bond trader at Goldman Sachs earned the bank more than \$100 million by buying junk bonds from customers from January 2016 and selling out of the position to other customers by the end of June.⁶⁹ Is that customer or proprietary trading?

⁶⁸ See Chung, Keppo, and Yuan (2016) and Demirguc-Kunt and Huizinga (2010) compared with Stiroh (2006), Fraser, Madura and Weigand (2002), and DeYoung and Roland (2001).

⁶⁹ Market Watch (2016).

- Citigroup's proprietary mortgage trading group—because it traded only U.S. and GSE-backed mortgages—was in compliance with the Volcker Rule.⁷⁰

Given these considerations, it is difficult to make a general case that trading and fund investment businesses are riskier than traditional banking businesses. In fact, a bank's loan portfolio is likely to do poorly in a general crisis and contribute to the capital shortfall of the financial sector as a whole.

Supporters of the Volcker Rule might counter that nonbanking businesses—from investment banking to insurance—are more correlated with market fluctuations and, therefore, increase the systemic risk of banks. The empirical evidence on this point, however, is mixed.⁷¹

Can Regulations of Scope Be Justified for Other Reasons?

Supporters of the Volcker Rule might argue that banks are given a safety net because their core businesses—taking deposits and lending to households and businesses—are systemic, highly levered, and not easily replicable outside the banking sector.⁷² Trading and fund investments, by contrast, which are easily accomplished outside banking, are best left to institutions that generally carry less systemic risk, like pension funds, mutual funds, hedge funds, and sovereign wealth funds.

⁷⁰ *The Wall Street Journal* (2014). The business was closed down in August 2016.

⁷¹ For papers finding that nonbank activities increase systemic risk, see Baele, De Jonghe, and Vennet (2007), Brunnermeier, Dong and Palia (2012) and King, Massoud, and Song (2013). For papers finding that nonbank activities decrease or do not change systemic risk, see Akhigbe and White (2004), Boyd, Graham, and Hewitt (1993), Cornett, Ors, and Tehrani (2002), Geyfman and Yeager (2009), and Jorion (2005).

⁷² See Fama (1985), Diamond (1984, 1991) and Petersen & Rajan (1994) for a discussion of the unique lending services provided by banks.

To analyze this argument, consider a related, though more extreme, proposal: restrict banks to making only short-term personal and corporate loans. This proposal, however, is questionable for several reasons.

First, banks are really in two businesses: creating liabilities that customers want and lending or investing funds. Discussions of banking often lose sight of the first business. Individuals and businesses want a relatively liquid and safe place to park their money, from super-liquid deposits to less-liquid but more remunerative certificates of deposit or commercial paper.⁷³ Any profitable activity with appropriate risk characteristics on the assets side—whether making loans or proprietary trading—allows a bank to provide customers with relatively safe and liquid assets that pay interest.

Second, to the extent that there are synergies across financial services, regulations of scope reduce the efficiency of the banking sector. A corporation, for example, might easily find it efficient—from an informational and operational perspective—for a single bank to handle its operational deposits, its bank borrowings, its private debt offerings, the management of its pension plan, its insurance policies, etc.

There are even synergies across relatively pure customer trades and relatively pure proprietary trades. In a “back book,” for example, traders try to profit through proprietary positions in particular markets. From time to time, customers of a bank who want to do large trades—but are turned away by the market-making desks—could be accommodated by the capacity created by the back book.

⁷³ See Gorton and Pennacchi (1990).

The empirical evidence on the synergies across financial services is mixed.⁷⁴ But the universal bank has been the reality in Europe and a recurring dream of financial service companies in the United States from the early 1900s.

The third reason why tight restrictions of scope are a bad idea is that they may simply push systemic risk from the banking system elsewhere. Systemic risk would probably be reduced, for example, if a stand-alone commodities trading business moved from a bank into a hedge fund.

But what if that trading business, because of its synergies with trade financing and with commodity derivatives trading and hedging, moved from a bank into a large and important nonbank financial intermediary? Systemic risk might very well increase. The failure of either the bank or nonbank, as significant intermediaries, might cause systemic disruption, but the bank might be better diversified and better regulated.

The potential danger of forcing synergistic intermediation businesses outside banking can be put more dramatically. By setting up stand-alone investment banks, was Glass-Steagall partially responsible for the crisis of 2007-2009?

Costs-Benefit Analysis and the Volcker Rule

One of the reasons that the Volcker Rule was passed as an amendment to the Bank Holding Company Act, rather than to securities laws, was to avoid the need for cost-benefit analysis in

⁷⁴ For papers finding evidence of synergies, see Cornett, Ors, and Tehranian (2002), Elsas, Hackethal, and Holzhauser (2009), Lown, Osler, Strahan, and Sufi (2000), and Yu (2003). For papers finding that diversification of financial businesses reduces value, see Delong (2001), King, Massoud, and Song (2013), Laeven and Levine (2007), and Stiroh (2004). Schmid and Walter (2009) find that synergies are evident in some combinations of businesses but not in others.

rulemaking.⁷⁵ It is certainly difficult to compare even large costs of compliance plus the costs of forgone business opportunities and financial innovation with the massive costs of a financial crisis. But cost-benefit analysis would be extremely useful to compare the efficiency of the Volcker Rule with the other tools of the regulatory regime with respect to reducing individual bank and systemic risks.

In comparisons of this sort, the Volcker Rule will almost certainly rank very poorly. First, with the need to justify all trades as proprietary or not and as prohibited investments or not, compliance costs are particularly high.⁷⁶ Second, Volcker Rule prohibitions simply do not correlate well with risk reductions. Risk-weighted capital requirements, leverage ratios, liquidity ratios, and stress tests, on the other hand, are all aimed directly at controlling risk.

The Volcker Rule has been particularly criticized as contributing to a decline in market liquidity. The argument is that dedicated market-makers and proprietary traders all provide liquidity by taking positions and bearing risks that others choose to avoid. By limiting risk-taking of this sort, the Volcker Rule reduces market liquidity.⁷⁷

The empirical support for this claim, however, is mixed. In the corporate bond market, for example, bid-ask spreads, volume, and issuance all indicate that liquidity is the same as it was before the

⁷⁵ See Gallagher (2013) and Stein (2013).

⁷⁶ Richardson (2012) argues for a Volcker Rule to be principle-based with safe harbors as opposed to a strictly rule-based approach. The reason relates to the difficulty (and frankly irrelevance for risk) of measuring principal trading versus market-making. Proprietary and hedge activities would be permitted within well-defined confines of the Volcker Rule. These boundaries could reasonably be related to the firm's aggregate gross and net inventories of assets. Any trading activity outside these inventory constraints would require permission by the bank's (or nonbank SIFI's) regulator.

⁷⁷ For a more detailed analysis, see Duffie (2012).

crisis or better.⁷⁸ On the other hand, execution of large corporate bond trades has become more expensive and riskier.⁷⁹ In any case, however, the Volcker Rule is only one of several relevant factors bearing on liquidity; others include regulatory changes at banks (i.e., increased capital requirements and the newly imposed leverage ratio); decreased risk appetites at banks; and the structural shift to high-frequency trading in U.S. Treasuries.

The entire debate about liquidity, however, may be off point. To the extent that banks took too much risk before the crisis, because of an underpriced safety net or systemic risk externalities, banks may very well have also provided too much liquidity. In that case, liquidity should be appropriately lower post-crisis.

Conclusion

The debate about regulations of scope is an old one. Carter Glass argued in the 1920s and 1930s that banks should have no connection with stock or corporate bond markets. Charles Mitchell, the chairman of National City Bank, argued that credit markets were an integrated whole that did not divide sensibly into loans versus securities.

Without an anchor to risk, the Volcker Rule makes artificial and superficial distinctions across credit markets. This has already led to confusion and regulatory arbitrage. Investments in local infrastructure projects under the Community Reinvestment Act may

⁷⁸ See the survey on market liquidity after the financial crisis by Adrian, Fleming, Shachar and Vogt (2016), and, more broadly, Mizrach (2015), Trebbi and Xiao (2015), Adrian, Fleming, Shachar and Vogt (2015), Adrian, Fleming, Vogt and Wojtowicz (2016) and Bessembinder, Jacobsen, Maxwell and Venkataraman (2016).

⁷⁹ See recent papers by Bao, O’Hara, and Zhou (2016) and Dick-Nielsen and Rossi (2016), and Blackrock (2015, 2016), BIS (2016) and Committee on Capital Markets Regulation (2015), and Deutsche Bank (2016), among others, for concerns about market liquidity in the corporate bond sector.

or may not be allowed. Regulators and market participants spar over collateralized loan obligations—which are generally permitted, unless they contain some bonds, in which case they are not.⁸⁰ And banks move to structure investments as merchant banking or business development companies to avoid the classification of “covered funds” under the Volcker Rule.⁸¹

Echoing Charles Mitchell in the 1930s, a spokesman from Goldman Sachs captured these ambiguities:

“Banks are in the business of providing businesses with the capital they need to grow. Sometimes that means offering a loan and other times making an equity investment... We ensure our investments comply with all regulations, including the Volcker Rule.”⁸²

Taking into account the disconnect between the Volcker Rule and risk, along with its steep costs of compliance, this paper concludes that the Volcker Rule should be scrapped in favor of other prudential tools, such as risk-weighted capital requirements, leverage ratios, liquidity ratios, Living Wills, and stress tests.⁸³

To the extent that the risks of particular positions are especially difficult to assess,⁸⁴ stricter applications of the tools might be appropriate. In these cases, it would be appropriate to conduct a cost-benefit analysis of the value-added of these positions to the bank and its customers, the synergies of such positions with other

⁸⁰ Bloomberg (2016).

⁸¹ See Lykken (2013), Popper (2015), Trefis (2013a), and Trefis (2013b).

⁸² Popper (2015).

⁸³ Dodd-Frank’s stated goal of preventing conflicts of interest between banks and its customers and counterparties can be achieved at much less cost in other ways.

⁸⁴ White (2009), for example, differentiates between bank activities that are “examinable and supervisable” and those that are not.

bank activities, and the systemic risk implications of pushing positions out of the bank into other systemic entities that are less regulated.

Cost-benefit analysis often includes only the costs to the regulated, but should also include the costs to the regulators. There are estimates that, to comply with the Volcker Rule, banks spent more than 6 million hours initially and need to spend an additional 1.75 million hours annually.⁸⁵ On top of this, however, are the many hours spent by the staff at the relevant regulatory agencies, both initially and on an ongoing basis, to the exclusion of their other responsibilities and possible activities.

Would it not be better for the regulators to improve the quality of their bank examinations, monitor market conditions, and talk with banks about risk than to have semantic and legalistic discussions about whether a trade is “proprietary” and whether an investment is in a “covered fund”?

If repeal proves politically impossible, there are several useful compromises that could substantially reduce the regulatory burden of the rule:

First, the rule could prohibit “bright-line” proprietary trading, as defined in the initial FSOC study on the Volcker Rule.⁸⁶ The phrase denotes businesses within banks that are organized like internal hedge funds and have no formal market-making responsibilities. This relatively narrow definition would leave a lot of room for banks to take positions that are anathema to supporters of the Volcker Rule. But the prohibition would be enormously simpler to implement, would—almost by definition—not disturb synergies within banking organizations too much, and would abolish a significant share of pure proprietary trading.

⁸⁵ Piasio (2013).

⁸⁶ FSOC (2011), pp. 27-28.

Second, any compromise to go beyond this “bright-line” should scrap the current form of the Volcker Rule and its minutiae.⁸⁷ Rather than judge each and every trade, the rule should instead permit most transactions within some safe harbor, possibly based on gross and net inventory. Beyond that safe harbor, transactions could be subject to additional scrutiny.

Third, the Volcker Rule is really aimed at universal banks that have widespread trading operations and the means to exploit leverage requirements and government guarantees. By all reports, however, small- to medium-sized banks have been caught in the compliance net of the Volcker Rule. Any revision of the rule should effectively exempt these smaller banks.⁸⁸

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⁸⁷ As an illustration, the final rule issued by the CFTC on January 31, 2014, is 269 pages long in small type.

⁸⁸ This exemption can be revisited over time should it lead to regulatory arbitrage with implications for systemic risk.

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