



# LOBBYING THE RULEMAKERS WITH LAWYERS: REFLECTIONS FROM THE VOLCKER RULE

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**W**hile Congress remains the Article One branch and primary lawmaking organ of the United States federal government, it is arguable that most federal policymaking actually occurs in the nation's administrative agencies. Since the beginnings of the Republic, Congress has delegated rulemaking authority to executive departments and independent regulatory agencies and has expected agencies to fill out the details of law by issuing rules of their own. With ever greater frequency in the late 19th century, these patterns of rulemaking began to concern regulation of the economy, not just safety but also prices and the pricing behavior of large corporations such as the railroads. With the Administrative Procedure Act of 1946, Congress attempted to provide new structure to administrative policymaking, endowing the administrative rulemaking mechanism with something like a petition process, allowing anyone to express their grievances and requests openly and in a public forum.<sup>1</sup>

Political influence tends to flow to sites of political power, and modern American regulation provides no exception. The result of the migration of decision-making authority to administrative agencies has been



President Barack Obama signs the Dodd-Frank Wall Street Reform and Consumer Protection Act in Washington, July 21, 2010.

Official White House Photo by Lawrence Jackson

a massive increase in business expenditure upon lobbying and legal services. To take one prominent and relevant example, consider the recent law regulating the financial sector of the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The law authorized over 390 rulemaking requirements, to be met by agencies across the federal government. Whereas the Obama administration wanted to avoid the perceived failures of the Clinton health plan in the 1990s by allowing as much as possible of the content to develop within Congress, the administration took a different tack in financial regulation,

preferring to keep the statute general and delegate rulemaking authority to agencies with the requisite expertise.<sup>2</sup>

The result was a different kind of lobbying, one we call “lobbying with lawyers.” Firms met with agencies before the rules were drafted and tried to influence content in less visible venues. These same companies then turned to the rulemaking process and submitted comments on a range of rules affecting everything from consumer loans to prudential bank regulation to minimum capital requirements. Large banks, often incorporated as bank holding companies, responded by substantially increasing their expenditure on legal



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services. Bank holding companies spent less than \$1 billion on legal expenses from 2004 through 2007 but, from 2009 to 2016 spent over \$48 billion, with a peak of roughly \$9 billion in 2012. While much of this legal expenditure concerned enforcement liability and compliance with new rules, much of it also concerned rulemaking, as journalists have discovered. By contrast, total reported lobbying expenditures during this period never exceeded \$4 billion in any given year.<sup>3</sup>

In an ongoing research project funded by the Washington Center for Equitable Growth, the Russell Sage Foundation and the Radcliffe Institute for Advanced Study, we are examining attempts by “financial firms” (and other “interest groups”) to influence these rules, as well as whether the attempts have been successful in their aims. It is possible to see the massive sum of activity as a form of political influence over policy. While political scientists have in recent years published important, path-breaking studies on how wealthier citizens are better represented in legislative policy decisions, the possibly differential influence of wealthier interests (such as banks) in bureaucratic policymaking has not been studied as heavily.<sup>4</sup>

## **Dodd-Frank and the Volcker Rule**

One of the most important rules issued under the authority of the Dodd-Frank Act was the Volcker Rule, so named after the former Federal Reserve Board Chairman Paul Volcker, who argued before, during and after the financial crisis that permitting depository and systemically important financial institutions to engage in highly speculative trading with their own funds created incentives and dynamics that placed the global financial system at high risk. In writing the Volcker Rule, federal agencies (especially the Federal Reserve Board) sought to limit the activity of certain large financial institutions to engage in proprietary trading — firms investing their own capital to conduct financial transactions, in highly speculative trades that take positions in complex financial products such as derivatives. In the Volcker Rule, Congress aimed to limit the financial risk of large institutions and to create a better alignment of incentives between banks' capital provision functions and their activities in speculative trading in complex financial instruments. Critically, they passed much of the content-writing of this rule to federal agencies.

Large bank-holding companies that had continually and profitably engaged in proprietary trading saw the matter differently, of course. They argued that proprietary trading was often done to maintain liquidity in the financial system and at the demand of their clients. In a fascinating study that contributes original data and perspective to the study of both financial regulation and administrative rulemaking, professor Kimberly Krawiec of Duke University tabulated the number of pre-notice of proposed rulemaking meetings between major banks and the rule-writing agencies for the Volcker Rule. Because everyone knew that the Volcker Rule was coming — the legislation called explicitly for such a rule — banks strategically lined up for meetings with agencies before the draft of a rule had even been published, much less scheduled.

Ten firms had 10 or more meetings with financial agencies in the run-up to the notice of proposed rulemaking: JPMorgan Chase & Co. (27 meetings, 11 with the Federal Reserve), Goldman Sachs (22 total meetings, six with the Fed and seven with Treasury), Morgan Stanley (19 total meetings, six with the Fed and seven with the Securities and Exchange Commission), Bank of America (15 total meetings, six



Federal Reserve Board of Governors

**Open Board meeting of the Federal Reserve on the Volcker Rule, December 13, 2013.**

with the Fed and five with the SEC), Barclays (14 total meetings, six with the Fed and four with the SEC), Credit Suisse (14 total meetings, five with the Fed and six with the SEC), Citigroup (13 total meetings, six with the Fed and four with the SEC), BNY Mellon (11 total meetings, four with the SEC and Treasury), RBC (11 total meetings, four with the Fed and five with the SEC), and State Street Financial Corporation (11 total meetings, four each with the Fed and the SEC). These 10 firms accounted for 44.7 percent of all bank meetings with the rule-writing agencies. On this critical rule, certain large bank-holding companies disproportionately populated the pre-drafting process of meetings.<sup>5</sup>

## Lobbying on Appendix B

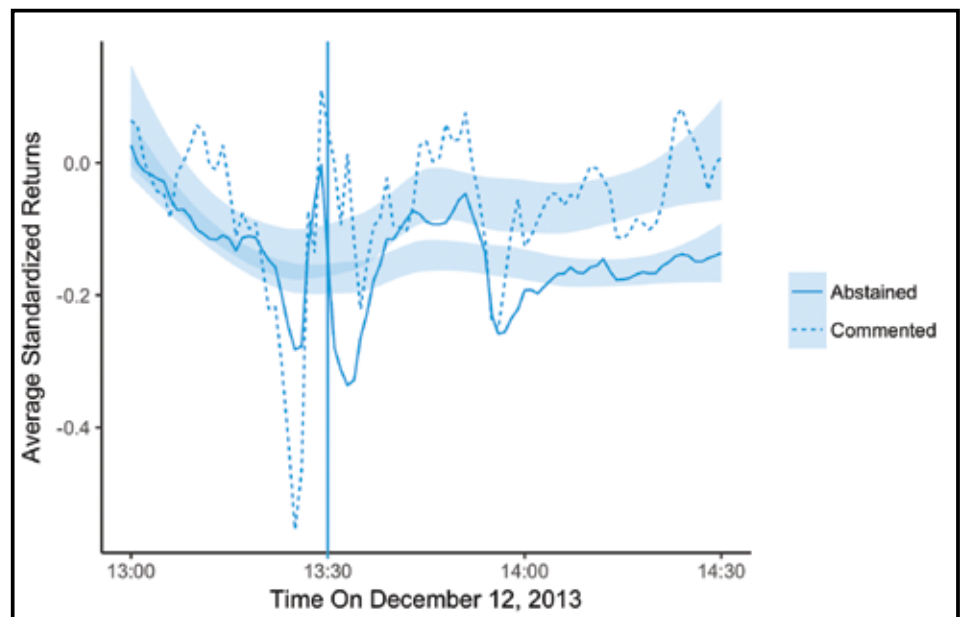
When it came to the notice-and-comment process, large bank-holding companies targeted a part of the draft rule called “Appendix B.” Appendix B elaborated a set of criteria by which regulators proposed to adjudicate whether a particular trade using a firm’s own assets qualified as a “market-making” trade — allowing a client and a counterparty to complete a trade, thus enhancing liquidity in the financial system, and hence legal — or whether it should be categorized

as proprietary trading and hence remain subject to the Volcker Rule’s prohibition. Appendix B laid out some sample criteria such as length of position taken in the asset, which particular trading desk at the bank had invested in the asset, and other standards by which regulators would make the differentiation.

Banks thought instead that the application of the market-making exemption to the proprietary trading prohibition should proceed more incrementally, in a common law

fashion. Several firms, including JPMorgan Chase & Co., openly argued in their Volcker Rule comments that Appendix B should be deleted entirely. Other banks did not so openly call for the elimination of the Appendix, but instead argued more philosophically for a better accounting of the utility of asset position taking for hedging counterparty risk. Goldman Sachs’ comment letter was exemplary.

The final rule did indeed eliminate Appendix B from the proposed rule. Were these and other favorable changes attributable to the comments and influence of bank holding companies like Goldman and JPMorgan? Cause-and-effect attribution is difficult, as the counterfactual of whether the rule would not have changed absent a particular comment’s intervention is difficult to assess. Nevertheless the Volcker Rule triggered a causally identified difference between firms that comment and abstained. Figure 1 compares the standardized returns for publicly traded financial firms that commented on the Volcker Rule with those that did not comment relative to the time when the final Volcker Rule was announced. Prior to the announcement of the rule at



**FIG. 1: DIFFERENTIAL RETURNS FROM VOLCKER RULE BY COMMENTER STATUS**  
Standardized returns for commenters and abstainers relative to the official announcement of the Volcker Rule. Shaded areas reflect the level of the price estimated via locally linear regression.

- **Inter-dealer trading:** Appendix B of the Proposed Rule provides that “market makers. . . typically only engage in transactions with non-customers to the extent that these transactions *directly* facilitate or support customer transactions.”<sup>31</sup> This statement, and the severe limits on inter-dealer trading that result from it, are inconsistent with the statute, which refers equally to “counterparties” as it does to “customers and clients.” Even more importantly, the statement is factually inaccurate when applied to many markets and could severely limit key elements of market making that depend on inter-dealer trading.

The FSOC Study acknowledged the role of trading in price discovery and market making as “an important and necessary part of managing the risk exposure of a market maker.”<sup>32</sup> In many cases, participation in inter-dealer markets is necessary to provide accurate prices to customers and is an indispensable source of hedging transactions for market makers seeking to mitigate risks arising from customer transactions. Inter-dealer markets also allow customers to access a larger pool of liquidity than any single dealer could provide. The range of customer transactions that a market maker would realistically be able to facilitate would be severely constrained if it could not price, exit or hedge positions through inter-dealer trading.

#### Excerpt from Goldman Sachs’ comment letter on the proposed Volcker Rule’s “Appendix B.”

1:30 p.m. on Dec. 12, 2013, the two sets of firms follow a common trend and their levels (estimated via local linear regression) are not statistically distinguishable. Twenty minutes after announcement, however, the difference in returns for commenters and abstainers is apparent. While it is difficult to imagine the market fully digesting the effect of the regulation in a mere 20 minutes, the broad-strokes were easier to evaluate, in part thanks to the Fed’s own press release, the preamble to the rule, news articles contemporaneously published (written with the benefit of prior access to the rule), and by the reports of equity analysts shared before and during the announcement. It was not hard to note, for example, that Appendix B had been deleted and that this was a major victory for firms extensively engaged in proprietary trading. One equity analysis firm, Morgan Lewis, remarked that “The Regulations no longer include Appendix B from the Proposed Rules. This is a significant accommodation to industry concerns over the requirements and impact of the proposed Appendix

B. While Appendix B purported to clarify what types of activities would be considered permissible market making-related activities, it contained a number of troublesome presumptions of activities that would be considered impermissible proprietary trading unless the banking entity could convince its regulators otherwise.”<sup>6</sup> As we have documented elsewhere, the firms whose comments were cited in the final rule in the market-making section saw systematically higher stock returns in the first hour after the final rules was announced. Moreover, as we have also documented elsewhere, this pattern is hardly unusual: American financial firms that comment usually have higher returns relative to their competitors following Dodd-Frank rule announcements. Of course, there are cases where commenters did worse or not much different from abstainers, but the tendency for firms that comment to make gains following regulatory announcements relative to firms that did not is still notable evidence of gains for lobbying financial regulators.

As the Trump administration seeks to weaken Dodd-Frank and banking regulation more generally, it will turn less to congressional legislation than to administrative rulemaking to accomplish its goals. Just this past May, the Fed combined with a range of other agencies to extend a notice of proposal rulemaking for revision of the Volcker Rule.<sup>7</sup> Early rulemaking under Dodd-Frank occurred with Democrats in control of the White House and the Senate. One wonders whether similar influences in comments will be observed that moderate the proposed rule. Because the initial proposed rule seeks to weaken the Volcker Rule’s proprietary trading restrictions, perhaps consumer comments will have more sway.

#### Capture or Informative Lobbying?

Whether the kinds of patterns witnessed in the Volcker Rule amount to a process that detracts from the public good or contributes to it is a difficult and thorny question. It is of

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course possible that banks, possessed of highly refined and expensive information about the probable costs and effects of a rule, will be incentivized by a tough proposed rule to lobby with information, in a way that “subsidizes” (as political scientist Richard Hall has documented) the rule-writing agency to focus on those parts of the rule in which the bank is most interested. This may correspond to informative lobbying but may also reflect a degree of bias if the wealthiest interests are able to direct debate and rule revision to some parts of the rule rather than others.<sup>8</sup>

Still another possibility is that this rulemaking process allows for capture of a sort. Capture is difficult to define, precisely because it is such a widely used and loaded word. Daniel Carpenter and David Moss, in their recent book *Preventing Regulatory Capture*, argue that capture prevails when special interests (especially industrial or business-based special interests) can capture a regulatory process by intentionally driving policy away from the public good and toward their own interest. If a strong version of the Volcker Rule was in the public interest, then perhaps the weakening of the Volcker Rule and the elimination of Appendix B qualify as capture, but as scholars have argued, it is very difficult to detect and measure the public good, as well as to detect and measure whether capture is occurring in a given instance.<sup>9</sup>

Krawiec’s fascinating data on pre-notice of proposed rulemaking meetings by banks suggests that, if capture is in fact prevailing, it may be the kind of “cultural capture” that University of Connecticut law professor James Kwak discusses in a 2013 essay that is rapidly becoming an emerging classic. Kwak argues that capture occurs not because the company or industry bribes the

regulator or somehow purchases influence, but rather through a deeply social process in which regulators become influenced by the status and power of bankers and adopt, sometimes slowly, the industry’s ways of thinking.<sup>10</sup>

What our research shows is that — whether the result is informative lobbying, capture by rulemaking or cultural capture — industry influence in financial regulation depends heavily upon the mobilization of legal expertise. To the extent that this hypothesis has merit, it means that political scientists and journalists are (quite radically) underestimating the amount of lobbying that truly goes on in American national politics, to say nothing of regulatory politics at the state and local levels. It also opens, we think, a new aperture into the dynamics of political inequality. Suffice it to say that only some banks, and only some bankers, can afford the kind of high-end, specialized legal expertise that bank holding companies marshaled in their meetings and their comments on the Volcker Rule. Because that kind of expertise is likely to be scarce for a long time to come, the process of lawyerly lobbying creates new inequalities in some of the most important public policy making in the modern United States.

## Notes

<sup>1</sup> Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877-1920* (New York: Cambridge University Press, 1982); Jerry L. Mashaw, *Creating the Administrative Constitution: The Lost One Hundred Years of Administrative Law* (New Haven: Yale University Press, 2014); Daniel Carpenter, “The Evolution of National Bureaucracy in the United States,” in *The Institutions of American Democracy: The Executive Branch*, eds. Joel D. Aberbach and Mark Peterson (New York: Oxford University Press, 2005), 41-71.

<sup>2</sup> For a summary review of rulemaking under Dodd-Frank, see Curtis W. Copeland, “Rulemaking Requirements and Authorities in the

Dodd-Frank Wall Street Reform and Consumer Protection Act,” Congressional Research Service Paper 7-5700 (2010), <http://www.llsdc.org/assets/DoddFrankdocs/crs-r41472.pdf>. On the role of bureaucratic politics in Dodd-Frank and its enforcement, consult J. Nicholas Ziegler and John T. Woolley, “After Dodd-Frank: Ideas and the Post-Enactment Politics of Financial Reform in the United States,” *Politics & Society* 44, no. 2 (2016): 249-280. Daniel Carpenter, “Institutional Strangulation: Bureaucratic Politics and Financial Reform in the Obama Administration,” *Perspectives on Politics* 8, no. 3 (2010): 825-845. For more general overview of the legislation, see Edward J. Kane, “Missing elements in US financial reform: A Kubler-Ross interpretation of the inadequacy of the Dodd-Frank Act,” *Journal of Banking and Finance* 36, no. 3 (2012): 654-661; Daniel Carpenter, “The Contest of Lobbies and Disciplines: Financial Politics and Regulatory Reform,” in *Reaching for a New Deal*, eds. Theda Skocpol and Lawrence Jacobs (New York: Russell Sage Foundation, 2011), 139-188.

<sup>3</sup> Brian Libgober and Daniel Carpenter, “Lobbying with Lawyers: Financial Market Evidence for Financial Firm Influence on Regulation,” working paper, Harvard University, and Washington Center for Equitable Growth.

<sup>4</sup> Larry Bartels, *Unequal Democracy* (Princeton, NJ: Princeton University Press, 2008); Martin Gilens, *Affluence and Influence* (Princeton, NJ: Princeton University Press, 2014). Professor Susan Webb Yackee of the University of Wisconsin-Madison has pioneered the development and testing of hypotheses for unequal influence in rulemaking notice-and-comment processes. Consult Susan Webb Yackee, “The Politics of *Ex Parte* Lobbying: Pre-Proposal Agenda Building and Blocking during Agency Rulemaking,” *Journal of Public Administration Research and Theory* 22, no. 2 (2012): 373-393; Jason Webb Yackee and Susan Webb Yackee, “A Bias Towards Business? Assessing Interest Group Influence on the U.S. Bureaucracy,” *Journal of Politics* 68, no. 1 (2006): 128-139.

<sup>5</sup> Kimberly D. Krawiec, “Don’t ‘Screw Joe the Plummer’: The Sausage-Making of Financial Reform,” *Arizona Law Review* 55, no. 1 (2013): Table 3, pg. 87.

<sup>6</sup> Morgan Lewis, “A Review of, and Insights into, the Volcker Rule Regulations,” January 2014, pg. 10, <http://documents.jdsupra.com/75903cde-9eb3-4a6a-ae61-4f94ac65aa47.pdf>.

<sup>7</sup> Sylvan Lane, “Fed votes to advance rule loosening Volcker rule on big banks,” *The Hill*, May 30, 2018, <http://thehill.com/policy/finance/389942-fed-advances-proposal-to-loosen-volcker-rule>.

<sup>8</sup> Richard L. Hall and Alan V. Deardorff, “Lobbying as Legislative Subsidy,” *American Political Science Review* 100, no. 1 (2006): 69-84.

<sup>9</sup> Daniel Carpenter and David A. Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York: Cambridge University Press, 2013); Carpenter, “Detecting and Measuring Capture,” in *Preventing Regulatory Capture*, 57-68.

<sup>10</sup> James Kwak, “Cultural Capture and the Financial Crisis,” in Carpenter and Moss, *Preventing Regulatory Capture*, 71-98.