Observation 2.0: The Anti-Evasion Provision of the Volcker Rule

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Overview

This *Client Alert* continues Pepper's observations on the Volcker Rule (other Volcker Rule observations can be found here http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2984). Critical attention should be paid to the Volcker Rule's anti-evasion provision, a powerful tool granted by Congress to the regulatory agencies to ensure compliance with the Volcker Rule. The Board of Governors of the Federal Reserve System (FRB) recently provided banking entities subject to the Volcker Rule with an extension until July 21, 2016 in order to conform their investments in, and relationships with, covered funds and foreign funds that were in place prior to December 31, 2013. That extension, however, did not apply to the conformance deadline of July 21, 2015 for Volcker Rule proprietary trading restrictions.[1] Therefore, the anti-evasion provision is a critical regulatory issue to watch in 2015.

A prime objective of bank supervision, which cannot be emphasized too often, is keeping banks "safe and sound" — the backstop to all bank supervisory rules. In addition, prudential supervisors urge banks to hold higher levels of quality capital and tie together capital planning to risk management as a bedrock to "safety and soundness". Whether a bank is acting prudently starts with the essential foundation of prudential regulation: The bank shall not engage in unsafe and unsound banking practices. Equally important, prudential bank regulators now increasingly focus on "risk based" objective standards, which include internal controls, information systems, internal audit systems and compensation, all of which involve risk assessment and risk management. Conformance to prudential examiner expectations regarding the Volcker Rule certainly will implicate a potential review of every critical element of a bank's system to ensure the bank does not engage in unsafe and unsound banking practices. It is also important to note that outsourcing any element of a bank's control system in connection with Volcker Rule conformance does not transfer the bank's liability to a third-party service provider. The bank retains responsibility to not be complicit in evading the Volcker Rule.

The Volcker Rule, enacted as part of the Dodd-Frank Act, generally prohibits banking entities from conducting proprietary trading and maintaining ownership of certain investment funds. Congress also included an anti-evasion provision in the Volcker Rule, which directed the FRB, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) (collectively, the Regulatory Agencies) to issue regulations establishing a compliance regime for the Volcker Rule. Congress also gave regulators a sweeping new power to nullify activities or investments if a regulator developed reasonable cause to believe that a banking entity did something that functioned as an evasion of the Volcker Rule's prohibitions. The regulations promulgated by the Regulatory Agencies detailed the compliance program requirements, but they did not further describe or provide guidance regarding the enforcement power under the anti-evasion regulatory provision and, instead, hewed closely to the statutory language.

Consequently, in the absence of further clarification or precedent, the anti-evasion provision raises significant interpretative challenges for industry participants and practitioners. For example, in their rulemaking, the Regulatory Agencies prohibited proprietary trading, but granted exceptions for activities that meet the Regulatory Agencies' definitions of activities related to market-making, underwriting and hedging. A banking entity, therefore, could engage in what it believes is a permitted activity, but it could then face scrutiny from a bank examiner concerning whether the activity meets one of the permitted exceptions.

Without further guidance from the Regulatory Agencies, resolving such a dispute will involve, at a minimum, in-depth analysis of the pertinent facts and circumstances and likely will depend heavily on the data from the banking entities' control systems and records. The scope of the anti-evasion provision will come to the forefront once the Regulatory Agencies begin case-by-case reviews, which lead to agency interpretations of the provision, because the provision was left untouched as part of the rulemaking process.

Below, we provide a more detailed discussion of the anti-evasion provision and offer further guidance.

Statutory Authority

Embedded in section 619 of the Dodd-Frank Act, the anti-evasion provision provides authority to the Regulatory Agencies to establish a compliance regime for banking entities and to nullify an investment or business activity that evades the Volcker Rule's prohibition on proprietary trading and fund activities. The legislative history of this provision indicates a belief that banking entities may seek to evade the prohibitions on proprietary trading or owning covered funds by shifting activity and investments to subsidiaries. Although such a tactic may protect bank depositors, it was believed by policymakers to be inadequate to ward off a potential future need to bail out banking entities, re-establish market discipline and refocus banking entities on credit extension and client services, which were the driving impulses of the legislative response to the financial crisis.[2]

To interpret the Volcker Rule's anti-evasion provision, we note that the statute first directs the Regulatory Agencies to develop a compliance program for adherence to the Volcker Rule.[3] The statute mandates the Regulatory Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance. The agencies have done so pursuant to their joint rulemaking, and we address the compliance program requirements below.

Under the Volcker Rule's anti-evasion provision, the statute next requires a Regulatory Agency to develop a **reasonable cause to believe** that a banking entity has done something that **functions as an evasion** of the Volcker Rule's prohibitions.[4] After developing its reasonable cause, the Regulatory Agency must provide notice and hearing to the banking entity, before issuing any order to cease the activity or change its investment to come into compliance. Lastly, the anti-evasion provision explicitly states that it does not otherwise affect the ability of federal and state regulators to restrict investments or activities provided by other laws.

Looking to the statute's plain language, the anti-evasion provision is an expansive tool for a few reasons. The threshold to support a regulatory enforcement response is not high; it needs to only be a "reasonable belief," which can provide for a wide spectrum of interpretation when a Regulatory Agency is scrutinizing an investment or activity. It also does not appear that an entity needs to have intended to evade the Volcker Rule; the offending investment or activity only needs to function like an evasion, or otherwise violate the Volcker Rule.

> ***Pepper Point:*** *The statute provides Regulatory Agencies grounds ultimately to disagree with, and invalidate, a banking entity's business practice on the grounds that the practice evades or violates the Volcker Rule, even in instances where employees of the banking entity could testify and show evidence of how they believed they were operating in conformance to the rule without any such intent to evade.*

Regulations

Pursuant to Dodd-Frank's mandate, the Regulatory Agencies jointly issued regulations, which included rules pertaining to the Volcker Rule anti-evasion provision.

The Volcker Rule regulations require extensive reporting. For example, a banking entity with between $10 billion and $50 billion in assets must write policies and procedures designed to document trading activities, set up internal controls designed to monitor compliance, establish a management framework that delineates responsibility and accountability for compliance, make data available for independent testing and auditing, provide training for trading personnel and managers to implement and enforce the compliance program and archive records for a minimum of five years to demonstrate compliance.[5] The rulemaking also notes that the purpose of this compliance program is to enable agencies to "help monitor potential evasions of the prohibitions and restrictions" of the Volcker Rule.[6]

Pertinent to the prohibitions and restrictions of the Volcker Rule are the regulations permitting underwriting and market-making-related activities and risk-mitigating hedging activities.[7] We have discussed these regulations previously (Observations

1.0 available at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2812 and 1.1 available at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2819 on the Volcker Rule) and will not address them at length here. However, the definitions of underwriting, market-making and hedging activities permitted by the Volcker Rule encompass the script of what the Regulatory Agencies have determined is permissible. If a banking entity engages in one of these permitted activities, it needs to do so with a documented business rationale, subject to comprehensive internal controls, to justify its actions as they will become subject to agency examinations.

Additionally, banking entities that qualify as foreign banking organizations under the Volcker Rule (addressed in Observation 1.2 available at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2832 on the Volcker Rule) could be exposed to regulatory risk from the anti-evasion provision in moving, from the United States to an offshore location, covered activity, such as proprietary trading. If a foreign banking organization decides to restructure its operations in this manner, it will need to develop a comprehensive approach and document a clear business purpose for moving its operations offshore, lest such a change be deemed an evasion of the Volcker Rule.

With respect to the Regulatory Agencies' enforcement actions, the regulations do not explicitly state the notice and hearing requirements of the statute — a point raised by at least one agency in its deliberative process for the anti-evasion provision — but the regulations do refer to the agencies only being able to take action as "permitted by law to enforce compliance." We expect that due process considerations will require notice and hearing in all such instances.[8]

The Regulatory Agencies also added language that requires a banking entity to liquidate an investment or halt a particular business activity that functions as an evasion "upon discovery."[9] There is an affirmative duty on banking entities to self-report and remediate the potential violation if they discover a violation.[10]

It is also clear that data-tracking a banking entity's activities will play a pivotal role in the Volcker Rule compliance regime. Indeed, the OCC issued its Volcker Rule Interim Examination Procedures to assist bank examiners in determining whether banks have business activities or investments that are subject to Volcker Rule and, if so, to enable banks to come into compliance during the conformance period. We noted, in Observation 1.0.1 (available at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2984) on the Volcker Rule, that the principal goals of the interim procedures included assessing the use of reporting metrics and progress in establishing compliance programs, such as measuring demand for financial institutions' market-making services, including their reasonably expected near-term demand.

> ***Pepper Point:*** *We anticipate that the many potential regulatory issues related to the anti-evasion provision will arise from a supervisor's routine examination of a banking entity's activities and largely will turn on whether the banking entity has established the required compliance program parameters and can document that its activities were proper, i.e., permitted market-making, underwriting or risk-mitigating hedging activities.*

In fashioning the final rule, the Regulatory Agencies rejected several recommendations from commenters to establish specific penalties for violating the anti-evasion provision, such as levying automatic fines, holding traders or management individually liable, removing a banking entity's officers or directors from office and imposing salary clawbacks.[11] Instead, the Regulatory Agencies noted that the statute added to their existing authority and explained that several other sources of authority already provide them with sufficient tools to punish violators beyond the penalties of the anti-evasion provision itself.[12] Such tools include criminal and civil penalties under section 8 of the Bank Holding Company Act; enforcement actions and safety and soundness orders authorized, respectively, under sections 8 and 39 of the Federal Deposit Insurance Act; and penalties for filing misleading or fraudulent reports to the OCC under 12 U.S.C. § 164.

Interestingly, the Regulatory Agencies explicitly rejected the use of section 13(d)(3) of the Bank Holding Company Act in connection with anti-evasion enforcement. Section 13(d)(3) permits the imposition of additional capital requirements and quantitative limitations of banking entities. The agencies explained that the capital treatment of banking entities' trading activities were being addressed in another rulemaking regarding regulatory capital rules. The Regulatory Agencies also stressed that they viewed section 13(d)(3) as a mechanism to bolster the "safety and soundness" of banking entities and the U.S. financial system as a whole. The agencies concluded that the authority provided under the section 13(d)(3) was not designed for a punitive purpose.

Notably, the Regulatory Agencies rejected the idea of having a lead enforcer or interpreter of the Volcker Rule regulations, including the anti-evasion provision. Acknowledging that, "on occasion," a banking entity may be subject to the jurisdiction of more than one agency, the agencies stated that they planned to coordinate their activities so as to limit duplicative actions and undue costs and burdens. This does not ensure uniformity in approach by the five Regulatory Agencies.

> ***Pepper Point:*** *In the coming early days of the new enforcement regime, we anticipate that the practical aspects of dealing with more than one enforcer for activities that allegedly violated the anti-evasion provision will most likely entail duplicative and costly action, such as responding to similar orders and document requests. We expect that the Regulatory Agencies will clarify internally, through informal understandings and memoranda of understanding, each Regulatory Agency's scope of jurisdiction and responsibilities.*

Anticipating Enforcement Under the Anti-Evasion Provision

The Volcker Rule's anti-evasion provision is not unique, and antecedents exist for regulation of the financial industry, such as authority conferred by Congress in the Truth In Lending Act and the Federal Reserve Act.[13] The common aspect of an anti-evasion provision is to enable the enforcing agency to have the power to make a substance-over-form determination. For example, under Regulation Z, promulgated pursuant to the Truth in Lending Act, creditors are forbidden from evading requirements for making high-interest mortgage loans for the principal dwellings of consumers by structuring transactions in a manner that resembles a home-equity line of credit, rather than a mortgage.[14] In promulgating the Regulation Z rule, the FRB stated that the anti-evasion provision was intended to reach instances where an examination of the circumstances demonstrated that a creditor had **no reasonable expectation** that the substance of the transaction warranted its form.[15] The standard under the Regulation Z rule is different, and arguably higher, than the Volcker Rule's anti-evasion provision, although both standards require an interpretation of what is reasonable. Similarly, an analogous anti-evasion provision also exists in the Federal Reserve Act, codified at 12 U.S.C. § 371c(e)(3), which enables the FRB to recast certain transactions in the securities of a "financial subsidiary of a bank by an affiliate of the bank" to be transactions made by the bank.

An alleged violation of the Volcker Rule will be undoubtedly an intensive facts and circumstances analysis linked to the data generated from a banking entity's compliance program. For example, the Volcker Rule regulations establish a presumption that a banking entity has conducted a prohibited proprietary trade if the banking entity purchases a financial instrument and holds it for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase.[16] The banking entity may rebut this presumption by demonstrating, "based on all relevant facts and circumstances," that the banking entity did not purchase the financial instrument "principally" for the forbidden purposes of making a short-term resale, benefitting from actual or expected short-term price movements or realizing short-term arbitrage profits. Thus, a banking entity needs to show its business justification for making a short-term trade, such as engaging in permitted hedging. If an activity meets the Volcker Rule exemption, then the Regulatory Agency likely will be hard pressed to find an evasive intent.

As a technical matter, during the Volcker Rule rulemaking process, commissioners from the Regulatory Agencies, such as the CFTC and the SEC, issued dissenting statements, reflecting some intra-agency conflict. Particularly to the anti-evasion provision, one of the CFTC's former commissioners, Scott D. O'Malia, criticized the CFTC's anti-evasion provision as inadequate in protecting a banking entity's procedural and substantive rights to due process.[17]

> ***Pepper Point:*** *Concerns about due process, in practice, may turn out to be overstated because the anti-evasion provision itself supplements the Regulatory Agencies' enforcement regimes, which provide for notice and hearing. With regard to the content of specific proposed orders or with respect to the legality of agency action generally, due process arguments may be available to challenge an enforcement action, including an anti-evasion action.*

The Regulatory Agencies clearly decided to fashion a rule that primarily tracks its authorizing statute. Constructing the rule in the manner in which they did, the Regulatory Agencies have arguably preserved their flexibility and left the development of the provision to specific orders and procedures generated by enforcement actions.

Pepper Point: *Since the issuance of the final rules, the Regulatory Agencies have provided further guidance on other aspects of the Volcker Rule, such as the OCC's Volcker Rule Interim Examination Procedures (available http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-27a.pdf) and the interagency Volcker Rule FAQs*[18] *(available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm). We remain hopeful that the agencies will provide guidance on the anti-evasion provision in forthcoming guidance as the conformance period for proprietary trading draws to a close in mid-2015.*

Endnotes

1. 12/17/14 FRB Order, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141218a1.pdf. Specifically, the order provided a one-year extension for the conformance period for covered funds and foreign funds until July 21, 2016 and expressed the FRB's intent to grant a final one-year extension for covered funds and foreign funds at some point in 2015 so that the conformance period would run until July 21, 2017.

2. *See, e.g.,* Statement of Sen. Merkley, 156 Cong. Rec. S5898 (daily ed. July 15, 2010); Statement of Hal S. Scott to the Senate Committee on Banking, Housing, and Urban Affairs (February 4, 2010).

3. "The appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall issue regulations, as part of the rulemaking provided for in subsection (b)(2), regarding internal controls and recordkeeping, in order to insure compliance with this section." 12 U.S.C. § 1851(e)(1).

4. The anti-evasion provision, now codified at 12 U.S.C. § 1851(e)(2), provides as follows:

   Notwithstanding any other provision of law, whenever an appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, has reasonable cause to believe that a banking entity or nonbank financial company supervised by the Board under the respective agency's jurisdiction has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section, the appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, shall order, after due notice and opportunity for hearing, the banking entity or nonbank financial company supervised by the Board to terminate the activity and, as relevant, dispose of the investment. Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.

5. *See, e.g.,* 17 C.F.R. § 255.20(b) (SEC regulations).

6. Final Rule Supplementary Information at 517, n. 1685.

7. *See, e.g.,* 17 C.F.R. §§ 255.4 (SEC regulations on underwriting and market-making-related activities) and 255.5 (SEC regulations on risk-mitigating hedging activities).

8. For instance, the SEC's regulation provides the following:

   Whenever the SEC finds **reasonable cause to believe** any banking entity has engaged in an activity or made an investment in violation of section 13 of the [Bank Holding Company (BHC)] Act or this part, or engaged in any activity or made any investment that **functions as an evasion** of the requirements of section 13 of the BHC Act or this part, **the SEC may take any action permitted by law to enforce compliance** with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.

   17 C.F.R. § 255.21(b) (emphasis added).

   The other agencies' corresponding regulations are located at 17 C.F.R § 75.21(b) (CFTC); 12 C.F.R. § 351.21(b) (FDIC); 12 C.F.R. § 248.21(b) (FRB); and 12 C.F.R. § 44.21(b) (OCC).

9. For instance, the SEC's regulation provides the following:

   Any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or this part, **or acts in a manner that functions as an evasion** of the requirements of section 13 of the BHC Act or this part, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or this part, **shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment.**

17 C.F.R. § 255.21(a) (emphasis added).

The other agencies' corresponding regulations are located at 17 C.F.R § 75.21(a) (CFTC); 12 C.F.R. § 351.21(a) (FDIC); 12 C.F.R. § 248.21(a) (FRB); and 12 C.F.R. § 44.21(a) (OCC).

10. Final Rule Supplementary Information at 921 n. 2793, 927–928.
11. *Id.* at 922–923.
12. *Id.* at 923 (citing 12 U.S.C. § 1851(g)(3)).
13. Notably, the Financial Stability Oversight Council (FSOC) also issued a regulation with an anti-evasion provision pursuant to the requirement of the Dodd-Frank Act to determine whether "material financial distress at a nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States." 12 C.F.R. § 1310.1. The FSOC anti-evasion provision allows the FSOC to order a nonbank financial company to be supervised by the FRB. *See* 12 C.F.R. § 1310.12.
14. 12 C.F.R. § 226.35(b)(4) ("Evasion; open-end credit. In connection with credit secured by a consumer's principal dwelling that does not meet the definition of open-end credit in §226.2(a)(20), a creditor shall not structure a home-secured loan as an open-end plan to evade the requirements of this section.").
15. 73 F.R. 44563.
16. 17 C.F.R. § 255.3(b)(2).
17. Statement of Dissent, Commissioner Scott D. O'Malia (Dec. 10, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement12101.
18. The FRB has issued FAQs on the Volcker Rule, and these FAQs mirror the other FAQs issued by the OCC, the FDIC, the SEC, and the CFTC. *See* FRB FAQs, *available at* http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm. The FAQs have been updated a number of times, including as recently as December 23, 2014; the SEC FAQs most clearly note updates. *See* SEC FAQs, *available at* http://www.sec.gov/divisions/marketreg/faq-volcker-rule-section13.htm.