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Financial Institutions Regulation Group Client Alert:

Out of the Frying-Pan into the Fire[1]: Enforcement of the Volcker Rule by the Five Agencies

BRIEF BACKGROUND

Today, after more than five long years of commentary, proposals, rulemaking and endless questions of interpretation, the restrictions imposed by Section 619 of the Dodd-Frank Act[2] and the final regulations thereunder (commonly referred to as the "Volcker Rule") will go into effect. The Volcker Rule generally prohibits covered banking entities from engaging in proprietary trading or making investments in covered funds. Starting today, banking entities must have in place effective Volcker Rule compliance programs. And beginning today, the five federal agencies charged with enforcing the Volcker Rule must determine how, whether and when to enforce violations of the rule. In this client alert, we address a fundamental question: under what authority will the Agencies enforce such violations?

Section 619 tasked five Agencies with jointly promulgating the regulations implementing the Volcker Rule: the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies"). Each Agency was required to issue regulations with respect to the entities for which they are the authorized regulatory supervisor. The Federal Reserve was authorized to promulgate regulations governing bank holding companies, their subsidiaries, and certain other nonbank financial companies; the Federal Reserve, FDIC and OCC were authorized to promulgate regulations with

[1] *The Hobbit*, J.R.R. Tolkien, Chapter six (1937).
[2] Section 619, *Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1 (2010).

respect to insured depository institutions; and the SEC and CFTC were authorized to promulgate regulations with respect to the entities for which each Agency acts as the primary financial regulator.[3] The final regulations were issued, essentially jointly, in late 2013.[4] Each Agency's rules were then codified separately in the Code of Federal Regulations.[5]

It would be reasonable to assume that each of these Agencies would have similar and fulsome enforcement powers with respect to the Volcker Rule. After all, if each Agency was authorized to promulgate the regulation, should it not have the authority to enforce it?

This assumption is wrong. As with many other aspects of the Volcker Rule, the manner in which it may be enforced is inherently unclear. The rule itself has an enforcement section, which refers obliquely to other available powers of enforcement, several of which appear to be unavailable to the relevant Agencies. Whether intentional or not, we believe that the Volcker Rule spreads enforcement authority unevenly among the five Agencies with, generally speaking, the SEC and the CFTC left partially powerless to employ the panoply of enforcement tools they have traditionally used to enforce violations of the securities and commodities laws, respectively. We discuss what is clear and what is unclear below.

THE VOLCKER RULE'S PROVISION OF ENFORCEMENT

Section __.21 of the Volcker Rule ("Termination of activities or investments; penalties for violations") states in subpart (a) that any banking entity that engages in an activity or makes an investment that violates the Volcker Rule (or evades or violates the Volcker Rule restrictions) shall promptly terminate the activity or dispose of the investment.[6] This provision is directed at each banking entity and appears to be self-enacting.

Subpart (b) of section __.21 is directed at each Agency. It states that, after an Agency has reasonable cause to believe that a banking entity has engaged in an activity or made an investment that violates (or evaded) the Volcker Rule, such Agency "may take any action permitted by law to enforce compliance" with the Volcker Rule, including

[3] 12 U.S.C. § 1851(b)(2).
[4] The Federal Reserve, OCC, FDIC, and SEC issued a joint rulemaking. *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014). The CFTC separately issued a virtually identical rulemaking. 79 Fed. Reg. 5808 (Jan. 31, 2014).
[5] *See* 12 C.F.R. Part 248 (Federal Reserve); 12 C.F.R. Part 351 (FDIC); 12 C.F.R. Part 44 (OCC); 17 C.F.R. Part 255 (SEC); 17 C.F.R. Part 75 (CFTC). The citations to the final regulations in this client alert refer to version codified by the Federal Reserve.
[6] 12 C.F.R. § 248.21(a).

"directing the banking entity to restrict, limit, or terminate any or all activities … and dispose of any investment."[7]

The Volcker Rule is clear that the responsible Agency may force a banking entity to stop proprietary trading or dispose of investments in covered funds. But what else can it do—what other actions are "permitted by law"? The preamble to the final regulations (the "Preamble") attempts to interpret this phrase, stating that "the Agencies may rely on their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law."[8] The Preamble then cites several specific authorities—section 13 of the Bank Holding Company Act of 1956 (the "BHCA"), section 8 of the Federal Deposit Insurance Act ("FDIA"), and section 39 of the FDIA—that are available solely to the federal banking regulators.[9] The Preamble goes on to state vaguely that violations "may also result in actions under applicable securities, commodities…and criminal laws," and that the Volcker Rule does "not limit the reach or applicability of the antifraud and other provisions of the federal laws."[10] However, the Preamble does *not* justify the grounds under which actions may be brought under such laws; it merely notes that the final regulations do not preclude their use.

So what, exactly, does Section __.21 mean? Does it permit each Agency to fine a banking entity? Can each Agency bring actions against individuals? In short, can each Agency do what it normally does with respect to regulations it has issued: use the full toolkit of enforcement techniques at its disposal to enforce compliance?

The answers to these questions appear to differ for each Agency. Below, we review how each Agency may enforce violations of the Volcker Rule.

BANKING AGENCIES

The Volcker Rule is fundamentally a banking law: the statute, issued as Section 619 of the Dodd-Frank Act, was codified in the BHCA as a new section 13 thereof. Its prohibitions apply to any "banking entity," generally referring to banks and their affiliates and subsidiaries.[11] There is little doubt that the three federal banking regulators—the Federal Reserve, the OCC, and the FDIC—can enforce compliance with the Volcker Rule. Each has broad supervisory and enforcement authorities under the FDIA or the BHCA, granting them the ability to take a wide range of enforcement actions either in response to a violation of law or on safety and soundness grounds.

[7] 12 C.F.R. § 248.21(b).
[8] 79 Fed. Reg. 5536, 5773 (Jan. 31, 2014).
[9] *Id.*
[10] *Id.*
[11] 12 C.F.R. § 248.2(c).

In practice, banking regulators have generally raised supervisory concerns in the first instance through the supervisory and examination process or other informal means. Provided that a banking entity has made a good faith effort to comply with the Volcker Rule, many initial concerns regarding the Volcker Rule may well be resolved in this way, especially in the initial period following the Volcker Rule's effective date. That being said, as noted above, the Preamble clearly envisions the possibility of enforcement actions brought under both the BHCA and FDIA.

As the Volcker Rule forms a part of the BHCA, the Federal Reserve may enforce violations of it pursuant to BHCA's penalty provisions. Section 8 of the BHCA provides for criminal penalties against any individual, or any company, that violates any provision of the BHCA or a regulation issued thereunder, provided that the violation was either committed "knowingly," or "with the intent to deceive, defraud, or profit significantly."[12] Section 8's civil money penalty provision, however, may be applied regardless of intent; any company that violates, and any individual that participates in a violation of, the BHCA or a regulation issued thereunder may be assessed a civil money penalty up to $37,500 each day.[13] Section 8 also contains penalties for any company that commits reporting violations under the BHCA,[14] and the Preamble specifically contemplates enforcement actions in connection with the submission of late, false, or misleading reports, including false statements on compliance with the Volcker Rule.[15]

Additionally, each federal banking Agency has enforcement powers under section 8 of the FDIA and section 39 of the FDIA. Enforcement tools available under Section 8 of the FDIA include cease and desist orders, removal and prohibition orders, and civil money penalties. A banking Agency may issue cease and desist orders in response to an unsafe or unsound practice, or if the Agency has reasonable cause to believe that a banking entity is violating any law, regulation, or written condition. [16] A banking Agency may also issue temporary cease and desist orders under certain conditions.[17] Section 8 sets forth a tiered structure of civil money penalties: "first tier" penalties may be assessed for violations of any law, regulation, or other orders or agreements (such as a consent order); the second and third tiers provide higher penalty amounts for more serious misconduct. A banking Agency may also suspend or remove an individual from the banking industry entirely under Section 8, although the threshold for bringing such an order is high; generally, the Agency would have to show that the individual's misconduct had a financial impact (generally, either personal gain or losses suffered by

[12] 12 U.S.C. § 1847(a).
[13] 12 U.S.C. § 1847(b). The statutory penalty amount has been adjusted for inflation pursuant to 12 C.F.R. 263.65(b)(5).
[14] 12 U.S.C. § 1847(d).
[15] Preamble, at 5773.
[16] 12 U.S.C. § 1818(b).
[17] 12 U.S.C. § 1818(c).

the entity) and involved personal dishonesty or willful disregard for the safety and soundness of the institution. Section 39 of the FDIA allows the federal banking Agencies to issue orders in response to violations of the standards for safety and soundness set by those Agencies.[18] Such orders allow an Agency to impose a range of restrictions on an insured depository institution until a violation is corrected.[19] All of these powers will be available to a federal banking agency to enforce a violation of Volcker by a banking entity under its supervision.

SEC AND CFTC ENFORCEMENT POWERS

The Volcker Rule tasks the SEC and CFTC with enforcing violations of the Volcker Rule with respect to banking entities "under the respective [Agency's] jurisdiction."[20] With respect to the SEC, such "functionally regulated subsidiaries" include registered broker-dealers, investment advisers, security-based swap dealers, majority security-based swap participants, and investment companies.[21] The CFTC's functionally regulated subsidiaries include swap dealers, major swap participants, futures commission merchants, commodity trading advisers, and commodity pool operators.[22] Both the enforcement powers of the SEC and the CFTC derive from the congressional statutes they are charged with administering: in the SEC's case, the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and other securities statutes[23]; and in the CFTC's case, the Commodity Exchange Act ("CEA").

In granting the SEC and CFTC these enforcement powers, Congress used virtually identical language circumscribing the limits of the delegated powers. For example, Section 21 of the Exchange Act endows the SEC with enforcement powers relating to

[18] 12 U.S.C. § 1831p–1.
[19] *Id*.
[20] 12 U.S.C. § 1851(c)(2).
[21] 12 U.S.C. § 1844(c)(5).
[22] *Id.* The Gramm-Leach-Bliley Act added a new section 10A to the BHCA, which limited the Federal Reserve's role as an "umbrella supervisor" with respect to functionally regulated subsidiaries. Under section 10A, the Federal Reserve would defer in most instances to the relevant functional regulator (*i.e.*, the SEC or CFTC), as applicable. This section was repealed by Section 604 of the Dodd-Frank Act, which generally expanded the Federal Reserve's examination authority with respect to functionally regulated subsidiaries. *See* 12 U.S.C. § 1844. As a result, the Federal Reserve may arguably also seek to enforce compliance with the Volcker Rule with respect to CFTC- and SEC-regulated entities. However, the SEC and CFTC are still considered the primary financial regulatory authorities for the entities under their jurisdiction, and are specifically tasked with enforcing Volcker Rule violations with respect to such entities. The Preamble acknowledges these "concerns about overlapping jurisdictional authority" and indicates that the Agencies plan to coordinate their examination and enforcement proceedings "to the extent possible and practicable." *See* Preamble at 5774.
[23] In addition to the Securities Act and Exchange Act, the principal securities statutes administered by the SEC are the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

violations of "any provision of this chapter [or] the rules or regulations thereunder" (*e.g.*, Section 10(b) and SEC Rule 10b-5).[24] Section 6(c) of the CEA does the same.[25]

While it is true that the SEC promulgated its own version of the Volcker Rule, it did not do so pursuant to the Securities Act, the Exchange Act, or any of the other statutes it is charged with administering and enforcing. Rather, it did so pursuant to the BHCA.[26] The same is true of the CFTC.[27] The enforcement powers delegated to the SEC and CFTC by the securities and commodities statutes by definition do not extend to rules promulgated under anything but those statutes. While in certain instances, a violation of the Volcker Rule may also be considered an independent violation of a securities or commodities law (for example, a "failure to supervise" violation), the fundamental issue remains: because the SEC and CFTC promulgated their own version of the Volcker Rule pursuant to the BHCA, not the federal securities or commodities laws, both of these Agencies arguably lack the power to deploy their traditional enforcement methods to enforce the Volcker Rule.

THE ENFORCEMENT DEBATE

The questionable nature of their enforcement powers has not gone unnoticed among the representatives of the SEC and CFTC. For instance, John Ramsay, at the time the acting director of the SEC's Trading and Markets Division, told Reuters in 2014 that the SEC lacked the authority "to sanction a firm for not keeping the records or documents they are required to keep" under the Volcker Rule, and that the SEC was considering whether to seek "the full range of authority."[28] SEC Commissioner Daniel Gallagher added: "There is no Exchange Act provision that links itself to our enforcement authority. I think we need a rulemaking under the Exchange Act."[29]

Around the same time, then-CFTC Commissioner Scott O'Malia issued a dissent from the CFTC's vote in approval of a final rule implementing the Volcker Rule. Commissioner O'Malia specifically questioned "the Commission's new jurisdiction and enforcement authority under § 13 of the Bank Holding Company Act of 1956," and went on to state that, "[b]y not also promulgating the final rule under the CEA, the Commission cannot use its full suite of enforcement tools under the CEA to ensure compliance with the Volcker Rule."[30] Instead, he saw the CFTC's enforcement

[24] 15 U.S.C. § 78u(a)(1). The Exchange Act also grants the SEC enforcement authority with respect to rules of national securities exchanges, registered clearing agencies, the Public Company Accounting Oversight Board, or the Municipal Securities Rulemaking Board. *See id.*
[25] *See* 7 U.S.C. § 9(4)(A).
[26] *See* 17 C.F.R. § 255.1(a) ("This part is issued by the SEC under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851.").
[27] *See* 17 C.F.R. § 75.1(a).
[28] Sarah N. Lynch, SEC May Seek More Power to Enforce Volcker Rule, *Reuters* (Jan. 16, 2014).
[29] *Id.*
[30] Scott D. O'Malia, Statement of Dissent from Commissioner Scott D. O'Malia on the Volcker Rule (Dec. 10, 2013).

authority as essentially limited to the ability to order an affected party to terminate a violative activity or dispose of an investment. In contrast, he noted that enforcing the Volcker Rule "is not a problem for the banking Agencies, who have broad supervisory powers over the safety and soundness of banking entities, and considerable enforcement powers under § 8 of the [BHCA], or §§ 8 or 39 of the [FDIA]."

THE ENFORCEMENT PATH AHEAD

Even today—more than five years after the Volcker Rule was first conceived, more than three years after implementing regulations were first proposed, and more than a year and a half after final regulations were issued—many aspects of the Volcker Rule are unsettled. Given the countless "good faith" interpretive positions that banking entities have been forced to take in the face of scant guidance and a looming compliance deadline, the question of how violations will actually be enforced is critical. The federal banking Agencies have fairly well-defined enforcement authorities, and their ability to enforce the Volcker Rule is not in question. However, notwithstanding the considerable doubts that have been raised regarding the SEC and CFTC's enforcement authority, no public actions have been taken by either Agency to remedy their apparent enforcement gaps with respect to the Volcker Rule.

At the same time, in the current enforcement climate, it is doubtful that either Agency will simply concede these apparent limitations. Indeed, in criticizing the CFTC's process, Commissioner O'Malia noted that the CFTC "may nevertheless try to read its enforcement powers under the CEA into its limited enforcement authority under the BHC Act."[31]

Inevitably, the SEC or the CFTC will attempt to pursue an enforcement action under the Volcker Rule and their own statutory authority. At such time, we believe a banking entity will have ample justification to challenge their authority to do so.

[31] *Id.*

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