UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 20 | Issue 1 Article 19

3-1-2016

The Volcker Rule: Clarifying the Anti-Evasion Provision to Facilitate Compliance

Vinita Tandon

The Volcker Rule: Clarifying the Anti-Evasion Provision to Facilitate Compliance

I. INTRODUCTION

The long-awaited Volcker Rule ("Rule")[1] was fully implemented on July 21, 2015, five years after being introduced.[2] As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[3] which added § 13 to the Bank Holding Company Act ("BHC Act") of 1956,[4] the Rule prohibits covered banking entities[5] from engaging in proprietary trading or investing in covered funds.[6] The trading prohibition applies to short-term trading, which is generally considered as holding a financial instrument for less than sixty days.[7] The final version of the Rule was released and adopted on April 1, 2014 by

---

1. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851 (2012); 12 C.F.R. §§ 44, 248, 351 (2015); 17 C.F.R. §§ 75, 255 (2015).

2. Daniel Roberts, *Volcker Rule Takes Effect Today After Years Of Delay*, FORTUNE (July 22, 2015), http://fortune.com/2015/07/22/volcker-rule/.

3. Dodd-Frank § 619, 12 U.S.C. § 1851.

4. Bank Holding Company Act of 1956 ("BHC Act"), H.R. 6227, 84th Cong. (1956).

5. *See* BINGHAM MCCUTCHEN LLP, FINAL VOLCKER RULE REGULATIONS: RESTRICTIONS ON COVERED FUND ACTIVITIES AND INVESTMENT 3–4 (Jan. 6, 2014) (defining banking entities as "any insured depository institution; any company that controls an insured depository institution; any company treated as a bank holding company for purposes of § 8 of the International Banking Act of 1978; and any affiliate or subsidiary of any of the foregoing institutions").

6. Dodd-Frank § 619, 12 U.S.C. § 1851; 17 C.F.R. § 75 (defining proprietary trading as "engaging as a principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments"); *see also* ARNOLD & PORTER LLP, ADVISORY: VOLCKER RULE-FINAL IMPLEMENTING RULES 3 (Feb. 2014), http://www.arnoldporter.com/resources/documents/ADV214VolckerRuleFinalImplementingRules.pdf (defining covered funds as "privately offered funds or pools that either (i) rely on Section 39(c)(1) or 3(c)(7) of the Investment Company Act for an exemption from that Act [or] (ii) are commodity pools offered privately in reliance on exemptions in CFTC Rule 4.7 . . . .").

7. *See* 17 C.F.R. § 75 (2015) (noting the rebuttable presumption that any purchases or sales of a financial instrument are considered for a short-term trading account if they are held for less than 60 days); Hillel T. Cohn, *The Volcker Rule Prohibitions on Proprietary Trading: Considerations for Broker-Dealer Affiliates of Foreign Banking Organizations*, THE COLUM. L. SCH. BLUE SKY BLOG, (Feb. 3, 2014), http://clsbluesky.law.columbia.edu/2014/02/03/the-volcker-rule-prohibitions-on-proprietary-trading-considerations-for-broker-dealer-affiliates-of-foreign-banking-organizations/.

the five agencies ("Regulators") charged with implementing the Rule ("Final Implementing Rules"): the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve System ("Fed"), the Federal Deposit Insurance Corporation ("FDIC"), the Commodity Futures Trading Commission ("CFTC"), and the Securities and Exchange Commission ("SEC").[8] Though the Rule went into effect April 1, 2014, covered banking entities had until July 21, 2015 ("Compliance Date"), to fully conform their proprietary trading activities and investments to the Rule's requirements.[9] However, banking entities have until July 21, 2016, to conform any investments in covered funds and foreign funds that were in place prior to December 31, 2013.[10]

Although the Rule bans proprietary trading, it also carves out limited exceptions for certain purposes ("Permitted Activities").[11] The Rule and the Final Implementing Rules permit proprietary trading in conjunction with the following activities: underwriting, market making, risk-mitigating hedging, trading in domestic government debt, trading on behalf of customers, and trading by insurance companies.[12] These Permitted Activities do not give banking entities free rein; rather the Permitted Activities are subject to a set of overriding limitations, collectively known as the "Prudential Backstops."[13] The Prudential

8. Dodd-Frank § 619, 12 U.S.C. § 1851(b)(2)(B)(i); 12 C.F.R. §§ 44, 248, 351, 255 (2015); Arnold & Porter LLP, *supra* note 6.

9. ARNOLD & PORTER LLP, *supra* note 6, at 1.

10. FRANK A. MAYER, III ET AL., PEPPER HAMILTON LLP, CLIENT ALERT: OBSERVATION 2.0: THE ANTI-EVASION PROVISION OF THE VOLCKER RULE 1 (Jan. 8, 2015), http://www.pepperlaw.com/uploads/files/clientalert010815.pdf.

11. *See* Dodd-Frank § 619, 12 U.S.C. § 1851(d)(1) (2012) (listing the generally permitted activities); *see also* Final Rule § ___.3, 79 Fed. Reg. 5536, 5781–82 (Jan. 31, 2014) (stating that a banking entity may not engage as principal in: (1) any purchase or sale of one or more "financial instruments" (2) for the "trading account" of the banking entity, (3) unless: the activity is excluded from the definition of "proprietary trading," or an exemption is available and its requirements are satisfied) (the text of the Final Rule, which contains the provisions common to all five Regulators, and its accompanying attachments may be found at http://www.federalreserve.gov/aboutthefed/boardmeetings/final-common-rules-20131210.pdf).

12. *See* Dodd-Frank § 619, 12 U.S.C. § 1851(d)(1) (2012) (highlighting all permitted activities and noting that "insurance company" includes those "directly engaged in the business of insurance for the general account of the company" as well as "any affiliate of such regulated insurance company"); DANIEL L. GOELZER, BAKER & MCKENZIE, CLIENT ALERT: THE VOLCKER RULE—COMPLIANCE PROGRAM REQUIREMENTS FOR FOREIGN BANKING ENTITIES (Apr. 2014), http://www.bakermckenzie.com/files/Publication/27b69c86-beb1-4319-ab19-537caeb84a7c/Presentation/PublicationAttachment/5bd77889-b44d-4c13-9a4d-58f27ee56697/al_bf_proprietarytradingprohibition_jan14.pdf).

13. *See* Final Rule § ____.7(a), 79 Fed. Reg. 5536, 5786–87 (Jan. 31, 2014) (laying out

Backstops indicate that proprietary trading activities that would otherwise be permissible—or, fall within an aforementioned exception—are *not* appropriate where they would result in "a material conflict of interest" or "a material exposure . . . to a high-risk asset or high-risk trading strategy."[14] Activities are also inappropriate where they would pose a threat either to the "safety and soundness" of a banking entity or to the "financial stability of the United States."[15]

The Prudential Backstops are not insurmountable—banking entities can overcome these "conflict[s] of interest" by making timely disclosures to the client prior to engaging in any transactions that may produce a conflict of interest, or by using information barriers that are addressed in their written policies.[16] A timely disclosure would need to provide the client with sufficient time to "evaluate and act on the information."[17] Information barriers could include actual separation of "personnel or functions," or certain limitations on types of activity permitted.[18] Despite these mitigating measures, the Prudential Backstops pose a potential problem given the high-level of subjectivity involved in determining whether an activity may cause a material conflict of interest, or, whether it rises to a sufficient level to be considered a threat either to the safety and soundness of the banking entity or, to the financial stability of the United States.[19]

---

the limitations on permitted proprietary trading exceptions to the Rule); *see also* SULLIVAN & CROMWELL LLP, U.S. AGENCIES APPROVE FINAL VOLCKER RULE, DETAILING PROHIBITIONS AND COMPLIANCE REGIMES APPLICABLE TO BANKING ENTITIES WORLDWIDE 118 (Jan. 27, 2014), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Volcker_Rule.pdf (noting that these overriding limitations are referred to by Regulators as "prudential backstops").

14. Dodd-Frank Wall Street Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(d)(2)(A) (2012); GOELZER, *supra* note 12.

15. Dodd-Frank § 619, 12 U.S.C. § 1851(d)(2)(A) (2012); GOELZER, *supra* note 12.

16. Final Rule § ____.7(b)(2), 79 Fed. Reg. 5536, 5781–82 (Jan. 31, 2014); MORRISON & FOERSTER LLP, A USER'S GUIDE TO THE VOLCKER RULE 12 (Feb. 18, 2014), http://media.mofo.com/files/Uploads/Images/131223-A-Users-Guide-to-The-Volcker-Rule.pdf

17. Final Rule § ____.7(b)(2), 79 Fed. Reg. 5536, 5781–82 (Jan. 31, 2014); Oliver Ireland & Daniel Nathan, *Bank Supervision: The Volcker Rule's Trojan Horse for Smaller Banking Entities?* [2014] Banking Daily (BNA) (Apr. 8, 2014).

18. Final Rule § ____.7(b)(2), 79 Fed. Reg. 5536, 5781–82 (Jan. 31, 2014); Ireland & Nathan, *supra* note 17.

19. *See* Charles K. Whitehead, *The Volcker Rule: Implementation and Impact*, CORNELL UNIV. L. SCH., https://www.richmondfed.org/~/media/richmondfedorg/conferences_and_events/banking/2014/pdf/cms_volcker_whitehead_2014.pdf (noting the potentially problematic nature of the Prudential Backstops given the lack of guidance on specific activities that may be likely to

The Rule's many proprietary trading exceptions and the restrictions the Prudential Backstops impose on those exceptions, force banking entities and Regulators to use what seems to be an excessive amount of discretion to distinguish between permissible and prohibited activity.[20] Since many activities (*e.g.*, market-making) are permissible under the Rule's exceptions,[21] banking entities engaging in these excepted activities will be greatly scrutinized by the Regulators.[22] In-depth scrutiny will ensure that such trading activity is permissible under the Prudential Backstops.[23]

Regulators are given even more discretion as a result of the Prudential Backstops, which may implicate the Rule's anti-evasion provision ("Anti-Evasion Provision").[24] The Anti-Evasion Provision delineates the Regulators' authority to take action where there is "reasonable cause to believe that a banking entity" has engaged in activity that "functions as an evasion of the requirements" of the Rule.[25] The Anti-Evasion Provision grants authority to each of the Regulators to order any banking entity, after providing appropriate due process and the opportunity for a hearing, to terminate any activity or dispose of any investments that *functionally* evade the requirements or violate the restrictions set forth in the Rule.[26] The Regulators uphold the Anti-Evasion Provision using the "reasonable cause" standard—which, is

violate the Backstops).

20. Deloitte, *The Final Volcker Rule: 10 Issues for Banks to Consider*, WALL ST. J. (Feb. 25, 2014), http://deloitte.wsj.com/riskandcompliance/2014/02/25/the-final-volcker-rule-10-issues-for-banks-to-consider/.

21. GOELZER, *supra* note 12.

22. *See* MAYER ET AL., *supra* note 10, at 1–2 (indicating that while a banking entity may be engaging in activity that it genuinely believes is within the permitted exceptions to the ban on proprietary trading, they could consequently face scrutiny by the Regulators as to whether such activity does in fact fall within the exceptions).

23. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, VOLCKER RULE INTERIM EXAMINATION PROCEDURES (June 2014) (discussing examples of the in-depth procedures with which regulators, such as the OCC, will use to evaluate banking entities' compliance with the Rule); *see also* Whitehead, *supra* note 19 (noting that one of the potential challenges to the Prudential Backstops is how to make a clear distinction between prohibited and permissible activity given differences across firms, difference amongst financial markets, and the potential for banking entities to mask prohibited activities as permitted activities).

24. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012); *see infra* Part III.

25. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2); *see infra* Part III.

26. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2); Memorandum by Paul Weiss, The Volcker Rule 5 (July 14, 2010); http://www.paulweiss.com/media/104137/PW14Jul10VR.pdf; *see infra* Part III.

simply that the entity's activity could, or does, function as an evasion.[27] "Reasonable cause" by itself does not set a high bar for enforcement, and the phrase "functions as an evasion" lowers the bar further by seemingly indicating that no intent is necessary to violate the Provision.[28]

This Note discusses both the Rule's gaps in adequately identifying the types of transactions that would implicate the Prudential Backstops, as well as the ambiguous guidelines for compliance with, and enforcement of, the Anti-Evasion Provision. Part II lays out how banking entities are expected to comply with the prohibition against proprietary trading, and the challenges in identifying activities permitted within the exceptions.[29] Part III addresses the Anti-Evasion Provision and the enforcement problems it poses to banking entities and Regulators.[30] Part IV discusses potential measures for reforming and clarifying the Anti-Evasion Provision by analyzing a similar anti-evasion provision from the Truth in Lending Act ("TILA").[31] Finally, Part V concludes by reiterating the importance of clarifying the Anti-Evasion Provision to facilitate compliance and ensure consistent enforcement of the Anti-Evasion Provision.[32]

II. COMPLIANCE AND ENFORCEMENT

Prior to the Compliance Date, banking entities had to thoroughly examine and assess their current trading practices to determine whether, and how, they were engaging in proprietary trading.[33] Banking entities mapped out their existing trading activities, covered fund activities, and investments and compared them to the Rule's requirements.[34] This

27. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); *see infra* Part III.

28. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); *see* PHILLIP HOFFMAN & TIMOTHY R. MCTAGGART, PEPPER HAMILTON LLP, CLIENT ALERT: OBSERVATION 3.0: FREQUENTLY ASKED QUESTIONS AND ANSWERS ON THE VOLCKER RULE AND THE IMPLICATIONS FOR FOREIGN BANKS INVESTING IN FOREIGN FUNDS Q.14 (Oct. 20, 2015), http://www.pepperlaw.com/uploads/files/clientalert010815.pdf (supporting the notion that an entity does not need to have intent to evade the Rule, and instead, the activity need only function like an evasion); *see infra* Part III.

29. *See infra* Part II; while the Rule's prohibitions also extend to investment in covered fund activities, this Note only addresses the challenges with proprietary trading.

30. *See infra* Part III.

31. *See infra* Part IV.

32. *See infra* Part VI.

33. ARNOLD & PORTER LLP, *supra* note 6, at 6.

34. *Id.*

comparison allowed each entity to create a plan to conform its proprietary trading activities to the requirements of the Rule, or in the alternative, to terminate or divest such activity by the Compliance Date.[35]

The specific compliance requirements vary depending on the size of the institution.[36] Smaller banking entities—those that either do not have investments in covered funds or have consolidated assets less than $10 billion—have very limited compliance requirements.[37] In fact, those smaller banking entities, sometimes called the "less active" entities[38], which do not engage in any covered activities—permitted proprietary trading and investing in hedge funds—are not required to establish a compliance program unless, or until, they begin engaging in such activities.[39] The smaller banking entities that have consolidated assets less than $10 billion and who engage in "modest" covered proprietary trading activities, have the option to incorporate the compliance requirements of the Final Implementing Rules into their *existing* compliance program—they can do this by adjusting their existing program and appropriately including references to the requirements of the Final Implementing Rules.[40] Banking entities that have more than $10 billion but less than $50 billion in consolidated assets, are required to adopt the general compliance program set forth by the Final Implementing Rules[41]—commonly known as the "six pillars."[42] More stringent compliance and reporting requirements[43]—in addition to what the six pillars require—apply to banking entities that have total

35. *Id.* at 5–6.

36. Final Rule § ____.20(a), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); ARNOLD & PORTER LLP, *supra* note 6, at 7–9.

37. ARNOLD & PORTER LLP, *supra* note 6, at 7.

38. Final Rule § ____.20(f), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

39. Ireland & Nathan, *supra* note 17.

40. Final Rule § ____.20(f), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014); Ireland & Nathan, *supra* note 17.

41. 12 C.F.R. §§ 44, 248, 351 (2015); 17 C.F.R. §§ 75, 255 (2015); Final Rule § ____.20(c)(2), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); Ireland & Nathan, *supra* note 17; DANIEL L. GOELZER, *supra* note 12.

42. ANNETE L. NAZARETH ET AL., DAVIS POLK & WARDWELL LLP, VOLCKER PROP TRADING PROVISIONS: HOW FIRMS ARE PREPARING 11 (June 15, 2015), http://www.davispolk.com/sites/default/files/2015-06-12_Volcker_Prop_Trading_Provisions_How_Firms_Are_Preparing.pdf.

43. *See* Ireland & Nathan, *supra* note 17 (indicating that the larger banking entities who engage in permitted proprietary trading, are to periodically provide the Regulators with reports regarding seven different quantitative metrics).

consolidated assets of $50 billion or more.[44]

As to the first pillar, written policies and procedures, many entities have taken a three-tiered approach with their structure.[45] The first tier includes a board-level policy, the second tier includes an entity-wide compliance manual, and the third tier has desk-specific policies and procedures.[46]

The second pillar, a system of internal controls, is designed to track trading activity and monitor for any instances of prohibited activity.[47] A large component of the internal controls system is determining the processes by which to communicate, internally and to the Regulators, those situations where prohibited activity has been, or may have been, identified.[48] Each banking entity must also assess the manner in which the required metrics will be calculated and reported to the Regulators.[49]

The third pillar sets out the expectation that banking entities will arrange their corporate governance in a manner that clearly and appropriately delegates responsibility and accountability for compliance with the Rule.[50] Banking entities are expected to determine who from their boards, and senior management, will be responsible for overseeing the various components of compliance.[51] Some of those delegated responsibilities include, arranging for training on the Rule and identifying the testing methods to be used for monitoring risky trading activity that

---

44. Final Rule § ____.20(c)(2), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); *see also* Ireland & Nathan, *supra* note 17 (noting that a foreign entity who has U.S. assets "as of the previous calendar year end of $50 billion or more" is also subject to increased compliance requirements). Additional entities may also be otherwise directed by regulators to comply with the enhanced requirements—these entities are simply notified by the relevant Regulator that they are to comply with the Enhanced Minimum Standards for Compliance Programs, set forth in Appendix B of the Rule. Final Rule § ____.20(c)(3), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); *see also* Final Rule Appendix B, 79 Fed. Reg. 5536, 5800–04 (Jan. 31, 2014) (detailing the additional minimum standards for an enhanced internal compliance program); ARNOLD & PORTER LLP, *supra* note 6, at 7.

45. Final Rule § ____.20(b)(1), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 11.

46. NAZARETH ET AL., *supra* note 42, at 11.

47. Final Rule § ____.20(b)(2), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 11.

48. NAZARETH ET AL., *supra* note 42, at 11.

49. *Id.*

50. Final Rule § ____.20(b)(3), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 11.

51. NAZARETH ET AL., *supra* note 42, at 11,14.

is in violation of the Rule.[52]

Independent testing and auditing, which comprise the fourth pillar, are periodically required to assess the effectiveness of the entire compliance program.[53] Such audits may be completed by qualified banking personnel, or by external auditors.[54] Any deficiencies found in the compliance program, or other violations of the Rule, must be appropriately resolved.[55]

The fifth pillar, training, requires banking entities to train senior management and those employees who work at the trading desks.[56] Trading desks are the units at the banking entity where "securities or other financial instruments are purchased or sold."[57] Such training is also necessary for any additional employees who would benefit from training on how to ensure that the compliance mechanisms are effectively implemented and followed.[58]

Recordkeeping, the sixth pillar, is in many ways one of the most important requirements.[59] This recordkeeping documentation serves to demonstrate compliance with the Rule.[60] Such documentation should be retained for a minimum of five years and submitted to Regulators upon their request.[61]

Banking entities under enhanced requirements have an additional responsibility that is not required of those entities subject only to the general compliance requirements.[62] The chief executive officers (CEOs) of those entities under enhanced requirements must, in writing, make

---

52. *Id.*

53. Final Rule § ____.20(b)(4), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 14.

54. Final Rule § ____.20(b)(4), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014)

55. ARNOLD & PORTER LLP, *supra* note 6, at 8.

56. NAZARETH ET AL., *supra* note 42, at 14; Ireland & Nathan, *supra* note 17.

57. Final Rule Appendix A, 79 Fed. Reg. 5536, 5797–800 (Jan. 31, 2014) (defining trading desk as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof."); Ireland & Nathan, *supra* note 17.

58. Final Rule § ____.20(b)(5), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 14; Ireland & Nathan, *supra* note 17.

59. *See* Final Rule § ____.20(b)(6), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014) (noting that records must be "sufficient to demonstrate compliance").

60. *Id.*; NAZARETH ET AL., *supra* note 42, at 14.

61. Final Rule § ____.20(b)(6), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 14.

62. Final Rule § ____.20(c), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014).

annual attestations regarding their institution.[63] These CEO attestations certify that the institution has an appropriate Rule compliance program in place that also accounts for processes by which to review and modify the program for continued compliance with the Rule.[64]

While the pillars of compliance themselves are straightforward, the standard by which compliance programs are to assess bank activity is riddled with exceptions.[65] The number of exceptions to the prohibited activities complicates institutions' ability to clearly determine whether any improper trades were made.[66] Additionally, because the Rule does not provide any definitive criteria for clearly identifying impermissible high-risk assets or high-risk trading strategies,[67] it is unclear how banking entities are expected to know when their trading activity is potentially in violation of the Rule. In addition to a lack of a clear standard for identifying improper activity, the Regulators have even broader discretion in deciding whether certain activity is a violation of the Anti-Evasion Provision.[68] This lack of clarity presents the risk that the Rule and its Anti-Evasion Provision will be inconsistently applied and enforced.[69] However, the reporting requirement under which banking

63. Final Rule Appendix B, 79 Fed. Reg. 5536, 5803 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 14.

64. Final Rule § ____.20(c), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); NAZARETH ET AL., *supra* note 42, at 14.

65. *See* Ireland & Nathan, *supra* note 17 ("The risk to a firm engaging in exempted activities are only increased by the fact that the conditions that would cause an otherwise permitted activity to be impermissible are defined somewhat subjectively.").

66. Deena Zaidi, *The 'Fine Print' of the Volcker Rule*, THE MARKET MOGUL (Aug. 17, 2015), http://themarketmogul.com/fine-print-volcker-rule/.

67. Final Rule § ____.7(a)(2), 79 Fed. Reg. 5536, 5786–87 (Jan. 31, 2014); *see also* Kobi Kastiel, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, THE VOLCKER RULE: A FIRST LOOK AT KEY CHANGES 2 (Dec. 18, 2013), http://www.skadden.com/sites/default/files/publications/2013-12-18-the-volcker-rule-a-first-look-at-key-changes.pdf (acknowledging that the Rule "does not provide any definitive criteria for identifying those assets or strategies.").

68. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012) (describing the level of discretion, "reasonable cause," given to Regulators for identifying violations of the Anti-Evasion Provision).

69. *See* Dodd-Frank § 619, 12 U.S.C. § 1851(b)(2)(B)(ii) (2012) (noting that the Regulators are to "consult and coordinate with each other" to ensure that the Final Implementing Rules from each Regulator are comparable with one another); *see also* Deanna J. Hayes, *Will the Volcker Rule's Complexity Be Its Undoing?* U. PA. REG. BLOG (July 22, 2015), http://www.regblog.org/2015/07/22/hayes-volcker-rule-complexity/ (pointing out that the Regulators may have differing approaches for how to handle potential problems with proprietary trading, given the lack of clearly defined activities, which may lead to potential conflict amongst the five agencies).

entities must report a specific set of data to the Regulators, may serve as an effective tool for the Regulators to better assess how banking entities are conducting their trading activity and to provide the necessary guidance, over time, for best identifying violations of the Rule.[70]

The quantitative metrics reported by banking entities are intended to enable the Regulators to evaluate whether such reporting measures are adequate for their process of accurately identifying and differentiating between appropriate and prohibited trading activity.[71] All seven reporting metrics are to be calculated daily for each trading desk, and for those banking entities with assets greater than $50 billion, reported monthly.[72] Other banks will only report quarterly.[73] When submitting their final reports to the Regulators, each entity will need to calculate an aggregated figure based on the metrics collected from each of their trading desks.[74] Such measurements are used to monitor each entity's trading activity and subsequently evaluate whether such activities are consistent with the requirements set forth by the Rule.[75] Upon evaluating the first set of data, Regulators will evaluate what changes, if any, are required to enhance the metrics reporting requirement and fulfill the requirement's purpose of facilitating the distinction between improper and permissible trading activity.[76]

---

70. CHRIS COLLINS ET AL., IMPLEMENTING VOLCKER: WHO SETS THE STANDARDS FOR COMPLIANCE AND REPORTING? CROSSINGS: THE SAPIENT J. OF TRADING & RISK MGMT. 6–7 (Spring 2014), http://www.sapient.com/content/dam/sapient/sapientglobalmarkets/pdf/thought-leadership/SGM_Crossings_Spring2014.pdf; *see also* MAYER ET AL., *supra* note 10 (suggesting that the data collected from, and reported by, the banking entities will be useful for identifying whether violations have occurred).

71. *See* Final Rule Appendix A (identifying the seven quantitative measures as risk and position limits and usage; risk factor sensitivities; value-at-risk and stress VaR; comprehensive profit and loss attribution; inventory turnover; inventory aging; and customer-facing trade ration); COLLINS ET AL., *supra* note 70, at 6–7.

72. Final Rule Appendix A (defining trading desk as, "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof"); *see also* Ireland & Nathan, *supra* note 17.

73. Final Rule § ____.20(d)(3), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); COLLINS ET AL., *supra* note 70, at 6.

74. Chris Kentouris, *The Volcker Rule: Managing the Seven Deadly Metrics*, FINOPS REP. (July 30, 2015), http://finops.co/trading/the-volcker-rule-managing-the-seven-deadly-metrics/.

75. Final Rule Appendix A, 79 Fed. Reg. 5536, 5797–5800 (Jan. 31, 2014).

76. COLLINS ET AL., *supra* note 70, at 6–7.

III. PROBLEMS WITH THE ANTI-EVASION PROVISION

Although the Rule as a whole is problematic,[77] one of the biggest concerns is that the vague distinction between permissible activities and proprietary trading will lead to inconsistent application of the Rule.[78] This lack of clarity may result in conflicts of interest amongst these agencies[79] as well as present a further challenge to the banking entities as they establish appropriate protocols to safeguard themselves from accusations of violating the Rule.[80]

Specifically, the Anti-Evasion Provision, which grants the Regulators authority to disallow permitted activities that "function as an evasion" of the Rule, does not provide a clear definition of, or guidelines for, what actually constitutes an evasion.[81] Additionally, the "reasonable cause"[82] standard is ambiguous and grants the Regulators extensive discretionary power in determining whether impermissible, functionally evasive activity has occurred.[83] Lastly, the absence of bright-line rules as to how the Regulators will identify and enforce violations of the Anti-Evasion Provision reflects the potential for conflict amongst the Regulators caused by differing interpretations of the Provision.[84]

---

77. *See* SULLIVAN & CROMWELL LLP, *supra* note 13, at 6 (acknowledging that the final regulations present numerous interpretive and implementation challenges); see also Zaidi, *supra* note 66 (highlighting the ambiguous language, unclear definitions, and challenges of having numerous exceptions to the limits on proprietary trading).

78. *See* SULLIVAN & CROMWELL LLP, *supra* note 13, at 6 (noting that the Rule does not have any way for the banking entities to seek "coordinated guidance" from the Regulators, and indicating that there was uncertainty as to how the Regulators would coordinate with one another as to matters of Rule interpretation and implementation).

79. Zaidi, *supra* note 66.

80. *See id.* (stating that the numerous requirements of the rule, and the exceptions, have made the implementation process more complex, and that the banks' task to "make this fine distinction between core banking functions and proprietary trading every single day" could be both troublesome and costly).

81. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012).

82. *Id.*

83. MAYER ET AL., *supra* note 10, at 2 (noting that ". . . 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.").

84. *See* Zaidi, *supra* note 66 (making note that amongst the Regulators there is a "high probability of inconsistency and lack of coordination that could result in conflict of interests").

A. Identifying Evasion

The Regulators must establish how they will determine whether a banking entity has, in fact, evaded the Rule, and even more importantly, how they will identify whether the alleged evasions were intentional or accidental.[85] Because there are many exceptions to the ban on proprietary trading, along with additional Prudential Backstops limiting the exceptions, it is unclear how banking entities can maintain appropriate controls to avoid accidental evasion of the Rule.[86]

The Anti-Evasion Provision allocates to Regulators the authority to take action where there is "reasonable cause to believe"[87] that a banking entity has engaged in an activity that "functions as an evasion of the requirements" of the Rule.[88] Based on the wording of the Anti-Evasion Provision, it is unclear what "functions as an evasion" actually means.[89] Black's Law Dictionary defines evasion as "a subtle endeavoring to set aside truth or to escape the punishment of law."[90] The Merriam-Webster dictionary defines evasion as "the act of avoiding something that you do not want to do or deal with or, a statement or action that avoids directly dealing with something."[91] Based on both dictionary definitions, the word "evasion" implies that a person consciously and purposefully *intends* to avoid something.[92] By adding, "functions as an evasion," the language of the Anti-Evasion Provision appears to encompass all activity that results in evasion, regardless of intent.[93] Failure to specify in the Anti-Evasion Provision whether evasive activities arise only out of gross negligence or a willful intent to violate

85. MAYER ET AL., *supra* note 10, at 2. While the Provision as it stands holds banking entities accountable for both intentional and accidental "evasions," being able to properly identify the banking entity's intent, or lack thereof, may assist Regulators with determining a "fair" penalty, as well as help banking entities establish adequate defenses to their alleged offenses. *See id.* (noting that the *offensive* activity "only needs to function like an evasion, or otherwise violate the Volcker Rule") (emphasis added).

86. Dodd-Frank § 619, 12 U.S.C. § 1851(d)(2) (2012) (listing the limitations on the permitted activities); MAYER ET AL., *supra* note 10.

87. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012).

88. *Id.*

89. *Id.*

90. *Evasion*, BLACK'S LAW DICTIONARY, http://thelawdictionary.org/evasion/ (last visited Oct. 28, 2015).

91. *Evasion*, MERRIAM-WEBSTER.COM, http://www.merriam-webster.com/dictionary/evasion (last visited Oct. 13, 2015).

92. BLACK'S, *supra* note 90; MERRIAM-WEBSTER, *supra* note 91.

93. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012).

the Rule means that banking entities are subject to penalty even for accidental violations.[94]

Identifying evasion then, perhaps rests on whether the questioned activity has triggered the Prudential Backstops.[95] Additionally, banking entities may intentionally try to evade the Rule's prohibition on proprietary trading and covered fund activities "by shifting activity and investments to subsidiaries,"[96] which will be important to examine when evaluating whether enforcement action should be taken. The ambiguous nature of the Anti-Evasion Provision's "functions as an evasion" language, leaves unanswered the questions of what exactly the Regulators are looking for and what consequences banking entities will face when, despite good faith efforts to comply, their trading activity nonetheless violates the Rule.[97]

B. What is "Reasonable Cause?"

As written, the Anti-Evasion Provision only requires that Regulators have "reasonable cause" in order to allege that there was a violation.[98] Neither the Anti-Evasion Provision, nor the Final Implementing Rules, however, provide any additional guidance as to what specific activity would warrant a Regulator's nullification of that entity's investment activity.[99] This poses a significant problem for banking entities that need the certainty of knowing in advance what activities may subject them to regulatory action[100] for violating the Anti-

94. MAYER ET AL., *supra* note 10, at 2 (articulating that a banking entity likely does not need to have intended to evade the Provision in order to be held liable).

95. *See* Final Rule § ____.7, 79 Fed. Reg. 5536, 5786–87 (Jan. 31, 2014) (laying out the exceptions to the exemptions from the prohibitions of the Rule); *see also* SULLIVAN & CROMWELL LLP, *supra* note 13, at 118 (noting that these overriding limitations are referred by the Regulators as "prudential backstops").

96. MAYER ET AL., *supra* note 10, at 2.

97. *See id.* at 1 (noting that "in the absence of further clarification or precedent, the anti-evasion provision raises significant interpretative challenges for industry participants and practitioners.").

98. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

99. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

100. *See* Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014) (noting that banking entities themselves must also, upon "discovery" of a potential violation, "promptly terminate the activity and, as relevant, dispose of the investment.").

Evasion Provision.[101] The "reasonable cause" standard does not appear to be a particularly difficult threshold to reach.[102] Because the Regulators can broadly interpret "reasonable," The Anti-Evasion Provision affords the Regulators a great deal of interpretative power to decide what trading practices and activities are evasions of the Rule.[103] The Rule does not specify the grounds on which a regulator would have "reasonable cause" to believe that proprietary trading activity had occurred, which also leaves banking entities in the dark as to the circumstances under which their trading activity may be held to be evasive.[104]

With such an extensive range of discretion embedded in the "reasonable cause" standard, the Regulators when scrutinizing an entity's activity, may have differing interpretations of what activity is impermissible.[105] Additionally, the statute explicitly mandates an affirmative duty of banking entities to self-report any violations of the Rule "upon discovery,"[106] which places the banking entities in murky territory with respect to recognizing when they may have evaded the Rule. Without a clear understanding of the criteria that Regulators will use to identify violations, banking entities may not be able to adequately fulfill their duty to self-report violations.

The ambiguous Anti-Evasion Provision results in uncertainty as to how the Regulators will justify legal action based on "reasonable cause,"[107] whether the Regulators will make joint decisions with regard to interpretative issues, and how significant challenges to the interpretation of the Provision will be resolved.[108]

C. Enforcement Concerns

The Anti-Evasion Provision provides that the Regulators' anti-evasion enforcement authority is in addition to their already established

---

101. MAYER ET AL., *supra* note 10, at 1–2.

102. *Id.* at 2.

103. *Id.* (noting that "reasonable belief . . . can provide for a wide spectrum of interpretation when a Regulatory Agency is scrutinizing an investment or activity.").

104. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012).

105. MAYER ET AL., *supra* note 10, at 1–2.

106. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); Final Rule § ___.21(a), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

107. Final Rule § ___.21(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

108. SULLIVAN & CROMWELL LLP, *supra* note 13, at 18.

enforcement authorities.[109] Banking entities may be subject to criminal and civil penalties by multiple regulators, since the Anti-Evasion Provision does not set forth a standard penalty for all Regulators.[110] As a result, banking entities may face both increased monetary fines and administrative action.[111] The Anti-Evasion Provision states that it provides the Regulators with anti-evasion enforcement authority—though this grant of authority is not clearly defined—which, includes a new power to nullify trading or investment activities, and to force a banking entity to stop proprietary trading, provided that the Regulator has "reasonable cause" to believe that the entity engaged in activity that functioned as an evasion.[112] The Anti-Evasion Provision also relies on the fact that each of the Regulators has their own enforcement capabilities.[113] Because the Rule is predominantly a banking rule, the SEC and CFTC have the least power and responsibility to enforce the Rule.[114] However, many institutions are subject to regulation by several of the five Regulators.[115]

---

109. Dodd-Frank § 619, 12 U.S.C. § 1851(e)(2) (2012); Memorandum, Simpson Thacher & Bartlett LLP, The Volcker Rule And Private Funds: Final Regulations Are Out 17 (Dec. 16, 2013), http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1672.pdf.

110. CTR. FOR THE STUDY OF FIN. MKT EVOLUTION: *Who Will Enforce The Volcker Rule, And How?* (July 23, 2015), http://csfme.org/News/TabId/120/ArtMID/983/ArticleID/306/Who-Will-Enforce-the-Volcker-Rule-and-How.aspx.

111. CREDIT UNION NAT'L ASS'N., *Truth in Lending Act and Regulation Z* 4–5 (2015), http://training.cuna.org/self_study/regtrac/member_regtrac/download/M4_SEC1.pdf.

112. MAYER ET AL., *supra* note 10, at 1; MILBANK, CLIENT ALERT: OUT OF THE FRYING-PAN INTO THE FIRE: ENFORCEMENT OF THE VOLCKER RULE BY THE FIVE AGENCIES 2–3 (July 21, 2015), http://www.milbank.com/images/content/2/1/21066/Out-of-the-Frying-Pan.pdf.

113. CTR. FOR THE STUDY OF FIN. MKT. EVOLUTION, *supra* note 110.

114. *See id.* (pointing out that while many financial institutions have functions that are overseen by the SEC and CFTC, the fact that their Volcker regulations are in accordance with the BHC Act, these agencies may not be able to use the enforcement methods to which they are accustomed, when enforcing the Rule); *see also* GIBSON, DUNN, & CRUTCHER LLP, PUB'N: THE FINAL VOLCKER RULE 2 (Dec. 13, 2013), http://www.gibsondunn.com/publications/documents/TheFinalVolckerRule.pdf (indicating that differing Agency enforcement approaches may present challenges to those banking entities that in addition to bank regulators, are also subject to "activities-based supervision" such as swap dealing).

115. *See* Henry Engler, *Volcker Rule Enforcement: Regulators Attempt a United Front* (Feb. 19, 2014), http://blogs.reuters.com/financial-regulatory-forum/2014/02/19/volcker-rule-enforcement-regulators-attempt-a-united-front/ (providing examples of where a banking entity may be regulated by more than one agency; for instance the article notes that where a derivative transaction originates within the "banking" side of the firm, but then hedges with a broker-dealer, both the OCC and SEC may intervene to evaluate whether the activity was proprietary or not).

For violations of the Anti-Evasion Provision, in addition to being permitted to mandate termination of the questionable trading and investment activity, each of the Regulators can rely on its existing powers, including imposing hefty monetary penalties for violations of any law or regulation.[116] The potential conflict between the Regulators arises when multiple Regulators,[117] all of whom could impose penalties in the event of an alleged evasion of the Rule, have some authority over a single institution.[118] Without any bright-line rules as to what activities fall into the exceptions granted to the ban on proprietary trading, the Regulators may differ in their interpretation of improper activity and disputes may arise.[119] Given the potential double liability, there is a risk that banking entities may also try to shift their investment and trading activity to other entities that are not subject to the Rule's regulations, namely the shadow banking system, which is unregulated.[120]

If claims for violating the Anti-Evasion Provision are brought against them, another necessary consideration for banking entities is the most effective way in which they can prove to the Regulators that their activity complies with the Rule.[121] It is important for banking entities to both analyze how investment activity will most appropriately be tracked and assess how adequate records will be best maintained—this will make sure that all trading activity is within the boundaries set by the Prudential Backstops and the Rule.[122] Strict adherence to the compliance program

---

116. Peter J. Henning, *Don't Expect Eye-Popping Fines for Volcker Rule Violations*, N.Y. TIMES (Dec. 16, 2013), http://dealbook.nytimes.com/2013/12/16/dont-expect-eye-popping-fines-for-volcker-rule-violations/?_r=0.

117. *See* Engler, *supra* note 115 (providing examples of where a banking entity may be regulated by more than one agency; for instance, the article notes that where a derivative transaction originates within the "banking" side of the firm, but then hedges with a broker-dealer, both the OCC and SEC may intervene to evaluate whether the activity was proprietary or not).

118. CTR. FOR THE STUDY OF FIN. MKT. EVOLUTION, *supra* note 110.

119. MAYER ET AL., *supra* note 10, at 2; *see also* GIBSON, DUNN, & CRUTCHER, *supra* note 114, at 2 (indicating that "Because the Final Rule's distinction between permitted and prohibited proprietary trading activities is so principles-based . . . [it] may give rise to widely differing Agency enforcement approaches.").

120. *See Much Ado About Trading*, THE ECONOMIST (July 25, 2015), http://www.economist.com/news/finance-and-economics/21659671-next-great-regulation-tame-banks-now-place-much-ado-about-trading (referring to the shadow banking system, to which trading may be shifted since that sector is unregulated).

121. MAYER ET AL., *supra* note 10, at 3.

122. *See* ARNOLD & PORTER LLP, *supra* note 6, at 8–9 (describing that for banking entities with more than $50 billion, reporting will be done every month while all other entities will report quarterly. All banking entities will need to submit documentation that confirms that

requirements will likely allow banking entities to present to Regulators investment activity tracking information as well as identify those individuals responsible for monitoring trading activity and documenting all compliance measures.[123]

IV. GUIDANCE FOR REFORMING AND CLARIFYING THE ANTI-EVASION PROVISION

Preserving the safety and soundness of banks lies at the heart of all banking regulations.[124] Risk management is facilitated through the use of internal controls and compliance measures such as the ones mandated in the Final Implementing Rules.[125] There is an expectation that banking entities refrain from engaging in activity that will be disruptive to the financial stability of the United States.[126] In order to limit any such disruption, the Anti-Evasion Provision gives Regulators broad discretion to invalidate and terminate any activity that by "reasonable cause"[127] is deemed an evasion of the Rule's prohibited activities.[128] The Rule details what internal compliance program requirements are necessary to avoid violating the Rule's prohibitions,[129] but it does not provide specific guidelines that outline exactly what activities are prohibited and the manner in which Regulators can appropriately enforce the Anti-Evasion Provision.[130]

As the Rule's effectiveness is evaluated, policymakers may consider providing a higher standard than "reasonable cause" by which Regulators enforce the Anti-Evasion Provision.[131] Imposing a higher

---

each sponsored fund is not actually a covered fund—detailed records must be maintained for at least five years to demonstrate compliance with the Rule).

123. Final Rule § ____.20(b), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); ARNOLD & PORTER LLP, *supra* note 6, at 8–9.

124. MAYER ET AL., *supra* note 10, at 1.

125. *See* ARNOLD & PORTER LLP, *supra* note 6, at 7–9 (overviewing the various risk management tools to be implemented by the banking entities).

126. Final Rule § ___.7, 79 Fed. Reg. 5536, 5786–87 (Jan. 31, 2014).

127. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014); MAYER ET AL., *supra* note 10, at 2.

128. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014); MAYER ET AL., *supra* note 10, at 2.

129. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

130. MAYER ET AL., *supra* note 10, at 1–2.

131. *See id.* at 2 (indicating that the current standard "to support a regulatory enforcement is not high.").

standard would require a statutory change; however, it would help to reduce the amount of discretion allowed to Regulators for determining whether a banking entity's trading activity "functions as an evasion" and thus, provide more uniformity across Regulators with respect to Rule and Anti-Evasion Provision enforcement.[132] Additionally, policymakers may benefit from analyzing TILA's Regulation Z and utilizing the Financial Stability Oversight Council ("FSOC") for guidance on how to best reform the Rule for enhanced compliance.[133]

A. Learning From TILA's Regulation Z

A close look at other anti-evasion provisions such as Regulation Z,[134] the implementing regulation of TILA,[135] may prove useful when considering how the Anti-Evasion Provision may be improved. For instance, revisions to the Provision may include adopting a "safe harbor" provision similar to that contained in Regulation Z.[136]

The primary function of TILA is to promote the informed use of consumer credit—in order to do so, certain disclosures must be made to inform consumers about the costs associated with borrowing.[137] Like the Rule, where the type of compliance measures required depend on the size of the entity,[138] Regulation Z is formatted such that the specific rules by which creditors must abide, depend on the type of credit (open-end or closed-end) being offered.[139] With respect to high-cost mortgage loans,[140] Regulation Z's anti-evasion provision provides that where credit

---

132. *See id.* (making clear that there will be "a wide spectrum of interpretation when a Regulatory Agency is scrutinizing an investment or activity.").

133. Regulation Z, 12 C.F.R. § 226 (2016); U.S. DEP'T OF TREASURY, *Frequently Asked Questions: What is the Financial Stability Oversight Council (FSOC) and What Does It Do?* (2015) [hereinafter FSOC], http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx.

134. Regulation Z, 12 C.F.R. § 226 (2016).

135. 15 U.S.C. §§ 1601-1667f.

136. *See* Regulation Z, 12 C.F.R. §226.36(e)(2)–(4) (2016) (detailing the "safe harbor," or presumption of compliance, on which loan originators may rely provided certain conditions are met); MAYER ET AL., *supra* note 10, at 4.

137. CONSUMER FIN. PROT. BUREAU CONSUMER LAWS AND REGULATIONS, TILA 5 (June 2013) [hereinafter CFPB CONSUMER LAWS], http://files.consumerfinance.gov/f/201306_cfpb_laws-and-regulations_tila-combined-june-2013.pdf.

138. ARNOLD & PORTER LLP, *supra* note 6, at 7.

139. CFPB CONSUMER LAWS, *supra* note 137, at 3.

140. See Truth in Lending Act, 12 C.F.R. §§ 1024, 1026 (2016) (defining "high-cost

is secured by a consumer's principal dwelling, which does not meet the definition of open-end credit as defined in § 226.2 of TILA, a creditor may not attempt to evade the requirements by structuring a home-secured loan as an open-end plan.[141] The provision provides a clear structure for what will be considered an evasion; this not only better guides consumers with their decision-making, but also it assists the Consumer Financial Protection Bureau ("CFPB") in exercising its enforcement authority.[142] In fact, the Fed commented that Regulation Z's anti-evasion provision was meant to reach those instances where a creditor had "no reasonable expectation that the substance of the transaction warranted its form," which implies that the totality of the circumstances must be assessed, as opposed to simply relying on what a particular trading activity or investment is called.[143] Although both Regulation Z and the Rule's Anti-Evasion Provision require an interpretation of what is reasonable, the standard of Regulation Z is "different, and arguably higher, than the Volcker Rule's anti-evasion provision."[144]

The Anti-Evasion Provision currently does not set forth clear criteria as to how evasion is to be defined or assessed.[145] Rather, the Anti-Evasion Provision merely describes the Regulators' ability to intervene for any activity which functions as an evasion or otherwise violates the restrictions set forth in the Rule.[146] TILA, however, includes both criminal and civil liability provisions that account exclusively for willful violations of the requirements set out in TILA.[147] Willful violations under TILA's criminal liability provisions could result in fines up to

---

mortgage loans" as home-equity mortgage loans with high interest rates or high fees).

141. Regulation Z, 12 C.F.R. § 226.35(4) (2016).

142. THE FEDERAL RESERVE, CONSUMER COMPLIANCE HANDBOOK: REGULATION Z: TRUTH IN LENDING ACT 2 (Nov. 2015), http://www.federalreserve.gov/boarddocs/supmanual/cch/til.pdf [hereinafter Consumer Compliance Handbook]. The Dodd-Frank Act amended TILA and also granted rulemaking authority to the Consumer Financial Protection Bureau (CFPB). *Id.*

143. MAYER ET AL., *supra* note 10, at 4 (stating that "Anti-evasion provisions have the common foundation allowing enforcement agencies to be able to make a substance-over-form determination"); *see also* ALSTON & BIRD, TAX BLOG: SUBSTANCE OVER FORM? (Sept. 28, 2011), http://www.alstontax.com/substance-over-form/ (describing the "substance over form" doctrine as a way to say that some 'facts' that are relevant for tax purposes are mostly controlled by common law fact finding and not labels).

144. *See* MAYER ET AL., *supra* note 10, at 4.

145. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012).

146. *Id.*

147. CREDIT UNION NAT'L ASS'N., *supra* note 111.

$5,000 and/or imprisonment for up to one year, whereas in a civil suit, creditors may be required to pay monetary damages and restitution.[148] These provisions clearly demarcate the types of acts that would warrant criminal or civil liability; such specificity is a practical tool to inform creditors of the ways in which they may be held liable.[149]

As previously discussed, courts are not inclined to hold a creditor liable for damages where the defendant has shown a sincere, good faith, effort to comply with TILA.[150] Similarly detailed criminal and civil liability provisions would be a positive addition to the Anti-Evasion Provision, and would be advantageous to both the Regulators and banking entities. These provisions would clarify the circumstances under which a banking entity may be required to pay a fine in addition to being ordered to cease and desist from any prohibited activity.[151]

Additionally, an important section of Regulation Z that prohibits steering,[152] outlines a review process by which transactions will be evaluated to see whether they are "in the consumer's interest."[153] Transactions are compared to all other possible loan offers available to that consumer by the same loan originator at that time.[154] As it can be

148. *See* CFPB CONSUMER LAWS, *supra* note 137, at 40 (noting that enforcement agencies may order restitution when disclosure errors to consumers result from a clear and consistent pattern of violations, gross negligence, or a willful violation that was intended to mislead the person to whom the credit was extended).

149. *Id.* at 39–40.

150. Welmaker v. WT Grant Co., 365 F. Supp. 533 (N.D. Ga. 1972) (holding that the defendant did not intentionally violate TILA as he had made good faith efforts to comply with the Act); *see* Consumer Compliance Handbook, *supra* note 119, at 4 ("Good faith compliance with the commentary protects creditors from civil liability under TILA."); CREDIT UNION NAT'L ASS'N, *supra* note 111.

151. *See* Final Rule § ___.21(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014) (noting that the Regulators "may take *any* action permitted by law to enforce compliance . . . including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.") (emphasis added). Currently, the lack of bright-line rules makes it difficult for banking entities to not only ascertain under what circumstances they may be held in violation of the Anti-Evasion Provision, but also the specific penalties to which they may be subject. *Id.*; Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012).

152. *See* MORRISON & FOERSTER LLP, CLIENT ALERT: FINAL RULE GOVERNING LOAN ORIGINATOR COMPENSATION PRACTICES 8 (Aug. 31, 2010) [hereinafter MORRISON & FOERSTER, LOAN ORIGINATOR], http://media.mofo.com/files/Uploads/Images/100831FinalRule.pdf (defining steering as, "advising, counseling, or otherwise influencing a consumer to accept a particular transaction.").

153. *Id.* at 9.

154. *Id.*

difficult to determine whether a transaction will be helpful or detrimental to the consumer's interest, loan originators are encouraged to utilize the safe harbor provided by Regulation Z.[155] This safe harbor essentially recognizes three different types of transactions which would safeguard the loan originator from enforcement action.[156] So long as the transaction information is presented according to the criteria stated in the provision, along with the loan originator's "good faith belief"[157] that the loan options presented are those for which the consumer actually qualifies, the loan originator will be protected.[158]

Like Regulation Z's prohibition against steering, the Rule's Prudential Backstops address the types of activities that will be considered violations of the Rule, such as anything that creates conflicts of interests with clients or results in "material exposures to high-risk assets."[159] As previously highlighted, there is a great amount of ambiguity surrounding how such conflicts and "material exposures" are to be determined both by the banking entities as they engage in such activity, and for the Regulators in terms of how they enforce the Anti-Evasion Provision.[160] Lack of clarity regarding the definition of evasive activity[161] may indicate that a safe harbor provision like that in Regulation Z[162] would be appropriate for the Rule.

Compliance is presumed if transactions fall within the safe harbor in Regulation Z.[163] Likewise, a safe harbor provision for the Rule might outline specific activities or categories of activities that are in the best interest of the consumer and do not pose a risk to the financial stability of the United States and thus, are compliant with the Prudential

155. Regulation Z,12 C.F.R. §226.36(e)(2)–(4) (2016); MORRISON & FOERSTER, LOAN ORIGINATOR, *supra* note 152, at 10–11.

156. *Id.*

157. *Id.*

158. *Id.*

159. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(d)(2)(A) (2012); *see also* GOELZER, *supra* note 12.

160. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014).

161. *Id.*; *see also* Zaidi, *supra* note 66 (emphasizing that there are a "lack of clear distinctive activities.").

162. Regulation Z, 12 C.F.R. §226.36(e)(2)–(4) (2016); *see also* MORRISON & FOERSTER, LOAN ORIGINATOR, *supra* note 152, at 10 (describing the types of transactions falling within the safe harbor).

163. THE FEDERAL RESERVE: COMPLIANCE GUIDE TO SMALL ENTITIES, REGULATION Z: LOAN ORIGINATOR COMPENSATION AND STEERING, (Aug. 2, 2013) [hereinafter THE FEDERAL RESERVE], http://www.federalreserve.gov/bankinforeg/regzcg.htm.

Backstops.[164] Such detailed information may also include extremely precise metric measuring, reporting, and assessment methods—if a banking entity can show that they in good faith implemented the stated methods, their activity can fall within the safe harbor. Specific criteria, which directly outline what is and is not permissible, will provide banking entities an effective system by which to assess their compliance and allow the safe harbor to be met.[165] As in Regulation Z, a good faith clause would be advisable so as to minimize the claims brought against banking entities for unintentional evasive activity since "prohibited activities . . . are in some cases extremely difficult to distinguish from permitted activities."[166]

Although the notion of good faith is not explicitly stated in the Anti-Evasion Provision, the strict requirements that mandate internal controls such as verification and documentation of all activity, reporting of metrics, and comprehensive training regarding compliance, are all intended to prevent evasion, as these measures "help monitor potential evasions of the prohibitions and restrictions" of the Rule.[167] The substance-over-form doctrine that lies at the core of all anti-evasion provisions[168] will mean that any claims made against a banking entity will be reviewed on a case-by-case basis, utilizing all of the facts and circumstances presented regarding the nature of the offending activity.[169] Similar to how loan originators must demonstrate that their loan transactions adhere to the criteria set forth in Regulation Z's safe harbor section, the Regulators could examine the entity's adherence to the Rule's internal monitoring and reporting requirements to assess whether the entity in good faith attempted to comply with the Anti-Evasion Provision.[170] Banking entities can be required to present comprehensive

164. Dodd-Frank § 619, 12 U.S.C. § 1851(d)(2)(A); GOELZER, *supra* note 12.

165. THE FEDERAL RESERVE, *supra* note 163.

166. SULLIVAN & CROMWELL LLP, *supra* note 13, at 3.

167. MAYER ET AL., *supra* note 10, at 2; David H. Carpenter and M. Maureen Murphy, *The Volcker Rule: A Legal Analysis*, Congressional Research Service, R43340 Summary (Mar. 27, 2014), https://www.fas.org/sgp/crs/misc/R43440.pdf.

168. *See* MAYER ET AL., *supra* note 10, at 4 (stating that "Anti-evasion provisions have the common foundation allowing enforcement agencies to be able to make a substance-over-form determination.").

169. MAYER ET AL., *supra* note 10, at 2.

170. PWC LLP, FS REGULATORY BRIEF: THE VOLCKER RULE: HOW MUCH FAITH IS GOOD FAITH? (2012), http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/pwc-volcker-rule-food-faith-compliance.pdf (illustrating examples of tangible actions that banking entities may use to demonstrate "good faith").

documentation, or "business justification," demonstrating that their activity was within the scope of permissible activity.[171] Given that banking entities are already expected to maintain adequate records for five years, presenting such justification to show good faith compliance with the Rule could help to eliminate unnecessary enforcement action for activity that was in no way meant to evade the Rule's requirements.[172]

B. Utilizing FSOC

The Regulators have the ultimate authority for interpreting which activity is impermissible or evasive.[173] Where there is uncertainty and lack of clarity, the Regulators may benefit from having a mediator assist with interpretation and help to streamline the enforcement process so as not to be unfair or inconsistent.[174] FSOC, which is responsible for identifying risks to the financial stability of the United States and responding to such threats to financial stability, may be in the best position to serve as mediator.[175] Another possible mediator could be the Federal Financial Institutions Examination Council ("FFIEC"), an interagency body that has the authority to establish "uniform principles, standards, and report forms" for examining financial institutions by the FRB, FDIC, OCC, CFPB, and the National Credit Union Administration.[176] The FFIEC can also make recommendations that would provide more uniformity in the supervision of financial institutions.[177] In theory, FFIEC appears to have vested in it the power to provide the uniformity for enforcement amongst Regulators that the Anti-Evasion Provision currently lacks. However, because the FFIEC does

171. MAYER ET AL., *supra* note 10, at 4.

172. Final Rule § ____.20(b)(6), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); *see also* ARNOLD & PORTER LLP, *supra* note 6, at 8–9 (highlighting that entities will need to submit documentation that confirms that each sponsored fund is not actually a covered fund, and noting that detailed records must be maintained for at least five years to demonstrate compliance with The Rule).

173. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5796–97 (Jan. 31, 2014); MAYER ET AL., *supra* note 10, at 2.

174. *See* SULLIVAN & CROMWELL LLP, *supra* note 13, at 17–18 (outlining some concerns with respect to coordination between Regulators—one of them being, to whom the regulators will direct any interpretative questions).

175. FSOC, *supra* note 133.

176. FFIEC: FED. FIN. INST. EXAMINATION COUNCIL, *About the FFIEC: Mission*, http://www.ffiec.gov/about.htm.

177. *Id*.

not include the SEC, which is also a critical player in the Final Implementing Rules and the Anti-Evasion Provision, utilizing the FFIEC as a mediator may not adequately resolve the existing enforcement inconsistencies.[178]

As a mediator, FSOC could step in to clarify best practices for the banking entities to ensure that their activity is not at risk of being considered an evasion of the Rule, as well as to provide additional and stricter standards to the Regulators to aid with enforcement.[179] Without more consistency, banking entities may face dual action from the various Regulators.[180] While the Regulators acknowledge that a banking entity may at times be subject to multiple Regulators' authority, they have repeatedly "rejected the idea of having a lead enforcer or interpreter of the Volcker Rule regulations" and instead, have opted to "coordinate their activities" in an effort to "limit duplicative actions and undue costs and burdens."[181] Such duplicative administrative action and civil money penalties will inevitably pose an undue cost and burden on U.S. financial institutions, which could lead to financial distress and present the type of risk to the financial stability of the United States that FSOC ultimately seeks to prevent.[182]

Given that the Regulators may differ in their application of "reasonable cause"[183] when identifying evasive activity, it may also be advisable to designate an interpretative mediator. FSOC, which conducted a 2011 study[184] regarding the Rule's implementation, may be

178. *Id.*

179. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 112, 12 U.S.C. § 1851 (2012) (laying out the FSOC's charge to identify risks to the financial stability of the United States).

180. Whitehead, *supra* note 19.

181. MAYER ET AL., *supra* note 10, at 4.

182. Whitehead, *supra* note 19.

183. Final Rule § ___.21(a)–(b), 79 Fed. Reg. 5536, 5797 (Jan. 31, 2014); MAYER ET AL., *supra* note 10, at 4.

184. *See generally* FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUND & PRIVATE EQUITY FUNDS (Jan. 2011), www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.; *see also* SHEARMAN & STERLING, CLIENT PUBLICATION: FSOC STUDY ON IMPLEMENTING THE VOLCKER RULE—A SERIES OF MISSED OPPORTUNITIES AND SOME SURPRISES (Jan. 2011), http://www.shearman.com/~/media/files/newsinsights/publications/2011/01/fsoc-study-on-implementing-the-volcker-rule—a-s__/files/view-full-memo-fsoc-study-on-implementing-the-vo__/fileattachment/fia012411fsocstudyonimplementingthevolckerrule.pdf (summarizing and reviewing the FSOC study's recommendations).

the most appropriate party to serve as an interpreter when the Regulators are unsure of whether or not a banking entity's activity goes beyond the Prudential Backstops. In its initial study, FSOC did not provide any recommendations as to what steps the Regulators may take to incorporate the safety and soundness component of the Prudential Backstops into their regulatory frameworks.[185] Without a consistent approach to regulation and enforcement of the Prudential Backstops, compliance is more challenging, which may cause a banking entity to run afoul of its responsibility to engage in safe and sound financial practices.[186] Since Congress has already, within the Rule, granted FSOC the power to coordinate supervisory activities, FSOC seems to be an optimal solution to resolving some of the Rule's ambiguities and the potential inconsistencies amongst the Regulators.[187] If FSOC is unwilling or unable to serve as an actual intermediary or supervisory authority for the Regulators, then at the very least, it could use its authority to make recommendations "to apply new or heightened standards and safeguards for financial activities or practices."[188]

The scope of FSOC's recommendations would likely depend on the results of the metric reporting data review.[189] Once the Regulators identify the nature of the trading activity taking place across entities, post-conformance, FSOC may be better able to suggest how each institution can modify its internal practices to monitor for prohibited trading activity. Similarly, once the data has been compiled and reviewed, FSOC may also be able to provide guidance to the Regulators on ways to alter the metric reporting requirements to ease their enforcement burden while still maintaining strict compliance with the Rule.[190]

---

185. *See* MORRISON & FOERSTER LLP, NEWS BULLETIN: REVIEW OF FINANCIAL STABILITY OVERSIGHT COUNCIL VOLCKER RULE STUDY 3 (Feb. 2011), http://media.mofo.com/files/Uploads/Images/110214_Review_of_FSOC_Volcker_Rule_Study.pdf (stating that the study merely "encourage[d] the Agencies to incorporate the safety and soundness limitations into the framework and procedures adopted to assure compliance with the Volcker Rule.").

186. Ken E Bentsen Jr., *Holes in the Volcker Rule*, THE HILL (Mar. 3, 2014), http://thehill.com/opinion/op-ed/199744-holes-in-the-volcker-rule.

187. *Id.*

188. Norbert J. Michel, *The Financial Stability Oversight Council: Helping to Enshrine "Too Big to Fail,"* (Apr. 1, 2014), http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.

189. *Supra* Part II.

190. *See* COLLINS ET AL., *supra* note 70, at 6 (indicating that after the metric reporting data is collected and reviewed, the requirements for such reporting may be adjusted).

V. CONCLUSION

While the numerous exceptions to the Rule's ban on proprietary trading favor banking entities and afford them greater flexibility with their trading activity than would be feasible under a stricter version of the Rule,[191] these exceptions may be causing more harm than good. The exceptions, limited by the Prudential Backstops, make it much more challenging for banking entities and Regulators alike to identify impermissible or evasive activity.[192] In the interest of consistency and fairness, the Anti-Evasion Provision should both be reexamined and amended to include clear guidelines that will allow banking entities to more efficiently protect themselves from administrative action stemming from the Anti-Evasion Provision,[193]

Such amendments to the Anti-Evasion Provision could be modeled after other anti-evasion provisions and safe harbors, such as those contained in TILA's Regulation Z,[194] and include a good faith provision to account for unintentional noncompliance, thereby reducing burdensome administrative action and costs. Banking entities and Regulators both would benefit from these suggested modifications to the Anti-Evasion Provision, and the FSOC's potential intervention[195] where there was a disagreement amongst the Regulators over how to interpret and enforce the Anti-Evasion Provision. Such an intervention would help to ensure uniformity in the interpretation and application of the Anti-Evasion Provision.[196] Higher standards and clear criteria for what constitutes "evasion"[197] will both enhance banking entities' ability to appropriately adhere to the Rule's requirements and clarify the

191. GOELZER, *supra* note 12.

192. Whitehead, *supra* note 19.

193. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") § 619, 12 U.S.C. § 1851(e)(2) (2012) (demonstrating the lack of bright line rules for when, under the Anti-Evasion Provision, Regulators can bring enforcement action against a banking entity). Clearer guidelines are critical to clarify the circumstances under which the Regulators may bring enforcement action against a banking entity for any violations of the Rule as they relate to proprietary trading or covered funds. *Id.*

194. Regulation Z, 12 C.F.R § 226 (2016); MAYER ET AL., *supra* note 10, at 4.

195. *Supra* Part IV.

196. *Supra* Part IV.

197. *Supra* Part III.

Regulators' enforcement efforts, rendering the Rule's implementation much more effective.

VINITA TANDON