

# Office of Inspector General

## Review of the Unauthorized Disclosure of a Confidential Staff Draft of the Volcker Rule Notice of Proposed Rulemaking



**Board of Governors of the Federal Reserve System**

**July 2012**



OFFICE OF INSPECTOR GENERAL  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
CONSUMER FINANCIAL PROTECTION BUREAU  
WASHINGTON, DC 20551

July 31, 2012

Chairman Ben S. Bernanke  
Board of Governors of the Federal Reserve System  
Washington, DC 20551

Dear Chairman Bernanke:

Enclosed is a copy of our report evaluating whether the staff of the Board of Governors of the Federal Reserve System (Board) or the Federal Reserve Bank of New York (FRB-NY) had knowledge of, or played a role in, the unauthorized disclosure of a confidential staff draft of the Volcker Rule notice of proposed rulemaking. As part of our review, we also assessed the Board's information-sharing practices for rulemaking activities.

Although our review identified several apparent instances of unauthorized disclosures that occurred during the rulemaking process, we did not find any evidence to indicate that these disclosures originated at the Board or at FRB-NY. Nonetheless, we identified three recommendations for improving information-sharing controls and procedures for future rulemaking activities.

We provided a copy of our report for review and comment to the Board's General Counsel; the Directors of the Divisions of Banking Supervision and Regulation, Research and Statistics, and Information Technology; and FRB-NY's Senior Vice President of Markets. The General Counsel provided a consolidated official response. With respect to our three recommendations, the General Counsel indicated that "serious consideration" will be given to recommendations 1 and 2 and that actions are being taken to address recommendation 3. Our evaluation of those responses follows each recommendation in the report. The consolidated official response is included in appendix 2 of this report. We will follow up on actions taken to implement each recommendation.

We appreciate the cooperation that we received from Board and FRB-NY staff during our review. The principal contributors to this report are listed in appendix 3. This report will be

added to our public website and will be summarized in our next semiannual report to Congress. Please contact me if you would like to discuss this report or any related issues.

Sincerely,



Mark Bialek  
Inspector General

Enclosures

cc: Vice Chair Janet L. Yellen  
Governor Elizabeth A. Duke  
Governor Daniel K. Tarullo  
Governor Sarah Bloom Raskin  
Governor Jerome H. Powell  
Governor Jeremy C. Stein  
Mr. Scott G. Alvarez  
Mr. Michael S. Gibson  
Ms. Sharon Mowry  
Mr. William C. Dudley  
Ms. Patricia C. Mosser

# Office of Inspector General

## Review of the Unauthorized Disclosure of a Confidential Staff Draft of the Volcker Rule Notice of Proposed Rulemaking



**Board of Governors of the Federal Reserve System**

**July 2012**



## **Abbreviations**

<b>The Agencies</b>	The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission
<b>Banking Entities</b>	Insured depository institutions, bank holding companies, and their subsidiaries or affiliates
<b>Board</b>	Board of Governors of the Federal Reserve System
<b>BS&amp;R</b>	The Board's Division of Banking Supervision and Regulation
<b>Dodd-Frank Act</b>	Dodd-Frank Wall Street Reform and Consumer Protection Act
<b>FDIC</b>	Federal Deposit Insurance Corporation
<b>FRB-NY</b>	Federal Reserve Bank of New York
<b>FSOC</b>	Financial Stability Oversight Council
<b>FSOC MOU</b>	Memorandum of Understanding Regarding the Treatment of Non-Public Information Shared Among Parties Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act
<b>NPRM</b>	Notice of Proposed Rulemaking
<b>OCC</b>	Office of the Comptroller of the Currency
<b>OFR</b>	Office of Financial Research
<b>OGE</b>	U.S. Office of Government Ethics
<b>OIG</b>	Office of Inspector General
<b>R&amp;S</b>	The Board's Division of Research and Statistics
<b>SEC</b>	Securities and Exchange Commission
<b>SEC MOU</b>	Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest
<b><i>Standards of Ethical Conduct</i></b>	Standards of Ethical Conduct for Employees of the Executive Branch



## Table of Contents

<b>Background .....</b>	<b>9</b>
<b>Objectives, Scope, and Methodology.....</b>	<b>10</b>
<b>Results of Our Review .....</b>	<b>11</b>
Policies, Procedures, and Practices Relating to the Treatment of Nonpublic Information or Rulemaking .....	11
Unauthorized Disclosures of the Draft NPRM.....	15
Further Analysis.....	16
Impact of the Unauthorized Disclosures.....	17
Conclusions and Recommendations .....	17
<b>Appendixes.....</b>	<b>23</b>
Appendix 1 – Articles Citing Draft NPRM Content.....	25
Appendix 2 – Management’s Response.....	27
Appendix 3 – Principal Contributors to This Report.....	31





## Background

On October 11, 2011, the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) each issued press releases requesting public comment on a notice of proposed rulemaking implementing the requirements of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>1</sup> Section 619, which amends the Bank Holding Company Act of 1956 (12 U.S.C. § 1841 et seq.), contains two key prohibitions on the activities of insured depository institutions, bank holding companies, and their subsidiaries or affiliates (banking entities).<sup>2</sup> The first prohibition precludes banking entities from engaging in short-term proprietary trading of any security, any derivative, and certain other financial instruments for a banking entity's own account, subject to certain exemptions.<sup>3</sup> The second prohibition precludes banking entities from owning, sponsoring, or having certain relationships with a hedge fund or a private equity fund, subject to certain exemptions.<sup>4</sup> These two prohibitions are commonly referred to as the "Volcker Rule."<sup>5</sup> The notice of proposed rulemaking to implement the Volcker Rule has attracted considerable attention because its prohibitions require adjustments to the business models of large, complex banking organizations. This notice of proposed rulemaking will be referred to herein as the NPRM.

In addition to describing the substantive topics to be addressed in the rulemaking, the Dodd-Frank Act outlined specific requirements to implement the Volcker Rule.<sup>6</sup> First, it required the Financial Stability Oversight Council (FSOC) to conduct a study and make recommendations for implementing the provisions of section 619 by January 21, 2011.<sup>7</sup> The FSOC issued the study

---

1. Section 619 of the Dodd-Frank Act appears in Pub. L. No. 111-203, 124 Stat. 1620-31, and is codified at 12 U.S.C. § 1851. The October 11, 2011, version of the notice of proposed rulemaking linked to the press releases had not been paginated or formatted for purposes of publication in the *Federal Register*. The notice of proposed rulemaking, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds," appeared in the November 7, 2011, *Federal Register*. 76 Fed. Reg. 68846 (Nov. 7, 2011).

2. Section 619 amends the Bank Holding Company Act of 1956 by adding a new section 13, "Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds."

3. Proprietary trading refers to trading in stocks or other financial instruments using the institution's own funds, to profit from short-term price changes.

4. Hedge funds are investment vehicles that engage in active trading of securities and other financial contracts. Private equity funds generally are funds that invest in companies or other less liquid investments.

5. Former Board Chairman Paul Volcker, while serving as the Chairman of the President's Economic Recovery Advisory Board, opined that the riskier trading activities of commercial banks and their affiliates contributed to the recent financial crisis.

6. Dodd-Frank Act, Pub. L. No. 111-203, § 619, 124 Stat. 1620, 1621-22 (amending the Bank Holding Company Act of 1956 and codified at 12 U.S.C. § 1851(b)).

7. Section 111 of the Dodd-Frank Act established the FSOC, a collaborative body chaired by the Secretary of the Treasury that brings together the expertise of the federal financial regulators, an insurance expert appointed by the President, and state regulators. Voting FSOC members include the heads of the Department of the Treasury, the Board, the OCC, the Securities and Exchange Commission, the FDIC, the Commodity Futures Trading Commission, the Consumer Financial Protection Bureau, the Federal Housing Finance Agency, and the National Credit Union Administration, as well as an independent member with insurance expertise. Among other duties, the FSOC is charged with identifying threats to the financial stability of the United States, promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.

on January 18, 2011, and it contained 10 recommendations for implementing the Volcker Rule.<sup>8</sup> Section 619 required the Board, the FDIC, the OCC, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (collectively, the Agencies) to consider the FSOC study's findings and jointly adopt rules to implement its provisions. The Agencies formed an interagency rulemaking team that met regularly from January 2011 through October 2011 to jointly develop the NPRM.

As part of this joint rulemaking process, Board employees distributed several versions of the NPRM to the Agencies for deliberation, including a version labeled "confidential staff draft" dated September 30, 2011. On October 5, 2011, *American Banker*, a banking and financial services media outlet, published this nonpublic, confidential staff draft of the NPRM on its website. The Board subsequently issued its October 11, 2011, press release to request public comment on the NPRM, and the NPRM formally appeared in the *Federal Register* on November 7, 2011.

## Objectives, Scope, and Methodology

We conducted this review to evaluate whether Board and/or Federal Reserve Bank of New York (FRB-NY) staff had knowledge of, or played a role in, the unauthorized disclosure of the confidential staff draft of the NPRM and to assess the Board's information-sharing practices for rulemaking activities. We conducted our fieldwork from October 2011 to March 2012 in accordance with the *Quality Standards for Inspection and Evaluation* issued by the Council of the Inspectors General on Integrity and Efficiency.

To accomplish our objectives, we reviewed relevant policies, procedures, and other materials. Board and FRB-NY policies on information-sharing are the same or substantially similar; therefore, we focused on the Board's information-sharing policies. We interviewed Board personnel as well as FRB-NY personnel who provided subject-matter expertise to the Board on a consultative basis in support of this rulemaking effort. Specifically, we interviewed 10 rulemaking participants from various Board divisions: 5 employees from the Legal Division, 4 employees from the Division of Banking Supervision and Regulation (BS&R), and 1 employee from the Division of Research and Statistics (R&S). In addition, we interviewed the Board's General Counsel and a staff member from the Public Affairs Office. We also interviewed 10 FRB-NY employees who contributed to the rulemaking, including 6 employees from the Financial Institution Supervision Group, 2 employees from the Legal Group, and 2 employees from the Markets Group. We also conducted a targeted analysis of certain Board rulemaking team members' e-mail communications and phone logs.

---

8. FSOC, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (January 18, 2011), <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>.

# Results of Our Review

## Policies, Procedures, and Practices Relating to the Treatment of Nonpublic Information or Rulemaking

### Nonpublic Information

We identified standards, policies, and agreements that establish requirements for the treatment of nonpublic information. Specifically, the U.S. Office of Government Ethics (OGE) *Standards of Ethical Conduct for Employees of the Executive Branch (Standards of Ethical Conduct)* and the Board's information security policies address Board employees' handling of nonpublic information. In addition, the Board has two memorandums of understanding with other federal agencies regarding the treatment of nonpublic information.

#### Standards of Ethical Conduct Issued by the OGE

The OGE *Standards of Ethical Conduct* apply to executive branch employees and all Board personnel. The standards prohibit any improper disclosure of nonpublic information. Specifically, the standards state, "An employee shall not . . . allow the improper use of nonpublic information to further his own private interest or that of another, whether through advice or recommendation, or by knowing unauthorized disclosure."<sup>9</sup> The OGE defines nonpublic information as information that an employee gains by reason of federal employment and knows, or reasonably should know, that it has not been made available to, or has not actually been disseminated to, the general public.

#### The Board's Internal Information Security Policies

The *Board Information Security Program* policy contains specific classification and handling standards for all printed and digital information.<sup>10</sup> This policy requires Board employees to categorize information using the following sensitivity classification levels: (1) Public, (2) Internal FR, (3) Board Personnel, (4) Restricted-FR, and (5) Restricted-Controlled FR.<sup>11</sup> Specific information-handling restrictions and requirements are based upon the respective classification level. Only information classified as Public may be disclosed outside the Board. The Board's policy considers all other information as unpublished information that must be kept "confidential"; unpublished information may only be disclosed to authorized Board or Reserve Bank officers, employees, or agents, consistent with the policy.

Interviewees stated that the rulemaking team categorized drafts of the NPRM circulated within the Board or FRB-NY as Restricted-FR. The Board's *Information Classification and Handling Standard* requires that access to documents categorized as Restricted-FR must be limited to those

---

9. 5 C.F.R. § 2635.703(a).

10. The *Board Information Security Program* is dated June 8, 2010. Its *Appendix J: Information Classification and Handling Standard* was updated on December 17, 2011.

11. The Board's *Information Security Program* also specifies an additional classification level: Federal Open Market Committee. No documents related to this rulemaking that we reviewed received that classification.

Board or Reserve Bank staff who are authorized and have a need to know for official business purposes. In addition, access to Restricted-FR information must be limited to as few people as possible, and approved encryption methods must be used when disseminating Restricted-FR information via e-mail.

### **Interagency Agreements Regarding the Treatment of Nonpublic Information**

During the course of our review, we identified two interagency agreements involving the Board that address the treatment of nonpublic information. In July 2008, the SEC and the Board entered into an agreement to establish a framework for collaborating, coordinating, and sharing information in areas of “common regulatory and supervisory interest.” In the “Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest” (SEC MOU), the SEC and the Board agreed to maintain the confidentiality of all nonpublic information obtained and to not disclose such information to any person outside the SEC or the Board. Although the SEC MOU addresses information exchanged between the SEC and the Board, it does not apply to the other federal financial regulatory agencies involved in this rulemaking.

In April 2011, the members of the FSOC established an agreement that applies to the handling of nonpublic information shared among the parties to the agreement in connection with FSOC functions or activities related to the Dodd-Frank Act. In accordance with the “Memorandum of Understanding Regarding the Treatment of Non-Public Information Shared Among Parties Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act” (FSOC MOU), the FSOC member agencies must take every reasonable step to protect and preserve nonpublic information that is shared in connection with the Department of the Treasury’s Office of Financial Research (OFR) or FSOC functions and activities.<sup>12</sup> The FSOC MOU creates a presumption of confidentiality for any materials shared between the parties to the agreement in connection with OFR or FSOC functions and activities and obligates recipients to take all reasonable steps necessary to preserve, protect, and maintain that confidentiality. However, while the FSOC conducted the study as required by section 619 of the Dodd-Frank Act, the FSOC did not conduct the interagency rulemaking.

### **The Board’s Policies on the Rulemaking Process**

We also identified two Board policies that govern the rulemaking process. First, the Board’s *Rulemaking Procedures—Improving Board Regulations; Policy Statement* establishes the procedures to be followed internally when developing rules. However, the scope of this policy does not include interagency rulemakings. Second, the Board’s *Guidance on Public Meetings and Contacts Regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act* establishes requirements for Board employee communications with outside parties regarding the Dodd-Frank Act. According to the policy, the Board must disclose on its public website all

---

12. The Dodd-Frank Act established the OFR within the Treasury Department to improve the quality of financial data available to policymakers and to facilitate more robust and sophisticated analysis of the financial system.

forms of communication with outside parties regarding matters subject to a potential or proposed rulemaking to ensure that all rulemakings are conducted in a fair, open, and transparent manner. The Dodd-Frank Act required this rulemaking to be developed on an interagency basis, and the above Board policies did not apply to rulemaking team members from other agencies. While the interagency rulemaking team did not establish information-sharing standards or policies specific to this rulemaking, Board employees indicated that there was a general understanding, based on discussions among the interagency rulemaking team members, not to disclose the drafts.

## **The Interagency Rulemaking Process for the NPRM**

### **Dodd-Frank Act Requirements**

The Dodd-Frank Act required the Agencies to consider the findings of the FSOC study and, within nine months of the study's completion, jointly adopt rules to implement section 619.<sup>13</sup> After the FSOC published its study on January 18, 2011, the Agencies commenced the rulemaking process. The Board issued a press release on October 11, 2011, to request public comment on the proposed rule, and the *Federal Register* published the NPRM on November 7, 2011.<sup>14</sup>

As required by the Dodd-Frank Act, the Secretary of the Treasury was responsible for coordinating the interagency rulemaking efforts.<sup>15</sup> The Dodd-Frank Act did not otherwise specify the roles and responsibilities of the Agencies. Board rulemaking participants informed us that each agency provided input and contributed its respective expertise and that the Board centrally managed the development and distribution of the drafts.

### **The Board's Internal Rulemaking Efforts**

With regard to the Board's internal approach to conducting this rulemaking, the Board selected staff from BS&R, R&S, and the Legal Division to participate in the interagency process. The Legal Division provided its expertise and coordinated the Board's internal rulemaking efforts. BS&R and R&S staff provided quantitative data and their respective technical expertise to support the resolution of specific policy matters. The Board consulted with specific FRB-NY staff who possessed necessary market risk, regulatory policy, and legal subject-matter expertise.

We inquired about the Board's process for selecting staff to participate in the rulemaking. We also sought to determine the Board's approach to mitigating the risk of conflicts of interest generated by relationships with individuals who are not Board employees. Specifically, we inquired whether Board policies or procedures address the prescreening of potential rulemaking

---

13. Dodd-Frank Act, Pub. L. No. 111-203, § 619, 124 Stat. 1620, 1621 (amending the Bank Holding Company Act of 1956 and codified at 12 U.S.C. § 1851(b)(2)(A)).

14. The Board's Regulatory Reform Project Tracking Tool acknowledges that the interagency rulemaking effort has not met the nine-month deadline for jointly adopting the rule.

15. Dodd-Frank Act, Pub. L. No. 111-203, § 619, 124 Stat. 1620, 1622 (amending the Bank Holding Company Act of 1956 and codified at 12 U.S.C. § 1851(b)(2)(B)).

participants to avoid situations that might give rise to actual or apparent conflicts of interest. Although the Board did not have policies or procedures addressing the prescreening of potential rulemaking participants, staff members referenced Board policies relating to information handling, guidance on public meetings and contacts regarding the Dodd-Frank Act, and ethical conduct guidelines that prohibit the disclosure of nonpublic information.

The Board assigned two attorneys from the Legal Division's Banking Regulation and Policy Group to lead the Board's rulemaking efforts, and the Legal Division led the interagency drafting efforts. The Board rulemaking team held internal meetings to discuss the NPRM. The Legal Division incorporated feedback from these discussions, disseminated updated drafts to Board rulemaking participants, and provided portions or entire copies of early draft documents to certain FRB-NY staff.

As the Legal Division updated drafts of the NPRM, it labeled them by date and version number. The Legal Division classified these drafts as Restricted-FR. The Legal Division stored the NPRM drafts on a shared network drive accessible to all employees in the Legal Division's Banking Regulation and Policy Group, including employees not participating on the rulemaking team. We learned that Legal Division staff use this shared drive routinely. However, as noted above, according to the *Information Classification and Handling Standard*, access to Restricted-FR information should be limited to authorized staff who have a need to know the information for official business purposes. Access to such information must be limited to as few people as possible.

### **The Board's Interagency Coordination Efforts**

Throughout the NPRM drafting process, from January 2011 through October 2011, the Board indicated the confidential nature of the draft NPRM. According to an interviewee, the Board's rulemaking team labeled a March 2011 draft of the NPRM "confidential and pre-decisional," to denote the nonpublic and restricted status of the draft and to indicate that it was still in development. Initially, the Legal Division disseminated drafts of the proposed rule via e-mail to all members of the interagency rulemaking team; the distribution list contained approximately 70 employees of the Agencies. According to interviewees, the Legal Division disseminated the NPRM drafts via e-mail communications that were not always encrypted. The interagency team examined the proposed rule from various perspectives, including systemic risk ramifications, protection of depositors, and implications regarding market conduct. The interagency rulemaking team discussed proposed changes during the interagency meetings until it reached consensus.

In June 2011, there was an indication that interagency meeting deliberations were disclosed to a media source. As a result, in July 2011, the Board (1) narrowed the e-mail distribution list from the interagency rulemaking participants to only the team leaders of the respective agencies and (2) communicated via e-mail to the rulemaking team that the draft NPRM remained a "confidential work product and not for discussion or sharing externally."

In September 2011, there were further indications that media sources not only had insight regarding interagency discussions, but also likely had access to a draft. As a result, a senior

attorney from the Board's Legal Division who was leading the drafting effort communicated the following message via e-mail to the rulemaking team on September 30, 2011:

PLEASE DO NOT PASS THESE DOCUMENTS ALONG TO ANYONE OUTSIDE YOUR AGENCY, and if you must pass along to others internally do so in a manner which is designed to prevent further dissemination. Leaks such as the one that has obviously occurred here are not constructive to the overall integrity or process of this rulemaking and . . . are not good public policy.

## **Communications with Members of the Public**

As part of the rulemaking process, the Board typically conducts meetings with members of the public to gather information. Board staff held more than 40 meetings with members of the public, including trade associations, banking organizations, and consumer groups. Staff members noted that these external parties presented various opinions that contributed to the rulemaking process. For example, external parties provided insight regarding the function and utility of different products that could be affected by the rule. Staff members noted that during these meetings they refrained from responding to questions from the external parties concerning the status of the rulemaking or specific policy determinations and did not share any content from the draft NPRM.

As required by the Board's *Guidance on Public Meetings and Contacts Regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act*, the Board informed the external parties that the matters discussed would be made public. In accordance with the policy and to ensure that the rulemaking was conducted in a fair, open, and transparent manner, the Board posted summaries of communications on the Board's website, including materials provided by external parties.<sup>16</sup>

## **Unauthorized Disclosures of the Draft NPRM**

### **Unauthorized Disclosures to the Media**

Prior to *American Banker's* publication of the draft NPRM on October 5, 2011, there were indications of unauthorized disclosures of previous draft versions of the NPRM. We reviewed five articles published by various media sources that cited content from a draft, claimed to have viewed a previous draft, or referenced detailed information regarding the ongoing deliberations within the interagency rulemaking team.<sup>17</sup> For example, in one article a media source claimed to have reviewed an August 2011 version of the proposed rule. Board staff members stated that these articles contained specific factual information that appeared to confirm that these media sources had actually gained access to the nonpublic draft documents. Our interviews with Board

---

16. According to the policy, however, confidential commercial or financial information obtained from an external party may be withheld from public disclosure to the extent permitted under the Freedom of Information Act (5 U.S.C. § 552).

17. See appendix 1 for a listing of the five articles.



and FRB-NY staff did not reveal any evidence indicating that the unauthorized disclosures of the drafts published or referenced by media sources originated from within the Board or FRB-NY.

### **Media Inquiries to the Board's Public Affairs Office**

During the rulemaking process, reporters contacted the Board's Public Affairs Office with questions regarding the rulemaking. A Public Affairs staff member noted that such inquiries are typical during an anticipated rulemaking, although the volume of inquiries regarding this rulemaking was atypically high. This staff member stated that Public Affairs had also noted several articles that indicated that the draft NPRM may have been prematurely released even prior to *American Banker's* publication of the draft on October 5, 2011. In response, a Public Affairs staff member discussed these articles with members of the Board rulemaking team to assure that the team was aware of the articles. We also learned that reporters contacted the Board's Public Affairs Office claiming that they had reviewed a copy of the draft NPRM and wanted to verify its contents. A Public Affairs staff member stated that she did not provide any additional information in response to inquiries from reporters regarding the draft NPRM.

### **Former Employee Communications**

We determined that a Board rulemaking participant received a copy of a nonpublic, confidential staff draft of the NPRM via e-mail on the morning of October 5, 2011, from a former Board employee. In this e-mail, the former Board employee requested that the Board rulemaking participant confirm whether the draft contained in the e-mail was the final version of the NPRM. The Board rulemaking participant promptly forwarded the e-mail to select members of the Board rulemaking team. The Board rulemaking participant noted that he did not confirm or deny for the former Board employee whether the document was the final draft. The former employee did not disclose to the Board rulemaking participant the source or the means used to obtain the draft NPRM.

On the afternoon of October 5, 2011, *American Banker* published the confidential staff draft of the NPRM on its website. This draft was not the same version that the Board rulemaking participant received via e-mail from the former employee. As part of our standard interview questions, we asked Board and FRB-NY rulemaking participants to describe any possible connections to *American Banker*; these interviewees did not identify any such connections.

### **Further Analysis**

Upon learning that a Board rulemaking participant received a copy of a nonpublic, confidential staff draft of the NPRM via e-mail from a former Board employee, we referred the matter to the Office of Inspector General (OIG) Investigations section. We coordinated with OIG investigators to conduct a focused review of employee phone logs and e-mail communications to determine whether unauthorized disclosures regarding the NPRM may have originated within the Board. This assessment included targeted reviews of key rulemaking participants' communications within specific time frames germane to the rulemaking effort. Our focused analysis of phone logs and over 2,300 e-mail communications did not reveal any evidence

indicating that the unauthorized disclosures of the drafts that were ultimately published or referenced by media outlets originated from within the Board.

We also contacted the former Board employee to discuss how he/she obtained the draft. The former Board employee, now working at a law firm, indicated that a client provided the draft NPRM to an attorney working at the firm. The former Board employee stated that the attorney who received the draft NPRM was not a former Board or Reserve Bank employee. The former Board employee chose not to identify the client who provided the draft NPRM to the law firm. In the former Board employee's opinion, an attorney at the law firm receiving the draft NPRM from a client constituted a protected communication covered by the attorney-client privilege.

## **Impact of the Unauthorized Disclosures**

We assessed the unauthorized disclosure of the NPRM draft by *American Banker* to determine whether it had any significant impact on the planned release date or content of the final NPRM. With regard to the planned release date, interviewees indicated that the NPRM was not affected by the publication of the draft in *American Banker*. As discussed above, the Board requested comment on the proposed rulemaking via press release on October 11, 2011, six days after the confidential staff draft was published on October 5, 2011, and the NPRM formally appeared in the *Federal Register* for public comment on November 7, 2011. Although an unauthorized disclosure could have created the opportunity for external parties to attempt to influence decisions regarding the final rule, Board rulemaking participants noted that no substantive changes occurred after or resulted from the unauthorized disclosure.

The unauthorized disclosure to *American Banker* circumvented the rulemaking process by publishing the draft version before the intended issuance of the final NPRM. The unauthorized disclosures that occurred throughout the drafting of the NPRM compromised the integrity of the rulemaking process. Board interviewees noted that interagency teams need trust and open dialogue to effectively carry out a joint rulemaking. As such, staff members noted that the unauthorized disclosures of the draft NPRM had a negative impact on the "interagency rulemaking dynamic."

## **Conclusions and Recommendations**

Our review noted several apparent instances of unauthorized disclosures that occurred during the rulemaking process. We did not find any evidence, however, to indicate that the unauthorized disclosures originated at the Board or FRB-NY. Nonetheless, we identified three recommendations for improving information-sharing controls and procedures for future rulemaking activities. The General Counsel's responses to the individual recommendations and our evaluation of those responses are outlined below. Appendix 2 contains the General Counsel's complete response.

**1. We recommend that the Board create information-sharing guidelines applicable to interagency rulemakings for distribution to the participating agencies when the Board has responsibility for drafting an interagency rulemaking.**

It is our understanding that over the years the federal banking agencies have developed informal and customary practices for sharing and controlling sensitive information as part of interagency rulemaking efforts. However, there are no formal written agreements or controlling standards concerning the treatment of nonpublic information applicable to interagency rulemaking activities. While we acknowledge that developing guidelines will not eliminate the risk of future unauthorized disclosures, we believe that such guidelines will serve to establish a common understanding for key terminology and expectations for the treatment of nonpublic information at the outset of interagency rulemaking activities.

**Management's Response**

Regarding recommendation 1, the General Counsel stated the following:

The Federal Reserve and other financial institution regulators have been sharing confidential information for generations. All parties involved are aware of the confidentiality expectations and, as the draft report acknowledges, those expectations were reiterated at various times throughout the Volcker rulemaking process. There is no reason to believe, either on the basis of the draft report or on the basis of other known information, that the disclosure motivating this report came about because the disclosing party failed to appreciate the confidential nature of the information disclosed. We will discuss with other regulators whether they are unclear regarding the confidentiality restrictions that apply in the context of interagency rulemakings, and will consider creating guidelines if clarity is lacking.

**OIG Evaluation**

Our review determined that there are no formal written agreements or standards guiding the treatment of nonpublic information applicable to interagency rulemaking activities, and we observed that the Board's rulemaking team initiated significant changes to the informal and customary interagency practices used during this rulemaking to ensure confidentiality once the unauthorized disclosures became evident. Specifically, the Board's rulemaking team limited the draft NPRM distribution list to the rulemaking team leaders at the respective agencies. Prior to this action, approximately 70 rulemaking participants were included in the distribution list. Further, the Board communicated to the interagency rulemaking participants with increased specificity regarding the need to avoid external disclosures of the draft NPRM. These actions, intended to tighten the interagency rulemaking information security practices, acknowledge the need for heightened levels of security controls in the interagency rulemaking process. In our opinion, implementing recommendation 1 to create information-sharing guidelines when the Board has drafting responsibility will help establish a common understanding for key terminology and expectations at the outset of interagency rulemaking activities.

- 2. We recommend that the Board’s General Counsel enhance user access controls on the Legal Division’s shared drive for prospective rulemaking materials to ensure that materials are appropriately restricted on a need-to-know basis and limited to as few employees as possible.**

Although the Legal Division labeled the NPRM drafts as Restricted-FR, the drafts were stored on a shared network drive accessible to all Legal Division employees within the Banking Regulation and Policy Group. The Legal Division limits employee user access on its shared drive according to employee groups, but has not adopted similar access controls within its employee groups. Therefore, certain employees within the Banking Regulation and Policy Group had access to drafts of the NPRM even though they did not need access to those materials in the current performance of their job duties. According to the Board’s *Information Classification and Handling Standard*, Restricted-FR information may only be shared with other authorized Federal Reserve staff who have a need to know the information for official business purposes and access to the information must be limited to as few people as possible. Even though our review did not reveal any evidence that this situation contributed to the unauthorized disclosures, we believe that control enhancements would result in greater consistency with Board policy. Although we learned that the Board is in the process of transitioning to new electronic document management capabilities, we believe that, in the interim, the Board’s General Counsel should enhance user access controls to appropriately restrict access for prospective rulemaking materials.

### **Management’s Response**

Regarding recommendation 2, the General Counsel stated the following:

It is clear from discussions between the General Counsel and the Inspector General that the Legal Division’s use of the shared drive did not contribute, either intentionally or unintentionally, to the unauthorized disclosure of the draft Volcker NPR. In my role as General Counsel, I have already placed restrictions on staff access to the information on the Legal Division’s shared drive. Those restrictions are designed to limit access to information to staff assigned to, or available for assignment on, regulatory projects while allowing the most effective and efficient assignment of Legal Division staff to these projects. We understand that the Board’s Division of Information Technology (“IT”) is developing a new system that provides more flexibility in controlling access to confidential information than the current system of hard drive administration. The Legal Division will work with IT to take advantage of these new systems as they are developed. In the meantime, the Legal Division will continue to conform to the Board’s confidentiality restrictions, will take the OIG’s observations into account, and will consult with experts in information security should any irregularities or questions arise.

## OIG Evaluation

As noted in this report, for this rulemaking, the current group-level restrictions for accessing information on the Legal Division's shared drive were not consistent with the Board's information classification and handling standard. That standard indicates that Restricted-FR information "may only be shared with other FR [Federal Reserve] staff who are authorized and have a need to know the information for official business purposes. Access to the Restricted FR must be limited to as few people as possible." We made this recommendation because we determined that approximately 30 staff members in the Legal Division's Banking Regulation and Policy group had access to the prior draft NPRMs for the Volcker Rule, even though, in our opinion, only 4 staff members within the group met the need-to-know standard for accessing these materials. After identifying this issue, we coordinated with OIG investigators to conduct targeted e-mail searches of the Legal Division employees with access to the draft NPRMs. We did not identify any evidence of unauthorized disclosures. Even though we observed no evidence that this vulnerability contributed to the unauthorized disclosures, we maintain that control enhancements are necessary to ensure compliance with the information classification and handling standard.

We confirmed with the former Director of the Division of Information Technology and current division personnel that the recommended control change is "technologically feasible" and "easily implemented." Accordingly, we continue to believe that the General Counsel should implement enhanced user access controls on the Legal Division's shared drive for prospective rulemakings to ensure that the division complies with the Board's information classification and handling standard.

- 3. We recommend that (a) the Director of the Division of Information Technology remind all Board employees of the Board's encryption capabilities for transmitting e-mail communications to other agencies and (b) the Board's General Counsel reiterate to Board participants in all rulemakings the need to use encryption methods when e-mailing Restricted-FR documents associated with interagency rulemakings.**

We learned that Board staff did not always transmit the drafts of the NPRM, which were labeled internally as Restricted-FR, through encrypted e-mail communications. The Board's *Information Classification and Handling Standard* states that Restricted-FR materials should be sent via encrypted e-mail. It is our understanding that the Board currently has capabilities to encrypt outgoing e-mails to both internal recipients and the respective agencies participating in this rulemaking. Even though our review did not reveal any evidence that the transmission of these unencrypted e-mails contributed to the unauthorized disclosures, Board staff should comply with applicable requirements concerning encrypted e-mail communications.

## **Management's Response**

Regarding recommendation 3, the General Counsel stated the following:

As the explanation accompanying this recommendation states, the transmission of unencrypted emails did not, intentionally or unintentionally, result in the disclosure of the draft Volcker NPR. Nonetheless, the General Counsel has already communicated to the Legal Division both the importance of using encryption services for transmitting e-mails on an interagency basis and the appropriate method for encrypting interagency e-mails (since the embedded encryption mechanism in the Board's Lotus Notes email service used frequently by staff does not encrypt e-mails transmitted outside the Federal Reserve). The Director of IT has also determined to remind staff about the methods of encrypting interagency messages. We also note that IT expects to implement a new email system that will make encryption of documents sent outside the Federal Reserve less cumbersome. The Legal Division staff has already begun training on this system and will be prepared to take advantage of this new encryption capability when it becomes available.

## **OIG Evaluation**

The Division of Information Technology reminded Board employees of the Board's encryption capabilities for transmitting e-mail communications outside the Federal Reserve System in the 2012 Information Security Awareness Training. We concur with the remainder of the General Counsel's response.



## **Appendixes**





## Appendix 1 – Articles Citing Draft NPRM Content

1. Braithwaite, Tom, “Fears Over Exemptions to Volcker Rule,” *Financial Times* (September 18, 2011).
2. Patterson, Scott, and McGrane, Victoria, “Volcker Rule May Lose Its Bite,” *Wall Street Journal* (September 22, 2011).
3. Hopkins, Cheyenne, and Mattingly, Phil, “Trader Pay May Face Restrictions Under Volcker Rule Mandated by Dodd-Frank,” *Bloomberg* (September 26, 2011).
4. Main, Carla, “Trader Pay, Rater Rules, ‘Sinister’ Insurance, EU Auditors: Compliance,” *Bloomberg* (September 27, 2011).
5. Adler, Joe, Borak, Donna, and Davidson, Kate, “Cheat Sheet: Details of the Long-Awaited Volcker Rule,” *American Banker* (October 5, 2011).



## Appendix 2 – Management’s Response



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ  
GENERAL COUNSEL

May 25, 2012

Mr. Mark Bialek  
Inspector General  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

Dear Mr. Bialek:

This is in response to your request for comment on your recent report titled “Review of the Unauthorized Disclosure of a ‘Confidential Staff Draft’ of the Volcker Rule Notice of Proposed Rulemaking,” which I have reviewed in draft form. The draft report concludes that the Inspector General “did not find any evidence [ ] to indicate that the unauthorized disclosures originated at the Board or FRB-NY.”<sup>1</sup> Staff appreciates the very thorough investigation of this matter conducted by the Office of Inspector General (“OIG”). The Federal Reserve staff maintain the highest standards of integrity and respect the importance of maintaining the confidentiality of agency work product and nonpublic supervisory information. It is an important affirmation of the effectiveness of our existing information security practices that you determined that no staff at either the Board or the New York Reserve Bank, either intentionally or unintentionally, engaged in the unauthorized disclosure of confidential information in this case.

Although the system as it exists effectively maintained the confidentiality of the draft Volcker Rule Notice of Proposed Rulemaking (“NPR”), the OIG offers three recommendations. One recommendation has already been acted on, and the others will receive serious consideration.

**Recommendation 1: We recommend that the Board create information sharing guidelines applicable to interagency rulemakings for distribution to the participating agencies when the Board has responsibility for drafting an interagency rulemaking.**

The Federal Reserve and other financial institution regulators have been sharing confidential information for generations. All parties involved are aware of the confidentiality expectations and, as the draft report acknowledges, those expectations were reiterated at various

<sup>1</sup> Office of Inspector General, *Review of the Unauthorized Disclosure of a “Confidential Staff Draft” of the Volcker Rule Notice of Proposed Rulemaking*, draft (May 2012), p. 17.

times throughout the Volcker rulemaking process. There is no reason to believe, either on the basis of the draft report or on the basis of other known information, that the disclosure motivating this report came about because the disclosing party failed to appreciate the confidential nature of the information disclosed. We will discuss with other regulators whether they are unclear regarding the confidentiality restrictions that apply in the context of interagency rulemakings, and will consider creating guidelines if clarity is lacking.

**Recommendation 2: We recommend that the Board’s General Counsel enhance user access controls on the Legal Division’s shared drive for prospective rulemaking materials to assure that materials are appropriately restricted on a need-to-know basis and limited to as few employees as possible.**

It is clear from discussions between the General Counsel and the Inspector General that the Legal Division’s use of the shared drive did not contribute, either intentionally or unintentionally, to the unauthorized disclosure of the draft Volcker NPR. In my role as General Counsel, I have already placed restrictions on staff access to the information on the Legal Division’s shared drive. Those restrictions are designed to limit access to information to staff assigned to, or available for assignment on, regulatory projects while allowing the most effective and efficient assignment of Legal Division staff to these projects. We understand that the Board’s Division of Information Technology (“IT”) is developing a new system that provides more flexibility in controlling access to confidential information than the current system of hard drive administration. The Legal Division will work with IT to take advantage of these new systems as they are developed. In the meantime, the Legal Division will continue to conform to the Board’s confidentiality restrictions, will take the OIG’s observations into account, and will consult with experts in information security should any irregularities or questions arise.

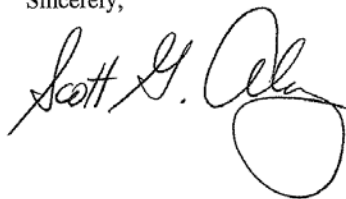
**Recommendation 3: We recommend that (a) the Director of the Division of Information Technology remind all Board employees of its encryption capabilities for transmitting e-mail communications to other agencies and (b) the Board’s General Counsel reiterate to Board participants in all rulemakings the need to use encryption methods when e-mailing Restricted-FR documents associated with interagency rulemakings.**

As the explanation accompanying this recommendation states, the transmission of unencrypted emails did not, intentionally or unintentionally, result in the disclosure of the draft Volcker NPR. Nonetheless, the General Counsel has already communicated to the Legal Division both the importance of using encryption services for transmitting e-mails on an interagency basis and the appropriate method for encrypting interagency e-mails (since the embedded encryption mechanism in the Board’s Lotus Notes email service used frequently by staff does not encrypt e-mails transmitted outside the Federal Reserve). The Director of IT has

also determined to remind staff about the methods of encrypting interagency messages. We also note that IT expects to implement a new email system that will make encryption of documents sent outside the Federal Reserve less cumbersome. The Legal Division staff has already begun training on this system and will be prepared to take advantage of this new encryption capability when it becomes available.

We appreciate the opportunity to comment on this draft report and are pleased that the OIG thoroughly examined the situation and determined that no Federal Reserve Board or System staff contributed to the unauthorized disclosure of the draft Volcker Rule NPR.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott G. Allen". The signature is written in a cursive style with a large, circular flourish at the end.



### **Appendix 3 – Principal Contributors to This Report**

Laura R. Shakarji, Project Leader and Auditor

Jina Hwang, Counsel

Charles M. Liuksila, Auditor

Michael A. Olukoya, Auditor

Jennifer L. Ksanznak, Auditor

Leah D. Garrison, Eric D. Shapiro, and Gabrielle Viscomi, Audit Interns

Michael P. VanHuysen, Office of Inspector General Senior Manager

Anthony J. Castaldo, Associate Inspector General for Inspections and Evaluations