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Financial Regulatory Reform Update: The Volcker Rule Looms Large Over Asset Management and Fund Investment Activities of Financial Institutions

The "Volcker Rule" – first introduced in the context of current financial reform legislation by the President in January – looms large in the financial regulatory reform package approved by the Senate on May 20, 2010 (the "Senate Bill"). As highlighted in this publication, fundamental questions remain regarding how the Volcker Rule would function in practice.

As addressed in greater detail below, if it becomes law, the Volcker Rule would:

- redraw existing boundaries on the types of trading activities that U.S. depository institution holding companies and non-U.S. banks with U.S. operations may conduct,
- significantly limit the fund-related activities that U.S. depository institution holding companies and non-U.S. banks with U.S. operations may conduct, and
- place a cap on M&A-related growth of large financial groups operating in the United States.[1]

The push for adoption of the Volcker Rule has been fueled by a nostalgic call to return to a more basic model of commercial banking that many associate with Glass-Steagall Act restrictions that were repealed in 1999.[2] Indeed, the Volcker Rule would mark a partial reversal of a decades-long trend towards a more expansive view of the lines of business in which institutions may engage under the commercial banking and bank holding company model.

Likelihood of Becoming Law

Particularly given the late introduction of the Volcker Rule into the reform dialogue, many initially questioned its political viability. The Rule, however, has already survived major hurdles in the form of votes of the Senate Banking Committee and, most recently, the full Senate. In addition, it has won the backing of both members of Congress expected to play leading roles in the House-Senate conference committee tasked with resolving the differences between the House and Senate reform bills – Barney Frank (D-MA), the Chairman of the House Financial Services Committee, and Christopher Dodd (D-CT), the Chairman of the Senate Banking Committee.[3]

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1 For more background, see our client memoranda, "Understanding the Significance of the Obama Administration's 'Volcker Rule'," dated February 17, 2010, available at http://www.shearman.com/understanding-the-significance-of-the-obama-administrations-proposed-volcker-rules-02-17-2010/ and "U.S. Senate Banking Committee Approves a Sweeping Financial Regulatory Reform Bill", dated April 2, 2010, available at http://www.shearman.com/us-senate-banking-committee-approves-a-sweeping-financial-regulatory-reform-bill-04-02-2010/.

2 The Volcker Rule, unlike the Glass-Steagall Act, would not force commercial banking groups to spin-off their investment banking operations. As described below, however, the Rule would likely require commercial banking groups to close, restructure or spin-off their in-house private funds operations.

3 The Volcker Rule, as outlined by the President, is only included in the Senate Bill. It was publicly proposed by the President more than a month following passage of reform legislation by the House of Representatives.

The Volcker Rule is expected to be among the most closely watched areas of debate and negotiation during the course of the upcoming House-Senate conference committee proceedings, which are due to commence this week. While we believe that there is a building consensus that the conference committee will approve some form of the Volcker Rule, its precise final form is still uncertain. In particular, much of the conversation regarding the Rule has begun to center around the question of whether the final statutory language would provide the U.S. federal banking agencies with sufficient flexibility in implementing the Rule's prohibitions and restrictions. As written in the Senate Bill, the agencies would be authorized to adopt "modifications" to the statutory rules (as summarized below). During the Senate floor debate, Senators Carl Levin (D-MI) and Jeff Merkley (D-OR) proposed to remove some of the regulatory flexibility currently provided by the Senate Bill's language. While that proposal was not brought to a vote by the Senate, the House-Senate conference might revisit this issue.

Overview of the Scope of the Volcker Rule

As formulated in the Senate Bill, there are four basic features of the Volcker Rule that apply to banking groups (including any subsidiary in the group) operating in the United States:[4]

- a prohibition on "proprietary trading" unrelated to customer-driven business,
- a prohibition on private equity and hedge fund "sponsorship" and investment,[5]
- a restriction on certain relationships (so-called "covered transactions") with "advised" or "managed" private equity and hedge funds, and
- a market concentration limit.

As used in the Senate Bill, "hedge funds" and "private equity funds" are funds exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (or a "similar fund", as determined by the federal banking agencies).

For these purposes, "sponsorship" of a hedge fund or a private equity fund – which would be prohibited – includes any of the following:

- Serving as a general partner, managing member, or trustee of a fund,
- In any manner selecting or controlling a majority of the directors, trustees or management of a fund, or
- Sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

On the other hand, it should be possible for a banking group to have contractual investment discretion (in a capacity as fund "advisor" or "manager") over a "third-party" fund without necessarily being deemed to "sponsor" a fund. However, as described in greater detail below, lending and certain other relationships with "advised" or "managed" funds would be restricted.

The Senate Bill provides that the new Financial Stability Oversight Council ("FSOC") must prepare a study of the likely effects of the Volcker Rule and develop recommendations on regulations within <u>six months</u> of the Bill becoming law, following which the bank regulatory agencies (Federal Reserve, FDIC and Office of the Comptroller of the Currency) are to issue final regulations based on the recommendations within nine months of issuance of the study. The U.S. federal banking agencies

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4 For these purposes, the Volcker Rule would draw upon the definition of "subsidiary" under the Bank Holding Company Act of 1956 (which encompasses certain entities that may not be operationally controlled or majority owned by a banking group).

5 The prohibition on investments in funds would not apply to investments in small business investment companies under the Small Business Investment Act of 1958 and certain approved "public welfare" investments (<u>e.g.</u>, designed primarily to promote the welfare of low- and moderate-income communities or families).

Mr. Volcker's Congressional testimony on February 2, 2010 could be read as suggesting support for a carve-out from the general prohibition on fund "sponsorship" for bank sponsored "Funds of Funds". No such carve-out, however, appears in the Senate Bill.

would be permitted to adopt "modifications" to any definitions, prohibitions, requirements, and limitations contained in the Senate Bill to the extent recommended by the FSOC.

Possible Effects of the Volcker Rule

As currently proposed in the Senate Bill, the Volcker Rule would have varying effects on major institutions. While the proprietary trading and concentration limits have received significant attention, the fund prohibitions would likely have the most significant immediate impact, particularly for the largest financial institutions operating in the United States.

Possible Effects: Prohibition on Proprietary Trading

For a U.S. financial institution subject to the U.S. Bank Holding Company Act of 1956 (the "BHCA"), the prohibition on proprietary trading would apply to all subsidiaries, both bank and non-bank and apparently both inside and outside of the United States. For non-U.S. institutions, an exemption would be available for trading by non-U.S. subsidiaries.

However, it continues to be very unclear where the line will be drawn between prohibited proprietary trading and permissible customer-driven transactions. In attempting to define its proscription, the Senate Bill uses the term "trading book" as the reference point for distinguishing the prohibited activity from other proprietary investment activities, with authority given to the U.S. federal banking agencies to expand coverage of the activities within the term (e.g., an "available for sale" account or "hold to maturity" account). Banks regularly make judgments whether particular securities or transactions are treated as being held in a "trading account," and those judgments are difficult to second-guess. This would appear to be a significant determination from the perspective of the Volcker Rule, as at least certain (and perhaps all) trades outside the "trading account" categorization would likely be permissible.

For most U.S. banking groups, non-customer-related trading represents only a relatively small percentage of trading (and total) revenues of the group. As a result, the prohibition on proprietary trading is likely to have relatively limited enterprise-wide consequences for any but the most active proprietary trading banks.[6]

Possible Effects: Concentration Limit

The concentration limit would apply only in the case of acquisitions and mergers among banking institutions or with a non-bank financial institution designated as systemically important.[7] Such a combination would not be permissible if the combined organization would control more than 10 percent of the total liabilities of covered financial institutions in the United States.

Accordingly, the limit would apply only in cases similar to the currently effective rule applicable to FDIC-insured deposits by banks[8] but with a broader measure to include a measure of "liabilities" of the entire organization and not only bank deposits (in the case of a non-U.S. institution, only U.S. liabilities are taken into account).[9] Thus, the denominator should be much larger than the currently applicable denominator, and it is not clear whether it would be as restrictive as the current rule. In part this may depend on how many financial

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6 It is not clear whether proprietary trades conducted by the institution for risk-management purposes would be permissible if not directly linked to hedging a customer trade. (The Senate Bill states that – subject to restrictions imposed by the federal banking agencies – "proprietary trading" does not include risk-mitigating hedging activities "related" to customer-linked trades or in facilitation of a customer relationship). If some form of indirect connection with customer trades would be satisfactory, it will likely fall to the bank regulatory agencies to delineate the requirements to support such a connection in their regulations.

7 Systemically important non-bank financial institutions would be those financial institutions that are not subject to the BHCA but that are considered to be so large or interconnected that they should be supervised by the Federal Reserve in many respects as though they were. Title I of the Senate Bill has a formal mechanism for determining who these institutions are and how they will be supervised. It should be noted that such institutions would not be subject to the prohibitions on proprietary trading or private equity and hedge fund activities (but would be subject to certain capital and quantitative restrictions in those areas).

8 See 12 U.S.C. § 1842(d)(2)(A).

9 "Liabilities" would generally be determined by reference to the risk-based capital rules applicable to the financial institution.

institutions are designated as systemically important. Also, it is not clear how the Federal Reserve will calculate the total liabilities for all of the types of financial institutions potentially subject to the concentration limit; the legislation could limit the calculation only to banking institutions, but the bill is not so drafted.

Nevertheless, to date only acquisitions by Bank of America and Wells Fargo were close to the 10 percent limit on bank deposits. It may be that very few otherwise permitted combinations would be constrained by the Volcker Rule limit.

Possible Effects: Prohibition on Sponsoring and Investing in Private Equity and Hedge Funds

In our view, the greatest effect of the Volcker Rule – as currently written in the Senate Bill – would likely be on bank-affiliated institution involvement with hedge and private equity funds. Several U.S. domestic and foreign institutions are heavily involved in this area at least to the extent of making investments in such funds, and in many cases in organizing and sponsoring them.[10] Adoption of the Volcker Rule in its present form would require some form of divestiture by the affected institutions.

It is also in this area that the proposed restrictions are the least coherent. Banking groups with Financial Holding Company status are allowed by the BHCA to make so-called "merchant banking investments," which are much the same types of investments in nonfinancial companies that private equity funds regularly make, but the Senate Bill does not appear to directly address their authority to continue engaging in this activity directly. Further, sponsoring hedge and private equity funds generally has the goal of satisfying client demand; the exception to the prohibition on proprietary trading, discussed above, allows such trading for the purpose of satisfying customer demand. Finally, banks have been managing customer funds through discretionary managed accounts for decades; it is not clear why financial institutions could not do so in pooled form (other than in the form of a fund actually registered under the Investment Company Act of 1940) when it can be more efficient and cost-effective to do so.[11]

Key Interpretive Questions Raised by the Fund Prohibition of the Volcker Rule

Several important issues will have to be resolved in order to implement the fund prohibition of the Volcker Rule in the Senate Bill's form:

1. Existing funds. How will existing funds sponsored by financial institutions be dealt with? Presumably they will have to be sold or spun off. The Senate Bill provides a two-year period (with the possibility of extensions) after issuance of final regulations implementing the Volcker Rule for such actions to take place (issuance of the regulation could take as long as 15 months after enactment of reform legislation). However, when such sales and spin-offs have been completed in the past, the selling institution has often retained some portion of the economics of the business for a period of time after the sale. The Federal Reserve's general policy toward divestitures has long been strict about the retention of a significant economic interest in the sold company, usually requiring the severing of any such retention in order for the divestiture to be considered valid. Will the Federal Reserve impose the same requirement in these cases?
2. Funds currently in process of formation. Many financial institutions that sponsor funds are currently in process of forming them, and financial institution

[10] See "An Unfair Advantage"? Combining Banking with Private Equity Investing," Lily Fang, Victoria Ivashina, and Josh Lerner, April 14, 2010 (Harvard Business School Working Paper, No. 10-106) ("Between 1983 and 2009, bank-affiliated private equity groups account for over a quarter of all private equity investments.")

[11] The Volcker Rule, in the form approved by the Senate, would not apply to a banking group's relationship with a fund registered under the Investment Company Act of 1940 or having elected to be regulated as a business development company.

investors are in process of considering and arranging to make investments. If not consummated by the time the statute becomes law, the question will be whether those transactions – either initial formation by a financial institution sponsor or investment by a financial institution – may be consummated afterward. As noted above, the prohibitions in the Senate Bill become effective two years after issuance of final regulations, which might not be issued until 15 months after passage of the law. May funds continue to be created and investments consummated during that period, even though they would have to be spun off later? The language implies that creation of funds and investments may continue until the end of the two-year period; But financial institutions may desire certainty upon enactment of the Bill, and it is not clear when any such comfort will be forthcoming, or what agency may provide it.

3. Transfer of unfunded commitments. Investments in private equity funds are usually in the form of unfunded commitments. Financial institution investors may have to transfer their existing private equity fund commitments to others, usually along with any funded portion of the commitment. Because other financial institutions covered by the Volcker Rule would not be eligible to acquire them, investors that are not subsidiaries of financial institutions subject to the BHCA would have to be found. It is not clear how many potential eligible investors there would be for what could be a large pool of commitments.

4. Transactions with advised private equity and hedge funds. Along the same lines, the Bill requires that no bank, parent bank holding company, or investment adviser subsidiary may enter into a transaction with an advised fund (i.e., a fund contractually advised or managed – but not "sponsored" – by the bank or a member of the banking group) that would be a "covered transaction" under Section 23A of the Federal Reserve Act.[12] Section 23A imposes limits on such transactions as bank loans to affiliates and purchases of assets from affiliates by a bank. Would these restrictions apply to existing sponsored funds during the interim period prior to issuance of regulations and divestiture? In addition, would the rules restricting covered transactions with advised funds apply where the bank or bank affiliate acts only as a sub-advisor to a fund? Further, it is not entirely clear whether the prohibition applies only to a bank, bank holding company parent, and investment adviser affiliate, and not to other nonbank subsidiaries of the financial institution. While the language can be read narrowly, general BHCA precedent applies prohibitions on a parent bank holding company to all of its subsidiaries. Finally, the Senate Bill also adds new "covered transactions" to Section 23A, including derivative transactions, but with an effective date one year after enactment; how, and when, would these new limits apply to existing sponsored funds?

5. Outsourcing fund "sponsorship". Prior to the enactment of the Gramm-Leach-Bliley Act of 1999 (which lifted certain restrictions on the fund-related activities of banking groups) and to a lesser degree thereafter, U.S. bank holding companies would at times act as advisers to funds that they effectively set up and arranged for others to act as general partner and administrator. Would this model, where a banking group effectively outsources the "fund sponsorship" function to a third-party, continue to be available under the Volcker Rule?

6. Non-U.S. financial institutions. Non-U.S. financial institutions covered by the Volcker Rule would generally be allowed to continue making investments and conducting private equity and hedge fund operations outside the United States. One important issue is whether there will be any restrictions on the

[12] As noted above, institutions covered by the Volcker Rule would be permitted to be advisers to private equity and hedge funds sponsored and controlled by others.

nature of the investments of non-U.S. funds sponsored by non-U.S. banking groups. Many such funds invest in U.S. companies and in non-U.S. companies with U.S. operations. The Federal Reserve's Regulation K has a set of complicated rules governing such investments in order to avoid too great an entanglement by non-U.S. banks subject to the BHCA in U.S. commercial activities that are generally prohibited for U.S. institutions. Will non-U.S. funds in which non-U.S. institutions invest be allowed to have ownership of interests in U.S. funds, or some significant amount of holdings of U.S. companies? Would the same Regulation K restrictions apply to such cases, or will some new body of rules apply? Would such a non-U.S. fund be allowed to have U.S. investors if non-U.S. institutions subject to the BHCA were allowed to invest? For non-U.S. institutions sponsoring non-U.S. funds, what limitations will have to be complied with in organizing, soliciting investors, and making investments in order to avoid being considered to be engaging in prohibited activity in the United States?

Conclusion

Some of the issues highlighted above might be clarified in the House-Senate conference and will bear watching as the conference continues. For those issues that are not clarified (in all likelihood, the great majority of issues), clear answers may have to await regulations, which likely will not be issued for at least one year following enactment. Financial institutions subject to the Volcker Rule will need to be prepared to determine what actions would be permissible in the meantime.

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