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Financial Regulatory Reform Update: The Volcker Rule Continues to Garner Outsized Attention in the Wake of Passage of Financial Reform Legislation.

The "Volcker Rule" continues to receive attention as one of the most forceful provisions adopted by Congress in its recent enactment of financial reform legislation. The Volcker Rule is far-reaching and covers both U.S. banking groups and non-U.S. banking groups with U.S. banking operations. Although the contours of the rule have now been established, the rule has become even more complex; substantial questions remain as to how the rule will be implemented, which we discuss below. As highlighted in this publication, Congress has given regulators little time to resolve these important issues.[1]

As we previously noted, the push for adoption of the Volcker Rule[2] was 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return to a more basic model of commercial banking that many associate with Glass-Steagall Act restrictions that were repealed in 1999. Indeed, the adoption of the Volcker Rule marks 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. Like Glass-Steagall, the rule is premised on a need to eliminate real and potential conflicts of interest between a banking entity

1 For more background, you may refer to our client memoranda, "Understanding the Significance of the Obama Administration's 'Volcker Rule'," dated February 17, 2010, available here, "Financial Regulatory Reform Update: The Volcker Rule Looms Large Over Asset Management and Fund Investment Activities of Financial Institutions," dated June 8, 2010, available here, and "Landmark Financial Regulatory Reform Legislation Passed By U.S. Congress," dated July 20, 2010, available at here.

2 The "Volcker Rule" is contained in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No. 111-203, 124 Stat. 1376 (2010) ("Dodd Frank").

and its customers. Congress' yearning for a simpler time, however, will impose increasingly complex rules on banking groups and will force them to change, if not abandon, practices that predate Glass-Steagall.

Unlike many other parts of Dodd-Frank, Congress has given the regulators broad authority to interpret and modify the rule.[3] As rules are proposed and adopted, there will be greater clarity on the extent to which covered activities will need to be transferred, terminated or wound down.

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3 The rule permits the appropriate federal banking agencies (Federal Reserve, FDIC, and Office of the Comptroller of the Currency), the SEC, and the CFTC authority to adopt rules on a "coordinated" basis, *i.e.*, to avoid the possibility of regulatory arbitrage, under the supervision of the Secretary of the Treasury, in his role as Chair of the FSOC.

Overview of the Scope of the Volcker Rule

As enacted by Congress, there are two basic features of the Volcker Rule that apply to banking groups (including any subsidiary in the group) operating in the United States:

- a prohibition on "proprietary trading" unrelated to customer-driven business, and
- a prohibition on private equity and hedge fund "sponsorship" and investment, subject to exceptions, *and* restrictions on certain relationships (so-called "covered transactions") with "advised" or "managed" private equity and hedge funds.

The rule applies to "banking entities," including insured depository institutions, their holding companies, and affiliates and subsidiaries of insured depository institutions and their holding companies.[4] A banking entity also includes any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 and any subsidiary or affiliate of that entity, *e.g.*, foreign banks with U.S.-based branches and agencies. Accordingly, the rule affects virtually every major commercial and investment bank worldwide. Further, portions of the rule also apply to nonbank financial companies that may be designated by the Financial Stability Oversight Council (FSOC) under Dodd-Frank to be supervised by the Federal Reserve and subject to enhanced prudential standards. Regulators may adopt regulations to impose additional capital charges or other quantitative restrictions on nonbank financial companies supervised by the Federal Reserve to address risks identified with proprietary trading and investments in hedge funds.

The rule's prohibitions affect every office and affiliate of U.S.-based institutions, so there is no ability for a domestic institution to shift business abroad to avoid the prohibitions. This provides an advantage to foreign institutions that act solely outside the U.S. For example, the rule does not affect the ability of foreign entities to trade in securities abroad, but foreign branches of U.S. banks may generally not engage in such conduct.

Prohibition on Proprietary Trading

Banks in the U.S. have engaged in proprietary trading in numerous asset classes since before the Civil War.[5] In reacting to the financial crises of 2007 and limiting the ability of banking entities to engage in proprietary trading,[6] Congress attempted to strike a balance between prohibiting speculative excess and simultaneously preserving the ability of banks to engage in traditional and essential trading activities. Congress thus broadly defined the terms "trading account" and "proprietary trading," and then built in exceptions. Trading account and proprietary trading are imprecise terms, both heavily dependent on the intent of the affected banking entity in conducting its operations.

4 The rule contains a narrow exception from the definition of insured depository institution for a trust company or similar institution that functions solely in a trust or fiduciary capacity if that institution does not accept demand deposits, substantially all the deposits of the institution are in trust funds, and the institution has no access to the discount window of the Federal Reserve.

5 The National Bank Act, with its origins dating to 1863, for example, permits national banks to deal in U.S. and municipal government securities, foreign exchange, and gold and silver, among other assets.

6 Regulators similarly must adopt regulations to impose additional capital charges or other quantitative restrictions on nonbank financial companies supervised by the Federal Reserve to address risks identified with proprietary trading.

"Trading account" means any account used to take positions in covered instruments "principally" for the purpose of selling in the near term, or otherwise to engage in short-term trading strategies, or other accounts that regulators later may determine by regulation.

"Proprietary trading" includes engaging as principal for the trading account of the banking entity in any transaction to purchase or sell or otherwise acquire or dispose of securities, derivatives, contracts for sale of a commodity for future delivery, and an option on the foregoing. Regulators have discretion to add other financial instruments to this list, including, for example, foreign exchange.

Bank examiners and others later will determine if a banking entity has engaged in prohibited proprietary trading by judging whether the entity intended to purchase and sell an instrument in the near term or in order to make a profit from short-term price movements. There is a danger that examiners will make *post hoc* judgments and find violations simply by observing whether a banking entity made or lost significant sums through apparent trading strategies, regardless of what the underlying motive actually was.

The statute creates exceptions from its prohibitions which are termed "permitted" trading-related activities. Banking entities thus may engage in—

- proprietary trading of obligations of the United States or any agency, Ginnie Mae, Fannie Mae, a Federal Home Loan Bank, Freddie Mac, Farmer Mac, a Farm Credit System institution, and municipal obligations.
- underwriting and market-making-related activities in securities that otherwise are prohibited for proprietary trading, but they may acquire inventory only to the extent necessary to meet the "reasonably expected near term demands" of customers.
- hedging or similar risk mitigation activities that are designed to reduce the specific risks arising from or related to covered instruments.
- purchase or sale of covered instruments "on behalf of" customers.
- investments in certain small business investment companies and other investments to promote the public welfare.
- investments in covered instruments by an insurance company and its affiliates for the company's general account.
- proprietary trading by non-U.S. entities outside the United States.

While not designated a "permitted" activity, a separate rule of construction makes clear that banking entities may sell or securitize (but not buy) loans without running afoul of the proprietary trading prohibition.

Regulators may add items to the list of permitted activities to promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

There also is a "clawback" or limitation on permitted activities in cases where a transaction or a class of transactions would involve a material conflict of interest between a banking entity and its clients, a material exposure of the banking entity to high-risk assets or trading strategies, or a threat to the safety and soundness of the banking entity or the United States. Regulators will adopt rules to provide guidance on the scope of this provision, but one may presume at a minimum that regulators will use the authority to rein in what they perceive as excessive trading in excepted instruments.

Prohibition on Sponsorship of and Investments in Hedge Funds and Private Equity Funds

Another prong of the Volcker Rule prohibits banking entities from sponsoring or investing in hedge funds and private equity funds, subject to a number of exceptions. Moreover, in addition to other provisions addressing capital, there is a separate provision allowing regulators to adopt regulations to impose additional capital charges or other quantitative restrictions on nonbank financial companies supervised by the Federal Reserve to address risks identified with investments in, and relationships with, hedge funds.

The statute defines the terms hedge fund and private equity fund coextensively. A hedge fund (or a private equity fund) is an issuer that would be an investment company but for the exceptions in sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.[7] Again, regulators may expand the definition of hedge fund to include "similar funds," presumably to include additional types of funds that evolve to mimic hedge funds or potentially evade the prohibitions of the Volcker Rule.

Sponsorship

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The statute defines the term "sponsor," which has any of three attributes: serving as a general partner, managing member or trustee; controlling a fund through the power to elect a majority of directors, trustees or management; or sharing the same name or a variant of the same name with the fund.

There is an exception from the prohibition against sponsorship to permit a banking entity to sponsor, organize and offer hedge funds to trust, fiduciary and investment advisory customers alone ("fiduciary customers," for purposes of this note), but subject to significant restrictions. The language can be read to permit a banking entity to offer such interests only to existing fiduciary customers. The banking entity may acquire an interest in the fund for seeding purposes but, as explained below, later must reduce the interest to a *de minimis* level. Directors and employees of the banking entity generally may not hold interests in such funds. The banking entity may not guarantee the fund's performance, and fund investors alone must bear the losses of the fund. This presents a potential issue for banks operating unregistered money market funds, for example. Transactions between a banking entity and an advised or sponsored fund are made subject to sections 23A and 23B of the Federal Reserve Act, as if the fund were a bank affiliate and the banking entity or affiliate were a member bank.

- ### Prime brokerage

The Federal Reserve may permit a banking entity to enter into prime brokerage transactions with a hedge fund or private equity fund in which a banking entity-sponsored (or managed or advised) fund has taken an equity, partnership or other ownership interest if the banking entity (1) is in compliance with the requirements governing the sponsorship of funds to fiduciary customers, (2) the chief executive officer of the banking entity certifies annually that the conditions in that exception are satisfied, and (3) the Federal Reserve determines that the transactions are consistent with the safe and sound operation of the banking entity.[8]

[7] For purposes of the treatment of illiquid funds, however, a hedge fund does not include a private equity fund as that term is used in section 203(m) of the Investment Advisers Act of 1940.

[8] Although Congress did not attempt to subject nonbank financial companies supervised by the Federal Reserve to sections 23A and 23B or the restrictions on prime brokerage relationships, it instructed regulators to adopt rules imposing further capital requirements on those companies to address the same conflicts of interest.

Investment

There are two limited exceptions to the prohibition on investment in hedge funds under the Volcker Rule. A banking entity may hold "*de minimis*" investments in funds that it organizes and offers in cases where the fund is open only to its fiduciary customers. The exception recognizes that frequently a bank needs to seed a fund until there are sufficient investors to make the fund free standing, but it also compels the entity to seek unaffiliated investors as promptly as possible. Thus, those *de minimis* investments are now subject to two separate three percent caps. Within a year of the establishment of a fund, the banking entity must reduce its interest in the fund to three percent of the fund's total ownership. Further, the banking entity must aggregate all of its investments in hedge funds and that aggregate amount may not exceed three percent of the entity's Tier 1 capital. A banking entity may apply for an extension of two years, beyond the ordinary one-year deadline, to meet the first of these three percent limits.

Second, the hedging or risk management exception to the prohibition against proprietary trading also extends to interests in hedge funds. Thus, in a case where a bank offers a structured note to its customer where the underlying is a hedge fund, that bank should be able to hold fund interests to hedge the transaction. Problematically, there is no exception permitting a banking entity to hold fund interests in satisfaction of a debt previously contracted, as discussed below.

The rule also provides for an orderly divestment of impermissible hedge fund investments. The Federal Reserve has six months to adopt divestment rules, or by January 21, 2011. Banking entities will have at least two years after the Volcker Rule becomes effective to complete their divestments. The Federal Reserve may extend the divestment period for no more than three one-year periods. In the case of funds designed to hold illiquid investments, *i.e.*, real estate or venture capital assets, the Federal Reserve may grant a one-time extension of five years for divestment.

Summary of hedge fund activities for a banking entity

After the Volcker Rule becomes effective, a banking entity's ability to engage in the hedge fund business becomes quite limited. A banking entity may:

- "advise" a fund;
- "organize and offer" a fund (only in cases where the fund is open for investment to fiduciary customers);
- directly invest in funds it organizes and offers, subject to the "3% caps" where the fund is open only to fiduciary customers of the bank;
- engage in risk-mitigation or hedging; and
- (if a non-U.S. banking entity) "sponsor" a fund outside the U.S., but the fund may not be offered or sold to U.S. residents.

Because the Volcker Rule is global in its reach, a U.S. banking entity may not escape the rule's application by attempting to relocate its funds and proprietary trading activities overseas. Non-U.S. entities will be able to relocate those activities from the United States to other locations, but will not be able to serve U.S. customers in doing so.

Going One Step Further

Congress evidenced its dissatisfaction with the financial industry by adding two provisions following the Volcker Rule, perhaps symbolically to serve notice that Congress had even further appetite to restrain the excesses it was addressing in

Dodd-Frank. While not generally thought of as properly part of the Volcker Rule, the placement is probably not accidental as both provisions also seek to limit conflicts of interest, and thus they are mentioned here.

First, Congress is looking for more financial wrongs to correct and is putting pressure on the regulators to expand their reach.[9] Federal banking agencies within 18 months of the date of enactment must review and prepare a report listing the permissible activities of banking entities and identify the risks associated with those activities (or investments) and any mitigation activities undertaken by banking entities to respond to those risks. Within two months after completing the study, the agencies also must present to Congress recommendations regarding whether those activities (or investments) could have a negative effect on the safety and soundness of banking entities or the U.S. financial system and possible additional restrictions to address those risks.

Second, Congress amended the Securities Act of 1933 to prohibit underwriters (or similar persons) of an asset-backed security within one year of the closing of the first sale of the security to engage in transactions that involve or would result in a conflict of interest with respect to an investor in the security.[10] There is an exception for risk-mitigating hedging activity relating to the underwriting of the asset-backed security and market-making activities, and the SEC is required to adopt rules to implement the section, so there is reason to expect further clarity in how the prohibition will be interpreted and perhaps narrowed.

Open Questions

As with any piece of legislation, it is in the rule writing and implementation phase that one may better understand the limits of the Volcker Rule's prohibitions. That process has only begun. We hope that during this process regulators will address some of the following questions.

Proprietary trading

- Trading account

We previously noted that it continues to be unclear where the line will be drawn between prohibited proprietary trading and permissible customer-driven transactions. 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, absent an intention to evade the rule, perhaps all) trades outside the "trading account" categorization would likely be permissible.

[9] *See* Dodd-Frank section 620.

[10] *See* Dodd-Frank section 621.

- Permitted activities

Regulators may add to the list of permitted activities to promote and protect the safety and soundness of the banking entity and the financial stability of the United States. Regulators should provide some indication as to their willingness to expand the list, hopefully through the identification of key criteria.

- Intent

It is unclear, for example, what types of conduct could constitute impermissible short-term trading and what conduct should be accorded "safe harbor" status. Because the definition of proprietary trading seems to rely on a state-of-mind standard, it will be difficult to determine under what conditions the requisite intent to trade is present. If bank examiners simply review profits or losses over a specified period in excess of predetermined ranges to determine whether the prohibition was violated, a number of transactions may mistakenly be captured within the prohibition. Might examiners view these different scenarios with suspicion and as evidence of possible speculative behavior?

- a banking entity maintains different levels of inventory for different types of securities for a purported market-making activity.
- a banking entity books an unhedged swap to accommodate a customer and is unable to create a satisfactory hedge before the customer determines to close out or terminate a losing bet early.
- a banking entity issues a short-term structured note, ostensibly to raise capital for the entity.

- Foreign government securities

The rule permits banking entities to trade in a variety of U.S. government and agency obligations, but ignores that U.S. banks may be active traders, through their foreign branches, in the bonds and other obligations of foreign governments, and would prohibit that activity. Unless there is an interpretation or other exception adopted in agency regulations permitting U.S. institutions to trade in foreign government bonds, there could well be unintended but very real disruptions in those markets where U.S. banking entities are substantial participants. For example, in those countries where U.S. banks are important participants in the secondary market for foreign government securities, the prohibition on proprietary trading might have an adverse impact on liquidity.

- Brokerage

Banking entities may engage in transactions in covered instruments "on behalf of" their customers. This could be interpreted as brokerage or something more expansive. It is unclear whether regulators will interpret this phrase coextensively with the term "customer facilitation," which was used in the Senate bill but dropped from the bill as enacted. If the terms are not coextensive, it is unclear which phrase should be read more or less expansively.

- Hedging

The language permitting hedging to reduce specific risks is limiting. It is not clear whether the provision is intended to narrow the range of hedging strategies that banking entities currently use. For example, would cross-hedging (e.g., hedging in Ford stock when GM stock is unavailable) be prohibited?

- Loan trading

Under the rules of construction, the new provision confirming the ability of banking entities to sell and securitize loans immediately draws into question the ability of those entities to trade in loans. The markets for trading syndicated loans, whole loans, and loan participations are huge. It is necessary for regulators to confirm that banking entities may continue to trade in these instruments as well, to avoid disruptions.

Funds

- We previously raised a number of questions concerning the prohibition of investments in hedge and private equity funds, a number of which continue to be pertinent:

Existing funds

When sales and spin-offs of existing funds 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?

Transfer of unfunded commitments

Investments in private equity funds are usually in the form of unfunded commitments. Depending on the length of the 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 Bank Holding Company Act of 1956, as amended (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.

Sections 23A and 23B

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? Dodd-Frank elsewhere adds new "covered transactions" to Section 23A, including derivative transactions, but with an effective date one year after the "transfer date," which is one year after the date of enactment, *i.e.*, July 21, 2011; how, and when, would these new limits apply to existing sponsored funds?

Sponsorship

The legislation contains a three-part definition of sponsorship applicable to the prohibition against investment in hedge funds. It would be helpful to the industry for regulators to explain what constitutes prohibited 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?

Non-U.S. financial institutions

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

- Debt previously contracted

Fundamental to the banking business is the ability of a bank to lend money on the security of collateral that a bank may not invest in directly. Equally fundamental is the ability of a bank to take that collateral to liquidate a debt that is not performing or otherwise is in default. The Volcker Rule, however, does not address the "debt previously contracted" exception that permits banks to foreclose on fund interests (and other assets that may not be permissible for direct investment by banks) collateralizing loans to funds or others parties. Ominously, one of the statute's express rules of construction is that notwithstanding any other provision of law, the prohibitions in the Volcker Rule shall apply to bank activities even if such activities are separately authorized.

Timeline for Effectiveness and Implementation

The Volcker Rule becomes effective on the earlier of twelve months after regulatory agencies issue final rules (some time between July 21, 2011 and October 21, 2012) or two years after the date of enactment of the provision, July 21, 2012. Before regulators act, within six months of the date of enactment, or by January 21, 2011, Dodd-Frank requires the FSOC to conduct a study and make recommendations, to inform coordinated agency rulemaking on the "Volcker Rule."

FSOC Study

The FSOC has announced its intent to complete its study on or before January 11, 2011. The FSOC study will contain recommendations specifically to—

- promote the safety and soundness of banking entities,
- protect taxpayers and consumers and enhance financial stability by minimizing risks to entities (and their affiliates) that accept deposit insurance,
- limit the inappropriate transfer of federal subsidies from institutions that enjoy deposit insurance and liquidity facilities to unregulated entities,
- reduce conflicts of interest between entities regulated by the Federal Reserve and the customers of those entities,
- limit activities that cause undue risks to banking entities,
- accommodate the business of insurance within an insurance company while protecting the safety and soundness of a banking entity with which the insurance company is affiliated, and
- appropriately time the divestiture of illiquid assets subject to the divestiture requirements of the Volcker Rule.

The FSOC also has issued a very broadly worded Notice and Request for Information (RFI) on this topic, which provides a mechanism for soliciting public and industry input during the development of the FSOC's formal study and recommendations. The RFI had a 30-day public comment period and was published on October 6, 2010.

Agency Rulemaking

Regulators have nine months after the completion of the FSOC study (some time between April 21 and October 21, 2011) to adopt implementing regulations for entities under their supervision. Assuming the FSOC completes its study and recommendations as announced, regulators must complete their rulemakings by October 11, 2011. As noted above, the CFTC and SEC have been added to the list of regulators adopting such rules, which inherently adds a further degree of complexity to the process. Regulators will need to adopt rules to—

- effect the FSOC's recommendations,
- impose additional capital requirements on entities that hold hedge fund interests during the transition period for divesting assets,
- add to the list of permitted activities that are excepted from the prohibition against proprietary trading or imposing restrictions on activities that are listed as permitted activities,
- impose additional capital requirements and quantitative restrictions (including diversification requirements) on permitted activities,
- impose internal control and recordkeeping requirements to prevent evasions of the rule,
- impose additional capital requirements or other restrictions to address risks assumed by nonbank financial companies supervised by the Federal Reserve that engage in proprietary trading or serve as sponsor, investment manager or investment adviser or provide prime brokerage services to hedge funds, and
- further define the terms hedge fund, proprietary trading, and trading account.

Federal Reserve Rulemaking

The Federal Reserve must separately adopt rules governing the divestment of impermissible hedge fund investments not later than six months after the enactment of the rule, or by January 21, 2011. The Volcker Rule contemplates that banking entities will have two years after the provision becomes effective to complete their divestments (some time between July 21, 2013 and July 21, 2014). The Federal Reserve may extend the period for divestment for no more than three one-year periods, or as late as July 2017. In an instance involving an illiquid fund, where a banking entity was under a commitment to extend funds entered into before May 2010, the Federal Reserve may grant a one-time extension for divestment of five years. It is not clear whether the five-year extension may be obtained in addition to the three-year extension available for divestment generally.

Conclusion

The Volcker Rule is a broad-ranging injunction against banking institution trading and hedge fund practices. The rule gives regulators given broad authority to interpret and modify the statute, potentially inhibiting these banking practices even further. Banking institutions tend to crave certainty, but the rulemaking timelines described above will force banking groups to remain in uncertain territory for a lengthy period. Once these rules are adopted, we will have much needed clarity on the extent to which trading activities will need to be transferred, terminated or wound down, although some activities, such as separately capitalized "proprietary trading" desks will certainly need to be terminated.

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This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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