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FSOC Study on Implementing the Volcker Rule — A Series of Missed Opportunities and Some Surprises

On January 18, 2011, the Financial Stability Oversight Council ("FSOC") issued its long-awaited report on a key provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act known as the "Volcker Rule," which generally prohibits banking entities from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds.[1] The Act required that the FSOC conduct a study on how the Volcker Rule could best be implemented by the five federal regulatory agencies[2] that are required to adopt rules to implement the Volcker Rule, which must be issued in final form within nine months of the Study's publication, or October 18, 2011.

The Volcker Rule has been criticized as both over-reaching in curbing legitimate banking functions and not going far enough in its proscriptions.[3] Preparation of the Study was accordingly recognized to be a daunting task, while also representing an opportunity for member agencies to reconcile apparent inconsistencies in the Volcker Rule through a process of consensus-building.

Our review of the FSOC Study indicates that the FSOC failed to seize a number of opportunities to resolve interpretive issues or provide needed guidance to banks. On the other hand, the Study does contain a few surprises. The Study appears to validate the suspicions of many observers that it is virtually impossible to recognize, much less define, a clear distinction between market-making and proprietary trading. Despite the drafters' obvious hard work and thoughtfulness, they have not managed to do it.

1 Public Law No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act" or the "Act"), signed into law by President Obama on July 21, 2010. The Volcker Rule is at Section 619 of the Act, which included the preparation of the study by the FSOC. The study is currently available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf and formally called *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, Financial Stability Oversight Council, January 2011 (the "Study").

2 The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Board), the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

3 If you wish to review further information regarding the Volcker Rule, you may refer to our Client Publication entitled "*The Volcker Rule Continues to Garner Outsized Attention in the Wake of Passage of Financial Reform Legislation*" (October 19, 2010) at http://www.shearman.com/financial-regulatory-reform-update--the-volcker-rule-continues-to-garner-outsized-attention-in-the-wake-of-passage-of-financial-reform-legislation-10-19-2010.

Summary Points

- *Many issues are left open.* The Study often fails to resolve those thorny issues, leaving it to the individual agencies to resolve through separate rulemakings.
- *10 recommendations.* The Study discharges its responsibility through 10 recommendations, including: (i) requiring banking entities to sell or wind down all impermissible proprietary trading desks and requiring divestiture of impermissible positions, (ii) performing supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading, and (iii) requiring banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
- *Recommendations regarding banks' relationships with private funds.* Four of the Study's 10 recommendations deal with the relationship between banking institutions and hedge funds. Specifically, the Study's recommendations include: (i) prohibiting banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers; (ii) prohibiting banking entities from engaging in transactions that would allow them to bail out a hedge fund or private equity fund; (iii) identifying similar funds that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule; and (iv) requiring banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.
- *Two approaches to identifying proprietary trading.* The Study takes two general approaches to identifying proprietary trading: (i) identifying proprietary trading in the rear-view mirror, and (ii) identifying proprietary trading by contrast with permitted activities, such as hedging and client facilitation.
- *Metrics for identification of proprietary trading through quantitative analysis.* The FSOC recommends that agencies develop a list of objective data points that banks would be required to collect and report in an attempt to identify instances in which a particular desk at a bank is engaging in impermissible proprietary trading. These data fall in the categories of "revenue-based metrics," "revenue-to-risk metrics," "inventory metrics," and "customer-flow metrics."
- *Tailored implementation.* The Study recommends more generally that regulators require banks to devise their own internal programs to avoid engaging in proprietary trading.
- *Non-U.S. banks.* The Study leaves many questions unanswered for non-U.S. banks, but does clarify that offshore proprietary trading will under the Volcker Rule be permissible for foreign banks with U.S. branches.

Interagency Effort

The Study, as expected, lingers on common ground found by agency participants. It also recognizes thorny issues that beg for resolution, but most often fails to resolve those issues, leaving it to the individual agencies to resolve through separate rulemakings. In discharging its function, the Study makes 10 key but general recommendations, but often phrases those recommendations as items that the agencies *should* consider when crafting regulations.

The list of 10 recommendations includes:

- Requiring banking entities to sell or wind down all impermissible proprietary trading desks;
- Requiring banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness;
- Requiring banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors;

- Performing supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading;
- Requiring banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated;
- Requiring divestiture of impermissible proprietary trading positions and impose penalties when warranted;
- Prohibiting banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers;
- Prohibiting banking entities from engaging in transactions that would allow them to bail out a hedge fund or private equity fund;
- Identifying similar funds that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule; and
- Requiring banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.

While not all aspects of the Study provide detailed or clear guidance to the industry, the Study does present moments of unexpected clarity, answering some questions in unexpected and indirect ways.

For example, it was unclear whether agencies would try to impose administrative exceptions from the Volcker Rule's prohibitions, even though the Dodd-Frank Act is conspicuous and even miserly in denying agencies the opportunity to create administrative exceptions to its prohibitions. There are at least four instances where the Study appears to endorse this approach, however. In particular, the FSOC:

- Endorses asset liability management activities, even though such activities are not expressly listed as permitted activities under the Volcker Rule;
- Agrees that exempting venture capital funds from the prohibition on investment in hedge funds and private equity funds is a "significant issue," and implies that an exception from the prohibition could be warranted;
- Urges agencies to consider interpreting the term "banking entity" to exclude hedge funds and private equity funds; and
- Urges the creation of safe harbors for insurance companies.[4]

Proprietary Trading Generally

The bulk of the Study is devoted to proprietary trading and in that respect the Study takes two general approaches:

Identifying proprietary trading in the rear-view mirror. The first approach can be characterized as the rear-view mirror approach – a banking entity should not make or lose too much money in its activities or it risks a violation of the proprietary trading prohibition.

Identifying proprietary trading by contrast with hedging and client facilitation. The second general approach is to acknowledge the difficulties in recognizing proprietary trading or distinguishing it from permitted activities. However, the Study fails to provide much needed guidance as to safe harbors or to define terms more definitively. For example, the FSOC agrees that the Volcker Rule should not be interpreted to prevent *bona fide* hedging, but

[4] Study at pp. 47, 62, 69, and 74.

hedging should not be used as a subterfuge for engaging in impermissible proprietary trading. The Study does not articulate the difference between the legitimate and the illegitimate, however.

In this regard, we note that the Study adopts an informal definition of customer-initiated trades that focuses on the unsolicited nature of such trades, stating that "'[c]ustomer-initiated' trades are those that come to trading desks unsolicited."[5] In our view, this definition is too narrow, for example ignoring the reality that most bank customers typically identify their financial needs and leave it to their banks to devise transactions that respond to those needs. Left unmodified, this new concept of the FSOC may cause innovation in financial products to suffer.[6]

Metrics

The FSOC has attempted to resolve one of several debates concerning the scope of the Volcker Rule: the problem of defining the *qualitative* factors that are inherent in proprietary trading, as opposed to permitted activities such as market making or hedging. The FSOC resolution is to reframe the debate by adopting *quantitative* measures to define those relevant terms. The FSOC recommends that agencies develop a list of objective data points that banks would be required to collect and report, apparently on a daily basis in some cases, in an attempt to catch instances in which a particular desk at a bank is engaging in impermissible proprietary trading. These data fall in the categories of "revenue-based metrics," "revenue-to-risk metrics," "inventory metrics," and "customer-flow metrics."

These four metrics are described as follows:

- "Revenue-based metrics" would attempt to measure daily revenue and revenue from specific trades relative to historical revenue and similar data for other banks (i.e., horizontal comparison).
- "Revenue-to-risk metrics" would attempt to measure revenue generated per unit of risk assumed.
- "Inventory metrics" take into account the need for market makers to hold inventory, but relates it to observed customer demand.
- "Customer-flow metrics" evaluate the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for the purposes of building inventory or hedging.

By attempting to solve one set of issues, the FSOC raises several others.

To its credit, the FSOC recognizes that there are weaknesses in this quantitative approach, and it identifies a number of issues that the approach presents. For example, the FSOC acknowledges that different metrics might be appropriate for different types of instruments. It also acknowledges that these standards could well be applied in ways that might prohibit activity that should be considered permissible, such as discerning whether some activities in fact hedge other activities so as not to violate the Volcker Rule.

However, the Study does not, as noted above, generally resolve these distinctions, leaving it to the agencies' final implementing rules. For example, the FSOC pronounces a number of rules-of-thumb to indicate when proprietary trading is likely to be present (instead of market making or inventory building or hedging), but these rules may well be simplistic and inaccurate, and fail to take into account items such as failed hedges.

[5] Study at p. 41.

[6] We note that the FSOC observes that banks are presently shutting down dedicated proprietary trading desks, hedge funds and private equity funds "that were a source of losses during the crisis." Study at p. 2. It is not clear, however, that banking entities have shut down only money-losing operations.

Systems challenges involved with implementation of a metrics-based approach

If the agencies adopt the Study's metrics-based approach, banking entities will likely have a huge systems development project on their hands. The FSOC readily admits that most existing risk management frameworks are incapable of implementing the Volcker Rule prohibition of proprietary trading. Banks' existing risk management systems capture information intended to limit risk of loss, not limit the risk of engaging in proprietary trading, and therefore may need to be modified in light of the proposed requirements.[7]

The Study recommends more generally that regulators require banks to devise their own internal programs to avoid engaging in proprietary trading. This seems to mean that banks would develop programs based on the types of instruments in which they are active; for example, registered equities are very liquid so market-makers should not need to hold them for significant periods of time, while derivatives may need to be held longer even for market-makers. The regulators would review each one for acceptability. This will allow for a "nuanced" approach to the challenge of quantitatively identifying proprietary (as opposed to permitted) trading, and the examiners would be able to determine whether, based on all the information received through the program as well as discussions with traders, a bank has gone over the line. This may well prove an extremely daunting exercise for examiners.

All of this systems development will be expensive. Importantly, banks will not be able to escape the requirement to implement system changes by simply stating that they have withdrawn from proprietary trading, so long as they continue to have some involvement in tradable financial instruments. If there is any market-making, underwriting or hedging going on — and it is hard to see how any major bank would not conduct these activities — then the agencies will apparently require that a program be in place to catch any instance in which those activities might have slipped over into proprietary trading.

Funds

While the Study devotes extensive attention to the Volcker Rule's prohibition of proprietary trading, it pays less attention to the prohibition of investment in hedge funds and private equity funds than it does to sponsorship of funds by banking entities. The Study includes thoughtful comments on dealing with the under-inclusiveness and over-inclusiveness of the definition of private equity and hedge funds that derives from sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940. For example, the Study notes that entities such as commodity pools might need to be covered on the basis of factors similar to prohibited funds, including use of leverage and how managers are compensated.

One aspect of the Study raises concerns. In particular, the Study at one point appears to conflate the feeder funds and funds of funds, raising the possibility of overbroad regulation at the agency level. Specifically, by denominating funds that pool customers' capital investments in third-party hedge funds and private equity funds as "feeder funds" rather than "funds of funds", the FSOC may create confusion.[8]

Foreign Banks

The Study almost totally omits discussion of the application of the Volcker Rule to foreign banks. It makes a reference to offshore proprietary trading being permissible for foreign banks with U.S. branches, reasoning that their offshore operations do not have access to the discount window or deposit insurance.[9] This point should be reassuring. Still, there are several issues regarding the application of the Volcker Rule to foreign banks that will need to be answered. For example, nothing in

[7] Study at p. 31.

[8] Study at p. 65.

[9] Study at p. 46.

the Study addresses foreign bank involvement in foreign hedge and private equity funds. However, the favorable mention of carving venture capital funds out of the definition of private equity funds, and thereby allowing banks to sponsor and invest in them, could be helpful for those foreign banks that sponsor non-U.S. funds investing in local small business and selling the interests to U.S. investors. Those funds that qualify as venture capital funds would not be subject to the Volcker Rule prohibitions.

Conclusion

The requirement to produce the Study represented a daunting task for member agencies, reconciling the apparent inconsistencies in the Volcker Rule through a process of consensus. The FSOC makes recommendations directly to its member agencies, and indirectly to the banking entities covered by the rule, to identify and eliminate prohibited proprietary trading activities and investments in or sponsorships of hedge funds and private equity funds by banking entities. There are hints of the common ground that agencies were able to find and, by extension, those areas that eluded consensus. The thorny issues that beg for resolution have been left to the individual agencies to resolve through separate rulemakings.

The danger now is that the agencies will take divergent, potentially inconsistent paths, leaving banking entities to sift through the differences to assess the merits of their own practices and activities. The next key event in this process will be the issuance of proposed regulations by each of the five agencies. All affected parties should remain alert to each agency's proposals in the next few months to see how closely they hew to the Study.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Barnabas W.B. Reynolds
London
+44 20 7655 5528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1 212 848 8410
bsabel@shearman.com

Russell D. Sacks
New York
+1 212 848 7585
rsacks@shearman.com

Azam H. Aziz
New York
+1 212 848 8154
aaziz@shearman.com

Laura S. Friedrich
New York
+1 212 848 7411
laura.friedrich@shearman.com

Geoffrey B. Goldman
New York
+1 212 848 4867
geoffrey.goldman@shearman.com

Nathan J. Greene
New York
+1 212 848 4668
ngreene@shearman.com

Donna M. Parisi
New York
+1 212 848 7367
dparisi@shearman.com

Paul S. Schreiber
New York
+1 212 848 8920
pschreiber@shearman.com

Donald N. Lamson
Washington, D.C.
+1 202 508 8130
donald.lamson@shearman.com

Gregg Rozansky
New York
+1 212 848 4055
gregg.rozansky@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM