October 27, 2011

In the Eye of the Beholder: The Volcker Rule Proposal and What It Means

Flesh is starting to be put on the bones of the Volcker Rule, but that isn't making it any more attractive. As proposed, the regulations that would implement the Rule would require a massive effort by large banking institutions, both domestic and foreign, to implement policies, procedures, controls and reporting systems in order to continue conducting trading and private funds activities. Following is a summary of the proposed regulations and their implications, and some of the issues that financial institutions should surface with the regulatory agencies during the comment period.

Four financial regulatory agencies have issued proposed uniform regulations that would implement the Volcker Rule, which requires major financial institutions to cease engaging in proprietary trading and most hedge fund and private fund investment and management activities in July 2012. The Rule is at Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and was enacted primarily at the urging of Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System. The proposed uniform regulations (herein, the "Proposal") were approved for issuance on October 12 and 13.[1] The Proposal provides additional detail on the Rule's requirements and a very elaborate compliance regime that institutions with significant trading activities would have to adopt for purposes of monitoring permissible activities. The comment period ends on January 15, 2012.

The four agencies (collectively, the "Agencies") are the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Securities and Exchange Commission, with each agency's version applicable to the particular financial institutions under its jurisdiction. The Commodity Futures Trading Commission was expected to participate in the rulemaking — indeed was arguably required by statute to participate — but did not do so; news reports indicate that it will issue its own proposed version at a later time.

[1] The Dodd-Frank Act is at Public Law No. 111-203, 124 Stat. 1376 (2010) and codified throughout the United States Code. The Proposal can be found on the Federal Reserve's website at www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm. If you are interested in reading about the background of the Volcker Rule, you may wish to review our previous client memoranda: "The Leaked Staff Drafts: New Volcker Rule-Related Concerns for Non-US Banks" (October 10, 2011); "Dodd-Frank: The GAO Struggles with the Volcker Rule" (July 22, 2011); "FSOC Study on Implementing the Volcker Rule — A Series of Missed Opportunities and Some Surprises" (January 2011); "Financial Regulatory Reform Update: The Volcker Rule Continues to Garner Outsized Attention in the Wake of Passage of Financial Reform Legislation" (October 19, 2010).

The general intent of the Volcker Rule is to prohibit US banking institutions from utilizing the benefits they obtain from deposit insurance and access to emergency lending facilities to make a profit from short-term trading and private fund investments that are unrelated to their customer business. An unstated intent is apparently to implement a belief of former Chairman Volcker that commercial banking is a relationship business, and that commercial banks should limit themselves to transactions that serve their customers, and not simply engage in trading and investing unrelated to customer needs.[2]

While this kernel of an idea is understandable, though debatable on a number of levels, the Proposal's expression of the idea and the mechanisms for explaining and enforcing it would provoke a vast compliance and recordkeeping structure unless it is significantly revised in its final form.

The Proposal continues to be reviewed by interested parties, and additional nuances reveal themselves on re-readings. Following is a summary of the salient parts of the Proposal and the issues that we believe deserve financial institutions' attention and on which they should provide commentary to the Agencies.

I. Who Has to Comply with the Rule?

Both the proprietary-trading and private-funds sections of the Proposal apply to "covered banking entities." This term refers to the specific types of "banking entities" to which an agency's version of the rule applies; for example, a registered broker-dealer or investment advisor would be a "covered banking entity" in the SEC's version of the regulation. "Banking entities" are defined, as they are in the statute, to include:

- Any insured depository institution and any company that controls such an institution;
- Any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 ("IBA"), which applies to non-US banks with US banking operations; and
- Any affiliate or subsidiary of the above, with clarifying exceptions for certain private funds.

Insured depository institutions by definition are banking institutions chartered under US law the deposits of which are insured by the Federal Deposit Insurance Corporation ("FDIC"). This includes banks that are defined as "banks" for purposes of the Bank Holding Company Act of 1956, as amended ("BHCA"), but also other institutions such as FDIC-insured banking institutions that are not, such as industrial loan companies, thrift institutions and credit card banks. Thus, any company that controls an insured depository institution is subject to the Rule, which is in new Section 13 of the BHCA, even if the company is not subject to the other sections of the BHCA.[3]

[2] He recently reiterated the point: "The justification for official support and protection of commercial banks is to assure maintenance of a flow of credit to business and individuals and to provide a stable, efficient payment system. Those are both matters entailed in continuing customer relations and necessarily imply an element of fiduciary responsibility. Imposing on those essential banking functions a system of highly rewarded – very highly rewarded – impersonal trading dismissive of client relationships presents cultural conflicts that are hard – I think really impossible – to successfully reconcile within a single institution." William Taylor Memorial Lecture at 10 (Sept. 23, 2011).

[3] Insurance companies subject to the BHCA and derivatives clearing organizations that are banks or affiliates of banks are subject to these rules and have special exemptions, which are not discussed below.

Non-US banks that have a US branch or agency, or control a commercial lending company, are subject to most provisions of the BHCA through the IBA. Accordingly, such non-US banks are also "banking entities" and are subject to the Rule.

Affiliates and subsidiaries are defined by reference to BHCA definitions, which incorporate the concept of "control" by one company of another. "Control" is deemed to exist if one company owns or controls 25 percent or more of any class of voting stock of another company or controls in any way the election or selection of a majority of the other company's board of directors. The Federal Reserve also has standards for determining whether one company has a controlling influence over another even if the company owns or controls less than 25 percent of voting stock or does not control the board, but it is not clear whether those standards are incorporated here.[4] The Proposal excludes from coverage a covered fund, as discussed in Section III below, that is controlled by a banking entity and any company controlled by such a fund. Apart from that exception, there is no exception for affiliates or subsidiaries, including those located outside the United States, and accordingly the Rule applies worldwide to all affiliates and subsidiaries of all "banking entities."

II. Proprietary Trading

A. In General

The Proposal's treatment of proprietary trading can be summarized through the following points:

- the definition of "proprietary trading,"
- the exemptions from the prohibition for certain proprietary trading activities, as well as exceptions to the exemptions, and
- the requirements that organizations must meet in order to conduct permitted trading activities, including the adoption of policies and procedures and of recordkeeping arrangements, including periodic reporting of the results of the recordkeeping to the Agencies.

B. Definition of "Proprietary Trading"

The Proposal adopts the Dodd-Frank Act's definition of "proprietary trading" and adds a host of additional definitions, many of which are packed with meaning. In outline form, showing the terms that need to be defined, the definition of "proprietary trading" is:

- "...engaging as principal
- for the trading account
- of the covered banking entity
- in any purchase or sale

[4] Footnote 79 of the Proposal states that the concept of control incorporated into the Rule is as defined in the BHCA "and as implemented by the" Federal Reserve. This may be an indication that the drafters intended to include those policies into the Rule for purposes of determining subsidiary or affiliate status.

- of one or more covered financial positions."[5]

"*Engaging as principal*" simply means engaging in transactions in one's own name and for one's own account, rather than acting as broker, agent or custodian.

The definition of "*trading account*" is any account that is used by a covered banking entity to:

- acquire covered financial positions (defined below) principally for the purpose of (a) short-term resale, (b) benefitting from actual or expected short-term price movements, (c) realizing short-term arbitrage profits or (d) hedging any of (a), (b) or (c);
- acquire or take covered financial positions that are "covered positions" (other than foreign exchange derivatives, commodity derivatives, or commodity futures contracts) for purposes of the banking agencies' market risk capital adequacy guidelines applicable to US entities; or
- acquire or take covered financial positions for any purpose if the banking entity is a registered (a) securities dealer, (b) Government securities dealer, (c) swap dealer, (d) securities swap dealer or (e) non-US entity engaged in such businesses, all to the extent of activities that cause the entity to be registered.

The second item — based on market risk capital rules — seems to apply by definition only to US institutions regulated by the US bank agencies; the theory seems to be that those institutions already know whether they have such an account because they would have had to characterize it as such in order to comply with capital guidelines. The first category is more general, but the Agencies state that it is substantially similar to the market risk definitions of the Basel Committee on Bank Supervision, on which the US market risk guidelines are based, and accordingly would cover both US and non-US banking entities. The third category reflects the Agencies' belief that any registered securities or swaps dealer should automatically be considered to be engaging in proprietary trading.

There is no definition of "short-term" for this purpose, but there is a rebuttable presumption that any position held for 60 days or less is a short-term position. Accordingly, any account that held such a position would generally be a trading account. The banking entity can rebut the presumption. Excluded from coverage are repurchase and reverse repurchase agreements for "assets" (not only securities), securities lending arrangements, and bona fide liquidity management programs pursuant to a written plan limiting the timing and types of instruments that may be purchased and sold.

The definition of "*covered banking entity*" is discussed above.

The definition of "*purchase or sale*" tracks the definitions used in the Securities Exchange Act of 1934, as amended ("1934 Act") and incorporates such things as the execution, termination and conveyance of a derivative.

A "*covered financial position*" is defined as long, short, synthetic "or other" position in a (a) security, (b) derivative, or (c) contract of sale of commodity for future delivery or option, but does not include a position in a (d) loan, (e) commodity or (f) foreign exchange. "Security" and "commodity" are defined by reference to the terms used in the 1934 Act and Commodity Exchange Act ("CEA"). "Derivative" is defined by reference to the CEA and 1934 Act but incorporates definitions as adopted by the SEC and CFTC in the future. The term excludes consumer, commercial and other agreements that the CFTC and SEC find are not "swaps" and also excludes "identified banking products", which generally includes bank deposits and other short-term bank issuances.

[5] Proposal at Section ___.3(b)(1).

In summary, a transaction taking place through any account on the books of a banking entity meeting the standards above is one that will be treated as proprietary trading. For this reason, the exemptions from the prohibition on proprietary trading become very important.

C. Exemptions from Prohibition on Proprietary Trading

There are two types of exemptions from the prohibition on proprietary trading. One is based on type of instrument, while the other is based on type of activity.

1. Type of Instrument

In general, US Government and agency obligations, obligations of the housing and agricultural agencies, and municipal obligations are exempt from the prohibition.[6] The theory for this exemption seems to be that US banks, for at least a century, have dealt in US Government securities without restriction and that there was no reason to disrupt the practice, which also appears not to have caused any significant amount of loss to financial institutions. It appears that derivatives of such obligations are not exempt.

The Agencies have the authority to exempt additional classes of instruments but the Proposal does not do so.

2. Type of Activity

The Rule exempts several types of activities that would otherwise be prohibited as proprietary trading. It is these exemptions that led the Agencies to believe that the elaborate recordkeeping and reporting systems discussed below are necessary. The fear is that an activity that is claimed to be exempt is in fact disguised proprietary trading. Much of the burden of complying with the Proposal results from these exemptions.

a. Underwriting

Consistent with Chairman Volcker's idea that banking is a relationship business, the Rule allows banking entities to underwrite securities as a way to provide financing to a customer. The Proposal's definition of the term is relatively straightforward. It applies only to securities and requires that the underwriting entity have appropriate registration for the activity. It requires a "distribution," defined as an offering, whether or not registered under the Securities Act of 1933 ("1933 Act"), that is different from ordinary trading by "the magnitude of the offering and the presence of special selling efforts and special methods." This seems to recognize private placements and non-issuer secondary offerings as underwriting.

In addition, three restrictions appear intended to address specific concerns about evading the prohibition: (a) the underwriting must be designed not to exceed "reasonably expected near term demands" of customers, (b) the underwriting must be designed to generate revenues "primarily" from fees, commissions, spreads and other income not attributable to appreciation in value or hedging and (c) compensation arrangements for underwriting personnel must be designed "not to reward proprietary risk-taking."

Finally, the banking entity must have written policies and procedures, internal controls and independent testing to assure compliance with the Rule, as specified in detail in the regulation. This point is discussed below.

[6] The housing and agricultural issuers are Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation and any Farm Credit System institution. Both general and limited obligations (such as revenue bonds) are included.

b. Market-making

The market-making exemption similarly is consistent with the idea that a bank should serve the needs of its customers, in this case by having securities and other instruments on hand to sell, and being willing to buy, in order to accommodate customer liquidity needs. However, unlike underwriting, market-making takes place in the secondary market, and accordingly is perceived as running a much greater danger of morphing into impermissible proprietary trading.

The requirements in the Proposal are much like those summarized above for underwriting, except that the exemption is not limited to market-making in securities. Hedging is authorized so long as the hedge reduces specific risks of the market-making positions, which may be on individual or aggregate positions, in the latter case as portfolio hedging. The requirements for policies and procedures, controls and monitoring are much more extensive than the ones for underwriting, discussed below.

c. Risk-mitigating Hedging

The Rule allows banking entities to enter into covered financial positions designed to reduce the specific risks of individual or aggregate positions or other contracts of the banking entity. The Proposal's requirements are much like those summarized above, with the addition that the hedge should not give rise at initiation to "significant exposures that were not already present" in the hedged position and must be monitored and managed to maintain a "reasonable level of correlation".

If a hedge is held in a legal entity different from the one holding the hedged position, the banking entity must document, at the time that the hedge is initiated, the risk-mitigating purpose of the hedge, the risks of the positions that the hedge is designed to reduce and the level of the organization establishing the hedge.

d. Trading on Behalf of Customers

Trading on behalf of customers is also an exemption consistent with the underlying premise that commercial banks may serve their customers. The Proposal limits this exemption to transactions (a) by an investment advisor, trustee or similar fiduciary for the account of the customer and for which the customer is beneficial owner, (b) as riskless principal and (c) by insurance companies for separate accounts.

e. Trading Outside the United States by Non-US Banking Entities

The statute recognizes that non-US banks subject to the Rule should be allowed the freedom to engage in trading activities outside of the United States. This exemption is consistent with the general approach of US banking regulation that non-US banks (organizations that are considered foreign banking organizations under the Federal Reserve's regulations under the BHCA) should not be significantly constrained by US law in their non-US operations and that any safety and soundness or related concerns are matters primarily for their home country supervisors.[7] However, significant constraints are put on the exemption.

The exemption is available only to transactions that are (a) authorized by sections of the BHCA that, under Federal Reserve regulations, are performed by non-US entities primarily engaged in business outside of the United States and (b) occur "solely outside of the United States". The latter requirement is met only if (a) the entity is organized under non-US law, (b) no party to the transaction is a "resident of the United States," (c) no personnel involved in the

[7] The regulations governing foreign banking organizations are at the Federal Reserve's Regulation K, Subpart B, 12 C.F.R. Part 211, Subpart B (2011).

transaction are physically located in the United States and (d) the transaction is executed "wholly outside of the United States." A "resident of the United States" does not clearly include a non-US subsidiary of a US entity, but does include a discretionary or non-discretionary account (other than an estate or trust) that is (a) held by a dealer or fiduciary for the benefit of a US resident or (b) is held by a US resident.

3. Covered Funds and their Holdings

As noted above, the definition of "banking entity" includes any subsidiary of a banking entity but excludes a private fund that a banking entity is authorized by the Proposal to own and control and any company that would be a subsidiary of such a fund. This exclusion seems clearly to allow a private fund to engage in proprietary trading without regard to the provisions of the Proposal. It also prevents any company controlled by such a fund from being subject to the Rule's prohibition. Without this exclusion, a banking entity holding a significant stake in a permissible sponsored private fund would cause the fund to be subject to the proprietary trading prohibition as well as any company in which the fund held a controlling interest.

D. Exceptions to the Exemptions

The exemptions summarized above are subject to certain limited prohibitions. Any transaction or activity that would otherwise be permissible due to an exemption is not permissible if it would (a) involve or result in a material conflict of interest between the banking entity and its customers, (b) result in a material exposure to a "high-risk asset or a high-risk trading strategy" or (c) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

The Proposal defines a conflict of interest as a transaction resulting in the banking entity's "interests being materially adverse" to its customer's interests. Such a conflict may be mitigated by disclosure that allows the customer to negate or substantially mitigate the conflict. A banking entity also must have information barriers, in written policies, designed to prevent such conflicts. A high-risk asset or trading strategy is one that would "significantly increase the likelihood" that the banking entity would suffer substantial loss or fail.

E. Compliance and Recordkeeping Requirements

1. Compliance and Recordkeeping Requirements Generally

The Proposal requires that any banking entity that conducts permissible trading activities — underwriting, market-making, hedging and the other permitted trading summarized above — adopt policies and procedures governing those activities in order to enforce compliance with the Volcker Rule. Effectively, the banking entity must take these actions in order to provide assurance that none of the permissible activities are disguised proprietary trading or change over time into proprietary trading. Banking entities of large size must have programs that address a greater number of points in greater detail than other banks.

In addition, most large organizations will be required to capture a wide range of data regarding those activities in order effectively to double-check compliance and to report it to the Agencies on a regular basis.

2. Compliance Programs

There are three levels of compliance programs.

First, a banking entity that is engaged in none of the trading activities discussed above must have measures designed to prevent becoming engaged in such activities and to require a compliance program if in the future it commences some form of permitted trading.

Second, any banking entity engaged in any permissible trading activity must have a written compliance program that includes:

- Written policies and procedures designed to document, describe and monitor trading activities to ensure that they comply with the Rule;
- A system of internal controls designed to monitor and identify potential areas of noncompliance and prevent their occurrence;
- A management framework clearly delineating responsibility and accountability for compliance;
- Independent testing of the effectiveness of the compliance program;
- Training for trading personnel and managers in order to implement the compliance program; and
- Making and maintaining (for at least five years) records sufficient to demonstrate compliance with the Rule.

If the banking entity is engaged in market-making, then the written compliance program must incorporate an extended commentary on market-making included in the Proposal.[8]

Finally, a banking entity engaged in proprietary trading that has trading assets and liabilities equal to or greater than $1 billion or 10 percent or more of its total assets, calculated on a worldwide consolidated basis as of the last day of each of the previous four calendar quarters, must cover additional items in its written compliance program and internal control system.

The additional items in its compliance program include:

- How the banking entity identifies which of its accounts are trading accounts;
- How the banking entity identifies each trading unit (defined below) and maps each unit to the organizational structure that manages the unit;
- A description of the mission and strategy of the unit, including such things as how revenues are intended to be generated, authorized activities and types of instruments and customers of the unit;
- Trader mandates for each trading unit, including such things as the parameters within which each trader may operate;
- A description of risks and risks management processes of the trading unit;
- Hedging policies and procedures;
- An explanation of how the mission and strategy of the trading unit complies with the Rule, including an explanation how the unit monitors for and prohibits potential exposure to high-risk assets or trading strategies; and
- How violations of the Rule are documented, addressed and remedied.

The additional items for its internal control system must include control systems including the following:

- A system to monitor and govern the types and levels of risk that may be taken by each trading unit, type of hedging instruments and strategies employed and the types of contracts, products and assets that may be traded;

8 The commentary is in "Appendix B: Commentary Regarding Identification of Permitted Market Making-Related Activities."

- Risk limits for each trading unit, including limits based on measures of loss;
- The performance of analysis and quantitative measurement of trading activities to insure consistency with mission, identify potential violation of the Rule and prevent it and protect the accuracy and integrity of quantitative measurements; and
- The monitoring of the effectiveness of the compliance program.

3. Recordkeeping and Reporting Requirements

a. General Requirements

The Proposal imposes recordkeeping and reporting requirements on any banking entity that has trading assets and liabilities in an average gross sum of $1 billion or more, calculated on a worldwide consolidated basis measured as of the last day of the four prior calendar quarters. Most of the data listed below is to be obtained on a daily basis and reported to the banking entity's Agency on a monthly basis.

b. "Trading Unit"

The data and reporting below must be done for each "trading unit" within the banking entity. "Trading unit" is defined as (a) each "discrete unit that is engaged in the coordinated implementation of a revenue-generation activity and that participates in the execution of any covered trading activity", (b) any organizational unit used to structure and control the risk-taking activities and employees of one or more units as defined in (a), (c) all trading operations collectively and (d) any other unit specified by an Agency. A footnote indicates that a trading unit could be an individual trading desk.

This definition seems to require recordkeeping and reporting for each such trading desk or other unit as well as on an aggregate basis for the entire organization. Because it applies to any trading unit engaged in a "covered trading activity," any unit engaged in trading US Government securities apparently is covered even though the Rule does not prohibit proprietary trading in such securities.[9]

c. Market-making: Banking Entities with Less Than $5 Billion

For those banking entities with trading assets and liabilities of $1 billion but less than $5 billion calculated as above, the following data points must be measured for each trading unit engaged in market-making activities:

- Comprehensive profit and loss;
- Portfolio profit and loss;
- Fee income and expense;
- Spread profit and loss;
- Value-at-Risk;
- Comprehensive Profit and loss attribution; volatility of comprehensive profit and loss and volatility of porftolio profit and loss; and

[9] "Covered trading activity" is defined by reference to the general definition of "proprietary trading", which refers to engaging as principal for the trading account in a "covered financial position." This in turn is defined to include a security, among other things, and excludes loans, commodities and foreign exchange. Accordingly, such trading in US Government securities appears to be covered. See the Proposal at §§ II. of Appendix A, __.3(b)(1) and __.3(b)(3). The same is true for trading by non-US banks at trading units outside the United States.

- Comprehensive profit and loss to volatility ratio and portfolio profit and loss to volatility ratio.

Each of these terms is defined in the Rule.

d. Market-Making: Banking Entities with $5 Billion or More

For those institutions with $5 billion or more in trading assets and liabilities calculated as above, and for each trading unit engaged in market-making activities, a total of 17 items, each defined in detail in the regulation, must be recorded along with additional ones:

- Value-at-Risk and stress VaR;
- VaR exceedence;
- Risk factor sensitivities;
- Risk and position limits;
- Comprehensive profit and loss;
- Portfolio profit and loss;
- Fee income and expense;
- Spread profit and loss;
- Comprehensive profit and loss attribution;
- Pay-to-receive spread ratio;
- Unprofitable trading days based on comprehensive profit and loss and unprofitable trading days based on portfolio profit and loss;
- Skewness of portfolio profit and loss and Kurtosis of portfolio profit and loss;
- Volatility of comprehensive profit and loss and volatility of portfolio profit and loss;
- Comprehensive profit and loss to volatility ratio and portfolio profit and loss to volatility ratio;
- Inventory risk turnover;
- Inventory aging; and
- Customer-facing trade ratio

e. Other Trading: Banking Entities with $5 Billion or More

Any banking entity with over $5 billion, and for each trading unit engaged in underwriting, hedging or US Government obligations trading (but not market-making), must record only the first, third, fourth and fifth items listed above along with comprehensive profit and loss attribution.

IV. Private Fund Investments and Activities

A. In General

The Proposal implements the Rule's prohibition on investments in certain types of funds and activities related to such funds in one sentence, stated in outline form:

- "...a covered banking entity
- may not, as principal, directly or indirectly,
- acquire or retain any ownership interest in
- or sponsor
- a covered fund."

As with proprietary trading, these terms have significant meanings.

B. Definitions

1. "Covered Banking Entity"

The Proposal's general definition of "banking entity" is outlined above in Section I of this memorandum. However, a significant amendment fixes what everyone seems to agree was a drafting oversight.

As noted above, the statute includes all affiliates or subsidiaries of the entities otherwise identified as "banking entities". The result of this definition is that a private fund permissibly controlled by a banking entity itself would be a banking entity, leading to illogical results. In order to avoid the conundrum, the Proposal carves out any subsidiary or affiliate that is (i) a "covered fund" under the Proposed Rule or (ii) an entity controlled by such a "covered fund". The effect of these carve-outs is that banking entities would not be prohibited from operating a "fund-of-funds" business where the fund of funds invests in third party funds, private funds that are controlled by a banking entity would not be prohibited from making investments in other such funds and companies controlled by a hedge fund or private equity fund that is controlled by a banking entity will not be subjected to the restrictions of the Rule.

2. "Covered Fund"

The statute defines both "hedge fund" and "private equity fund" as (1) an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) thereof, or (2) such similar funds as the appropriate agencies may determine by rule. The Proposal merges the terms "hedge fund" and "private equity fund" into a single defined term, "covered fund."

In addition, the Proposal adds to the definition of "covered funds" two types of "similar funds": commodity pools as defined in the CEA and issuers organized or offered outside of the United States that would otherwise be a covered fund were they organized or offered under the laws of, or offered to one or more residents of, the United States. The Proposal draws no distinction between registered and unregistered commodity pools. As to the second addition, these might be thought of as non-US analogs to covered funds and are clearly intended to cover hedge funds and private equity funds that would otherwise avoid "covered fund" status simply by limiting their offerings of securities to non-US persons. The addition is, however, probably broader in effect than intended in that it appears to cover some non-US registered investment funds, such as a retail fund in Europe or Asia.

The Proposal also narrows the statutory definition by effectively excluding from the definition of "covered fund" certain entities that, by themselves and without other extenuating circumstances or factors, do not raise the type of concerns that the Agencies believe the Dodd-Frank Act was intended to address. The Proposal generally permits a banking entity to acquire or retain an ownership interest in or act as sponsor to (a) joint ventures that are operating companies and do not make investments prohibited under the proposed rule, (b) acquisition vehicles with a sole purpose to effectuate a merger or acquisition, (c) entities that, despite relying on the 3(c)(1) or 3(c)(7) exemptions, have such characteristics as would allow them to rely on a different exception or exemption from the definition of "investment company" under the Investment Company Act, apparently carving out real estate investment funds and some types of finance companies, (d) wholly-owned subsidiaries engaged in bona fide liquidity management activities and (e) certain issuers of asset-backed securities in the context of securitizations.

Why these types of entities need action by the Agencies to carve them out may not be obvious to readers unfamiliar with the breadth of the Investment Company Act. The issue is that the Act potentially catches within its ambit many common organizational structures and treats them as "investment companies" subject to the need for an exception or exemption. Because the Section 3(c)(1) and 3(c)(7) exemptions are the broadest ones available, these two exemptions are widely used in practice outside the hedge fund and private fund contexts.

3. "As Principal"

The Proposal states that a covered banking entity may not "as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor" a covered fund.

The statute does not include the phrase "as principal, directly or indirectly", which has been added in the Proposal presumably in order to both address possible circumvention of the Rule by indirect action and also to carve out certain situations where a banking entity's involvement with a covered fund is not within the scope of the activities that the statute is intended to address. The Proposal would generally not prohibit the acquisition or retention of an interest in a covered fund in cases in which (a) a banking entity was acting in good faith as a fiduciary, or in its capacity as a custodian, broker or agent for an unaffiliated third party, (b) an ownership interest in a covered fund is held by a banking entity's qualified employee benefits plan under ERISA or (c) the interest in a covered fund is held in a personal capacity by a banking entity's director or employee who is directly engaged in providing services to the covered fund, unless the interest was acquired through a direct or indirect extension of credit from the banking entity.

Adding the phrase "directly or indirectly" to the definition is also a potential source of continuing confusion and uncertainty. For general BHCA purposes, "indirectly" means through a subsidiary, but the structure in the Proposal seems to make the term redundant. As noted above, any entity controlled by a banking entity is itself defined as a banking entity, except for certain funds as described above, and thereby subject to the Rule's prohibitions directly.

4. "Ownership Interest"

The statute uses the phrase "ownership interest" but does not define it. The Proposal states that, with one exception, an "ownership interest" consists of any equity, partnership, or other similar interest in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. The Proposal's definition focuses on function over form: the key inquiry is whether the interest provides a banking entity with economic exposure to the profits and losses of the covered fund. As a result, if an instrument not enumerated in the definition has characteristics of equity, the instrument could be deemed to fall under the definition as an "other similar interest".

The exception is for a carried interest. "Carried interest" received by a banking entity as compensation for providing investment advisory services to a covered fund will not be considered an "ownership interest" in the covered fund subject to several conditions, including a requirement that the carried interest, once allocated, be distributed to the banking entity promptly after being earned. This requirement is contrary to common fund industry practice of reinvesting in the fund.

5. "Sponsor"

The Proposal imports unchanged the Dodd-Frank Act's definition of "sponsor" as an entity that (a) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund, (b) in any manner selects or controls a majority of the directors, trustees, or management of a covered fund or (c) shares with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. The term "trustee" excludes trustees that do not exercise investment discretion with respect to a covered fund, including directed trustees.

C. Exemptions from the Prohibition on Private Fund Activity

The Proposal contains a number of exemptions to both the general prohibition on banking entities sponsoring covered funds and the related ban on their acquiring and retaining ownership interest in such funds generally, subject to specified conditions and limitations.

1. Bona Fide Services

The statute provides an exclusion from the prohibition for "bona fide trust, fiduciary, investment advisory, or commodity trading advisory services" to persons who are customers of these services. The Proposal states that this exemption recognizes that banking entities should continue to be able to engage in traditional asset management and advisory activities for their customers.

At the same time, however, a number of conditions accompany the exemption in an attempt to ensure that the exemption is not used by a banking entity for the purpose of sponsoring a covered fund that it would use as a means of itself investing in the fund or assets held by the fund. They generally require:

- a "credible plan" or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund,
- certain mandated disclosures to investors,
- a restriction on holdings in the covered fund by the banking entity's officers and directors to those individuals who are directly engaged in providing it with services (such a restriction would be contrary to existing practice in which, for example, participation in a fund historically has been attractive for bank executives),
- a prohibition on naming a fund with the same name as the covered banking entity or a variation, and
- a prohibition on any guarantee of the fund's performance by the sponsoring banking entity.

The Proposal does not require that a pre-existing relationship exist with the customers to whom the banking entity offers interests in the sponsored fund. This clarification widens the scope of potential investors in any covered fund that it sponsors and allows the continuing organization of new funds over time instead of a grandfathering-style rule that might have been more limited. The only relationship between a banking customer and the banking entity can be the provision of advisory services to the customer through the customer's investment in a covered fund.

2. De Minimis Investments

In connection with the exclusion above for sponsoring a private fund, a banking entity may also make limited investments in such a fund. This exception allows a sponsoring banking entity to "seed" a new fund. The exclusion is generally subject to four principal limitations:

- The banking entity may only invest in covered funds that it, an affiliate or a subsidiary has sponsored;

- The investment may not represent more than three percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule, which is generally one year from the date of the fund's establishment);
- The investment may not result in more than three percent of the losses of the covered fund being allocable to the banking entity's investment; and
- The banking entity may invest in the aggregate no more than three percent of its tier 1 capital in covered funds.

In addition, (i) co-investments alongside of a covered fund will be treated as an investment by the banking entity in the fund itself (and counted toward the three-percent-per-fund limitation) if such co-investments arise from a contractual obligation or if the banking entity is found to be acting "in concert toward a common goal" of investing in a covered fund, and (ii) the full value of a banking entity's capital commitments to a covered fund, whether called or uncalled, are counted towards the various thresholds. A banking entity must perform the relevant calculations at least quarterly in order to monitor its compliance with the various de minimis tests set forth in the Proposal; this requirement may prove difficult in situations where a covered fund holds illiquid assets or market disruptions have occurred or are continuing, and, moreover, quarterly valuations are far from industry standard for private funds.

Also, in calculating the amount of its investment in a covered fund, special attribution rules apply. The banking entity must include (a) the full value of any positions held by any entity directly or indirectly controlled by the banking entity and (b) the pro rata value of any positions held by an entity that the banking entity does not control, but in which it has the power to vote more than five percent of the outstanding voting shares. The attribution rule for a controlled company is consistent with BHCA rules applicable to subsidiaries generally, but the pro rata calculation is not. This rule might create difficult monitoring and reporting issues with respect to interests in covered funds held by minority-held merchant banking and other investments. However, because the banking entity as sponsor will likely know the identity of the initial investors in a new covered fund, it may not have a significant problem doing so, and allowing a banking entity to use companies in which it has significant investments to make investments in new funds might in fact allow evasion.

3. Certain Non-US Transactions

Similar to an analogous provision for proprietary trading (see Section II.C.2.e. above), non-US banking entities may generally rely on an exception to the prohibition on acquiring or retaining an ownership interest in or sponsoring a covered fund. Any such activity must generally meet the following criteria:

- The banking entity involved must not be directly or indirectly controlled by a US entity;
- The banking entity must satisfy Federal Reserve requirements (as for proprietary trading, discussed in Section II.D.2.d. above) intended to assure the "foreignness" of the entity;
- No ownership interest in such fund is offered for sale or sold to a resident of the United States; and
- The activity occurs solely outside of the United States.

An activity will be considered to have occurred outside of the United States only if, in addition to the criteria set forth above, no subsidiary, affiliate or employee of the covered banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States. This requirement seems to be in contrast to other provisions of the securities laws such as Regulation S under the 1933 Act where such intermediary activity does not necessarily affect the analysis of a transaction's locus so long as the actual offerees are non-US persons. However, back-office operations involving no investor contact may be conducted in the United States.

4. Other Exemptions

In addition to the de minimis exemption discussed above, banking entities may make investments (a) in small business investment companies, (b) to promote the public welfare, (c) in certain qualified rehabilitation expenditures within the Internal Revenue Code or similar State historic preservation tax credit programs and (d) for certain risk-mitigating hedge purposes that is engaged in to reduce specific risks arising in connection with either the banking entity's acting as intermediary on behalf of a customer or the banking entity covering a compensation arrangement with an employee with respect to the performance of a particular covered fund.

Apart from these very limited cases, there is no exception, de minimis or otherwise, for a US banking entity to invest in a covered fund for other than seeding purposes. This effectively means that US banking entities will no longer be able to invest in covered funds sponsored by third parties.[10]

D. Restrictions on Transactions with Covered Funds

The Dodd-Frank Act broadly prohibits a banking entity that serves, directly or indirectly, as an investment manager, investment advisor, commodity trading advisor or sponsor to a covered fund and banking entities that organize and offer a covered fund (and affiliates of that banking entity) from entering into a transaction with the covered fund (or any other covered fund controlled by the fund) that would be a covered transaction under Section 23A of the Federal Reserve Act as if the banking entity or its affiliate were a member bank and the covered fund were an affiliate of the banking entity. This provision, known as "Super 23A," is more restrictive than the general application of Section 23A, which permits covered transactions within statutory quantitative and qualitative limits.[11] The prohibited transactions are:

- A loan to an affiliated covered fund, including a purchase of assets subject to an agreement to repurchase;
- A purchase of or investment in securities issued by an affiliated covered fund;
- A purchase of assets from the affiliated covered fund;
- Acceptance of securities or other debt issued by the affiliated covered fund as collateral for any loan;
- Issuing any guarantee, acceptance or letter of credit on behalf of the affiliated covered fund;
- The borrowing or lending of securities to the extent that such transaction causes a banking entity to have credit exposure to the affiliated covered fund; and
- Certain derivative transactions that cause a banking entity to have credit exposure to the affiliated covered fund.

The imposition of "Super 23A" on permissible covered funds will create significant burdens on banking entities in that they will not be in a position to provide services for their funds. One exception in the statute allows a banking entity to serve as a prime broker, not for a banking entity's sponsored fund, but rather for funds in which such a fund invests that are sponsored by others.

[10] Accordingly, as a general matter, the BHCA authority to make an investment in any entity in an amount less than five percent of any class of voting stock would not be applicable to covered funds, except in limited cases.

[11] If you would like more information about Section 23A and its effect on private funds, you may refer to our client memorandum, "Dodd-Frank Act: Derivatives as Credit Extensions of Banks" (Aug. 16, 2010).

E. Exceptions to the Exemptions

Under the Proposal, regardless of whether an investment or activity is otherwise permitted, a banking entity may not engage in the investment or activity if (i) there would be a material conflict of interest between the banking entity and its clients, customers or counterparties, (ii) there would be material exposure, directly or indirectly, to high-risk assets or a high-risk trading strategy or (iii) the investment or activity poses a safety and soundness risk to the banking entity or a risk to the financial stability of the United States. These are effectively the same provisions limiting a banking entity's involvement in permissible trading and subject to the same conditions (See Section II.D. above).

Unlike proprietary trading, in the private funds business there are common conflicts of interest that are inherent to a private fund's structure, such as conflicts between a fund's investment manager and its investors with respect to incentive fees (e.g. the manager's incentive to take more aggressive positions that otherwise would be the case in an effort to increase such fees). It is not clear what effect internal information barriers would have on such inherent conflicts or what could be done otherwise to negate or substantially mitigate them.

F. Compliance Requirements

Like proprietary trading, engagement in permissible funds activities requires that a banking entity have a written compliance program designed to enforce compliance with the Rule's requirements. The statistical monitoring and reporting that the large institutions engaged in permissible trading will have to perform is not required in the funds business.

Any banking entity that is not engaged in any activity involving covered funds is required to incorporate measures designed to prevent engagement in sponsoring or investing in covered funds and to require establishment of a compliance program if in the future it commences a permissible private funds activity. This is the same standard as for proprietary trading.

To the extent that a banking entity engages in activities or investments that are prohibited or restricted by the Proposal, each such entity must develop and provide for the ongoing administration of a compliance program that is reasonably designed to ensure and monitor compliance with the provisions of the Volcker Rule. The required compliance program must, at a minimum, contain each of the following elements:

- Internal written policies and procedures reasonably designed to document, describe and monitor activities and investments with respect to covered funds to ensure that such activities and investments comply with the Volcker Rule;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Volcker Rule and to prevent the occurrence of activities or investments that are prohibited thereby;
- A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule;
- Independent testing for the effectiveness of the compliance program conducted by qualified personnel of the banking entity or by a qualified outside party;
- Training for personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- Making and keeping records sufficient to demonstrate compliance with the Volcker Rule for a period of no less than five years.

In addition, any banking entity that either has, together with its affiliates and subsidiaries, (i) trading assets and liabilities equaling at least $1 billion or 10 percent of its total assets or (ii) aggregate investments in, or sponsors or advises, one or more covered funds with aggregate assets equaling at least $1 billion is subject to a more detailed version of the minimum standards enumerated above that sets forth additional specific criteria to be met with respect to each required element.

V. Effective Date

The Proposal notes that the Rule becomes effective by statute on July 21, 2012. It also notes that banking entities would be expected to have developed and implemented the required compliance program as of that date, even though prohibited activities and positions would not have been conformed as of that date. Pursuant to an earlier rulemaking by the Federal Reserve, banking entities will have as long as two years after July 2012, and in some cases even longer, to bring existing activities and positions into compliance.[12] The Proposal also states that the Agencies expect that banking entities would begin furnishing the required reports by July 2012, though they will not be used to identify impermissible activities until they are required to be conformed.[13]

VI. Comments and Concerns

The Proposal raises an endless list of questions and interpretive difficulties. The Agencies seem to recognize this: they strew throughout the Proposal almost 400 individual numbered questions about almost all of its aspects. It is not at all clear how the Agencies will be able to review and digest the likely volume of responses they will receive to the Proposal as a whole, let alone the responses to those questions, in time to have a final rule that will be fit for compliance by July 2012, as required by the statute.

We identify below several comments and concerns that the Proposal raises, for all banking entities and then specific ones applicable to non-US banking entities.

A. All Banking Entities

1. The recordkeeping requirements for market-making for large banking entities seem enormous. These requirements are not required by the statute. The notion of requiring some amount of recordkeeping in order to discern whether an institution has actually conducted proprietary trading through its market-making or other activities was floated in the FSOC study in January, but since then the idea has been on steroids. It will be up to the largest institutions to indicate how burdensome the recordkeeping and reporting requirements will be for them. In many cases, their existing risk management systems may already capture much of the information required by the Proposal. However, to the extent that changes must be made and additional information obtained, the systems work that would have to be done is likely to take much longer than July to implement. The list of data points is so long and detailed that one wonders whether the drafters wanted to include items that are not necessary so that they could be

12 76 Fed. Reg. 8265 (Feb. 14, 2011). The Proposal would incorporate that rulemaking into the Federal Reserve's version of the regulations.

13 Proposal at Section III.A.1.b.

removed in the final rule as a way to show a willingness to be "reasonable" to critics. Another explanation is that the Agencies are seizing on the Rule as an opportunity to generate a huge amount of microdata about trading activities generally that they can use for other supervisory purposes.

2. The exemption for proprietary trading in US Government securities apparently does not extend to derivatives on such securities (at least those derivatives that are not themselves "securities", such as options). Will the prohibition on proprietary trading in such derivatives create a problem, or affect the market for US Government securities generally?

3. The requirement to contemporaneously document every hedge transaction when done in a legal entity different from the entity holding the hedged position is likely to require significant resources and monitoring to assure compliance.

4. The exception for US Government securities does not extend to government securities issued by other governments, such as gilts in London and JGBs in Tokyo. What effect will the imposition of the requirements on market-making have on those major US banking entities with sizable offshore operations engaging in trading local government securities? Apart from the effect on the US banking entities themselves, would such limitations have an effect on the liquidity of those markets?

5. The restrictions on private funds present the potential to fundamentally change the role of banking organizations in the global private funds industry. Due primarily to new commercial and compliance complexities, the sponsorship limitations will likely drive some banking entities to exit the business of organizing and sponsoring such funds despite the reasonably broad carve-out for investment advisory services. Compliance and legal personnel will ask themselves hard questions about the type of seed investments their organizations can make and how to measure and comply with the new limits, permitted versus prohibited interrelationships between the bank and its funds (including the increasing emphasis on mitigating conflicts of interest), the interaction of rules on on-shore and off-shore activities and how to respond to the new carried interest rules, among many other issues. More generally, the private funds industry will face the pull-back of banking entities as potential third-party investors.

6. Many of the compliance requirements include a provision requiring that compensation arrangements for personnel involved in the activity be designed so as not to reward risk-taking. The Agencies have already proposed compensation guidelines on US and non-US financial institutions generally directed to the same issues. Why should there be a duplicative requirement for Volcker Rule purposes?

B. Non-US Banking Entities

1. One of the most glaring omissions in the Proposal is the failure to exclude many requirements, including the recordkeeping and compliance requirements for market-making activities, from applying to non-US offices of non-US banking entities. One part of the Proposal implies that the drafters' concern is with prohibited proprietary trading inside the United States and not with non-US banks' non-US activities.[14] However, this

[14] Appendix A states as one of its purposes to evaluate whether covered trading units that are engaged in permitted trading "subject to §§ __.4, __.5, or __.6(a)" are complying with the prohibition on high-risk assets or high-risk trading strategies. This would exclude activities subject to § __.6(d), which permits non-US trading by non-US banks. See Appendix A, § I. item (iv).

thought is not carried through in the text of the regulatory language. Thus, it appears that, for example, a non-US banking entity would have to find all of its trading units throughout the world and impose the same recordkeeping and reporting requirements on them as are imposed on US banking entities. Such a rule might be justified as an attempt to detect impermissible trading activity wherever conducted by those institutions that have a significant exemption. However, the statistical analytics appear to have nothing to do with the exemption for non-US activities. It is hard to believe that such a requirement will survive in the final version, but it will behoove non-US institutions to make this point en masse.

2. On the same lines, for example, does Super 23A apply to transactions between a permissible non-US private fund and a non-US office of the non-US bank? It seems clear that no purpose would be served by imposing Super 23A in that context.

3. May non-US banks' US operations take on hedge positions that hedge non-US trading operations? Must each one have to be documented pursuant to the requirement that hedges at different levels of an organization be documented contemporaneously?

4. The Federal Reserve in 2003 issued an interpretation stating that "the underwriting of securities to be distributed in the United States is an activity conducted in the United States, regardless of the location at which the underwriting risk is assumed and the underwriting fees are booked."[15] The effect of this interpretation is that participation by non-US offices of non-US banking entities in a US securities distribution is deemed to occur in the United States. Does this interpretation apply to the Proposal? Does the Rule have the effect of requiring such non-US offices to comply with the conditions applicable to US underwriting?

5. Even where the Proposal addresses cross-border issues, in connection with the requirement that non-US banking entities engage in proprietary trading and fund activities "solely outside of the United States," it does not address a variety of issues.

    a. What does it mean to "execute" a transaction solely outside of the United States? May a non-US banking entity engage in trading in US equities outside the United States? Execution might take place on a US securities exchange, or settlement might take place at a US custodian.

    b. May US personnel offer advice or information to a non-US trader concerning a proposed transaction?

    c. Will proprietary trading activities conducted at a "shell" off-shore branch, such as in the Cayman Islands or the Bahamas, be impermissible if directed by US branch personnel?

    d. The Proposal defines a "resident of the United States" for this purpose to include a discretionary or non-discretionary account of a US resident. What will this mean for non-US banking entities in conducting transactions with or for such an account at a non-US offices of the entity?

    e. There is no mention of restrictions on investments by non-US funds sponsored and managed by non-US banking entities other than that the entity comply with Federal Reserve regulations applicable to foreign banking organizations. Those rules include restrictions on equity investments in US companies or non-US companies with US subsidiaries. Do those rules apply to a non-US fund?

[15] 12 C.F.R. § 211.605 (2011).

f. May off-shore personnel consult with US compliance personnel in connection with trading or funds activities generally in order to obtain advice on compliance with the Rule?

We will continue to work with clients on the Volcker Rule to address these issues and to deal with additional issues and ramifications as they surface.

This memorandum 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.

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:

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
russell.sacks@shearman.com

Barnabas W. B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Charles S. Gittleman
New York
+1.212.848.7317
cgittleman@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@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

Donald N. Lamson
Washington, DC
+1.202.508.8130
donald.lamson@shearman.com

Gregg L. Rozansky
New York
+1.212.848.4055
gregg.rozansky@shearman.com

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Jesse P. Kanach
Washington, DC
+1.202.508.8026
jesse.kanach@shearman.com

Justin P. Houghton
New York
+1.212.848.4987
justin.houghton@shearman.com