

April 24, 2012

Dodd-Frank's Volcker Rule: The Federal Reserve Clarifies the Deadline for Compliance but It's Not a Ticket to Ride.

The Federal Reserve issued a statement last week clarifying that it will interpret the Volcker Rule to afford banking entities the full two-year period provided by the statute to conform their activities and investments to the Rule's prohibitions and restrictions. The financial services industry should welcome this alternative to curtailing trading and investment activities earlier than the statute on its face would have required, but inevitably some questions remain. The Federal Reserve still has not given any indication whether it may extend this period. As compliance activities progress and we gain greater insight into the effect of the Rule on the economy, the public may seek even clearer guidance on this aspect of the Federal Reserve's discretion.

Statute

The Volcker Rule added a new section 13 ("Section 13") to the Bank Holding Company Act of 1956 imposing prohibitions and requirements on a banking entity that engages in proprietary trading and has investments in or certain relationships with a hedge fund or private equity fund.¹ The Rule also provides that a non-bank financial company supervised by the Federal Reserve that engages in proprietary trading or makes hedge fund investments must comply with certain other requirements,

¹ Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Volcker Rule" or "Rule"). A "banking entity" includes any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company under section 8 of the International Banking Act of 1978 and any affiliate or subsidiary of any of those entities. A "hedge fund" and a "private equity fund" are defined identically as an issuer that would be an investment company, as defined under the Investment Company Act of 1940 (but for two exceptions of that Act), or any similar fund as the appropriate Federal banking agencies, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") may determine.

including supplemental capital requirements or quantitative limitations.² The Rule takes effect on the earlier of two years after the date of its enactment, July 21, 2012, or 12 months after the date of issuance of rules implementing that section. Because the Agencies did not issue implementing rules by July 21, 2011, the effective date will be July 21, 2012.

Conformance Period Rule

The Federal Reserve must adopt rules governing the period for banking entities to conform their activities and investments to the Rule's requirements. Unless the Federal Reserve extends the conformance period, a banking entity must conform its activities and investments to the Rule's requirements and any final implementing rules no later than two years after the effective date. The Federal Reserve may extend the conformance period three times with separate one-year extensions, as well as the period for retaining an ownership interest in an illiquid fund. The Federal Reserve issued its final conformance rule on February 9, 2011.³

Need for Clarification

The Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and SEC (together with the CFTC, the "Agencies") in October 2011 proposed interagency rules implementing the Volcker Rule.⁴ A number of commenters on that proposal sought clarification that a banking entity had the full period permitted by statute to conform its investments and activities and that the requirements would not apply to activities conducted and investments made during the conformance period. In response, and in apparent coordination with the other Agencies, the Federal Reserve has now clarified how the conformance period will operate and how the Rule's prohibitions will be enforced by confirming the statute's plain language that banking entities have two years, until July 21, 2014, to conform their activities and investments to the Volcker Rule, unless that period is extended. Please see the attached timeline for a graphic presenting all the deadlines connected with the Rule's implementation in light of the Federal Reserve statement.

No Free Ride

The Federal Reserve's clarification is not intended to be a license for banking entities to continue business as before, for it comes with strings. During the two year conformance period, the Federal Reserve expects banking entities to engage in good-faith planning efforts to conform their activities and investments to the requirements of the Rule, which may include complying with new reporting or recordkeeping requirements. The Federal Reserve signaled that the Agencies may likely adopt such requirements for the conformance period in final rules implementing the Rule.

² The Financial Stability Oversight Council ("FSOC") may determine that a non-bank financial company (i.e., a company predominantly engaged in financial activities) shall be subject to supervision by the Federal Reserve. The FSOC has not yet made any determinations, nor has the Federal Reserve yet proposed to impose prudential supervisory requirements on a nonbank financial company.

³ "Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 76 FR 8265 (Feb. 14, 2011). The conformance rule provides that extensions beyond the general conformance date (other than for newly chartered banks) would only be available with prior Federal Reserve approval on a bank-by-bank basis where certain conditions have been met. The Federal Reserve did not use its broader authority to automatically extend the Volcker Rule conformance date beyond the default July 21, 2014 date.

⁴ Those proposed rules may be found at 76 FR 68846 (Nov. 7, 2011). The CFTC later requested comment on a substantially similar proposal. This proposed rule may be found at 77 FR 8332 (Feb. 14, 2012).

A banking entity also should undertake good-faith efforts actually to conform its activities and investments to the requirements of the Rule. The entity should evaluate the extent to which it is engaged in activities and investments that are covered by the Rule and develop and implement a specific plan about how it will conform its activities and investments by the deadline.

Enforcement

In a further sign of interagency coordination, the Federal Reserve announced that the Agencies will administer their oversight of banking entities under their respective jurisdictions in accordance with the conformance rule and this new clarification. However, the Federal Reserve could not help but repeat the familiar dictum that this new guidance does not restrict in any way the authority of the Agencies to limit – even during the conformance period – any activity determined to be unsafe or unsound or otherwise in violation of law.

Unanswered Questions

While the statement is welcome, there remain several important questions that it does not purport to address:

1. How strictly will the agencies construe the requirement to be in “good faith”? It is understood that the agencies differ in their views on the importance of the Volcker Rule generally. Will some agencies be lenient while others are strict? If so, would this matter? Would the strictest agency as a practical matter set the bar that an organization will have to enforce throughout the organization?
2. Can organizations continue to organize and invest in private equity funds during the conformance period? Proprietary trading on its face seems likely to be amenable to a phase-down within the two-year period, though the nature of the final regulations will define whether this is so. However, investments in private equity funds are usually commitments for a long period, much longer than two years. Can an organization make an investment during the two-year period in good faith? Must it have a strong legal right to transfer its interest to third parties or be redeemed out? Can an organization organize a new fund during that period? If the organization does not know the final requirements for the fiduciary-sponsorship exception for organizing new funds, how can it be sure that its design will be in good faith?
3. When will decisions on good faith be made? Will the agencies review the required conformance plans in a coordinated manner among themselves, or will different agencies come to conclusions on their own and at their own pace?
4. What are non-US banks to do during the conformance period? The US agencies are not global supervisors of those organizations. While they supervise regulated US operations, one of the very difficult questions under the proposed rules was the extent to which activities may be conducted that are “solely outside of the United States”. Will non-US banks be expected to take actions at their non-US operations in order to be ready for the final rules?
5. On a more technical level, what exactly is the status of the “statement”? Pronouncements by a Federal agency have more or less weight in court depending on their nature. A “statement” is generally not treated with great deference. In light of likely legal challenges to anything the agencies do, this might be an important point. The fact that the Statement refers to itself as an “interpretation” will likely allow it to be treated as such, which should cause a court to give it great deference.

Conclusion

The Federal Reserve provided assurance to the industry that there would be a full two years in which to conform trading and investment activities to the Volcker Rule's requirements, but any gratitude it earned may soon turn to impatience. The Federal Reserve still shows no sign whether it will provide additional extensions of time within which banking entities may conform their activities. It will be only a matter of time until we hear calls for additional clarity on this point as well. As we continue to observe the effect of the Rule on the financial services industry, these calls may well become louder.

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.

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Volcker Rule Compliance Timeline for Banking Entities Under the Statement and the Federal Reserve’s Final Conformance Rule

