Published on *The National Law Review* https://natlawreview.com

Federal Agencies Propose Implementation of Volcker Rule

Article By:

John J. O'Brien

Ethan W. Johnson

On October 11 and 12, several federal agencies jointly released proposed rules that would implement the so-called "Volcker Rule."[1] The Volcker Rule, which prohibits "banking entities" from certain proprietary trading and from having certain relationships with "covered funds," was originally set forth in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which amended the Bank Holding Company Act of 1956 to add Section 13. The Volcker Rule will also impact broker-dealers affiliated with banks because these entities are considered "banking entities" under the rule.

In total, four federal agencies proposed rules: the Federal Reserve Board (Fed), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC). The Commodity Futures Trading Commission (CFTC) is expected to issue a comparable proposal soon. In general, the proposed rules would apply to "covered banking entities," which include depository institutions insured by the FDIC and their controlling entities, bank holding companies, savings and loan holding companies, and foreign banks that are regulated as bank holding companies.

The Dodd-Frank Act restricts which agencies may impose rules under the Volcker Rule. The Fed, OCC, and FDIC may jointly impose rules on any insured depositary institution, but the Fed may also impose rules on bank holding companies and their subsidiaries that do not otherwise have a primary financial regulator. The SEC and CFTC may only impose rules on those entities for which they act as the primary financial regulator. As such, navigating the regulatory framework that develops out of the Volcker Rule, if adopted, will be arduous.

We encourage all market participants to actively participate in the comment process. Comments on the nearly 300-page joint release (and the nearly 400 questions contained therein) are due by January 13, 2012.

Sponsoring and Investing in Private Investment Funds

The proposed regulations implementing the Volcker Rule will place certain restrictions on the private investment fund activities of "banking entities." "Banking entities" would include (i) any FDIC-insured depository institution and its controlling entities (U.S.-based or otherwise), (ii) any company (U.S.-based or otherwise) that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and (iii) any affiliate or subsidiary (U.S.-based or otherwise) of any of the foregoing. Banking entities will be generally prohibited from acquiring or retaining as principal an ownership interest in, acting as a sponsor to, or having certain other relationships with a "covered fund" unless certain exemptions are met (several of which are described below).

Under the proposed regulations, "covered funds" include commodity pools and so-called "3(c)(1) funds" and "3(c)(7) funds" as well as foreign funds that otherwise would be a covered fund if formed in the United States or offered to U.S. residents. An "ownership interest" will include not only equity securities or partnership interests but generally any interest that holds voting rights, rights to share in a covered fund's profits and losses, or the ability to earn a return based on the performance of a covered fund's underlying investments. A banking entity will be deemed to be a "sponsor" of a covered fund if it (i) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund; (ii) selects or controls a majority of the directors, trustees, or management of a covered fund; or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation thereof. However, it should be noted that, assuming certain conditions are met, "carried interest" allocable to a banking entity or its affiliate in connection with its role as an investment manager, investment adviser, or commodity trading advisor of a covered fund will not be deemed to be an ownership interest.

While the proposed regulations appear to severely restrict the ability of banking entities to sponsor or hold an ownership interest in a covered fund, a banking entity will not be entirely precluded from engaging in such activities. For instance, a banking entity will generally be permitted to sponsor or hold an ownership interest in a covered fund if the banking entity's ownership interest in such fund does not exceed 3% of the aggregate outstanding ownership interests of such fund, and the aggregate investments in all covered funds by such banking entity does not exceed 3% of its Tier 1 capital. In addition, a banking entity may "seed" a covered fund and provide it with sufficient initial equity for investment to attract investors unaffiliated with such fund so long as such banking entity will reduce its ownership interest in such fund below the *de minimis* limit described above within one year of such fund's establishment (or such longer period determined by the Federal Reserve Board).

The proposed regulations also contain an exemption for certain foreign banks sponsoring or investing in foreign covered funds. Such foreign banks must generally be (i) organized under foreign law and controlled only by entities organized under foreign law, and (ii) deemed to be a "qualifying foreign banking organization" under the Federal Reserve Board's Regulation K or, alternatively, comply with certain other requirements to ensure that such foreign bank's business is conducted outside the United States, as measured by assets, revenues, and income. However, note that it may be difficult for some foreign banks to meet the terms of clause (ii) above depending on the breadth of their current U.S. operations. As a result, such banks may consider a reduction in their U.S. operations to ensure their eligibility for this exemption. In any case, any foreign bank meeting the above qualifications must also ensure that no ownership interest in the covered fund will be offered for sale to a U.S. resident and that no subsidiary, affiliate, or employee of the 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.

Notwithstanding the foregoing, a banking entity will still be prohibited from forming and offering a covered fund if such activity would involve a material conflict of interest between such banking entity and its clients, customers, or counterparties; result in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. In addition, the Volcker Rule regulations also address certain requirements for banking entities with respect to their compliance programs. Generally, if a banking entity engages in covered fund activities or investments, it will be required to design its compliance program in a manner reasonably designed to ensure and monitor compliance with the specifications of the Volcker Rule as appropriate for the size, scope, and complexity of the activities and structure of such banking entity. Finally, even if a banking entity does not engage in covered fund activities or investments, it will nevertheless be required to ensure that its existing compliance policies and procedures include measures that are designed to prevent it from becoming engaged in such activities or investments.

Engaging in Proprietary Trading

Another significant and wide-ranging impact on banking entities contemplated in the proposed rules is the prohibition on proprietary trading. Based on the broad definition of activities that constitute prohibited proprietary trading and the limited exceptions available, banking entities will need to restrict trading or adopt new policies and procedures in numerous areas, including handling customer trades, underwriting, market making, hedging, and trading outside the United States.

Under the proposed rules, if the following three elements are met, the transaction will be prohibited:

- *Principal Capacity.* The banking entity is not acting solely as agent, broker, or custodian for an unaffiliated third party.
- *Covered Financial Position.* The transaction involves any long, short, synthetic, or other position (including options) in a security, derivative, or futures contract. Positions in loans, commodities, foreign exchange, or currency are excluded from the definition of a "covered financial position," but derivatives based on those positions (e.g., foreign exchange forwards) are not.
- *Trading Account.* The transaction occurs in an account (i) that is used for short-term trading (e.g., 60 days or less), including arbitrage and hedging short-term positions; (ii) where a banking entity subject to the market risk capital rules holds a covered position other than foreign exchange derivatives, commodity derivatives, or futures; or (iii) that is held by a registered broker-dealer, municipal securities dealer, swaps dealer, or security-based swaps dealer or a foreign entity engaged in one of these businesses. Transactions involving positions acquired as a result of repurchase, reverse-repurchase, or securities lending transactions or for liquidity management purposes, however, will *not* cause an account to be designated a trading account.

There are several exemptions to the prohibitions, but, given the proposed regulations' broad definition of proprietary trading, banking entities will need to be keenly aware of each requirement of the narrowly tailored exemptions in order to be able to continue conducting many of their activities. Additionally, even if a transaction meets one of the following exemptions, it still will not be permitted if it creates a material conflict of interest between the banking entity and its customer or counterparty, creates a material exposure to the banking entity to a high-risk asset or trading strategy, or poses a threat to the safety or soundness of the banking entity or to the financial stability of the United States.

- *Handling Customer Trades.* The banking entity must either (i) for positions where the banking entity or its affiliates have no beneficial interest, act in a role as an investment adviser, commodity trading advisor, trustee, or a similar fiduciary capacity; or (ii) execute a riskless principal trade where the purchase and sale occur contemporaneously.
- *Underwriting.* If a banking entity is acting as underwriter for the security and is purchasing or

selling the security in connection with a distribution, the transaction is permitted if the banking entity (i) establishes an internal compliance program to monitor for compliance with these rules; (ii) registers as a dealer, is exempt from registration as a dealer, or is a foreign dealer subject to similar regulation in its jurisdiction; (iii) limits its activity to the near-term demands of customers; and (iv) structures its compensation to be based on fees, commissions, and underwriting spreads and not to benefit from the security appreciating in value or to reward employees for proprietary risk-taking.

- *Market Making.* Purchases and sales relating to market making are exempt if the banking entity (i) establishes an internal compliance program to monitor for compliance with these rules; (ii) holds itself out as willing to purchase or sell the instrument for its own account on a regular and continuous basis; (iii) limits its activity to the near-term demands of customers or counterparties; (iv) is properly registered to transact in the instrument, is exempt from registration, or is a foreign entity subject to similar registration in its jurisdiction; (v) structures its compensation to be based on fees, commissions, and bid-ask spreads and not to benefit from the covered financial position appreciating in value or to reward employees for proprietary risk-taking; and (vi) keeps its risk at levels that are consistent with the amount required for market making.
- *Hedging.* A banking entity is permitted to hedge specific risks relating to individual or aggregate positions if the banking entity (i) establishes an internal compliance program to monitor for compliance with these rules; (ii) effects its trades consistently with its internal compliance program; (iii) effects the transaction to hedge an actual risk arising from individual or aggregate positions of the banking entity (anticipatory hedging is permitted if the hedging occurs slightly before the banking entity undertakes the risk, is consistent with the internal compliance program, the transaction otherwise meets the hedging exception, and does not have the potential for a speculative profit); (iv) reviews transactions on an ongoing basis to confirm that the hedge position is reasonably correlated to the risk that it is intended to mitigate; (v) monitors on an ongoing basis to ensure that the hedge position does not significantly increase the risk of any of its other holdings; (vi) structures employee compensation to avoid rewarding proprietary risk-taking; and (vii) for hedges established by a different level of the organization than the level of the organization that holds the corresponding risk, contemporaneously documents the risk-mitigating purpose of the hedge, the risks that the hedge is designed to reduce, and the level of the organization establishing the hedge.
- *Trading Outside the United States.* Among other restrictions, this exemption is limited to purchases and sales that occur entirely outside the United States and is not available to banking entities that are controlled directly or indirectly by a banking entity organized in the United States. Banking entities intending to rely on this exemption need to make sure that the transaction does not involve personnel or customers in the United States.

Implications for Banking Entities

First and foremost, banking entities and their affiliates should begin analyzing how the proposed rules, if adopted, would affect their business models and organizational structures. They should also consider the costs of complying with these proposals, not only in terms of making the necessary changes to their compliance policies and procedures, but also in terms of how these proposals would impact the products and services offered to the public and the prices at which those products and services may be offered. Given the recent *Business Roundtable* decision by the U.S. Court of Appeals for the D.C. Circuit, which vacated the SEC's proxy access rule for failure to meet its statutory obligation to determine the economic implications of the rule, regulatory agencies are likely paying careful attention to the economic analysis that goes into rulemaking.[2] Active engagement in the comment process by interested parties can only result in a more informed final rule.

Broker-dealers that are affiliates of banks appear to be directly affected by the proposed Volcker Rule, both with respect to limits on proprietary trading and with respect to investing in "covered funds" (e.g., private funds as well as commodity pools). Although there are exemptions for customer facilitation and hedging activities, those exemptions appear limited. Further, the compliance burden of the proprietary trading rules, particularly with respect to demonstrating the availability of the market making and hedging exemptions, is significant and may have the effect of discouraging these beneficial market activities. In addition, there is some ambiguity around the scope of the funds subject to the exemption. For example, the term "commodity pool" appears to cover funds having a registered CPO, which would include a broad group of publicly issued instruments, including a number of commodity exchange-traded funds.

[1]. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, Dep't of the Treasury, 12 C.F.R. 44, Bd. of Governors of the Fed. Reserve Sys., 12 C.F.R. 248, Fed. Deposit Ins. Corp., 12 C.F.R. 351, Sec. and Exch. Comm'n, 17 C.F.R. 255, Exchange Act Release No. 65,545 (Oct. 12, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-65545.pdf.

[2]. *See Business Roundtable and Chamber of Commerce of the U.S.A. v. S.E.C.*, No. 10-1305 (D.C. Cir. July 22, 2011), *available at* http://online.wsj.com/public/resources/documents/ProxyAccessDecision07222011

National Law Review, Volume I, Number 306