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# Federal Regulators Request Comments on Proposal to Implement Volcker Rule

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On October 11, 2011, the Federal banking agencies and the Securities and Exchange Commission (the "Agencies") proposed a common rule (the "Proposed Rule") to implement Section 619 of the Dodd-Frank Act, more commonly known as the Volcker Rule. The Volcker Rule, which is codified as new section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. In addition, BHC Act section 13 subjects certain nonbank financial companies that engage in such activities or have such interests or relationships to additional capital requirements, quantitative limits, or other restrictions.

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The Volcker Rule, as it would be implemented under the Proposed Rule, generally would ***apply only to***:

- **Covered banking entities** — any insured depository institution (other than certain limited purpose trust companies), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any of the foregoing. The Proposed Rule excepts from covered banking entities certain "covered funds" and their controlling entities as described in greater detail below.
- **Certain nonbank financial companies** — any company that the Financial Stability Oversight Council (the "FSOC") determines must be subject to supervision by the Board of Governors of the Federal Reserve System (the "Board") and prudential standards.[1]

The restrictions and prohibitions of BHC Act section 13 become effective July 21, 2012, subject to section 13's conformance period. The deadline to submit comments is January 13, 2012.

## Prohibitions on Proprietary Trading

The Proposed Rule implements BHC Act section 13's statutory prohibition on proprietary trading and its various exceptions.

### Key Definitions

The Proposed Rule's definition of "proprietary trading" generally parallels the statutory definition and includes engaging, as principal, for the "trading account" of the covered banking entity in any purchase or sale of one or more "covered financial positions."

"Trading account" is defined as any account that is used to take: (i) positions generally taken for the principal for the purpose of certain short-term benefits, such as for the purpose of short-term resale and short-term arbitrage; (ii) positions that, with certain limitations, are considered "covered positions" under the current federal banking agencies market risk capital rules; and (iii) positions acquired or taken by certain registered securities and derivatives dealers.

The proposed rule also creates a rebuttable presumption that an account is a trading account for certain positions a banking entity holds for less than 60 days. The definition excludes accounts that take covered financial positions; (i) under repurchase agreements and reverse repurchase agreements, (ii) arising under securities lending arrangements; (iii) for liquidity management purposes or (iv) taken in connection with clearing derivatives or securities transactions.

The definition of "covered financial positions" includes positions (including long, short, synthetic and other positions) in securities, derivatives, commodity futures, and options on such instruments, but does not include positions in loans, spot foreign exchange or spot commodities.

Importantly, the term "proprietary trading" does not include acting solely as agent, broker, or custodian for an unaffiliated third party.

# Permitted Proprietary Trading Activities

Subject to the limitations discussed below, the Proposed Rule provides the following exemptions from the general prohibition on proprietary trading, which parallel those under BHC Act section 13:

- underwriting and market-making activities;
- risk-mitigating hedging activities;
- trading in certain government obligations;
- trading on behalf of customers;
- trading by a regulated insurance company; and
- trading by certain banking entities outside of the United States.

Notably, Appendix B to the Proposed Rule provides commentary regarding factors the Agencies propose to use to help distinguish permitted market-making related activities from prohibited proprietary trading. Generally, the market-making activities exemption is permitted only to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, and counterparties. Accordingly, to fall within the proposed exemption, a market-maker should not provide compensation incentives to its personnel that would primarily reward proprietary risk-taking.

In addition, the Proposed Rule qualifies the following transactions as trading on behalf of customers: (i) transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of a customer where the customer, and not the banking entity, has beneficial ownership of the related positions; (ii) riskless principal transactions and (iii) transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders, subject to certain conditions. Despite rulemaking authority under BHC Act section 13, the Agencies have not provided additional exemptions in the Proposed Rule for activities that would promote safety and soundness of a banking entity and the financial stability of the United States.

All covered banking entities engaging in permitted proprietary trading activities must comply with the recordkeeping requirements required under the compliance program provisions of the Proposed Rule (as discussed below) and in Appendix C to the Proposed Rule, as applicable. However, certain covered banking entities that have trading assets and liabilities the average gross sum of which (on a consolidated basis) is equal to or greater than $1 billion must also comply with the quantitative reporting and recordkeeping requirements described in Appendix A to the Proposed Rule. The quantitative measurements that must be reported under Appendix A vary depending on the scope and size of the covered trading activities.

# Prohibitions and Restrictions on Ownership Interests in and Relationships with Hedge Funds and Private Equity Funds

The Proposed Rule prohibits a covered banking entity, as principal, from directly or indirectly acquiring or retaining any ownership interest in or sponsoring a "covered fund," unless otherwise permitted by the Proposed Rule. The general prohibition does not prevent banking entities from acquiring interests in hedge funds or private equity funds for third parties. This allows for the continuance of traditional banking business, such as custody and fiduciary services.

## Key Definitions

The term “covered fund” covers more than what would traditionally be considered hedge funds and private equity funds. A “covered fund” is defined as: (i) an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the “1940 Act”), but for section 3(c)(1) or 3(c)(7) of the 1940 Act; (ii) a commodity pool, as defined in section 1a(10) of the Commodity Exchange Act; (iii) any issuer, as defined in section 2(a)(22) of the 1940 Act, that is organized or offered outside of the U.S. that would be a covered fund were it organized or offered under the laws, or offered to one or more residents, of the U.S. or of one or more States; and (iv) any such similar fund as the appropriate Agencies and the CFTC may determine through rulemaking.

“Ownership interest” is broadly defined to include not only equity, but also debt securities that exhibit similar characteristics as equity. Notably, subject to certain conditions, “ownership interest” does not include carried interest in the covered fund for which the covered banking entity (or an affiliate) serves as investment manager, investment adviser or commodity trading adviser. The term “sponsor” includes serving as a general partner, managing member, trustee or commodity pool operator of a covered fund as well as either selecting or controlling the management of a covered fund or sharing the same name or variation of the same name with a covered fund.

## Permitted Covered Fund Activities and Investments

The provisions of the Proposed Rule regarding the *de minimus* exemption to the general prohibition on investing in and sponsoring a covered fund generally parallel the companion provisions of BHC Act section 13. However, the Proposed Rule clarifies that a covered fund must be organized and offered in connection with the provisions of bona fide trust, fiduciary, investment advisory or commodity trading advisory services pursuant to a credible plan or similar documentation with a customer that outlines how the covered banking entity intends to provides services to its customers through such covered fund. Among other enumerated requirements for the *de minimus* exemption, the Proposed Rule contains express language that must be provided in writing to investors, such as in a covered fund’s offering memorandum, disclosing that any losses will be borne solely by investors and not by the banking entity or its affiliates. The Proposed Rule also sets forth how to calculate ownership interests in a single covered fund, which calculation must include controlled and non-controlled investments and parallel fund investments, as well as how to calculate Tier 1 capital for aggregate ownership interests in all covered funds.

Subject to the limitations discussed below, the Proposed Rule provides the following additional permitted covered fund activities and related investments, which generally parallel those under BHC Act section 13: (i) investments in SBICs and related investments; (ii) certain risk-mitigating hedging activities; (iii) certain activities and investments made outside the U.S. and (iv) acquiring or retaining any ownership interests in or acting as sponsor to certain issuers of asset-backed securities. Expressly determined to be permissible by the Proposed Rule, a banking entity generally may acquire or retain any ownership interest in or act as sponsor to: (i) a separate account of bank-owned life insurance; (ii) certain affiliated joint venture and acquisition vehicles; (iii) certain issuers of asset-backed securities; (iv) wholly-owned subsidiaries engaged in performing certain liquidity management activities; and (v) a covered fund in the ordinary course of collecting a debt previously contracted in good faith, if such interest is divested within applicable time periods provided for by the Agencies.

All banking entities engaged in any covered fund activity or investment under the Proposed Rule must comply with the internal controls, reporting and recordkeeping requirements required under the compliance program provisions of the Proposed Rule (discussed below) and Appendix C to the Proposed Rule, as applicable, and such other reporting and recordkeeping requirements as the Agencies may deem necessary to appropriately evaluate the covered banking entity’s compliance with the Proposed Rule.

## Limitations on Covered Funds Relationships

The Proposed Rule implements BHC Act section 13’s limitations on certain covered fund relationships. Generally, the Proposed Rule prohibits banking entities that serve, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organize and offer a covered fund (along with their affiliates) from entering into a transaction with a covered fund that would be a covered transaction under section 23A of the Federal Reserve Act as if such banking entity (or its affiliate) were a member bank and the covered fund were an affiliate. As an exception to the prohibition, covered banking entities may enter into certain prime brokerage transactions with covered funds, but such transactions must be subject to section 23B of the Federal Reserve Act as if the counterparty were an affiliate of the covered banking entity. The Proposed Rule defines “prime brokerage transactions” as one or more products or services provided by a covered banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.

## Additional Limitations on Permitted Proprietary Trading and Covered Fund Activities

The Proposed Rule prohibits any covered banking entity from engaging in otherwise permissible proprietary trading or covered fund activities if the activity would:

- involve or result in the covered banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such activity (except for certain conflicts timely disclosed with an opportunity to be negated or substantially mitigated and conflicts mitigated with appropriate information barriers);
- result in a material exposure to high-risk assets or high-risk trading strategies that would significantly increase the likelihood of substantial loss or failure; or
- pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.

## Compliance Program Requirements

All covered banking entities engaging in permitted proprietary trading activities must develop and maintain a compliance program reasonably designed to ensure and monitor compliance with BHC Act section 13 and the Proposed Rule. The compliance program must be appropriate for the size, scope and complexity of activities and business structure of such covered banking entity. The Proposed Rule specifies six elements that each compliance program must, at a minimum, include:

- Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading activities and covered fund activities and investments of the banking entity to ensure that such activities comply with BHC Act section 13 and the Proposed Rule;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with BHC Act section 13 and the Proposed Rule;
- A management framework that clearly delineates responsibility and accountability for compliance with BHC Act section 13 and the Proposed Rule;
- Independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;
- Compliance training for trading personnel and managers; and
- Making and retaining records sufficient to demonstrate compliance with section BHC Act section 13 and the Proposed Rule, which a banking entity must promptly provide to the relevant Agency upon request and retain for a period of no less than five years.

Additional compliance program requirements set forth in Appendix C to the Proposed Rule apply to any covered banking entity that either (i) engages in proprietary trading and has trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), is equal to or greater than $1 billion, or equals 10% or more of its total assets; (ii) invests in, or has relationships with, a covered fund and has aggregate investments (on a consolidated basis) in one or more covered funds, the average value of which is equal to or greater than $1 billion; or (iii) sponsors or advises one or more covered funds, the average total assets (on a consolidated basis) of which are, equal to or greater than $1 billion. Any covered banking entity that does not engage in activities or investments prohibited or restricted by the Proposed Rule must have compliance policies and procedures designed to prevent the covered banking entity from becoming engaged in such activities or making such investments.

## Request for Comments

The Agencies request comments on nearly 400 specific topics and on the potential impacts the Proposed Rule may have on banking entities and the businesses in which they engage. Comments on such impacts should include quantitative data where possible. T**he deadline to submit comments is January 13, 2012.**

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[1]The Supplemental Information released with the Proposed Rule states the Board is not proposing at this time any additional capital requirements, quantitative limits, or other restrictions on nonbank financial companies pursuant to BHC

Act section, as it believes doing so would be premature in light of the fact that the FSOC has not yet finalized the criteria for designation of, nor yet designated, any nonbank financial company.



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