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The Volcker Rule

On June 25, 2010, a House-Senate conference committee approved the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"), which includes a modified version of the so-called "Volcker rule." First proposed by President Barack Obama and former Federal Reserve Chairman Paul Volcker, the rule is aimed at restricting the size and scope of risk-taking activities of banking institutions.

As adopted in the Act, the Volcker rule prohibits any "banking entity" from engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds, subject to limited exceptions. "Banking entity" is defined to include any insured depository institution, any company that controls an insured depository institution or that is regulated as a bank holding company, and any affiliate or subsidiary of any such entity. The Act also requires the Federal Reserve to adopt rules imposing additional capital requirements and quantitative limits on systemically important non-bank financial companies that engage in proprietary trading or sponsor or invest in hedge funds or private equity funds.

Prohibition on Proprietary Trading

The prohibition on proprietary trading extends to any transaction in the trading account of the banking entity where the entity acts as a principal. "Trading account" is defined as any account used for acquiring or taking positions in securities or other instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any other account that the appropriate regulators, by rule, determine should be covered by the prohibition.

The Act provides exceptions to the prohibition on proprietary trading for the following permitted activities:

- transactions in obligations of the United States government, government-sponsored enterprises or state or municipal governments;

- transactions in connection with market making or underwriting activities, to the extent such transactions are designed "not to exceed the reasonably expected near term demands of clients, customers or counterparties;"

- risk-mitigating hedging activities related to individual or aggregated positions, contracts or other holdings of the banking entity that are designed to reduce specific risks;

- transactions in securities or other instruments "on behalf of customers;"

- investments in small business investment companies or certain other investments that are designed to promote the "public welfare" or that are qualified rehabilitation expenditures;

- transactions conducted by regulated insurance companies, provided that the appropriate banking regulators have not determined to prohibit such transactions;

- proprietary trading conducted by a banking entity solely outside of the United States, provided that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States; and

- such other activities as the appropriate federal banking agencies, the SEC and the CFTC determine, by rule, would "promote and protect" the safety and soundness of the banking entity and the financial stability of the United States.

The Act further provides that no transaction may be deemed a permitted activity under the exceptions described above if it would (i) give rise to a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure to "high-risk assets" or "high-risk trading strategies," as such terms are defined by rulemaking; (iii) pose a threat to the safety and soundness of the banking entity; or (iv) pose a threat to the financial stability of the United States.

Prohibition on Sponsoring or Investing in Hedge Funds or Private Equity Funds

The Volcker rule generally prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring any hedge fund or private equity fund. "Sponsoring" is defined broadly as (i) serving as a general partner, managing member or trustee of a fund; (ii) selecting or controlling a majority of the directors, trustees or management of the fund; or (iii) sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. "Hedge fund" and "private equity fund" are defined to include any issuer that would be an investment company subject to registration under the Investment Company Act of 1940 (the "Investment Company Act") but for an exemption provided by Section 3(c)(1) or Section 3(c)(7) of that Act, and any other issuer that the regulators determine, by rule, should be subject to the Volcker rule.

The Act provides exceptions for the following permitted activities:

- organizing and offering a hedge fund or private equity fund, including sponsoring such a fund, as long as all of the following conditions are met:

  (i) the banking entity provides bona fide trust, fiduciary or investment advisory services;

  (ii) the fund is organized and offered only in connection with the provision of such services and is only offered to customers of such services of the banking entity;

(iii) the banking entity does not have an equity or other ownership interest in the fund except for the following de minimis investments:

- seed investments to establish the fund and provide the fund with sufficient initial equity for investment to attract unaffiliated investors; and

- other de minimis investments;

provided that, in making either of the above investments, (x) the banking entity must actively seek unaffiliated investors to reduce its ownership interest to not more than 3% of the total ownership interest of the fund within one year of the establishment of the fund (which period of time may be extended for up to two additional years upon application to the Federal Reserve); and (y) the banking entity's aggregate interests in all funds in which it is permitted to invest may not exceed 3% of its Tier 1 capital;[1]

(iv) the banking entity does not enter into covered transactions (as defined in Section 23A of the Federal Reserve Act, these transactions generally include providing loans or guarantees to funds and purchasing fund assets or securities) with the funds it organizes and offers and complies with the requirements of Section 23B of the Federal Reserve Act, which imposes restrictions on transactions between banks and their affiliates;

(v) the banking entity does not guarantee, assume or otherwise insure the obligations or performance of the fund or any other hedge fund or private equity fund in which the fund invests;

(vi) the banking entity does not share the same name or a variation of the same name with the fund;

(vii) no director or employee of the banking entity takes or retains an equity or other ownership interest in the fund, except for any director or employee who is directly engaged in providing investment advisory or other services to the fund; and

(viii) the banking entity discloses to prospective and actual investors that the fund's losses are borne by the fund's investors and not by the banking entity;

- investing in small business investment companies or certain other investments that are designed to promote the "public welfare" or that are qualified rehabilitation expenditures;

- investing in or sponsoring a hedge fund or private equity fund solely outside the United States, provided that the banking entity is not directly or indirectly controlled

[1] Tier 1 capital, as defined in the Bank Holding Company Act, generally is the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments and other items that are required to be deducted under certain requirements.

by a banking entity organized in the United States and the interests in the fund are not offered or sold to a resident of the United States; and

- engaging in such other activities as the appropriate federal banking agencies, the SEC and the CFTC determine, by rule, would "promote and protect" the safety and soundness of the banking entity and the financial stability of the United States.

These exceptions for permitted activities are subject to the same limitations described above with respect to proprietary trading, *i.e.*, such transactions must not give rise to material conflicts of interest, involve high-risk assets or strategies or pose a threat to the banking entity or the U.S. financial system.

Limitations on Relationships with Hedge Funds and Private Equity Funds

The Volcker rule generally prohibits any banking entity that serves, directly or indirectly, as the investment manager, investment adviser or sponsor to a hedge fund or private equity fund, and any affiliate of such banking entity, from entering into a covered transaction (as defined in Section 23A of the Federal Reserve Act) with the fund or any other hedge fund or private equity fund that is controlled by the fund. This means that banking entities will generally be restricted in their ability to make loans or provide guarantees on behalf of their funds or to purchase fund assets or securities. Any such banking entity will also be subject to Section 23B of the Federal Reserve Act, which imposes other restrictions on transactions between banks and their affiliates. However, the Act does include an exception for prime brokerage transactions, pursuant to which the Federal Reserve is authorized to permit a banking entity to serve as prime broker for its own funds, subject to specified conditions.

Additional Capital Requirements and Quantitative Limitations for Permitted Activities

The Act authorizes the appropriate regulators to adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, with respect to banking entities engaging in permitted activities under the exceptions to the Volcker rule. For purposes of complying with such additional capital requirements, the aggregate amount of de minimis investments of a banking entity in a hedge funds and private equity funds will be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction will increase commensurate with the leverage of the hedge fund or private equity fund.

Nonbank Financial Companies Supervised by the Board

As noted above, the Federal Reserve is mandated to adopt rules imposing additional capital requirements and quantitative limits on systemically important nonbank financial companies regulated by the Federal Reserve that engage in proprietary trading or sponsor or acquire interests in private equity and hedge funds.

Anti-Evasion

In order to insure compliance with the Volcker rule, the appropriate federal banking agencies, the SEC and the CFTC must issue rules regarding internal controls and recordkeeping. In addition, whenever the appropriate federal regulator has reasonable cause to believe that a banking entity or systemically important nonbank financial company has made an investment or engaged in an activity "in a manner that functions as an evasion of the requirements" of the Volcker rule, such regulator must order termination of such activity and, as relevant, disposal of such investment.

Implementation

The Act requires that the newly-established Financial Stability Oversight Council (a council of regulators chaired by the Treasury Secretary) conduct a study and make recommendations with respect to implementation of the Volcker rule within six months after enactment of the Act. Then within nine months after completion of the study, the appropriate federal banking regulators, the SEC and the CFTC are required to adopt coordinated final rules implementing the Volcker rule provisions of the Act. The Volcker rule provisions will formally take effect on the earlier of 12 months after the adoption of final regulations and two years after the date of enactment of the Act. Financial institutions covered by the rule will then have up to an additional two years to bring their activities and investments into compliance. Banking regulators are allowed to grant up to three one-year extensions to this deadline. In addition, the Federal Reserve is authorized to grant an extended exemption of up to five years for certain "illiquid funds," which are defined as funds that are principally invested in illiquid assets, such as portfolio companies, real estate investments and venture capital investments, to the extent necessary to fulfill contractual obligations that were in effect on May 1, 2010.

The federal banking agencies are directed jointly to review and prepare a report on the types of activities that a banking entity should be permitted to engage in under federal law. Separately, the Government Accountability Office is directed to study the risks and conflicts associated with proprietary trading and report back to Congress within 15 months of the enactment of the Act.

Key Open Questions

- **Trading account and scope of market making exception.** For purposes of the prohibition on proprietary trading, the Act provides only a very general description of the term "trading account" and the accompanying exception for permitted market making activities. The scope of both the rule and the exception are likely to be the subject of intense debate during the implementation period, and the final rules can be expected to contain considerably more detail as to prohibited and permitted activities.

- **Application to employees' securities companies.** The Volcker rule's prohibition on sponsoring and investing applies to hedge funds and private equity funds that are exempt from registration under the Investment Company Act pursuant to either Section 3(c)(1) or Section 3(c)(7), and to "such similar funds as the regulators may, by rule, determine." Sections 3(c)(1) and 3(c)(7) focus on the number of investors in a fund and the amount of investments held by an investor, respectively, rather than the specific relationship between the banking entity and the beneficial owners. Employees' securities companies (within the meaning of Section 2(a)(13) of the Investment Company Act) are exempted from the registration (and certain other) requirements of the Investment Company Act upon application pursuant to Section 6(b). Since employees' securities companies are exempted under a different section due to the specific relationship between the investors (employees) and the employer banking entity, investing in, and sponsoring funds organized as employees' securities companies should be exempted from the prohibitions of the Volcker rule. Making it clear that these funds will not be considered "similar funds" will be vital to their continued existence for banking entities. Regulations should also address situations in which these funds invest in parallel with funds sponsored by the bank employer.

- **The extent of the de minimis investment exemption.** The Volcker rule indicates that the de minimis investment exemption only applies to funds that are organized and offered by the banking entity and not to third party sponsored funds in which the banking entity might otherwise make an investment, other than through a bank sponsored fund of funds. It is not apparent that any other exemption would allow such direct investment in third party funds. If the de minimis exemption were intended to apply to third party funds, it would need to be clarified in the Act or regulations.

- **Restrictions on investments by in-house pension plans.** The Act's restrictions on bank investments in hedge and private equity funds may apply to a pension plan established by the bank for its own employees. The restrictions apply to covered banks and their "affiliates" and a bank-sponsored pension plan is arguably such an affiliate. Guidance will be needed here, and the problem may be solvable only by amending the provision or in future regulations. Without such action and given the seeming prohibition described above on bank entities investing in third party funds, bank-sponsored pension plans would generally be excluded from making the kind of alternative investments widely pursued by private and governmental pension plans.

- **Unintended consequence for sponsoring funds of funds.** The combination of the prohibition on investing in third party funds and the overly broad definition of "banking entity" has another clearly unintended consequence with respect to a bank sponsored fund of funds. If such fund is controlled by the bank, it would itself be a "banking entity" and, therefore, prohibited from investing in any hedge fund or private equity fund other than one sponsored by the bank. Such a result would eliminate the ability of banks to sponsor funds of funds for their clients. This consequence also needs to be addressed by amendment or regulations.

- **Parallel funds and alternative investment vehicles.** Funds often set up parallel funds or alternative investment vehicles, commonly referred to as AIVs, to meet the needs of different groups of investors for a variety of specialized tax or regulatory reasons. An investor, such as a banking entity, may choose to invest its entire capital contribution in the main fund and not any of the parallel funds or AIVs. In maintaining its investment in the fund to not more than 3% of the total ownership interest of the fund, a banking entity needs to be certain if the amount of capital held by parallel funds and AIVs are considered as part of the total ownership interest of an overall fund and the 3% limit applies based on the capital of the overall fund. Regulations should provide that the parallel funds and AIVs will be treated as one entity with the main fund and the 3% capital holding requirement should be applied based on the capital of the overall fund.

- **Conversion to nonbank financial institution status.** The Act may create an incentive for bank holding companies to sell their insured depository arms and convert to nonbank financial institutions. However, entities that received TARP funds and have over $50 billion in assets will continue to be regulated by the Federal Reserve as nonbank financial institutions. The profitability of the conversion will depend on how harsh the Federal Reserve regulations on nonbank financial institutions are relative to the prohibitions on banking entities in the Act.

- **Regulation of nonbank financial institutions.** It remains to be seen the extent to which the Federal Reserve will seek to impose the Volcker rule principles on systemically important nonbank financial institutions. Minimum capital requirements and quantitative restrictions may make certain hedge fund strategies unprofitable.

- **Scope of exception for foreign entities.** The Act provides exceptions for proprietary trading and investing in and sponsoring hedge funds and private equity funds solely outside the United States by financial institutions that are not controlled by a banking entity organized in the United States. It is unclear whether the regulators will provide additional exceptions for foreign entities that would permit, among other things, foreign banks to conduct proprietary trading with U.S. counterparties on U.S. exchanges.

- **Conformance period for divestiture**. The Act provides that a banking entity must bring its activities and investments into compliance with the Volcker rule within two years of the effectiveness of the Volcker rule provisions. During this so-called "conformance period for divestiture," it is unclear whether and the extent to which banking entities will be permitted to continue proprietary trading and making new investments in funds, or whether they will only be permitted to wind-down such activities.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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