The Volcker Rule

Charles M. Horn
Christopher Laursen
Matthew Richardson
Dwight Smith

July 7, 2011
The Volcker Rule

- Basics and Some History
- Proprietary Trading
- Private Equity Funds and Hedge Funds
- Other Restrictions
- Some Things to Keep in Mind
Basics and Some History
The full Volcker Rule contains two broad prohibitions for banking entities:

- No proprietary trading
- No ownership interest in or sponsorship of a private equity fund or hedge fund

Note that entities with a bank functioning solely in a trust or fiduciary capacity are exempt from these prohibitions
Basics

For nonbanking entities:

- Prohibitions on proprietary trading and private equity fund/hedge fund ownership or sponsorship do not apply.

- A nonbanking financial company that is systemically important will be subject to additional capital requirements and quantitative limits on proprietary trading and ownership in or sponsorship of a private equity or hedge fund.
Volcker Rule “embraces the spirit of the Glass-Steagall Act’s separation of ‘commercial’ from ‘investment’ banking by restoring a protective barrier around our critical financial infrastructure.”

Sen. Merkley (D-OR)
History

Rule is intended to “prohibit or restrict certain types of financial activity … that are high-risk or which create significant conflicts of interest.”

Intent of prohibition is to:

- Limit threats to safety and soundness
- Limit threats to financial stability
- Eliminate any economic subsidy to high-risk activities that is provided by access to lower-cost capital because of participation in the regulatory safety net

Senate Banking Committee
(April 2010)
Chronology—History

January 2009: Group of 30 Report
  Proprietary trading a major reason for the financial crisis
  Recommends prohibition on proprietary trading by systemically important institutions

June 2009: Administration proposals; no Volcker-type provisions
December 2009: H.R. 4173 passed; no Volcker-type provisions
January 2010: Obama Administration announces support for Rule
April 2010: Merkley-Levin Amendment
May 2010: S. 3217, passed, with amendment
June 2010: Conference committee adds “de minimis” exception to private equity/hedge fund prohibition
July 21, 2010: Dodd-Frank Act signed into law
Chronology—Post-Enactment

- November 2010: FRB proposes rule on conformance periods
- Jan. 2011: FSOC publishes required study
- Feb. 2011: FRB releases final rule on conformance periods

Still to come:
- 3rd Quarter 2011: Interagency proposal on substance of Volcker rule
- 4th Quarter 2011: Final regulations on Volcker Rule (Oct. 21 is Dodd-Frank requirement)
- July 21, 2012: Volcker Rule to take effect—with 2-year conformance period
- July 21, 2014: Across-the-board conformance period ends, but extensions are available
Proprietary Trading
Trading

Section 619 limits “proprietary trading” of “banking entities” which benefit from Federal insurance on customer deposits or from access to the discount window.
Trading—Key Provisions

• Generally Prohibited
  • Proprietary trading: “Trading activity” in which a “banking entity” acts as “principal” in order to profit from “near-term” price movements

ü Specifically Permitted
  ü Transactions in specific classes of instruments or for specific purposes
  ü Permitted transactions are subject to specific prudential restrictions, as provided in regulations
Statutory Definitions

Proprietary trading is defined as
- engaging as principal for the trading account of the banking entity or NBFC
- in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or “any other security or financial instrument” that the appropriate federal agencies may determine

Trading account is defined as
- Any account used for acquiring or taking positions *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)*
- Any such other accounts specified by rule
Trading—Legal Issues

Rulemaking

The FSOC study recognizes the difficulty of determining proprietary versus non-proprietary trading in different industries and identifies five principles to be used in rulemaking:

- Unlawful trading to be prohibited with “whatever combination of tools and methods are necessary”
- Rules should be “dynamic and flexible”
- Consistent application of rules across similar banking entities
- Supervision should facilitate “predictable facilitations of outcomes”
- Rules should account for differences among asset classes

The study encourages the agencies to develop criteria for a “bright line” for certain widely recognized trading activities but does not specify criteria.
Trading—Legal Issues

Permissible transactions

- Transactions in U.S. government securities (including GSE securities)
- Transactions in connection with underwriting or market-making activities, to the extent designed not to “exceed the reasonably expected near term demands of clients, customers or counterparties”
- Risk-mitigating hedging activities designed to reduce specific risks
- Transactions for customers
- SBIC investments
- Purchase or sale of securities and derivatives by a regulated insurance company engaged in the insurance business
- Trading solely outside the U.S. by banking entities organized under non-U.S. law and subject to several conditions

Note: Diversification and higher capital requirements could be applied
Sale or securitization of loans also permitted
Trading—Decision Tree

Will transaction create proprietary trading position?

Yes → Is trade on behalf of customer (including underwriting)?

Yes → Does trade result in material conflict of interest?

No → Does trade...

Yes → Create material high risk asset or trading strategy?

Yes → STOP

No → Threaten safety of banking entity?

Yes → STOP

No → Threaten safety of financial system?

Yes → STOP

No → Volcker rule does not preclude transaction

STOP

No

Volcker Rule does not preclude transaction

No

Does trade represent...

Market making?

Yes → STOP

No

Risk-mitigating hedge?

Yes → STOP

No

U.S. Gov’t or agency security or SBIC?

Yes → STOP

No → STOP

STOP

This is MoFo.
The FSOC study recommends that each banking entity establish a risk management framework to identify and restrict proprietary trading. There are four elements to the recommendation:

- Programmatic compliance regime
- Analysis and reporting of quantitative metrics
- Supervisory review and oversight of trading operations
- Enforcement procedures for violations

Federal bank regulators may require certain risk management practices on a case-by-case basis as part of its safety and soundness authority.
Trading—Recommendations

Recommendations to Banking Entities:

1. Implement mechanism that identifies customer initiated trades
2. Perform quantitative analysis to detect potentially impermissible proprietary trading
3. Implement robust compliance regime, including CEO public attestation of effectiveness
4. Divest impermissible positions and wind down trading desks engaged in impermissible activities

Recommendation to Regulators:

5. Perform review to distinguish between permissible and impermissible trading activity
Trading—Prudential Backstops

Otherwise permissible proprietary trading is forbidden if it would:
- Result in a material conflict of interest for the banking entity
- Result in a material exposure for the banking entity to high-risk assets or high-risk trading strategies
- Pose a threat to the safety and soundness of the banking entity
- Pose a threat to the financial stability of the U.S.

Prudential backstop requirements were the subject of some discussion in the FSOC study:
- The study suggests the need for broad banking entity and NBFC conflict-of-interest policies and procedures
- In addition, the study recommended a supervisory framework for the identification and management of high-risk assets and trading strategies
Private Equity Funds and Hedge Funds
Funds—The Basic Elements

Hedge funds and private equity funds are those funds exempt from the Investment Company Act of 1940 under sections 3(c)(1) or 3(c)(7).

- Regulatory agencies have authority to extend the covered fund limitations to other types of funds.

Volcker Rule limitations apply to investments in, acquisitions of, and sponsorships of hedge funds and private equity funds.

The prudential backstops for proprietary trading also apply to permissible fund activity.

Two statutory categories of permissible fund-related activity:

- Bona fide trust or advisory business coupled with de minimis investments
- Prime brokerage services

Agencies have authority to apply the Volcker Rule to other classes of private funds.
Funds—Bona Fide Fiduciary Activity

- Institution that functions solely in a trust or fiduciary capacity is excluded from definition of banking entity.
- Banking entity that provides bona fide trust, fiduciary, or investment advisory services may organize and offer a fund, if it:
  - Offers interests in fund only in connection with providing trust or related services to customers.
  - Retains only a de minimis investment in fund.
  - Observes 23A- and 23B-type restrictions on transactions with fund.
  - Does not, directly or indirectly, support fund obligations or performance.
  - Does not share a name (or derivation) or marketing with fund.
  - Does not permit any director or employee of entity to have economic interest in fund, except persons directly engaged in providing investment advisory services to fund.
  - Discloses to investors that losses are not borne by banking entity.
Funds—De Minimis Investments

Under the de minimis requirement for funds launched by a banking entity as part of its trust, fiduciary, or investment advisory services, a banking entity may organize, invest in, and offer a fund otherwise prohibited by the Volcker Rule under three conditions:

1. The banking entity seeks unaffiliated investors
2. The start-up investment in a fund is unrestricted but within one year of the start date, the banking entity’s investments shall not exceed more than 3% of the total ownership interests in the fund
3. The aggregate of investments in all such funds does not exceed 3% of the banking entity’s Tier 1 capital
Funds—Other Permissible Activities

- Provision of prime brokerage services to a sponsored fund if the provision of such services complies with other applicable restrictions of the regulations and the CEO (or equivalent officer) of the banking entity certifies annually to such compliance
  - Prime brokerage transactions will be subject to Section 23B.
- Investment in or sponsorship of a covered fund pursuant to Section 4(c)(9) or 4(c)(13) of the BHCA “solely” outside of the United States if:
  - interests in the fund are not offered or sold to a U.S. resident; and
  - the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.
- Investment advisory services for covered funds
Funds—Rulemaking

FSOC study identifies several elements of the Volcker Rule that will require clarification in rulemaking:

- Definition of “fund.” Term appears to include venture capital funds and exclude certain commodity pools, which may not be sound policy.
- Definition of “customer.” No statutory definition, and a variety of relationships could or could not create a “customer.”
- Feeder funds. These funds are permissible but present potential conflicts of interest.
- Calculation of “de minimis.” Nature of fund investments does not lend itself to an easy calculation of the 3% cap.
- Definition of “banking entity.” The definition in the statute is circular.

FSOC study encourages regulatory agencies to consider preservation of venture fund activities but also to identify fund activities that are substantively similar to covered funds.
Other Restrictions
23A and 23B

- Section 23A limits a bank’s extensions of credit to or certain other transactions—known as “covered transactions”—with any affiliate to certain percentages of the bank’s capital and imposes collateral and other requirements. These transactions generally are not prohibited.

- Section 23B requires, in general, that any transaction between an affiliate and a bank be on terms at least as favorable to the bank as a comparable transaction with a third party. This rule is often referred to as the “market terms” requirement.
23A and 23B

23A under the Volcker Rule: a banking entity that serves as an investment adviser to or sponsor of a fund or that organizes and offers interests in a fund may not enter into “covered transactions” with the fund. This is an absolute prohibition.

23B under the Volcker Rule: a banking entity also is subject to the market terms and other restrictions of Section 23B in respect of transactions with the fund—even if the fund would not otherwise qualify as an affiliate.
Conflicts of Interest

- Section 621 of Dodd-Frank, which bars certain conflicts of interest, may overlap with the Volcker Rule.

- An underwriter, placement agent, initial purchaser, sponsor (or any affiliate) of an asset-backed security (including synthetic asset-backed securities) shall not engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

- This prohibition will apply for a one-year period that begins on the offering date.

- SEC final rules were due April 15, 2011. SEC plans to issue proposal by the end of July.
Conflicts of Interest

- The prohibition shall be subject to exceptions for:
  - Risk-mitigating hedging activities in connection with underwriting or offering the asset-backed security; provided such activities are designed to reduce specific risk to the financial intermediary associated with positions arising in connection with the asset-backed security offering.
  - Purchases or sales of asset-backed securities made pursuant to and consistent with (i) commitments by the financial intermediary to provide liquidity for the asset-backed security or (ii) bona fide market-making in the asset backed security.
Some Things to Keep in Mind
Deadlines

- Volcker Rule provisions take effect on the **earlier** of:
  - 12 months after the date of the issuance of the final rules, or
  - Two years after the date of enactment of the Dodd-Frank Bill.
- Dodd-Frank requires final rule by Oct. 21; deadline likely to slip
- FRB has issued a final rule on conformance deadlines
- Institutions generally will have until July 21, 2014, to bring activities into compliance
- Three one-year extensions are available if FRB determines that extension is consistent with purposes of the Volcker Rule and would not be detrimental to the public interest.
- FRB may grant single five-year extension for up to five years for illiquid funds owned as of May 1, 2010.
Major Takeaways

- Different rules for banking entities and nonbank financial companies
- A banking entity may continue to trade in a range of securities.
- Dealing, underwriting, and market making functions should not be affected
- Venture capital should largely be unaffected
- A bank may sponsor a hedge fund or private equity fund in a fiduciary or advisory capacity for its customers
- Rules begin to take effect July 21, 2012, but extensions are available for fund-related activities
Contact Information

Charles M. Horn
(202) 887-1555
charleshorn@mofo.com

Christopher Laursen
(202) 466-9203
christopher.laursen@nera.com

Dwight C. Smith
(202) 887-1562
dsmith@mofo.com

Matthew Richardson
(212) 998-0349
mrichar0@stern.nyu.edu