The Volcker Rule (“Volcker” or the “Rule”), one of the more interesting (not to say peculiar) provisions of the Dodd-Frank Act, prohibits or limits (i) proprietary trading and (ii) sponsoring or holding an ownership interest in a hedge fund or a private equity fund. These requirements apply to all banking entities, regardless of size. Nonbank financial companies that have been declared systemically important by the Financial Stability Oversight Council (the “Council”) and supervised by the Board may engage in these activities but will be subject to higher capital requirements for the activities and may be subject to quantitative limits or diversification requirements set by the Federal Reserve Board (the “Board”). The restrictions do not apply to banking organizations where the bank is engaged solely in trust or fiduciary activities.

The public policies underlying the Rule are both complex and obscure. Unduly risky trading and investment activities at banking institutions, made possible by the federal safety net of deposit insurance and access to the discount window either were, according to some commentators, a cause of the financial crisis or will be the source of the next one. The Rule accordingly attempts to sever any connection between these activities and the federal safety net. From another perspective, the Rule—a relative latecomer in the Dodd-Frank legislative process—re-erects some of the walls between commercial and investment banking that were first built by the Glass-Steagall Act in 1933 and later taken down by the Gramm-Leach-Bliley Act. From a third viewpoint that essentially ignores the specific complexities of the Rule, compliance (even if not complete) will reduce liquidity in the financial system—a perceived problem during the financial crisis—and prevent or mitigate any future crisis.

Five federal agencies (collectively, the “Agencies”) are responsible for implementation of the Rule. On November 7, 2011, four of the Agencies—Board, the Office of the Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the “FDIC”), and the Securities and Exchange Commission (the “Commission”—jointly published a proposed regulation (the “Proposal”). The FDIC and the Commission had signed off on a consensus proposal (the “Proposed Rule”). After one extension, the comment period expired on February 13, 2012. The fifth agency, the Commodity Futures Trading Commission (the “CFTC”), published a substantially similar proposal on February 14, 2012; the comment period on this proposal ended on April 16, 2012. Several thousand comments have been filed. While form comments comprise the large majority of the comments, a few hundred comments address various specific provisions in the Proposal. The comments also include an unusually large number from foreign governments and foreign banks. Given the volume of comments, finalization of the Proposal may be a long way off.

The impact of the Proposed Rule on proprietary trading and investments in and sponsorships of hedge funds or private equity funds may be difficult to measure. The Proposed Rule does not provide any bright lines for distinguishing permissible from impermissible activities. The Proposed Rule also imposes compliance and reporting requirements that are likely to be quite burdensome. For an analysis of the compliance requirements in the Proposed Rule, please see our recent paper, “The Volcker Rule: Compliance Considerations,” available at
Proprietary Trading

— While a banking entity may not continue to trade for its own account, it may continue to hold securities on a short-term basis in connection with underwriting, market making, or risk-mitigating hedging activities. Trading in government obligations and trading on behalf of a customer also are allowed. Regulated insurance companies are not subject to the Volcker Rule restrictions on trading.

Hedge Funds and Private Equity Funds

— The Proposed Rule defines hedge funds and private equity funds broadly and primarily as funds that are exempt from the requirements of the Investment Company Act under Section 3(c)(1) or (c)(7) of that statute. The Agencies candidly acknowledge that this definition covers venture capital and other funds that do not have the characteristics that the Rule was meant to address. The Proposed Rule contains the exception in the statute for investment funds offered in a fiduciary or advisory capacity to a banking entity’s customers. These customers need not have been pre-existing customers. A covered entity may provide the seed investment necessary to get the fund up and running but within a year must reduce the investment to a de minimis level of 3 percent of the fund’s assets.

Securitizations

— The treatment of participation in a securitization transaction, either as a trading activity or as a sponsorship of or an ownership interest in a hedge fund or private equity fund, is unclear. Dodd-Frank directs that the Rule should not be construed to limit a banking entity’s ability to sell or securitize loans, but this provision does not appear to be broad enough to cover all securitization-related activities. Among the questions raised by the Proposed Rule is how securitization-related activities should be addressed.

Prudential Backstops

— The Rule bars otherwise permissible trading or fund-related activities if the activity (i) presents a material conflict of interest, (ii) reflects investment in a high-risk asset or a high-risk trading strategy, (iii) threatens the safety and soundness of the institution or (iv) could threaten the financial stability of the United States. A related provision of Dodd-Frank, section 621, requires the Commission to issue rules to bar material conflicts of interest in connection with certain securitizations. Given the similarity between this provision and the Rule’s ban on material conflicts of interest, the Commission has placed its section 621 proposal along the same timeline as that of the Rule.
Foreign Banking Organizations

— The Volcker Rule prohibits any banking entity, including any company that is treated as a bank holding company under section 8(a) of the IBA, from engaging in proprietary trading, subject to certain exceptions and from taking an ownership interest in or sponsoring a private equity fund or hedge fund. We recently discussed the extraterritorial effects of the Rule in a bulletin, “The Volcker Rule’s Impact on Foreign Banking Organizations,” published on July 2, 2012, and available at http://www.mofo.com/files/Uploads/Images/120611-Extraterritoriality-Volcker-Rule.pdf.

— The Volcker Rule does not apply to any proprietary trading conducted by a foreign bank that is subject to Section 8 of the IBA or its affiliates if such trading is conducted pursuant to section 4(c)(9) or 4(c) (13) of the Bank Holding Company Act, the trading occurs “solely outside the United States,” and the foreign bank and its affiliates are not directly or indirectly controlled by a U.S. banking entity.

— Along the same lines, a foreign banking entity that is subject to Section 8 of the IBA or its affiliates may take an ownership interest in or sponsor a private equity fund or hedge fund if (i) the activity is conducted pursuant to section 4(c)(9) or 4(c) (13) of the Bank Holding Company Act; (ii) interests in the fund are not offered or sold to U.S. residents; and (iii) the activity occurs solely outside the United States.

— Even if an FBO, an affiliate or a subsidiary qualifies for an “outside-the-U.S.” exemption, it remains subject to the prudential backstops described above.

— In some cases, an FBO may be prohibited from making a loan to a fund with which it has certain interests.

— Separately, the Rule exempts trading in obligations of the U.S. government (and certain other agencies and entities) from the proprietary trading prohibition. The exemption does not extend to trading in the obligations of foreign sovereign governments—an issue of considerable importance to foreign governments, perhaps most notably Canada and its provincial governments.

Compliance

— The Proposed Rule requires every banking organization in the United States to establish some kind of compliance program, even if the institution engages in no Volcker-related activities. For those that do engage in permissible trading and investment fund activities, there are robust compliance standards that in practice should be tailored to the nature of the institution and its activities. The compliance requirements for institutions engaged in market making may be particularly burdensome.

— Appendix C to the Proposed Rule describes an elaborate compliance regime that is more detailed and specific than most compliance requirements for other banking activities. Appendices A and B require banking entities to maintain daily records at the trading desk level and to submit monthly reports to the regulators.

Timing
Timing is an especially complex part of the Rule and the Proposal.

— The Rule as set forth in the Dodd-Frank Act takes effect on July 21, 2012—even though the regulation has not been finalized. Dodd-Frank provides for a two-year conformance period, meaning that the prohibitions and restrictions have no enforceable effect until July 21, 2014. In the meantime, the Agencies presumably will have completed a final regulation.

— Banking entities should be aware that they have four duties during the conformance period: (i) prepare for full compliance on July 21, 2014, (ii) draft a conformance plan that describes how the entity will achieve this goal, (iii) demonstrate a “good faith” effort to achieve compliance during the conformance period, and (iv) prepare for possible recordkeeping and reporting requirements that the Agencies may impose before July 21, 2014. We have discussed the conformance period in a client alert, “Volcker Rule: Guidance on the Conformance Period,” published on April 20, 2012, and available at http://www.mofo.com/files/Uploads/Images/120419-Volcker-Rule-Conformance.pdf.

— The Board may extend the conformance period by up to three one-year periods, if the extension is consistent with the purpose of the Volcker Rule and not detrimental to the public. An additional five-year extension is available for an ownership interest in an illiquid fund that was contractually agreed upon before May 1, 2010.