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Legal Update
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# The Volcker Rule: Proprietary Trading and Private Fund Restrictions

On June 25, 2010, the House-Senate Conferees agreed to a final version of the "Volcker Rule." Along with the rest of this historic financial reform legislation, it will now have to be approved by the House of Representatives and the Senate before it can go the President for signature.

The Volcker Rule would broadly restrict banking entities from engaging in (i) proprietary trading and (ii) private fund sponsorship, management and investment activities *(for text of the Volcker Rule see [http://www.mayerbrown.com/public_docs/VolckerRuleFinalText06-30-2010.pdf](http://www.mayerbrown.com/public_docs/VolckerRuleFinalText06-30-2010.pdf))*.

The House-Senate conference made substantial changes to the version of the Volcker Rule passed by the Senate by adopting several provisions from the Merkley-Levin amendment, which had not been brought up for a formal vote in the Senate. It made the restrictions statutory, rather than subject to implementation by regulation; clarified the scope of the proprietary trading ban, and the exceptions thereto (including an exception for insurance companies); established a *de minimis* exemption permitting banking entities to make limited investments in private funds; added a general prohibition on conflicts of interest in exempted transactions; and limited the scope of changes in the statutory prohibitions that could be implemented through the Financial Stability Oversight Council (FSOC) study.

Part I of this update addresses the proprietary trading prohibition, Part II discusses the prohibition on investing in and sponsoring hedge funds and private equity funds, and Part III outlines the process for implementing the provisions of the Volcker Rule.

## WHAT TYPES OF FIRMS WOULD BE COVERED BY THE VOLCKER RULE?

The Volcker Rule will apply to any FDIC-insured depository institution, any company that controls an insured depository institution or is treated as a bank holding company under the Bank Holding Company Act of 1956 (BHCA), and any subsidiary of an insured depository institution or company. Thus, the prohibition would apply to:
(i) FDIC-insured commercial banks, savings banks and industrial loan companies (certain limited purpose trust companies would be exempt);
(ii) any company that controls such a depository institution—no matter what the size of the depository institution; (iii) any non-US banking organization (and any parent thereof) that has a US branch, agency, commercial lending company or depository institution subsidiary, and (iv) any subsidiary of the foregoing (covered banking entities). Non-US banking entities that *do not* have such banking operations in the United States, such as non-US banking entities with only US representative offices, generally would not be subject to the Volcker Rule.

As discussed below the Volcker Rule will also apply in a more limited way to nonbank financial institutions.

### WHAT REGULATORS WILL BE IN CHARGE OF IMPLEMENTING THE RULE?

The federal banking regulators responsible for supervising firms covered by the Volcker Rule include the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), plus the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). These regulators must "consult and coordinate with each other, as appropriate" with the goal, "to the extent possible," of adopting regulations that "are comparable and provide for consistent application and implementation." The Chairman of the FSOC (i.e., the Secretary of the Treasury) is responsible for coordinating the regulations to be issued. The FRB has the lead role in many aspects of the implementation.

## PART I: Ban on Proprietary Trading

### WHAT KINDS OF PRODUCTS ARE AFFECTED BY THE PROPRIETARY TRADING PROHIBITION?

The statutory ban applies to any security, any derivative, any future, any option on any of the foregoing, or any other security or financial instrument designated by rule by the federal regulators (covered instruments). The scope of covered instruments as amended in conference is less broad than in the Senate bill. Commodities such as precious metals and energy products are no longer included in the blanket statutory definition (other than any contract of sale for future delivery), and the ability of the regulators to expand the scope of covered instruments is limited to securities and other financial instruments. The prohibition on proprietary trading in derivatives by insured depository institutions is also referenced in section 716(m) of the legislation, which is the "Lincoln amendment" that restricts certain derivatives activities of banks.

### WHAT IS THE DEFINITION OF PROPRIETARY TRADING?

Proprietary trading is defined as "engaging as a principal for the trading account" of a covered banking entity in buying or selling any covered instrument. The addition of the quoted language in conference suggests that an entity acting as agent for a third party or affiliate, rather than as principal, would not itself be deemed to be engaged in proprietary trading, although the third party or affiliate will likely be deemed to be so engaged.

"Trading account" was also further defined in conference as any account used for acquiring or taking positions in covered 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)." The more specific definition of trading account provides further confirmation that securities and other financial instruments held in investment accounts would not be subject to the ban, as does section 620 of the legislation which requires a study of bank investment activities.

### WHAT ACTIVITIES ARE EXEMPT FROM THE BAN ON PROPRIETARY TRADING?

The statute identifies a list of "permitted activities" that are exempt from the ban, subject to restrictions that the regulators may adopt, including with respect to capital and quantitative limits. There are four enumerated exemptions generally available to all covered banking entities. First, a broad range of US government securities (Treasuries, GSE securities like Fannie Mae and Freddie Mac obligations, Farm Credit Bank obligations and Federal Home Loan Bank securities) and state government obligations are excluded from covered instruments. Second,

transactions "in connection with underwriting or market-making-related activities, to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties" are exempt. Third, transactions "on behalf of customers" are exempt. Finally, "risk-mitigating hedging activities" in connection with individual or aggregated holdings of the covered banking entity are exempt.

All these activities no doubt will be further clarified in the implementing regulations. For example, one issue relates to the importance of the deletion in conference of an exemption for activities done "in facilitation of" customer relationships. While the intended effect of this change in language was to "tighten" the language of the exemptions to the Volcker Rule, some of the activities that would arguably fall within the scope of being "in facilitation of" customer relationships may still qualify as activities done "on behalf of customers" or in connection with market-making-related activities. Purchasing and selling as principal, but on a back-to-back or riskless principal basis, may also come within the exemption for purchases and sales "on behalf of customers," or in connection with market-making-related activities.

## WHAT ACTIVITIES ARE PERMITTED FOR INSURANCE COMPANIES?

The conference also added an exemption for regulated insurance companies and their affiliates that make investments for the general account of the insurance company in accordance with applicable state law. The exemption would not be available if the regulators jointly determine that applicable state law is insufficient to protect the safety and soundness of the covered banking entity.

## WHAT IS THE EXEMPTION FOR OFFSHORE TRADING?

The conference modified the Senate bill's exemption for offshore trading. The legislation now provides that a covered banking entity may trade solely outside the United States so long as it is not directly or indirectly owned or controlled by a covered banking entity organized under the laws of the United States or any state. The practical effect of the exemption appears to be that it is only available to non-US based banking groups that are subject to the Volcker Rule by virtue of having a US depository institution or a US branch or agency. Such groups can establish companies or have companies outside the United States that are not directly or indirectly controlled by a company organized in the United States. In the case of US banking groups, this exemption does not appear to be available because, by definition, every company in the group is a subsidiary of the ultimate US parent. Thus, major US banking organizations that operate abroad through subsidiaries will not be able to trade through those subsidiaries. By the same token, it is not clear that this exemption would permit covered foreign banking organizations to conduct proprietary trading on US exchanges and trading facilities, even if the entity effecting a transaction is a non-US entity. As noted above, foreign banks that do not have US banking operations are altogether exempt from the Volcker Rule, including with respect to activities conducted by their nonbank affiliates in the United States.

## WHAT LIMITS ARE IMPOSED ON THE EXEMPTED ACTIVITIES?

None of the activities exempted above are permitted if they would involve, or would result in, a material conflict of interest, would result in material exposures by the covered banking entity to high-risk assets or high-risk trading strategies, would pose a threat to the safety and soundness of the banking entity or would pose a threat to the financial stability of the United States.[1] "Material conflict of interest," "high-risk asset" and "high-risk trading strategy" will be defined by regulation. The regulators may also impose additional capital requirements and quantitative limitations, including diversification

requirements, regarding the activities permitted under the regulations.

## Part II: Prohibitions on Certain Relationships with Private Funds

### HOW WOULD THE VOLCKER RULE AFFECT THE PRIVATE FUND ACTIVITIES OF COVERED BANKING ENTITIES?

The statute would prohibit covered banking entities from sponsoring or investing in hedge funds or private equity funds (private funds), except as discussed below. It would also prohibit a banking entity and its affiliates from entering into any transaction with a private fund that is sponsored or advised by the banking entity where the transaction would constitute a "covered transaction" under section 23A of the Federal Reserve Act (in general: loans to funds, purchases of fund assets or securities, or financial guarantees to, or on behalf of, funds). In addition, covered banking entities that advise private funds would be subject to the "market terms" and other restrictions of section 23B of the Federal Reserve Act in transactions entered into with those funds.

### WHAT CONSTITUTES PROHIBITED "SPONSORING" OF A PRIVATE FUND UNDER THE VOLCKER RULE?

Sponsoring is defined as: (i) serving as a general partner, managing member or trustee of a private fund; (ii) selecting or controlling in any manner (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a private fund; or (iii) sharing with a private fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.

### WHAT TYPES OF PRIVATE FUNDS ARE INCLUDED WITHIN THE VOLCKER RULE'S PROHIBITIONS?

Any private fund that relies on either section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 for its exemption from registration under that Act would be covered under the Volcker Rule (covered fund). These include private funds that ordinarily are not considered to be the market equivalent of hedge funds or private equity funds (e.g., collateralized debt obligations or other bank loan funds, and securitization special purpose entities). The legislation does not provide specific exemptions for venture capital funds, and, under a literal reading, they would be included within the Volcker Rule's prohibitions. Private funds that rely on other Investment Company Act exemptions (e.g., bank-sponsored collective funds or mortgage-backed securities issuers that rely on section 3(c)(5)(C) under the Investment Company Act), would not be covered. The federal regulatory agencies, however, would have the authority to extend the Volcker Rule's coverage to other "similar" types of unregistered private funds. In addition, the Volcker Rule contains an exception for a covered banking entity's sale or securitization of "loans in a manner otherwise permitted by law."

### WHAT ACTIVITIES ARE PERMITTED WITH RESPECT TO PRIVATE FUNDS?

As with the ban on proprietary trading, the legislation identifies certain activities that are permitted subject to regulatory restrictions. These include an exemption for funds organized and offered to customers in connection with *bona fide* trust, fiduciary or investment advisory services and an offshore exemption that allows otherwise prohibited private fund activities to be conducted "solely" outside of the United States if the fund is not offered to US residents and the banking entity relying on the exemption is not controlled by a US banking entity. These permitted activities are subject to the material conflict of interest and other restrictions noted above in connection with permitted proprietary trading activities.

### WHAT IS THE FIDUCIARY EXEMPTION?

Banking entities are permitted to organize and offer a private fund, including serving as a general partner or managing member, if the following eight conditions are satisfied: (i) the banking entity provides investment advisory,

trust or other fiduciary services, (ii) the fund is organized and offered only in connection with such services and is offered only to customers of the banking entity; (iii) the banking entity does not have an equity interest in the fund, except for a *de minimis* investment; (iv) the banking entity does not enter into any covered transactions with the fund (as described above); (v) the banking entity does not guarantee or insure obligations or performance of the fund; (vi) the banking entity does not share with the fund the same name for corporate, marketing, promotional or other purposes; (vii) no director or employee of the banking entity has an interest in the private fund, except for any director or employee who is directly engaged in providing advisory services; and (viii) the offering documents provide adequate disclosures that the fund's losses are not borne by the banking entity.

### WHAT IS A *DE MINIMIS* INVESTMENT?

Banking entities are permitted to make investments in the private funds that they organize and offer to their customers for purposes of either (i) establishing the private fund and providing it with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (ii) making a *de minimis* investment. The Volcker Rule specifically provides that a banking entity's aggregate investment in all private funds may not exceed 3 percent of the Tier 1 capital of the banking entity. Moreover, the banking entity must reduce its ownership in a private fund not later than one year after the date of the fund's establishment to not more than 3 percent of the total ownership interests of the fund.

While this exemption appears to relax the complete prohibition on investments in private funds initially proposed by the Senate, it appears to apply only to the private funds that the investing banking entity "organizes and offers" its customer pursuant to the fiduciary exemption and not to private funds in which the banking entity would make a passive investment.

It also is unclear how the *de minimis* investment authority can be reconciled with the Volcker Rule language that prohibits transactions between a banking entity (and any affiliate) and a private fund advised or sponsored by the banking entity that would be covered transactions under section 23A of the Federal Reserve Act. A purchase of fund securities or ownership interests plainly would be a covered transaction under section 23A.

### HOW DOES THE VOLCKER RULE APPLY TO NON-US BANKING ORGANIZATION PRIVATE FUND ACTIVITIES?

Private fund activities conducted "solely" outside of the United States by covered banking entities within the meaning of sections 4(c)(9) and 4(c)(13) of the BHCA are exempt, as long as the non-US entity is not directly or indirectly owned or controlled by a banking entity that is organized under US federal or state law. This exemption is subject to the condition that no ownership interest be offered for sale or sold to a resident of the United States. The exemption should mean, at a minimum, that many private funds sponsored by covered non-US banking organizations that are organized and governed by non-US law, and that are not offered or sold to investors in the United States, would not be affected. However, non-US funds that make significant investments in US securities potentially could be affected to the extent that their US investments could cause their activities to be treated as not solely outside of the United States.

### ARE THERE EXCEPTIONS FROM THE VOLCKER RULE FOR ANY TYPES OF 3(C)(1) OR 3(C)(7) FUNDS?

Investments in small business investment companies (SBICs), covered funds that are "designed primarily to promote the public welfare" or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure would be exempt from the

Volcker Rule. However, because the language of this exemption provides that the private fund prohibition shall not apply with respect to an "investment" in such funds, it is unclear whether *sponsorship* of such funds would be allowed. The regulators have limited authority to exempt other types of covered funds.

### HOW WOULD NONBANK FINANCIAL FIRMS BE AFFECTED BY THE VOLCKER RULE?

Any nonbank firm that is engaged predominantly in financial activities, and that is designated as systemically important under the legislation, would be subject to heightened capital adequacy requirements and quantitative limits adopted by the regulators with respect to its proprietary trading and private fund activities that are not "permitted activities." In the case of designated foreign nonbanking firms (which would be subject to designation if they have "substantial" US assets or operations), these additional requirements would apply to their US operations.

## PART III: The Process to Implement the Volcker Rule

### WHAT IS THE ROLE OF THE STUDY?

The FSOC is required to complete a study on several specific topics relating to the Volcker Rule within six months of enactment. The FSOC is authorized to study and make recommendations on implementing the provisions of the Volcker Rule so as to promote safety and soundness, protect taxpayers and ensure financial stability by minimizing risk, reducing conflicts of interest, accommodating insurance businesses and providing for appropriate divestiture of illiquid assets affected by the rule. Unlike the Senate bill, however, the final text does not authorize the FSOC to recommend changes to the prohibitions or limitations imposed by the statute that would enable the regulators to soften its impact (other than with respect to insurance).

### WOULD THE FEDERAL REGULATORS HAVE THE ABILITY TO MODIFY OR LIMIT THE VOLCKER RULE?

The federal regulators are required to issue regulations within nine months after the completion of the study and to consider the findings and recommendations of the study in the regulations. As noted above, the FSOC has little discretion to recommend significant changes that reduce the limits or the prohibitions of the Volcker Rule. On the other hand, many of the provisions are vague and unclear, so, as a practical matter, it is likely that the regulators will have to adopt definitions and interpretations to clarify both the prohibitions and the exemptions.

### WHEN WOULD THE VOLCKER RULE BECOME EFFECTIVE?

The prohibitions take effect on the earlier of (i) two years after the date of enactment or (ii) 12 months after the issuance of final regulations (effective date). Presumably as of the effective date, new investments in covered funds and new proprietary trading activities will be prohibited. However, covered banking entities and nonbank financial companies will have two years after the effective date to bring their existing activities and investments into compliance. The FRB may grant up to three one-year extensions if it concludes that such extensions are in the public interest and consistent with the purposes of the Volcker Rule. Thus, existing fund investments and activities may not be required to be divested until seven years after the date of enactment.

### ARE THERE ANY SPECIAL PHASE-IN PROVISIONS FOR FUND INVESTMENTS?

With respect to a contractual obligation that was in effect on May 1, 2010, involving an "illiquid fund," the FRB may permit a covered banking entity to retain its interest in, or otherwise provide capital to, the fund pursuant to an extension not to exceed five years in total. "Illiquid fund" is defined as a hedge fund or

private equity fund that as of May 1, 2010, was principally invested in, or contractually committed to invest principally in, illiquid assets pursuant to an investment strategy to invest in such assets. After the date on which the contractual obligation to invest in the illiquid fund terminates, the banking entity must divest its interest in the fund. It appears that this extension would be in addition to the phase-in periods discussed above.

The FRB must issue phase-in regulations for the conformance and divestiture requirements within six months of the bill's enactment.

## Endnote

[1] Section 621 of the legislation implements another provision in the Merkley-Levin amendment by prohibiting transactions involving material conflicts of interest on the part of sponsors and underwriters of asset-backed securities.

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