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Treasury Proposes “Volcker Rule” Legislative Text

On March 3, 2010, the Department of the Treasury delivered to the Hill proposed legislative text to implement the “Volcker Rule” announced by the Obama Administration on January 21st. The following bullets briefly summarize the provisions of Treasury’s proposal, which takes the form of new sections 13 and 13a of the Bank Holding Company Act of 1956.

Prohibition on Proprietary Trading

Not self-executing. The “appropriate Federal banking agencies” are directed by statute to prohibit proprietary trading by covered companies.

Who is covered?

- Insured banks and thrifts; bank, thrift and other depository institution holding companies; and any company “treated as a bank holding company for purposes of the [Bank Holding Company Act]”, including
    - foreign banks with a U.S. branch, agency or commercial lending company subsidiary (but subject to Section 4(c)(9) exemption discussed below).
- Broker-dealers and other non-bank affiliates appear not to be subject to the prohibition, but their proprietary trading may be subject to additional capital requirements and quantitative limits as discussed below.

How is “proprietary trading” defined?

- Acquiring or disposing of stocks, bonds, options, commodities, derivatives, or other financial instruments for the institution’s or company’s own trading book, and not:
    - on behalf of a customer;
    - as part of market making activities; or
    - otherwise in connection with or in facilitation of customer relationships, including hedging activities related to the foregoing.

Ban does not apply to proprietary trading:

- in U.S. government and agency securities; GSE-issued securities; and state and municipal securities, but only if the covered entity is independently authorized to engage in such proprietary trading and subject to any conditions imposed by the covered entity’s “appropriate Federal banking agency;” or
- conducted solely outside of the United States by a foreign or other company pursuant to Section 4(c)(9) or Section 4(c)(13) of the Bank Holding Company Act, unless the company is directly or indirectly controlled by a company organized in the United States.
    - Note: no exception for trading in financial instruments for FX, interest rates or gold or other precious metals, which have all traditionally been considered to be bank eligible.

Prohibition on Sponsoring or Investing in Private Equity or Hedge Funds

Not self-executing. The “appropriate Federal banking agencies” are directed by statute to prohibit covered companies from sponsoring or investing in private equity or hedge funds.

Who is covered?

- Same as under the proprietary trading ban.

How are "hedge fund" and "private equity fund" defined?

- Any company or other entity that is exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act or "such similar funds as determined by the appropriate Federal banking agencies."

What does "sponsoring" a fund cover?

- Serving as a general partner, managing member, or trustee of a fund;
    - note that merely serving as investment adviser to a fund, as long as the fund has independent management, does not appear to constitute "sponsoring" a fund
- Selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a fund; or
- Sharing the same name (or a variant) as a fund.

Ban does not apply to:

- Investments in small business investment companies and certain "public welfare" investments, but only if the covered entity is independently authorized to make such investments and subject to any conditions imposed by the covered entity's "appropriate Federal banking agency."

No express exception for offshore activities conducted by a foreign or other company under Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unlike for ban on proprietary trading.

Limitations on Transactions or Relationships with "Advised" Private Equity or Hedge Funds

Self-executing. Does not require any agency action.

Who is covered?

- Same as under the proprietary trading ban.

Outright ban on any "covered transaction" as defined in Section 23A of the Federal Reserve Act between any covered company that serves as the investment manager or investment adviser of a private equity or hedge fund and such fund.

- Note that the House bill and November Dodd Proposal would expand the definition of covered transaction in 23A to include credit exposure on derivatives.

Outright ban on any such company providing custody, securities lending and other prime brokerage services to such fund.

"Market terms" and other requirements of Section 23B of the Federal Reserve Act apply to any covered company (other than an insured depository institution) as if such company were a member bank and such fund were an affiliate. (Insured depository institutions are already subject to Section 23B.)

Capital and Quantitative Limitations for Certain Nonbank Financial Companies

Not self-executing. The Federal Reserve Board is directed by statute to adopt rules applying capital and quantitative limits to covered companies.

Who is covered?

- Any “nonbank financial company” that is “under” the Federal Reserve Board’s “supervision”
- This term is undefined and unclear.
- This might include any nonbank financial company subsidiary of a bank holding company, such as a broker-dealer, even if it is primarily subject to another agency’s supervision.
- This might also include a nonbank financial company that is not a subsidiary of a bank holding company but which becomes subject to the Federal Reserve Board’s supervision because it is deemed to be systemically important or otherwise.

No outright ban on proprietary trading or sponsoring or investing in private equity or hedge funds by such nonbanking financial companies.

- Instead, the Federal Reserve Board is required to adopt “additional” capital requirements and quantitative limits for such nonbanking financial companies that are engaged in proprietary trading and fund sponsoring or investing activities.
- Exception for proprietary trading in U.S. government and agency securities; GSE-issued securities; and state and municipal securities.

Concentration Limit on Large Financial Firms

Prohibits any “financial company” from acquiring control of another company if the resulting company’s total consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year.

Defines “financial company” as:

- An insured bank or thrift;
- A bank holding company;
- Any other company that controls an insured bank or thrift (i.e., a thrift holding company or other depository institution holding company);
- Any foreign bank that has a U.S. branch, agency or commercial lending company subsidiary;
- Any other foreign company treated as a bank holding company for purposes of the Bank Holding Company Act; and
- Any nonbank financial company supervised by the Federal Reserve Board.
    - This last category could include a nonbank financial company subsidiary of a bank holding company (such as a broker-dealer subsidiary) or any other nonbank financial company that is otherwise subject to the supervision of the Federal Reserve Board because it is systemically important or otherwise.

Defines “liabilities” as:

- A financial company’s total risk-weighted assets, adjusted for regulatory capital deductions, minus total regulatory capital, as determined under bank holding company capital rules.
    - Liabilities for a foreign-based financial company are limited to the risk-weighted assets of its U.S. operations as “determined pursuant to applicable risk-based capital rules.”

  - Board is authorized and required to promulgate regulations to adapt the definition of liabilities with respect to insurance companies and other non-bank financial companies to provide for consistent and equitable treatment.

The concentration limit does not apply, subject to Fed approval, to acquisitions:

- Of failing or failed banks;
- Of banks that are receiving FDIC assistance; or
- That would result in only a *de minimis* increase in a financial company's liabilities.

Rulemaking Authority to Carry-out Entire Section

Granted to the appropriate Federal banking agencies.

Effective Date

Provisions of this section would become effective 180 days after the date of enactment.

Transition Period

Covered companies would have 2 years from the effective date to conform their activities and investments to the restrictions in this section, subject to up to 3 one-year extensions at the discretion of the company's appropriate Federal banking agency.

No grandfathering provision for investments or activities beyond the 2 to 5 year transition period.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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