June 25, 2010

Senate-House Conference Agrees on Final Volcker Rule

Early this morning, the House-Senate Conference on the Dodd-Frank Act of 2010 (the "Act") agreed on the final legislative text of the Act, including Section 619 (the "Volcker Rule"). The Volcker Rule is a revised version of an amendment introduced by Senators Merkley (D–OR) and Levin (D–MI) in the final stages of the Senate debate, and takes the form of new Section 13 of the Bank Holding Company Act of 1956 and new Section 27B of the Securities Act of 1933.

Summary. Subject to certain exceptions, the Volcker Rule prohibits any "banking entity" from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. It also requires systemically important nonbank financial companies to carry additional capital and comply with certain other quantitative limits on such activities, although it does not expressly prohibit them.

Ban on proprietary trading. The Volcker Rule prohibits any "banking entity" from engaging in proprietary trading, subject to certain exceptions.

- **Who is covered?**
  - Any "banking entity," defined as any insured bank or thrift, company that controls an insured bank or thrift, a company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate of such an entity.
- **How is "proprietary trading" defined?**
  - Engaging as a principal for the "trading account" of a banking entity or systemically important nonbank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or other security or financial instrument that the appropriate Federal banking agencies, the SEC, and the CFTC (the "regulators") may, by rule, determine.
  - **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 accounts as the regulators may, by rule, determine.
- **Permitted activities.**
  - Subject to certain limitations described below (including the absence of any material conflict of interest), and any additional restrictions or limitations that the regulators may impose, the following types of transactions are excluded from the ban on proprietary trading:
    - Purchases, sales, acquisitions or dispositions of the following instruments
      - U.S. government or agency obligations
      - obligations, participations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; or
      - state or municipal obligations.

- Purchases, sales, acquisitions or dispositions of any security or other instrument "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."
- Risk-mitigating hedging activities "in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings."
- Purchases, sales, acquisitions or dispositions of any security or other instrument "on behalf of customers."
- Investments in small business investment companies and certain "public welfare" investments.
- Purchases, sales, acquisitions or dispositions of any security or other instrument by a regulated insurance company directly engaged in the business of insurance for the general account of the company, or by its affiliates (also for the general account of the company), if:
  - conducted in compliance with insurance company investment laws, regulations and guidance of the jurisdiction in which such insurance company is domiciled; and
  - the appropriate Federal banking agencies, after consulting with the new systemic risk council of regulators and relevant state insurance commissioners, have not jointly determined that a particular law, regulation or item of guidance is insufficient to protect the safety and soundness of the banking entity (*e.g.*, the parent of the insurance company) or of U.S. financial stability.
- Proprietary trading conducted by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States.
- Such other activity as the regulators determine, by rule, would "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

- **Limitation on permitted activities.**
  - No transaction, class of transactions or activity may be deemed to be a "permitted activity" under the Volcker Rule if it would:
    - Involve or result in a "material" conflict of interest (as defined by rule) between the banking entity and its clients, customers, or counterparties;
    - Result, directly or indirectly, in a "material" exposure to high risk assets or high risk trading strategies (as defined by rule);
    - Pose a threat to the safety and soundness of such banking entity; or
    - Pose a threat to U.S. financial stability.
  - The regulators are required to issue regulations implementing these limitations with respect to otherwise permitted activities.

Ban on sponsoring or investing in private equity or hedge funds. The Volcker Rule also 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, subject to certain exceptions.

- **Who is covered?**
  - Same as under the proprietary trading ban: any banking entity.
- **How are "hedge fund" and "private equity fund" defined?**
  - Defined as any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that act, or "such similar funds" as the regulators may, by rule, determine. Potentially broader that ordinary definition of hedge funds and private equity funds.
- **What does "sponsoring" a fund cover?**
  - To serve as a general partner, managing member, or trustee of a fund;
  - In any manner to select or control (or to have employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a fund; or
  - To share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variant of the same name.
- **Permitted activities.**
  - Subject to the same limitations on permitted activities described above under proprietary trading (*e.g.*, the absence of any material conflict of interest), and any additional restrictions or limitations that the regulators may impose, the following activities are excluded from the ban on sponsoring or investing in hedge funds or private equity funds:
    - "Organizing and offering" a private equity or hedge fund, including ***sponsoring*** such a fund (*except* that the same name or a variant on the name may not be shared), if all of the following conditions are met:
      - The banking entity provides bona fide trust, fiduciary or investment advisory services; and
      - The fund is organized and offered only in connection with the provision of such services, and only to persons who are customers of such services of the banking entity; and
      - The banking entity does not acquire or retain an equity interest, partnership interest or other ownership interest in the fund other than the following investments:
        - **Seed investments** – *i.e.*, any investment made or retained in any amount of the total ownership of a fund (including 100%) for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, and
        - **Other de minimis investments** – i.e., any other investment in a hedge fund or private equity fund,

          provided that in each case:
          - the banking entity "actively" seeks unaffiliated investors to reduce or dilute its investment;

  - the bank entity's investment is reduced to not more than 3% of the total ownership of the fund within 1 year after the fund's establishment (with the possibility of a 2-year extension); and
  - the investment is "immaterial" to the banking entity, as defined by the regulators pursuant to rulemaking, but in no case may the aggregate of all of the banking entity's permitted seed and other de minimis investments exceed 3% of the banking entity's Tier 1 capital; and

- The banking entity, and its affiliates, **comply with the 23A and 23B restrictions** on transactions with such funds, as described below; and
- The banking entity does **not**, directly or indirectly, **guarantee**, assume or otherwise insure the obligations or performance of the **fund**, or any fund in which such fund invests (anti-bailout provision); and
- The banking entity does **not share** with the fund, for corporate, marketing, promotional or other purposes, the **same name** or a variant of the same name; and
- No **director or employee** of the banking entity takes or retains an equity interest, partnership interest 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
- The banking entity **discloses** to prospective and actual investors in the fund, in writing, that any losses in such fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules that the regulators may issue that are designed to ensure that losses are so borne.

- Acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, a hedge fund or private equity fund by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States, and provided that no ownership interest in such fund is offered for sale or sold to a U.S. resident.
- Such other activity as the regulators determine, by rule, would "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

Additional Capital and Other Quantitative Limits on Permitted Activities.

- If the regulators determine that additional capital requirements or quantitative limits, including diversification requirements, would be appropriate to protect the safety and soundness any banking entities engaged in permitted proprietary trading or sponsoring or investing in hedge funds or private equity funds, the regulators are required to impose such additional capital requirements and quantitative limits.
  - For purposes of determining compliance with any of these additional capital requirements, the aggregate amount of outstanding investments by a banking entity under the exception for seed or other de minimis investments must be deducted from assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate with the leverage of the fund invested in.

23A and 23B limitations on transactions with advised or managed funds.

- **General Prohibition on 23A Covered Transactions**. Prohibits any banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor of a fund, or that organizes and offers a fund as a permitted activity, and any affiliate of such banking entity, from entering into a covered transaction as defined by Section 23A of the Federal Reserve Act with any such fund, or any hedge fund or private equity fund controlled by such fund, as if the banking entity and its affiliate were a member bank and the fund were the affiliate.
- **Compliance with 23B**. In addition, any banking entity that serves, directly or indirectly, as the investment manager or investment adviser of a fund, or that organizes and offers a fund as a permitted activity will be subject to Section 23B of the Federal Reserve Act as if the banking entity were a member bank and the fund were its affiliate.
- **Exception for prime brokerage transactions with hedge funds or private equity funds.**
  - The Federal Reserve may grant an exemption from the prohibition on 23A covered transactions for purposes of permitting a banking entity or systemically important nonbank financial company to enter into prime brokerage transactions (undefined) with any hedge fund or private equity fund that it manages, sponsors or advises or in which it has taken an equity, partnership or other ownership interest, if:
    - The banking entity or systemically important nonbank financial company is in compliance with each of the conditions set forth in the permitted activity exception for sponsoring or making seed or de minimis investments in hedge funds or private equity funds described above;
    - The CEO (or equivalent officer) certifies in writing annually that the anti-bailout condition of that permitted activity exception is satisfied; and
    - The Federal Reserve has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity or systemically important nonbank financial company.

Systemically important nonbank financial companies.

- **Additional capital requirements and quantitative limitations**. Although systemically important nonbank financial companies are not subject to the prohibitions on proprietary trading or sponsoring or investing in hedge funds or private equity funds, the Board is required to impose additional capital requirements and other quantitative limits on such activities.
- **23A and 23B Type Limits**. Although systemically important nonbank financial companies are not subject to the 23A and 23B limits described above, the regulators are required to adopt rules imposing additional capital charges or other restrictions to address the same types of risks and conflicts of interest addressed by the 23A and 23B limits applicable to banking entities.

Anti-evasion.

- The regulators must issue rules regarding internal controls and recordkeeping to insure compliance with the Volcker Rule.
- 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 than functions as an evasion” of the requirements of the Volcker Rule, including through abuse of a permitted activity, or otherwise violates the Volcker Rule’s restrictions, the regulator shall order termination of such activity or disposal of such investment.

Effective date; Transition period.

- **Effective date**. None of the prohibitions, requirements or limitations of the Volcker Rule are effective until the earlier of:
  - 12 months after the issuance of final rules implementing the Volcker Rule; and
  - 2 years after the date of enactment of the Volcker Rule.
- **Transition period**.
  - **Initial 2-year period**. Within 2 years after the effective date of the Volcker Rule, banking entities and systemically important nonbank financial companies must conform their activities and investments to be in compliance with the Volcker Rule.
  - **3 one-year extensions possible.** The Federal Reserve may grant up to three 1-year extensions of the transition period, if "consistent with the purposes of this section" and "not detrimental to the public interest."
  - **Extended transition period for illiquid funds.** The Federal Reserve may, upon application by any banking entity, extend the transition period for up to a **maximum of 5 years** "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010" to take or retain any equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund.
    - **Illiquid fund defined**. Subject to rulemaking by the Federal Reserve, an illiquid fund is a hedge fund or private equity fund that:
      - as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets (undefined) "such as portfolio companies, real estate investments and venture capital investments"; and
      - makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

Council study and rulemaking.

- **Study and Timing**. The Financial Stability Oversight Council must conduct a study and issue recommendations on implementation of the Volcker Rule's provisions within 6 months of enactment.
- **Rulemaking and Timing**. The regulators are required to issue rules implementing the Volcker Rule within 9 months after completion of the study. They are also required to issue rules implementing the transition rules within 6 months of the Volcker Rule's enactment.
- **Rulemaking Authority**. Granted to different regulators (who must consider the findings of the Council study in their rulemaking) depending on the entity:
  - The appropriate Federal banking agencies (the Federal Reserve, the FDIC, the OCC and the OTS), jointly, with respect to insured banks and thrifts;
  - The Federal Reserve, with respect to any company that controls an insured bank or thrift or is treated as a bank holding company under section 8 of the International Banking Act of 1978 or any systemically important nonbank financial company and any subsidiary of any of the foregoing (other than a subsidiary for which a different regulator is its primary financial regulatory agency);
  - The CFTC, with respect to any entity for which it is the primary financial regulatory agency; and

- The SEC, with respect to any entity for which it is the primary financial regulatory agency.

- **Coordination**. The regulators must consult with each other and coordinate their rulemaking, but rules need not be issued jointly. The Chair of the Financial Stability Oversight Council will be responsible for coordination of regulations issued under this section.

Prohibitions on conflicts of interest relating to certain securitizations.

- **Prohibition on conflicts of interest for one year following first sale**.
  - Prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an asset-backed security (including synthetic ABS) from engaging in any transaction for one year after the first closing of the sale of the ABS that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity
  - **Exception**. Prohibition does not apply to:
    - Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or
    - Purchases or sales of asset-backed securities made pursuant to and consistent with:
      - commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
      - bona-fide market-making in the asset backed security.

Study of banking activities.

- Within 18 months of enactment, the appropriate Federal banking agencies must jointly review and report on the activities that a banking entity may engage in under federal and state law, including activities authorized by statute, order, interpretation and guidance.
  - In the report, the agencies must include recommendations regarding the potential negative effect of such activities on safety and soundness of banking entities and the U.S. financial system, the "appropriateness" of the conduct of such activities and such additional restrictions as may be necessary to address risks to safety and soundness arising from such activities.

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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