

New “PROP Trading Act” Would Expand “Volcker” Prohibitions

Executive Summary

Senators Merkley (D-OR) and Levin (D-MI) proposed a bill yesterday that would substantially expand the prohibitions on proprietary trading and certain asset management activities recently proposed by the Administration.

Expanded Coverage. In addition to imposing the prohibitions on insured depository institutions and their holding companies, the new bill would extend them to non-bank affiliates, including broker-dealer and asset manager affiliates, even if the deposit insurance fund is insulated from the risks of these non-bank affiliates.

- **No Express Exemption for Customer-Related Trading, Market-Making or Hedging.** Unlike the Administration’s proposal, the bill does not include express exemptions for proprietary trading activities that facilitate serving customers, are part of market-making activities, or are otherwise in connection with or in facilitation of customer relationships, including hedging activities.
- **Exemptions Must be Granted by the Federal Reserve and the FDIC.** The proposed bill gives the Federal Reserve and the FDIC constrained authority to grant exemptions, including for dealing in government securities, “underwriting and market-making to serve clients, customers, or counterparties” and “risk-mitigating hedging activities,” but only if certain conditions are satisfied.

Could Extend to Broker-Dealers and Private Equity or Hedge Fund Managers that are Not Affiliated with Banks. Depending on how the enhanced capital requirements and quantitative limits are defined, all “specified” broker-dealers and private equity or hedge fund managers could be subject to limits on their proprietary trading or asset management businesses, even if they have no affiliation whatsoever with insured depository institutions.

Self-Executing. The bill is self-executing, meaning that the prohibitions apply without any rulemaking by the federal banking agencies.

Potentially Destabilizing. The bill would require covered bank and nonbank financial companies to sell or shut down any prohibited trading and fund businesses within two years of the bill’s enactment, which, by requiring all of these businesses to be dumped on the market at the same time, could be destabilizing.

- **Already Disruptive.** In fact, just the prospect that certain bank and nonbank financial companies could be forced to sell their private equity or hedge fund operations is already causing some investors to take a “wait and see” attitude towards investing in new funds, thus disrupting existing businesses.

No Size Limits. Unlike the Administration’s proposal, the Merkley-Levin bill does not include any liability caps designed to limit the size of financial institutions.

New Limits on Securitizations. The bill would, however, include certain new and not clearly defined restrictions on the activities of underwriters, placement agents, initial purchasers and sponsors of asset-backed securities, including restrictions on transactions that would create a material conflict of interest with respect to an investor or undermine the value of the asset-backed securities, and on proprietary trading in securities that are derived from or related to asset-backed securities.

Attached as [Appendix A](#) please find a more detailed summary of the Merkley-Levin bill.

Appendix A

Detailed Summary of the Merkley-Levin Proposal

Senators Merkley (D-OR) and Levin (D-MI) proposed a bill on March 10, 2010 that would substantially expand the prohibitions on proprietary trading and certain asset management activities recently proposed by the Administration.

Outright Ban on Proprietary Trading

Like the Administration's proposal, the bill would prohibit any "banking entity" from engaging in proprietary trading. But the bill defines "banking entity" more broadly.

Expanded coverage

- The bill defines the term "banking entity" to include not only insured depository institutions, their direct and indirect parents and other companies treated as bank holding companies (e.g., foreign banks with a U.S. branch, agency or commercial lending company subsidiary), but also **any affiliates of such companies**.
- Thus, unlike the Administration's proposal, which appeared to exclude non-bank affiliates of a bank holding company group from its prohibitions, this bill would clearly extend the prohibitions to all non-bank affiliates, including **broker-dealer and asset manager affiliates**, even if the insured depository institution affiliates are insulated from the risks of these non-bank affiliates by Sections 23A and 23B of the Federal Reserve Act and other statutory or regulatory firewalls.

Prohibition is self-executing; exceptions require agency action

- Unlike the Administration's proposal, the prohibitions in this bill are self-executing, meaning that they apply without any rulemaking action by federal banking agencies.
- In contrast, as explained more fully below, any exceptions to the prohibitions are not self-executing, but require affirmative agency action and are subject to statutory constraints on such agency action.

How "proprietary trading" is defined

- "[E]ngaging as a principal in any transaction to purchase or sell, or which would put capital at risk as a principal in or related to, any stock, bond, option, contract of sale of a commodity for future delivery, swap, security-based swap, or any other security or financial instrument" as jointly determined by the Federal Reserve and the FDIC, by rule.¹

¹ To add a security or other financial instrument to the litany of financial instruments covered by the definition of "proprietary trading," the Federal Reserve and the FDIC are required to consider, in consultation with the SEC and CFTC: (i) the length of time that the relevant asset or combination of assets is held; (ii) the size and direction of the inventory of the relevant asset, relative to the size and direction of client demand in the relevant asset; (iii) whether the asset is for investment or trading purposes; (iv) any leverage applied to or embedded in an asset; (v) the maximum loss exposure of an asset; (vi) the total holdings of assets for market-making purposes; (vii) the total holdings of over-the counter derivatives; (viii) the total leverage of the institution; and (ix) any other factors that the Federal Reserve and the FDIC may determine appropriate.

Constrained agency exemptive authority

- Unlike the Administration's proposal, the bill does not include express statutory exemptions for proprietary trading activities that facilitate serving customers, are part of market-making activities, or are otherwise in connection with or in facilitation of customer relationships, including hedging activities; for government securities dealing; or for trading outside the United States by a foreign or other company pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act.
- Instead, the bill grants the Federal Reserve and the FDIC **constrained authority** to grant exemptions for any "transaction, class of transactions, or activity," including any of the following, **but only if** certain conditions described below are satisfied:
 - purchases or sales of U.S. government and agency securities; GSE-issued securities; and state and municipal securities;
 - underwriting and market-making to serve clients, customers, or counterparties;
 - risk-mitigating hedging activities;
 - investments in small business investment companies and certain "public welfare" investments; and
 - proprietary trading conducted solely outside of the United States by a foreign bank or other company pursuant to Section 4(c)(9) or Section 4(c)(13) of the Bank Holding Company Act, unless the bank or company is directly or indirectly controlled by a company organized in the United States.
- However, the Federal Reserve and the FDIC **may not exempt** any transaction, class of transactions or activity if it would:
 - result in a material conflict of interest between the banking entity (or the nonbank financial company discussed below) and its clients, customers, or counterparties;
 - result, directly or indirectly, in exposure to high risk assets or high risk trading strategies, as jointly defined by the Federal Reserve and the FDIC;
 - pose a threat to the safety and soundness of such banking entity (or nonbank financial company discussed below); or
 - pose a threat to the financial stability of the United States.
- Similar to the Administration's proposal, there is no express 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.

Outright Ban on Sponsoring or Investing in Private Equity or Hedge Funds

Like the Administration's proposal, the bill would prohibit any banking entity from investing in or sponsoring a hedge fund or private equity fund.

Expanded coverage

- Same as under the proprietary trading ban, but unlike the Administration's proposal, this bill defines "banking entity" to extend to all of the affiliates of an insured depository institution, bank or other depository institution holding company and any other company treated as a bank holding company under the Bank Holding Company Act.

Prohibition is self-executing; exceptions require agency action

- Same as under the proprietary trading ban: any banking entity as more broadly defined by the bill.

How “hedge fund” and “private equity fund” are defined

- Same as the Administration’s proposal, namely 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 Federal Reserve.

What “sponsoring” a fund covers

- Same as the Administration’s proposal, namely:
 - serving as a general partner, managing member, or trustee of 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 for corporate, marketing or promotional purposes.

How investing is defined

- Unlike the Administration’s proposal, which is vague on this point, a banking entity may not “take or retain any equity, partnership, or other ownership interest in . . . a hedge fund or a private equity fund.”

No statutory exceptions

- Unlike the Administration’s proposal, the bill does **not** include any express statutory exemptions for investing in small business investment companies.

Constrained agency exemptive authority

- Same as under the proprietary trading ban.

Limitations on Transactions or Relationships with “Advised” Private Equity or Hedge Funds

Any banking entity that serves as the investment adviser or investment manager to a hedge fund or private equity fund will be subject to certain limitations on transactions with such funds.

Who is covered

- Same as under the proprietary trading ban: any banking entity as more broadly defined by the bill.

Outright ban on any “covered transaction” as defined in Section 23A of the Federal Reserve Act

- Same as the Administration’s proposal, there is an outright ban on “covered transactions” between any banking entity (as more broadly defined) 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 Section 23A to include credit exposure on derivatives.

Outright ban on custody, securities lending or other prime brokerage services provided by any banking entity to such fund, as in the Administration’s proposal.

“Market terms” and other requirements of Section 23B of the Federal Reserve Act would apply to any banking entity as if such banking entity were a member bank and such fund were an affiliate, as in the Administration’s proposal.

Enhanced Capital Requirements and Quantitative Limitations for “Specified Nonbank Financial Companies”

Any specified nonbank financial company that engages in proprietary trading or invests in or sponsors a hedge fund or private equity fund will be subject to enhanced capital requirements and quantitative limits on such activities.

Who is covered

- A “specified nonbank financial company” is defined as any U.S. or foreign nonbank financial company “subject to prudential supervision by” the Federal Reserve.
- This category would include broker-dealers and private equity and hedge fund managers that are not affiliated with an insured depository institution but are otherwise subject to the prudential supervision of the Federal Reserve because they have been found to be “systemically important” or otherwise.

Constrained agency exemptive authority

- Same as under the ban on prohibited trading and fund activities.

Concentration Limit on Large Financial Firms

Not addressed in the Merkley-Levin bill.

Rulemaking Authority to Carry out the Bill

Granted jointly to the Federal Reserve and the FDIC, which must consult with the SEC and the CFTC in the rulemaking process, rather than the “appropriate Federal banking agencies” as in the Administration’s proposal.

Effective Date and Grace Period

- The prohibitions and limitations of the bill would become effective on the earlier of (i) 18 months after the adoption of final rules under the bill and (ii) 24 months after its date of enactment.
- The Federal Reserve and the FDIC would be required to grant covered companies a grace period for conforming their activities and investments to the restrictions in the bill, but the bill would limit that grace period to a maximum of two years after the date of enactment of the bill, with no authority to grant exemptions.

Prohibitions on Conflicts of Interest Relating to Certain Securitizations

Prohibition on conflicts of interest

- Prohibits an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security from engaging in any transaction that would:
 - give rise to any material conflict of interest with respect to any investor in a transaction arising out of such activity, or
 - undermine the value, risk, or performance of the asset-backed security.
- Prohibition applies during any period when the asset-backed security is outstanding and held by unaffiliated investors.
- Could prohibit hedging of retained interests and interfere with customer-related transactions with respect to the assets underlying the security.

Restrictions on proprietary trading

- Requires the SEC to issue rules, within 180 days of enactment of the bill, to restrict the timing and extent of proprietary trading by an underwriter, placement agent, initial purchaser, or sponsor and any affiliates or subsidiaries of such entity in any securities, security-based swaps, or similar financial instruments that are derived from, or related to, an asset-backed security for which the entity, its affiliate, or its subsidiary acts as underwriter, placement agent, initial purchaser, or sponsor.

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