The Volcker Rule

The "Volcker Rule"1 prohibits an insured depository institution and its affiliates from:

- engaging in "proprietary trading";
- acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and
- sponsoring a hedge fund or a private equity fund.

Nonbank financial companies designated by the Council for supervision by the Board of Governors would not be subject to this prohibition. The Act provides, however, that they could be subject to additional capital requirements for, and additional quantitative limits with respect to, the foregoing activities.

The Volcker Rule would apply to proprietary trading and fund activities by U.S. banking organizations regardless of where the trading or activities are conducted. However, for non-U.S. banking organiza- tions, the Volcker Rule would apply only to proprietary trading and fund activities in the U.S., or such activities outside the U.S., if they involve the offering of securities to any U.S. resident.

While the Volcker Rule has been moderated since its inception, these limitations would have a signifi- cant impact on the ability of U.S. banking organizations to provide investment management products and services that are competitive with nonbanking firms generally and with non-U.S. banking organi- zations in overseas markets. It would also effectively prohibit short-term trading strategies by any U.S. banking organization, regardless of the location of its trading business, if those strategies involve instruments other than those specifically permitted for trading, as described below.

Proprietary Trading

The Volcker Rule would prohibit any insured depository institution and its affiliates from engaging in "proprietary trading" of debt and equity securities, commodities, derivatives, or other financial instru- ments. "Proprietary trading"2 is defined as engaging as a principal for the trading account of a banking organization or supervised nonbank financial company in any transaction to purchase or sell, or other- wise acquire or dispose of:

- any security;
- any derivative;
- any contract of sale of a commodity for future delivery;
- any option on any such security, derivative, or contract; or
- any other security or financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC (the "Regulators") may determine by rule.

1The Volcker Rule is implemented by Title VI of the Dodd-Frank Act; it is named

for former Federal Reserve Chairman Paul Volcker.
2 Act § 619 (to be codified at 12 U.S.C. § 1851(h)(4)).

The key term "trading account" is defined as any account used for acquiring or taking positions in the proprietary trading of securities and 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 such other accounts as the Regulators may determine by rule.3
In summary, investments made "for the trading account" would be deemed proprietary trading and therefore prohibited. The "trading account" definition only covers "near-term" transactions or transac- tions that involve "short-term price movements." Thus, this definition substantially limits the scope of prohibited proprietary trading. However, the Volcker Rule also provides the Regulators with the author- ity to determine that other accounts meet the "trading account" definition. The Regulators could use this authority to expand the scope of the prohibition.
The Volcker Rule also specifically permits trading transactions:
• in government securities;4
• in connection with underwriting or market-making, to the extent that either does not exceed near term demands of clients, customers, or counterparties;
• on behalf of customers; or • by an insurance business for the general account of the insurance company.5
The Volcker Rule also permits certain risk-mitigating hedging related to an insured depository institu- tion's holdings. Investments in small business investment companies, the public welfare, and qualified rehabilitation expenditures also would be excluded from the ban. Additionally, offshore proprietary trading conducted by insured depository institutions, that are not U.S.-controlled, is permitted. Finally, additional activities may be permitted to the extent the Regulators determine that they promote and protect the safety and soundness of the banking organization and financial stability of the United States.

Fund Sponsorship

The Volcker Rule prohibits insured depository institutions and their affiliates from "sponsoring" a hedge fund or private equity fund. It would not prohibit banking organizations from providing advice to such funds.
The Volcker Rule defines "hedge fund" and "private equity fund" to include any issuer that is exempt from SEC registration under the Investment Company Act of 1940 (the "1940 Act") based on Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (qualified purchasers).6 It also would include any "similar fund" determined by the Regulators. See "Private Fund Investment Advisers."
The Volcker Rule defines "sponsoring" a fund as: • serving as a general

partner, managing partner, or trustee of a fund;
3 Act § 619 (to be codified at 12 U.S.C. § 1851(h)(6)).
4 The government securities exception for proprietary trading is much narrower than the universe of bank- eligible "investment securities" that have been permitted for national banks under the National Bank Act and OCC regulations, for the most part, for the last century.
5 Act § 619(d)(1)(F). 6 Act § 619 (to be codified at 12 U.S.C. § 1851(h)(2)).

• selecting or controlling (or having employees, officers, directors, or agents constituting) a majority of the directors, trustees, or management of a fund; or
• sharing the same name of the banking organization or any affiliate or a similar name with the fund.7
The sponsorship concept is based on a model that the Board of Governors used to allow banking organizations, prior to the adoption of the Gramm-Leach-Bliley Act, to sponsor and advise funds if they met similar requirements.
In certain circumstances, the Volcker Rule permits a banking organization to organize and offer a hedge fund or private equity fund, including serving as general partner, management member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund. See also "Private Fund Investment Advisers." The banking organization may organize and offer a hedge fund or private equity fund if it:
• provides trust, fiduciary, or investment advisory services and the fund is organized and offered only in connection with such services and only to customers of such services;
• does not have an ownership interest in the fund except for a seed8 or de minimis investment (subject to certain limitations);
• complies with Section 23A and 23B affiliate transaction limitations; • does not guarantee, assume, or otherwise insure obligations or performance of the fund; • does not share the same or similar name as the fund;
• prohibits directors or employees from having an ownership interest in the fund, except for any director or employee who is directly providing investment advisory or other services to the fund; and
• discloses, in writing, to investors that any losses in the fund are borne solely by the investors.9

Fund Ownership Interest

The general prohibition on the ownership of any interest in a fund is subject to an exception for a seed investment in a fund advised by the banking organization or its affiliates that comes within the exception above permitting the sponsorship of certain funds, for the purpose of providing the fund sufficient initial equity for investment to permit the fund to attract unaffiliated investors. If the banking organization makes a seed investment, it must seek unaffiliated investors to

reduce or dilute the investment to not more than 3% of total ownership interest of the fund within one year after the date of establishment of the fund (the Board of Governors may extend the period for two years); and be "immaterial" (as defined by rules

7 Act § 619 (to be codified at 12 U.S.C. § 1851(h)(5)).

8 A banking organization may make a seed investment only for the purpose of establishing the fund and providing the fund sufficient initial equity for investment to permit the fund to attract unaffiliated investors. Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)).

9 Act § 619 (to be codified at 12 U.S.C. § 1851(d)(1)(G)).

to be issued by the Regulators). In addition, the aggregate investment in all the investment interests in such funds may not exceed 3% of the Tier 1 capital of the banking organization. See "Private Fund Investment Advisers."

Foreign banking organizations (outside of the United States) may operate without regard to the Volcker Rule provided no ownership interest in such fund is offered for sale or sold to a U.S. resident. Finally, other sponsorships may be permitted to the extent the Regulators determine that they promote and protect the safety and soundness of the banking organization and financial stability of the United States.

Affiliate Transactions Prohibited

The Volcker Rule flatly prohibits a banking organization (and any of its affiliates) that manages, sponsors, advises, or organizes and offers a fund from entering into a Section 23A covered transaction (loans to the fund and asset purchases from the fund) with such fund. This is considerably broader than the prohibition on sponsorship and effectively prohibits such transactions where the banking organization has nothing more than an advisory role. In addition, the banking organization and such fund are subject to Section 23B's10 requirements for arm's-length terms on all services and transactions with such fund. The Board of Governors may grant a banking organization a Section 23A exception for the purpose of entering into any prime brokerage transactions with a fund in which a fund that the banking organiza- tion manages, sponsors or advises has taken an equity, partnership or other ownership interest. This exception permits prime brokerage transactions with funds in which a "fund of funds" has invested. In general, the grant of the exception requires the following conditions to be met:

- The banking organization complies with the Volcker Rule's exception for sponsoring or making seed or de minimis investments in funds;
- The CEO (or equivalent officer) annually certifies, in writing, that the banking organization does not guarantee, assume, or otherwise insure the obligations or performance of the fund or any other fund in which such fund invests; and
- The Board of Governors determines that such transaction is consistent with

the safe and sound operation and condition of the banking entity.11

Conflicts of Interest Prohibited

The Volcker Rule provides that no transaction, class of transaction, or activity by a banking organization may be deemed to be permitted under the authority described above to conduct certain permitted proprietary trading or fund sponsorship or investment if it would:

- result in a material conflict of interest between the banking organization and its clients, customers, or counterparties;
- result in material exposure by the banking organization to "high-risk assets" or "high-risk strategies" (as defined by rules to be issued by the Regulators);

10Act § 619 (to be codified at 12 U.S.C. § 1851(f)(1)-(2)). 11Act § 619 (to be codified at 12 U.S.C. § 1851(f)(3)).

- pose a threat to the safety and soundness of the banking organization; or
- pose a threat to the financial stability of the United States.

The Regulators are required to impose additional capital requirements and quantitative limitations on permitted activities if they determine that such requirements and limitations are needed to protect the safety and soundness of the banking organizations. The Regulators also are required to issue regulations regarding internal controls and recordkeeping to ensure compliance with the Volcker Rule.

Finally, the Volcker Rule prohibits a banking organization or designated nonbank financial company from engaging in activities that are authorized under another authority if such activities are prohibited by the Volcker Rule. It remains to be seen how the Board of Governors will interpret this limitation on reliance on other authority. In particular, will investments that are not prohibited by the Volcker Rule's proprietary trading prohibition and are separately authorized under provisions such as the merchant bank authority be prohibited solely because the form of the ownership is regarded as a fund? Will the Volcker Rule propri- etary trading prohibition be interpreted to prohibit derivative activities permitted by Title VII of the Act? See "Derivatives."

Nonbank Supervised Entities

The Volcker Rule would not prohibit proprietary trading or fund activities by a designated nonbank financial company. However, it would allow the Board of Governors to impose capital requirements and quantitative limits on the conduct of such activities by those companies. These additional requirements and limitations will not apply to the permitted activities exemptions discussed above. Also, the Regula- tors are required to adopt regulations imposing additional capital charges or other restrictions for these companies to address the risks to and conflicts of interest of banking entities described in the affiliate transaction

limitations.

Timeline

Within six months of enactment of the Act, the Council is required to complete a study of the definitions and restrictions imposed by the Volcker Rule. The study could recommend “modifications” of the definitions or limitations contained in the Volcker Rule. Within nine months after completion of the Council’s study, the Regulators are required to issue a joint rulemaking reflecting the recommendations and modifications contained in the study.
The Volcker Rule would become effective upon the earlier of two years after its enactment or 12 months after issuance of the final rules. It is unlikely that the Regulators will issue the final rules earlier than 12 months after the enactment of the Volcker Rule. Therefore, it is expected that the Volcker Rule will become effective two years after its enactment. It is possible that the Regulators will not have effective regulation in place within two years, and the law would become effective without the guidance of such regulations.
Once the Volcker Rule regulations become effective, the Volcker Rule would require banking organiza- tions to divest or discontinue prohibited activities within two years. The regulators could then grant specific one-year extensions for up to three additional years. The divestiture period and extensions probably would be interpreted to allow only for transition and wind down and not to allow for new or expanded activities otherwise prohibited by the Volcker Rule.

The Volcker Rule allows the Board of Governors to grant a banking organization a single extension of up to five years to take or retain its ownership interest in, or provide additional capital to, “illiquid funds.” This authority allows a banking organization to make additional investments in illiquid funds pursuant to contractual obligations after the Volcker Rule is effective. The “up to five year” period for an investment in an illiquid fund could be read to run from the effective date of the Volcker Rule. In the alternative, it could be read to allow a banking organization to have a five-year period in addition to all other periods permitted.