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Banking Entities, Other Significant Financial Service Companies to Face Significant Restrictions Under New "Volcker Rule"

The Dodd-Frank Wall Street Reform and Consumer Protection Act features a number of significant new restrictions on financial services firms. Banking entities and other financial service companies should be especially attentive to the so-called "Volcker Rule," which will substantially restrict their proprietary trading and investing activities, as well as their relationships with hedge funds and private equity funds.

Background

The Volcker Rule appears as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), and, upon enactment, will become new Section 13 of the Bank Holding Company Act of 1956 (Bank Holding Company Act) and new Section 27A of the Securities Act of 1933. In brief, it would, subject to a number of limited exceptions, prohibit any "banking entity" from:

- Engaging in proprietary trading; or
- Sponsoring or investing in hedge funds and private equity funds.

For purposes of the Volcker Rule, a "banking entity" is defined as any insured depository institution, any company that controls such an institution, any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., any non-US bank with a branch or agency office in the United States), and any affiliate or subsidiary of any such entity.[1]

In addition, a systemically significant *nonbank* financial company subject to supervision by the Federal Reserve Board (Federal Reserve)[2] that engages in such activities will be subject to rules establishing enhanced capital standards and quantitative limits on these types of activities, but such activities will not be prohibited.

1 In general, institutions that function solely in a trust or fiduciary capacity will not be deemed "banking entities."

2 The Act provides that nonbanking financial companies meeting specified criteria can be designated as "systemically significant" and be subject to supervision by the Federal Reserve.

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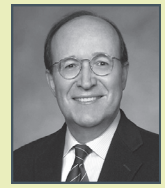

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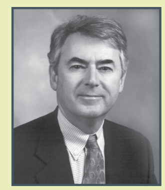

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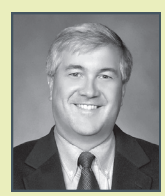

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All of the principal financial regulators (i.e., the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission) must adopt rules to put these restrictions into effect. In general, the Volcker Rule's requirements will be effective on the earlier of two years from the date of enactment, or one year from the issuance of substantive regulations. An initial set of regulations, however, is required to be issued by the Federal Reserve within six months of enactment, and is to implement a phase-in schedule of at least two years for entities subject to the Volcker Rule to divest of prohibited holdings or positions. Regulators must allow such entities a reasonable time to divest themselves of illiquid assets, so under some circumstances, compliance periods may extend into 2022. This is, however, only for cases involving illiquid investments, and as permitted by the Federal Reserve. In most cases, investments and activities must be conformed within two years of the effective date of the Volcker Rule provisions, with the possibility of three one-year extensions by the Federal Reserve.

I. Proprietary Trading Restrictions

Not all proprietary transactions would be subject to the restrictions on proprietary trading. The Volcker Rule defines "proprietary trading" to mean engaging as a principal for an entity's "trading account" in purchases or sales of securities, derivatives, commodity futures, options on such instruments, or any other instrument identified by regulators. A "trading account," in turn, is defined as an account used to take positions "principally for the purpose of selling in the near term," or "with the intent to resell in order to profit from short-term price movements," or any other account defined by regulation.

The legislation also specifies certain activities that would nevertheless be permitted for banking entities, subject to limits adopted by regulators. These activities include:

- Transactions in government securities, agency securities, and state and municipal obligations;
- Transactions in connection with underwriting or market-making-related activities to the extent they are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";
- Risk-mitigating hedging activities designed to reduce specific risks of a firm's individual or aggregated positions or holdings;
- Transactions on behalf of customers;
- Investments in small business investment companies and certain enterprises devoted to the public interest;[3]
- Transactions by any 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), as permitted by relevant state insurance company investment laws and regulations (subject to additional review by the appropriate Federal banking agencies, after consultation with the Act's new systemic risk council and state insurance commissioners);
- Proprietary trading by a banking entity conducted solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act,[4] unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States; and
- Other activity as permitted by regulation.

Such activities would be permitted so long as they would not involve a material conflict of interest (as defined by regulation) between the banking entity and its clients, customers, or counterparties or result in a high degree of risk to the banking entity or US financial stability. Systemically significant nonbank financial companies supervised by the Federal Reserve would also be permitted to engage in these activities, subject to enhanced capital requirements and quantitative limitations, including diversification requirements, as regulators deem appropriate.

3 It appears that investments pursuant to this "public interest" exception could include those of a type that would allow banks to claim Community Reinvestment Act credits.

4 12 U.S.C. § 1843(c)(9), (13).

II. Restrictions on Relationships with Hedge Funds and Private Equity Funds

The Volcker Rule will, subject to limited exceptions outlined below, prohibit banking entities from sponsoring or investing in "private equity funds" or "hedge funds." It will also subject systemically significant nonbank financial companies supervised by the Federal Reserve to enhanced capital requirements and quantitative limits if they engage in such fund-related activities. The legislation defines "private equity funds" and "hedge funds" as those that are not "investment companies" pursuant to Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, "or such similar funds as [regulators] may, by rule…determine." Thus, regulators could define other types of pooled investment vehicles as "private equity" or "hedge" funds in addition to those specified. "Sponsoring" a fund means to:

- Serve as a general partner, managing member, or trustee of a fund;
- 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
- Share a name or a variant of a name with a fund.

Again, the legislation provides exceptions, subject to limits adopted by regulators. Specifically allowed activities include:

- Organizing and offering a fund, even to the extent of sponsorship, as long as the fund and entity do not share a name or name variant, and the following conditions are met:
  - The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services;
  - The banking entity may not acquire or retain an equity, partnership or other ownership interest in the fund;
  - However, "de minimis investments" (as defined by regulators) would be permitted. Such investments would have to be immaterial to a banking entity, could not, in the aggregate, exceed 3 percent of a banking entity's Tier I Capital, and could not exceed 3 percent of the total ownership interests in any one fund. Subject to similar restrictions, a banking entity would also be permitted to make "seed" investments (i.e., initial investments of up to 100 percent of a fund for the purpose of establishing it and providing it with sufficient initial equity for investment to permit it to attract unaffiliated investors). The banking entity would then be required to reduce or dilute its investment to permitted levels within one year after the fund's establishment (with the possibility of a two-year extension).
  - The banking entity, and its affiliates, comply with restrictions on transactions with such fund under Sections 23A and 23B of the Federal Reserve Act, as described below;
  - The banking entity may not guarantee the fund, or any fund in which the fund invests, against losses or to a minimum performance;
  - The banking entity discloses to prospective and actual investors, in writing, that the fund's losses are borne solely by investors and not by the banking entity, and otherwise complies with rules that the regulators may issue to ensure that losses are so borne;
  - No director or employee of the banking entity may have an ownership interest in the fund, unless they directly provide investment advisory or other services to the fund.
- 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, provided that no ownership interest in such fund is offered for sale or sold to a US resident and that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States;

- Other activities that regulators have determined would promote safety and soundness of the entity and financial stability as a whole.

Again, such activities would be permitted so long as they do not involve a material conflict of interest (as defined by regulation) between the banking entity and its clients, customers or counterparties, or would result in exposure to a high degree of risk to the bank or US financial stability. Systemically significant nonbank financial companies supervised by the Federal Reserve would be permitted to engage in these activities subject to enhanced capital requirements and quantitative limitations, including diversification requirements, as regulators deem appropriate.

III. Other Limitations on Relationships with Hedge Funds and Private Equity Funds

If a banking entity serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or organizes such a fund pursuant to the exception described above, then that banking entity and its affiliates would be:

- Prohibited from entering into a "covered transaction" as defined by Section 23A of the Federal Reserve Act.[5] Thus, the banking entity and its affiliates could not, among other things, extend credit to the fund, or enter purchase and repurchase agreements with the fund.[6]
- Subject to Section 23B of the Federal Reserve Act.[7] Thus, in certain other transactions between the banking entity (or its affiliate) and the fund, the terms must be not less favorable to the banking entity than those prevailing between non-affiliates, and restrictions apply to fiduciary investments in the fund.

If a nonbank financial company supervised by the Federal Reserve engages in similar activities, it will be subject to additional capital requirements and restrictions to address the same types of conflicts of interest that banking entities would face in such transactions.

IV. Loan Securitization

The Volcker Rule does not limit or restrict a banking entity's ability (or the ability of a nonbank financial company supervised by the Federal Reserve) to sell or securitize loans. On the other hand, other portions of the Act would affect securitizations. For example, pursuant to a new Section 27B of the Securities Act of 1933, an underwriter, placement agent, initial purchaser, a sponsor, or any affiliate thereof could not engage in any activity that would result in a material conflict of interest with any investor in the securitization for a period of one year. The Act would also require lenders and loan securitizers to retain credit risk in asset-backed securities that they package or sell.

Challenges of Implementation

The Volcker Rule will have significant effects on banking entities and firms that find themselves under Federal Reserve supervision, some of which may not be intended. For example, prohibiting banking entities from investments in hedge funds is intended to reduce risks for such firms. However, many hedge fund investments are profitable for banks, and hedge funds are often designed to be counter-cyclical or to produce absolute returns. By disallowing investments in hedge funds, the Volcker Rule may actually increase banking entities' exposure to market volatility and close them off from a source of revenue.

Implementation of the Volcker Rule will also present many challenges. The scope and impact of the Volcker Rule will ultimately be determined by how the statutory definitions and other provisions are interpreted and implemented through regulations promulgated by relevant financial regulatory agencies. Banking entities (as well as other financial firms that may anticipate Federal Reserve supervision) should be prepared to engage in the regulatory rulemaking process and interact with regulators as rulemakings begin.

5 12 U.S.C. § 371c.

6 Nonetheless, an exception would apply that would permit a banking entity, under certain conditions, and if allowed by the Federal Reserve, to enter into prime brokerage transactions with such a fund.

7 12 U.S.C. § 371c-1.

One of many challenges that regulators will face is determining how to implement the Volcker Rule's prohibition on short-term proprietary trading. Bank holding companies have historically had authority to make investments in equity securities under Sections 4(c)(5) and 4(c)(6) of the Bank Holding Company Act. Also, Section 4(k) of the Bank Holding Company Act permits bank holding companies that are treated as financial holding companies to make merchant banking investments. In addition, the National Bank Act (as implemented by the Office of the Comptroller of the Currency (OCC)) permits national banks to make certain types of "bank-eligible" investments. To some extent, the Volcker Rule could be read to override these existing investment authorities, because it states that, notwithstanding any other provisions of law, its prohibitions and restrictions will apply "even if such activities are authorized for a banking entity." Given this broad language, regulators may choose to adopt rules that define short-term trading in ways that could curtail otherwise permissible long-term investing activities. On the other hand, the prohibition on short-term trading does not appear to be meant to prohibit long-term proprietary investments. Indeed, one of the exceptions to the proprietary trading restriction explicitly permits hedging for a firm's individual or aggregated holdings, which, at least arguably, contemplates maintenance of the status quo. However, it should be noted that it is unclear how the Volcker Rule's restrictions, including this exception for hedging activities, will interact with the provisions in Title VII of the Act known as the "Swaps Push-Out Rules," which restrict the ability of banks and bank holding companies from engaging in certain types of derivatives activities. In any event, as regulators move to adopt regulations under the Volcker Rule, the parameters of "short-term trading" will be subject to interpretation, so banking entities and other firms must be prepared to monitor events and communicate with federal agencies on this issue.

Special considerations will also apply in the context of international banking. Under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,[8] bank holding companies (including non-US banks regulated as such) may, as permitted by the Federal Reserve, acquire ownership or control of nonbanking companies that do not do business in the United States (except as an incident to their non-US operations), or that are organized outside of the United States and that primarily conduct their business outside of the United States.

The Volcker Rule, as noted above, stipulates that activities conducted by a banking entity pursuant to these authorizations will be permitted, notwithstanding its restrictions on proprietary trading and relationships with private equity and hedge funds, as long as the activities are conducted "solely outside the United States" and the banking entity conducting these activities is not directly or indirectly controlled by a banking entity organized in the United States. At the same time, the legislation calls for regulators to issue rules, including rules covering such international activities and investments, for the preservation of financial stability. It remains to be seen how regulators will craft such rules and define new parameters of acceptable activity. For example, Sections 4(c)(9) and 4(c)(13) have been interpreted and implemented by the Federal Reserve in a manner which permits a certain amount of incidental activity in the United States. It is unclear whether the Volcker Rule's requirement that any otherwise prohibited proprietary trading or fund-related activity conducted under these exceptions be conducted "solely outside the United States" will be interpreted by regulatory agencies as prohibiting any such previously permissible incidental US activity. On a similar note, it also remains to be seen how the regulators will apply the exemptions for proprietary trading and fund-related activities conducted outside the US under Sections 4(c)(9) and 4(c)(13), which have historically been applicable only to bank holding companies, in the cases of companies that are not bank holding companies. For example, it is unclear whether these exemptions from the Volcker Rules restrictions will be applicable to proprietary

8 12 U.S.C. § 1843(c)(9), (13).

trading or fund-related activities conducted entirely outside the United States by a foreign company that controls a US industrial loan company, thrift institution or non grandfathered savings and loan holding company.

Arnold & Porter is available to respond to questions raised by recent or forthcoming legislation, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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