Agencies Propose Regulations Implementing Volcker Rule

On October 11 and 12, 2011, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Securities and Exchange Commission (SEC) proposed a common set of rules to implement Section 619 of the Dodd Frank Wall Street Reform and Consumer Protection Act, also known as the "Volcker Rule." Section 619 is codified as Section 13 of the Bank Holding Company Act, 12 U.S.C. 1851. The CFTC is expected to propose a similar rule. Comments on the proposed rules are due by January 13, 2012.

The Volcker Rule prohibits banks and their affiliates (referred to as "banking entities") from (1) engaging in "proprietary trading" in most securities and derivatives and (2) owning an interest in or sponsoring a private investment fund that relies on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act for an exemption under that Act, or other similar types of funds designated by the regulators (referred to as "covered funds"). The Volcker Rule also restricts certain relationships between a banking entity and a covered fund. The Volcker Rule applies to all US banking entities (other than nondepository trust companies with no FDIC-insured affiliate banks) and their domestic and global affiliates, and to non-US banks that have a branch, agency, or commercial lending subsidiary in the US to the extent that the foreign banks' activities are conducted in the United States or with US investors or counterparties.

The Volcker Rule does not add any powers. Instead, it limits powers that banking entities might otherwise have under other laws. In determining whether an investment, position, or activity is permitted for a banking entity, it is necessary first to determine whether there is authority for the investment, position, or activity in the relevant banking laws and any limits or conditions placed by those other laws, and then to determine whether the Volcker Rule prohibits or restricts the investment, position, or activity that would otherwise be authorized for the banking entity. The activities subject to the Volcker Rule may also be limited or conditioned by other provisions of the Dodd-Frank Act and related rules, particularly the Title VII provisions on regulation of the swaps and derivatives markets and the provisions regarding compensation of bank and securities firm management.

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Silicon Valley
+1 415.356.3000

Washington, DC
+1 202.942.5000

The statute, and the implementing rules, go into effect on June 21, 2012. Pre-existing investments must be conformed to the new requirements by June 21, 2014, with the possibility of three one-year extensions by the Federal Reserve in some cases, and for five additional years for certain illiquid investments that were committed prior to May 2010.

Key early action items for banking entities include:

- Assessing the impact of the Volcker Rule on current and planned activities, investments, and positions;
- Developing compliance, control, recordkeeping, and reporting systems and infrastructure to address compliance with the rule (the infrastructure required by the rule is greater for larger banking entities);
- Involving the board of directors and senior management in the development of policies and procedures to address Volcker Rule requirements;
- Conforming new activities, investments, and positions as of June 21, 2012; and
- Preparing to conform pre-existing investments and positions by June 21, 2014, or such later date as may be permitted through an extension from the Federal Reserve.

The Volcker Rule contains statutory exemptions from both sets of prohibitions, including exemptions for:

- Trading in US government and municipal government obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activity;
- Trading on behalf of customers;
- Investments in Small Business Investment Companies (SBICs) and Community Reinvestment Act investments;
- Trading for the general account of insurance companies;
- Organizing and offering a covered fund (including limited investments in such funds);
- Foreign trading by non-US banking entities; and
- Foreign covered fund activities by non-US banking entities.

The proposed rule implements these exemptions and imposes tests and conditions to reliance upon them.

The proposed rule has five parts and three appendices:

- Subpart A contains general provisions and defines some basic terms;
- Subpart B addresses proprietary trading;
- Subpart C addresses “covered fund” investments and relationships;
- Subpart D requires banking entities to establish a compliance program regarding the Volcker Rule, including written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping;
- Subpart E (which is included only in the Federal Reserve version of the proposed rule) contains provisions on conforming prior investments and positions, and the process for requesting extensions. This portion was adopted by the Federal Reserve in early 2011 as part of Regulation Y and is being moved to subpart E of the proposed rule;
- Appendix A details quantitative measurements of trading activities that certain banking entities must compute and report;
- Appendix B provides factors that distinguish permitted market making-related activities from prohibited proprietary trading; and
- Appendix C details standards for compliance programs required under subpart D.

Proprietary Trading

The proposed rules treat securities and derivatives positions in a “trading account” as presumptively prohibited unless documented by the banking entity to be permitted under an exception. Positions held for less than 60 days bring a rebuttable presumption that they involve proprietary trading. The term “trading account” is defined in the proposed rule to include positions that are: (a) taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position; (b) deemed to be a "covered position" under the federal banking agencies' Market Risk Capital Rules, other than certain foreign exchange and commodities positions; or (c) acquired or taken by securities or derivatives dealer units. The definition excludes positions that do not involve short-term trading intent, such as in repo and securities lending transactions, as well as positions taken for liquidity management.

Covered financial positions include all long, short, synthetic, and other positions in securities and derivatives, but do not include positions in loans, spot foreign exchange, or spot commodities. Swaps and forward contracts on FX and other commodities are, however, covered.

The proposed rule exempts underwriting, market making-related activities and risk-mitigating hedging, trading in government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by foreign banking entities outside the United States, but establishes requirements for each exemption. The proposed rule describes three categories of transactions that would qualify for the "customer trading" exemption in the Volcker Rule: transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in another fiduciary capacity for the account of a customer; riskless principal transactions; and transactions conducted by an insurance company.

The proposed rule specifies the permitted trading outside of the United States by a foreign banking entity and when trading will be considered to have occurred solely outside of the United States.

The proposed rule requires banking entities with significant trading activities to undertake reporting and recordkeeping on their proprietary trading activities. Banking entities with larger and more significant covered trading are subject to detailed and extensive recordkeeping and reporting requirements. The recordkeeping and reporting is designed to help determine whether the activity and particular transactions and positions are permitted under the Volcker Rule, as well as to measure and control risk.

Investments in and Relationships with Covered Funds

Subpart C of the proposed rule implements the provisions of the Volcker Rule related to banking entity investments in and relationships with private investment funds. The proposal expands the list of covered funds beyond private funds that rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act to also cover commodity pools and foreign investment funds. The proposed rule exempts third-party bank- owned life insurance (BOLI) from the Volcker Rule investment prohibition and certain bank asset securitization structures, joint ventures, and corporate entity structures from the Volcker Rule prohibitions. The proposed rule also clarifies that securities and derivatives trading activity conducted within a covered fund that happens to be "controlled" by the banking entity, and thus technically a subsidiary and therefore a "banking entity" within the meaning of the BHC Act, is not subject to the Volcker Rule prohibition on proprietary trading.

The proposed rule implements and defines some of the requirements for investment in covered funds by a banking entity, including certain aspects of how the statutory 3%/3% limits on those investments must be calculated. The proposed rule excludes from being counted as an ownership interest a profits interest in a fund that is not capitalized by the banking entity and held for purposes of obtaining a carried interest or other performance allocation.

In addition to limiting the direct ownership by a banking entity and its subsidiaries of interests in a covered fund, in some cases the proposed rule also attributes to the banking entity ownership interests owned by other related persons and entities. For example, the proposed rule attributes to a banking entity the ownership of a covered fund by a company that the covered fund owns 5 percent or more of, and may also attribute ownership if the banking entity invests in parallel with the covered fund in underlying portfolio transactions. The proposed rule also attributes ownership interest in a covered fund by a banking entity director or employee to the banking entity, if the banking entity lends money to the person to acquire the interest, guarantees the purchase, or guarantees the director or employee against investment loss.

The proposed rule requires written disclosures to investors that any losses will be borne solely by investors and not by the banking entity and that the banking entity's losses in the fund will be limited to losses on the interests in the fund owned as principal by the banking entity. The proposed rule also requires the offering documents to clearly disclose that an investor should read the fund offering documents before investing in the fund; that the interests are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed by any banking entity; and disclose the services provided by the banking entity to the fund.

Compliance Program

Appendix C to the proposed rule sets out detailed standards for the compliance program (which must be periodically reviewed and revised) covering trading activities and covered fund activities and investments. The six required elements of the compliance program are written policies and procedures; internal controls (including identification, monitoring, measurement, risk limits, documentation and analysis of the activities conducted, and methods of detecting violations); and standards for responsibility and accountability, including involvement and responsibility of the board of directors, senior management, and managers at each relevant business unit, independent testing, training of personnel, and recordkeeping.

Conclusion

The agencies have requested comments on the proposal, and asked specifically for comments on a long list of questions posed by the agencies in the release. In the open meetings at which the agencies determined to propose the rules, members of the governing boards and staff members of the agencies expressed interest in further refining the rules in response to comments received on the proposed rules. There may be changes to the proposed rules before they are adopted. In view, however, of the long lead time required to build a compliance program that includes the elements in the proposed rule, and to prepare for compliance on June 21, 2012, it would be appropriate for banking entities to begin now to prepare to comply with the Volcker Rule.

Arnold & Porter LLP has long represented financial companies in resolving their regulatory and supervisory issues. We have been assisting such companies during the legislative and rulemaking process in understanding the implications of the Dodd-Frank Act and its implementing rules. We are available to respond to questions raised by the Volcker Rule, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

Alan Avery
+1 212.715.1056
Alan.Avery@aporter.com

A. Patrick Doyle
+1 202.942.5949
+1 212.715.1770
APatrick.Doyle@aporter.com

David F. Freeman, Jr.
+202-942-5745
David.Freeman@aporter.com

Dan Waldman
+202-942-5804
Dan.Waldman@aporter.com