Client Alert

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CURRENT ISSUES RELATED TO OUR CLIENTS JULY 23, 2010

The Volcker Rule in the New Financial Regulation Law (Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010)

The "Volcker Rule" covers three separate issues. First, subject to some exceptions, it prohibits a bank holding company and its affiliates from engaging in "proprietary trading." Second, subject to some exceptions, it prohibits such companies from owning an interest in or "sponsoring" a hedge fund or private equity fund. These two provisions are contained in Section 619 of the new law and are generally now referred to as the Volcker Rule. We discuss these provisions below.

The third element of the original Volcker Rule, as announced by President Obama last January, is a prohibition on a company holding more than 10% of the liabilities of financial companies in the US. We will discuss this provision, contained in Section 622 of the new law, in a separate Client Alert describing how the new law affects the rules for acquisitions of banks and other financial companies.

I. Proprietary Trading

- *Who is Prohibited from Proprietary Trading?*

Any bank, any thrift, any bank holding company (including the US operations of a foreign bank) (BHC), any savings and loan holding company (SLHC), and all of their affiliates. This means the prohibition covers broker-dealer and fund manager affiliates of banks (and all other affiliates of banks). Section 619 defines all these companies as "banking entities."

- *What is Proprietary Trading?*

Section 619 defines proprietary trading as any transaction a banking entity enters into as principal for its "trading account" to buy (or otherwise acquire) or sell (or otherwise dispose of) a security, a derivative, or a future delivery contract for a commodity. Section 619 also covers an option on any of these items and any other "security or financial instrument" regulators determine should be covered.

  - *What types of financial contracts are covered?*

  Under this definition of proprietary trading, the ban clearly covers trading of traditional securities, futures contracts, and OTC derivatives. The regulations that must be issued before the ban becomes effective will likely provide more information on the scope of the ban.

  - *What "principal trading" activities in such contracts are covered?*

  This is unclear. Section 619 states that a "trading account" is any account used for acquiring or taking positions in the types of financial contracts covered by the prohibition "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)." "Trading account" also includes any account the regulators determine should be covered. Again, the regulations that must be issued before the ban becomes effective will likely give more guidance on what constitutes a trading account.

- *What are the exceptions?*

There are two types of exceptions. One type of exception permits "proprietary trading" in certain securities, derivatives, or futures contracts. Thus, banking entities can engage in proprietary trading of certain government related obligations.[1] They can also make investments in small business investment companies, "public welfare" investments authorized for national banks, and investments that qualify as qualified rehabilitation expenditures related to qualified rehabilitated buildings or historic structures. Since these last three exceptions are for investments, they are probably more relevant as exceptions to the ban on hedge fund and private equity fund investments than for proprietary trading.

The second type of exception is for "proprietary trading" that reflects an approved purpose. This includes trading (1) for the account of a customer; (2) that represents risk-mitigating hedging related to actual holdings if designed to reduce risk; and (3) that is "in connection with underwriting or market-making activities" so long as such activity is designed "not to exceed the reasonably expected near term demands of clients, customers, or counterparties." In addition, insurance companies are not banned from making investments for their general account (directly or through affiliates) if the investment is permitted by state insurance law unless the federal banking regulators find it conflicts with the safety of a BHC or SLHC. These exceptions will also likely be clarified by the regulations that must be issued before the ban becomes effective.

- *Can regulators make more exceptions?*

Yes. The SEC, the CFTC, and the federal banking regulator for a banking entity (acting together) can permit a banking entity to engage in such other trading activity as they determine "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." Such an exemption must be established by rule.

- *How Does the Ban Apply to Foreign Banks?*

The proprietary trading ban does not apply to trading "solely" outside the US by any "banking entity" that is not controlled by a US banking entity. Foreign banks with US operations can, therefore, continue to conduct proprietary trading outside the US wherever it is permitted so long as such activity occurs "solely" outside the US. The regulations that implement the Volcker Rule will presumably clarify what that means for foreign banks (e.g., whether the trading can involve investments in US companies.)

II. Hedge Fund or Private Equity Fund Ownership or Sponsorship

- *Who is Prohibited From Having an Interest in or Sponsoring a Hedge Fund or Private Equity Fund?*

The same banking entities that are banned from proprietary trading.

- *What is a Hedge Fund or Private Equity Fund?*

Although the ownership and sponsorship ban covers these specific types of funds, Section 619 defines each as being any company that would be an investment company under the Investment Company Act of 1940 but for the exemptions in Sections 3(c)(1) or 3(c)(7). Because many types of companies, such as asset backed commercial paper con-

1 This covers obligation of the US government or any of its agencies, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agriculture Mortgage Corporation, a Farm Credit institution, or any state or political subdivision of a state.

duits, rely on these exemptions from the '40 Act, it is unclear whether the ban will ultimately cover all companies that rely on the 3(c)(1) or 3(c)(7) exemption.

- *Can Regulators Clarify the Meaning of Hedge Fund and Private Equity Fund?*

Section 619 authorizes regulators to identify "such similar funds" as they determine should be included in the definition of hedge fund or private equity fund. This suggests they are not authorized to limit the coverage of all companies exempt under 3(c)(1) or 3(c)(7). The entire ban, however, does not take effect until after regulators adopt rules to "carry out" Section 619 including the ban on hedge fund or private equity fund activities. This may permit clarifications that would eliminate some activities from the ban.

Section 619(g)(2) states that nothing in Section 619 (i.e., nothing in the Volcker Rule) limits the ability of a banking entity to sell or securitize loans. Regulators might use this clarification of the scope of Section 619 to enumerate exceptions for activities related to loan securitizations.

- *What Ownership of a Fund is Banned?*

In general a banking entity may not own any equity, partnership, or other ownership interest in a hedge fund or private equity fund.

- *Are There Exceptions?*

The same exceptions as for proprietary trading apply. Since, however, most of those exceptions relate to the actual activity of proprietary trading or to government securities, the relevant exceptions seem to be the exceptions for investments in SBICs, "public welfare" investments, and, perhaps, qualified rehabilitation expenditures. As with proprietary trading, the SEC, CFTC, and federal banking regulators could permit other hedge fund/private equity fund activities by rule if they find such exceptions promote safety and soundness and financial stability.

In addition, Section 619(d)(1)(G) provides a highly tailored exception for bank sponsored funds in connection with providing trust, fiduciary, or investment advisory services only to customers of the banking entity. A banking entity can sponsor such a fund and invest up to 100% of the fund's original capital. It must then actively seek unaffiliated investors to reduce its ownership and must reduce its ownership to 3% within 1 year (subject to 2 possible 1 year extensions). All such investments by any banking entity can not exceed 3% of the banking entity's Tier 1 capital. A banking entity can make investments in such a fund after the original "seed investment" period, so long as such investment is in a *de minimis* amount. The banking entity, however, would be required to actively seek investors to reduce that investment unless (or until) it were small enough to be "immaterial to the banking entity" as that amount will be established by rule. Various limitations apply to the banking entity's involvement with such a fund, including Section 23A and B limitations.

- *What is Sponsorship of a Fund?*

Sponsorship includes serving as a general partner, managing member, or trustee of a fund. It also includes selecting or controlling a majority of the directors, trustees, or management of a fund (including having employees of the banking entity holding a majority of any such positions). Finally, it includes sharing the banking entity's name with the fund or a variation of that name.

- *How Do These Bans Apply to Nonbank Financial Companies Supervised By the Federal Reserve?*

As explained in our July 23, 2010, Client Alert "*Nonbank Financial Company Systemic Risk Regulation,"* the bans do not apply, but regulators are instructed to establish limits on and capital requirements for these activities conducted by nonbank financial companies supervised by the Federal Reserve.

III. Certain Prohibitions Override Exceptions

All the exceptions permitting proprietary trading or sponsorship and interests in hedge funds or private equity funds are subject to the requirements that they (1) not result in a material conflict of interest between the banking entity and it clients, customers, or counterparties; (2) not result in the banking entity having a material exposures to high risk assets or high risk trading; (3) not threaten the safety and soundness of the banking entity; and (4) not threaten financial stability in the US.

The federal banking regulators, the SEC, and the CFTC must issue regulations jointly to define these four requirements as part of the implementing regulations for the bans on proprietary trading and hedge fund or private equity fund sponsorship or ownership.

IV. Effective Dates

Both the proprietary trading and hedge fund/private equity fund provisions only become effective after 2 years, or, if earlier (which is unlikely), 1 year after implementing regulations are issued. Those regulations must be issued 9 months after the Oversight Council completes a study of the Section 619 bans and provides its recommendations for implementing the bans. The Council is directed to complete the study and recommendations within 6 months. The CFTC, SEC, and "appropriate banking regulators" will issue the implementing regulations. For bank holding companies and State member banks, the appropriate regulator is the Federal Reserve. The OCC is the appropriate regulator for national banks. The FDIC is the appropriate regulator for non-member State banks. Presumably, all 5 regulators will jointly issue the required regulations. Along with the implementing regulations, the same regulators are instructed to issue additional capital requirements and other restrictions "as appropriate" for banking entity interests in or sponsorships of hedge funds or private equity funds. These capital requirements and other restrictions, if any, would apply during the transition period for disposing of existing interests and, perhaps, for at least some future activities covered by exceptions.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact the Chapman attorney with whom you usually work or visit us at chapman.com.