



## Review of Financial Stability Oversight Council Volcker Rule Study

On January 18, 2011, the Financial Stability Oversight Council (“FSOC”) released a study on the implementation of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Volcker Rule”),<sup>1</sup> which prohibits banking entities from proprietary trading and certain relationships with hedge funds and private equity funds. The study, which was required under section 619(b) of Volcker Rule,<sup>2</sup> outlines the FSOC recommendations to the implementing financial regulatory agencies (the “Agencies”).<sup>3</sup>

The study makes recommendations regarding the two components of the Volcker Rule: (1) proprietary trading and (2) hedge fund and private equity fund (collectively, “Fund”) investment restrictions. The study also addresses the complexities of permissible trading and investment activities with respect to the “business of insurance.”<sup>4</sup> Our review of these areas follows.

### Proprietary Trading

The Volcker Rule broadly prohibits banking entities from engaging in proprietary trading, subject to certain exceptions for permitted activities, such as trading in government securities, market-making and underwriting activities, hedging and risk management activities, and transactions on behalf of customers. There is also an exception for certain insurance activities, which is discussed further, below. The study recognizes that, aside from certain readily identifiable “bright line” proprietary trading activities, the primary challenge presented by the Volcker Rule’s proprietary trading prohibition is the core task of delineating permissible and impermissible activities. Certain classes of permitted activities—such as market making, hedging, underwriting, and other customer transactions—may exhibit outwardly similar characteristics to proprietary trading, even as they pursue different objectives, and that characteristics of permitted activities in one market or asset class may not be the same in another market. To address this core challenge, the study recommends that the Agencies should be guided by five fundamental principles in implementing the Volcker Rule: (i) proprietary trading should be prohibited with “whatever combination of tools and methods [that] are necessary”; (ii) regulations and supervision should be “dynamic and flexible”; (iii) regulations and supervision should be consistently applied across similar banking entities; (iv) regulations and supervision should facilitate “predictable evaluations of outcomes”; and (v) regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary. The study also encourages the Agencies to develop criteria for “bright line” proprietary

<sup>1</sup> The FSOC “Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Fund & Private Equity Funds” is available at [www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20org.pdf](http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20org.pdf).

<sup>2</sup> 12 U.S.C. § 1851(b)(1).

<sup>3</sup> The Agencies include the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”), the Board of Governors of the Federal Reserve System (the “Board”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”).

<sup>4</sup> *Id.* at § 1851(d)(1)(F).

trading on the theory that there is a “general consensus” that certain types of historical banking entity trading activities plainly are not allowed under the Volcker Rule.

### ***Proprietary Trading Implementation Framework***

Recognizing that most banking entities' risk management infrastructures are not designed to identify and restrict proprietary trading, the FSOC study proposes a new risk management framework to address this infrastructure deficiency, consisting of four primary elements:

- *A programmatic compliance regime.* The study recommends that the Agencies compel banking entities to develop and integrate into current compliance regimes a new, specifically-tailored program of policies, procedures, and other controls designed to ensure adherence to the Volcker Rule and facilitate supervision, including appropriate internal policies and procedures, internal quantitative and other controls, adequate recordkeeping and reporting systems, independent testing, and CEO and board accountability.
- *Analysis and reporting of quantitative metrics.* To take advantage of the fact that proprietary trading may evidence different quantitative characteristics than permitted activities conducted in response to customer demand, the study recommends the use of four key metrics: revenue-based metrics (*e.g.*, historical revenue comparisons, day one profit and loss measurements, and bid-offer and pay-to-receive ratios), revenue-to-risk metrics, inventory metrics, and customer flow metrics to assess the permissibility of banking entities trading activities.
- *Supervisory review and oversight of trading operations.* The study recommends a supervisory oversight regimen that incorporates several key supervisory elements: periodic review and testing of internal controls and procedures; ongoing supervisory monitoring and review of trading activities; frequent communication with trading personnel; and review of quantitative metrics for red flags.
- *Enforcement procedures for violations.* The study urges the Agencies to establish an investigation process for assuring compliance with the Volcker Rule. If that process identifies a violation, the Volcker Rule requires that the Agencies take steps to order the termination or disposition of non-compliant activities or investments after providing notice and opportunity for a hearing.

### ***Additional Limits on Permitted Proprietary Trading***

Four provisions of the Volcker Rule that have not received much attention thus far are those provisions that prohibit or limit otherwise-permitted activities if (i) they involve or would result in a material conflict of interest, (ii) the activities would result, directly or indirectly, in a “material exposure by the banking entity to high-risk assets or high-risk trading strategies,” (iii) a permitted activity would pose a threat to the safety and soundness of a banking entity, or (iv) an activity poses a threat to the financial stability of the United States. This limitation represents the “prudential backstop” of the Volcker Rule.

With respect to conflicts, the study broadly observes that “proprietary trading presents potentially serious conflicts of interest between a firm’s activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets,” and that the combination of banking and trading present the prospect of other forms of conflicts of interest. In turn, the FSOC recommends that in implementing the Volcker Rule, the banking agencies should consider the extent to which the permitted activities present risks that banking entities will conduct transactions that place the banking entity’s own interests ahead of its obligations to its customers and counterparties, and that the Agencies should consider “all types of transactions, structures and roles in connection with permitted activities” that pose a heightened risk for material conflicts of interest. The Agencies also are encouraged to take into consideration existing conflict of interest laws applicable to banking entities engaged in permitted activities. In short, the FSOC’s recommendations may easily form the basis of a

broad and potentially intrusive conflicts regulatory and supervisory framework that extends to all forms of *permissible* proprietary trading.

On the issue of limiting high-risk trading strategies within permissible proprietary trading, the Agencies are encouraged to develop guidance on identifying such strategies that can be incorporated into the existing supervisory process, and to develop a flexible framework for identifying such strategies and assets rather than “rigid definitions.”

The study had little of substance to say about the safety and soundness or financial stability limitations on permitted trading activities, other than to encourage the Agencies to incorporate the safety and soundness limitations into the framework and procedures adopted to assure compliance with the Volcker Rule. Potentially worrisome, however, is the FSOC’s vague warning that the Agencies can take action where an individual firm’s activities may constitute permissible activities, but, in the aggregate, may create “imbalances” in the financial markets.

### **Fund Investment and Sponsorship Activities**

Generally, the Volcker Rule prohibits a banking entity from “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a [Fund].”<sup>5</sup> The FSOC identifies two main purposes for this prohibition: (i) preventing banking entities from making risky investments in Funds while taking advantage of the federal safety net and (ii) reducing the potential for a conflict of interest between a banking entity’s own capital investments and its customer’s Fund investments. For purposes of the Volcker Rule, a Fund is defined as “an issuer that would be an investment company, as defined in the Investment Company Act of 1940 . . . but for section 3(c)(1) and 3(c)(7) of that Act, or similar such funds as the appropriate Federal banking agencies, the SEC, and the CFTC may . . . determine.”<sup>6</sup>

Notwithstanding the general prohibitions, banking entities are permitted to organize and offer Funds as part of a “bona fide” trust, fiduciary, or advisory business, and are permitted to make *de minimis* investments to establish Funds in connection with these types of customer-related business. Such *de minimis* investments are limited to (i) seeding Funds—however, after one year any interest in a fund may be no more than 3 percent of total ownership—and (ii) aggregate interests of no more than 3 percent of the Tier 1 capital of the bank. The Volcker Rule also permits a banking entity to offer prime brokerage services to an independent Fund under certain circumstances. Permitted activities, however, are subject to “the prudential backstop” (discussed above) that prohibits such activities if they would result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to the financial stability of the United States.<sup>7</sup>

### ***Issues in Fund Investment/Sponsorship Implementation***

The Study identifies a number of issues, and makes recommendations, with respect to the Funds component of the Volcker Rule. The issues include:

- ***Defining Fund.*** As described above, the Volcker Rule defines a Fund as any issuer that relies on either of the exemptions in sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, which exclude from the meaning of investment company any issuer with 100 or fewer investors that does not make a public offering of its securities, and any issuer whose outstanding securities are owned exclusively by qualified purchasers (*i.e.*, investors with \$5 million or more in investable assets), respectively.<sup>8</sup> The FSOC

<sup>5</sup> *Id.* at § 1851(a)(1)(B).

<sup>6</sup> *Id.* at § 1851(h)(2).

<sup>7</sup> *Id.* at § 1851(d)(2).

<sup>8</sup> 15 U.S.C. §§ 80b-3(c)(1), -3(c)(7).

points out, however, that this definition may be both over inclusive and under inclusive. For example, many venture capital funds fall within these exemptions; the study, however, cites a number of commenters that suggest that venture capital funds should be excluded from the Volcker Rule's definition of Fund. Conversely, the study notes that certain investment vehicles, such as certain commodity pools, share the characteristics of traditional Funds but do not rely on the section 3(c)(1) and 3(c)(7) exemptions. To develop a more precise definition of a fund, the FSOC recommends that the Agencies consider compensation structure, investment strategy, use of leverage, and investor composition as factors in identifying what Funds are to be covered.

- *Defining customer.* The FSOC acknowledges that the Agencies need to define who is a “customer” of a banking entity,<sup>9</sup> as it relates to the bona fide trust, fiduciary, or investment advisory services, because the Volcker Rule does not provide a definition. Because a banking entity's initial relationship with a person may be as a customer of the Fund's business, banking entities have an interest in being able to read the Volcker Rule to permit new relationships. The FSOC recommended that the Agencies, in defining customer, consider whether there is a continuing relationship, a previous knowledge of financial needs and risk tolerance, and a direct customer relationship, and whether the relationship was initiated by the customer or the banking entity.
- *Feeder funds.* The Volcker Rule permits banking entities to provide customers with access to third-party Funds through feeder funds. Feeder funds are permissible under the Volcker Rule because the risks are typically borne entirely by Fund investors and none of the banking entity's assets are at risk. However, the FSOC suggests that is a potential for conflicts of interest with respect to third-party Funds with which the banking entity has other business relationships. To address the potential conflict, the FSOC recommends that, with respect to considering whether a banking entity's activities should be permissible feeder fund activities, the Agencies' rules consider whether the feeder fund activity should be subject to the prohibition on “covered transactions,” as if the banking entity were subject to the section 23A of the Federal Reserve Act, and the section 23B “arm's length” transaction requirements. The FSOC further recommends that the Agencies consider whether the arrangement could create the opportunity and incentive for the banking entity to protect the third-party Fund from losses or whether there is any exposure to outsized risk.
- *De minimis calculation.* The FSOC also recommends that the Agencies take care to develop rules that clearly address the risk exposure and avoid understating risk. For example, the FSOC recommends that Agencies' rules address whether committed, but not yet invested, cash in private equity investments should count toward the *de minimis* cap. In addition, the FSOC recommends that the Agencies determine how frequently a banking entity should calculate its investment interest vis-à-vis the *de minimis* cap (*e.g.*, is a one-time test sufficient or should it be an ongoing evaluation). Finally, the FSOC recommends that the Agencies consider how much time a banking entity that exceeds the 3 percent *de minimis* cap should have to sell down its interests.
- *Defining banking entity.* The FSOC also recommends that the Agencies clarify the term “banking entity.” The Volcker Rule defined “banking entity” to include banks, bank holding companies, “and any affiliate or subsidiary of any such entity.”<sup>10</sup> However, the Study points out that there is an inherent circularity to this definition, which could subject an advised Fund to the Volcker Rule as an affiliate, even though investment in advised Funds is explicitly permitted. The FSOC lists other clearly unintended results and recommends that the Agencies define “banking entity” in a way that avoids these results.

<sup>9</sup> 12 U.S.C. § 1851(d)(1)(G)(ii).

<sup>10</sup> *Id.* at § 1851(h)(1).

### ***Compliance Programs***

The FSOC recommends a robust regime to ensure compliance with the Volcker Rule's Fund restrictions. Notably, the regime includes a public attestation of compliance by the CEO and Board of Directors approval of the objectives, strategies, and policies governing permissible Fund investments. The FSOC also recommend that the Agencies consider requiring banking entities to publicly disclose certain information for Funds that banking entities are permitted to invest in, organize and offer, or sponsor.

The FSOC also recommends that the Agencies take into account the effect of the rules on existing permissions for banking entities, such as the authority of certain banking entities to engage in merchant banking.

### **Accommodation of the Business of Insurance**

The study gives special attention to permitted activities conducted by "regulated insurance companies directly engaged in the business of insurance."<sup>11</sup> As an initial matter, the Volcker Rule provides that regulated insurance companies affiliated with insured banks or non-bank financial institutions regulated by the Board may purchase, sell, acquire, or dispose of securities and other instruments described in the Volcker Rule definition of proprietary trading.<sup>12</sup> The study explains that insurance companies' investment returns support underwriting and the payment of future claims to policyholders and claimants. The study further suggests that "the overall insurance business model . . . could be unduly disrupted if certain provisions of the Volcker Rule applied."

The study identifies a series of definitional issues that the Agencies will have to consider when determining the scope of permitted proprietary trading by regulated insurance companies. The FSOC recommends that the Agencies provide definitions for terms not defined by the Volcker Rule, including "regulated insurance company," "business of insurance," and "general account." Despite the issues unique to each of these terms, the study acknowledges that there are existing, generally-accepted statutory definitions, and the FSOC encourages consistency those existing definitions.

The Volcker Rule limits regulated insurance companies' activities in two key respects. First, all permitted activities must be in compliance with "insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which each such insurance company is domiciled." The study provides little guidance regarding this restriction, but encourages the Agencies to work with the state insurance regulators to ensure compliance. The FSOC defers to the Agencies, however, with respect to the Volcker Rule's language regarding the company's domiciliary state *or* jurisdiction, which has led some to question whether the Volcker Rule restrictions apply to foreign insurance companies.

The second limitation to the "business of insurance" exception is the general prudential backstop, described above. However, the study raises an issue with respect to these limits coming into conflict: what if an insurance company is compliant with state laws, regulations, etc., but those laws are insufficient to protect the safety and soundness of a banking entity or the financial stability of the United States? The study suggests that at some point in the future, the Agencies will have to make a determination, after consulting with the state insurance commissioners, regarding any insufficiency, and the appropriate remedies.

The study raises two additional issues regarding the "business of insurance exemption." First, certain insurance products may be registered under the Investment Company Act exclusions 3(c)(1) or 3(c)(7), which the Volcker Rule uses to define Funds, as discussed above. The FSOC cautions the Agencies not to infringe on the "business of insurance" when proscribing Fund investment and sponsorship activities. Second, the study raises the concern that innovative insurance products could be used to "game" the Volcker Rule. The FSOC encourages the Agencies

---

<sup>11</sup> See *Id.* at § 1851(d)(1)(F).

<sup>12</sup> See *Id.* at § 1851(h)(4).

to carefully monitor the flow of funds between banking entities and affiliated insurance companies and take appropriate steps to close any loopholes.

### Some Observations

Overall, the study is disappointing in its failure to articulate more precise substantive criteria and benchmarks for application of the Volcker Rule to covered banking entity activities. Thus, the study effectively “kicks down the road” most of the hard decisions that will have to be made in the Agencies’ rulemaking process about what is or is not covered by the Volcker Rule. Affected banking entities therefore will have to continue living with the very substantial business uncertainties created by the Volcker Rule, and will have to continue to wait for specific, concrete implementation requirements and standards. In addition, for those in the financial services industry that were hoping for a more lenient approach by the FSOC and the Agencies in implementing the Volcker Rule, there is little in the study that holds out the hope of such an approach. To the contrary, the overall tone and substance (such as it is) of the study plainly points to the possibility of an aggressive Agency regulatory and supervisory regime for applying and enforcing the Volcker Rule, which the study describes as an “essential” piece of the financial regulatory reform framework.

What may be of greater practical concern to affected banking entities are the study’s recommendations regarding the development of a new compliance and enforcement regime for administering the Volcker Rule. It is entirely possible that the upshot of the study’s recommendations will be a burdensome regulatory compliance infrastructure that does not fit easily within existing banking entity compliance and technology frameworks, and will pose substantial implementation challenges. In this regard, the study’s broad-brush statement about the need to control conflicts of interest and high-risk activities in all forms of otherwise-permitted trading activities conceivably could open the door to the creation of a broad conflicts- and risk-management framework that extends substantially beyond existing conflicts- and risk-management requirements under current federal and state laws, regulations, and supervisory requirements.

### A Look Ahead

The Agencies will now develop proposed rules implementing the Volcker Rule, taking into consideration the FSOC recommendations. The Volcker Rule requires that the Agencies adopt rules no later than nine months after the completion of the study.<sup>13</sup> We expect that the Agencies will propose implementing rules sometime this Spring. The Board has issued final rules regarding the required conformance period,<sup>14</sup> which require conformance two years after the date on which the final rules become effective, or two years after a nonbank financial company is designated for supervision by the Board, whichever is later. The Board has some discretion to grant extensions for the conformance period.<sup>15</sup>

---

#### Contacts

Barbara R. Mendelson  
(212) 468-8118  
[bmendelson@mof.com](mailto:bmendelson@mof.com)

Charles M. Horn  
(202) 887-1555  
[charleshorn@mof.com](mailto:charleshorn@mof.com)

Mark Gillett  
(213) 892-5289  
[mgillett@mof.com](mailto:mgillett@mof.com)

Jeremy R. Mandell  
(202) 887-1589  
[jmandell@mof.com](mailto:jmandell@mof.com)

---

<sup>13</sup> *Id.* at § 1851(b)(2).

<sup>14</sup> 76 Fed. Reg. 8265 (February 14, 2011).

<sup>15</sup> See 12 U.S.C. §§ 1851(c)(2), (3).

### About Morrison & Foerster

---

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

© 2011 Morrison & Foerster LLP. All rights reserved.

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*