

THE VOLCKER RULE PROVISIONS (as of October 2011)

Unduly risky trading and investment activities at banking institutions, made possible by the federal safety net of deposit insurance and access to the discount window, either, according to some commentators, were a cause of the financial crisis or will be the source of the next one. The Volcker Rule—a relative latecomer to the Dodd-Frank legislative process—responds to these concerns by re-erecting some of the walls between commercial and investment banking that were first built by the Glass-Steagall Act in 1933.

In a nutshell, the Volcker Rule prohibits or limits (i) proprietary trading and (ii) sponsorship of or an ownership interest in a hedge fund or a private equity fund. Banking entities—regardless of size—are prohibited from engaging in these activities. Nonbank financial companies that have been declared systemically important by the Financial Stability Oversight Council and supervised by the Federal Reserve may engage in these activities but will be subject to higher capital requirements for the activities and may be subject to quantitative limits or diversification requirements set forth by the Federal Reserve. The restrictions do not apply to banking organizations where the bank is engaged solely in trust or fiduciary activities.

As of October 14, four of the federal agencies responsible for administering the Volcker Rule—the Federal Reserve, OCC, FDIC, and SEC—had signed off on a consensus proposal (the “Proposed Rule”). (A fifth agency, the CFTC, is, as of this writing, still working on its own version of a proposal.) The comment period runs through January 13, 2012. A final rule cannot reasonably be expected until April 2012 at the earliest. Timing is important because, as the law now stands, the Volcker Rule provisions in Dodd-Frank will take effect on July 21, 2012, rule or no rule.

Once the Volcker Rule takes effect, banking entities should plan to wind down any impermissible trading or investment activities by July 21, 2014. The Federal Reserve may extend the conformance period by up to three one-year periods, if the extension is consistent with the purpose of the Volcker Rule and not detrimental to the public. An additional five-year extension is available for an ownership interest in an illiquid fund that was contractually agreed upon before May 1, 2010.

The impact of the Proposed Rule on proprietary trading and investments in and sponsorships of hedge funds or private equity funds may be difficult to measure. The Proposed Rule takes a relatively broad view of permissible activities—or, to put it another way, the Proposed Rule could have been more stringent—but imposes compliance and reporting requirements that are likely to be quite burdensome.

Proprietary Trading

While a banking entity may not continue to trade for its own account, it may continue to hold securities on a short-term basis in connection with underwriting, market making, or risk-mitigating hedging activities. Trading in government obligations and trading on behalf of a customer also are allowed. Regulated insurance companies are not subject to the Volcker Rule restrictions on trading.

Hedge and Private Equity Funds

The Proposed Rule defines hedge funds and private equity funds broadly and primarily as funds that are exempt from the requirements of the Investment Company Act under section 3(c)(1) or (c)(7) of that statute. The Agencies candidly acknowledge that this definition covers venture capital and other funds that do not have the characteristics that the Volcker Rule was meant to address. Nevertheless, the Proposed Rule is broad in this respect. The Proposed Rule contains the exception in the statute for investment funds oriented to a banking entity’s clients.

Securitizations

The treatment of participation in a securitization transaction, either as a trading activity or as a sponsorship of or an ownership interest in a hedge fund or private equity fund is unclear. Dodd-Frank directs that the Volcker Rule

should not be construed to limit a banking entity's ability to sell or securitize loans. Among the questions raised by the Proposed Rule is how securitization-related activities should be addressed.

Foreign Banking Organizations

Foreign banking organizations that are treated as bank holding companies in the U.S. are subject to the Volcker Rule restrictions. Unlike U.S. bank holding companies, however, a foreign banking organization may conduct otherwise prohibited activities offshore.

Compliance

Permissible trading and investment fund activities are subject to a prudential backstop and must adhere to a robust set of compliance standards. A banking entity may not engage in an activity if it presents a material conflict of interest or if it would expose the entity to a high-risk trading strategy or a high-risk asset. A banking entity can disclose its way out of a conflict, however.

Appendix C to the Proposed Rule describes a robust compliance regime that is more detailed and specific than most compliance requirements for other banking activities. Appendices A and B require banking entities to maintain daily records at the trading desk level and to submit monthly reports to the regulators.