

FINANCIAL STABILITY OVERSIGHT COUNCIL PUBLISHES *STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS*

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) charged the newly created Financial Stability Oversight Council (“FSOC”) with preparing numerous studies and recommendations regarding various implementing regulations to be adopted by federal agencies (the “Agencies”).¹ Section 619 of the Dodd-Frank Act, also known as the “Volcker Rule,” is one of the cornerstones of this wide-ranging financial reform legislation. The Volcker Rule generally prohibits financial institutions subject to the provisions, termed “banking entities,”² from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain significant exceptions.

On January 18, 2011, FSOC released its highly anticipated *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (the “Study”). The Study provides the Agencies with substantive guidance for effectively implementing the statutory objectives of the Volcker Rule. Consequently, in many places the Study provides a detailed framework of recommended regulations; elsewhere, the Study highlights areas where the Agencies are encouraged to give thought and consideration to developing additional regulations and supervisory guidance.

The Agencies must adopt rules and regulations implementing the Volcker Rule no later than nine months from the date of the Study. The Agencies must consider FSOC’s recommendations in developing and adopting regulations, and are required to consult and coordinate with each other in order to adopt regulations as comparable as possible to ensure consistent implementation and application of the Volcker Rule across the Agencies.

Although not all recommendations will ultimately be adopted by the Agencies in the form recommended by the Study, the Study provides an important framework for how the Agencies will likely implement the Volcker Rule. It also gives market participants and other interested parties critical perspective regarding how key questions arising from the Volcker Rule may eventually be addressed. In addition to the impact the Volcker Rule and implementing

¹ As described in the Study, “Agencies” refers to 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 Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), which are responsible for implementing the Volcker Rule provisions by rulemaking.

² The Volcker Rule generally defines a “banking entity” as “any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such entity.”

regulations will have on banking entities' business strategies, these regulations will also likely increase banking entities' administrative, management, data production, reporting and supervisory burdens. This client update is designed to provide a brief summary and description of FSOC's key recommendations of new regulations contained in the Study.

I. **Proprietary Trading**

A. **Overview:** the Volcker Rule expressly prohibits banking entities from engaging in proprietary trading, except for limited exceptions for specified permitted activities. The Study contains numerous recommendations that are designed to eliminate prohibited proprietary trading activities, prevent evasion of the Volcker Rule's prohibition using the guise of permitted activities, and minimize any related capital markets disruption.

B. **Distinguishing between proprietary trading and permitted activities:**

1. **"Bright line" proprietary trading:** FSOC believes that certain activities should always be considered proprietary trading, and the Agencies should identify and limit these activities. Such "bright line" proprietary trading typically has one or more of the following characteristics:
 - a. Organized to conduct trading activities for the sole purpose of generating profits from trading strategies;
 - b. No formal market making responsibilities or customer exposure (or customer exposure that is not commensurate with the level of trading);
 - c. Physical and/or operational separation from market making and other operations having customer contact;
 - d. Trades with, or is provided the services of, sell side analysts, brokers, and dealers;
 - e. Receives and utilizes research or soft dollar credits provided by other broker-dealers; and/or
 - f. Compensation structures similar to those of hedge fund managers and other managers of private pools of capital.
2. **Certain permitted activities:** the Volcker Rule provides explicit exceptions from the broad prohibition for certain trading activities, including market making, hedging and underwriting activities. To assist the Agencies with recognizing permitted activities, the Study includes indicia of each permitted activity, including (1) market making for liquid

markets, (2) market making for less liquid markets,³ (3) hedging and (4) underwriting.

C. **Recommendations for implementation of proprietary trading prohibition:** the Study contains a four-part supervisory framework designed to prohibit proprietary trading effectively. The Study recommends that the Agencies be flexible in adapting the recommendations to address different situations, activities and asset classes among banking entities.

1. **Programmatic compliance regime:** the Study recommends that banking entities be required to develop a robust compliance regime consisting of five components to establish policies, procedures and controls to ensure adherence to the Volcker Rule. These five components include (1) the development of necessary internal policies and procedures, (2) internal qualitative and other controls, (3) recordkeeping and reporting systems, (4) independent testing and (5) CEO and board accountability.⁴
2. **Analysis and reporting of quantitative metrics:** the Study recommends that the Agencies require banking entities to report quantitative metrics to identify impermissible activities and market trends. The Study identifies four potential categories of quantitative metrics that the Agencies may require from banking entities, including (1) revenue-based metrics, (2) revenue-to-risk metrics, (3) inventory metrics and (4) customer-flow metrics.
3. **Supervisory review and oversight:** FSOC expects that in addition to adopting regulations implementing the Volcker Rule, the Agencies will also develop strong supervisory processes. The Study recommends supervisory components with the understanding that the Agencies will need to allocate resources and manpower to construct a new supervisory framework to oversee banking entities.
4. **Enforcement procedures for violations:** the Study recommends that the Agencies identify various enforcement actions they may take with respect to an array of potential violations, consistent with the Volcker Rule.

³ For example, these markets include debt, derivatives and asset-backed security markets, which generally do not have a mechanism for widely-disseminated quotations.

⁴ The Study recommends that the Agencies require the banking entity's CEO to attest publicly to the ongoing effectiveness of the banking entity's internal compliance regime.

- D. **Statutory limitations on permitted activities:** the Volcker Rule permits banking entities to engage in trading activities, subject to certain limitations under 12 U.S.C. § 1851(d)(2)(A). Although it does not lay out a detailed framework for recommended regulations, the Study provides the Agencies with conceptual guidance in connection with adopting regulations for permitted activities.
1. **Material conflicts of interest:** under the Volcker Rule, permitted activities are prohibited if they involve or would result in a material conflict of interest. The Study recommends that the Agencies look closely at whether additional regulation will strengthen protections such that banking customers do not suffer financial injury through a firm's other permitted trading activities. In particular, FSOC encourages the Agencies to examine activities and relationships that give rise to conflicts of interest for the banking entity and consider whether existing laws appropriately address these conflicts.
 2. **Material exposure to high-risk assets or high-risk trading strategies:** the Volcker Rule expressly limits permitted activities if they would result in a material exposure to high-risk assets or high-risk trading strategies. The Study counsels the Agencies to provide flexible regulatory guidance on what constitutes a high-risk asset or a high-risk trading strategy, and to review compliance through the supervisory process. In addition, the Study recommends that banking entities be required to establish a committee with relevant expertise to assess the firm's potential exposure to high-risk assets and high-risk trading strategies. The Study identifies certain characteristics which may indicate a high-risk asset or high-risk trading strategy, including, but not limited to, (1) the introduction of new products with rapid growth, (2) assets or strategies that include embedded leverage and (3) historical volatility of the asset or strategy.
 3. **Threat to the safety and soundness of a banking entity:** the Volcker Rule requires that the Agencies assess whether any permitted activity would pose a threat to the safety and soundness of an individual banking entity.
 4. **Threat to the financial stability of the United States:** in the unlikely event that the other limitations on permitted activities discussed above fail to address systemic risks to the financial system of the United States, the Agencies are required to take action to prohibit those activities.

II. Hedge Fund and Private Equity Fund Investment Restrictions

- A. **Overview:** under the Volcker Rule, banking entities are generally prohibited from acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, a hedge fund or private equity fund, or entering into certain transactions with hedge funds and private equity funds. However, banking entities are permitted to engage in customer-focused advisory services, including prime brokerage services, investment management and investment advisory services, trust and estate planning and administration, and custody and safekeeping arrangements for securities and valuables. In addition, banking entities are permitted to organize and offer or invest in hedge funds and private equity funds to facilitate customer-focused advisory services, subject to a *de minimis* investment limit and other restrictions. The Study provides guidance on several key issues identified by industry observers following the passage of the Dodd-Frank Act, but generally falls short of making detailed recommendations to the Agencies for implementing regulations.
- B. **Implementation of prohibited activities—scope of prohibited investments:** FSOC believes that the Volcker Rule’s definitions of “hedge fund” and “private equity fund” will not adequately capture all funds intended to be subject to that rule. Consequently, the Study recommends that the Agencies use their authority to expand upon those definitions through their regulations to include funds that do not rely on the section 3(c)(1) or 3(c)(7) exclusions, but nonetheless engage in activities or have similar characteristics of a hedge fund or private equity fund. These funds would be deemed “similar funds” under Section 619(h)(2) of the Dodd-Frank Act, and become subject to the Volcker Rule. The Study lists a number of characteristics that the Agencies may consider in designing appropriate regulation to capture “similar funds,” including (1) whether the fund’s manager earns an allocation based on fund performance including both realized and unrealized gains, (2) the types of trading or investment strategy the fund utilizes, (3) whether the fund borrows or otherwise utilizes material leverage for the purpose of increasing investment performance and (4) whether the fund’s capital is received from a broad group of unaffiliated investors.
- C. **Implementation of regulation on permitted activities:** the Study addresses several key issues in connection with the implementation of permitted activities under the Volcker Rule. One significant exemption from the prohibition on sponsors investing in hedge funds and private equity funds, generally known as the “*de minimis*” exemption, is available for a banking entity that sponsors a hedge fund or private equity fund for its customers subject to certain requirements.

1. **“Customer requirement”:** the Volcker Rule permits banking entities to organize, offer and invest in a hedge fund or private equity fund if “the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity.” The Volcker Rule does not define “customers,” and the Study advises the Agencies to develop regulations clarifying the meaning of “customer.”⁵ The Study suggests that the Agencies look to existing statutory definitions and regulations that define customer relationships,⁶ and also address the following considerations—
 - a. continuing relationship versus knowledge of financial needs;
 - b. direct versus indirect customer relationships; and
 - c. relationships initiated by potential customers versus banking entities.
2. **Feeder funds:** FSOC is concerned that conflicts of interest may arise where a banking entity directs a feeder fund to a third-party hedge fund or private equity fund with which the banking entity has other business relationships. The Study recommends that the Agencies consider whether these kinds of business relationships should be subject to prohibition, and to what extent such arrangements could create an opportunity and incentive for banking entities to protect hedge funds and private equity funds from losses or expose the banking entity to material risk.
3. ***De minimis* investments:** the Volcker Rule permits banking entities to take or retain a 3% or lower *de minimis* investment in a hedge fund or private equity fund, subject to certain other restrictions on the size and holding period of the investment. FSOC urges the Agencies to consider whether the *de minimis* investment framework is sufficient to prevent loopholes and prohibit banking entities from engaging in proprietary trading by adopting rules that will (1) avoid understating risk and (2) effectively monitor compliance with *de minimis* investment limits.

⁵ The Volcker Rule also refers to “clients” in several places throughout the statute, and the Study recommends that the Agencies seek to clarify the meaning of this term as well.

⁶ The Study notes that guidance addressing customer relationships exists within both banking law and securities law, which the Agencies may consider in addressing the “customer requirement.” 12 CFR 216.3(i)(1) (defining customer relationship) and Use of Electronic Media, Securities Act Release No. 7856 (Apr. 28, 2000) (defining substantive and preexisting customer relationship).

- D. **Clarification of the term “banking entity”:** the Study recognizes that the Dodd-Frank Act’s definition of “banking entity” could lead to problems as enacted, because “affiliate” and “subsidiary” are each defined terms under the Bank Holding Company Act of 1956. For example, although setting up an advised fund is a permitted activity under the Volcker Rule, such fund could be defined as an affiliate of the banking entity, which would subject the fund to the Volcker Rule’s proprietary trading and hedge fund and private equity fund restrictions. Such a fund could also be subject to naming and other restrictions if its advisor were relying on the *de minimis* exemption in sponsoring the fund. Acknowledging that these results were not the intent of the statute, FSOC recommends that the Agencies carefully consider ways to implement the term “banking entity” that do not lead to unintended results.
- E. **Monitoring compliance:** like the Study’s recommendations in connection with proprietary trading discussed above, the Study also recommends regulations to ensure compliance with the restrictions regarding hedge funds and private equity funds.
1. **Programmatic compliance:**
 - a. **Investment and risk oversight:** the Study includes recommendations for the banking entity’s board of directors and other employees, including but not limited to the adoption of objectives, strategies and policies governing permissible investments, as well as active compliance monitoring of those internal policies and procedures.
 - b. **Management and public attestation:** the Study recommends that the banking entity’s CEO be required to attest publicly to the ongoing effectiveness of the internal compliance regime with respect to permitted investments in hedge funds and private equity funds.
 2. **Transparency:** in addition to the recommended programmatic compliance regime, the Study urges the Agencies to consider requiring banking entities to publicly disclose certain information regarding hedge funds and private equity funds that they are permitted to invest in, organize and offer, and sponsor, including the type and amount of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital.

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