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SEC Update

Willkie Farr & Gallagher LLP
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— David S. Katz, Jack I. Habert, and Laura P. Gavenman

Agencies Adopt Final Rules Implementing the Volcker Rule; Federal Reserve Board Extends Conformance Period

On December 10, 2013, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued joint Final Rules (Final Rules) implementing a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] commonly known as the "Volcker Rule."[2] The Volcker Rule, which was added to the Bank Holding Company Act of 1956 (BHCA)[3] by Section 619 of Dodd-Frank, generally prohibits banking entities[4] from engaging in proprietary trading and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds (Covered Funds), subject to certain exemptions. The Final Rules will become effective April 1, 2014. However, the Board has extended the conformance period by one year, so that covered banking entities have until July 21, 2015 to fully conform their activities and investments to the requirements of the Final Rules. Section 13 of the BHCA permits the Board to extend this conformance period, one year at a time, for two additional years.

The Final Rules provide certain key definitions and identify the characteristics of permitted and prohibited activities and investments. Below are highlights of the Final Rules.

Proprietary Trading Prohibition

The Final Rules prohibit proprietary trading,[5] which is defined as engaging as principal for the trading account of a banking entity in a transaction to purchase or sell certain financial instruments. A "trading account" includes an account used for the purchase or sale of certain financial instruments principally for short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position. The Final Rules include a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for its "trading account" if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase or sale. A "financial instrument" includes securities,

derivatives, commodity futures, and options on such instruments, but does not include loans, spot foreign exchange or spot physical commodities.

Exemptions from the Proprietary Trading Prohibition

The Final Rules provide for a number of exemptions from the prohibition on proprietary trading, including:

Underwriting– This exemption permits underwriting activities of a banking entity if the entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to the distribution, provided that, among other things, the underwriting position is designed not to exceed the reasonably expected near-term demands of clients.

Market Making-Related Activities– This exemption permits market making-related activities of a banking entity, provided that the trading desk managing the financial exposure routinely stands ready to purchase and sell one or more financial instruments related to its exposure, and the trading desk's inventory is designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, among other things. These market making-related activities may not be designed to primarily generate revenues from fees or other client-related revenue sources or to incentivize prohibited proprietary trading.

Risk-Mitigating Hedging– This exemption permits risk-mitigating hedging that is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks,[6] based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings, and the risks and liquidity thereof. General "portfolio hedging" is not permitted. In addition, the risk-mitigated hedging cannot give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged. Risk-mitigated hedging must be subject to ongoing review and monitoring. The banking entity may also be required to document its rationale for a particular hedge in certain circumstances.

Domestic Government Obligations– This exemption permits a banking entity to trade in certain US government and agency obligations, obligations and other instruments of specified government sponsored entities, such as, for example, the Government National Mortgage Association, and in state and municipal obligations.

Non-US Government Obligations– This exemption permits the US operations of foreign banking entities to engage in certain proprietary trading in the US in the foreign sovereign debt of the foreign sovereign under whose laws the banking entity is organized, subject to certain conditions. The exemption also permits a foreign bank controlled by a US banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign bank is organized, subject to certain conditions. For example, a US bank's German affiliate would be permitted to trade in German government securities, provided that the other conditions of the exemption are met.

Trading on Behalf of Customers as a Fiduciary– The exemption permits certain trading on behalf of customers in a fiduciary capacity, provided that the banking entity does not have beneficial ownership of the financial instruments, and also permits certain riskless principal trades.

Regulated Insurance Companies– The exemption permits trading by a banking entity that is an insurance company or an affiliate thereof for the general account of the insurance company or for a separate account of the insurance company.

Foreign Banking Entities– Trading by foreign banking entities is generally not prohibited, so long as the principal risk, the decision-making, and the accounting for this activity occur solely outside of the US.

Limitation on Exemptions: Activities that Create a Material Conflict of Interest. The exemptions listed above are not permissible if they involve a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of

the banking entity or to the financial stability of the US. A material conflict of interest between a banking entity and its clients would exist if the banking entity engaged in an activity when its interests were materially adverse to that of its clients, and the banking entity did not disclose the conflict and maintain certain information barriers, among other things.

Covered Funds Prohibition

Under the Final Rules, banking entities are prohibited from owning or sponsoring Covered Funds, which definition includes hedge funds and private equity funds,[7] certain commodity pools,[8] and certain asset-backed securitizations (other than loan securitizations).[9] The definition of a Covered Fund as it applies to commodity pools is more limited than in the proposed rules to implement the Volcker Rule (Proposed Rules).[10] With regard to funds organized outside of the US, a Covered Fund would include, among other things, a fund sponsored by a US banking entity or in which a US banking entity is an investor.

Exclusions from the Definition of Covered Fund

A number of different types of entities are specifically excluded from the definition of a Covered Fund, including foreign public funds (which are similar to US mutual funds), wholly owned subsidiaries, certain joint ventures, insurance company separate accounts, loan securitizations,[11] qualifying asset-backed commercial paper conduits, qualifying covered bonds, registered investment companies, business development companies and funds that may rely on a 1940 Act exclusion or exemption other than Section 3(c)(1) or 3(c)(7).

Permitted Activities With Respect to Covered Funds

Under the Final Rules, a banking entity may generally only sponsor or invest in a Covered Fund in connection with organizing and offering such Covered Fund subject to certain other conditions. The banking entity's investment (including investments by its affiliates) may not exceed either three percent of the value of the Covered Fund or three percent of the number of ownership interests in the Covered Fund at the end of the seeding period, provided that the banking entity may retain a higher percentage if required pursuant to the asset-backed securitization risk retention rules added in Dodd-Frank.[12] The Final Rules, subject to certain conditions, also permit certain other investments in Covered Funds that, for example, are in connection with risk-mitigating hedging activities, activities that occur outside of the US, or activities engaged in by regulated insurance companies.

Compliance Program Requirement

Under the Final Rules, the scope and detail of a compliance program will be commensurate with the size, activities and complexity of banking entities in an effort to ensure that banking entities that engage in more active trading have enhanced compliance programs compared to those that engage in little or no trading activity. A banking entity that does not engage in covered trading activities (other than trading in US government or agency obligations and other permissible investments) or Covered Fund activities need only establish a compliance program before engaging in such activities. Smaller banking entities (those with total consolidated assets of $10 billion or less) that engage in covered trading activities and/or Covered Fund activities or investments may satisfy the compliance requirements of the Final Rules by including in their existing compliance program appropriate references to the requirements of Section 13 of the BHCA and the Final Rules. Larger entities have additional compliance requirements. For example, a banking entity with $50 billion or more total consolidated assets or that is required to report metrics[13] under the Final Rules must adopt an enhanced compliance program with detailed policies, limits, governance processes and reporting. In addition, the Chief Executive Officer of such an

entity must attest that the entity has a program reasonably designed to achieve compliance with the requirements of Section 13 of the BHCA and the Final Rules.

NOTES

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 The Final Rules, the preamble to the Final Rules and related documents are available on the websites of the federal regulators that adopted the Final Rules. For example, these documents are available on the Board's website at *http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm*.

3 The Volcker Rule added new Section 13 to the BHCA and is codified at 12 U.S.C. 1851.

4 The term "banking entity" includes any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company treated as a bank holding company under section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of the foregoing.

5 "Proprietary trading" does not include certain purchases and sales of financial instruments that generally do not involve short-term trading intent, such as the purchase and sale of financial instruments arising under certain repurchase arrangements or securities lending transactions and securities acquired or taken for bona fide liquidity management purposes.

6 Specific risks identified in the Final Rules include market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity.

7 Hedge funds and private equity funds are issuers that would be investment companies under the Investment Company Act of 1940, as amended (1940 Act), if they were not otherwise excluded from the definition of investment company by Section 3(c)(1) or 3(c)(7) of the 1940 Act.

8 Commodity pools for which the commodity pool operator has claimed an exemption under 17 C.F.R. § 4.7 or registered commodity pool operators of pools owned by qualified eligible persons under 17 C.F.R. § 4.7(a)(2) and § 4.7(a)(3), among other things, are included in the definition of a Covered Fund.

9 The definition of a Covered Fund would also include pooled investment vehicles such as a collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs), which rely on the exemption in Section 3(c)(1) or 3(c)(7) of the 1940 Act and would not qualify for a different exclusion under the 1940 Act or the Final Rules. However, on January 14, 2014, the five federal agencies that adopted the Final Rules approved an interim final rule permitting banking entities to retain interests in certain TruPS CDOs, provided that certain conditions are met, including: (i) the TruPS CDO was established, and the interest was issued, before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in certain qualifying TruPS collateral; and (iii) the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013. The interim final rule also clarified that this relief extends to activities of the banking entity as a sponsor or trustee for these securitizations and that banking entities may continue to act as market makers in TruPS CDOs.

10 The Proposed Rules are available in the Federal Register at 76 Fed. Reg. 68846 (Nov. 7, 2011) and on the Board's website at *http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm*.

11 Under the Proposed Rules, loan securitization vehicles relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act were treated as Covered Funds, with a limited exemption for certain activities and investments. Under the Final Rules, entities that issue loan securitizations and asset-backed commercial paper conduits that meet certain requirements are specifically excluded from the definition of a Covered Fund.

[12] Dodd-Frank, *supra* n.1 § 941(b) (creating new Section 15G of the Securities Exchange Act of 1934).

[13] Appendix A to the Final Rules discusses certain quantitative measurements or "metrics" that must be periodically reported that are designed to monitor certain trading activities. The "metrics" reporting requirements will be phased in over time based on the size of an entity's trading activities, among other factors. There are seven "metrics" that must be reported for subject entities, including risk and position limits and usage, risk factor sensitivities and comprehensive profit and loss attribution.