Regulations Proposed to Implement the Volcker Rule

October 13, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") included the so-called "Volcker Rule," which prohibits banking entities from engaging in proprietary trading and from investing in or sponsoring private equity funds and hedge funds. The Volcker Rule, which was codified as Section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act"),[1] takes effect on July 21, 2012 and banking entities have until July 21, 2014 to bring their activities into compliance with the rule. The Board of Governors of the Federal Reserve System (the "Federal Reserve") has the authority to grant extensions to banking entities beyond July 21, 2014 and on February 14, 2011 it issued final rules governing such extensions. The Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (the "FDIC") and the Securities and Exchange Commission (the "SEC") are obligated by Dodd-Frank to issue final regulations governing the Volcker Rule (other than the conformance period extensions) by October 18, 2011. On October 11, 2011, the agencies issued for public comment a joint notice entitled "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds" (the "Proposed Rule").

The public comment period for the Proposed Rule will run until January 13, 2012. Nearly 400 questions have been layered within the proposal to guide public and industry comment and, given the prominence of the Volcker Rule and the financial industry's oft-expressed concerns about its potential effects, the comment period is expected to be an active one. Following the comment period, the agencies are expected to issue a final rule in early 2012.

A. THE GENERAL PROHIBITION

The Volcker Rule broadly prohibits proprietary trading and sponsoring or investing in private funds. In adopting the Proposed Rule, the agencies stated that these prohibitions are not intended to prevent banking entities from engaging in client-oriented financial services, including underwriting, market making and asset management.

In the case of the prohibition on sponsoring or investing in private funds, this interpretation of the intent of the Volcker Rule results in a Proposed Rule that is favorable to banking entities. In particular, the Proposed Rule will provide banking entities with considerable leeway to sponsor private funds as long as they are primarily a way to provide investment management services to others rather than for the banking entities to make investments for its own account.

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1 12 U.S.C. § 1851, *et seq.*

In the case of the prohibition on proprietary trading, the distinction between client-oriented financial services and other trading activities is sometimes difficult to make. The agencies acknowledge this challenge and attempt to meet it by adopting a "multi-faceted approach." In addition to writing a regulation that sets forth criteria for determining what is permissible and impermissible, the agencies mandate, in considerable detail, the compliance programs that banking entities must establish. The Proposed Rule also contains a separate commentary on how the agencies will distinguish permissible and impermissible activities. Finally, banking entities are required to collect and report extensive quantitative data that is intended to assist both banking entities and agencies in making this distinction.

The Volcker Rule does not apply to nonbank financial institutions that are designated as systemically important by the Financial Stability Oversight Council and, as a result, are subject to supervision by the Federal Reserve. However, Dodd-Frank requires the Federal Reserve to impose on such companies that engage in activities prohibited by the Volcker Rule additional capital requirements, quantitative limits, or other restrictions. The Proposed Rule does not address such restrictions, which the agencies believed would be premature in light of the fact that the Council has not designated any nonbank financial institution as systemically significant or even finalized the criteria for such designations.

B. THE PROHIBITION OF PROPRIETARY TRADING

The Proposed Rule defines proprietary trading to mean engaging in the purchase or sale of one or more covered financial positions as principal for the trading account of the banking entity. A "covered financial position" is defined as any long, short, synthetic or other position in a security, a derivative or a contract of sale of a commodity for future delivery. For this purpose, a "derivative" does not include transactions that have been excluded from the definition of swap by the Commodity Futures Trading Commission and the SEC, or identified banking products (as defined by statute).

1. Definition of Trading Account

The term "trading account" is defined in the Proposed Rule as any account used for taking covered financial positions for the purpose of: (i) short-term resale[2]; (ii) benefiting from short-term price movements; (iii) realizing short-term arbitrage profits[3]; or (iv) hedging one or more such positions. The term also includes any account used by a banking entity that is subject to the Market Risk Capital Rules to acquire a position that is subject to those rules, with certain exceptions. Finally, the term includes any account used by a banking entity that is a securities

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2 The explanation of the Proposed Rule states that this would include a derivative, commodity future or other position that, regardless of the term of that position, is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements.

3 This would include positions taken to benefit from varying prices in different markets, even if no price movements are required to achieve the benefit.

dealer, swap dealer or securities-based swap dealer to acquire or take a position in connection with its dealing activities.

The Proposed Rule excludes from the definition of trading account certain positions under repurchase and reverse repurchase agreements, securities lending transactions, positions taken for bona fide liquidity management purposes, and certain positions held by clearing agencies.

The definition of trading account repeatedly uses the phrase "short-term," without further defining that phrase. The agencies state in the rule that "the precise period of time that may be considered near-term or short-term for purposes of evaluating any particular covered financial position would depend on a variety of factors, including the facts and circumstances of the covered financial position's acquisition, the banking entity's trading and business strategies, and the nature of relevant markets."[4] However, the Proposed Rule includes a rebuttable presumption that an account is a trading account if it is used to take a position that is held for less than 60 days.

2. *Permitted Underwriting Activities*

The prohibition on proprietary trading excludes normal underwriting activities. The Proposed Rule makes it clear that this exemption includes private placements. In general, this exemption does not present difficult interpretive issues.

3. *Permitted Market Making Activities*

The prohibition on proprietary trading does not apply to market making. Perhaps the most difficult aspect of implementing the Volcker Rule is distinguishing permissible market making activities from proprietary trading. The agencies noted that: "Market making-related activities, like prohibited proprietary trading, sometimes require the taking of positions as principal, and the amount of principal risk that must be assumed by a market maker varies considerably by asset class and differing market conditions."[5]

The Proposed Rule attacks this issue from three directions. First, it sets forth a number of criteria that a banking entity must satisfy to demonstrate that it is engaged in bona fide market making activities rather than trading. Second, it includes as Appendix B to the Proposed Rule a commentary that discusses how the agencies will distinguish between market making and trading. Third, it requires banking entities that hold a significant amount of trading assets to collect and report detailed quantitative information that is intended to permit both the banking entity and the agencies to identify activities that may constitute proprietary trading.

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4 Proposed Rule, at 31.

5 Proposed Rule, at 53.

a. *Criteria for Market Making Activities*

The Proposed Rule sets forth seven criteria for permitted market making activities. The first criterion is that the banking entity must establish a compliance program in accordance with Subpart D to the Proposed Rule. Subpart D requires: (i) internal policies and procedures reasonably designed to document, describe, and monitor trading activities; (ii) a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Volcker Rule and to prevent the occurrence of activities and investments that are prohibited by the Volcker Rule; (iii) a management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule; (iv) independent testing of the effectiveness of the compliance program; (v) training for trading personnel and managers; and (vi) making and keeping records sufficient to demonstrate compliance.

The second criterion is that the trading desk or other organization unit within a banking entity that relies on the market making exception to take a covered position must actually make a market in that type of covered position by holding itself out as being willing to buy and sell the covered position on a regular and continuous basis. In liquid markets, whether a banking entity is holding itself out as making a market is not difficult to determine. In illiquid markets, the agencies acknowledge that providing quotes may be regular, but not continuous, and that transaction volumes and risk retention will be a function of customer liquidity and investment needs. Bona fide market making includes block positioning if it is for the purpose of intermediating customer trading.

The third criterion is that positions taken must be designed so as not to exceed the reasonably expected near-term demands of clients. The agencies stated that this expectation "should generally be based on the unique customer base of the banking entity's specific market making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation."[6] The agencies expect that the data that banking entities will be required to collect will be useful in assessing compliance with this criterion.

The fourth criterion is that the banking entity must be appropriately registered as a dealer (or a particular type of dealer) under applicable law.

The fifth criterion is that the revenues attributable to market making activities must be derived primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the covered positions held in connection with the market making activity.

The sixth criterion is that compensation of employees in the market making function must not be designed to encourage or reward proprietary risk-taking.

6 Proposed Rule, at 58.

The seventh criterion is that the market making activities must be consistent with the commentary provided in Appendix B to the Proposed Rule, which describes how agencies' will distinguish between permissible market making activities and impermissible proprietary trading.

b. Market Making Commentary

Due to differences in markets and in market conditions, the agencies were not able to embody the distinction between permissible market making activities and impermissible proprietary trading in a set of hard and fast rules. For this reason, the criteria described above are supplemented with a commentary that describes, in general terms, the difference between market making and proprietary trading, in terms of the purpose of the activity (intermediation rather than to earn profits as a result of price movements), the source of profitability (fees and commissions rather than price movements on covered positions), the volatility of profits (consistent profitability and low earnings volatility under normal market conditions), and the amount of transactions with non-customers (engaged in only to facilitate transactions with customers).

The commentary maps these differences to the following key factors: risk management; source of revenues; revenues relative to risk; customer facing activity; payment of fees; and compensation incentives. For each such factor, the commentary specifically describes what the agencies will look for in assessing whether the trading unit is engaged in proprietary trading and which of the quantitative measures that banking entities are required to collect the agencies consider relevant to the assessment of that factor. The agencies will consider not only the metrics provided by the trading unit, but those provided by other trading units within the banking entity and those provided by unaffiliated banking entities for the same type of covered position.

For example, in the case of risk management, the commentary states that where a trading unit retains risk in excess of the size and type required to provide intermediation services to customers, the agencies will consider the trading unit to be engaged in proprietary trading. In reaching this judgment, the agencies will consider the amount of risk that generally must be retained to make a market in the position in question, the hedging options that are available to the trading unit, the amount of risk retained by the trading unit in the past, and the risk retained and hedging policies of other trading units. In considering how current behavior compares to past behavior, the agencies will consider market-wide changes in risk and hedging options, as well as the existence of temporary market disruptions. The metrics that the agencies will use to assess the risk management factor are VaR and Stress VaR, VaR Exceedence, and Risk Factor Sensitivities.

The commentary proceeds through the other five factors in a similar fashion, citing the relevant considerations, the circumstances that will suggest impermissible proprietary trading, and the particular quantitative measures that the agencies consider relevant to assessing that factor.

c. Quantitative Reporting Requirements

Appendix A to the Proposed Rule sets forth reporting and recordkeeping requirements that must be complied with by banking entities that hold a significant amount of trading assets. A banking entity is subject to these requirements if its trading assets and liabilities at the end of each of the prior four quarters equal or exceed either $1 billion or 10% of its total assets. A more extensive set of requirements applies to any banking entity that has trading assets and liabilities at the end of each of the prior four quarters that equal or exceed $5 billion.

The quantitative measurements must be collected at the level of each "trading unit." The particular entity that is actually executing the transactions is a trading unit. If another entity oversees that unit and coordinates risk-management for multiple such units, that second entity would also be considered a trading unit and would be required to collect and report the quantitative measurements with respect to the first trading unit as well as other trading units for which it is responsible. The top tier entity in the banking organization, is also considered a trading unit. In this way the activity of the trading unit that is executing the transactions will be reflected in information collected and reported by a series of other trading units within the banking organization.

Appendix A then lists the specific quantitative measures that must be maintained (*e.g.*, Value-at-Risk, Stress VaR, VaR Exceedence), calculation periods, the frequency of required calculation and reporting, and recordkeeping requirements.

4. Permitted Hedging Activities

Another exception from the Volcker Rule prohibition on proprietary trading is risk-mitigating hedging activities. This exception also presents challenges to the agencies in distinguishing between hedging transactions that a banking entity enters into so as to manage or eliminate risks arising from related positions and hedging transactions that a banking entity enters into to benefit from price movements relating to the hedge position itself. As in the case of market making, the agencies are adopting a multifaceted approach to making such distinctions: a set of criteria that attempt to distinguish permissible from impermissible activities; the requirement that banking entities put a compliance program in place (including written hedging policies at the trading unit level and clearly articulated trader mandates); and the requirement to collect quantitative information relating to specific metrics.

The criteria that the Proposed Rule sets forth for engaging in risk-mitigating hedging activities include a requirement that hedging transactions mitigate one or more specific risks (including market risk, counterparty risk, currency risk, interest rate risk, basis risk and similar risks) arising in connection with or related to individual or aggregated positions of the banking entity. The banking entity also must be prepared to identify the specific risks being hedged and how the hedge reduces those risks. The hedging transaction may not itself give rise to significant exposures that are not themselves hedged in a contemporaneous transaction. The hedging transaction also must be subject to continuing review, monitoring and management after the hedge is established. Finally, the banking entity must document, at the time the hedge is established, the risk-mitigating purpose of the transaction.

5. Other Permitted Proprietary Trading Activities

a. Trading on Behalf of Customers

The Volcker Rule excludes from the prohibition on proprietary trading transactions entered into "on behalf of customers" without defining that phrase. The Proposed Rule specifies three types of transactions that meet this standard: (i) purchase or sale of a financial position in the capacity of an investment advisor or similar fiduciary where the customer is the beneficial owner of the position; (ii) riskless principal transactions; and (iii) trading for the separate account of insurance policyholders by a banking entity that is an insurance company.

b. Permitted Trading by a Regulated Insurance Company

The Volcker Rule includes an exception that permits a banking entity to purchase and sell a covered financial position if the banking entity is a regulated insurance company acting for its general account or an affiliate of an insurance company acting for the insurance company's general account, and the transaction is subject to, and in compliance with, the insurance company investment laws of the jurisdiction in which the insurance company operates.

The Proposed Rule includes this exemption. The Proposed Rule defines a "general account" as all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law. The Proposed Rule's treatment of this exemption generally appears to be noncontroversial.

One point that is not addressed by the Proposed Rule is whether the exemption extends to investments in private funds. The term "covered financial position" is certainly broad enough to cover an interest in a private fund. However, investments in private funds are not typically acquired with the intent to hold them only for the short term, so arguably such investments are simply not relevant to the ban on proprietary trading (or to the insurance company general account exemption from that ban). If that is the case, then it would appear that insurance companies would need a separate exemption from the Volcker Rule ban on banking entity investments in private funds. The Volcker Rule itself does not provide one; neither does the Proposed Rule regarding such investments (discussed below).

The agencies do not discuss this point in the Proposed Rule so it is difficult to say whether the result is intentional or simply an oversight. It should be noted that the Volcker Rule only applies to insurance companies that own or control a depository institution or that are foreign banking organizations with a U.S. branch or agency. In adopting capital rules for banking entities to implement the Collins Amendment, which (like the Volcker Rule) only applies to insurance companies that own a U.S. depository institution, the Federal Reserve disregarded comments from insurance companies that bank capital requirements are inappropriate for insurance companies in light of their very different business model. The treatment of insurance company investments in private funds may similarly reflect a view that, absent a statutory exemption, insurance companies that choose to own depository institutions must live with the same rules as other companies that own them.

c. Permitted Trading Outside of the United States

The general policy of the United States with respect to foreign banking organizations that engage in banking in the United States through a U.S. branch, agency or bank subsidiary is to generally subject their U.S. financial activities to the same restrictions as apply to U.S. banking organizations, while not restricting the foreign banking organizations' non-U.S. activities. Section 4(c)(9) of the BHC Act provides the Federal Reserve with the authority to implement that policy by exempting from the BHC Act activities of foreign banking organizations where such an exemption is consistent with the purposes of the BHC Act and in the public interest. This authority has been used, for example, to exempt from the restrictions of the BHC Act the non-U.S. activities of foreign banking organizations. In order to be eligible for these exemptions, the foreign bank must be a "qualified foreign banking organization" (a "QFBO"). The QFBO test, which is based on assets, revenue and net income, is intended to ensure that the exemptions are only available to a foreign banking organization that it is primarily a bank (its non-U.S. banking business exceeds its worldwide nonbanking business) and the banking business of which is primarily foreign (its non-U.S. banking business exceeds its U.S. banking business).

Prior to Dodd-Frank, foreign companies that owned depository institutions that are not "banks" for purposes of the BHC Act (such as thrifts, credit card banks, and industrial loan companies) were not subject to the BHC Act. Such foreign companies come within the definition of "banking entity" in the Volcker Rule and are generally subject to its restrictions. Such companies may not be engaged in banking (other than holding a U.S. depository institution) and, if that is the case, will not qualify as QFBOs. The Proposed Rule nevertheless allows such foreign banking entities to rely upon the same exemption from the Volcker Rule as QFBOs to engage in proprietary trading outside the United States provided that, by certain measures of assets, revenues and net income, the foreign company's non-U.S. business is larger than its U.S. business.

The exemption from the Volcker Rule for proprietary trading that occurs solely outside the United States is only available to QFBOs and foreign companies that conduct a majority of their business outside the United States. In addition, a transaction will be considered to have occurred solely outside of the United States and exempt from the ban on proprietary trading only if four conditions are met. The first condition is that the transaction is conducted by a banking entity that is not organized under the laws of the United States. Because any entity that controls a company is deemed to be engaged in the activities of that company, this means that not only must the banking entity that engages in the transaction be foreign, but that each entity that controls the banking entity must also be foreign. For example, a QFBO could not rely on this exemption for activity conducted by a subsidiary that is organized under U.S. law.

The second condition is that no party to the transaction may be a resident of the United States. This is a very strict interpretation of Section 4(c)(9). In general, for purposes of Section 4(c)(9), an activity is considered to be engaged in within the United States only if it is conducted through a U.S. office or subsidiary. The requirement of the Proposed Rule that no party to the transaction may be a resident of the United States means that, for example, a foreign bank that has a trading operation outside the United States, and that has no trading personnel in the United States, is engaged in prohibited proprietary trading in the United States if in the course of that activity it purchases a security on an exchange or from an individual located in the United States. In light of this condition, the remaining two conditions (that no personnel of the foreign bank that is directly involved in the transaction be located in the United States and that the transaction is executed wholly outside the United States) may be superfluous.

The term "resident of the United States" is defined to include:

> (i) any natural person resident in the United States; (ii) any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State; (iii) any estate of which any executor or administrator is a resident of the United States; (iv) any trust of which any trustee, beneficiary or, if the trust is revocable, settlor is a resident of the United States; (v) any agency or branch of a foreign entity located in the United States; (vi) any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the United States; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a resident of the United States; or (viii) any partnership or corporation organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States principally for the purpose of engaging in one or more transactions described in . . . the Proposed Rule.[7]

d. Limitations on Permitted Proprietary Trading Activities

Proprietary trading that is generally permitted by the Proposed Rule, such as permissible underwriting and market making activities and risk-mitigating hedging activities, nevertheless is impermissible if it involves a material conflict of interest between the banking entity and its customers or counterparties, results in a material exposure by the banking entity to a high-risk asset or poses a threat to the safety and soundness of the banking entity or the financial stability of the United States.

7 Proposed Rule, at 80.

The Propose Rule states that the mere fact that a buyer and seller are on opposite sides of a transaction does not, considered alone, amount to a material conflict of interest of the type that the Volcker Rule was intended to address.

Where a material conflict of interest does exist, it can be addressed by the banking entity through "clear, timely, and effective disclosure of the conflict"[8]. The Proposed Rule provides additional detail on this way of dealing with conflicts of interest. In many cases, banking entities use information barriers to prevent a material conflict of interest from having an adverse effect on a client or counterparty. The Proposed Rule generally accepts information barriers as a way of addressing potential conflicts of interest. However, if, notwithstanding such information barriers, the banking entity "knows or should reasonably know" that a material conflict of interest may have a material adverse effect upon a client or counterparty, it may not rely on such information barriers alone. In such cases, timely and effective disclosure of the conflict may also be required.

Otherwise permissible trading activities are also impermissible if they results in a material exposure by the banking entity to a high-risk asset or involve a high-risk trading strategy, which are defined in the Proposed Rule as assets or strategies that significantly increase the likelihood that the banking entity would incur a substantial loss or would fail. Other than noting that assets or strategies with significant embedded leverage might be high risk, it appears that, at least for now, the agencies will look to the banking entities, which are required to address high-risk assets and high-risk strategies in their compliance programs, to define what those terms mean.

C. THE PROHIBITION ON INVESTING IN AND SPONSORING PRIVATE FUNDS

The Proposed Rule implements this prohibition by generally prohibiting a "banking entity," "as principal," from directly or indirectly, acquiring or retaining an equity, partnership or other "ownership interest" in, or acting as "sponsor" to, a "covered fund." These terms are critical to understanding the Proposed Rule and are discussed below.

1. "Banking Entity"

The definition of "banking entity" closely tracks the language of Dodd-Frank. A banking entity includes: (i) any insured depository institution; (ii) any company that controls an insured depository institution (*i.e.*, bank and thrift holding companies, but also any company that directly or indirectly controls a "nonbank bank," such as a credit card bank or industrial loan company); and (iii) any company that is treated as a banking holding company under the International Banking Act of 1978 (*i.e.*, foreign banks that have a U.S. branch, agency or commercial lending subsidiary).

Although the term banking entity is defined to include any affiliate or subsidiary of such banking entities, the Proposed Rule carves out any affiliate or subsidiary of a banking entity

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[8] Proposed Rule, at 105.

that is a "covered fund" for purposes of the Volcker Rule or an entity controlled by such covered fund. This exclusion has a number of ramifications. For example, it was clearly contemplated that banking entities would be permitted to control certain private funds and that those entities would in turn invest in private funds, in a "fund of funds" structure or otherwise. Had the definition of banking entity included covered funds controlled by a banking entity, such structures would have been impermissible. Another effect (discussed below) is to exclude portfolio companies of a covered fund from the prohibition on transactions between a banking entity and a covered fund.

2. *"Covered Fund"*

The Volcker Rule, as adopted by Congress, applies to sponsorships of and investments in a "private equity fund," "hedge fund" or "such similar funds" as the appropriate federal banking and other financial agencies may determine by rule. The Volcker Rule defines a private equity fund and a hedge fund synonymously as any issuer that would be an investment company but for the exemptions provided by Section 3(c)(1) (funds with 100 or fewer holders) or 3(c)(7) (funds sold only to "qualified purchasers") of the Investment Company Act of 1940. The Proposed Rule defines such funds, and similar funds that the agencies may define by rule, as "covered funds."

The agencies make clear in the Proposed Rule that an issuer will not be considered a covered fund if it meets the standards for an exemption from the definition of an "investment company" under the Investment Company Act other than the Section 3(c)(1) or 3(c)(7) exemptions, even if it also meets and has relied upon Section 3(c)(1) or 3(c)(7).

Since the enactment of Dodd-Frank and the Financial Stability Oversight Council's study on the Volcker Rule that was issued on January 18, 2011, there has been uncertainty as to what the agencies might include within the "such similar funds" bucket. In the Proposed Rule, two types of funds have been so designated:

- *Commodity Pools*—a commodity pool, as defined in the Commodity Exchange Act, and
- *"Foreign Equivalents" of Covered Funds*—funds that are organized or offered outside the United States that, if organized or offered within the United States, would be covered funds but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

The proposal explains that these entities will be treated as covered funds because they are generally managed and structured similar to a covered fund, except that they are generally not subject to federal securities laws due to the types of instruments in which they invest or the fact that they are not organized in the United States.

It is not clear how the foreign equivalent fund provision will be implemented inasmuch as such funds may be similar to U.S. private funds without precisely fitting the Section 3(c)(1) or 3(c)(7) exemption. The agencies may find it necessary to define such foreign equivalents in terms of structural characteristics, such as the number and type of investors. It should be clear that foreign mutual funds are not equivalent to covered funds. Also, to the extent that foreign funds are sponsored and sold by QFBOs solely outside the United States, they will be exempt from the Volcker Rule even if they are foreign equivalents of covered funds.

The proposal recognizes that certain entities and corporate structures could technically fall within the definition of a covered fund, even though they would not usually be thought of as a private equity fund or hedge fund. Accordingly, the following entities are effectively excluded from the definition of a covered fund:

- *Joint Ventures*—joint ventures that are operating companies and do not engage in any activity prohibited under the Volcker Rule.
- *Acquisition vehicles*—an acquisition vehicle whose sole purpose and effect is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates.
- *Certain wholly-owned subsidiaries*—wholly-owned subsidiaries of a banking entity that are principally engaged in performing bona fide liquidity management activities and are carried on the balance sheet of the banking entity.
- *Loan securitization vehicles*—certain issuers of asset-backed securities in the securitization context.

These exceptions are very narrow. It is not clear that joint ventures that are operating companies and wholly-owned subsidiaries of banking entities would come within the investment company definition in the first place. As suggested by one of the questions on which the agencies seek comment, in excluding entities that the Volcker Rule was not intended to cover, it would be more helpful for the Proposed Rule to cite the characteristics of a private fund that might involve the conflict of interest concerns that gave rise to the Volcker Rule.

3. "As Principal"

The general prohibition on a banking entity investing in covered funds applies only when the banking entity is investing "as principal," either directly or indirectly. The Proposed Rule states that the prohibition on investing or retaining an ownership interest (including a general partner or membership interest) in a covered fund does *not* apply to investments made: (i) by a banking entity's director or officer who acquires ownership interests in his or her personal capacity and who is directly engaged in providing "advisory or other services" to the covered fund, provided that such person does not use funds borrowed from the banking entity to make the investment; (ii) by a banking entity acting in good faith in a fiduciary capacity or in its capacity as a custodian, broker or agent for an unaffiliated third party; and (iii) by a qualified employee benefits plan under ERISA.[9]

This language in the Proposed Rule relates to investments in covered funds as a general matter. In that regard, item (i) appears to be incorrectly worded: an investment by a director or officer

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[9] Proposed Rule, at 113.

in a fund should not be considered an investment by the banking entity, regardless of whether or not the person is directly engaged in providing "advisory or other services" to the covered fund. The language appears to confuse the general analysis of when a banking entity is investing as principal, with the rules that apply to a particular exemption for covered funds that are sponsored by banking entities and in which they have a de minimis investment. One of the conditions to that exemption (discussed below) is that directors and employees, other than directors and employees who are directly engaged in providing "advisory or other services" to the covered fund, may not invest in the fund.

4. "Ownership Interest"

An "ownership interest" in a covered fund is defined broadly to include any equity, partnership or "other similar interest" in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. This would include, without limitation, shares, equity securities, warrants, options, general partnership interests, limited partnership interests and membership interests.

The proposal makes clear that substance, not form, will be what matters. In this regard, the focus will be on the attributes of an ownership interest and, specifically, whether it provides a banking entity with economic exposure to the profits and losses of the covered fund. For example, if a debt instrument exhibits substantially the same characteristics as an equity instrument (*e.g.*, voting rights; the right or ability to share in the fund's profits or losses; the ability to earn a return, either directly by contract or through a synthetic interest, based on the performance of the fund's underlying holdings or investments), then the agencies may treat it as an ownership interest for purposes of the Volcker Rule.

"Carried interest" received by a banking entity as compensation for serving as an investment manager or investment advisor to a covered fund will not be considered an ownership interest in such fund provided that: (i) the sole purpose of the interest is to provide performance compensation for services provided to the fund; (ii) the carried interest is distributed to the banking entity (or if temporarily reinvested in the fund, the banking entity does not share in the profits or losses related to such reinvestment); (iii) the banking entity provides no funds in connection with acquiring or retaining this interest and (iv) the interest is not generally transferrable by the banking entity.

5. "Sponsor"

The definition of sponsorship under the Proposed Rule is the same as the definition provided by the statute. An entity will be the "sponsor" of a covered fund if it: (i) serves as its general partner, managing member, trustee (unless such trustee does not exercise investment discretion) or commodity pool operator; (ii) in any manner, selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or (iii) shares with a covered fund the same name or a variation of the same name for corporate, marketing, promotional or other purposes.

D. THE MAIN EXEMPTIONS

There are a number of exemptions from the Volcker Rule's general prohibition on banking entities sponsoring or investing in covered funds. The main exemptions are discussed below, but there are also a number of exemptions, including those for investing in funds qualifying as "small business investment companies" and community reinvestment-related funds, bank owned life insurance (BOLI), and funds for which an ownership interest has been acquired in the ordinary course of collecting a debt previously contracted.

1. The Sponsored Funds Exemption

Perhaps the most important aspect of the Proposed Rule as it relates to private funds is the treatment of funds sponsored by a banking entity in which the banking entity has a small investment. The statutory language requires that such a fund be 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." This language could have been interpreted to mean that such a fund could only be sold to persons who had a significant pre-existing relationship to the banking entity as a trust, fiduciary or investment advisory client, in which case this exemption would have been of little use to most banking entities, preventing them from sponsoring funds going forward. Instead, the agencies drafted the Proposed Rule so that banking entities will be permitted to sponsor funds in the future, provided that this activity is primarily a way to offer investment management services rather than as a way of making proprietary investments in funds.

a. Bona Fide Trust, Fiduciary, or Investment Advisory Service to Customers

The Proposed Rule interprets generously the statutory requirement that the fund be 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." First, it does not interpret the language to mean that the fund may only be offered to pre-existing customers of the banking entity's bona fide trust, fiduciary, or investment advisory services. No pre-existing relationship is required. Second, the Proposed Rule does not require that any services be offered directly to the customer. The services needs only be provided to the fund, and indirectly to the customer as an investor on the fund. Third, the agencies note that banking entities provide trust, fiduciary, investment advisory or commodity trading advisory services in a variety of different ways and state that the exemption does not require that such services be offered in any particular way to such a fund.

Although the agencies' interpretation of this statutory language is somewhat generous, it is consistent with the agencies' overall view of the purpose of the Volcker Rule: it was intended to restrict proprietary investments, but was not intended to interfere with client-oriented activities of banking entities.

b. Investment Limitations

A banking entity that makes or retains an investment under this exemption must comply with specified investment limitations.

(A) Per Fund Limitation

An investment in a single fund held pursuant to this exemption may not exceed 3% of the total amount *or* value of outstanding ownership interests of such fund at any time after one year from the date of the fund's establishment.

For this purpose, a banking entity is required to include investments in the covered fund that are made by any entity that the banking entity controls, and the pro rata share of investments in the covered fund by any entity in which the banking entity has an investment that is non-controlling but that constitutes more than 5% of the voting shares of the entity.[10] The banking entity is not required to include investments made by directors and employees (who are permitted to invest provided that they are directly engaged in providing investment advisory or other services to the covered fund), as long as the banking entity has not funded such investments or guaranteed them against loss.

Co-investments alongside of a fund will be treated as an investment by the banking entity in the fund itself (and, accordingly, counted toward the 3% per-fund limitation) if such co-investments arise from a contractual obligation or if the banking entity is found to be acting in concert toward a common goal of investing in a fund that it organized or offered. This restriction would prevent a banking entity from sponsoring a fund and effectively holding a greater than 3% interest in the fund by co-investing alongside the fund each time it makes an investment. Similarly, it would prevent a banking entity from evading the prohibition on investing in third-party funds by entering into a formal or informal agreement with such a fund to invest lock step alongside the fund. We expect that the agencies will recharacterize co-investments as investments in a fund only where there is an actual agreement or a pattern of co-investing that suggests an agreement. It seems unlikely that a merchant banking investment by a banking entity in a portfolio company would be recharacterized as an investment in a fund merely because both the banking entity and an unrelated fund invested in the same company.

The calculation of the 3% limit is based on investments made and ownership interests held, without regard to committed funds not yet called for investment. The banking entity must calculate its investment in the same manner and according to the same standards utilized by the fund itself. The banking entity may not hold more than 3% of the value of all the investments made in the fund (*i.e.*, the value of its investments in the fund, divided by the value of the investments made by all other investors in that fund), 3% of the ownership interests issued by the fund (*i.e.*, the number of ownership interests held in the fund divided by the total number of ownership interests held by all persons in that fund), or be subject to more than 3% of the losses of the fund.

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10 Proposed Rule, at 238.

The agencies will expect a banking entity to calculate its per-fund limitation whenever the fund performs such calculation or issues or redeems interests, but in any event no less frequently than quarterly.

(B) Aggregate Tier 1 Capital Limitation; Deduction from Capital

With respect to all covered funds that a banking entity invests in pursuant to this advised fund exemption, the aggregate ownership interest must not exceed 3% of the banking entity's Tier 1 capital, as calculated on a quarterly basis. For the purposes of this test, the valuation of a banking entity's investments is based on applicable accounting standards.

For certain banking entities, such as thrift holding companies or holding companies for industrial loan companies, which do not calculate and report Tier 1 capital in accordance with regulatory capital standards, the Proposed Rule requires that such entities rely on the total amount of shareholders' equity of the top-tier entity within such organization.

The Proposed Rule also requires that investments in advised covered funds be deducted from Tier 1 capital. The statute provided that such deduction increase commensurate with the leverage of the fund. The Proposed Rule does not include such a requirement, but the questions posed in the rule request comment on whether and how the rule should be modified to include such a requirement. The questions suggest an approach in which only investments in highly leveraged funds would be fully deducted from Tier 1 capital.[11]

c. No Guarantees or Name Sharing; Required Disclosures

The Proposed Rule implements the prohibition on a banking entity guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which the first covered fund invests. Also prohibited is any sharing of the same name, or a variation of the same name, by the covered fund with the banking entity for corporate, marketing, promotional or other purposes. The covered fund is not permitted to use the word "bank" in its name. For the exemption to apply, the banking entity must also make certain disclosures to prospective and actual investors regarding, among other things, the role of the banking entity (including its affiliates, subsidiaries and employees) in sponsoring or providing services to the covered fund and that any losses in the fund are to borne solely by investors.

d. Limitations on Ownership by Directors and Employees

A banking entity's directors and employees are prohibited from acquiring or retaining an ownership interest in a covered fund that relies upon this exemption, except for any director or employee who is directly engaged in providing investment advisory or other services to the covered fund. The agencies appear to recognize that allowing certain directors and employees to acquire or retain an ownership in a covered fund is consistent with industry practice in that

[11] Proposed Rule, at 137 (Question 269).

fund customers and clients often request that such individuals have "skin in the game" with respect to the fund they manage or advise. To address concerns that director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the per-fund and aggregate investment limits, the Proposed Rule generally attributes an ownership interest in a covered fund to the employing banking entity if the banking entity either extends credit for the director or employee to acquire an ownership interest or guarantees the director or employee against loss on the investment.

e. Affiliate Transaction Restrictions

As discussed more fully below, the Proposed Rule requires that the banking entity comply with the limitations on certain relationships with covered funds.

2. Offshore Exemption Applicable to Foreign Banks

As discussed above in the context of proprietary trading, the Volcker Rule applies to a foreign banking organization that is subject to the BHC Act by virtue of having a branch, agency or bank subsidiary in the United States. Such foreign banks, provided that they meet the QFBO test, may engage in activities deemed to occur outside the United States without regard to the Volcker Rule or the other restrictions of the BHC Act. Regulation K generally provides that an activity is deemed to be engaged in within the United States if it is conducted through a U.S. office or subsidiary of a foreign banking organization. The Volcker Rule provides much more restrictive requirements that must be met in order for proprietary trading (discussed above) and sponsoring and investing in private funds to be considered outside the United States.

The Volcker Rule also applies to a foreign company that directly or indirectly controls an insured depository institution that is not a "bank" for purposes of the BHC Act, such as a thrift, credit card bank or a industrial loan company. Such a foreign company may not be a foreign banking organization or satisfy the QFBO test. The Proposed Rule makes available to such companies, provided that they are organized under foreign law and the majority of their business is foreign, the same exemptions from the Volcker Rule that are available to QFBOs.

Under the Proposed Rule, a covered fund investment or sponsorship will be considered to have occurred solely outside of the United States only if the following conditions are satisfied:

- the banking entity making the investment or engaging in sponsorship activities is not organized under U.S. law (as explained above);
- no subsidiary, affiliate or employee of the banking entity *that is "involved" in the offer or sale of an ownership interest in the covered fund* is incorporated or physically located in the United States; and
- no ownership interest in the covered fund is offered for sale or sold to a U.S. resident.

Importantly, the exemption is not dependent on the location of the assets in which the fund invests, the location of the investment manager for those assets, or (except as noted below) the jurisdiction in which the fund is organized. All of those things may occur in the United States.

Therefore, a U.S. private fund that is not itself a banking entity, may sponsor a fund that is sold to foreign banking entities as long as the fund is offered and sold solely to non-U.S. residents and the individuals and entities of the foreign banking entity that are involved in the investment are incorporated and physically located outside the United States.

In anticipation of the Proposed Rule, private equity groups have considered whether this exemption could be satisfied by a parallel fund structure in which one fund would be offered to U.S. investors, a second fund would be offered and sold solely to non-U.S. investors, and the two funds would invest in lock step and be managed by a single private equity group. Such a structure would be consistent with the language of the Proposed Rule, although the more closely such funds are managed in parallel the more risk there will be that the agencies regard them as a single fund.

In a case in which a foreign banking entity itself wishes to sponsor a fund to be offered and sold to non-U.S. residents, it would appear that the fund would need to be organized under non-U.S. law because it would be viewed as an affiliate of the foreign banking entity and the exemption requires that no affiliate of the banking entity that is "involved" in the offer or sale of an ownership interest in the covered fund is incorporated in the United States.

3. Hedging-Related Exemption

The Proposed Rule provides an exemption for a banking entity having an ownership interest in a covered fund in order to reduce specific risks arising in connection with two situations: (i) where the banking entity acts as intermediary on behalf of a non-banking entity customer to facilitate the exposure by the customer to the profits and losses of the covered fund; and (ii) where the banking entity provides an employee with incentive-based compensation directly tied to the performance of a particular covered fund, provided that the employee "directly provides investment advisory or other services" to such fund. A banking entity could only rely on this exemption to hedge obligations or liabilities that flow from these two situations. However, even with respect to these two situations, the scope of this exemption is intended to be narrow. Among other things, the Proposed Rule requires a close match between the reference asset and the hedge. That is, the acquisition or retention of an interest in a covered fund must hedge a "substantially similar offsetting exposure" to the same covered fund and in the same amount of ownership interests in that covered fund. The agencies will also require documentation at the time the hedging transaction is effected, not afterwards, that identifies the specific risks the transaction is designed to reduce. Also, the acquisition or retention of an interest in a covered fund, as a hedge, may not give rise to significant exposures that were not already present at the time of the transaction.

E. RESTRICTIONS ON TRANSACTIONS WITH ADVISED COVERED FUNDS

Consistent with the Volcker Rule, the Proposed Rule flatly prohibits a banking entity that serves as an investment manager, advisor or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to an exemption), including any of the banking entity's affiliates, from entering into any "covered transaction" with the covered fund or any covered fund that is controlled by the first-tier covered fund.

The term "covered transaction" comes from Section 23A of the Federal Reserve Act and includes loans, extensions of credit, purchases of assets and affiliate securities, issuances of guarantees by an insured depository institution and credit exposures from derivatives transactions. Unlike Section 23A, which permits covered transactions between a bank and its affiliate so long as such transactions meet specified quantitative and other requirements, the Volcker Rule prohibits such covered transactions outright. Accordingly, none of the exemptions contained in Section 23A and the Federal Reserve's Regulation W are incorporated into the Proposed Rule.

Importantly, the prohibition on covered transactions does not extend to a covered fund's transactions with other covered funds in which it invests, nor does it extend to transactions between a banking entity and portfolio companies of a covered fund. The prohibition also does not apply to prime brokerage transactions (*e.g.*, custody, clearance, securities borrowing or lending services, trade execution or financing, data, operational and portfolio management support) with a covered fund, subject to certain conditions. Investments and ownership interests in covered funds expressly permitted by the Volcker Rule (for example, the acquisition of up to 3% of a sponsored fund's total ownership) are also not prohibited, even though they might otherwise fall within the boundaries of Section 23A.

The Proposed Rule also implements the requirement that all transactions between a covered fund and a banking entity that serves as its investment manager, advisor or sponsor (or that organizes and offers such covered fund pursuant to an exemption) satisfy the qualitative standard set forth in Section 23B of the Federal Reserve Act. Section 23B generally provides that transactions between a bank and an affiliate be on "market" terms and under circumstances that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies broadly to most commercial transactions with an affiliate, including prime brokerage transactions with a covered fund and any transaction in which an affiliate is receiving a fee for providing services.

F. COMPLIANCE MATTERS

Under the Proposed Rule, banking entities engaged in proprietary trading or covered fund activities and investments will need to establish a compliance program "reasonably designed" to ensure and monitor compliance with the Volcker Rule and related regulations. The compliance program must be appropriate for the size, scope and complexity of the banking entity's activities and business structure. At a minimum, the compliance program must comprise the following elements: (i) written policies and procedures designed to document, describe and monitor proprietary trading and covered fund activities and investments; (ii) internal controls to monitor and identify potential areas of noncompliance; (iii) a management framework that delineates responsibility and accountability for compliance; (iv) independent testing of effectiveness; (v) training; and (vi) recordkeeping. For a banking entity with significant proprietary trading or covered fund investments and activities (*i.e.*, if it has, together with its affiliates and subsidiaries, trading assets and liabilities of at least $1 billion or 10% of total assets, or aggregate investments in or sponsorships of covered funds of at least $1 billion), the Proposed Rule specifies a variety of minimum standards for each element of the compliance program.

As proposed, banking entities must develop and implement a compliance program by July 21, 2012, even though any prohibited activities and investments are not required to be conformed to comply with the Volcker Rule by that date.

G. THE CONFORMANCE PERIOD AND THE BAN ON "NEW" INVESTMENTS

The Proposed Rule specifies that the effective date for the Volcker Rule is July 21, 2012. After this date, banking entities are expected to fully conform their investments and activities within a two-year conformance period that lasts until July 21, 2014. The Federal Reserve has the ability to extend this period, upon a request by a banking entity, in accordance with the final rule it issued on February 14, 2011 (the "Conformance Rule").[12] The Proposed Rule incorporates the Conformance Rule, but makes minor technical and conforming edits to account for changes related to the definition of "banking entity" and the new "covered fund" definition, among other things.

Significantly, the preamble to the Proposed Rule states that the Conformance Rule "does *not* authorize a banking entity to engage in *new* or *additional* prohibited activities or investments" during the two-year conformance period. As applied to particular activities and investments, this interpretation does not appear to be consistent with the plain language of the Volcker Rule. On the other hand, it does seem to be a reasonable interpretation to regard this two year period as one in which banking entities should be winding down their impermissible activities rather than ramping them up. We would not expect that the agencies would prevent a banking entity from completing an acquisition during this conformance period that included some activities and investments that will be prohibited by the Proposed Rule, provided that the banking entity has a plan for achieving compliance within a reasonable period. Any such transaction should be discussed with the agencies in advance.

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The issuance of the Proposed Rule marks an important milestone for implementation of the Volcker Rule. While the final rule adopted by the agencies in 2012 will no doubt differ from the Proposed Rule in some respects, it is clear that implementation of the Volcker Rule will have significant implications for banking entities and private funds.

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12 *See* "Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 76 Fed. Reg. 8265 (Feb. 14, 2011). For background regarding the Conformance Rule, please see our memorandum, titled "Reflections on Dodd-Frank: A Look Back and a Look Forward," dated July 21, 2011, at 37-43, *available at* http://www.simpsonthacher.com/content/Publications/pub1248.pdf.

For more information about the Proposed Rule and its potential implications, as well as how comments may be submitted to the agencies, please contact any of the members of our Financial Institutions or Private Funds groups, as listed below.

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