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Volcker Unveiled – Some Answers, More Questions

BY THE GLOBAL BANKING AND PAYMENT SYSTEMS GROUP

On December 10, 2013, the three federal banking agencies, the Federal Reserve Board ("FRB"), Federal Deposit Insurance Corporation ("FDIC"), and Office of the Comptroller of the Currency ("OCC"), joined the Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies") in issuing a final rule ("Final Rule") implementing the so-called "Volcker Rule" under Section 619 of the Dodd-Frank Act.[1] The Volcker Rule generally prohibits two activities of banking entities: (i) engaging in proprietary trading; and (ii) owning, sponsoring, or having certain relationships with a hedge fund or private equity fund.

In developing the Final Rule, the Agencies faced the daunting task of implementing a broad, proscriptive law that had the potential to destabilize the U.S. and global securities and capital markets if not skillfully implemented. Since issuing the proposed rule ("Proposed Rule")[2] over two years ago, the Agencies received over 18,000 comments addressing a wide variety of issues, including definitions, exemptions for market-making activities, risk-mitigating hedging activities, covered fund activities and investments, the use of quantitative metrics, and compliance and reporting requirements. This synopsis highlights the general contours of the Final Rule, including new developments, and is intended as a general overview of how the Final Rule implements the Volcker Rule's restrictions on the ability of a bank to engage in proprietary trading and invest in hedge funds and private equity funds.

This is the first in a series of client alerts that will be issued by Paul Hastings over the upcoming weeks exploring various aspects, issues, and challenges presented to banks by the Final Rule. This alert presents initial observations about some of the most significant aspects of the Final Rule and some of the important themes and issues it addresses.

What is New?

The following are preliminary observations on new aspects of the Final Rule as compared to the Proposed Rule:

Developments on the Proprietary Trading Prohibition

- ***Market-Making Activities***. The Final Rule implements the statutory exemption to permit market-making related activities, but imposes requirements to preclude prohibited proprietary trading disguised as permitted market-making activities. Accordingly, the Final Rule requires that market-making activities be *genuinely client-facing* and designed not to

exceed the *reasonably expected near-term demands of clients, customers, or counterparties.* While market-making requires that a banking entity be ready to purchase or sell financial instruments for its own account, the Final Rule requires that market-makers hold only *commercially reasonable amounts* of securities and other financial instruments in their trading account to satisfy anticipated demands through market cycles. Similarly, a market-maker's inventory must be designed not to exceed the *reasonably expected near-term demands of clients, customers, or counterparties*, which must be based upon an analysis of historical and projected customer demand, based on the liquidity, maturity, and depth of the market for the subject financial instrument.

- ***Underwriting Activities***. The Final Rule implements the statutory exemption to permit securities underwriting activities, but imposes requirements to preclude prohibited proprietary trading disguised as underwriting. Specifically, like the parameters for the market-making exemption, underwriting must be *genuinely client-facing* and designed not to *exceed the reasonably expected near-term demands of clients, customers, and counterparties*.

- ***Hedging***. While the Final Rule addresses many of the questions and issues raised in the Proposed Rule, it appears to have taken a distinctly more aggressive position with respect to certain issues. For example, the Proposed Rule invited comment on seven required criteria that would have to be established for a covered banking entity to avail itself of the risk-mitigating hedging exemption for the restriction on proprietary trading; however, the Final Rule jettisons that approach in favor of a significantly "amped up" restriction on portfolio hedging activities. In effect, while attempting to preserve the statutory hedging exemption, the Agencies may have created a significant compliance burden for banks to demonstrate that they are not engaging in proprietary trading through their hedging activities. As with most parts of the Final Rule, how the Agencies implement the hedging exemption will ultimately determine the impact of the compliance burden.

- ***Trading in Foreign Government Debt Obligations***. The Final Rule also veered away from the Proposed Rule, albeit not sharply, with respect to the treatment of trading in foreign government obligations. Reacting to strong policy criticism levied by a number of foreign governments on the treatment of foreign sovereign debt relative to U.S. Treasuries under the Proposed Rule, the Agencies implemented a "limited exemption" to the ban on proprietary trading in foreign government debt obligations. The exemption allows a foreign banking entity operating in the U.S. to engage in proprietary trading in the U.S. in the debt obligations of (and instruments issued or guaranteed by) its home country, as well as political subdivisions of the home country. The exemption also extends to debt issued by a multinational central bank in which the foreign banking entity's home country is a member. The exemption is not available, however, to a foreign banking entity operating as an insured depository institution.

- ***Certain Trading Activities of Foreign Banking Entities***. The Final Rule mirrored the Proposed Rule with respect to foreign banking entities eligible for the Volcker Rule foreign trading exemption (the banking entity may not be "directly or indirectly" controlled by a U.S. banking entity). However, the Agencies modified their approach in the Final Rule with respect to the broad U.S. nexus provision that operated to disqualify the availability of the exemption for many foreign banks. Rather than retaining the Proposed Rule's approach requiring the absence of any U.S. person/party or U.S. geographic nexus for a transaction to

be exempt, the Agencies opted for an approach that ensures that the principal risks of proprietary trading by foreign banking entities remain solely outside the U.S. In doing so, the Final Rule imposes numerous conditions intended to insulate the exposure of the U.S. financial system to such risks, including that the foreign banking entity and its trade personnel cannot be located in the U.S., requirements that ensure the principal risk is borne by an entity outside the U.S., and the transaction cannot be conducted with or through any U.S. entity other than the foreign operations of a U.S. entity, or in connection with certain cleared transactions with an unaffiliated market intermediary.

- ***Compensation Arrangements for Traders***. The Final Rule requires that, for purposes of the availability of the market-making exemption, compensation arrangements for traders should be structured to avoid incentivizing or rewarding prohibited proprietary trading. The Agencies note that the Final Rule does not prohibit compensation for successful market-making, which involves some risk-taking. Banks relying on the market-making exemption, however, should provide trader compensation incentives that primarily reward customer revenues and customer service, rather than prohibited proprietary trading. As noted in the preamble to the Final Rule, "a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a position held in inventory, rather than use of that inventory to successfully provide effective and timely intermediation and liquidity services to customers, [is] inconsistent with permitted [market-making] activities."[3]

Developments on the Covered Fund Prohibitions

- ***Definition of "Covered Fund" Narrowed***. The Final Rule tailors the broad definition of "covered fund" from the Proposed Rule to focus on the business activities of entities rather than just their corporate form. Specifically, the Final Rule seeks to limit the definition of "covered fund" to those entities formed to invest in or trade in securities or derivatives and that are typically only offered to institutional investors and high net-worth individuals.[4] The Final Rule includes the statutory requirement, as reflected in the Proposed Rule, that a "covered fund" include issuers that would be investment companies but for Sections 3(c)(1) and 3(c)(7) of the Investment Company Act ("ICA").[5] However, as requested by many commenters, the Final Rule exempts entities that may rely on the Section 3(c)(1) or 3(c)(7) exemption but are not engaged in the types of activities that the Volcker Rule is designed to address. These exempted entities include foreign public funds, wholly-owned subsidiaries, acquisition vehicles, registered investment companies, joint ventures that do not invest money for others, and certain types of loan securitization vehicles and asset-backed commercial paper issuers.[6]

- ***Clarification of the "Sponsor" Role***. The term "sponsor" is a key definition defining, in part, the scope of activities to which the Volcker Rule's covered fund restrictions apply. Serving as a "sponsor" to a covered fund is also relevant to the determination of whether the so-called "Super 23A" restriction applies.[7] The Final Rule generally retains the definition of "sponsor" as provided in the statute and the Proposed Rule.[8] However, with respect to the act of selecting or controlling a majority of the directors, trustees, or management of a covered fund that would trigger the definition of "sponsor," the preamble to the Final Rule clarifies that "a banking entity that does not continue to select or control a majority of the board of directors would not be considered to be a sponsor under this part of the definition once that role or control terminates."[9] Therefore, in the case of a covered fund that will have a self-perpetuating board of directors or a board selected by the fund's shareholders, such

termination of a banking entity's role as "sponsor" would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity. This clarification is particularly helpful for a banking entity that may be viewed as an initial sponsor of a covered fund by selecting the initial directors, trustees, or management of a covered fund, but can later disassociate itself from such role once it no longer has such responsibility.

- ***Exemptions for Asset-Backed Securitization Activities***. The Final Rule includes key exemptions for certain securitization vehicles that would otherwise be subject to many of the restrictions on covered fund activities. Under a statutory rule of construction, the Dodd-Frank Act provides that nothing in the Volcker Rule is to be construed to limit or restrict the ability of a banking entity or nonbank financial company to sell or securitize loans in a manner otherwise permitted by law.[10] While the Proposed Rule reflected this rule of construction by exempting certain loan securitization vehicles from the general restrictions on covered fund investments and ownership[11], many entities that engage in other securitization activities and typically rely on Sections 3(c)(1) and (3)(c)(7) of the ICA would be subject to the covered fund restrictions. Under the Final Rule, in addition to loan securitization vehicles, issuers of short term asset-backed securities ("ABS") that satisfy certain requirements, including being supported by a liquidity facility that provides 100% liquidity coverage from a regulated liquidity provider, are exempt from the definition of "covered fund."[12] Additionally, given the unique circumstances and ownership structures presented by securitizations, the Final Rule also permits a banking entity to organize and offer a covered fund that is an ABS issuing entity, and to retain a greater than 3% ownership interest in the ABS issuer for the purpose of complying with the risk retention requirements contained in Section 941 of the Dodd-Frank Act.[13]

Developments on Compliance and Reporting Requirements

- ***Streamlined Compliance Program for Community Banks***. As most community banks (those with less than $10 billion in total consolidated assets) are generally expected to have little or no involvement in proprietary trading or investments in covered funds, the Final Rule places minimal compliance burden on such banks. Community banks have no compliance obligations under the Final Rule if they do not engage in any covered activities other than trading in certain government, agency, state, or municipal obligations, which are exempted from the Final Rule. For community banks that engage in other covered activities, compliance program requirements can be met by amending the bank's existing policies and procedures to include appropriate references to the relevant portions of the Final Rule addressing the covered activities that the bank conducts. Additionally, community banks that do engage in covered activities will be able to benefit from the general extended time frame (until July 21, 2015) to conform their activities and policies to the Final Rule. Again, it remains to be seen whether these provisions will be implemented in a manner consistent with the spirit of the Final Rule to minimize community bank compliance burdens.

- ***CEO Attestation Requirement***. The Final Rule adds a CEO attestation requirement to the enhanced standards for the compliance program implemented by the rule. This provision requires that the Chief Executive Officer of the banking entity annually attest in writing that the entity has processes in place "to establish, maintain, enforce, review, test and modify the compliance program" established under the Final Rule "in a manner reasonably designed to achieve compliance with section 13 of the BHC Act" and the Final Rule.[14] Attestation for a

U.S. Branch or agency of a foreign banking entity may be provided by the senior management officer of U.S. operations who is located in the U.S.

- ***Extended Conformance Period***. At the same time the Agencies announced the release of the Final Rule, the FRB released a statement announcing extension of the conformance period for all banking entities (with the exception of certain reporting requirements) for one year until July 21, 2015.[15] The extension is the result of the FRB exercising its authority allowing the first of three available one-year extensions deferring compliance with the Volcker Rule, which was otherwise scheduled to be effective July 21, 2014. The one-year extension does not, however, apply to the data reporting and recordkeeping requirements applicable to certain banking entities with significant trading activities. During the conformance period, each banking entity is expected to engage in "good-faith efforts, appropriate for its activities and investments," that will result in the conformance of all of its activities and investments to the requirements of the Final Rule by no later than the end of the conformance period.[16] Banking entities with "stand-alone proprietary trading operations are expected to promptly terminate or divest those operations."[17]

Remaining Questions

The Final Rule raises a number of important questions that were considered by the Agencies in their deliberation and adoption of the Final Rule, but that still remain to be answered. While the Agencies have undertaken considerable efforts evident in the Final Rule to address such questions, many issues remain and, in many respects, are dependent on the actual implementation of the Final Rule by the Agencies. The more significant questions and issues include:

- As each of the five Agencies approach their supervisory responsibilities from different perspectives, will there be uniform implementation of the Final Rule by the Agencies? In particular, will the approach of the Federal Banking Agencies differ from that of the CFTC and and/or the SEC? How the Final Rule will be administered and enforced by the Agencies appears to be the most pressing question that remains to be answered in the implementation stage.

- What will be the competitive impact of the Final Rule on U.S. banking entities *vis à vis* their foreign counterparts?

- What will be the impact of the CEO attestation requirement on bank compliance programs and the Agencies' supervisory, compliance, and enforcement posture with respect to the rule?

- How restrictive or liberal will the Agencies be with respect to the availability of the exemptions?

- What will be the impact of the Final Rule on U.S. and global liquidity and the capital markets?

- What will be the impact of the Final Rule on U.S. and global securities markets?

- Can we expect additional extensions of the conformance period?

- What will be the tolerance of the Agencies with respect to bank hedging activities? And should we expect that this will be based on a dynamic process rather than a static set of guidelines issued by the Agencies?
- To what extent will Volcker Rule compliance burdens push smaller banks out of activities covered by the Final Rule? And what will be the actual costs of compliance across the banking industry?
- Should we expect more detailed Volcker Rule guidance from the Agencies in the months ahead?
- How should trader compensation arrangements be structured, and how should such arrangement be monitored by bank internal compliance staff? And how will the Agencies monitor compliance with the compensation standards?
- How will trading account activities be monitored by the Agencies? And what should banks do to avoid potential problems that could draw into question the integrity of their proprietary trading compliance systems? As well as their covered fund compliance mechanisms?

These are but a few of the remaining questions that the Agencies and industry must grapple with before the landscape becomes clearer regarding the true, long-term impact of the Volcker Rule.

Timing and Implementation

The effective date of the Final Rule is April 1, 2014. As noted above, the FRB has extended the conformance period until July 21, 2015. However, beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities will be required to report quantitative measurements. Banking entities with at least $25 billion, but less than $50 billion, in consolidated trading assets and liabilities will become subject to this requirement on April 30, 2016. Those with at least $10 billion, but less than $25 billion, in consolidated trading assets and liabilities will become subject to the requirement on Dec. 31, 2016. The Agencies will review the data collected prior to Sept. 30, 2015, and revise the collection requirement as appropriate.

The Paul Hastings Global Banking and Payment Systems Group will be providing additional analysis regarding the details of the Final Rule in the coming weeks. We will forward this information as it becomes available.

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[1] Section 619, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010).

[2] 76 Fed. Reg. 68846 (Nov. 7, 2011).

[3] Preamble to Final Rule, p. 630-632.

[4] Preamble to Final Rule at p. 464.

[5] *See* 15 U.S.C. §§ 80a–3(c)(1) & (c)(7).

[6] Final Rule at §_.10(c).

[7] Pursuant to the so-called "Super 23A" prohibition, no banking entity or its affiliate that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to the asset management exemption, or that continues to hold an ownership interest in accordance with the asset-backed securitization exemption, may enter into a covered transaction (as defined in Section 23A of the Federal Reserve Act, 12 U.S.C. § 371c) with the covered fund, or with any other covered fund that is controlled by such covered fund. 12 U.S.C. § 1851(f)(1), implemented at § _.14 of the Final Rule.

[8] That is, the definition of "sponsor" in the Final Rule covers an entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund as defined in CFTC regulations, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. Final Rule at § _.10(d)(9).

[9] Preamble to Final Rule, p. 630-632.

[10] 12 U.S.C. § 1851(g)(2).

[11] See Proposed Rule at §§_.13(d) & .14(a)(2)(v); 76 Fed. Reg. at 68954.

[12] Final Rule at §_.11(b), referencing Section 15G of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-11.

[13] Final Rule at §§_.11(b) & _.12(b)(3).

[14] Preamble to Final Rule at p. 803; Final Rule at § _.20(c), referencing Appendix B: Enhanced Minimum Standards for Compliance Programs.

[15] FRB Order Approving Extension of Conformance Period, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[16] *See id.*

[17] *Id.*