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FEDERAL AGENCIES PROPOSE COMPREHENSIVE VOLCKER RULE IMPLEMENTATION

To Our Clients and Friends:

On Tuesday, October 11, 2011, the Federal Reserve Board ("Fed") and the Office of the Comptroller of the Currency ("OCC") released for public comment and the Federal Deposit Insurance Corporation (the "FDIC") met in open session and unanimously approved and released proposed rules implementing the Volcker Rule, Section 619 of the Dodd-Frank Consumer Protection Act of 2010 ("Dodd-Frank"). The Securities and Exchange Commission ("SEC") voted unanimously to approve the proposed rule on Wednesday, October 12. The final rule will be issued jointly by the FDIC, the Fed, the OCC, and the SEC. The FDIC staff indicated during the FDIC open meeting that the Commodity Futures Trading Commission ("CFTC") is expected to issue a comparable proposal in the near future.[1] Note the FDIC staff open meeting comments discussed in detail below. While the other agencies did not provide a public forum for their staffs to comment on the proposed rule to the extent that the FDIC did, some voting members of those agencies provided context for their decision. SEC Commissioner Troy Paredes, for example, disclosed that his vote in favor of seeking public comment on the rule was qualified by concerns about the potential compliance cost and impact on global competitiveness to U.S. firms.

For additional information on the Volcker Rule, please see previous Gibson Dunn alerts: "The Final 'Volcker Rule' under the Dodd-Frank U.S. Financial Regulatory Reform Bill" (July 12, 2010) and "U.S. Regulatory Reform Heads to the Implementation Phase" (July 23, 2010).

Comments Due: The agencies are soliciting comments on all aspects of the proposed rule including 383 specific questions put out for public comment. Questions include, for example, the scope of implementation of the various exemptions for permitted activities. Comments are due by January 13, 2012, at approximately 90 days a relatively long period that appears to reflect the proposal's its length, complexity and the need for covered companies to consider the implications of compliance. Including its Supplementary Information the proposed rule is 298 pages long. The comment period is not dependent upon the date of the proposal's publication in the Federal Register.

"Banking Entities" and "Supervised NBFCs". The Volcker Rule prohibits "banking entities" from engaging in proprietary trading and private capital sponsorship and investing transactions, with several categories of exceptions. The term "banking entity" is broadly defined in both the original Dodd-Frank language and the proposal to include all insured depository institutions ("IDIs") and any company that controls an IDI such as a bank holding company and all of its affiliates and subsidiaries and including, for example, broker-dealers and futures commission merchants within the bank holding company structure. The Volcker Rule also gives regulators authority to restrict nonbank financial companies that the Financial Stability Oversight Council ("FSOC") has designated for supervised by the Fed under section 113 of Dodd-Frank (Supervised NBFCs") from engaging in proprietary trading and private capital sponsorship and investing transactions. However the proposed rule does not include proposed restrictions on Supervised NBFCs because the agencies regarded such action premature because no NBFCs have yet been designated for Fed supervision.[2]

I. Proprietary Trading

The FDIC staff discussed in open session that the Volcker Rule generally prohibits banking entities from proprietary trading, which is defined as engaging as principal for the "trading account", as defined, at the banking entity and in the purchase or sale of one or more financial positions. The staff did not discuss the impact of the Volcker Rule on Supervised NBFCs, and the proposed rule clarifies that the Fed is "not proposing at this time an additional capital requirements, quantitative limits, or other restrictions on nonbank financial companies… as it believes doing so would be premature" because as of October 11 the FSOC had proposed but not yet finalized criteria for evaluating whether NBFCs should be designated for enhanced Fed supervision.[3]

Permitted Activities. A series of activities are permitted under the Volker Rule statutory provisions, including trading in obligations of the U.S. government or a U.S. government agency, the government-sponsored enterprises, and state and local governments, are exempt from the statute's prohibitions. However, it is not clear whether trading in derivates of U.S. government debt is permitted, as the proposal asks specifically whether the agencies should "provide an exemption for options or other derivatives with respect to U.S. government debt obligations". See Question 121 of the proposed rule, at page 72.

Also exempt are underwriting and market-making related activities, risk mitigation hedging activities, trading for the benefit of customers, investments in small business investment companies and public interest investments. Trading for the general account of insurance companies, organizing and offering a covered fund including limited investment in such funds, foreign trading by non-U.S. banking entities, and foreign covered fund activities by non-U.S. banking entities are also generally permitted.

Permitted Market Making Activities. An appendix to the rule contains commentary regarding identification of permitted market making activities and distinguishes these activities from prohibited proprietary trades.

"Trading Account". The proposed rule defines "proprietary trading" to include engaging as a principal for the "trading account" of a banking entity in any transaction to purchase or sell certain types of financial positions.[4] The proposed rule in turn defines a "trading account" as any account used to acquire a financial position for the purpose of short-term resale, benefitting from actual or expected price movements, realizing short-term arbitrage profits and certain hedging positions. With certain exemptions this definition will include all positions held in a banking entity's trading book as defined by the banking agencies' Market Risk Capital Rule.[5] In addition, trading account transactions will include all positions held by securities or municipal securities dealers registered by the SEC, government securities dealers that registered, or that has filed notice, with an appropriate regulatory agency, swap dealers registered with the CFTC, securities based swap dealers registered with the SEC and similar entities outside of the United States.[6]

Rebuttable Presumption on Short-Term Trading. The proposed rule includes a rebuttable presumption that any other account is considered a trading account if a financial position is held in the account for a period of 60 days or less. The banking entity would have the ability to rebut this presumption based on the facts and circumstances of the transaction.

Positions Excluded from Trading Account. The proposed rule excludes certain positions from being included in a trading account. This includes repurchase or reverse repurchase agreements, certain securities borrowing and lending activities and exposures to liquidity management. To qualify for this liquidity management exemption the liquidity management plan of the banking entity must meet certain documentation requirements which are subject to supervisory review. For example, positions must address risks to the banking entity's near-term funding needs and exposure must meet certain minimum liquidity and marketability standards.

II. Private Capital Prohibition

The Volcker Rule generally prohibits a banking entity from acquiring or retaining an ownership interest in or sponsoring a hedge fund or private equity fund. Section 13(h)(2) of the Bank Holding Company Act ("BHCA") defines the terms "hedge fund" and "private equity fund" expansively to mean "any issuer that would be an investment company, as defined in the [Investment Company Act], but for section 3(c)(1) or 3(c)(7) of that Act." While the proposed rule acknowledges that the universe of entities relying on the 3(c)(1) and 3(c)(7) exclusions potentially include many entities and corporate structures that would not usually be thought of as "hedge funds" or "private equity funds", such as joint ventures, acquisition vehicles, and certain wholly-owned subsidiaries, the proposed rule suggests that concerns about including these structures within the definition is ameliorated because "[t]hese types of entities are generally not used to engage in investment or trading activities".[7] The proposed rule does not attempt to distinguish between what is a "hedge fund" and what is a "private equity fund".

The proposed rule gives the agencies significant discretion in designating other types of funds that do not fit within the "covered fund" definition, as well as discretion to exclude entities that would fit within the definition. The proposed rule incorporated the statutory provision of BHCA section 13(h)(2) providing that the definition of hedge fund or private equity fund will also include "such similar funds as the Agencies may determine by rule".[8] It also would permit certain types of investments in covered funds, pursuant to section 13(d)(1)(J) of the BHCA, which authorizes the agencies to exclude from covered fund activity those activities that would promote the safety and soundness of the banking entity.[9]

Securitizations and Fee Structures. The FDIC staff advised during the open meeting that the expansive definition of "hedge fund or private equity fund" would include certain securitization vehicles.[10] However Section __.14 of the proposed rule would exclude from the prohibition certain joint ventures and interests in securitization vehicles retained in compliance with the minimum credit risk retention requirements of section 15G of the Exchange Act.[11]

Permitted *de minimis* Investments. The staff mentioned during the FDIC open meeting that, under the Volcker Rule, a banking entity must reduce its ownership interest in a sponsored fund to no more than 3% by value of the total ownership interest in that fund within one year of the date on which the covered fund is established. In addition, a banking entity's aggregate direct or indirect ownership interest in all covered funds may not exceed 3% of the banking entity's Tier One Capital. However, a host of questions remain unanswered surrounding these *de minimis* exemptions, including, for example, whether banking entities are required to aggregate their interests in all preexisting fund investments and count these toward the 3% of Tier One Capital limit.

No Conflict of Interest with Clients. The Volcker Rule provides that no class of transaction or activity is otherwise permissible if it would result in a material conflict of interest between the banking entity and its clients, customers or counterparts. The proposed rule includes definitions for material conflict of interest that includes certain disclosure requirements or information barriers for the banking entity.

High Risk Activities. During the open meeting the staff reported that an activity would be prohibited if it would result, directly or indirectly, in a material exposure by a banking entity to a high risk asset or trading strategy, or if the transaction or activity would otherwise pose a threat to the safety of the banking entity or the financial stability of the financial system of the United States. The proposal itself contains reporting and recordkeeping requirements that are intended, among other things, to "identify certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies".[12]

III. Internal Compliance Program.

The proposed rule requires banking entities to establish an internal compliance program that is designed to ensure and monitor compliance with the statute's prohibitions and restrictions, and implementing regulations. The internal compliance program would be subject to oversight by the banking entity's board of directors and federal supervisory agency.

Compliance Framework. During the FDIC open meeting the staff commented that entities with $1 billion or more in trading assets and liabilities, entities whose trading assets and liabilities exceed 10% of its total assets, and entities that invest in or have material relationships with hedge and private equity funds would be required under the proposed rule to establish a robust compliance program that contains specific elements and minimum standards included in appendices to the proposed rule.

These appendices require banking entities to provide periodic reports regarding quantitative measures of the trading activities and to maintain records documenting the preparation and contents of these reports. The FDIC staff reported in the open meeting that the quantitative measurements are designed to reflect the characteristics of trading activities that are considered to be particularly helpful in differentiate permissible market-making activities from prohibited proprietary trades and in identify where trading activities result in material exposure to high risk assets and high risk trading strategies.

An appendix to the proposal outlines the minimal standards required of a large banking entity compliance program, requiring that large banking entities establish, maintain and enforce an effective compliance program consistent with written policies and procedures, internally controls and a management framework, independent testing, trading and record-keeping that are designed to clearly document, describe and monitor the covered trading and the covered fund activities or investments. The policies and procedures must be subject to internal review and testing.

Acting Chairman Gruenberg made the following comments during the open meeting in support of internal compliance programs for large banking entities:

The NPR would require banking agencies, in order to comply with the rule, to establish internal compliance programs which must include written policies and procedures, internal controls, a management framework and independent testing, training, and record-keeping. It would also require banking entities to calculate a variety of metrics and report them to regulators on a periodic basis. These metrics will assist firms and regulators in identifying potential proprietary trading. These metrics would measure profit and loss, risk, risk to return and turnover. The metrics would provide a valuable source of information on trading activities and large banking organizations and should help regulators enforce the Volcker Rule in a consistent manner.

Smaller and Less Complex Banking Entities. The proposal generally applies to all banking entities regardless of size. However, the FDIC staff reported in the open meeting that, in developing a compliance framework, the agencies were mindful of the potential burdens on smaller banking entities and banking entities (possibly without regard to size) that engage in little or no prohibited activities. The proposal therefore includes elements intended to reduce the burden of the proposal on smaller and "less-complex" banking entities.[13] For example, the proposal limits the extent to which smaller and less complex banking entities are required to report quantitative measurements. The rule specifically proposes that entities with $1 billion or less in trading assets and liabilities be treated as "smaller banking entities". The Supplementary Information to the Proposed Rule explains that the reporting and recordkeeping requirements of the rule apply only where a banking entity, together with its affiliates and subsidiaries, has trading assets and liabilities the average gross sum of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.[14] Also, the compliance requirements for certain exemption categories such as the market making exemption applicable to the ban on proprietary trading are structured to take into account the magnitude of the trading activities of the banking entity. The FDIC staff at the open meeting explained that the intent is for smaller banking entities to ensure that their existing compliance policies and procedures include measures that are designed to prevent the banking entity from engaging in activities that are prohibited by the proposed rule.

IV. Management Accountability

The FDIC staff commented in the open meeting that the policies and procedures used to identify prohibited activities and investments must make senior management and intermediate managers accountable for the effective implementation of the compliance program and ensure that the Board of Directors and CEO of each banking entity review the effectiveness of the compliance program.

Restrictions on Compensation Arrangements Related to Underwriting Activities. The proposed rule would require that the compensation arrangement of persons performing underwriting activities at a banking entity be designed not to reward speculative proprietary risk taking. The proposed rule explains that "[a]ctivities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of securities underwritten, rather than success in bringing securities to market for a client, are inconsistent with permitted underwriting activities under the proposed rule".[15]

[1] The Fed press release and Notice of Proposed Rulemaking is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

[2] The FSOC, in an open meeting that also took place on Tuesday, October 11, 2011, proposed for public comment guidance regarding the process by which the FSOC would evaluate whether to designate nonbank financial institutions for enhanced prudential and Fed supervision. See, FSOC Notice of Proposed Rulemaking at http://www.treasury.gov/initiatives/fsoc/Pages/notices-of-proposed-rulemaking.aspx.

[3] See footnote 4 of the Supplementary Information to the Proposed Rule at 6.

[4] See footnote 27 of the Supplementary Information to the Proposed Rule at 11.

[5] See discussion of short-term trading and the Market Risk Capital Rules at Supplementary Information to the Proposed Rule at 12.

[6] See discussion of the third prong of the proposed "trading account" definition at Supplementary Information to the Proposed Rule at 32-33.

[7] Supplementary Information to the Proposed Rule at 114.

[8] See "Definition of covered fund" at Supplementary Information to the Proposed Rule at 113-114.

[9] See Supplementary Information to the Proposed Rule at 184.

[10] See discussion in Part II.G of the Supplementary Information to the Proposed Rule, "Application of Section 13 of the BHC Act to Securitization Vehicles or Issuers of Asset-Backed Securities".

[11] See Supplementary Information to the Proposed Rule at 184.

[12] See Supplementary Information to the Proposed Rule, "General approach to reporting and recordkeeping requirements", at 82.

[13] Application of the Proposed Rule to smaller, less-complex banking entities is discussed in Part II.F of the Supplemental Information to the Proposed Rule, "Treatment of Smaller, Less-Complex Banking Entities".

[14] See discussion at Supplementary Information to the Proposed Rule at 82 (including footnote 189) and Section __.7(a) of the Proposed Rule.

[15] See Supplementary Information to the Proposed Rule at 50.

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Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have about these developments. Please contact the Gibson Dunn lawyer with whom you work, Kimble Charles Cannon (310-229-7084, kcannon@gibsondunn.com) in the firm's Los Angeles office, or C. F. Muckenfuss (202-955-8514, cmuckenfuss@gibsondunn.com) or Michael Bopp (202-955-8256, mbopp@gibsondunn.com) in the firm's Washington, D.C. office.