# An Introduction to the Proposed Regulations Under the Volcker Rule

On October 11 and 12, 2011, the Office of the Comptroller of the Currency, Department of the Treasury (OCC); the Board of Governors of the Federal Reserve System (Federal Reserve); the Federal Deposit Insurance Corporation (FDIC); and the Securities and Exchange Commission (SEC)[1] jointly released a notice of proposed rulemaking (the Notice)[2] pursuant to the authority granted to those agencies by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[3] commonly referred to as the "Volcker Rule." In the Notice, the agencies released the text of the regulations proposed pursuant to the Volcker Rule and an introduction containing supplemental information.[4]

The introduction includes a summary of the proposed regulations and provides commentary and guidance on the proposed regulations. The introduction also includes questions and requests for public comment on more than 350 topics, covering virtually every aspect of the proposed regulations. Public comments on the proposed regulations are due on or before January 13, 2012.

The Volcker Rule prohibits covered banking entities from engaging in proprietary trading, or acquiring or retaining an ownership interest in, or sponsoring, a hedge fund or private equity fund.[5] The proposed regulations define "banking entity" as:

- any insured depository institution;
- any company that controls an insured depository institution;
- any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and
- any affiliate or subsidiary of any of the above (other than covered funds organized, offered and held by any of the above in accordance with the Volcker Rule or entities controlled by such covered funds).[6]

The Volcker Rule will become effective on July 21, 2012,[7] and the agencies will implement a phased schedule of conformance to the Volcker Rule's requirements after that date.[8] Banking entities must come into compliance with the Volcker Rule by July 21, 2014, subject to a maximum of three one-year extensions at the discretion of the Federal Reserve.[9] The proposed regulations cover the following topics:

---

[1] These agencies consulted with the staff of the Commodity Futures Trading Commission (CFTC) in preparing the Notice. The CFTC may consider regulations implementing the Volcker Rule at a later date. *See Volcker Rule*, U.S. Commodity Futures Trading Commission, *available at* http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm.

[2] The Notice includes and can be found with the Proposed Regulations. See footnote 4 below.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, 12 U.S.C. § 1851 (the Dodd-Frank Act).

[4] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (proposed Oct. 11 and 12, 2011) (to be codified at 12 C.F.R. pts. 44, 248 & 351 & 17 C.F.R. pt. 255) (the Proposed Regulations), *available at* http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-126a.pdf.

[5] Dodd-Frank Act § 619(a), 12 U.S.C. § 1581(a).

[6] Proposed Regulations § __.2(e). In addition, each agency applies the definition to the specific entities (deemed "covered banking entities") under its purview. These definitions are set out in the agency-specific text at the end of the Proposed Regulations. *See* Proposed Regulations § 44.2(j) (to be codified at 12 C.F.R. 44.2(j)) (OCC proposed definition); Proposed Regulations § __.2(j) (Federal Reserve proposed definition); Proposed Regulations § 351.2(j) (to be codified at 12 C.F.R. § 351.2(j)) (FDIC proposed definition); Proposed Regulations § 225.2(j) (to be codified at 12 C.F.R. § 225.2(j)) (proposed SEC definition).

[7] Dodd-Frank Act § 619(c)(1), 12 U.S.C. § 1851(c)(1).

[8] *Id.* § 619(c)(2), 12 U.S.C. § 1851(c)(2).

[9] *Id.* Upon application by a banking entity, the Federal Reserve also may grant a single extension period of up to

**Proprietary Trading Regulation.** The proposed regulations create a framework to distinguish a covered banking entity's permitted trading activities — including trading in certain government securities, hedging, liquidity management and customer-oriented activities such as underwriting, market making and undertaking trades on behalf of customers — from prohibited proprietary trading activity. The regulations prohibit covered banking entities from any purchase or sale of "covered financial positions" in a "trading account," defined as an account which is used to take or acquire one or more covered positions for prohibited short-term purposes.

The proposed regulations also describe several activities that either would not constitute proprietary trading or would not cause an account to be deemed a trading account, along with qualifications and factors to distinguish those activities from proprietary trading. Covered banking entities wishing to engage in the permitted activities would be subject to extensive recordkeeping and reporting requirements and, for certain activities, specific internal compliance requirements. In addition, liquidity management or hedging activity would require covered banking entities to establish and apply detailed plans or policies and procedures. Regulated firms may find it challenging to formulate any such plans, policies or procedures that are specific enough to satisfy the regulators' requirements but also sufficiently flexible to allow the entities to respond to varied market conditions.

The proposed regulations describe a number of criteria to determine when a position would constitute a permitted activity. For instance, the revenue from underwriting or market making activities must be derived principally from fees, commissions and, in the case of underwriting, spreads rather than from gains or losses from proprietary risk-taking. Risk and revenue must be measured on an ongoing basis to monitor the ongoing performance of positions and facilitate the analysis of whether the criteria are met. The regulations contain no bright-line tests for any of the criteria, however, leaving regulators with significant discretion to decide whether any particular activity has met the requirements for the permitted activities.

We would expect industry responses to the agencies' requests for public comment on the scope and approach of the proprietary trading restrictions to advocate increases in the breadth and certainty of the permitted activities. We would not be surprised to see extensive changes in the final form of these provisions.

**Hedge Fund and Private Equity Fund Restrictions.** The Volcker Rule prohibits a banking entity from sponsoring or investing in a hedge fund or private equity fund, subject to certain exceptions. The proposed regulations clarify certain aspects of the private fund restrictions but also present a number of questions. For example, the regulators use the authority granted by the statutory definition of "hedge fund" and "private equity fund" to designate as "similar funds" commodity pools and certain non-U.S. counterparts of covered funds. The proposed addition of commodity pools has the potential to extend the prohibition to entities not traditionally considered to be hedge funds or private equity funds. Moreover, the proposed addition of foreign counterparts does not provide clear guidance regarding which foreign entities are meant to be covered.

The proposed regulations also codify the statutory exceptions to the general prohibition, including the eight-factor permitted funds exception, which is the primary exception that a banking entity may use to

---

five years during which a banking entity may retain its interest in, or provide additional capital to, an illiquid fund to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. *Id.* § 619(c)(3), 12 U.S.C. § 1851(c)(3).

sponsor and invest in a covered fund. For some of the eight factors, the proposed regulations provide welcome clarification. For example, following the FSOC Study[10] it was unclear how the Volcker Rule's customer requirement would be interpreted. The proposed regulations clarify that a banking entity may offer a covered fund not only to pre-existing customers but also to potential purchasers who would become its customers upon acquiring interests in the fund. In other respects, however, the proposed regulations provide little or no guidance beyond the statutory language of the Volcker Rule. The statutory text allows directors and employees of the banking entity to invest in a covered fund only if those directors and employees are "directly engaged" in providing "investment advisory or other services" to the covered fund. The scope of this prohibition remains unclear: What does "directly engaged" entail, and what types of "other services" are contemplated? The proposed regulations provide no guidance on this definition.

The agencies' requests for public comment solicit alternatives to the approaches set forth in many provisions of the covered funds regulations. Given the uncertainty that remains in the private funds provisions, we anticipate a large volume of public comments and perhaps substantive changes in the rule before final regulations are adopted.

**Securitizations.** Although the Volcker Rule expressly states that nothing in it should be construed to limit or restrict the ability of a banking entity to securitize loans, the proposed regulations, if enacted in their current form, would have a significant adverse impact on many common securitization practices. By defining a covered fund by reference to particular Investment Company Act exemptions, the proposed regulations cover not only private equity funds and hedge funds, but also traditional asset-backed commercial paper conduits, issuers of collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) and other ABS issuers. Under the proposed regulations, a banking entity could no longer sponsor a traditional asset-backed commercial paper conduit and provide liquidity or credit enhancement to the conduit. A banking entity could no longer sponsor a CDO backed by securities, whether ABS or high yield corporate bonds, or possibly even a CLO that permitted any investment in securities, even on a short-term or limited basis. A banking entity could no longer sponsor or hold an ownership interest in an ABS issuer or asset-backed commercial paper conduit that is a covered fund and holds a security issued as part of an intermediate securitization of the loans.

**Insurance Company Investment Activities.** Insurance companies that control or are affiliated with an insured depository institution, or that are an affiliate or subsidiary of a bank holding company, are treated as "covered banking entities" under the proposed regulations. The proposed regulations would subject such insurance companies to restrictions on proprietary trading and on acquiring or retaining an ownership interest in, or acting as a sponsor to, a hedge fund or a private equity fund. Certain exceptions to the proprietary trading ban would permit insurance companies to pursue ordinary course investment activities on behalf of customers (with respect to trading for separate accounts) and investments activities in compliance with, and subject to, insurance company investment laws and regulations (with respect to trading for general accounts). The proposed regulations do not otherwise distinguish investment activities conducted by insurance companies from investment activities conducted by other covered banking entities.

---

[10] Fin. Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Jan. 18, 2011) (FSOC Study), *available at* http://www.sifma.org/uploadedfiles/issues/regulatory_reform/volcker_rules/fsoc%20volcker%20section%20619%20dodd-frank%20study%20final%201%2018%2011%20rg.pdf.

Such insurance companies would be subject to requirements for extensive reporting and recordkeeping under the proposed regulations. The new reporting and recordkeeping requirements likely would add to the administrative burdens of insurance companies that already are required to comply with separate reporting and recordkeeping requirements under state insurance laws and regulations.