



Global Finance Alert

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The Dodd-Frank Act implementation of the Volcker Rule

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The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010, is historic legislation to reform the nation's financial regulatory system. Section 619 of the Act ("Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds") implements the so-called "Volcker Rule." Originally proposed by former Federal Reserve Chairman Paul Volcker, this provision severely limits investments by banking entities in private funds of all types and will impose restrictions on sponsorship by banking entities and their affiliates of hedge funds and other private funds.

General prohibition

Section 619 amends the Bank Holding Company Act of 1956 ("BHCA") by adding a new section 13 that provides for a general prohibition on banking entities from:

- engaging in "proprietary trading;" or
- acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or private equity fund.

What entities are covered?

The general prohibition of Section 619 applies to any "banking entity." Banking entity means 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, and any affiliate or subsidiary of such entity. For purposes of Section 619, an insured depository institution does not include an institution that functions solely in a trust or fiduciary capacity and accepts deposits on a limited basis.

A non-bank financial company designated for supervision by the Federal Reserve Board ("FRB") pursuant to Section 113 of the Dodd-Frank Act is not prohibited from engaging in proprietary trading or investing or sponsoring hedge funds or private equity funds, but will be subject to additional capital requirements and quantitative limits on its proprietary trading and investments in or sponsoring of hedge funds and private equity funds. The additional capital requirements and quantitative limits will not apply to permitted activities described below.

What is proprietary trading?

Proprietary trading means engaging as a principal for the trading account of the banking entity or non-bank financial company subject to supervision by the FRB in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC determine by rule.

Trading account means any account used for acquiring or taking positions in the securities and instruments described above principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements, and any other accounts as the appropriate federal banking agencies, the SEC, and the CFTC determine by rule.

What is a hedge fund or private equity fund?

“Hedge fund” and “private equity fund” mean an issuer that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or such similar funds that the banking agencies, the SEC, and the CFTC may determine by rule. A fund relying on Section 3(c)(1) may not have more than 100 investors, while a 3(c)(7) fund is not limited in the number of its investors but all of its investors must be “qualified purchasers” (i.e., institutional investors and high net worth individuals). Sections 3(c)(1) and 3(c)(7) are the provisions upon which almost all privately-placed investment funds and private pools of capital rely to avoid registration as investment companies.

What does it mean to sponsor a hedge fund or private equity fund?

Sponsoring a fund means to

- serve as a general partner, managing member, or trustee of a fund;
- select or to control, or have employees, officers, or directors or agents who constitute, a majority of the directors, trustees, or management of a fund; or
- share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Exceptions to the general prohibitions

Permitted activities

The prohibitions of the Volcker Rule, as contained in Section 619 of the Dodd-Frank Act, do not apply to the following activities:

- purchases, sales, acquisitions, or dispositions of U.S. government or agency securities, obligations, or instruments of GNMA, FNMA, FHLMC, a Federal Home Loan Bank, the Federal Agriculture Mortgage Corporation, or a Farm Credit System Institution chartered under and subject to the provisions of the Farm Credit Act, or state and municipal bonds;

- underwriting or market-making related activities to the extent that any such activities permitted are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;
- risk-mitigating hedging activities designed to reduce specific risks to the banking entity in connection with and related to its individual or aggregate positions, contracts, or other holdings;
- transactions to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, or any option on any such security, derivative, or contract conducted on behalf of the banking entity's customers;
- investments in small business investment companies, investments designed primarily to promote the public welfare (of the type permitted under paragraph (11) of 12 U.S.C. 24), and investments qualifying as rehabilitation expenses with respect to qualified rehabilitated buildings and certified historic structures;
- investments in any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract conducted by a regulated insurance company for its general account, or by an affiliate of such regulated insurance company provided such activities by the affiliate are solely for the general account of the regulated insurance company, as permitted by relevant state insurance company investment laws and regulations;
- organizing and offering a private equity or hedge fund including sponsoring a fund only if:
 - the banking entity provides bona fide trust, fiduciary, or investment advisory services;
 - the fund is 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;
 - the banking entity does not acquire or retain more than a *de minimis* investment in the fund subject and in compliance with the *de minimis* exception described below;
 - the banking entity complies with the affiliate transactions limitations described below;
 - the banking entity does not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the fund;
 - the banking entity does not share with the fund for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name;
 - no director or employee of the banking entity takes or retains an equity, partnership interest, or other ownership interest in the fund except for any director or employee who is directly engaged in providing investment advisory or other services to the fund; and
 - the banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in such fund are borne solely by investors in the fund and not by the banking entity, and the banking entity complies with additional rules of the appropriate federal banking agencies, the SEC, and the CFTC designed to ensure that losses in such funds are borne solely by investors in the fund and not the banking entity (the "Trust Services Exception");

- proprietary trading activity by a company organized under the laws of a foreign country or that does no business in the United States provided the foreign company is not, directly or indirectly, controlled by a U.S. banking entity, and that the trading occurs solely outside the United States;
- acquisition or retention of any equity, partnership, or other ownership interests or sponsorship of a hedge fund or private equity fund by a company organized under the laws of a foreign country or that does no business in the United States provided the foreign company is not, directly or indirectly, controlled by a U.S. banking entity provided no ownership interests are offered for sale or sold to a resident of the United States; and
- such other activities permitted by the appropriate federal banking agencies, the SEC, and the CFTC by rule subject to the safety and soundness of the banking entity and the financial stability of the United States.

Limitations on permitted activities

The permitted activities described above will not be permitted if the transactions or activity would result in a material conflict of interest (such term to be defined in regulations) between the banking entity and its clients, customers, or counterparties; result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (both terms to be defined in regulations); pose a threat to the safety and soundness of the banking entity; or pose a threat to the financial stability of the United States.

Capital requirements and quantitative limitations on permitted activities

The appropriate federal bank regulatory agencies, the SEC, and the CFTC are required to issue rules that impose additional capital requirements and quantitative limitations, including diversification requirements, regarding the permitted activities if such agencies determine such requirements are appropriate to protect the safety and soundness of the banking entities engaged in such activities.

De minimis investments

A banking entity may make and retain an investment in a hedge fund or private equity fund that the banking entity organizes and offers, subject to the *de minimis* rule set forth in new Section 13(d)(4) of the BHCA. Such investments are permitted for purposes of (1) establishing the fund and providing initial capital to the fund and (2) making a *de minimis* investment.

A banking entity that organizes and offers a fund is required to actively seek unaffiliated investors in the fund to reduce or dilute the banking entity's investment. Not later than one year after the establishment of the fund, the sponsoring banking entity's investment must not be more than 3 percent of the total ownership interests of the fund. The one-year deadline for reducing the banking entity's interest in a fund may be extended by the FRB for two additional years, if the FRB finds that an extension would be consistent with safety and soundness and in the public interest. In addition to the requirement that a banking entity's ownership interest in any sponsored fund must represent 3 percent or less of the fund's total ownership interests, the *de minimis* rule that a banking entity's aggregate investments in sponsored funds must be "immaterial" to the banking entity; the definition of immateriality will be defined by regulation, but the Act provides that the aggregate of all interests of the banking entity in such funds may not exceed 3 percent of its Tier 1 capital.

The banking entity must deduct the aggregate amount of these investments outstanding from its assets and tangible equity for purposes of compliance with any additional capital requirements that apply to the permitted activities. The amount of the deduction must increase commensurate with the leverage of the hedge fund or private equity fund.

Sale or securitization of loans

Section 619 does not limit or restrict the ability of a banking entity or nonbank financial company supervised by the FRB to sell or securitize loans in a manner otherwise permitted by law.

Anti-evasion rules

The Volcker Rule directs the appropriate federal banking agencies, the SEC, and the CFTC to issue regulations regarding internal controls and recordkeeping in order to ensure compliance with Section 619 of the Dodd-Frank Act.

The appropriate federal banking agencies, the SEC, and the CFTC also have authority to order, after due notice and opportunity for hearing, a banking entity or non-bank financial company supervised by the FRB to terminate an activity or dispose of an investment if such agency has cause to believe that the investment or activity functions as an evasion of the requirements of Section 619, including an abuse of any permitted activity, or otherwise violates the restrictions of Section 619.

Affiliate transaction limitations

A banking entity and its affiliates that serve as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund or that organizes and offers any such fund pursuant to the Trust Services Exception may not enter into a covered transaction, as defined in Section 23A of the Federal Reserve Act, with the hedge fund or private equity fund or with any other hedge fund or private equity fund that is controlled by such fund. There is an exception for prime brokerage transactions if the banking entity is in compliance with all of the limitations in the Trust Services Exception; the chief executive officer of the banking entity certifies in writing annually that the banking entity has not guaranteed, assumed, or otherwise insured the obligations or performance of the fund; and the FRB has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity.

In addition, a banking entity that serves as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund or that organizes and offers any such fund pursuant to the Trust Services Exception will be subject to Section 23B of the Federal Reserve Act as if the banking entity were a member bank and the hedge fund or private equity fund were an affiliate thereof.

The banking agencies, the SEC, and the CFTC are directed to adopt rules imposing additional capital requirements or other restrictions on non-bank financial companies subject to supervision of the FRB to address the risks to and conflicts of interest that banking entities would face in such affiliated transactions.

Implementation of the Volcker Rule

Implementation steps

The prohibitions of Section 619 will be implemented over time. First, an initial study on implementing the provisions of Section 619 by the Financial Stability Oversight Council is required

to be completed within six months of enactment of the Dodd-Frank Act. Not later than nine months after completion of the study, the appropriate federal bank regulatory agencies, the SEC, and the CFTC are required to adopt regulations to carry out the provisions of Section 619, taking into consideration the results of the study.

Effective date

The provisions of Section 619 will take effect on the earlier of:

- Twelve months after the date of the issuance of the final rules by the appropriate federal bank regulatory agencies, the SEC, and the CFTC; or
- Two years after the date of enactment of the Dodd-Frank Act.

Implementation period

Institutions covered by Section 619 will have two years after the effective date to bring its activities and investments into compliance with the rule. Non-bank financial companies will be required to be in compliance within two years from the date on which the entity becomes supervised by the FRB. The FRB, by rule or order, may grant up to three one-year extensions.

The FRB may grant an additional extension up to five years for banking entities that have a contractual obligation that was in effect on May 1, 2010, regarding investments or ownership in, or to provide additional capital to, an illiquid fund.

Capital requirements during implementation

The appropriate federal bank regulatory agencies, the SEC, and the CFTC are required to issue rules that impose additional capital requirements on any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or private equity fund by a banking entity.

For further information, please contact your Nixon Peabody attorney or:

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