Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Dodd-Frank Rulemaking: Volcker Rule and SIFI Proposals

Commentary and Insights

Skadden

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

November 17, 2011

Dear Clients and Friends:

In October, federal agencies proposed two new sets of regulations under the Dodd-Frank Act. The proposals — to implement the Volcker Rule and to create standards to designate certain nonbanks as systematically important financial institutions (SIFIs) — are expected to have profound consequences in the financial sector and on the broader economy. In this report, we explore the Volcker Rule and SIFI proposals and their potential implications for participants in the financial services industry.

The Volcker Rule is a central part of the legislative response to the financial crisis. It emerged from the premise that proprietary trading and sponsorship and investment in private funds by banking entities pose an unacceptable level of risk to the financial system. The Volcker Rule, as embodied by the proposed implementing regulations, can be viewed as an attempt to recreate the division between banks and securities firms established by the Glass-Steagall Act in 1933 (and repealed in 1999). Given how the financial system has since changed and the significant questions that the proposed regulations would leave unresolved, it remains to be seen whether that division proves to be a solution or an anachronism.

In the proposed nonbank SIFI standards, the Financial Stability Oversight Council has established an analytical framework to determine whether a particular nonbank institution is a SIFI in accordance with the factors specified in Dodd-Frank. The proposed rule illuminates some aspects of the process for designating nonbank SIFIs, but leaves the Council with significant discretion.

We hope you find this report helpful in your efforts to understand and adapt to the evolving financial regulatory environment. If you would like to discuss any of the matters analyzed here, please contact any of the authors or your usual Skadden, Arps contact.

Regards,

Eric J. Friedman
Executive Partner

Our analysis of the proposed Volcker Rule and SIFI regulations was coordinated by William J. Sweet, Jr., head of our financial institutions regulatory practice in Washington, D.C., and Michael D. Dorum, a partner in our New York financial institutions group. Monica E. Tarazi and Chris K. Suh, associates in our New York financial institutions group, provided editorial assistance with this project.

Skadden

Table of Contents

(Click on a title below to read the corresponding text.)

Executive Summary

Volcker Rule

On October 11 and 12, 2011, the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission proposed regulations to implement the Volcker Rule. Our analysis covers the following aspects of the proposed Volcker Rule regulations:

- **Proprietary trading.** To implement the limitations mandated by Dodd-Frank on proprietary trading by banking entities, the proposed regulations set forth principles and criteria for distinguishing prohibited trading activity from permitted activities, including activities related to market making, underwriting and hedging. To engage in permitted underwriting and market making activities, banking entities will be required to satisfy conditions that could significantly constrain their operations, including conditions based on the types of revenues that the activities generate, the scale of the activities in relation to expected near-term customer demand and the criteria used to determine the compensation provided to individuals who conduct the activities. The proposed regulations require banking entities to establish new internal compliance practices to monitor, control and report on the permitted activities. The proposed regulations also specify quantitative metrics to be considered in determinations regarding compliance with the requirements for permitted activities, but include no bright-line tests for such determinations.
- **Private funds.** As required by Dodd-Frank, the proposed regulations restrict the ability of banking entities to sponsor and invest in hedge funds and private equity funds. The proposed regulations also extend those restrictions to commodity pools (with or without characteristics of traditional hedge funds or private equity funds) and to certain non-U.S. counterparts of covered funds. The proposed regulations add clarity to the prohibitions set forth in Dodd-Frank and the exceptions to those prohibitions in several important respects, but also leave many significant questions unanswered.
- **Securitizations.** The proposed regulations, contrary to the stated intention of the Volcker Rule as expressed in Dodd-Frank, will prohibit banking entities from sponsoring transactions involving asset-backed commercial paper, collateralized debt obligations and collateralized loan obligations.
- **Insurance companies.** Insurance companies that have specified affiliations with banking entities are subject to the proposed regulations. With only limited exceptions, the regulations will apply to those insurance companies in the same manner as they apply to banking entities generally.

SIFI Standards and Related Developments

On October 11, 2011, the Financial Stability Oversight Council (the Council) proposed standards for the designation of nonbanks as systemically important financial institutions (SIFIs). The proposed rule and the proposed interpretive guidance that accompanies it establish standards and factors for the designation of nonbanks as SIFIs and a three-stage process that the Council expects to follow in making SIFI designations. The proposed rule and guidance move toward providing clarity as to the Council's approach to key concepts such as systemic risk, however, the standards and factors remain too general to serve as reliable tools for predicting whether any particular firm may be subject to designation as a SIFI.

In related developments, the Federal Reserve approved rules governing the "living wills" that SIFIs will be required to establish, and international regulators have moved forward with efforts to identify and designate global systemically important financial institutions (or G-SIFIs).

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.

Proprietary Trading Restrictions Under the Proposed Regulations

Finance industry participants have expressed concern over the burden of complying with the proprietary trading restrictions in the Volcker Rule and the potential effects of those restrictions on the competitiveness of U.S. banks.[1] The proposed regulations impose significant new recordkeeping and reporting requirements to provide data for banking entities and regulators to police the boundaries between prohibited proprietary trading and permitted activities. In the proposed regulations, the agencies have provided exceptions prescribed by statute to the prohibition against proprietary trading, with the objective of allowing banking entities to continue to provide traditional client-oriented financial services, including underwriting, market making and asset management services, and to engage in hedging and liquidity management activities designed to enhance the safety of their operations.[2] Regulators face considerable pressure from the financial services industry to preserve the scope of these activities, which are difficult to distinguish, both in regulatory language and in practice, from the prohibited proprietary trading activities.

These challenges have been compounded by the level of interagency cooperation required for the formulation of the proposed regulations.[3] Representatives of individual agencies involved in the rulemaking process have publicly expressed reservations about the end result.[4] Moreover, the Commodity Futures Trading Commission (CFTC), the agency that will develop and enforce the new regulatory regime for swap transactions imposed by the Dodd-Frank Act, did not join in issuing the proposed regulations and is expected to adopt its own version of the Volcker Rule.[5] The CFTC will enforce its formulation of the Volcker Rule with respect to entities for which the CFTC is the "primary financial regulatory agency."[6] Its abstention illustrates the difficulties the agencies would face in assembling and maintaining a consistent regulatory and enforcement approach, especially in areas where the regulatory boundaries between the CFTC and banking agencies are not well defined. In a regulatory area as complex and nuanced as this one, enforcement would be especially vulnerable to localized failures of will or of budget.

Despite the volume and specificity of the proposed regulations, these difficulties make it unlikely that the proposed regulations, as released, are in their final form. The agencies signaled that revisions are likely by including requests for public comment on hundreds of topics bearing on virtually every aspect of the regulations. The public comment period will end on January 13, 2012.

---

[1] *See, e.g.*, Letter from Sec. Indus. & Fin. Mkts. Ass'n to Fin. Stability Oversight Council 13 (Nov. 5, 2010), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=22126; *Global Investment Banks: Regulatory Arbitrage Series: OW European over US IBs*, J.P. Morgan Cazenove, 22 (2011), https://mm.jpmorgan.com/stp/t/c.do?i=5930E-12&u=a_p*d_558208.pdf*h_-2igf3ms.

[2] Proposed Regulations §§ __.4 - __.6.

[3] *See* Notice at 6-7 ("Authority for developing and adopting regulations to implement the prohibitions and restrictions of [the Volcker Rule] is divided between the [multiple agencies] … The statute also requires the [a]gencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions.").

[4] *See* Ben Protess, *Volcker Rule Divides Regulators*, N.Y. Times Dealbook (Oct. 16, 2011), http://dealbook.nytimes.com/2011/10/16/volcker-rule-divides-regulators/.

[5] *See* Skadden, Arps, Slate, Meagher & Flom LLP, *Title VII of the Dodd-Frank Act One Year Later: Piecing Together the Dodd-Frank 'Mosaic' for Derivatives Regulation* 21-22 (2011), *available at* http://www.skadden.com/newsletters/Title_VII_of_the_Dodd-Frank_Act_One_Year_Later.pdf.

[6] The CFTC is the primary financial regulatory agency for futures commission merchants, commodity pool operators, commodity trading advisors and other entities, with respect to activities that require such entities to be registered under the Commodity Exchange Act. Dodd-Frank Act § 2(12)(C), 12 U.S.C. § 5301(12)(C).

Contributors / Partners / Stacy J. Kanter, Stacy.Kanter@skadden.com, 212.735.3497 / John W. Osborn, John.Osborn@skadden.com, 212.735.3270 / **Counsel /** Joyce Penn Farnsworth, Joycepenn.Farnsworth@skadden.com , 212.735.3233, / Laura A. Kaufmann Belkhayat, Laura.Kaufmann@skadden.com, 212.735.2439

Application of Regulations

"Covered banking entities" are subject to the proposed regulations. A covered banking entity is defined separately by each issuing agency to describe the application of the regulations to the specific banking entities within its purview.[7] The proposed regulations define banking entity to mean:

- 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 or entities controlled by such covered funds).[8]

Prohibited Proprietary Trading

The proposed regulations prohibit covered banking entities from proprietary trading in "covered financial positions." Covered financial positions include long, short, synthetic and other positions in:

- securities;
- derivatives (which include swaps, security-based swaps, commodity forwards, foreign exchange forwards and swaps);
- commodity futures; and
- options on all of the above.[9]

A covered financial position does not include any position that is itself a loan, commodity or currency, including a position obtained via a spot purchase, but would include a derivative, future or option in respect of the same loan, commodity or currency.[10] The proposed regulations include no criteria for identifying a "loan" and no indication of how the determination should be affected by equity-like control or economic features in an instrument denominated as a loan.[11]

The proposed regulations define proprietary trading as engaging as principal (*i.e.*, not as agent, broker or custodian for unrelated third parties) for the trading account of the covered banking entity in any purchase or sale of covered financial positions,[12] with certain exceptions, as described below.[13] The proposed

---

[7] 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).

[8] Proposed Regulations § __.2(e).

[9] *Id.* § __.3(b)(3)(i).

[10] *Id.* § __.3(b)(3)(ii); *see also* Notice at 12.

[11] The agencies in the introduction request public comment concerning the definition of "loan" and whether a "loan" should exclude a security. Notice at 47.

[12] Proposed Regulations § __.3(b)(1).

[13] *See id.* § __.3(b)(2)(iii).

regulations define a "trading account" as any account used by a covered banking entity to acquire or take one or more covered financial positions:

- principally for the purposes of
  - short-term resale,
  - benefiting from actual or expected short-term price movements,
  - realizing short-term arbitrage profits, or
  - hedging one or more such positions;
- that are market-risk, capital-rule covered positions if the covered banking entity or any bank holding company affiliate so calculates risk-based capital ratios; or
- in connection with their business as dealers, municipal securities dealers, swap dealers or security-based swap dealers, including dealers engaging in such business outside of the United States.[14]

An account will not be deemed a trading account to the extent it is used for:

- repurchase, reverse repurchase and securities lending agreements;
- the purpose of *bona fide* liquidity management under a qualifying documented liquidity management plan to meet near-term liquidity needs; or
- clearing, for covered banking entities that are derivatives clearing organizations or clearing agencies.[15]

Even though the definition of trading account is central to the prohibition against proprietary trading, the proposed regulations have not expressed with any degree of precision what a trading account is intended to encompass. The regulations indicate that an account is a trading account if it is used under certain specified circumstances to "[a]cquire or take one or more" covered financial positions for listed purposes.[16] This represents a change from the language of the statute, which would deem an account to be a trading account if it is "used for acquiring or taking positions" under the specified circumstances.[17] The proposed regulations contain no express requirement to segregate assets, and yet the text of the proposed regulations, taken literally, means that even a single short-term position in an account will make every position in that account (unless subject to an exclusion or exemption) a prohibited position. Given the complexity of modern settlement practices and the diversity of the accounts involved for any major institution, the proposed regulations appear to suggest that the agencies expect covered banking entities to make fundamental changes in their trading account practices.

[14] *Id.* § __.3(b)(2)(i).

[15] *Id.* § __.3(b)(2)(iii).

[16] *Id.* § __.(3)(b)(2)(i)(A).

[17] Dodd-Frank Act § 619(h)(6), 12 U.S.C. § 1851(h)(6). In contrast, for purposes of the market-risk capital rules, assets and positions are categorized separately from their accounts, and the purpose of the assets themselves (not the account) is determinative (although banks are encouraged to separate their trading assets from other assets), and failure to establish a separate account will not prevent assets from being trading assets. Fed. Fin. Inst. Examination Council, *Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and 041), A-78a to A-79 (2011), *available at* http://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201109_i.pdf.

Permitted *Bona Fide* Liquidity Management Activity

Activities undertaken for *bona fide* liquidity management and in accordance with a documented liquidity management plan would not cause an account to be a trading account. In order to qualify for the liquidity management exclusion, the plan must:

- specifically contemplate and authorize the particular instrument to be used, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the instrument may or must be used;
- require that any transaction contemplated and authorized by the plan be principally for the purposes of managing liquidity and not for any of the prohibited short-term trading purposes;
- require that any position taken be highly liquid and limited to financial instruments which are not expected to give rise to appreciable profits or losses from short-term price movements;
- limit the aggregate of liquidity management positions to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations, as estimated and documented as specified in the plan; and
- be consistent with the applicable regulatory agency's supervisory requirements regarding liquidity management; or
- be taken by a registered derivatives clearing organization or clearing agency in connection with its clearing business.[18]

The applicable regulatory agency will be authorized to review liquidity management plans and transactions through supervisory and examination processes to ensure that they are consistent with the plans. These provisions reflect a concern of the regulators that a banking entity could use financial instruments for short-term trading purposes rather than to ensure that it has liquid assets available to meet its short-term liquidity needs.[19] The requirements are accompanied by a number of requests for public comment regarding current liquidity practices, [20] suggesting that in this area regulators would need to rapidly gain expertise to distinguish permitted transactions from prohibited trading. Banking entities would also need to scramble to assemble liquidity management plans. We anticipate that regulators will find it difficult to articulate principles that allow prudent adaptation to diverse market circumstances, yet are sufficiently specific to facilitate detection of prohibited proprietary trading.

Determining whether positions are taken for short-term purposes would be difficult, especially during periods of market dislocation. Accordingly, the proposed regulations establish a rebuttable presumption that a position (other than the market-risk, capital-rule covered positions or dealing positions described above) that is taken for a period of 60 days or less will cause the related account to be a trading account. The banking entity can overcome this presumption if it demonstrates, based on all the facts and circumstances, that the covered financial position, individually or as a category, was not acquired or taken principally for short-term purposes.[21]

---

[18] Proposed Regulations § __.3(b)(2)(iii)(C)(D).

[19] Notice at 38.

[20] *Id.* at 39-41.

[21] Proposed Regulations § __.3(b)(2)(ii).

Finally, the application of the covered financial position definition to the trading programs of regulated institutions may have unintended consequences. By operation of that definition, the proprietary trading restrictions would not apply to a banking entity's position that is itself a loan, commodity or currency. The restrictions would apply, however, to positions in a derivative, future or option in respect of a loan, commodity or currency. In many cases, banking entities will use both types of positions in a unified trading strategy. A banking entity may, for example, effect spot purchases in commodities as part of the same strategy that involves derivatives, futures or options in respect of commodities (which may or may not be hedging related). We question whether such a trading program would remain viable if it is not permitted to include both types of positions. The disparate treatment of these types of positions and the utility of running the programs in a unified manner may drive such trading programs out of covered banking entities and into nonbanks or foreign banks that are not subject to the restrictions.

Permitted Proprietary Trading Activities

As embodied by the Dodd-Frank Act, the Volcker Rule permits banking entities to pursue the following activities, as exceptions to the prohibition against proprietary trading:[22]

- trading in certain government obligations (in order to support markets in those obligations);
- underwriting and market making activities;
- certain risk-mitigating activity;
- trading on behalf of customers;
- trading by a regulated insurance company and its affiliates for the general account of the insurance company;[23] and
- trading outside the U.S. by non-U.S. banking entities.

The Volcker Rule also allows the regulatory agencies to adopt rules permitting other activities if they would promote and protect the safety and soundness and the financial stability of the United States.[24] The proposed regulations contain no such exemptions, although the regulators have requested public comment as to whether any should be adopted.

Permitted Underwriting and Market Making Activity

Consistent with the objective of allowing banking entities to continue to engage in traditional client-oriented financial services, the proposed regulations permit underwriting and market making activities that otherwise would be construed as prohibited proprietary trading.[25] Certain criteria are applicable to both the permitted underwriting and market making activities. First, to utilize either exception to the proprietary trading ban a banking entity must have established the internal compliance program prescribed by

---

[22] Dodd-Frank Act § 619(d), 12 U.S.C. § 1851(d).

[23] For a description of the exception for insurance company general account transactions, see The Proposed Regulations and Insurance Company Investment Activities.

[24] *See* Dodd-Frank Act § 619(d)(1), 12 U.S.C. § 1851(d)(1); *see also* Notice at 81.

[25] Proposed Regulations § __.4(a)-(b).

the proposed regulations.[26] Second, revenues must be derived primarily from fees, commissions, underwriting spreads, bid/ask spreads or other income and not from appreciation in the value of the financial positions held by the banking entity or the hedging of related covered financial positions.[27] Third, the compensation arrangements of persons who perform underwriting or market making activities must be designed not to encourage or reward proprietary risk-taking.[28]

Internal Compliance Procedures. In addition to compiling and reporting on the quantitative information required by the proposed regulations (discussed below with regard to market making), entities utilizing either the permitted underwriting or market making activity would be required to implement new internal compliance procedures. Under the proposed regulations, each banking entity must establish an internal compliance program that is suitable for the "size, scope and complexity of activities and business structure of the covered banking entity"[29] and that includes the following elements:

- internal written policies and procedures designed to document, describe and monitor covered trading activities (as well as covered fund activities and investments) of the banking entity;
- a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the proposed regulations and to prevent the occurrence of prohibited activities;
- a management framework that clearly identifies the parties responsible for compliance and accountability;
- independent testing for the effectiveness of the compliance program, conducted either by qualified personnel or a qualified outside party;
- training for trading personnel, managers and other appropriate personnel; and
- keeping records sufficient to demonstrate compliance.[30]

The introduction to the proposed regulations states that such compliance programs should not be developed by a generic "one-size-fits-all" approach, but rather should be carefully tailored to "take into account and reflect the unique manner in which a banking entity operates, as well as the particular compliance risks and challenges its businesses present."[31] If this requirement is implemented, the compliance regimes may vary considerably among banking entities. The potential costs and administrative impact of such programs within an individual banking entity's operating structure will depend on the extent of the banking entity's underwriting and market making activities and how broadly such activities are conducted throughout its operational structure and thus will be difficult to project.

The proposed regulations do not provide a complete framework for the implementation of compliance programs, but the introduction to the proposed regulations requests public comment as to how the proposed compliance requirement should be implemented and enforced.[32] Prior to the release of the proposed regulations, many industry observers anticipated that the compliance and reporting require-

---

[26] *Id.* §§ __.4(a)(2)(i) & (b)(2)(i).

[27] *Id.* §§ __.4(a)(2)(vi) & (b)(2)(v).

[28] *Id.* §§ __.4(a)(2)(vii) & (b)(2)(vii).

[29] *Id.* § __.20(a).

[30] *Id.* § __.20(b)(1)-(6).

[31] Notice at 162.

[32] *Id.* at 165-170.

ments would include a mandate for CEO certifications similar to those required under Sarbanes-Oxley.[33] The agencies did not include a requirement for such certifications in the regulations as proposed but have requested public comment about the potential benefits and drawbacks of adding such a requirement.[34]

Revenue Requirements. The proposed regulations require that a banking entity's underwriting or market making activities be designed to generate revenues primarily from fees, commissions, underwriting spreads, bid/ask spreads or other income not attributable to appreciation in the value of the financial positions it holds or from the hedging of covered financial positions.[35] Because the proposed regulations provide no bright-line test for the percentage of revenues that must be derived from fees and commissions rather than from changes in value of securities held as a result of underwriting or market making activities, banking entities attempting to comply with this requirement will face significant challenges in evaluating and interpreting the relevant facts. For example, banking entities may keep more securities in inventory or other retained principal positions, particularly for market making purposes, than the agencies would expect based on average trading volumes, for both publicly traded equity securities and debt and derivatives traded over the counter, either as a matter of ordinary market making practice or unintentionally as a result of shifting market conditions. Retention of such securities for significant periods of time or during periods of high volatility and the realization of income from appreciation in the value of such positions could be construed as proprietary trading under the proposed regulations, even if the positions were in fact established to provide market making inventory.[36] Uncertainty as to what level of revenue or loss from changes in asset value is permissible may limit a banking entity's ability to function as an effective market maker.

Compensation. The proposed regulations require that the compensation arrangements for employees engaged in underwriting or market making activities be designed to discourage proprietary risk-taking.[37] Compensation must be structured to reward client returns and effective client service in the case of underwriting, or timely intermediation and liquidity services to customers in the case of market making, rather than profits from proprietary risk-taking or speculation regarding the market value of a covered financial position held in inventory.[38] In their compensation decisions, banking entities relying on either the permitted underwriting or market making activity may take into account revenues resulting from movements in the prices of securities or other positions held in inventory. However, they can do so only to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk or retained principal risk.[39] We expect that banking entities will need to review the compensation structures of the business units engaged in underwriting and market making and may find it necessary to adjust current compensation practices to comply with this requirement. With respect to their ability to retain qualified personnel, such changes may place banking entities at a competitive disadvantage in relation to institutions where compensation practices are not subject to the same constraints.

---

[33] Sarbanes-Oxley Act of 2002, § 906(a), 18 U.S.C. § 1350.

[34] Notice at 168.

[35] Proposed Regulations §§ __.4(a)(2)(vi) *&* (b)(2)(v).

[36] *See id.* § __.3.

[37] *Id.* §§ __.4(a)(2)(vii) & (b)(2)(vii).

[38] *See* Notice at 50, 60-61.

[39] *Id.*

In examining the trading activity of a business unit of a banking entity to determine whether it provides impermissible compensation incentives that reward proprietary risk-taking, the agencies will evaluate the extent to which compensation incentives reward revenues from movements in the price of retained principal positions and risks, the extent to which compensation incentives reward customer revenues, and the compensation incentives provided by other banking entities to similarly situated personnel.[40]

Permitted Underwriting Activity. The proposed regulations would permit a banking entity to engage in underwriting activities, even if such activities would involve the acquisition of a principal position in a covered security, to the extent that such activities are designed to meet the reasonably expected near-term demand of clients, customers or counterparties.[41] Banking entities must meet the following seven criteria to pursue transactions under this exception to the proprietary trading ban:

- the banking entity must have established the internal compliance program required under the proposed regulations;
- the covered financial position to be purchased or sold by the banking entity must be a security pursuant to Section 3(a)(10) of the Securities Exchange Act of 1934, as amended (the Exchange Act);
- the transaction must be effected solely in connection with a distribution of securities for which the banking entity acts as an underwriter;
- the banking entity must have the appropriate dealer registration or otherwise be exempt from registration or excluded from regulation as a dealer;
- the underwriting activities must be designed to meet, rather than exceed, the reasonably expected near-term demands of clients, customers and counterparties;
- revenues must be derived principally from fees, commissions, underwriting spreads or other similar income; and
- the compensation arrangements of persons who perform underwriting activities must be designed not to encourage proprietary risk-taking.[42]

The proposed regulations define the terms "distribution" and "underwriter" as such terms are defined under Regulation M.[43] The introduction states that, when determining whether a banking entity is acting as an underwriter, the agencies expect to consider the extent to which it is engaged in the following activities:

- assisting an issuer in capital-raising;
- performing due diligence;
- advising the issuer on market conditions and/or assisting in the preparation of offering documents;
- purchasing securities from an issuer, selling security holder or underwriter for resale to the public;

[40] Proposed Regulations app. B.III.C.5.

[41] *Id.* § __.4(a)(1).

[42] *Id.* § __.4(a)(2)(i)-(vii).

[43] *Id.* § __.4(a)(3)-(4); *see also* Notice at 48-49.

- participating in or organizing a syndicate of investment banks;
- marketing securities; and
- providing a post-issuance secondary market and facilitating price discovery.[44]

The proposed regulations expand the Regulation M definition of "underwriter" to include not only parties which have an agreement with an issuer or selling security holder to purchase securities for distribution or otherwise manage a distribution, but also parties that have agreements with any such Regulation M underwriter to engage in a distribution of securities on behalf of an issuer or selling security holder, such as dealers.[45] In the introduction to the proposed regulations, the agencies also recognize that activities of underwriters often vary depending on the type of securities offered and, therefore, the factors serve as indicia of underwriting rather than a bright-line test.[46]

In the introduction, the agencies acknowledge that, in certain instances, underwriters may hold securities for a prolonged period of time rather than immediately reselling them, typically when they are unable to sell all or a portion of the securities offered in an underwritten transaction. Sale of such securities at a later time is permitted if the original acquisition of the securities occurred in connection with underwriting activities and pursuant to the permitted underwriting activity.[47]

As is the case under Regulation M, to qualify as a "distribution," the offering must be of a certain "magnitude" and involve "special selling efforts and selling methods."[48] In the introduction, the agencies indicate that they expect to utilize the same factors that the SEC considers when evaluating a distribution pursuant to Regulation M. Magnitude may be established by taking into consideration the number of shares to be sold and the percentage of the outstanding shares, public float and trading volume that those shares represent.[49] In the introduction, the agencies note that under Regulation M, this criterion does not require a distribution to be large but rather to be distinguishable from ordinary trading.[50] Accordingly, the definition of distribution under the proposed regulations would not preclude a small offering or private placement from qualifying for the permitted underwriting activity, as long as, on a relative basis, the scale of the offering exceeds ordinary trades of the offered securities.[51] Indicia of special selling efforts and methods include delivering a sales document and conducting road shows. The introduction also indicates that compensation at a level greater than normal for secondary trades but consistent with underwriting compensation is an indicator of special selling efforts and methods.[52] The proposed regulations, however, stop short of providing a bright-line test for compliance by a particular transaction with the distribution component of the permitted underwriting activity.

[44]Notice at 49.
[45]Proposed Regulations § __.4(a)(4); *see also* Notice at 49.
[46]Notice at 49.
[47]*Id.*
[48]Proposed Regulations § __.4(a)(3); *see also* Notice at 48.
[49]Notice at 48.
[50]*Id.* at 48-49.
[51]*Id.* at 49.
[52]*Id.* at 48.

Permitted Market Making Activity. The proposed regulations permit banking entities to purchase or sell covered financial positions in connection with the banking entity's market making-related activities.[53] The agencies acknowledge the difficulty of distinguishing proprietary positions acquired in the context of market making from those acquired for impermissible speculative purposes.[54] The proposed regulations employ a multifaceted approach to the problem of drawing such distinctions.[55] This multifaceted approach includes a new reporting regime that requires disclosure by banking entities of quantitative measurements relating to their principal investments.[56] Although quantitative metrics are to be used in testing permitted market making activities, the proposed regulations again stop short of providing a bright-line test to evaluate compliance of particular principal transactions.

Banking entities must meet the following requirements to utilize the exception for permitted market making activities:

- the banking entity must have established the internal compliance program required under the proposed regulations (as described below);[57]
- the banking entity must engage in *bona fide* market making activity;
- the market making activity must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties;
- the banking entity must register, or be exempt from registration, as a dealer under the securities or commodities laws, as appropriate;
- revenues from the securities transactions in question must be derived principally from fees, commissions, bid/ask spreads or other similar income, rather than gains or losses resulting from market appreciation or appreciation of such security;
- the compensation arrangements for persons who perform market making activities must be designed to compensate for client service rather encourage or reward proprietary risk-taking; and
- the market making activity must be consistent with the guidance in the proposed regulations distinguishing proprietary trading from market making.[58]

The market making exception in its current form may assuage industry concern that the regulations would prevent financial intermediaries, including dealers in over-the-counter derivatives, from accommodating their customers by executing either complex positions or positions with complex hedges. Although the Dodd-Frank Act will require most standardized derivative transactions to be cleared and customers will thus execute many of their hedges through clearing participants, dealers should retain their ability to engage in custom transactions if they meet the requirements for exempted market making activity and hedge promptly and appropriately.

[53] Proposed Regulations § __.4(b)(1).

[54] *See* Notice at 53.

[55] *See id.* at 53-54.

[56] Proposed Regulations app. A.III.A; *see also* Notice at 54.

[57] *See* Internal Complinace Procedures.

[58] *See* Proposed Regulations § __.4(b)(2).

***Bona Fide* Market Making.** The exception for market making-related activity requires that the relevant banking entity engage in conduct that is considered "*bona fide* market making activity." To satisfy this requirement, a banking entity must hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position for its own account on a regular or continuous basis, depending on the liquidity of the type of security involved.[59]

The "market maker" definition in the proposed regulations is similar to the definition of market maker under Section 3(a)(38) of the Exchange Act. The introduction to the proposed regulations indicates that the agencies intend to evaluate the presence of *bona fide* market making in a manner similar to that currently used by the SEC to identify market making.[60] The introduction contemplates that, in the context of relatively liquid positions, such as publicly traded equity securities, market making activity generally would include:

- making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; and
- making continuous quotations that are at or near the market on both sides; and
- providing widely accessible and broadly disseminated quotes.[61]

In the context of less liquid positions, such as debt securities or over-the-counter derivatives, indicators of market making activity will vary but generally will include:

- holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;
- regularly purchasing covered financial positions from, or selling the positions to, clients, customers or counterparties in the secondary market; and
- transaction volumes and risk proportionate to historical customer liquidity and investment needs.[62]

The introduction to the proposed regulations indicates that *bona fide* permitted market making-related activity will include block positioning if undertaken for the purpose of intermediating customer trading, as well as taking significant block positions in securities in anticipation of customer demand, as long as such anticipatory buying or selling is reasonable and related to clear, demonstrable trading interests of clients, customers or counterparties.[63] However, because compliance with this requirement relies on a standard of "reasonably expected near[-]term demands," it is not clear whether it would be available for significant block positions that may be held on a continuous basis by market makers to facilitate large block trades in

[59] Proposed Regulations § __.4(b)(2)(ii). *See also* Notice at 56-57.

[60] Notice at 56.

[61] *Id.* at 56-57.

[62] *Id.* at 57.

[63] *Id.* at 57-58.

otherwise highly liquid securities. To provide liquidity for large block trades, a market maker may be required to hold positions that appear to be beyond the scale necessary to facilitate reasonably expected near-term demand, if that expectation is based on the volume of ordinary day-to-day trading. We would hope that the concept of near-term demand will be interpreted in a manner that is sufficiently elastic to accommodate such block trading.

Market making-related hedging transactions also are permissible if they meet two requirements. First, the purpose of the purchase or sale must be to reduce the specific risks to the banking entity related to individual or aggregated positions, contracts or other holdings acquired pursuant to the permitted market making activity.[64] Second, the hedging transaction must satisfy the requirements for the general risk-mitigating permitted hedging activity under the proposed regulations.[65] These criteria are intended to define the scope of permissible risk-mitigating hedging, to foreclose reliance on the exemption for prohibited proprietary trading conducted in the context of, or mischaracterized as, hedging activity, and to require documentation regarding the hedging purpose of certain transactions at a different level of organization than is required for the underlying risks being hedged.[66]

The permitted market making activity is specific both to the trading desk or organizational unit that is actually making the market in the covered financial position and to the type of covered financial position involved, since liquidity varies considerably by type of security. This exception will not permit non-market making trades by trading units that also engage in permitted market making, nor will it cover positions in covered securities taken by a banking entity's non-market making organizational units, even if other organizational units within the banking entity provide market making liquidity.[67]

Reasonably Expected to Meet Near-Term Demands of Clients. Market making-related activities must be reasonably expected to meet the near-term demands of clients, customers and counterparties.[68] The introduction states that expectations of demand should be based on more than a mere expectation of price appreciation and the related generic increase in marketplace demand.[69] The introduction does not provide guidance regarding the consequences to a banking entity that fails to accurately predict near-term demand and, as a result, holds positions in covered securities for periods longer than the typical holding period for the applicable securities.

The agencies have proposed a quantitative component to the analysis of near-term demand. The proposed regulations require the monitoring and reporting of up to 22 quantitative metrics intended to be indicative of whether a trading unit has acquired principal positions for the purpose of market making-related activities.[70] For banking entities that have $5 billion or more of gross trading assets and liabilities, each trading unit engaged in market making-related activity must conduct daily evaluations of 17 quantitative measurements, and all trading units of such banking entities must conduct daily evaluations of five quantitative measurements.[71] The results of such evaluations must be reported on a monthly basis to the relevant agency.[72]

---

64 Proposed Regulations § __.4(b)(3)(i).

65 *Id.* § __.4(b)(3)(ii); *see also* Permitted Risk-Mitigating Hedging Activity.

66 Notice at 61.

67 *Id.* at 56.

68 Proposed Regulations § __.4(b)(2)(iii).

69 Notice at 58; *see also* Proposed Regulations app. A.III.A.

70 Proposed Regulations app. A.III; *see also* Notice at 89.

71 Proposed Regulations app. A.III.A(i). The reporting metrics are less onerous for banking entities with between $1 and $5 billion of gross trading assets and liabilities. *See Id.* app. A.III.A(ii); *see also* Notice at 89, 90.

72 Proposed Regulations app. A.III.B.

The specific quantitative metrics fall into the following broad categories:

- risk-management measurements;
- source-of-revenue measurements;
- revenues-relative-to-risk measurements;
- customer-facing activity measurements; and
- payment of fees, commissions and spreads measurements.[73]

The proposed regulations describe these metrics and provide guidance as to how each must be calculated.[74] They do not, however, provide specific quantitative limits that would enable a banking entity to ascertain whether the metrics it reports fall within an appropriate range to qualify as permitted activity. The agencies have requested public comment on whether to incorporate such numerical thresholds for some or all of the quantitative metrics and, if so, what the appropriate thresholds should be.[75]

Even if the agencies were to adopt bright-line metrics, their implementation to evaluate compliance with the market making exemption could have a chilling effect on the ability of banking entities to engage in permissible market making activities. Reporting of the metrics by individual trading units (as currently proposed) would require coordination among participants in active trades to assure that, collectively, trading levels within the institution did not exceed permitted levels on any given day or other measurement period. Given the volume and velocity of transactions that may be executed by active trading units devoted to market making, such coordination may not be feasible or may result in timing or transactional inefficiencies that work in opposition to client-driven market making objectives.

Consistency With Agency Guidance Distinguishing Proprietary Trading From Market Making. To qualify as a permitted activity under the proposed regulations, market making-related activities must be consistent with the guidance provided by the agencies for distinguishing proprietary trading from market making, including the factors described below. Absent "explanatory circumstances,"[76] the presence of any of these six factors would result in a banking entity being deemed to be engaged in proprietary trading:

- trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;
- trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks rather than customer revenues;
- trading activity in which a trading unit generates only very small or very large amounts of revenue per unit of risk taken, does not demonstrate consistent profitability or demonstrates high earnings volatility;
- trading activity in which a trading unit either does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to

[73]Notice at 92.

[74]Proposed Regulations app. A.III.

[75]Notice at 88.

[76]*Id.* at 99. The introduction to the proposed regulations provides examples of such facts and circumstances. *See id.* at 99-100.

provide liquidity services, or holds principal positions in excess of reasonably expected near-term customer demands;

- trading activity in which a trading unit routinely pays rather than earns fees, commissions or spreads; and
- the use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.[77]

Permitted Risk-Mitigating Hedging Activity

The Volcker Rule seeks to influence banking entities to structure their businesses in a manner that increases their safety and soundness. To this end, the proposed regulations permit a banking entity to purchase or sell a covered financial position in connection with, related to, and designed to reduce the specific risks associated with, the banking entity's individual or aggregated positions or holdings.[78] As is the case for the underwriting and market making permitted activities, banking entities seeking to engage in permitted hedging activity must have established the required internal compliance program, including robust, detailed hedging policies and procedures designed to prevent prohibited proprietary trading in this context.[79]

Transaction Requirements. If a banking entity seeks to qualify to engage in permitted hedging activity, it will be required to establish that each purchase or sale:

- is made in accordance with the banking entity's written policies, procedures and internal controls established as described above;
- hedges or otherwise mitigates a specific risk arising out of individual or aggregated positions or other holdings of the banking entity;
- is reasonably correlated to risks intended to be hedged or mitigated;
- does not give rise, at the inception of the hedge, to significant exposures that were not already present in the hedged positions and that are not themselves hedged contemporaneously; and
- is subject to the banking entity's continuing review, monitoring and management that:
  - is consistent with the established hedging policies and procedures;
  - maintains a reasonable correlation with the risks intended to be hedged or mitigated; and
  - mitigates any significant exposure arising out of the hedge after inception.

In addition, the compensation arrangements of persons performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.[80]

---

[77] Proposed Regulations app. B.III.C.1-6; *see also* Notice at 99-100.

[78] Proposed Regulations § __.5.

[79] *Id.* § __.5(b)(1); *see also* Notice at 65.

[80] Proposed Regulations §§ __.5(b)(2)(ii)-(vi); *see also* Notice at 65-67.

The proposed regulations also impose a documentation requirement for each hedge established at a different a level of organization from that of the underlying exposure. At the time any such hedge is entered into, the banking entity must document, at a minimum, the risk-mitigating purpose of such a hedge, and the risks of the individual or aggregated positions it is designed to reduce.[81]

General Characteristics of Hedging Regulation. The proposed regulations follow the Volcker Rule[82] in allowing hedges of aggregated positions. The agencies, however, have solicited public comment as to whether the proposed regulations could better address strategies and techniques used to hedge aggregated positions.[83]

The requirement that a hedging transaction be reasonably correlated to risks intended to be hedged or mitigated is designed to ensure that banking entities can demonstrate quantitatively that hedging transactions reduce risk in the aggregate. Reasonable correlation does not require perfect correlation with any particular risk, but should take into account the costs and feasibility (including with respect to the liquidity of both the underlying and hedge positions) of effectively hedging a spectrum of associated risks.[84] The regulators note that changing circumstances will require hedges to be adjusted to maintain a reasonable level of correlation and particularly that hedges should be increased or unwound as the underlying exposure increases or decreases.[85] This is consistent with a general view that selective hedging, hedging that introduces new unhedged risks at inception and hedging that has the potential to generate profits in excess of losses that could result from the underlying position are all indicative of proprietary trading.

Similarly, the proposed regulations suggest that the regulators will view deviations from a banking entity's established hedging policies and procedures as a potential indication of proprietary trading. This is reflected specifically in the documentation requirement for a hedge established at a different a level of organization from the underlying exposure.[86] That requirement springs from the regulators' concern that the separation of the hedge and the underlying exposure at different levels of organization may otherwise present heightened potential for prohibited proprietary trading by allowing the banking entity to match trades after the fact to other risks that happened to exist at the time of the putative hedge.[87] Banking entities, however, may choose to move hedging activities to the level that generated the underlying risks to avoid this additional layer of documentation. In that case, the banking entities may forego the benefit of a more independent internal view of those risks.

Permitted Trading on Behalf of Customers

The proposed regulations permit trading on behalf of customers in which gains and losses flow to the customer and not the banking entity. The following categories of trading are permitted:

- trading in a fiduciary capacity where the customer has beneficial ownership of the positions;
- riskless principal transactions (in which the covered banking entity enters into a purchase or sale of a

81 Proposed Regulations § __.5(c).

82 Dodd-Frank Act § 619(d)(1)(C), 12 U.S.C. § 1851(d)(1)(C).

83 Notice at 69-71.

84 The Notice explicitly rejects the FASB hedge accounting standards, which tend to be narrow and quite specific, as being designed for a different purpose and subject to change. Notice at 66.

85 Proposed Regulations §§ __.5(b)(2)(iii)–(iv); *see also* Notice at 67.

86 Proposed Regulations § __.5(c).

87 Notice at 68.

covered position for its own account to offset a contemporaneous sale to or purchase from a customer);[88] and

- transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders.[89]

Overriding Restrictions on Permitted Activities

The proposed regulations include a provision that would prohibit transactions or activities that would otherwise be permitted if such transactions or activities:

- involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;[90]
- result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[91] or
- pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[92]

The proposed definition of material conflict of interest includes any transaction or activity that would involve the banking entity's interest being materially adverse to the interest of its client, customer or counterparty. The proposed regulations embody a regulatory focus on disclosure of conflicts or informational walls to manage conflicts.[93] Little guidance is provided as to what types of transactions could give rise to a material conflict of interest. The introduction to the proposed regulations states that the existence of such a conflict will be evaluated on a facts-and-circumstances basis. It also provides the example of a banking entity that acquires substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its various banking activities which, if improperly shared with its own trading desks and used in its own trading operations, would permit the banking entity to use such information to the disadvantage of its customers, clients or other counterparties.[94] As market making-related hedging transactions that are on opposite sides of the liquidity-generating position are specifically permitted by the proposed regulations,[95] it is unlikely that these types of transactions would constitute a material conflict of interest, although the exact reach of this provision is difficult to project. In light of the recent synthetic CDO settlements and the prospect of these new regulations, however, we can expect dealers to consider potential conflicts more carefully and to require more specific conflict waivers in transaction documentation going forward.

---

[88] In the case of the riskless principal transaction exception, the agencies note that the language mirrors the Board's Regulation Y, OCC interpretive letters and the SEC's Rule 3a5-1 under the Exchange Act, implying that the contemporaneous purchase or sale should occur within one business day of the customer transaction. Notice at 74.

[89] Proposed Regulations § __.6(b). The exception for insurance company separate account transactions is described in The Proposed Regulations and Insurance Company Investment Activities.

[90] Proposed Regulations § __.8(a)(1).

[91] *Id.* § __.8(a)(2).

[92] *Id.* § __.8(a)(3).

[93] *See id.* § __.8(b); *see also* Notice at 105.

[94] Notice at 105.

[95] Proposed Regulations § __.5(a).

Compliance Requirements

The proposed regulations include recordkeeping and internal compliance requirements (including external testing) for any covered banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities of $1 billion or more, with varying degrees of compliance infrastructure depending on the extent to which the entity engages in covered activities. Appendices specify requirements for quantitative measurements, factors for evaluating permitted market making transactions and minimum standards for program compliance.[96]

The proposed regulations attach a high degree of significance to the proportion of the revenues of the regulated entities that is derived from price movements and risk-taking (considered to be associated with prohibited proprietary trading) as opposed to the proportion derived from commissions and fees (considered to be associated with permitted underwriting activity and permitted market making activity). Similarly, the proposed regulations discourage regulated entities from structuring compensation of trading personnel to reward proprietary risk taking. Although these concepts may have intuitive appeal, applying a quantitative basis for this distinction will be difficult and may become more difficult over time, as professionals who receive compensation based on the profitability of their trading units become more adept at structuring their compensation and revenues to correlate with measures other than risk taking.

The proposed regulations rely on the ability of the enhanced compliance program to make difficult factual determinations, especially as to permitted market making, liquidity management and customer accommodation transactions. Because the internal compliance measures would be difficult and costly to implement, these customer-oriented activities may migrate toward a small number of large banks that have the resources to implement them — or be driven from regulated banking entities entirely.

[96] *See id.* § __.7(a), app. A; *see also* Notice at 14, 82, 89-90.

Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations

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 expand the definitions of "hedge fund" and "private equity fund" to include commodity pools and certain non-U.S. counterparts of covered funds. These additions present a number of questions and may lead to unintended consequences. Additionally, the proposed regulations codify the Volcker Rule's statutory exemptions, including exceptions related to permitted funds, permitted risk-mitigating hedging and non-U.S. activities of non-U.S. banking entities. The proposed regulations also specify several permitted activities, such as bank-owned life insurance separate accounts, certain corporate organization vehicles that may otherwise be included in the definition of a "covered fund" and debt collection in the ordinary course. The agencies have requested public comment on all aspects of the proposed covered fund regulations, and both the volume of the questions posed by the regulators and the uncertainty that remains in these sections leads us to expect changes in or further guidance on the final rule.

I. Key Provisions

The proposed regulations prohibit any banking entity from "sponsoring" a "covered fund," or acquiring or retaining "as principal" any "ownership interest" in a covered fund, subject to certain exceptions.[1] The proposed regulations define these and other key terms as follows:

Covered Fund

1. an issuer that relies on the Section 3(c)(1) or 3(c)(7) exclusions[2] from the definition of investment company under the Investment Company Act of 1940, as amended (the Investment Company Act);[3]

2. a commodity pool;[4]

[1] Proposed Regulations § __.10.

[2] Section 3(c)(1) of the Investment Company Act provides an exclusion from the definition of "investment company" for any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act provides an exclusion for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.

[3] 15 U.S.C. 80(a)-1-64. This is a "but for" test. An issuer that relies on Section 3(c)(1) or 3(c)(7) and also may rely on another exclusion or exemption from the Investment Company Act (*e.g.*, Section 3(c)(5)(C) for certain real estate funds) is not covered by Clause 1 of the definition of covered fund. *See* Notice at 114.

[4] Commodity pool is defined in Section 1a(10) of the Commodity Exchange Act of 1936, as amended (the Commodity Exchange Act) 7 U.S.C. §§ 1-26, to mean any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests, including any: (i) commodity for future delivery, security futures product or swap; (ii) agreement, contract, or transaction described in Section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under Section 4c of the Commodity Exchange Act; or (iv) leverage transaction authorized under Section 23 of the Commodity Exchange Act.

Contributors / Partners / Heather Cruz, Heather.Cruz@skadden.com, 212.735.2772 / William J. Sweet, Jr., William.Sweet@skadden.com, 202.371.7030 / **Associate /** Geoff Bauer, Geoff.Bauer@skadden.com, 212.735.3619

3. an issuer organized or offered outside of the U.S. that would, if organized or offered in the United States, satisfy Clause 1 or Clause 2 above;[5] or

4. any similar fund as may be designated by rule.

Clause 1 of this definition tracks the statutory application of the Volcker Rule, substituting the Dodd-Frank Act's defined terms "hedge fund" and "private equity fund" with a combined definition of a "covered fund."[6] Clauses 2 and 3 were added based on the statutory authority to expand the definition of covered fund using the designation of "similar funds." Clause 2 expands the definition to include commodity pools. Clause 3 expands the definition to include non-U.S. issuers that would be covered by Clauses 1 or 2 were they located in the U.S. or offered to U.S. persons.

The FSOC Study indicated that the agencies may designate as similar funds entities that have the characteristics or engage in the activities of a traditional hedge fund or private equity fund.[7] The proposed regulations, however, designate all commodity pools as covered funds without regard to whether any particular commodity pool has the characteristics of a hedge fund or private equity fund. The proposed regulations would bring many regulated entities not traditionally considered to be hedge funds or private equity funds within the definition of a covered fund.[8] For example, otherwise-regulated entities such as SEC-registered investment companies and bank collective trust funds often fall under the definition of commodity pool. The operators of these entities typically qualify for an exclusion from the CFTC's registration requirements (and accordingly are excluded from much of the CFTC's reporting requirements) due to their regulation by other federal regulators,[9] and are not within the spirit of similar funds meant to be covered by the Volcker Rule. The inclusion of commodity pools also would bring within the definition of covered funds certain companies that rely upon exemptions from the definition of investment company other than Section 3(c)(1) or 3(c)(7), which also do not appear to be within the spirit of similar funds meant to be covered by the Volcker Rule. The introduction to the proposed regulations requests public comment as to whether the inclusion of commodity pools is "consistent with the language and purpose of the statute."[10] We encourage interested parties to comment on this issue and hope that the agencies will revise the definition of covered fund in the final rules to exclude such entities from the scope of the Volcker Rule.

The proposed regulations also incorporate non-U.S. equivalents by including as a covered fund any issuer organized or offered outside of the U. S. that would be a covered fund if it were organized or offered in the U. S. or to one or more U.S. residents. Non-U.S. jurisdictions often approach the question of what

---

[5] The applicability of the proposed regulations to such non-U.S. entities is stated as follows:

> Any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940, that is organized or offered outside of the United States that would be a covered fund [as defined herein] … were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States.

[6] Proposed Regulations § __10; *see* Dodd-Frank Act § 619(h)(2), 12 U.S.C. § 1851(h)(2).

[7] FSOC Study at 63. Indeed, even the language in the proposed regulations indicates that the agencies intended to include similar funds that are "generally managed and structured similar to" a hedge fund or private equity fund. *See* Notice at 184.

[8] The inclusion of commodity pools in the definition of covered fund follows a similar definition in the SEC's and CFTC's systemic risk-reporting regime on Form PF. Form PF defines the term hedge fund to include, among other things, any commodity pool that meets the definition of a private fund, also without reference to the CFTC's exemptions for certain commodity pool operators. The proposed regulations are in fact broader than Form PF, as the proposed regulations are applicable to all commodity pools, not only private funds.

[9] For example, CFTC Rule 4.5 exempts the commodity pool operators of registered investment companies and bank collective trusts from registration with the CFTC. 17 C.F.R. § 4.5 (2011).

[10] Notice at 117.

constitutes a public or private investment vehicle in a manner that is not directly analogous to the 3(c)(1) and 3(c)(7) exclusions or the commodity pool definition. Just as many U.S. investment vehicles are organized specifically to comply with U.S. regulatory requirements, many non-U.S. investment vehicles are organized specifically to comply with applicable non-U.S. regulatory requirements. Treating a non-U.S. fund as if it were organized or offered in the U.S. is incongruous with the purposes and methods of existing regulations in both the U.S. and overseas. The introduction to the proposed regulations requests comments as to whether non-U.S. funds instead should be defined by direct reference to the fund's structural criteria, such as whether it is limited in its number or type of investors and whether it operates without regard to regulatory requirements relating to the types of instruments in which it may invest or the degree of leverage it may incur.[11] We expect the public comments to include requests for further guidance on how to identify and incorporate non-U.S. funds.

As Principal

The proposed regulations prohibit a covered banking entity from acquiring or retaining an ownership interest in a covered fund "as principal."[12] The proposed regulations do not define the scope of the "as principal" limitation, but the introduction to the proposed regulations lists the following examples of permitted ownership interests in a covered fund:

- an ownership interest held by a banking entity in good faith in a fiduciary capacity (except where such ownership interest is held under a trust that constitutes a company as defined in Section (2)(b) of the Bank Holding Company Act, or BHC Act);
- an ownership interest held by a banking entity in good faith in its capacity as a custodian, broker or agent for an unaffiliated third party;
- an ownership interest held by a "qualified plan," as defined in Section 401 of the Internal Revenue Code of 1956, if the ownership interest would be attributed to a banking entity solely by operation of Section 2(g)(2) of the BHC Act; or
- an ownership interest held by a director or employee of a banking entity who (i) acquires the interest in his or her personal capacity and (ii) is directly engaged in providing advisory or other services to the covered fund (unless the banking entity extended credit for purposes of acquiring the ownership interest).[13]

Ownership Interest

The term "ownership interest" is defined broadly.[14] It is based on the attributes of the interest and whether the interest provides the banking entity with economic exposure to the profits and losses of the covered fund as opposed to the form of the interest. To the extent that a debt security or other interest exhibits

[11] Notice at 118.

[12] Proposed Regulations § __.10(a).

[13] Notice at 113.

[14] Ownership interest is defined as any equity, partnership or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest. *See* Proposed Regulations § __.10(b)(3)(i).

substantially the same characteristics as an equity interest, the agencies are likely to consider it to be an ownership interest.[15]

The proposed regulations exclude a carried interest received from a covered fund if the banking entity serves as investment adviser or commodity trading advisor, and:

- the sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the banking entity, provided that the banking entity may be obligated under the terms of such interest to return profits previously received;
- all such profit, once allocated, is distributed to the banking entity promptly after being earned or, if not so distributed, the reinvested profit of the banking entity does not share in the subsequent profits and losses of the covered fund;
- the banking entity does not provide funds to the covered fund in connection with acquiring or retaining this interest; and
- the interest is not transferable by the banking entity except to an affiliate or subsidiary thereof.[16]

Thus, the proposed regulations would allow banking entities to receive a carried interest notwithstanding the ownership restrictions but would prohibit them from reinvesting the proceeds of the carried interest in future profits and losses of the fund. This approach represents an attempt to compromise between an outright prohibition of carried interest and unrestricted use of carried interest (which regulators fear could be used as a means of circumventing the Volcker Rule's restrictions). The introduction to the proposed regulations requests public comment as to whether the proposed exemption is appropriate, adequately addresses existing carried interest arrangements, and is consistent with the current tax treatment of carried interest arrangements.[17]

Sponsorship

The proposed regulations define the term "sponsor" in the same manner as the statutory text of the Volcker Rule, with the addition of "commodity pool operator."[18] Specifically, the proposed regulations define the term sponsor as an entity that serves as a general partner, managing member, trustee or commodity pool operator of a covered fund; 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 shares with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.[19]

In the introduction to the proposed regulations, the agencies explain that the definition of sponsor focuses on the ability to control the decision-making and operational functions of the fund.[20] In keeping with this focus, the proposed regulations define the term "trustee" (which is a part of the definition of

[15] Notice at 115.

[16] Proposed Regulations § __.10(b)(3)(ii)(A).

[17] Notice at 119.

[18] The addition is a result of Clause 2 of the definition of covered fund.

[19] Proposed Regulations § __.10(b)(5). *Cf.* Dodd-Frank Act § 619(h)(5), 12 U.S.C. § 1851(h)(5).

[20] Notice at 116.

sponsor) to exclude a trustee that does not exercise investment discretion with respect to a covered fund. The proposed regulations provide that a trustee includes any banking entity that directs a directed trustee[21] or any person who possesses authority and discretion to manage and control the assets of the covered fund.[22]

Prime Brokerage Transactions

The proposed regulations adopt a definition of "prime brokerage transaction" to effectuate the Dodd-Frank Act's exemption for permitted prime brokerage activities with respect to a covered fund. The proposed regulations define prime brokerage transaction to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution or financing, data, operational and portfolio management support.[23]

II. Permitted Funds Exemption

The primary exemption from the general prohibition on sponsorship or investment in a covered fund is the eight-factor permitted funds exemption. [24] The proposed regulations codify this exemption as follows:

1. ***Bona Fide* Services:** The banking entity must provide *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services. The proposed regulations do not specify what services would qualify; instead, the proposed regulations track the statutory language and reflect the intention that as long as the banking entity provides such services in compliance with relevant statutory and regulatory requirements, this requirement generally would be deemed to be satisfied.

2. **Customer Requirement:** The covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity. The proposed regulations do not require that the customer relationship exist prior to the organization and offering of the covered fund. Rather, the organization and offering of a covered fund must be a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary or advisory services to the customer. To effectuate this requirement, banking entities must adopt a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the covered fund.[25] The absence of any requirement in this definition for a pre-existing relationship between the banking entity and the offerees would allow banking entities to continue to offer their funds and provide related services in a manner that is consistent with existing law and regulation. In the introduction to the proposed regulations, however, the agencies request public comment regarding the customer requirement, including whether the agencies should adopt a definition of "customer of such services" for purposes of this exemption.[26]

---

[21]As defined in Section 403(a)(1) of the Employee's Retirement Income Security Act (ERISA), 29 U.S.C. § 1103(a)(1).

[22]Notice at 116.

[23]Proposed Regulations § __.10(b)(4).

[24]*Id.* § __.11(a)-(h).

[25]Notice at 123.

[26]*Id.* at 127.

3. **Investment Limitations:** The banking entity may not acquire or retain an ownership interest in the covered fund except as permitted under Subpart C of the proposed regulations relating to covered funds activities and investment. This section embodies the Volcker Rule's 3 percent *de minimis* ownership limitation with respect to single funds and in the aggregate.[27] The proposed regulations also codify the procedure for requesting an extension of time to divest an ownership interest.

   – **Single Fund Investment Limitations:** A banking entity may own up to 3 percent of the total amount or value of a covered fund, and the investment may not result in more than 3 percent of the losses of the fund being allocable to the banking entity's investment. The single fund investment limitation includes the following investments in a covered fund:

     - investments held directly by the banking entity;
     - investments held by any entity controlled, directly or indirectly, by the banking entity;
     - the *pro rata* amount of investments held by any entity not controlled by the banking entity if the banking entity holds more than 5 percent of the voting shares of such entity; and
     - any investments by the banking entity acting in concert with a covered fund.[28]

   – **Aggregate Investment Limitations:** A banking entity's aggregate investments in covered funds may not exceed 3 percent of its Tier 1 capital. The proposed regulations clarify how the 3 percent of a Tier 1 capital test would be calculated for various types of banking entities, including insured depository institutions, bank holding companies and other banking entities that themselves do not calculate Tier 1 capital.[29] Additionally, the proposed regulations provide a method of determining Tier 1 capital for complex banking entity structures for purposes of this provision.[30]

4. **Section 23A and 23B Relationships:** The banking entity must comply with the restrictions governing relationships with covered funds under Section —.16 of the proposed regulations. The proposed regulations incorporate the Volcker Rule's statutory "Super 23A" prohibition on "covered transactions" as defined in Section 23A of the Federal Reserve Act of 1913, as amended (the Federal Reserve Act), as if the banking entity (and any affiliate) were a member bank and the covered fund were an affiliate thereof. The proposed regulations apply Super 23A without incorporating any of the provisions in Section 23A that provide exemptions for certain types of covered transactions.[31]

5. **No Guarantees:** The banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. The proposed regulations incorporate the statutory language preventing guarantees and do not provide any further guidance. This approach retains the ambiguity inherent in the

[27] *See* Dodd-Frank Act § 619(d)(4), 12 U.S.C. § 1851(d)(4).

[28] Proposed Regulations § __.12(b).

[29] *Id.* § __.12(c).

[30] *Id.* § __.12(c)(2). *See also* Notice at 132.

[31] The proposed regulations do, however, incorporate the exclusion from the definition of covered transaction for certain purchases of real and personal property that are specifically exempted by the Federal Reserve. The introduction to the proposed regulations confirms that since these transactions, by definition, are excluded from the definition of covered transaction, they would not be covered by Super 23A. *See* Notice at 155. *See also* Dodd-Frank Act §§ 619(f)(1) & (2), 12 U.S.C. §§ 1851(f)(1) & (2).

statutory language, including the scope of the "directly or indirectly" limitation. In the introduction to the proposed regulations, the agencies request public comment concerning whether the proposed regulations effectively implement the prohibition on guarantees and request public comment as to potential alternative approaches.[32]

6. **Limitation on Name Sharing:** The covered fund, for corporate, marketing, promotional or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and may not use the word "bank" in its name. In a change from the statutory language, the proposed regulations extend this restriction to affiliates or subsidiaries of the banking entity and prohibit the use of the word "bank" in the name. The restriction on sharing the same name as affiliates or subsidiaries of the banking entity may present difficulties for asset management subsidiaries of banking entities, which in many cases have a different name than the parent banking entity and use such name for branding purposes. The agencies, in the introduction, request comment on whether the prohibition should be limited to specific types of banking entities (*e.g.*, insured depository institutions and bank holding companies) or only to the banking entity that organizes and offers the fund.[33]

7. **Limitation on Ownership by Directors and Employees:** No director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund. The proposed regulations provide no further guidance on what constitutes being "directly engaged" in providing investment advisory "or other services" to the fund. Due to the lack of guidance, the scope of this definition remains unclear. For example, the definition may include senior management-level employees who provide oversight or employees who provide services other than investment services. The introduction to the proposed regulations requests public comment on whether the agencies should provide additional guidance on what "other services" should be included for purposes of satisfying the permitted funds exemption.[34]

   Further, the introduction to the proposed regulations indicates that the agencies generally would attribute a director's or employee's ownership interest in a fund to the employing banking entity if the banking entity extends credit for the purchase of the interest, guarantees the purchase, or guarantees the director or employee against loss on the investment. The agencies describe this provision as a response to the opportunity for a banking entity to evade its ownership limitation by way of director or employee investments.[35]

8. **Disclosure Requirements:** The banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund certain enumerated disclosures contained in the proposed regulations and comply with any additional rules of the appropriate agencies designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity. The proposed regulations specify information that must be disclosed to investors (such as through disclosure in the fund's offering documents). The required disclosure includes a statement that all losses of the fund are borne by the investors of the fund and not by the banking entity.[36]

[32] Notice at 127.

[33] *Id.*

[34] *Id.*

[35] *Id.* at 125.

[36] Proposed Regulations § __.11(h)(1).

III. Additional Statutory Exceptions

Permitted Risk-Mitigating Hedging Activity

The proposed regulations codify the statutory exception that allows ownership of covered fund interests for permitted risk-mitigating hedging purposes.[37] Like many of the proprietary trading restrictions in the proposed regulations, this exception is extensive and imposes an onerous compliance burden; however, it may allow banking entities additional flexibility to continue to serve their customers and compensate their employees through permitted risk-mitigating hedges.

The general prohibition on ownership does not apply if the acquisition or retention of the ownership interest meets all of the following criteria:[38]

- The acquisition or retention is made in connection with and related to *individual or aggregated obligations or liabilities* of the banking entity that are:
  - taken by the banking entity when *acting as intermediary on behalf of a customer* that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or
  - *directly connected to a compensation arrangement* with an employee that directly provides investment advisory or other services to the covered fund.
- The acquisition or retention is *designed to reduce the specific risks* to the banking entity in connection with and related to such obligations or liabilities.
- The acquisition or retention is made in accordance with the *written policies, procedures and internal controls* established by the banking entity pursuant to the proposed regulations.
- The acquisition or retention *hedges or otherwise mitigates* an exposure to a covered fund through an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that:
  - arises out of a transaction *conducted solely to accommodate a specific customer request* with respect to that covered fund, or
  - is *directly connected to its compensation arrangement* with an employee that directly provides investment advisory or other services to that covered fund.
- The acquisition or retention *does not give rise*, at the inception of the hedge, *to significant exposures* that were not already present in individual or aggregated positions, contracts or other holdings of a banking entity and that are not hedged contemporaneously.
- The acquisition or retention is *subject to continuing review*, monitoring and management by the banking entity that:

[37] *Id.*
[38] *Id.*

- is consistent with its written hedging policies and procedures;
- *maintains a substantially similar offsetting exposure* to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and
- *mitigates any significant exposure* arising out of the hedge after inception.

- The *compensation arrangements* of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.
- With respect to any acquisition or retention of an ownership interest in a covered fund by a banking entity pursuant to this paragraph, the banking entity must *document*, at the time the transaction is conducted:
  - the risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund;
  - the risks of the individual or aggregated obligation or liability of a banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce; and
  - the level of organization that is establishing the hedge.

Non-U.S. Activities by Non-U.S. Banking Entities

The proposed regulations implement the Volcker Rule's exemption for non-U.S. banking entities engaged in sponsoring a covered fund or acquiring or retaining ownership interests in a covered fund solely outside of the United States.[39] The regulations define the type of non-U.S. banking entities eligible for the exemption and the activities allowable pursuant to the exemption.[40]

- **Non-U.S. Banking Entity.** A non-U.S. banking entity is eligible for the exemption if:
  - the banking entity is not controlled, directly or indirectly, by a banking entity organized under U.S. law; and
  - the non-U.S. banking entity meets one of the following criteria:
    - **Criteria Applicable to Foreign Banking Organizations.** With respect to a banking entity that is a foreign banking organization, the banking entity is a qualifying foreign banking organization and is conducting the activity in compliance with Subpart B of the Federal Reserve's Regulation K;[41] or

[39] Dodd-Frank Act § 619(d)(1)(I), 12 U.S.C. § 1851(d)(1)(I).

[40] Proposed Regulations § __.13(c).

[41] Regulation K, 12 C.F.R. 24.20 (2011), specifies a number of conditions and requirements that a foreign banking organization must meet in order to rely on such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.

- **Criteria Applicable to Other Non-U.S. Banking Entites.** With respect to a non-U.S. banking entity that is not a foreign banking organization, the banking entity meets *at least two* of the following requirements:
  - total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;
  - total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or
  - total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

- **Activities Solely Outside the United States**. An activity by an eligible non-U.S. banking entity is exempt from the Volcker Rule's general prohibition if:
  - the banking entity engaging in the activity is not organized under the laws of the United States;
  - 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;[42] and
  - no ownership interest in the covered fund is offered for sale or sold to a resident of the United States.[43]

Other Exceptions

The proposed regulations also implement the statutory exceptions for loan securitization vehicles and small business investment companies and related investments.[44]

---

[42]The proposed regulations include an exemption from this requirement for employees or entities with no customer relationship and who are involved solely in providing administrative services or "back office" functions to the fund. *See* Notice at 146. The narrow scope of this exemption may require banking entities to closely monitor any such employees to ensure compliance.

[43]The agencies note that the defined term "resident of the United States" is similar, but not identical, to the definition contained in Regulation S under the Securities Act. Specifically, the proposed regulations expand the definition to include discretionary accounts held by a dealer or fiduciary for the benefit or account of a U.S. person. The proposed regulations also do not include the exclusions from the definition, including the exclusion for non-U.S. branches of U.S. entities. *See* Notice at 80.

[44]Proposed Regulations §§ __.13(a) & (d). The exemption for loan securitization vehicles is described in more detail in Impact of the Proposed Regulations on Securitizations.

IV. Permitted Activities

The Dodd-Frank Act grants regulators the authority to authorize certain activities that promote and protect the safety and soundness of a banking entity and the financial stability of the U.S.[45] The proposed regulations include the following permitted activities:

BOLI Separate Accounts

The proposed regulations allow banking entities to acquire and retain an investment in, as well as sponsor, a bank owned life insurance (BOLI) separate account. To qualify for this exception, the banking entity may not control the investment decisions regarding the underlying assets or holdings of the separate account and must hold its ownership interest in the separate account in compliance with applicable supervisory guidance regarding bank owned life insurance.[46]

Corporate Organization Vehicles

The agencies acknowledge that the definition of covered fund may include certain entities and corporate structures that typically would not be considered a hedge fund or a private equity fund. In order to allow banking entities to utilize such structures, the proposed regulations exempt from the general prohibition on sponsorship and investment the following types of entities:

- joint ventures, provided the joint venture is an operating company and does not engage in any activity or make any investment that is prohibited under the proposed regulations;[47]
- acquisition vehicles, provided the sole purpose and effect of the entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or an affiliate;[48]
- certain issuers of asset-backed securities in compliance with Section 15G of the Exchange Act;[49]
- liquidity management vehicles, provided that the vehicle is a wholly owned subsidiary of the banking entity that is engaged principally in performing *bona fide* liquidity management activities described in the proprietary trading section of the proposed regulations and carried on the balance sheet of the banking entity;[50] and
- a covered fund that is an issuer of asset-backed securities, as described more fully in the section of the proposed regulations relating to loan securitizations.[51]

[45] Dodd-Frank Act § 619(d)(1)(J), 12 U.S.C. § 1851(d)(1)(J).

[46] Proposed Regulations § __.14(a)(1). *See* The Proposed Regulations and Insurance Company Investment Activities.

[47] Proposed Regulations § __.14(a)(2)(i).

[48] *Id.* § __.14(a)(2)(ii).

[49] *Id.* § __.14(a)(2)(iii).

[50] *Id.* § __.14(a)(2)(iv); *see also* Proposed Regulations § __.3(b)(2)(iii)(C).

[51] *Id.* § __.14(a)(2)(v). *See* Impact of the Proposed Regulations on Securitizations.

Ordinary Course of Debt Collection and Conformance Period

Finally, the proposed regulations provide an exemption from the general prohibition of sponsorship and ownership when the ownership interest is obtained in the ordinary course of collecting a debt previously contracted in good faith, provided the banking entity divests within applicable time periods provided by the applicable federal agency, or when the fund is owned or sponsored pursuant to the Volcker Rule's conformance or extended transition period.[52]

V. Compliance Program

The proposed regulations contain a detailed compliance program to ensure that banking entities establish, maintain and enforce compliance procedures and controls with respect to the requirements of the Volcker Rule.[53] The compliance program is broadly divided into six elements, which include:

- internal written policies and procedures reasonably designed to document, describe and monitor the covered activities in order to ensure they comply with the proposed regulations;
- a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the proposed regulations;
- a management framework that clearly delineates responsibility and accountability for compliance with the proposed regulations;
- independent testing for the effectiveness of the compliance program, conducted by qualified internal or third-party personnel;
- training for appropriate personnel, including trading personnel and managers, to implement and enforce the compliance program; and
- making and keeping records sufficient to demonstrate compliance with the proposed regulations, which must be retained for at least five years and provided to the relevant supervisory regulator upon request.

In addition, certain banking entities with significant covered fund activities[54] will be subject to a heightened compliance program, which includes making senior and intermediate management accountable for the effective implementation of the compliance program and ensuring that the board of directors or chief executive officer reviews the effectiveness of the compliance program.

[52] Proposed Regulations § __.14(b).

[53] *Id.* § __.20.

[54] Generally defined to include banking entities that, together with their affiliates, have more than $1 billion in aggregate covered fund investments or sponsor or advise covered funds with average total assets of more than $1 billion. *See* Proposed Regulations § __.20(c)(ii).

VI. Material Conflict of Interest Limitation

The proposed regulations implement the Dodd-Frank Act's "material conflict of interest" limitation on the exemptions described above.[55] The proposed regulations provide that no transaction or activity is permissible under the exemptions if such transaction or activity would:

- involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;
- result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[56] or
- pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.[57]

A material conflict of interest exists between a banking entity and its clients, customers or counterparties if the banking entity "engages in any transaction, class of transactions, or activity that would involve or result in the covered banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity."[58] The proposed regulations allow for material conflicts to be cured by (a) disclosure to the other party and the opportunity to mitigate or (b) the establishment and enforcement of information barriers within the banking entity.[59]

---

[55] *See* Proposed Regulations § __.17.

[56] The proposed regulations define "high-risk asset" as "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail" and "high-risk trading strategy" as "a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail." Proposed Regulations § __.17(c).

[57] *Id.* § __.17(a)(1)-(3).

[58] *Id.* § __.17(b).

[59] *Id.*

Return to the Table of Contents

Impact of the Proposed Regulations On Securitizations

Introduction

Securitization has been the focus of many rulemaking initiatives in the wake of the financial crisis. The Volcker Rule is not directly targeted at securitization and expressly states that nothing in it should be construed to limit or restrict the ability of a banking entity to securitize loans.[1] Nevertheless, the proposed regulations, if enacted in their current form, would prohibit or restrict banking entities from engaging in many common securitization practices in the asset-backed commercial paper market and in other sectors. The most significant issues arise because the definition of "covered fund," which is intended to target hedge funds and private equity funds, also encompasses many issuers of asset-backed securities (ABS), including collateralized debt obligations (CDOs) and asset-backed commercial paper (ABCP) conduits. Banking entities will be prohibited from holding an ownership interest in or sponsoring a covered fund under the proposed regulations, subject to narrow exceptions. The proposed regulations effectively would mean that a U.S. bank could not sponsor and lend to an ABCP conduit in the manner that most such conduits are currently structured and could not hold an ownership interest in a CDO. In addition, the prohibition in the proposed regulations on proprietary trading would require banking entities, which could include bank-sponsored issuers of ABS that do not fall under the definition of covered funds, to establish and implement compliance programs and satisfy recordkeeping and reporting requirements.

Prohibition on Banking Entity Investment in Covered Funds

The proposed regulations prohibit banking entities from directly or indirectly acquiring or retaining an ownership interest in or sponsoring a covered fund, subject to certain exceptions. A "covered fund" is defined to include "[a]n issuer that would be an investment company, as defined in the Investment Company Act of 1940 … but for section 3(c)(1) or 3(c)(7) of that Act."[2]

Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities (other than commercial paper) are beneficially owned by no more than 100 persons and are not offered in a public offering in the United States.[3] Section 3(c)(7) is an exclusion for issuers who do not offer their securities in a public offering in the United States and who restrict the offering to "qualified purchasers," a category of large investors similar to those who would qualify as "qualified institutional buyers" for the purposes of Rule 144A under the Securities Act.[4] These exclusions are utilized for many types of securitization transactions including CDOs, collateralized loan obligations (CLOs) and ABCP conduit transactions.

[1] Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).

[2] Proposed Regulations § __.10(b)(1).

[3] By a series of no-action letters beginning with Touche Remnant Co., SEC No-Action Letter, 1984 SEC No-Act, LEXIS 2566, at *1 (Aug. 27, 1984), a non-U.S. issuer may conduct an offshore offering and a private U.S. offering simultaneously and count only the U.S. beneficial owners for that test.

[4] Similar to the relief provided in the Touche Remnant no-action letter under Section 3(c)(1), the SEC staff provided no-action letter relief under Section 3(c)(7) in Goodwin, Procter & Hoar, SEC No-Action Letter, 1997 SEC No-Act, LEXIS 375, at *1 (Feb. 28, 1997), to the effect that an offshore fund may conduct an offshore offering and a private U.S. offering simultaneously and only the U.S. beneficial owners need be qualified purchasers under Section 3(c)(7).

Contributing Partners / Susan M. Curtis, Susan.Curtis@skadden.com, 212.735.2119 / Andrew M. Faulkner, Andrew.Faulkner@skadden.com, 212.735.2853

Alternative Investment Company Act Exemptions. Many issuers of ABS rely on other exclusions from investment company status, most significantly Section 3(c)(5) of the Investment Company Act and Rule 3a-7 under the Investment Company Act rules and regulations.[5] Most traditional securitizations, including mortgage loan, auto loan and credit card securitizations, rely on the exemptions provided under Section 3(c)(5) or Rule 3a-7, or both. Many mortgage financing transactions, including those involving real estate investment trusts (REITs), rely on Section 3(c)(5)(C). If an entity, including an ABS issuer, satisfies the requirement for an Investment Company Act exclusion or exemption other than Section 3(c)(1) and 3(c)(7), it will not be a "covered fund" under the proposed regulations, even if that entity is subject to a legal document that requires compliance with Section 3(c)(1) or 3(c)(7).

Other Recent SEC Proposals Modifying Investment Company Act Exemptions. The SEC recently requested public comment on two separate proposals:

- a concept release with respect to Section 3(c)(5)(C) of the Investment Company Act, and
- an advanced notice of proposed rulemaking with respect to Rule 3a-7 and Section 3(c)(5) that could significantly restrict or in some circumstances eliminate the ability of ABS issuers to rely on these exemptions.[6]

In particular, the SEC questions whether Section 3(c)(5) should be amended to limit the ability of issuers of ABS to rely on Section 3(c)(5) and what the effect would be if issuers of ABS could no longer rely on Section 3(c)(5). The result could be that Rule 3a-7 would no longer be just a safe harbor for issuers of ABS but would become the exclusive means for an issuer of ABS to avoid investment company status without also becoming a covered fund under the proposed regulations under the Volcker Rule.

However, the SEC has suggested significant new conditions to obtaining the relief provided by Rule 3a-7, including a requirement for independent review of the underlying assets and an opinion from an independent evaluator regarding expected cash flows from the assets; appointment of a credit risk manager to evaluate repurchase requests related to breaches of representations and warranties, consistent with an SEC proposal for S-3 shelf-eligibility for ABS; and incorporation of requirements that may be adopted with respect to conflicts of interest in ABS transactions and risk retention requirements. These additional conditions could be added in lieu of the current references to ratings from a nationally recognized statistical rating organization that may be removed from Rule 3a-7 in response to the Dodd-Frank Act directive to review any references to or requirements regarding credit ratings in regulations.[7]

It is too early to determine what, if any, additional conditions may be imposed upon reliance on Rule 3a-7 and whether Section 3(c)(5) will remain available for ABS transactions. Ultimately, issuers could find that

---

[5] Section 3(c)(5) of the Investment Company Act provides an exclusion for an entity primarily engaged in the business of purchasing or acquiring receivables and other obligations representing part or all of the sales price for merchandise, insurance or services; making loans to manufacturers, sellers or purchasers of merchandise, insurance or services; or purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Rule 3a-7 provides an exclusion for most ABS issuers if they issue fixed-income securities that entitle their holders to receive payments that depend primarily on the cash flow from financial assets that convert into cash within a finite time period, subject to certain conditions.

[6] *See* SEC Press Release, *SEC Seeks Public Comment on Asset-Backed Issuers and Mortgage-Related Pools Under Investment Company Act* (Aug. 31, 2011), *available at* http://www.sec.gov/news/press/2011/2011-176.htm See *also* Concept Release, Request for Comments, *available at* http://www.sec.gov/rules/concept/2011/ic-29778.pdf; Advance Notice of Proposed Rulemaking, *available at* http://www.sec.gov/rules/concept/2011/ic-29779.pdf. The exclusion provided by Section 3(c)(5) was included in the Investment Company Act at a time prior to the development of ABS but was the main exclusion relied upon by issuers of ABS prior to the adoption of Rule 3a-7 in 1992.

[7] Dodd-Frank Act § 939(a), 12 U.S.C. §§ 1817 & 1831(e).

Section 3(c)(5) is no longer available and Rule 3a-7 is subject to prohibitive conditions. The remaining option for issuers in those asset classes would be to pursue private transactions that rely solely upon the exemptions provided by Section 3(c)(1) or Section 3(c)(7), which would cause the issuer to be a "covered fund" under the proposed regulations. [8]

Definition of Ownership Interest. A banking entity is permitted to acquire or retain an interest in, or a security of, an ABS issuer that is a covered fund if the interest or security does not qualify as an "ownership interest" under the proposed regulations. "Ownership interest" means any equity, partnership or other similar interest in a covered fund, whether voting or nonvoting, as well as any derivative of such interest.[9] The focus of the definition is on whether the interest in the covered fund provides a banking entity with exposure to the profits and losses of the covered fund rather than on the form of the interest in the covered fund held by the covered banking entity. A security in the form of debt that would expose the banking entity to the profits and losses of the covered fund could be deemed an ownership interest.

Definition of Sponsor. A covered banking entity is prohibited from acting as a "sponsor" of a covered fund. The proposed definition of "sponsor" focuses on the ability to control the decision-making and operational functions of the covered fund.[10] The definition of "sponsor" used in the proposed regulations is different from the definition used in SEC's Regulation AB, which focuses on the person who organizes and initiates an ABS transaction.[11] In the introduction to the proposed regulations, the agencies request public comment as to whether a "sponsor," as defined under Regulation AB, would be an appropriate party to treat as a "sponsor" under the proposed regulations.[12] While it is not entirely clear, a servicer or a collateral manager could be viewed as a "sponsor" under the proposed regulations, and the agencies specifically request public comment on this potential result.[13]

'Three Percent Rule' Exception. Among the exceptions to the prohibition on a covered banking entity acquiring or retaining an ownership interest in a covered fund is the "3 percent rule," which provides that:

- the banking entity's investment in a covered fund may not represent more than 3 percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule);
- the banking entity's investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment; and
- a banking entity may invest no more than 3 percent of its Tier 1 capital in covered funds.[14]

[8]It should be noted that the SEC has proposed that a private ABS transaction contain all the disclosure required of public ABS transactions in Reg AB relating to that asset class. *See* SEC Proposed Rule Release No. 33-9117 (April 7, 2010) *available at* http://www.sec.gov/rules/proposed/2010/33-9117.pdf. *See also* Skadden, Arps, Slate, Meagher & Flom LLP, Summary of SEC's Proposed Changes to Regulation AB, *available at* http://www.skadden.com/content/sitefiles/Skadden_B8DFAEB3452B3136EB9F870A4E68968B.pdf (June 7, 2010).

[9]Proposed Regulations § __.10(b)(3). *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[10]Proposed Regulations § __.10(b)(5). *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[11]In Regulation AB, "sponsor" is defined as the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. *See* 17 C.F.R. 229.1101(l) (2011).

[12]Notice at 117 (Question 219).

[13]Notice at 117 (Question 220).

[14]Proposed Regulations § __.12a. *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under

For a covered fund that is an ABS issuer, depending on the transaction structure, the calculation to determine if the banking entity is in conformance with the 3 percent rule may need to be performed each time a payment is made to any holder of the issuer's ABS and, in any event, no less frequently than at the end of every quarter.[15] A banking entity holding a subordinate interest in a securitization that constitutes an ownership interest would need to consider the possibility of breaching this test if, as is typical, the percentage it represents increases as a percentage of the pool balance as any senior securities that would be viewed as ownership interests are paid down prior to the subordinate interest.

Loan Securitization Vehicle Exemption. The proposed regulations permit a covered banking entity to acquire or maintain an ownership interest in, or sponsor, a covered fund if the covered fund is an issuer of asset-backed securities and the assets or holdings of the ABS issuer are solely comprised of:

- loans;
- contractual rights or assets directly arising from those loans supporting the asset-backed securities; and
- interest rate or foreign exchange derivatives that:
  - materially relate to the terms of such loans or contractual rights or assets; and
  - are used for hedging purposes with respect to the securitization structure.[16]

This provision is designed to implement Section 13(g)(2) of the BHC Act, which provides that nothing in Section 13 of the act is to be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law.[17] The agencies, however, have taken a narrow approach to crafting the exception for this permitted activity. This exemption does not explicitly permit several other types of assets often held by ABS issuers, such as liquidity arrangements (including liquidity and asset purchase agreements and third-party credit enhancement agreements, such as guarantees or letters of credit). Moreover, it does not address servicer advances, which are common features of residential and commercial mortgage securitizations.

Most significantly, the definition of "loans" in the proposed regulations is limited to "any loan, lease, extension of credit, or secured or unsecured receivable."[18] The introduction to the proposed regulations indicates that the definition of "loan" is intended to exclude ABS issued in connection with a loan securitization or otherwise backed by loans, which would mean that holding an ownership interest in or sponsoring a covered fund that is a CDO backed by a portfolio of asset-backed securities would not qualify as a permitted activity for a covered banking entity.[19] In the introduction, the agencies request public comment as to whether a "loan" should exclude a "security."[20] If it does, a covered banking entity would not be permitted under these provisions of the proposed regulations to hold an ownership interest in, or sponsor, a covered fund that is an issuer in a CLO transaction that allows investment in a limited basket of high-yield bonds and other types of securities (and conceivably even re-investment of cash proceeds in short-term investments).

---

the Proposed Regulations.

[15] Proposed Regulations § __.12(c)(2)(i).

[16] *Id.* § __.13(d).

[17] Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).

[18] Proposed Regulations § __.2(q).

[19] Notice at 45.

[20] Notice at 47 (Question 61).

In addition, the agencies ask whether an ABS transaction with an intermediate securitization, such as an auto lease securitization or many ABCP conduits, should be viewed as a single transaction and included within a securitization of "loans" or viewed as a separate securitization.[21] If viewed as a separate securitization, the exemption for securitization of loans would not apply to the second securitization where the asset is a "security" backed by "loans." This issue would affect not just asset-backed CDOs, but also several common types of traditional securitizations, unless those securitizations can rely on Section 3(c)(5) or Rule 3a-7 rather than Section 3(c)(1) or 3(c)(7). Auto lease securitizations typically involve a trust or other entity that holds the title to the vehicles and leases and issues a security representing the beneficial interest in a specific pool of vehicles and related leases to the entity that issues ABS to third-party investors. Similarly, ABCP conduits often hold variable funding notes issued by securitization vehicles, such as credit card master trusts, as well as direct interests in pools of receivables. If the agencies do not ultimately treat such structures as a single securitization, a covered banking entity would not be permitted under these provisions of the proposed regulations to hold an ownership interest in, or sponsor, a covered fund that holds securities from intermediate securitizations. In this case, the holding of an ownership interest in the covered fund by a banking entity would be limited to the amount permissible under the 3 percent rule. Further, the covered banking entity may be restricted from providing credit and/or liquidity to the ABS issuer.

The provision allowing "contractual rights or assets directly arising from those loans supporting the asset-backed securities"[22] appears to encompass proceeds and rights to foreclose on properties pledged to secure loans; however, it does not explicitly encompass the right to require repurchase of assets for breaches of representations and warranties or the investment of cash proceeds in short-term securities that are cash equivalents pending distribution to security holders.

The proposed regulations limit interest rate and foreign exchange derivatives to a notional amount tied to the outstanding principal balance of the loans supporting the ABS of an issuer.[23] Such derivatives must be used solely to hedge mismatches between the loans and the related ABS. Examples of permitted derivatives include an interest rate swap for a pool of fixed-rate loans collateralizing floating rate ABS or for a pool of loans with rates tied to prime rate collateralizing LIBOR asset-backed securities and a currency swap for a pool of Euro-denominated loans collateralizing dollar-denominated ABS.[24] Interest rate caps related to the terms of the loans also should be acceptable. Credit default swaps and total return swaps would not be permitted assets.

Narrow Exemption for Required Risk Retention. Under Section 941 of the Dodd-Frank Act, regulatory agencies are directed to issue rules regarding risk retention that require a sponsor or originator of an ABS transaction to retain an interest in the securitized assets.[25] The proposed regulations permit the banking entity to comply with this requirement by including an exemption to the prohibition of ownership by a banking entity of an interest in a covered fund that would allow the banking entity to retain the minimum amount required under the risk retention requirements.[26] This allowance is quite narrow given

[21] Notice at 148 (Question 301).

[22] Proposed Regulations § __.13(d)(2).

[23] *Id.* § __.13(d).

[24] Notice at 147.

[25] Dodd-Frank Act § 941(b), 15 U.S.C. § 78o-11. As required under this section, the relevant agencies issued a proposed rule to implement the requirements of Section 15G of the Securities Exchange Act of 1934, as amended. *See* Credit Risk Retention, 76 FR 24090, 24090 (Apr. 29, 2011).

[26] Proposed Regulations § __.14(a)(2)(iii).

that the risk retention proposal acknowledges that investors or other participants in a transaction may require a higher level of retention than is required by the rule. Securitizers offering securities to investors outside the United States may be subject to additional or different risk retention requirements that may exceed the minimum retention required under U.S. regulations.[27] Also, certain forms of retention, like a seller's interest in a credit card securitization transaction, fluctuate in size regularly and thus would typically be maintained in an amount in excess of any minimum requirement to avoid breaching the required minimum when variability causes a reduction in size.

Application of Super 23A and 23B to Securitizations. Issuers of ABS generally have not been considered affiliates of sponsoring banks for purposes of Sections 23A and 23B of the Federal Reserve Act but the proposed regulations generally would deem covered funds to be affiliates of banking entities for purposes of applying Section 23A and 23B. The so-called "Super 23A" prohibitions would restrict certain activities between a banking entity, serving as an investment adviser, investment manager or sponsor to a covered fund, and the covered fund.[28] The proposed regulations generally prohibit banking entities from entering into "covered transactions" with covered funds that would be treated as "affiliates" for 23A purposes.[29] Prohibited covered transactions would include loans or extensions of credit to the covered fund, repurchases of assets from the covered fund — which could prevent a banking entity from repurchasing assets from a covered fund upon a breach of representation or warranty — and issuances of guarantees or letters of credit on behalf of the covered fund.[30] The proposed regulations also provide that any permitted transaction is subject to the requirements of Section 23B of the Federal Reserve Act, as if the banking entity were a member bank and the covered fund were an affiliate of the banking entity.[31] Section 23B requires services and transactions between member banks and affiliates thereof to be on market terms or on terms at least as favorable to the banking entity as those of a comparable transaction by the banking entity with an unaffiliated third party.[32] This would apply to transfers of assets by the banking entity to the ABS issuer and to servicing functions performed by the banking entity.

Effect of Securitization on Proprietary Trading Prohibition. The proposed regulations also contain provisions intended to prohibit banking entities from engaging in proprietary trading transactions.[33] The introduction to the proposed regulations highlights the possibility that issuers of ABS that are not covered funds may be included within the definition of banking entity.[34] This would be the case for an issuer of ABS that does not rely on an exclusion contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act and is an "affiliate" or "subsidiary" of a banking entity, as those terms are defined in the BHC Act.[35] As noted above, issuers of ABS generally do not constitute "affiliates" of their bank sponsors under

[27] *See, e.g.*, Article 122a of the European Union Capital Requirements Directive, Council Directive 2009/111/EC, art. 122A, 2009 O.J. (L 302) 110, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF.

[28] *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations

[29] Proposed Regulations § __.16(a).

[30] 12 U.S.C. § 371c.

[31] Proposed Regulations § __.16(b).

[32] 12 U.S.C. § 371c-1.

[33] Proposed Regulations § __.3. *See* Proprietary Trading Restrictions Under the Proposed Regulations

[34] Notice at 21.

[35] *Id.*

the BHC Act because the related bank generally does not "control" the issuer of ABS as defined under the BHC Act. If, however, a banking entity were to satisfy the "control" requirements in relation to an issuer of ABS or the agencies were to interpret the definition of "affiliate" or "subsidiary" broadly, any covered banking entity that exceeds the asset and liability threshold would need to satisfy recordkeeping and internal compliance requirements,[36] which could impose additional costs on securitization transactions and require infrastructure not currently in place for issuers of ABS.

Relationship of the Proposed Regulations to Proposed Conflict-of-Interest Rule Under Section 621

On September 19, 2011, the SEC proposed a new rule pursuant to Section 621 of the Dodd-Frank Act intended to prohibit certain material conflicts of interest between those who create or distribute ABS, including synthetic ABS, and investors in the ABS.[37] The SEC notes in the commentary to the Section 621 conflicts-of-interest rule proposal that, given the similarities between the Volcker Rule and Section 621, the exceptions for risk-mitigating hedging activities and *bona fide* market making-related activities in the proposed Section 621 conflicts-of-interest rule "should be viewed no less narrowly than the comparable exceptions for such activities under the Volcker Rule."[38] The proposed regulations provide much greater detail regarding acceptable market making-related activities and risk-mitigating hedging than is included in the Section 621 conflicts-of-interest rules.[39] These regulations also include detailed compliance and reporting procedures that must be satisfied in order to benefit from the relevant exemptions.[40] Further, the proposed regulations include a provision defining material conflicts-of-interest that are prohibited, if they arise in connection with permitted trading activity, unless addressed and mitigated through timely and effective disclosure or informational barriers.[41]

The Section 621 conflicts-of-interest rule proposal does not explicitly recognize disclosure of information barriers as providing exemptions from the conflicts prohibition, but includes a discussion of disclosure and informational barriers as potential mitigants to conflicts of interest. The guidance provided in the introduction to the proposed regulations with respect to disclosure and informational barriers as mitigants to conflicts of interest establishes a benchmark for potentially incorporating those concepts under the Section 621 conflict-of-interest rule.[42] The proposed regulations require that, in order to be viewed as an effective mitigant to the conflicts-of-interest prohibition, disclosure must be made explicitly and effectively, and in a manner that provides the recipient the opportunity to negate or substantially mitigate any material adverse effect created by the conflict of interest used to restrict the dissemination of information within complex organization.[43] The proposed regulations also provide that information barriers may be a mitigant

---

[36]Proposed Regulations § __.20(c). *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[37]*See* Press Release, SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Asset-Backed Securities Transactions (Sept. 19, 2011), *available at* http://www.sec.gov/news/press/2011/2011-185.htm. *See* Skadden, Arps, Slate, Meagher & Flom LLP, SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Securitizations (Sept. 26, 2011), *available at* http://www.skadden.com/Index.cfm?contentID=51&itemID=2538.

[38]*Id.* at 81.

[39]Proposed Regulations §§ __.4(b), __.5, __.13(b).

[40]Proposed Regulation app. C. *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[41]Proposed Regulations § __.8. *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[42]Notice at 189.

[43]Proposed Regulations § __.8(b)(1).

to conflicts, but not if the banking entity knows or should reasonably know that a material conflict of interest arising out of a transaction may result in a material adverse effect on a client, customer or counterparty.[44]

Looking Ahead: Potential Consequences of the Volcker Rule

Despite the inclusion in the Volcker Rule of a provision stating that it is not to be "construed to limit or restrict the ability of banking entities or nonbank financial companies … to sell or securitize loans,"[45] the proposed regulations would prohibit or place significant limitations on common securitization practices. In proposing to define a covered fund by reference to specific exemptions from investment company status, the agencies have swept in ABCP conduits, CDOs, CLOs and other ABS issuers. The consequences of this approach could include:

- forcing ABCP conduits to restructure to qualify for an alternative investment company exemption or exclusion, which could result in fewer types of assets being financed through ABCP conduits;
- eliminating bank sponsored CDOs backed by ABS, high-yield bonds or other securities, which would eliminate a source of liquidity for tranches of residential mortgage loan securitizations and other ABS and therefore make it more difficult for originators to finance those assets and reestablish necessary financing practices in that market;
- placing significant new limitations on the assets that can be included in CLOs, which could hamper that fragile market; and
- restricting banking entities from sponsoring certain auto lease and credit card receivable securitizations that include an intermediate securitization.

[44] *Id.* § __.8(b)(2).

[45] Dodd-Frank Act § 619(g)(2), 12 U.S.C. § 1851(g)(2).

Return to the Table of Contents

The Proposed Regulations and Insurance Company Investment Activities

Designation as a 'Covered Banking Entity'

An insurance company is a "covered banking entity" if it controls or is affiliated with an insured depository institution (as defined in Section 3(c) of the Federal Deposit Insurance Act), which includes any bank, thrift, industrial loan company or other entity whose deposits are insured by the FDIC.[1] An insurance company also is a covered banking entity if it is an affiliate or subsidiary of a bank holding company (as defined in Section 8 of the International Banking Act of 1978), which includes any non-U.S. bank that has a U.S. branch, agency or commercial lending company subsidiary and the parent company of such non-U.S. bank.[2] Under the proposed regulations, except as otherwise permitted, an insurance company that is a covered banking entity is subject to the prohibitions on proprietary trading[3] and acquiring or retaining an ownership interest in, or acting as a sponsor to, a hedge fund or private equity fund.[4] It also is subject to extensive reporting and recordkeeping requirements applicable to other covered banking entities.[5]

Exemptions Applicable to Insurance Companies

The proposed regulations exempt certain proprietary trading activities by covered banking entities, two of which are directly applicable to insurance companies:

Permitted trading on behalf of customers: The proposed regulations permit proprietary trading to the extent that it is conducted on behalf of customers.[6] Insurance company investment activities for separate accounts are considered to be "on behalf of customers" if:

- the insurance company is directly engaged in the business of insurance and subject to regulation by a State[7] insurance regulator or foreign insurance regulator;
- the insurance company purchases or sells the covered financial position solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- all profits and losses arising from the purchase or sale of a covered financial position are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by that separate account and not to the insurance company; and
- the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws and other laws, regulations and written guidance of the State or jurisdiction in which such insurance company is domiciled.[8]

---

[1] Proposed Regulations § __.2(e).

[2] *Id.*

[3] *Id.* § __.3. *See* also Proprietary Trading Restrictions Under the Proposed Regulations.

[4] Proposed Regulations § __.10. *See also* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[5] *See* Proposed Regulations § __.7.

[6] *Id.* § __.6(b). *See also* Proprietary Trading Restrictions Under the Proposed Regulations.

[7] The proposed regulations define "State" as any state, territory or possession of the United States and the District of Columbia. Proposed Regulations § __.2(aa).

[8] *Id.* § __.6(b)(iii).

Contributing Partner / J. Stephanie Nam, Stephanie.Nam@skadden.com, 212.735.2653

This permitted activity relates to trading by regulated insurance companies for separate accounts, which the proposed regulations define as "an account established and maintained by an insurance company subject to regulation by a State insurance regulator or a foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company."[9] The exemption applies equally to U.S. and non-U.S. regulated insurance companies.

Permitted trading by a regulated insurance company: The prohibition on proprietary trading does not apply to the purchase or sale of a covered financial position by an insurance company or any affiliate of an insurance company if:

- the insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;
- the insurance company or its affiliate purchases or sells the covered financial position solely for the general account of the insurance company;
- the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- the appropriate federal banking agencies, after consultation with the Council and the relevant State insurance commissioners, have not jointly determined, after notice and comments, that a particular law, regulation or written guidance of the State or jurisdiction in which such insurance company is domiciled is insufficient to protect the safety and soundness of the covered banking entity or the financial stability of the United States.[10]

An insurance company general account is defined as all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State or foreign law.[11]

By permitting trading and investment activities in the separate accounts and general accounts of regulated insurance companies, the proposed regulations enable insurance companies that may otherwise be precluded by their affiliation with a depository institution or bank holding company to continue conducting ordinary insurer investment activities. These permitted activities manifest a recognition that insurance companies and their investment activities already are regulated extensively and supervised closely by state insurance regulators.

Reporting and Recordkeeping Requirements

Although proprietary trading activities by insurance companies in compliance with all applicable insurance investment laws and regulations are permitted,[12] an insurance company that is a covered banking entity nonetheless must comply with the reporting and recordkeeping requirements of the proposed regulations.[13]

---

[9] *Id.* § __.2(z).

[10] *Id.* § __.6(c).

[11] *Id.* § __.3(c)(6).

[12] *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[13] *See* Proposed Regulations § __.7.

If a covered banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion, the proposed regulations require that banking entity to comply with the quantitative measurement, recordkeeping and reporting requirements set forth in Appendix A of the proposed regulations.[14] Covered banking entities with less significant trading activities are not subject to the requirements of Appendix A but are required to establish a compliance program and satisfy other reporting and recordkeeping requirements.[15]

Limitations on Permitted Trading Activities

Notwithstanding the exemptions provided for certain trading activities involving insurance company general and separate accounts, the proposed regulations would impose prudential "backstops" on such activities. The proposed regulations would not permit any transaction, class of transactions or activity to the extent that it would:

- involve or result in a material conflict of interest between the covered entity and its clients, customers or counterparties;
- result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy; or
- pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.[16]

Trading in Hedge Funds and Private Equity Funds

With certain exceptions, a covered banking entity is prohibited from acquiring or retaining any ownership interest in or sponsoring a hedge fund or private equity fund (defined as "covered funds").[17] Unlike the proposed regulations with respect to proprietary trading, the proposed regulations for covered fund activities and investments, except as they relate to bank owned life insurance (BOLI), do not contain exemptions directly applicable to covered banking entities that are regulated insurance companies.

BOLI: The prohibition on acquiring or retaining any ownership interest in or sponsoring a covered fund does not apply to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to BOLI.[18] BOLI is defined as a separate account that is used solely for the purpose of allowing a covered banking entity to purchase an insurance policy for which the covered banking entity is the beneficiary.[19] BOLI policies are purchased by banking entities to cover key employees and help them reduce their employee benefit costs. The exemption is available only if the covered banking entity that purchases the insurance policy does not control the investment decisions regarding the underlying assets

[14] *Id.* § __.7(a).

[15] *Id.* §§ __.7(b) & (c).

[16] *Id.* § __.8.

[17] *Id.* § __.10. *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations for a description and discussion of the prohibition on covered fund activities and investments, as well as the exceptions to the prohibition.

[18] Proposed Regulations § __.14(a).

[19] *Id.* § __.14(a)(1).

or holdings of the separate account. In addition, the exemption requires the entity to hold its ownership interest in the separate account in compliance with applicable supervisory guidance regarding BOLI.[20] The exemption allows insurance companies to offer separate account BOLI products to bank clients, even though such accounts, like the traditional hedge funds and private equity funds, would be investment companies but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

[20] *Id.*

Postscript: Toward a New Regulatory Environment

The Volcker Rule was advanced as a means of protecting the public from the risks of negative externalities and the effect of distorted incentives (or "moral hazard") arising from proprietary trading activities by financial institutions that have access to funding through insured deposits or access to the Federal Reserve's discount window. Proponents of the ban on proprietary trading offered this description of the rationale: "After taxpayers were forced to bail out banks and other systemically significant financial companies whose proprietary trades went awry, we determined that the economy and taxpayers need strong protections against an increasingly casino-like financial system."[1] Paul Volcker observed that "adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense … when those risks arise from more speculative activities far better suited for other areas of the financial markets"[2] and that, accordingly, a robust financial system requires regulatory limitations on the proprietary activities of banks to balance the moral hazard implied by the public safety net.[3] The utility of the regulations proposed to implement the Volcker Rule will depend upon the effectiveness of the protections that they provide against these risks, balanced against the costs and unintended consequences that they generate.

Objectives of the Rule and Potential Unintended Consequences

The perception that proprietary trading by banks could cause catastrophic losses was an important impetus to the enactment of the Volcker Rule. Proprietary trading was seen as inherently risky[4] and a significant contributor to the financial crisis.[5] Moreover, it was viewed as a source of distraction from the provision by banks of credit and other core services, and a source of unacceptable conflicts of interest between banks and their customers.[6] The rule's architects objected to the use of federal support[7] by banks to enable their trading desks to speculate in financial assets. The prohibition against sponsoring and investing in private funds was viewed as necessary to counteract incentives that may impel banks to "bail out" a sponsored private fund and to prevent banks from using such investments to circumvent the proprietary trading ban.[8]

These views are not universally held. Some observers have questioned whether long-term investments (in, for example, collateralized debt obligations, mortgage-backed securities and leveraged loans), which

[1] Letter from Jeff Merkley *et al.*, Senator, U.S. Senate, to FSOC, 2 (Oct. 28, 2010), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-0822. *See also* Fin. Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds* 15 (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 (indicating that a purpose of the Volcker Rule is to "[s]eparate federal support for the banking system from speculative trading activity with the banking entity's own capital").

[2] Paul Volcker, Op-Ed, *How to Reform Our Financial System*, N.Y. Times, Jan. 31, 2010, at WK11. The Volcker Rule is named for former Federal Reserve Chairman Paul Volcker.

[3] *See id.*

[4] *See* U.S. Gov't Accountability Office, GAO-11-529, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (2011) (GAO Report), *available at* http://www.gao.gov/new.items/d11529.pdf.

[5] *Id.* at 6, 43.

[6] *Id.* at 10.

[7] The FSOC Study, in describing the prohibitions mandated by the Volcker Rule, observes that banking entities "benefit from federal insurance on customer deposits or access to the discount window." FSOC Study at 1.

[8] *Id.* at 6.

the rules would allow, present banks with a greater risk of destabilizing losses than the short-term trading that the rules prohibit.[9] Others have observed that the rules allow short-term proprietary trading in debt issued by the Treasury or government-sponsored enterprises.[10] Opponents of the Volcker Rule have questioned whether proprietary trading played any part in a financial crisis "caused by the erosion of lending standards and the federal government's poorly-conceived efforts to subsidize mortgage lending."[11] In addition, some have questioned whether the risk of loss arising from proprietary trading could be addressed more effectively by other means, such as improvements to the risk-based capital rules or requirements for elevated levels of margin in interbank transactions.[12]

Even if the Volcker Rule is an appropriate legislative response to the financial crisis, its utility will depend on whether the regulations issued to implement it will give regulators the tools they need to satisfy its objectives. The introduction to the proposed regulations evinces an overriding concern with trades that may appear (at least superficially) to be permitted market making or hedging activities but, in some more genuine sense, constitute a proscribed form of proprietary trading.[13] In one important dimension, the effectiveness of the regulations will depend on whether they provide sufficient means to detect such covert forms of proprietary trading.

The regulations will function effectively in the complex arena of modern trading only to the extent that they prove to be sufficiently dynamic and flexible to keep pace with rapid market innovation. There is a danger that the rules represent the regulatory equivalent of "fighting the last war." Even if they leave no risk that the conditions that caused the financial crisis will recur, the more relevant question is whether the rules can prevent the next crisis.

The proposed regulations will tilt the playing field toward financial firms — within and outside of the U.S. — that compete with the covered banking entities but are not subject to the same regulations. Banks outside the reach of U.S. regulation will gain a competitive advantage if, as expected, foreign regulatory authorities do not adopt the Volcker Rule's regulatory approach.[14] Non-U.S. banks and U.S. nonbanks that are not subject to the regulations can be expected to assume more of the risk attending the proprietary trading activities prohibited by the regulations. Given the uncertainty, complexity and cost that regulated banking entities will face in attempting to comply with the conditions that the regulations impose upon activities — such as market making — that the regulations are intended to allow, unregulated non-U.S. banks and U.S. nonbanks may assume an increasing share of those functions as well.

---

9 GAO Report at 24-26 (showing that between June 2006 and December 2010, the six largest bank holding companies "usually experienced larger revenues and losses from activities other than stand-alone proprietary trading … including writedowns on the values of these firms' positions in CDOs and leveraged loans"). *See also* Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 Harv. Bus. L. Rev. 39, 41 n.10 (2011).

10 *See, e.g.*, Editorial, *So Much for the Volcker Rule*, *Wall St. J.*, Oct. 24, 2011, at A14.

11 Letter from Spencer Bachus, Ranking Member, Committee on Financial Services, U.S. House of Representatives, to FSOC 1 (Nov. 3, 2010), *available at* http://www.ft.com/intl/cms/d983eaa6-e793-11df-8ade-00144feab49a.pdf.

12 *See, e.g.*, Editorial, *So Much for the Volcker Rule*, *Wall St. J.*, *supra* note 10.

13 Notice at 10, 13-14, 47-71.

14 *See* J.P.Morgan Cazenove, *Global Investment Banks: Regulatory Arbitrage Series: OW European Over US IBs* 24 (2011), *available at* https://mm.jpmorgan.com/stp/t/c.do?i=5930E-12&u=a_p*d_558208.pdf*h_-2igf3ms. In the United Kingdom, for example, regulators propose to permit any bank to continue proprietary trading activities if those activities are separated by a "ring-fence" from that bank's retail banking activities. *See* Independent Commission on Banking, Final Report Recommendations (2011) 35, *available at* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/201%7/ICB-Final-Report.pdf.

By restricting proprietary trading and altering the competitive landscape, the proposed regulations may channel risk to financial intermediaries that are not subject to prudential regulation, without reducing the overall level of risk in the financial system. This prospect may not appear to be inconsistent with the Volcker Rule's objectives, because those entities do not receive governmental support. Any such realignment, however, may cause regulated banks to depend increasingly on those other intermediaries to absorb risk,[15] increase the proportion of risk that lies beyond the reach of any prudential regulation and elevate systemic leverage. The soundness of the entities that assume additional risk in this shift, particularly if that risk is accompanied by greater leverage, could be highly inter-correlated, and any disruption ultimately may cause risk to flow back to the banks that the proposed regulations are designed to insulate.

Essential Financial Intermediation Services as 'Permitted Activities'

In the introduction to the proposed regulations, the agencies recognize that the provision by banking entities of "client-oriented financial services, which include underwriting, market making, and traditional asset management services, is important to the U.S. financial markets and the participants in those markets."[16] A fundamental challenge presented to the governmental agencies called upon to give regulatory substance to the Volcker Rule is to arrive at a wise balance between satisfying the goals of the rule and permitting banking entities to continue to perform functions that benefit the financial markets and the global economy.

The regulations attempt to accommodate this need by excluding certain "permitted activities" from the prohibition against proprietary trading. The permitted activities are designed to "preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 [of the Bank Holding Company Act] expressly protects and permits."[17] Thus the permitted activities are viewed as a means to "ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation."[18]

If the new regulations are to permit banks to continue to provide core financial intermediation services, such as market making, and to mitigate risk through hedging, the permitted activities (as expressed in the regulations and applied by the regulators) must function as intended. Moreover, if banks are to create necessary solutions to financial intermediation problems in complex and novel transactions, the permitted activities must provide adequate exceptions from the restrictions imposed by the regulations. The effectiveness of these provisions may be undermined by uncertainty in their meaning and consequences; insufficiency in their breadth and scope; and the costs that regulated institutions will be required to bear to comply with them.

The permitted activities must be sufficiently clear and definite to allow banks to continue to provide essential financial services. The agencies recognize that "the delineation of what constitutes a prohibited or permitted activity under section 13 of the BHC Act often involves subtle distinctions that are difficult

[15]*See* Whitehead, *supra note 9*, at 44-46.

[16]Notice at 9.

[17]*Id. See also* FSOC Study at 1 (Permitted activities are intended "to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation.").

[18]FSOC Study at 1.

both to describe comprehensively within regulation and to evaluate in practice."[19] With respect to the distinction between proprietary trading and market making, for example, the agencies observe that "[a]lthough the purpose and function of these two activities are markedly different — market making-related activities provide intermediation and liquidity services to customers, while proprietary trading involves the generation of profit through speculative risk-taking — clearly distinguishing these activities may be difficult in practice."[20]

Several key provisions attempt to distinguish permitted activities from prohibited proprietary trading based on the purpose, design and intention of the trading unit entering into the transaction in question.[21] Any attempt by an outside observer to ascertain the mental state of even a single individual, in performing even one action, is difficult. In the case of the proprietary trading restrictions, the actor is a business organization comprised of numerous individuals, and the proposed regulations would require the agencies to determine the intention or purpose of that actor in a multitude of trading transactions, many of which may be executed simultaneously.

From the perspective of a banking entity attempting to comply with the rules, the uncertainty of these provisions, the difficulty of their application and the risk of being second-guessed may have a chilling effect on its provision of financial services. The rules on hedging, for example, require that a hedge be entered into "to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings."[22] If that hedge fails, however, its failure may appear, in hindsight, to have been inevitable and to suggest that the relevant transaction was pursued for purposes of speculation, rather than risk reduction. Similarly, a banking entity would be required to rebut the presumption that a position violated the prohibition against positions acquired principally for the purpose of short-term resale[23] if, contrary to plan, unanticipated circumstances require disposition of that position in the short term. The presumption may be overcome "by reference to all facts and circumstances surrounding the acquisition,"[24] but the banking entity would bear the burden of producing evidence of those facts and circumstances and persuading the regulators that the acquisition should be permitted. This dynamic may lead a banking entity to conclude that the potential benefits of a contemplated activity do not justify the time, effort and resources that would be required to pursue it under the regulations. Thus the regulations may inhibit the process of innovation that creates solutions to financial intermediation problems.

The regulations also are unclear as to how they would treat actions that are undertaken for multiple purposes. A "trading account," for example, is used to "[a]cquire or take financial positions *principally* for the purpose" of specified categories of short-term trading activities.[25] The need to ascertain whether short-term trading is a "principal" purpose (as opposed, presumably, to a secondary or incidental purpose or another purpose of a lesser rank), adds a further dimension to the practical difficulty of assigning determinative significance to the banking entity's purpose or objective in pursuing the relevant transaction. Accordingly, if a banking entity wishes to market separately managed accounts and acquires positions in

---

[19]Notice at 9. *See also* Notice at 27, 53, 64, 177, 179; Proposed Regulations app. B.III.C.

[20]Notice at 53.

[21]Proposed Regulations app. B. *See also* Notice at 82.

[22]*Id.* § __.5(a).

[23]*Id.* § __.3(b)(2)(ii).

[24]Notice at 34.

[25]Proposed Regulations § __.3(b)(2)(emphasis added).

its own account to establish a track record for use in its marketing efforts, would the "principal" purpose of those positions be the creation of a track record, when they will only serve that purpose if the institution is successful in executing short-term trades in the account?[26] Where the regulations would restrict an activity of a banking entity based on the purpose of that activity, but include no express reference to the ranking of that purpose in relation to others,[27] will regulators find the restriction to apply if the specified purpose is not a "principal" purpose — or even a significant purpose?

The proposed regulations prescribe factors, based on quantitative metrics, for use by regulators to determine the intention or purpose of trading activity.[28] However, the factors draw no bright lines. The regulations provide many criteria, but no guidance on how to apply them and no indication of what specific level of a measured quantity should be viewed as the boundary between what is permitted and what is prohibited. These conceptual gaps include the level of risk "required" for conducting market making activities,[29] the level of "Portfolio Profit and Loss" in proportion to "Comprehensive Profit and Loss" that will indicate that a trading unit's revenues are derived from movements in the price of retained principal positions (and thus indicative of proprietary trading)[30] and the means to determine "reasonably expected near term customer demands" that would justify a trading unit in retaining a principal position for market making (as opposed to proprietary trading).[31] Thus, the rules leave broad discretion to the regulators and place enormous pressure on the resources and insight they will bring to bear on these determinations. Banking entities, in turn, are left with little guidance or certainty as to where the boundaries lie.

Individual institutions and the broader financial system may benefit if the agencies, in applying the regulations, either establish bright lines or allow regulated firms to lead the process of determining whether the requirements for permitted activities have been satisfied. The rules provide a framework for banking entities to establish their own criteria and processes for making the relevant determinations;[32] and the agencies may be justified in deferring to them in light of their resources, experience and understanding of the facts and circumstances relevant to the specified criteria in the context of their particular trading operations. Alternatively, the regulators may attempt to establish clearly delineated safe harbors, based on the quantitative metrics contained in the regulations, for permitted activities. If the regulators neither establish bright lines nor allow a degree of self-regulation by the banking entities, we would anticipate that the uncertainty, unpredictability of outcomes and increased transaction costs engendered by the regulations will work against the efficient provision by banking entities of liquidity and other financial intermediation services.

Even apart from the absence of bright-line standards, however, regulated entities may find it challenging to interpret and apply many of the criteria that the proposed regulations would prescribe to identify

---

[26]The regulations allow banking entities to provide seed capital in the private fund context (*see* Proposed Regulations § __.12(a)(1)) but do not expressly authorize seeding activity outside of the private fund context.

[27]*See, e.g.*, Proposed Regulations §§ __.3(b)(2)(i)-(iii), __12.(a)(i) & __.14(2).

[28]"The quantitative measurements that must be furnished under the proposed rule are generally designed to reflect, and provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful to help differentiate permitted market making-related activities from prohibited proprietary trading and to identify whether certain trading activities result in a material exposure to high-risk assets or high-risk trading strategies." Notice at 14.

[29]Proposed Regulations app. B.III.C.1.

[30]*Id.* app. B.III.C.2.

[31]*Id.* app. B.III.C.4.

[32]*Id.* app. C. *See also* Notice at 10, 13, 14, 54, 84, 163-164.

permitted activities. The regulations, for example, attempt to identify a conceptual link between "customer"-oriented services and market making. The regulations would deem a purchase or sale of a covered financial position to be made in connection with market making-related activities only if (among other things) "the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of *clients, customers, or counterparties*."[33] Separately, the regulations provide that activities of a trading unit will be prohibited as proprietary trading, rather than permitted as market making-related activities, if that trading unit "retains principal … risks in excess of reasonably expected near term *customer* demands."[34] The omission of "clients" and "counterparties" in the second provision is not explained. In addition, the criteria indicate that the agencies will use the "Customer Facing Trade Ratio" metric to help them assess the extent to which a trading unit's transactions are with "customers versus non-customers."[35] The Customer Facing Trade Ratio relies on a distinction between a "*counterparty* that is a *customer*" and a "*counterparty* that is not a *customer*."[36] The clarity of the market making exception may be improved to the extent that the final regulations can harmonize these provisions.

The distinction between a "customer" and a "non-customer" thus appears to be essential to the determination of whether trading will be considered permitted market making activity.[37] A clear concept of "customer" is elusive, however, and the regulations provide little illumination.[38] An appendix to the regulations provides that a transaction counterparty is not a customer if the transaction is executed on a national securities exchange,[39] but a separate appendix provides that a customer is a person on behalf of whom a broker-dealer or other market participant submits a buy or sell order on an exchange.[40] Appendix B indicates that a customer in an OTC market makes use of the market maker's intermediation services either by requesting those services or by entering into a continuing relationship with the market maker with respect to those services.[41] No guidance is offered to identify a "continuing relationship." Moreover, no definition or explanation of the term "intermediation services" is offered. Indeed, the entire process of distinguishing market making from proprietary trading can be viewed as an exercise in identifying "intermediation."

The introduction to the proposed regulations indicates that "for a banking entity's expectations regarding near-term demand to be considered reasonable, such expectations should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's 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

[33] Proposed Regulations § __.4(b)(2)(iii) (emphasis added).

[34] *Id.* app. B.III.C.4 (emphasis added).

[35] *Id.* app. B.III.C.4.

[36] *Id.* app. A.IV.D (emphasis added).

[37] *Id.* app. B.III.C.4. *See also* Notice at 92-95, 262-263.

[38] The agencies may add definitions of "client," "customer" and "counterparty" to the final regulations. The agencies seek public comment as to whether and how such terms should be defined. Notice at 64.

[39] Proposed Regulation app. A.IV.D.3.

[40] Proposed Regulation app. B.III.A.

[41] *Id.*

appreciation."[42] To benefit from this guidance, a trading unit considering whether a position would be commensurate with near-term demand of its customers (or, in the alternative formulation, its clients, customers and counterparties) would appear to be required to infer the underlying motivation for projected demand. The agencies offer no suggestion of what factor "beyond" an expectation of price appreciation may drive such demand.

In addition to the foregoing issues concerning the interpretation and application of the proposed criteria for the permitted activities, banking entities should consider the scope and breadth of those permitted activities. The Dodd-Frank Act invited the agencies to establish exemptions to the proprietary trading restrictions beyond those that the Act enumerated specifically,[43] but the agencies have not proposed any such discretionary exemptions. If the permitted activities as set forth in the final rules are not sufficiently broad and comprehensive, the regulations may inhibit banking entities from providing innovative solutions to financial intermediation problems in an evolving financial system. During the public comment period, financial industry participants will have an opportunity to identify and communicate to the agencies any needs for additional exemptions.

Jurisdictional Reach of the Proposed Regulations

Market participants within and outside the U.S. may be surprised by the jurisdictional reach of the regulations. The permitted activity in respect of trading effected "solely outside of the United States" is narrowly circumscribed. An entity may be subject to the proposed regulations as a "banking entity" if it is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, even if that bank holding company has only a minimal presence (such as a single branch or agency) in the U.S. Such a banking entity would not be permitted to enter into a proprietary trading transaction with a non-U.S. subsidiary of a U.S. corporation (even if that corporation is in no respect subject to banking regulation) if that subsidiary was formed for the purpose of entering into such transactions.[44] A foreign banking entity would not be permitted to enter into a proprietary trading transaction with a non-U.S. counterparty if any employee of the banking entity "directly involved" in the transaction is located in the U.S.[45] or if the transaction is not "executed wholly outside of the United States."[46] The proposed regulations provide no guidance as to what it means for an employee to be "directly involved" or where a transaction would be deemed "executed" for these purposes.

The proposed regulations would appear to require a foreign banking entity with a minimal U.S. presence to comply with the recordkeeping and reporting provisions of the regulations to establish that it is permitted to effect any transaction that qualifies for the permitted activity in respect of trading effected "solely outside of the United States."[47] Even if such a banking entity is otherwise permitted to pursue a transaction "solely outside of the United States," the regulations would appear to prohibit that transaction if it would give rise to a material conflict of interest between the non-U.S. banking entity and its clients or counterparties; expose the banking entity to a high-risk asset or high-risk trading strategy (*i.e.*, an asset or strategy that would significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail); or pose a threat to the safety and soundness of the banking entity.[48]

[42]Notice at 58.

[43]Dodd-Frank Act § 619(d)(1)(J), 12 U.S.C. § 1851(d)(1)(J).

[44]Proposed Regulations §§ __.2(t)(8) & __.6(d)(3)(ii).

[45]*Id.* § __.6(d)(3)(iii).

[46]*Id.* § __.6(d)(3)(iv).

[47]*Id.* § __.7.

[48]*Id.* § __.8.

Costs of Compliance With the Proposed Regulations

Each time that any trading unit of a banking entity even considers a transaction that may be within the scope of the proposed regulations, that entity will incur the cost of interpreting the applicable provisions of the regulations and analyzing whether, and in what form, the regulations may permit the proposed transaction to be effected. The trading unit will be required to ascertain, in real time, the impact upon any applicable quantitative metrics of the contemplated trade, together with any other trades being executed or considered within the applicable period by that trading unit and the larger institution. If it enters into such a transaction, the banking entity will bear additional costs, including costs arising from monitoring and reporting on trading data as required to establish that transactions qualify as permitted activities under the regulations.

The rules would require banking entities to monitor and report on a range of metrics[49] for trades that are often executed in high volumes and at high velocities. The rules would require each trading unit within a regulated institution to monitor and report this information separately.[50] Governmental agencies, in turn, will incur costs to respond to interpretive requests of regulated entities, analyze the information provided in periodic reports and take any necessary regulatory action. In the introduction to the proposed regulations, the agencies request public comment concerning the potential economic impact of the proposed regulations, including the costs and benefits of compliance and the potential for the requirements and costs of complying with the proposed regulations to cause banking entities to alter their business practices and trading systems.[51]

The cost of complying with the regulations' requirements for interpretation, monitoring and reporting may distort the market for financial services and thus reduce economic efficiency in the financial sector as a whole. These transaction costs, along with the uncertainty and other risks described in this analysis, have the potential to create disincentives for regulated firms to continue to provide financial intermediation services such as market making. As a result, entities that are not subject to similar regulation may come to provide a larger share of these services even if, apart from their advantage in being free of the costs associated with complying with the rules, they are less efficient providers of the services.

[49] *Id.* § __.8, app. A.

[50] *Id.* app. A.III.A(i)(a).

[51] Notice at 192-193.

Regulation of Systematically Important Financial Institutions

I. Analysis of Financial Stability Oversight Council Proposed Rule Regarding the Designation of Nonbank Financial Companies as Systemically Important

Overview of the Proposed Rule

On October 11, 2011, the Financial Stability Oversight Council (the Council) released its second notice of proposed rulemaking (the SIFI Notice) implementing its authority under Section 113 of the Dodd-Frank Act to designate certain nonbank financial companies for enhanced supervision and regulation by the Board of Governors of the Federal Reserve System.[1] Nonbank financial companies designated by the Council commonly are referred to as systemically important financial institutions, or SIFIs.[2] The proposed rule is accompanied by proposed interpretive guidance.

The proposed rule, together with the proposed guidance, moves towards providing some clarity on the designation process but preserves a significant amount of discretion for the Council. In particular, the proposed rule and guidance describe a three-stage process for winnowing the pool of prospective SIFIs:

In Stage 1, the Council will consider a series of specified quantitative metrics intended to eliminate from consideration many smaller, less interconnected firms.[3] By performing internal calculations using the published Stage 1 metrics, many firms will probably be able to anticipate whether they will advance in the consideration process to Stage 2.

Stage 2 will be a more substantive, firm-by-firm analysis that will examine both additional quantitative metrics and qualitative standards. The Council generally will rely on information available from existing public or regulatory sources to conduct Stage 2 review.[4] While the proposed rule and guidance describe the various metrics that the Council will consider in Stage 2, there appears to be little practical guidance that would assist any particular nonbank financial company in evaluating the likelihood that it would progress from Stage 2 to Stage 3 review.

Stage 3 is the final stage prior to Council designation and offers the first meaningful opportunity for a nonbank financial company to contest the Council's consideration. Stage 3 will involve a continuation of the qualitative and quantitative firm-by-firm assessment conducted under Stage 2, but the proposed rule and guidance suggest the Council will seek considerable additional information from the company in

[1] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310) (the Proposed Rule), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.

[2] Under the Dodd-Frank Act, certain large, interconnected bank holding companies also will be SIFIs. In this article, however, we use the term "SIFIs" to refer only to nonbank SIFIs (except as otherwise indicated).

[3] *See* SIFI Notice at 62.

[4] *Id.*

Contributors / Partners / William J. Sweet, Jr., William.Sweet@skadden.com, 202.371.7030 / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290 / **Associates /** Michael P. Bonafide, Michael.Bonafide@skadden.com, 202.371.7913 / Geoff Bauer, Geoff.Bauer@skadden.com, 212.735.3619 / Collin P. Janus, Collin.Janus@skadden.com, 202.371.7224

Stage 3. The culmination of Stage 3 will be the Council's vote as to whether or not to issue a notice of proposed determination of SIFI status.[5] As discussed below, the proposed rule will provide an opportunity to contest such a determination at the beginning of Stage 3.

Overall, the proposed rule and guidance may offer some further insight into how the Council views the concept of systemic risk. However, the standards and factors remain too general to serve as reliable tools for predicting whether a particular firm may be subject to designation. Accordingly, uncertainty regarding which firms may be brought within the heightened regulatory regime triggered by SIFI status is likely to linger for some time after the process of designation gets under way in 2012.

Standards and Factors for Designation

The proposed rule provides that a nonbank financial company may be designated as a SIFI if the Council determines that either of the following standards is met: first, material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States (the First Standard); or second, the nature, scope, size, scale, concentration, interconnectedness or mix of the nonbank financial company's activities could pose a threat to U.S. financial stability (the Second Standard).[6] The First and Second Standards are informed by the list of 10 statutory factors for consideration at Section 113(a)(2), as well as the "analytical framework" and qualitative and quantitative factors and metrics discussed in the proposed rule and guidance.

The Council did not define the terms "material financial distress" or "financial stability" in its January 26, 2011, notice of proposed rulemaking regarding the designation of nonbank financial companies. In response to a number of comments, however, the Council has included in the proposed guidance definitions of "material financial distress" and "threat to the financial stability of the United States," as well as further guidance on how it will assess the "nature, scope, size, scale, concentration, interconnectedness, or mix" of a nonbank financial company's activities.[7] The proposed guidance also offers additional details on how the Council will incorporate the list of 10 statutory factors for consideration into its evaluation of whether a nonbank financial company should be designated as a SIFI.[8]

Material Financial Distress

The First Standard concerns the impact on the U.S. financial system as the financial condition of a nonbank financial company deteriorates. Specifically, the First Standard questions whether "material financial distress" at a given nonbank financial company would pose a threat to U.S. financial stability. According to the proposed guidance, the Council believes that "material financial distress" will exist where a nonbank financial company "is in imminent danger of insolvency or defaulting on its financial obligations."[9] The proposed guidance does not define or otherwise expand on the concept of "imminent danger."

The Council will consider the threat posed by material financial distress at a given firm within the broader context of "a period of overall stress in the financial services industry and in a weak macroeconomic environment."[10] This context has the potential to increase the number of firms that will be designated by

---

[5] SIFI Notice at 63.

[6] Proposed Rule § 1310.10(a). *See also* SIFI Notice at 52; Dodd-Frank Act § 113(a)(1), 12 U.S.C. § 5323(a)(1).

[7] SIFI Notice at 52-55.

[8] *See id.* at 55-62

[9] *Id.* at 54.

[10] *Id.*

examining the impact on a financial environment where even the failure of a relatively small, less interconnected financial firm could be significantly disruptive. Arguably, material financial distress at a firm that is truly "systemically important" would likely pose a threat to U.S. financial stability even in an otherwise robust macroeconomic environment.

Nature, Scope, Size, Scale, Concentration, Interconnectedness or Mix of Activities

The Second Standard concerns the impact on the U.S. financial system of the activities conducted by a given nonbank financial company without regard to the financial condition of the company. Under this standard, the Council will consider the nature of a nonbank financial company's business practices, conduct or operations in order to assess whether the company's activities could pose a threat to U.S. financial stability, whether or not the company is in a distressed condition.[11] The metrics described below in the discussion of the "Six-Category Framework" probably provide the best practical guidance currently available as to how the Council may evaluate the nature, scope, size, scale, concentration, interconnectedness or mix of a company's activities.

Threat to the Financial Stability of the United States

Both the First and the Second Standards require that the circumstances present a "threat to the financial stability of the United States."[12] The Council will consider a "threat to the financial stability of the United States" to exist if there would be an "impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[13] Both the liquidity crisis and subsequent withdrawal of credit from the financial markets that occurred in the autumn of 2008 are likely to constitute the type of impairment about which the Council is concerned.

The proposed guidance notes that material financial distress and the riskiness of a firm's activities may be transmitted into the broader financial system through several channels, resulting in a threat to financial stability. The Council specifically identifies the following ways in which distress or risk may be spread: exposure to a troubled or risky firm, market disruption or losses caused by asset liquidation, and disruption caused by the loss of a critical function relied on by market participants.[14]

Exposure. The creditors, counterparties, investors or other market participants that have exposure to a distressed or risky firm represent a potential direct channel for contagion. Where parties have exposure to a nonbank financial company that is significant enough to materially impair those creditors, counterparties, investors or other market participants, these relationships may pose a threat to U.S. financial stability. The proposed guidance notes that, in its initial analysis of nonbank financial companies with respect to exposure, the Council expects to consider metrics including total consolidated assets, credit default swaps outstanding, derivative liabilities, loans and bonds outstanding, and leverage ratio.[15]

Asset Liquidation. The rapid liquidation of assets is another channel for the distress of a nonbank financial company to infect the broader market. A large-scale, rapid liquidation potentially could disrupt trading or funding in key markets. In addition, as prices are driven down by forced selling, the liquidation

[11] *Id.* at 53.

[12] *Id.*

[13] *Id.*

[14] *See id.* at 53-54.

[15] *Id.* at 53.

could exacerbate losses at the firm attempting to sell those assets and likewise cause losses or funding problems for other firms with similar holdings.

The proposed guidance suggests that the Council views this channel as most relevant for a nonbank financial company with a funding and liquid asset profile that makes it likely that the company would be forced to liquidate assets quickly if it came under financial pressure. Accordingly, in evaluating this potential channel, the Council will focus on firms that rely more heavily on short-term funding and expects to consider metrics including total consolidated assets and short-term debt ratio.[16]

Critical Function or Service. The withdrawal of a critical function or service on which market participants rely could have a significant destabilizing effect on financial markets. As such, the Council sees a greater potential for threat where there would be no ready substitutes if a nonbank financial company were no longer able or willing to provide such a critical function or service.

The Council expects that its consideration of this channel will be largely firm-specific, rather than based upon a general metric. Because of this channel's focus on critical services, the Council's consideration will involve an assessment of the services a firm provides, its market share, and the ability of other firms to step in and replace those services if they were withdrawn.[17]

Analytical Framework for Statutory Considerations

The Dodd-Frank Act sets forth a list of 10 statutory considerations for the Council to consider when making a SIFI designation.[18] The proposed guidance attempts to provide additional detail by describing an "analytical framework" that the Council will use to evaluate these considerations. This proposed analytical framework divides the statutory considerations into two groups of three categories (the Six-Category Framework) and provides examples of the type of metrics the Council will consider under each of the six categories.[19] Nevertheless, the administrative step of grouping the 10 statutory factors into six new categories appears to be of little practical significance.

The Six-Category Framework is broken down as follows:

- categories designed to assess the potential impact of the nonbank financial company's financial distress on the broader economy:
  - size;
  - interconnectedness; and
  - substitutability; and
- categories designed to assess the vulnerability of a nonbank financial company to financial distress:
  - leverage;
  - liquidity risk and maturity mismatch; and
  - existing regulatory scrutiny.

[16] *Id.*

[17] *Id.* at 54.

[18] Dodd-Frank Act § 113(a)(2), 12 U.S.C. § 5323(a)(2).

[19] *See* SIFI Notice at 55-56. The Council's January 2011 notice of proposed rulemaking lacked any such examples.

The proposed guidance provides a chart that illustrates the relationship between the two groups, six categories, and 10 statutory factors applicable to U.S. nonbank financial companies. Certain statutory factors fall within multiple categories.[20]

Group	**Statutory factors** *Section 113(a)(2)—*	Category or categories in which this factor would be considered
Potential impact of the nonbank financial company's financial distress on the broader economy	(B) the extent and nature of the off-balance-sheet exposures of the company	Size; interconnectedness
	(C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies	Interconnectedness
	(E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities	Substitutability
	(F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse	Size; interconnectedness
	(G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company	Size; substitutability; interconnectedness
	(I) the amount and nature of the financial assets of the company	Size; interconnectedness
	(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Size; interconnectedness
Vulnerability of a nonbank financial company to financial distress	(A) the extent of the leverage of the company	Leverage
	(H) the degree to which the company is already regulated by one or more primary financial regulatory agencies	Existing regulatory scrutiny
	(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Liquidity risk and maturity mismatch
Other	(K) any other risk-related factors that the Council deems appropriate	Appropriate category or categories based on the nature of the additional risk-related factor

[20] *See id.* at 57.

The Six Categories

1. **Size.** The Council views the size of a nonbank financial company as a significant factor, although not the determining factor, in assessing whether the firm may pose a threat to U.S. financial stability. That is, holding other factors equal, a larger firm is likely to pose greater risk to U.S. financial stability than a smaller one. Accordingly, the Council expects to examine a number of metrics that relate to the size of a particular nonbank financial company. Consolidated assets and liabilities are likely to be the primary considerations in evaluating size. The proposed guidance also notes, however, that the Council will consider other indicators consistent with its notion of size, such as assets under management, off-balance sheet exposures (*e.g.*, lines of credit) and direct written premiums as reported by insurance companies.[21] These additional metrics appear intended to broaden the scope of the "size" evaluation but in some cases may be more indicative of market share or interconnectedness.

2. **Interconnectedness.** The Council views the interconnectedness of financial firms as a natural channel through which distress and risk may be transmitted into and through the financial system. In evaluating interconnectedness, the Council is expected to consider the number of counterparties a firm has, as well as the firm's importance to those counterparties and the extent to which those counterparties are, in turn, connected to other financial firms, the financial system and the broader economy.

   The Council will review the following metrics, among others, in evaluating a firm's interconnectedness:

   - counterparties' exposures to a nonbank financial company, including derivatives, reinsurance, loans, securities borrowing and lending, and lines of credit;
   - the number, size and financial strength of a nonbank financial company's counterparties, including the proportion of its counterparties' exposure to the nonbank financial company relative to the counterparties' capital;
   - aggregate amounts of a nonbank financial company's gross or net derivatives exposures and the number of its derivatives counterparties; and
   - the amount of gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity.[22]

3. **Substitutability.** The consideration of substitutability goes to the Council's concern that a threat to U.S. financial stability may be exacerbated by the sudden removal from the system of a function or service upon which other market participants rely. The Council expects to examine the extent to which other firms could provide similar services at a similar price and quantity if a nonbank financial company were to withdraw from a market. The primary metric for assessing substitutability will be the market share of a firm subject to evaluation and of competitors offering a substantially similar service.[23]

[21] *Id.* at 59-60.
[22] *Id.* at 58.
[23] *Id.* at 58-60.

4. **Leverage.** The Council views leverage, which is a traditional source of supervisory concern, as a tool with the potential to amplify a company's risk of financial distress, both by raising "the likelihood that a company will suffer losses exceeding its capital" and by increasing a company's "dependence on its creditors' willingness and ability to fund its balance sheet."[24] The Council also believes that leverage has the potential to increase the risk a nonbank financial company poses to other firms and market participants.

   The proposed guidance discusses metrics, including the following, that the Council will use to evaluate a firm's leverage:

   – total assets and total debt measured relative to total equity, which is intended to measure financial leverage;

   – gross notional exposure of derivatives and off-balance sheet obligations relative to total equity or net assets under management, which is intended to show how much off-balance sheet leverage a nonbank financial company may have; and

   – the ratio of risk to statutory capital, which is relevant to certain insurance companies and is intended to show how much risk exposure a nonbank financial company has in relation to its ability to absorb loss.[25]

5. **Liquidity Risk and Maturity Mismatch.** Liquidity risk and maturity mismatch are related concerns that were highlighted during the recent financial crisis. Liquidity risk generally refers to the risk that a nonbank financial company will have insufficient cash or liquid assets on hand to cover its short-term funding needs. Liquidity risk can be heightened where formerly highly liquid assets (*e.g.*, auction rate securities) become illiquid due to market forces. Maturity mismatch refers to the similar concept that a firm may be funding long-term assets using short-term borrowing. In such cases, the firm is exposed to the risk that short-term funding tightens or dries up and the firm may suddenly face significantly increased funding costs, if funding is available at all. The proposed guidance notes that maturity mismatches may also exist where the duration of a nonbank's liabilities exceeds the duration of its assets. For example, an insurance company with liabilities of 30 years or more may have difficulty finding equivalently long-term assets.

   To assess liquidity risk and maturity mismatch, the Council proposes the following metrics:

   – fraction of assets that are classified as Level 2 and Level 3 under applicable accounting standards;

   – liquid asset ratios;

   – ratio of unencumbered and highly liquid assets to the net cash outflows that a nonbank financial company could encounter in a short-term stress scenario;

   – callable debt as a fraction of total debt;

   – asset-backed funding versus other funding;

[24] *Id.* at 60.

[25] *See id.*

– asset-liability duration and gap analysis; and

– short-term debt as a percentage of total debt and as a percentage of total assets.[26]

6. **Existing Regulatory Scrutiny.** Both as a statutory factor and as part of the Six-Category Framework, the Council will consider the current supervision of a particular nonbank financial company in determining whether it would be appropriate for the Council to designate the firm as a SIFI and subject it to heightened supervisory and prudential requirements.[27] This factor may be most useful to non-U.S. firms and U.S. insurance companies subject to significant supervision at the state level. Non-U.S. firms may be well positioned to demonstrate that home country supervision is sufficiently stringent to make SIFI status unnecessary in the United States. Likewise, insurance companies may be able to make a persuasive case that state regulation is more than adequate. It appears unlikely, however, that the Council would be dissuaded from designating as a SIFI a U.S. nonbank financial company based upon the firm being otherwise supervised by one of the Council's member agencies.

Procedure for SIFI Designation

The proposed guidance describes the three-stage process that the Council expects to follow in determining whether to designate a nonbank financial company as a SIFI. In Stage 1, a set of uniform quantitative thresholds will be applied to a broad group of nonbank financial companies in order to reduce the number of companies for additional review in Stage 2. Companies identified in Stage 1 will be further analyzed and prioritized in Stage 2, based upon a wider range of quantitative and qualitative information available to the Council. The information used in Stages 1 and 2 generally will be from public and regulatory sources. Companies selected for Stage 3 review will receive notice and be subject to an in-depth evaluation of information collected directly from the company as well as information collected during Stages 1 and 2. At the end of Stage 3, the Council will consider whether to make a proposed determination with respect to the nonbank financial company. The company may request a hearing if such a determination is made.

As the review process progresses through its successive stages, the potential demands upon the subject company to produce and report quantitative and qualitative information will increase, while the criteria for the determination will become more opaque.

Stage 1 Review

Overview. Stage 1 will identify a broad range of nonbank financial companies that the Council believes merit review. The Council plans to apply six uniform quantitative thresholds to this initial list of companies, using information that generally is available from existing public or regulatory resources. The evaluation will progress to Stage 2 if the company surpasses both the "total consolidated assets" threshold, plus one of the five other thresholds. In addition, in limited cases, the Council may subject certain companies during Stage 1 to review based on other company-specific factors, such as substitutability and existing regulatory scrutiny.[28] Thus, a company may still progress to Stage 2 of the review process even if it does not exceed any of the thresholds.

[26] *Id.* at 60-61.

[27] *Id.* at 61-62.

[28] *See id.* at 63-66.

The Council believes the thresholds-based approach provides the maximum possible transparency, thereby reducing the likelihood that uncertainty about the determination process could negatively affect financial markets. Nonetheless, the Stage 1 review process will leave open a number of questions.

The proposed rule and guidance do not provide information on how the initial companies will be identified. It is possible that this list will include only those companies that exceed $50 billion in total consolidated assets, since the Council's thresholds-based test relies heavily on the assets threshold. The Council may include some companies below the $50 billion assets threshold, however, since the Council explicitly retains the authority to further evaluate or designate companies that do not exceed any of the thresholds.

Proposed Quantitative Thresholds. The Council's proposed thresholds-based test utilizes quantitative thresholds based on the following six metrics:

- total consolidated assets;
- credit default swaps outstanding;
- derivative liabilities;
- loans and bonds outstanding;
- leverage ratio; and
- short-term debt ratio.[29]

The Council selected the six quantitative thresholds because of their applicability to nonbank financial companies that operate in different types of financial markets and industries, the meaningful initial assessment that such thresholds provide regarding the potential for a nonbank financial company to pose a threat to financial stability in diverse markets and the current availability of data.[30] The six thresholds also relate to the four categories of the Six-Category Framework that the Council considered more readily quantifiable (*i.e.*, interconnectedness, size, leverage, and liquidity risk and maturity mismatch).

Even if a company does not surpass the total consolidated assets threshold plus one of the five other thresholds, the Council may further review the company to determine if it should be designated as a SIFI.[31] The proposed guidance explains that "because the uniform quantitative thresholds may not capture all of the potential ways in which a nonbank financial company could pose a threat to financial stability, the Council may, in limited cases, initially evaluate nonbank financial companies in Stage 1 based on other firm-specific qualitative or quantitative factors."[32] Thus, the thresholds do not form a safe harbor, and the Council leaves open the possibility that a company can be below all the thresholds but still become subject to further review in Stage 2 and a possible SIFI designation. This reduces the usefulness of a nonbank financial company being able to reproduce the Stage 1 calculations for itself. Furthermore, the Council provides little guidance regarding when such an occasion would occur, which reintroduces much of the uncertainty it sought to reduce by using a thresholds-based approach.

---

[29] *Id.* at 64-65.

[30] *Id.* at 63.

[31] *See id.* at 65.

[32] *Id.*

Because the Council will rely in part on information available from regulatory sources to calculate a specific company's metrics, the Stage 1 process provides some clarity for nonbank financial companies regarding whether they will proceed to Stage 2. Although this information is available to the company, it may not be available to investors or the market. Therefore, some uncertainty will remain, which could negatively affect financial markets.

The Council increased uncertainty by stating that it would be adding an additional threshold relating to derivatives. In particular, once the SEC and the CFTC finalize certain rules, the Council intends to add a new threshold based on factors such as a nonbank financial company's current and potential future exposure from its outstanding derivatives. The Council intends to use such a threshold to assist in identifying major swap participants and major security-based swap participants that should be examined further in Stage 2.[33] Also, the Council states that it will consider evaluating certain companies using other yet-to-be established metrics or thresholds. These companies include hedge funds and private equity firms, including their advisers, as well as asset management companies and financial guarantors. The Council believes these companies may pose risks that are not well measured by the quantitative thresholds approach.[34]

The six quantitative thresholds also may change over time. The Council expects to review the thresholds as appropriate, *i.e.*, as reporting requirements evolve and new data about certain industries and companies become available.

A brief discussion of the six quantitative thresholds proposed by the Council appears below.

Assets — $50 Billion. The Council intends to establish a threshold of $50 billion in total consolidated assets. The metric will be based on global total consolidated assets for U.S. nonbank financial companies and U.S. total consolidated assets for foreign nonbank financial companies.[35] The total consolidated assets threshold is used as a basic measure of size. A nonbank financial company will be evaluated in Stage 2 if this threshold is satisfied along with one of the other five thresholds.[36]

Credit Default Swaps — $30 Billion. The Council intends to establish a threshold of $30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity. Gross notional value equals the sum of credit default swaps contracts bought (or equivalently sold). This threshold is used to evaluate interconnectedness. [37]

Derivatives — $3.5 Billion. The Council intends to apply a threshold of $3.5 billion of derivative liabilities. The Accounting Standards Codification 815 will be used to calculate the derivative liabilities. The Council states that this threshold also is a proxy for interconnectedness.[38]

Loans and Bonds — $20 Billion. As another measure of interconnectedness, the Council intends to apply a threshold of $20 billion of outstanding loans borrowed and bonds issued. [39] The Council does not define "loans" or "bonds."

---

[33] *Id.* at 21.

[34] *Id.* at 20.

[35] *Id.* at 64.

[36] *Id.*

[37] *Id.*

[38] *Id.* As discussed above, the Council intends, after the SEC and CFTC complete certain rulemaking, to create a new threshold based on current and potential future exposure from outstanding derivatives. It is not clear if the new threshold will modify or replace this threshold or instead result in two thresholds explicitly based on derivatives.

[39] *Id.*

Leverage — 15 to One. The Council intends to apply a minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to one. The Council excludes separate accounts because they are not available to satisfy claims by general creditors.[40]

Short-Term Debt — 10 Percent. The Council intends to apply a threshold ratio of short-term debt to total consolidated assets (excluding separate accounts) of 10 percent. Short-term debt is debt with a maturity of less than 12 months. This threshold is a proxy for liquidity risk and maturity mismatch.[41]

Stage 2 Review

Individual Review Under Six-Category Framework. Once a nonbank financial company is identified in Stage 1, the Council will conduct a review of its risk profile and characteristics in Stage 2. Stage 2 will consist of a robust analysis of the potential threat the nonbank financial company could pose to the financial stability of the United States. This review generally will be based on information available to the Council from existing public or regulatory sources, such as reports filed with the primary financial regulatory agency or home country supervisor of the nonbank financial company. The review may include information provided voluntarily by the nonbank financial company.[42]

The Council's review in Stage 2 will be based on a range of quantitative and qualitative factors. Unlike Stage 1, this review is not limited to uniform quantitative metrics. The Stage 2 evaluation will use the Six-Category Framework described above and will include a review of qualitative factors, such as whether the resolution of the nonbank financial company could pose a threat to U.S. financial stability and the extent to which the nonbank financial company is already subject to regulation.[43]

Based on the Council's Stage 2 review, the Council will advance certain nonbank financial companies to Stage 3 for further evaluation.

Stage 3 Review

Notice of Consideration. Each nonbank financial company moved to the Stage 3 pool will receive a written notice that the nonbank financial company is under consideration for a proposed determination. The notice of consideration is likely to include a request that the nonbank financial company provide information that the Council deems relevant to its evaluation. Further, the nonbank financial company will have an opportunity to submit written materials to the Council to contest the Council's consideration of the nonbank financial company for a proposed determination.[44]

Continued Review Under the Six-Category Framework. The Council will conduct a detailed review of each nonbank financial company in the Stage 3 pool using the Six-Category Framework and the metrics described above.

Stage 3 review is expected to be a highly individualized review of the nonbank financial company's potential threat to U.S. financial stability, based both on the quantitative framework used in Stages 1

[40] *See id.* at 65.
[41] *Id.*
[42] *Id.* at 65-66.
[43] *Id.*
[44] *Id.* at 66.

and 2 as well as additional qualitative factors. This review will be based on information obtained from the nonbank financial company's primary regulator or the Office of Financial Research (the OFR). During this stage, the Council also has the ability to request information and reports from the nonbank financial company. These information requests are expected to involve both qualitative and quantitative data. The Council may request confidential business information, such as internal assessments and risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, and any other anticipated changes to the nonbank financial company that could affect the nonbank financial company's impact on the financial stability of the United States.[45]

If the Council is unable to determine whether the activities of the nonbank financial company pose a threat to the financial stability of the United States, the Council may request that the Federal Reserve conduct an examination of the nonbank financial company and its subsidiaries for the sole purpose of determining whether the nonbank financial company should be supervised by the Federal Reserve. The Council will review the results of such examination in connection with any proposed or final determination.[46]

Qualitative Factors. In Stage 3, the Council expects to have access to a greater degree of qualitative information about an individual nonbank financial company than it will have had in the earlier stages of the review. This information may relate to factors that are not easily quantifiable. The Council acknowledges that certain of these factors may not directly cause a nonbank financial company to pose a threat to the financial stability of the United States, but these factors could mitigate or aggravate the potential of such a threat. These factors may include the nonbank financial company's resolvability, the opacity of its operations, its complexity and the extent to which it is subject to existing regulatory scrutiny and the nature of such scrutiny.[47]

The Stage 3 analysis will include an evaluation of the resolvability of the nonbank financial company and potential risks to financial stability in the event of the company's failure. This assessment will entail a review of the complexity of the nonbank financial company's legal, funding and operational structure, as well as any obstacles to the rapid and orderly resolution of the nonbank financial company. The evaluation also will consider legal entity and cross-border operations issues, including the ability to separate functions and spin off segments of the nonbank financial company, the likelihood of preserving franchise value in a recovery or resolution scenario, the need to maintain continuity of critical services, the degree of the nonbank financial company's intra-group dependency for liquidity and funding, payment operation and risk management needs, and the size and nature of the nonbank financial company's intragroup transactions.[48]

Confidentiality of Information. The Council intends to maintain the confidentiality of any data, information and reports submitted with respect to the designation process. Specifically, the proposed rule confirms that the submission of any nonpublicly available data or information shall not constitute a waiver of, or otherwise affect, any federal or state legal privilege to which the data or information is otherwise subject.[49] However, the Freedom of Information Act (FOIA) and the exceptions thereunder will apply to any data or information submitted in accordance with the designation process.[50]

---

[45] *Id.*

[46] *See* Proposed Rule § 1310.10(c).

[47] *See* SIFI Notice at 66-67.

[48] *Id.*

[49] Proposed Rule § 1310.20(e)(2).

[50] Proposed Rule § 1310.20(e)(3).

Proposed Determination. The Council will notify the nonbank financial company once the Council has completed its data gathering and the evidentiary record is complete. At this point, the Council will review the relevant information regarding the nonbank financial company and consider the nonbank financial company for a proposed determination.[51]

The Council will be required to make a proposed determination within 180 days after the nonbank financial company receives the notice of completion. If the Council does not make a determination within this 180-day period, the Council may not make a determination without starting over from the beginning of Stage 3 with a subsequent Stage 3 notice of consideration.[52] The proposed rule does not limit the Council's ability to restart Stage 3 in the event this 180-day period expires without the issuance of a proposed determination.[53]

A proposed determination requires a two-thirds vote of the voting members of the Council then serving, including the affirmative vote of the Chairperson of the Council. The vote of the Council may not be delegated to any other party.[54]

Upon an affirmative vote by the Council, the Council will provide written notice of the proposed determination to the nonbank financial company, including an explanation of the basis of the proposed determination and the date by which the nonbank financial company may request an evidentiary hearing to contest the proposed determination.[55]

Opportunities to Contest Designation

The proposed rule includes several opportunities for a nonbank financial company to contest a designation by the Council, although such opportunities are limited to the latter stages of the Council's three-stage process and generally have short, or indeterminate, timeframes for the nonbank financial company to prepare its materials. As a result, companies that believe they meet the Stage 1 criteria described above should consider preparing relevant documentation well in advance of a formal request from the Council.

Notice of Consideration (1310.21(a))

After receiving a notice of consideration marking the beginning of Stage 3 review, a nonbank financial company will have the opportunity to submit written materials to the Council. This is the first opportunity a nonbank financial company will have to submit a formal counterargument to the Council. These materials may contest the Council's consideration of the nonbank financial company for a proposed determination, presenting the company's view that neither material financial distress at the nonbank financial company, nor the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company, would be expected to pose a threat to the financial stability of the United States. There is no fixed time period for the nonbank financial company to prepare this information; the proposed rule gives the Council the authority to determine an appropriate timeframe.[56]

---

[51] Proposed Rule § 1310.21.

[52] Proposed Rule § 1310.21(f)(1).

[53] Proposed Rule § 1310.21(f)(2).

[54] Proposed Rule § 1310.10(b).

[55] Proposed Rule § 1310.21(b).

[56] Proposed Rule § 1310.21(a).

Notice of Proposed Determination (1310.21(c))

Upon receipt of a notice of proposed determination, the nonbank financial company will have the right to request an evidentiary hearing to contest the proposed determination. The nonbank financial company must request this hearing within 30 days after the receipt of the notice of proposed determination.[57]

If a nonbank financial company requests an evidentiary hearing, the Council will fix a time for the hearing not more than 30 days after receipt of the request. The hearing will consist of the submission of written materials (or, at the sole discretion of the Council, oral testimony and oral argument) to contest the proposed determination.[58]

Within 60 days after the hearing date, the Council must make a final determination with respect to the nonbank financial company's status. A final determination requires the same two-thirds vote of the voting members of the Council then serving, plus the affirmative vote of the Chairperson, that is required for a proposed determination. Upon a final determination, the Council will notify the nonbank financial company in writing of the final determination and include a statement of the basis for the Council's decision. The Council also will announce the decision publicly.[59]

If a nonbank financial company does not request an evidentiary hearing, the Council nevertheless will deliver a notice of final determination to the nonbank financial company and announce its decision publicly. Such final determination will be made within 10 days after the date by which the nonbank financial company could have requested an evidentiary hearing.[60]

Judicial Review

If the Council makes a final determination, the nonbank financial company may file for judicial review in U.S. district court. The nonbank financial company must commence such action within 30 days after receipt of the notice of final determination. The district court's review is limited to whether the final determination of the Council was arbitrary and capricious.[61]

Reevaluation and Rescission of Determinations

The Council will reevaluate each current determination not less frequently than annually and rescind any determination if the Council determines that the nonbank financial company no longer meets the standards for supervision by the Federal Reserve, taking into account the analytical framework described above. Rescinding a determination requires the same voting threshold as making a determination, *i.e.,* two-thirds of the voting members of the Council then serving, including the affirmative vote of the Chairperson of the Council.[62]

[57] Proposed Rule § 1310.21(c)(2).

[58] Proposed Rule § 1310.21(c)(2).

[59] Proposed Rule § 1310.21(d).

[60] Proposed Rule § 1310.21(e).

[61] *See* Dodd-Frank Act § 113(h), 12 U.S.C. § 5323(h).

[62] Proposed Rule § 1310.23.

II. The Implications of Designation as a SIFI: New Rules Detail the 'Living Wills' Requirement for Bank and Nonbank SIFIs

On October 17, 2011, the Federal Reserve approved a final joint rule implementing the requirement of the Dodd-Frank Act that SIFIs periodically report "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure" to the Federal Reserve, the FDIC and the Council.[63] The final rule is identical to the proposed rule published by the FDIC on September 13 (which was the subject of a prior Skadden publication).[64] The final rule come into effect on November 30, 2011. Pursuant to the rule, designation of a financial institution as a SIFI has significant consequences with respect to a financial institution's planning and preparation for potential financial distress or insolvency. The institution will be required to prepare a so-called "living will," or contingency plan, for resolving its affairs under the U.S. Bankruptcy Code in the event that it experiences material financial distress.[65] If the institution is in danger of becoming insolvent, the FDIC may be appointed receiver pursuant to the Orderly Liquidation Authority contained in Article II of the Dodd-Frank Act.[66] In such case, the Secretary of the Treasury will use the institution's "living will" to determine whether resolution of the institution's affairs is best achieved under the Bankruptcy Code or the Orderly Liquidation Authority.

III. International Efforts to Identify and Designate Global SIFIs

On November 4, 2011, the G20 Finance Ministers and Central Bank Governors, through the Financial Stability Board (FSB), published the names of an initial group of 29 banks determined to be "global systemically important financial institutions" (G-SIFIs).[67] At the same time, the FSB released an "integrated set" of policy measures to address the risks to the global financial system from G-SIFIs.[68] Among these policy measures was a publication of the Basel Committee on Banking Supervision which established an assessment methodology featuring an "indicator-based measurement approach" for evaluating systemic risk that weights both categories and indicators of size, substitutability, interconnectedness, cross-jurisdictional activity, and complexity.[69] This framework is intended initially to be applied to global systemically important banks, however, it may be extended for use in the assessment of nonbank G-SIFIs and could be relevant to the Council's evaluation of nonbank SIFIs under the proposed rule.

---

[63] Dodd-Frank Act § 165(d)(1), 12 U.S.C. § 5365(d)(1). The final rule is published as Regulation QQ for the Federal Reserve (12 C.F.R. Part 243) and Part 381 for the FDIC (12 C.F.R. Part 381), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111017a1.pdf. It applies to both interconnected large bank holding companies and nonbank institutions designated as SIFIs in the manner as described above.

[64] *See* Skadden, Arps, Slate, Meagher & Flom LLP, *Dodd-Frank, FDIC and FSA Rules Require Financial Companies to Develop Global Insolvency Contingency Plans* (Sept. 23, 2011), *available at* http://www.skadden.com/newsletters/Dodd-Frank_FDIC_and_FSA_Rules_Require_Financial_Companies_to_Develop_Global_Insolvency_Contingency_Plans.pdf. *See* also *Skadden Commentary on the Dodd-Frank Act, Orderly Liquidation Authority* (July 9, 2010), *available at* http://www.skadden.com/newsletters/FSR_Orderly_Liquidation_Authority.pdf.

[65] Dodd-Frank Act § 165(d)(4), 12 U.S.C. § 5365(d)(4).

[66] Dodd-Frank Act § 204(a), 12 U.S.C. § 5384(a).

[67] *See* Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions (November 4, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

[68] *Id.*

[69] *See* Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement* (November 2011), *available at* http://bis.org/publ/bcbs207.pdf

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Beijing
Boston
Brussels
Chicago
Frankfurt
Hong Kong
Houston
London
Los Angeles
Moscow
Munich
New York
Palo Alto
Paris
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Toronto
Vienna
Washington, D.C.
Wilmington