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A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

Entering a New Regulatory Era Under the Final Volcker Rule

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In December 2013, five U.S. financial regulatory agencies adopted final regulations to implement the Volcker Rule.[1] As expressed in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule generally prohibits banking entities from engaging in proprietary trading, but permits certain types of proprietary trading activities — including underwriting, market making and risk-mitigating hedging. The Volcker Rule also prohibits banking entities from making substantial investments in, and conducting certain other activities with respect to, private equity funds and hedge funds. The Volcker Rule represents an effort to separate the "social safety net" afforded by the Federal Reserve's discount window (which provides short-term, low-interest loans to banking institutions to cover shortages of liquidity) from risks incurred by financial institutions through their own short-term investments.

Overview

The Volcker Rule is intended to prevent the type of proprietary trading that poses significant risks to a banking entity and the financial system while allowing the banking entity to continue to provide services, including underwriting and market making, that are considered essential commercial banking functions. The actions that banking entities and their regulators will take in 2014 as they adapt to life under the final rule will begin to reveal answers to the following key questions:

- In a dynamic and rapidly evolving trading environment, will the final rule provide market participants and regulators with the interpretive tools necessary to distinguish permitted underwriting, market making and hedging from prohibited proprietary trading?
- Will the final rule impose costs on banking entities that will impair the efficiency of the market for financial services?
- Will the final rule create distortions and imbalances in the supply of and demand for financial instruments? Will the final rule increase the cost and decrease the availability of credit?

In 2014, each financial institution subject to the Volcker Rule must begin the interpretive and administrative work necessary to bring its trading practices into conformity with the rule and to implement the internal compliance systems the rule requires. Foreign financial institutions also must assess their global operations, in light of the extraterritorial reach of the final rule, to ensure they either comply with the prohibition on proprietary trading or with the specific standards set forth in the final rule with respect to the locus of the decision makers in a purchase or sale of financial instruments and the other extraterritorial requirements of the final rule. Additionally, institutions will face uncertainty as to the range of potential interpretations that each agency may adopt as it applies and enforces the final rule. This uncertainty is magnified by the complexity, ambiguity and subjectivity of the rule's provisions and the discretion that the final rule provides regulators. During the coming year, observers will attempt to ascertain whether the rule will chill the market-making activities and other essential services and functions it intends to permit and, thus, drive up the cost of capital in the U.S. financial markets.

[1] http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

Aspects of the final rule may be challenged in 2014; moreover, legislative and regulatory initiatives may affect its application. Since the release of the final rule in December, the following potential sources of change have emerged:

- The American Bankers Association filed a lawsuit to block portions of the final rule that treat debt interests in collateralized debt obligations of trust-preferred securities as ownership interests in a covered fund. In response to the lawsuit, the regulators have issued an amendment to the final rule, which permits banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities.
- The chairman of the House Financial Services Committee and the chairwoman of the Financial Institutions Subcommittee introduced legislation to allow ownership of covered funds "predominantly" backed by trust-preferred securities held prior to the release of the final rule. Senate Republicans have introduced broader legislation that would allow ownership of debt securities issued by collateralized loan obligations prior to the adoption of the final rule. Senators Manchin and Wicker have introduced legislation that would allow institutions with total consolidated assets below $50 billion to retain ownership of collateralized loan obligations where the "primary purpose" was to be a vehicle for trust preferred securities and the investment was made prior to the adoption of the final rule. All of the legislative proposals are broader than the amendment to the final rule. Other similar proposals may be introduced in the coming weeks.
- A recent letter from the chairman of the House Financial Services Committee to the chairwoman of the SEC asserted that the absence of cost-benefit analysis from the rulemaking process violates federal law. As noted in the letter, the courts have supported challenges to other regulations issued under Dodd-Frank on the grounds that the rulemaking process was "arbitrary and capricious" due to insufficient analysis of the economic consequences.
- Reports in the media indicate that the European Union plans to implement its own ban on proprietary trading, bringing the EU's approach to regulation of its largest financial institutions more into congruence with the Volcker Rule. This represents a departure from previous expectations that the EU would, rather than imposing any such ban, follow some EU national governments in requiring financial institutions to "ring-fence" their proprietary trading and other investment banking activities into a separate business unit or subsidiary.[2]

"Institutions will face uncertainty as to the range of potential interpretations that each agency may adopt as it applies and enforces the final rule."

Applicability

Subject to certain exclusions, the final rule applies to the following types of entities and their affiliates or subsidiaries:

- any FDIC-insured depository institution;
- any company that controls an FDIC-insured depository institution; and
- any company that is treated as a bank holding company under the International Banking Act of 1978.

[2] *See* The Vickers Report: The UK Proposal to 'Ring-Fence' Banking Operations, *available at* http://www.skadden.com/sites/default/files/publications/Skadden_2012_Insights_Financial_Regulation_0.pdf.

Although the compliance and reporting obligations mandated by the final rule are scaled to the size of the regulated entity, the fundamental prohibitions apply to banking entities of any size. The final rule does not address how the restrictions might apply to nonbank entities designated as systemically important financial institutions (SIFIs). The preamble to the final rule notes that two of the three companies currently designated as nonbank SIFIs are affiliated with insured depository institutions and are, therefore, covered by the final rule as banking entities. The regulatory agencies are continuing to consider whether the remaining nonbank SIFI engages in activity subject to the final rule and what requirements may apply.

Prohibited Proprietary Trading

The final rule prohibits banking entities from engaging in proprietary trading, subject to certain exceptions. For these purposes, proprietary trading means "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments." A trading account is generally an account used for short-term trading activities. The final rule includes a rebuttable presumption that purchases or sales of a financial instrument are for the trading account of the institution if held for fewer than 60 days or if the banking entity substantially transfers the risk of a financial instrument within 60 days of the purchase or sale.

The final rule permits banking entities to pursue the following permitted activities:

- underwriting and market making-related activities,
- certain risk-mitigating hedging activities,
- trading on behalf of customers,
- trading by a regulated insurance company and its affiliates for the general account of the insurance company,
- trading in certain domestic and foreign government obligations (in order to support markets in those obligations), and
- trading activities of foreign banking entities.

None of the foregoing activities is permitted if it involves a material conflict of interest, results in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy, or poses a threat to the safety and soundness of the banking entity or to the financial stability of the United States. Under the final rule, banking entities engaged in permitted activities, including underwriting, market making and risk-mitigating hedging, must establish internal compliance programs that contain reasonably designed written policies and procedures, internal controls, analysis and independent testing. These heightened compliance program requirements will force significant and expensive changes in the structure and operations of the regulated entities. The cost of these changes may be mitigated, however, to the extent that the final rule allows internal policies and procedures to be tailored to different markets and asset classes based on characteristics such as liquidity.

A detailed discussion of the final rule's prohibition on proprietary trading is available at http://www.skadden.com/insights/proprietary-trading-restrictions-under-final-volcker-rule-0.

Private Equity Funds and Hedge Funds

The Volcker Rule generally prohibits banking entities from making investments in "covered funds." The final rule defines a covered fund to include:

- an issuer that would be an investment company as defined in the Investment Company Act of 1940 but for Section 3(c)(1) or Section 3(c)(7) thereof;
- any commodity pool for which the commodity pool operator has claimed an exemption under CFTC Rule 4.7 or a commodity pool that is substantively similar; and
- foreign funds sponsored or owned, directly or indirectly, by a U.S. banking entity (except foreign public funds).

Although the final rule expands the statutory definition of a covered fund by including commodity pools, it (unlike the original proposal) covers only those commodity pools that are offered privately to investors who meet a heightened sophistication standard — much like traditional hedge funds or private equity funds.

The final rule excludes certain categories of entities from the definition of covered fund. Entities that are specifically excluded include wholly owned subsidiaries, joint ventures, acquisition vehicles, foreign pension funds, insurance company separate accounts, bank-owned life insurance funds, certain loan securitization entities, qualifying asset-backed commercial paper conduits, qualifying covered bonds, small business investment companies and public welfare investment funds, registered investment companies and business development companies, and funds exempt or excluded from the Investment Company Act of 1940 that rely on an exemption or exclusion other than Section 3(c)(1) or Section 3(c)(7).

Despite the ban on investments in covered funds, however, the final rule allows banking entities to continue to sponsor and invest in covered funds, subject to certain exemptions. These "permitted funds exemptions" allow banking entities to provide covered funds with seed capital. They also allow for *de minimis* investments generally of no greater than 3 percent of the value of the fund and, across the institution's investments in all covered funds, of no greater than 3 percent of the institution's tier 1 capital.

Impact on Securitizations

The Dodd-Frank Act provides that the Volcker Rule should not be construed to limit or restrict the ability of a banking entity to securitize loans, but the definition of covered fund in the final rule is broad enough to encompass many securitization transactions. The final rule excludes certain types of securitizations, but it will nonetheless have a significant impact on certain active segments of the securitization market, particularly collateralized loan obligations (CLOs) and asset-backed commercial paper (ABCP) conduits. Sponsors may be able to structure new CLOs and ABCP conduits and other securitizations of financial assets to take advantage of the exclusions provided under the Volcker Rule for loan securitizations, qualifying ABCP conduits and wholly owned subsidiaries of banking entities. Certain existing securitization entities, however, will be considered covered funds under the final rule. Banking entities will generally not be permitted to hold ownership interests in covered funds after the extended conformance period ends in July 2015 (subject to any further extension).

The broad reach of the covered fund definition forces banking entities to consider whether any securitization entity that they organize or in which they invest will be

viewed as a covered fund. If so, they must examine whether they have an ownership interest in the covered fund, act as a sponsor with respect to the covered fund or have other relationships with the covered fund, including market-making activities, that may now be limited or prohibited. Ownership interest is broadly defined to include not only equity interests but also traditional debt securities that have rights to participate in the removal or replacement of an investment manager for a covered fund, which includes debt securities issued by most CLOs.

A detailed discussion of the final rule's impact on securitizations is available at http://www.skadden.com/insights/structured-finance-alert-final-volcker-rule-impact-securitizations.

Compliance and Reporting Requirements

The final rule imposes a number of compliance and procedural requirements on banking entities. It applies increasingly stringent and comprehensive compliance requirements to banking entities that are larger and more heavily involved in covered activities.

The most rigorous compliance requirements apply to banking entities with at least $50 billion in total consolidated assets (or $50 billion in U.S. assets in the case of non-U.S. banking entities), as well as banking entities with significant trading assets. These institutions must implement a "six pillar" compliance program and meet "enhanced" standards for compliance, which include a requirement that the chief executive officer provide an annual attestation, in writing, to the appropriate regulator that the banking entity employs a compliance program reasonably designed to achieve compliance with the final rule.

Beginning on June 30, 2014, banking entities with $50 billion or more in worldwide trading assets and liabilities (excluding certain U.S. government obligations) will be required to report specified quantitative metrics regarding their trading activities to the applicable agency. That threshold is reduced to $25 billion on April 30, 2016, and to $10 billion on December 31, 2016.

Expected Developments

In 2014, participants in the financial services industry will begin to bear the burden of interpreting and operating within the new regulatory environment created by the Volcker Rule. The agencies charged with administering the rule will similarly be forced to confront the interpretive and practical challenges it presents. The courts also may be called upon to interpret various aspects of the rule. The interactions to come among the financial industry, the regulators and the courts, as each develops its understanding of and approach to the final rule, will begin to reveal the full extent of its impact.