The Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

The Volcker Rule: A First Look at Key Changes

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday December 18, 2013

Editor's Note: The following post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP, and is based on a Skadden memorandum.

On December 10, 2013, five U.S. financial regulators (the Agencies) adopted a final rule implementing the Volcker Rule.[1] The text of the final rule and its accompanying preamble are available here.[2] The Volcker Rule was created by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and prohibits banking entities from engaging in "proprietary trading" and making investments and conducting certain other activities with "private equity funds and hedge funds."

In October 2011, the Agencies released a proposed rule to implement the Volcker Rule. Our analysis of the proposed rule is available here.[3] The proposal generated extensive and diverse feedback from industry participants, policymakers and the public. After more than two years of deliberation, the final rule reflects the efforts of the Agencies to incorporate this feedback to the extent consistent with statutory requirements and policy objectives.

We expect that the financial services industry will spend the coming months in close analysis of the final rule. This publication is offered to help those affected by the rule to identify some key differences between the proposal and the final rule. A redline comparison of the operative text of the final rule against that of the proposed rule is available here.[4]

1. Structure of the Final Rule

The proposed rule was formidable in length and complexity. Some commenters had encouraged the Agencies to conduct a wholesale rewriting of the rule in favor of a more streamlined,

[1] The Agencies are the Board of Governors of the Federal Reserve System (the Federal Reserve), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (CFTC).

[2] *See* http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

[3] *See* http://www.skadden.com/sites/default/files/publications/Dodd_Frank_Rule_Making_Volcker_Rule_and_SIFI_Proposals_111711_0.pdf.

[4] *See* http://www.skadden.com/NewsLetters/Redline.pdf.

principles-based approach. The final rule retains the basic structure of the proposed rule—although various aspects of the rule appear simultaneously to be more stringent, more lenient, more clear and more complex. The final rule is roughly 70 pages and is accompanied by an adopting release of almost 900 pages. The adopting release provides additional guidance and clarification on the intent of the final rule.

In many areas, the final rule does not provide objective criteria or prescribe clear boundaries. The final rule relies in large part on banking entities implementing policies, procedures and "frameworks" to avoid engaging in prohibited activities and to manage the risks of permitted activities. Thus, the final rule leaves considerable discretion to examiners and supervisors in their implementation and enforcement of the Volcker Rule. For example, the Volcker Rule prohibits any transaction or activity by a banking entity that would result in a material exposure to "high-risk assets" or "high-risk trading strategies"—but the final rule does not provide any definitive criteria for identifying those assets or strategies.

2. Applicability

Like the proposal, the final rule applies to the following types of entities:

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

The final rule, and this publication, refer to these covered organizations as "banking entities." Although the final rule provides some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size.

The proposed rule did not address how the restrictions of the Volcker Rule might apply to nonbank entities designated systemically important financial institutions (SIFI). The adopting release 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 rule as banking entities. The Agencies are continuing to review whether the remaining nonbank SIFI engages in activity subject to the Volcker Rule and what requirements may apply.

3. Timing

The final rule becomes effective April 1, 2014. In a parallel action taken on Tuesday, however, the Federal Reserve extended the conformance period for all banking entities until July 21, 2015.[5] During the conformance period, a banking entity must engage in good faith efforts, appropriate for its activities and investments, to enable the banking entity to conform its activities and investments to the requirements of the final rule by July 21, 2015.[6] The Federal Reserve noted that a banking entity should not expand its activities or make investments during the conformance based on an expectation that the conformance period might be extended beyond July 21, 2015.

The Federal Reserve stated that a banking entity with stand-alone proprietary trading operations is expected to promptly terminate or divest those operations. Other than stand-alone proprietary trading operations, good faith efforts made during the conformance period should not require a banking entity to terminate activities and investments it was engaged in or held prior to July 21, 2012, provided that all activities comply with the final rule by the end of the conformance period.

4. Proprietary Trading

Basic Definition of 'Proprietary Trading'

The Volcker Rule generally prohibits banking entities from engaging in "proprietary trading." The final rule defines "proprietary trading" much the same as the proposed rule: "engaging as a principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."

The final rule replaces the proposal's term "covered financial position" with the term "financial instrument." This is largely a change in nomenclature, as the final rule effectively retains the proposal's substantive definition. The term "financial instrument" includes a security, option on a security, derivative, option on a derivative, contract of sale of a commodity for future delivery and an option on a contract of sale of a commodity for future delivery. The term "financial instrument" does not include a loan, certain commodities or foreign exchange or currency.

The term "trading account" is defined in the final rule and is generally focused on trading for short-term resale or short-term price movements. Like the proposed rule, the final rule contains a rebuttable presumption that certain purchases or sales of a financial instrument are deemed for

[5] Certain banking entities are required under the final rule to make regular reports on their trading metrics. These requirements become effective under a different timeline discussed later in this publication.

[6] In February 2011, the Federal Reserve adopted a rule setting forth the standards for banking entities during the Volcker Rule conformance period. Tuesday's action extended the conformance period one year, but did not otherwise modify the conformance period rule. 76 Fed. Reg. 8265 (Feb. 14, 2011) (adopting conformance period rule); 77 Fed. Reg. 33949 (June 8, 2012) (statement clarifying conformance period).

the “trading account” if the position is held fewer than 60 days. But the final rule expands the presumption somewhat to also cover a financial instrument held for 60 days or more if the banking entity “substantially transfers” the risk of that financial instrument within 60 days of the purchase or sale. The adopting release indicates that this expansion was intended to cover basis trades.

Like the proposed rule, the final rule provides a number of exceptions to permit certain trading activities, several of which are highlighted below.

Exception for Market Making

Like the proposed rule, the final rule permits a banking entity to acquire proprietary positions in connection with market making-related activities for the purpose of meeting the reasonably expected near-term demands of clients, customers or counterparties. However, the final rule refines the exception to more clearly allow a banking entity to engage in market making in different types of asset classes and to permit market making practices that vary based on the liquidity, maturity and depth of the market for the particular financial instrument.

Unlike the proposed rule, the final rule permits a banking entity’s trading desk to conduct hedging activity associated with its own market making activity *without* those hedging activities also being required to satisfy the rule’s separate standards for permitted risk mitigating hedging activity (which are discussed below).

The proposed rule would have required that market making-related activities of a banking entity be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions it holds in trading accounts or the hedging of such positions. The final rule eliminates this requirement.

Exception for Hedging

The proposed and final rules both contain an exception permitting banking entities to engage in risk mitigating hedging activities. The final rule narrows this exception. In order for a position to qualify as a permitted risk mitigating hedge under the final rule, the hedge from inception must “demonstrably reduce or otherwise significantly” mitigate the specific, “identifiable” risks of a specific, “identifiable” individual position (or aggregated positions), and the banking entity must conduct analysis, “including correlation analysis,” to ensure that such positions are reasonably expected to “demonstrably reduce or otherwise significantly” mitigate such risks.

These new limitations generally reflect the Agencies' intent that the hedging exception not be available for hedges related to scenarios or events unrelated to identifiable positions (*e.g.*, "portfolio hedging" or "macro-hedging"). In the adopting release, the Agencies note that the hedging exception is not available for activities that are designed to "reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions, profit in the case of a general economic downturn, counterbalance revenue declines generally or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity."

On the other hand, the final rule expanded the hedging exception somewhat by removing a requirement in the proposed rule that an anticipatory hedge be established "slightly" before the banking entity becomes exposed to the specific, identifiable risk.

Applicability to Sovereign Debt

Unlike the proposed rule, the final rule provides two additional exceptions related to non-U.S. sovereign debt. First, the U.S. operations of a non-U.S. banking entity, other than an FDIC insured depository institution, may trade in obligations of the home chartering authority of the non-U.S. banking entity. Second, a non-U.S. bank or broker-dealer owned by a U.S. banking entity may trade in obligations of the non-U.S. sovereign that charters the non-U.S. bank or broker-dealer.

Non-U.S. Banking Entities Trading Solely Outside the United States

The proposed and final rules contain an exception permitting non-U.S. banking entities to engage in trading activities "solely outside the United States." The final rule clarifies that the phrase "solely outside the United States" allows non-U.S. banking entities to conduct trades on an "anonymous basis" on a U.S. exchange or through an unaffiliated intermediary in a transaction cleared through a U.S. central counterparty, or in a transaction with the foreign operations of a U.S. entity, *provided* that the risk of the trade, the decision-making, hedging, financing and accounting are located outside the United States. This exception is available only for a non-U.S. banking entity organized outside of the United States that is not directly or indirectly controlled by a U.S. banking entity.

Despite this exception, non-U.S. banking entities will need to assess the final rule's impact on their operations. For EU banks with U.S. branches or affiliates, Volcker Rule compliance is expected to interact in various ways with EU proposals to ring fence "retail" operations from "investment banking" operations. U.K., French and German ring fencing laws and proposals do not contain Volcker-style prohibitions. To differing extents, however, they contain a principle that proprietary trading operations either are kept physically separate from or are not funded by retail banking units. The relevant laws will contain exemptions that allow ring-fenced bodies to conduct hedging, liquidity management and agency dealing. Experience suggests that the EU approach to these concepts will not match their Volcker Rule equivalents. Compliance with both the Volcker Rule and the eventual EU ring fencing requirements may increase the trend of subsidiarizing global banking operations with the attendant extra regulatory capital costs, which some commentators say could dis-incentivize “real economy” lending.

Exception for Liquidity Management

The proposed and final rules include an exception that permits banking entities to conduct trading for liquidity management. The final rule narrows the scope of this exception to be available only for transactions in highly liquid *securities*. The proposed rule would have made the liquidity management exception available for transactions in a broader range of financial instruments.

New Exceptions Added by Final Rule

The Agencies have expressly excluded certain additional activities from the definition of proprietary trading, including, for example, “excluded clearing activities” engaged in by a banking entity that is a member of a clearing agency, derivatives clearing organization (DCO) or financial market utility as well as certain purchases and sales of financial instruments made by the banking entity as a trustee for the benefit of its employees.[7]

5. Private Equity Funds and Hedge Funds

Definition of Covered Fund

The Volcker Rule generally prohibits banking entities from making investments in, and conducting certain other activities related to, “covered funds.” The final rule narrows and clarifies the definition of “covered fund” that was included in the proposed rule. 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

[7] The final rule defines “excluded clearing activities” expansively to include, among other things, purchases and sales of financial instruments that relate to activities that are critical to the orderly operation of a clearing agency, DCO or a designated financial market utility.

- foreign funds sponsored or owned, directly or indirectly, by a U.S. banking entity (except foreign public funds).

Like the proposed rule, the final rule includes Section 3(c)(1) or Section 3(c)(7) funds as covered funds. Unlike the proposed rule, which categorized all commodity pools as covered funds, the final rule limits the definition of covered funds to commodity pools that are offered privately to investors who meet a heightened sophistication standard—much like traditional hedge funds or private equity funds.

The proposed rule contained a broad catchall for foreign funds, which could have covered many non-U.S. funds (such as UCITS funds) that differ in form and substance from traditional hedge funds and private equity funds. The final rule clarifies this ambiguity and provides additional guidance on the scope of the definition for foreign funds and foreign banks.

The final rule specifically 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 securitizations (see below), qualifying asset-backed commercial paper conduits, qualifying covered bonds, SBICs 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).

Permitted Funds Exemption

The Volcker Rule allows banking entities to continue to sponsor and invest in covered funds subject to certain exemptions. The so-called "permitted funds exemption" included in the proposed rule has been retained in the final rule with relatively minor changes and clarifications. The changes include a new definition of the date of establishment of a covered fund for purposes of providing the fund with seed capital, which triggers a one-year period to reduce the banking entity's interest in the covered fund to 3 percent of the fund's total ownership interests. In the final rule, the date of establishment is defined as the date on which the investment adviser begins making investments that execute an investment or trading strategy for the covered fund. Further, the final rule changes the per-fund investment limitation to provide that a banking entity must count an investment in a covered fund only if the investment is made by the banking entity itself or a company controlled by the banking entity, and removes the proposed rule's look-through for noncontrolled entities. In addition to the permitted funds exemption that appeared in the proposed rule, the final rule includes a specific permitted funds exemption for issuers of loan securitizations.

Finally, the final rule specifically permits underwriting and market making activities related to ownership interests in covered funds, subject to certain limitations.

Securitizations and Asset-Backed Securities

The proposed rule would have treated loan securitization vehicles that rely on Section 3(c)(1) or Section 3(c)(7) as covered funds, although it provided a limited exemption for certain activities and investments. In the final rule, the definition of covered fund contains specific exclusions for entities that issue loan securitizations and asset-backed commercial paper (ABCP) conduits meeting certain requirements.

The exclusion for loan securitization entities generally allows the entity to hold only "loans," "servicing assets," short-term cash equivalents and certain other instruments. However, the definition of "loans" is very narrow and expressly excludes securities and derivatives, though loan securitization entities are expressly permitted to hold certain securities representing an interest in underlying assets created to facilitate a securitization and interest rate and currency swaps used for hedging the collateral. The exclusion of loan securitizations from the definition of covered fund should provide relief for many collateralized loan obligations that do not hold any corporate bonds or synthetic exposures.

Although the final rule excludes qualifying ABCP conduits from the definition of covered fund, the exclusion limits the assets of the ABCP conduit to loans permissible for a loan securitization and certain asset-backed securities acquired at issuance. It also requires a qualifying ABCP conduit to have a regulated liquidity provider that has committed to provide full credit support and liquidity coverage with respect to all outstanding ABCP, regardless of the performance of the related assets or other credit support.

6. Compliance and Reporting Requirements

Tiered Requirements

Like the proposed rule, the final rule imposes a number of compliance and procedural requirements on banking entities. In the final rule, the Agencies sought to tailor those requirements based on the size and characteristics of different banking entities. The final rule creates several categories of banking entities based on their size and level of involvement in activities covered by the Volcker Rule. The final rule applies increasingly stringent and comprehensive compliance requirements to banking entities in larger and more involved categories.

On one end of the spectrum are banking entities with at least $50 billion in total consolidated assets (or with $50 billion in U.S. assets in the case of non-U.S. banking entities), as well as banking entities required under the rule to report trading metrics. Banking entities in this compliance tier must implement a new “6 pillar” compliance program requirement set forth in Section 20(b) of the final rule and meet “enhanced” standards for compliance set forth in Appendix B of the final rule.

On the other end of the spectrum are banking entities that do not engage in any of the activities covered by the Volcker Rule (other than with respect to certain U.S. government obligations). These banking entities are not required to adopt any formal compliance program specific to the Volcker Rule. Similarly, the final rule provides that a banking entity engaged in some covered activities, but having total consolidated assets of $10 billion or less, need not implement a comprehensive Volcker Rule compliance program—but may instead make adjustments to its existing compliance policies and procedures appropriate given the activities, size, scope and complexity of the banking entity.

Attestation by Chief Executive Officer

Unlike the proposed rule, the final rule includes a requirement that the chief executive officers of certain banking entities provide an annual attestation. This requirement applies to:

- banking entities with $50 billion or more in total consolidated assets;
- foreign banking entities with $50 billion or more in U.S. assets; and
- banking entities required under the rule to report trading metrics (see below)

Based on a review by the CEO of the banking entity, the CEO must annually attest in writing to the appropriate Agency that the banking entity has in place a compliance program reasonably designed to achieve compliance with the Volcker Rule. The substance of this attestation is less onerous than many alternative versions mentioned in press reports ahead of the final rule. Nevertheless, the attestation requirement is intended to impose accountability at the executive level.

Reporting on Trading Metrics

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 information regarding their trading activity to the applicable Agency. That threshold is reduced to $25 billion on April 30, 2016, and to $10 billion on December 31, 2016.

7. Potential Challenges to the Rule

Certain substantive provisions of the final rule and certain aspects of the rule-making process that produced it may generate litigation challenging the validity of the regulation. Such a challenge may allege defects in the notice-and-comment rule-making process by which the final rule was promulgated. For example, a proposed rule and its final version ordinarily may differ only insofar as the latter is a "logical outgrowth" of the former—a requirement designed to ensure meaningful opportunity for comment by interested parties. In the case of the Volcker Rule, litigants may focus on those aspects of the final rule that are more restrictive than the proposal, as well as on the fact that the preamble to the proposed rule posed hundreds of questions to the public (and therefore was arguably more akin to an information collection than a concrete proposal). Indeed, numerous commenters and dissenting members of regulatory commissions unsuccessfully advocated that the Agencies "re-propose" the Volcker Rule before finalizing it.

Litigants may also argue that the final rule reflects inadequate economic analysis. This style of administrative law challenge has recently succeeded against financial regulation—most prominently when the District of Columbia Circuit vacated the SEC's proxy access rule in 2011. In the case of the Volcker Rule, the dissenting members of regulatory commissions expressed disappointment in the extent of the cost-benefit analysis reflected in the final rule. The adopting release appears to anticipate litigation on this ground: It asserts that the Bank Holding Company Act (as amended by Dodd-Frank), which is the statutory authority on which the Volcker Rule relies, does not require the promulgating agency to analyze the costs and benefits of regulation to the same extent as, for example, the Commodity Exchange Act.

In addition, litigants may challenge particular provisions of the Volcker Rule on the ground that they stray from statutory direction. The practical effect of the various potential challenges to the Volcker Rule—to the extent that those challenges succeed—will depend both on the scope of the challenges and on the remedies fashioned by the courts. Because the conformance period has been extended to July 21, 2015, any litigation challenges might not soon be resolved.