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The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact, Issues and Concerns in Implementing the Volcker Rule

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") represents the single most important and comprehensive piece of financial system reform legislation since the myriad reforms following the Great Depression. With the primary goal to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them," the Dodd-Frank Act will have broad impact on the financial services industry for years to come. The Act includes significant reforms and refinements to modernize existing laws to address emerging risks and issues in our evolving financial system. It also establishes entirely new regulatory regimes, including in areas such as systemic risk regulation, over-the-counter ("OTC") derivatives market oversight, and Federal consumer protection.

All participants of our financial services and banking industries are affected – with some industry segments and firms substantially impacted – by the Dodd-Frank Act reforms. The spectrum of affected participants includes banks, thrifts, depository institution holding companies, mortgage lenders, insurance companies, industrial loan companies, broker-dealers and other securities and investment advisory firms, private equity and hedge funds, consumers, and numerous federal agencies and the federal regulatory structure.

This StayCurrent bulletin addresses the impact, issues and concerns present with implementing the so-called "Volcker Rule," set forth at section 619 of the Dodd-Frank Act.

Impact and Concerns in Implementing the Volcker Rule

Generally, the Volcker Rule bars a "banking entity" from engaging in proprietary trading as well as investing in private equity and hedge funds. As defined by the Act, a "banking entity" includes any insured depository institution ("IDI") and any company controlling an IDI, as well as any company deemed a bank holding company ("BHC") under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.

The Volcker Rule also imposes certain limitations on "nonbank financial companies supervised by the FRB" that engage in proprietary trading and invest in private equity and hedge funds, but these

entities are not subject to the ban on proprietary trading and investing in private equity and hedge funds. The Act defines a "nonbank financial company" as an entity predominantly engaged in financial activities. A "nonbank financial company supervised by the FRB" is a nonbank financial company that the FSOC has determined pursuant to section 113 of the Act is systemically significant.

Issues with the Ban on Proprietary Trading

Pursuant to the Act, "proprietary trading" involves a banking entity engaging as a principal for its "trading account" in any transaction to purchase or sell any security, derivative commodity futures contract, option, derivative, contract, or other security or financial instrument that the regulators, i.e., Federal banking agencies ("FBAs"), Securities and Exchange Commission ("SEC"), or Commodities Future Trading Commission (CFTC"), as appropriate, may determine by rule to be covered. A "trading account" is defined as any account used for acquiring or taking positions in any of the above listed financial instruments principally for the purpose of selling in the near term and any other such account that the regulators may determine is a trading account.

Issues with the ban on proprietary trading generally arise with respect to the exceptions to the restriction (see below); however, it should be noted that the regulators may impose additional capital and quantitative limitations if appropriate to protect the safety and soundness of banking entities engaged in such activities. Absent a material conflict of interest, material exposure to the banking entity from high-risk assets or a high-risk trading strategy, or transactions or activity that would pose a threat to the entity's safety and soundness or U.S. financial stability, a banking entity may engage in the following permitted activities:

- Purchasing, selling, acquiring or disposing of U.S. government or agency securities, including obligations or instruments issued by Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Banks, and state, municipal and other political subdivision obligations;
- Purchasing, selling, acquiring or disposing of securities in connection with underwriting or market-making type activities, but only to the extent reasonably expected to fulfill near term customer demand;
- Risk-mitigating hedging activities in connection with individual or aggregated positions or other holdings designed to reduce specific risks to a banking entity in connection with such positions or holdings;
- Purchasing, selling, acquiring or disposing of securities on behalf of the banking entity's customers;
- Investments in small business investment companies or investments designed primarily to promote the public welfare;
- Purchasing, selling, acquiring or disposing of securities by a regulated insurance company or its affiliate for the general account of the insurance company, provided the transaction is in compliance with and subject to applicable state law, and the appropriate federal regulator, in consultation with the FSOC, has not determined that the applicable state law is insufficient to protect the safety and soundness of the banking entity or U.S. financial stability;
- Purchasing, selling, acquiring or disposing of securities solely outside the U.S. and the banking entity is not directly or indirectly controlled by a U.S. banking entity; and

- Engaging in such other activities the regulators (FBAs, SEC or CFTC, as appropriate) determine, by rule, would promote/protect the safety and soundness of the banking entity and U.S. financial stability.

Issues with the Ban on Investing in Private Equity and Hedge Funds

As with the ban on proprietary trading, issues with the ban on private equity and hedge fund investments arise with respect to the exceptions to the general restriction on acquiring or holding an interest in, or sponsoring, a private equity or hedge fund. Generally, a private equity or hedge fund includes an issuer that is exempt from registration as an investment company pursuant to §§ 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, or such similar funds as the regulators may by rule determine. Notwithstanding regulatory discretion to cover "similar" bank-sponsored funds by rule, the specific reference to §§ 3(c)(1) and 3(c)(7) may suggest a Congressional intent to exclude bank-sponsored funds otherwise exempt under § 3(c). For funds covered by the Volcker Rule, "sponsoring" includes serving as a general partner, managing member, or trustee of a fund, selecting or controlling a majority of the directors, trustees or management of a fund, or sharing a same/similar name.

Absent a material conflict of interest, material exposure to the banking entity from high-risk assets or a high-risk trading strategy, or transactions or activity that would pose a threat to the entity's safety and soundness or U.S. financial stability, a banking entity may organize, offer or otherwise sponsor a private equity or hedge fund if:

- The banking entity provides bona fide trust, fiduciary or investment advisory services;
- The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services, and only to customers receiving such services from the banking entity;
- The banking entity does not acquire or hold an ownership interest in the fund other than:
    - i. Initial investments to establish and provide the fund with sufficient equity to enable the fund to attract investors, or
    - ii. De minimis investments in a fund by the banking entity

      provided a bank entity's investment in either case is reduced to less than 3% of fund ownership within a year after the fund is established (which may be extended an additional two years), the aggregate of the banking entity's investments may not exceed 3% of the banking entity's Tier 1 capital, and the investments may not be material to the banking entity;
- The banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the fund, or any fund in which such fund invests;
- The banking entity complies with the affiliate transactions restrictions under Federal Reserve Act ("FRA") §§ 23A and 23B;
- No director or employee of a banking entity takes or retains an ownership interest in the fund (unless such person is directly involved in providing investment advisory or similar services to the fund); and

- Written disclosure is provided to fund investors that any losses in the fund are borne solely by fund investors and not by the banking entity.

In addition to the above, a banking entity may acquire, hold or sponsor an ownership interest in a private equity or hedge fund outside the U.S., unless the banking entity is controlled by a U.S. banking entity, and provided no ownership interest in such fund is offered or sold to a U.S. resident.

Similar to the ban on proprietary trading, a banking entity may engage in such other activities the regulators (FBAs, SEC or CFTC, as appropriate) determine would promote/protect the safety and soundness of the banking entity and U.S. financial stability.

Additional Capital and Quantitative Limitations

Authority with Respect to Banking Entities

Pursuant to the Dodd-Frank Act, the regulators may adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, in connection with the activities covered by the Volcker Rule if the regulators determine that such limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities. In determining compliance with any applicable capital standards set by the regulators, the Volcker Rule specifies that the aggregate amount of any outstanding de minimis investments in a private equity or hedge fund by a banking entity, including retained earnings, must be deducted from the assets and tangible equity of the banking entity. Further, the amount of any such deduction must increase commensurate with the leverage of the private equity or hedge fund.

In addition to these capital limitations, a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a private equity or hedge fund, or that organizes and offers a private equity or hedge fund, and no affiliate of such banking entity, may enter into a "covered transaction," pursuant to FRA § 23A, with the fund or any fund controlled by such fund. Similarly, any such banking entity shall be subject to the arm's length and other requirements of FRA § 23B. Notwithstanding the restriction on covered transactions under FRA § 23A, the FRB may permit a banking entity to enter into any "prime brokerage transaction" with any private equity or hedge fund in which a fund managed, sponsored, or advised by the banking entity has taken an ownership interest, provided the banking entity (i) is otherwise in compliance with the de minimis investment requirements of the Volcker Rule, (ii) the CEO (or equivalent officer) of the banking entity annually certifies in writing that such requirements are satisfied, and (iii) the FRB determines that such transaction is consistent with the safe and sound operation and operation and condition of the banking entity. Significantly, the term "prime brokerage transaction" is not defined by the Volcker Rule.

Authority with Respect to Nonbank Financial Companies Supervised by the FRB

In addition to imposing additional capital requirements, quantitative limitations, and FRA §§ 23A and 23B affiliate transaction restrictions on banking entities, the regulators are required to impose similar requirements, limitations and restrictions (as described above) on systemically important nonbank financial companies supervised by the FRB.

Miscellaneous Provisions

Importantly, the Volcker Rule provides that the general ban on proprietary trading and investment in private equity and hedge funds, as well as the above capital, quantitative and affiliate transaction restrictions, do not limit or restrict the ability of a banking entity or nonbank financial company supervised by the FRB to sell or securitize loans otherwise permitted by law.

Another important aspect of the Volcker Rule is its anti-evasion authority which requires the regulators to include in their implementing regulations internal controls and recordkeeping requirements to insure compliance with the rule. Further, the regulators are authorized to terminate activities and investments, subject to due notice and an opportunity for a hearing, not in compliance with, or that the appropriate regulator determines is an evasion of, the requirements of the Volcker Rule.

Timing and Regulatory Implementation

Pursuant to the Dodd-Frank Act, the FSOC is required to conduct a study and make recommendations on implementing the Volcker Rule within six months after the date of enactment of the Act. Within nine months after the issuance of the FSOC study and recommendations, the regulators (the FBAs, SEC and CFTC) are required to issue regulations implementing the Volcker Rule. In any event, the provisions of the Volcker Rule become effective on the earlier of twelve months following the issuance of final agency rules implementing the Volcker Rule or two years after the date of enactment of the Dodd-Frank Act.

Upon the effectiveness of the Volcker Rule, banking entities and nonbank financial companies subject to FRB supervision have a two-year transition period in which to conform their activities and investments to the requirements of the rule. However, the FRB may grant up to three one-year extensions of the transition period, provided such extension is consistent with the purposes of the Volcker Rule and not detrimental to the public interest.

Further, the FRB may provide a banking entity an additional one-time five-year extension to retain an ownership interest in an “illiquid fund” that the banking entity was contractually obligated to own as of May 1, 2010. A banking entity must divest its ownership interest in an illiquid fund upon the earlier of the date the contractual obligation to invest in the illiquid fund expires or the conclusion of the extended five-year transition period. The rule defines an “illiquid fund” as a private equity or hedge fund that, as of May 1, 2010, was principally invested in or contractually committed principally to invest in illiquid assets, such as portfolio companies, real estate investments and venture capital investments, and makes all investments pursuant to an investment strategy to principally invest in illiquid assets. This extended transition authority for illiquid funds may be particularly important to banking entities holding sizable investments in real estate funds. As with many other aspects of the Volcker Rule, the availability and scope of this extended illiquid asset transition authority will ultimately depend on the extent and coverage of the implementing rules and requirements issued by the FRB and other regulators.

Finally, the applicable regulator may impose such additional capital requirements on a banking entity as it deems appropriate during any applicable transition period, including the initial two-year transition period and all subsequent transition periods.

Conclusion and Action Plan

While some regulatory discretion was eliminated from the final version of the Volcker Rule, there remains a significant degree of latitude for the regulators to determine the scope and applicability of the various provisions and requirements of the rule. Given the extent to which the regulators could narrow or expand the Volcker Rule, it is in the interest of parties potentially affected by the rule to engage the regulators to conduct a dialogue regarding the impact, issues and concerns with implementation of the rule. In this regard, an effective course of action will be to understand and identify the overall market impact of the various aspects of the rule, including the extent to which sound public policy can be served by a particular approach, and to pursue/encourage a regulatory agenda consistent with such approach.

To view other thought leadership pieces on how this landmark legislation and the myriads of implementing regulations will affect your industry, please follow this link.

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