Regulators Adopt Final Volcker Rule Regulations

On December 10, 2013, the federal banking agencies,[1] the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission (the "CFTC," and, together with the federal banking agencies and the SEC, the "Agencies") jointly adopted long awaited regulations (the "Final Regulations") to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule.[2]

The Volcker Rule prohibits any "banking entity" from (i) engaging in proprietary trading and (ii) acquiring and retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds and certain other private funds ("covered funds"), subject to certain exemptions.

The federal banking agencies and the SEC published proposed rules to implement the Volcker Rule on October 11, 2011, and the CFTC published a substantively similar proposal on January 11, 2012 (the "Proposed Regulations").[3] The regulators received over 18,000 comments on the Proposed Regulations from financial institutions, advocacy groups, foreign governments, and other interested parties, and the Proposed Regulations have been the subject of intense debate and discussion since they were released.

It was anticipated that the Final Regulations would be tougher in certain respects than the Proposed Regulations, particularly with respect to the exemption for risk-mitigating hedging activities. At the same time, financial institutions and other market participants were hopeful that the regulators might provide relief from some of the Proposed Regulations' requirements or clarity regarding their application.

The following are some of the key highlights from the Final Regulations. We will provide more detail regarding the Final Regulations in a series of Alerts that we expect to publish in the coming weeks.

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[1] The federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "FRB"), and the Federal Deposit Insurance Corporation.

[2] The Final Regulations and accompanying statements, fact sheets, and related documents can be found on the websites of the Agencies. For example, they are available on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

[3] For a summary of the Proposed Regulations, *see* Bingham McCutchen LLP Legal Alert: Proposed Volker Rule Regulations: A Summary (Oct. 18, 2011). The Proposed Regulations can be found in the Federal Register at 76 FR 68846 (Nov. 7, 2011) and on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

Banking Entity

- The Final Regulations keep the same general definition of "banking entity" that is included in the statute and the Proposed Regulations, but exclude a broader range of entities. A covered fund will not be a banking entity solely based on the fact that it is an affiliate or subsidiary of a banking entity. There are also exclusions for certain portfolio companies held under the Bank Holding Company Act's merchant banking and insurance company investment authorities and portfolio concerns that are controlled by a small business investment company.

Proprietary Trading

- Under the Final Regulations, the proprietary trading restrictions do not apply to trading activity such as clearing, liquidity management, transactions in satisfaction of debts previously contracted, and other types of transactions that, in the view of the Agencies, do not involve an intent by the banking entity to resell in order to profit from short-term price movements. These activities are excluded from the definition of proprietary trading.

- With respect to the permitted proprietary trading activities:

    - The Final Regulations clarify the parameters for permitted underwriting and related activities of trading desks in connection with distribution of securities. Compliance programs specific to underwriting and related trading desk activities are required, and must include written policies and procedures, internal controls, analysis and testing, among other things, that address the trading desk activities and risks arising from the underwriting and related activities.

    - The Final Regulations do not require that market-making-related activities be designed to generate revenues primarily from fees. However, the Final Regulations require banking entities with significant trading activity to report data regarding patterns of revenue generation by market-making desks. The Final Regulations provide that a banking entity may engage in market-making in different types of asset classes and that market-making-related activity may vary based on the liquidity, maturity and depth of the market for the particular financial instrument. The Final Regulations also make clear that dealers in securities, derivatives and other financial instruments may continue to act as principal when making markets.

    - The Final Regulations permit hedging of specific and aggregate positions. However, any permitted hedging activity, at the inception of the hedge, must be designed to demonstrably reduce or otherwise significantly mitigate one or

more specific, identifiable risks to the banking entity in connection with, and related to, positions, contracts or other holdings of the banking entity.

- The exemption for proprietary trading by regulated insurance companies includes both trading through general accounts and separate accounts. Under the Proposed Regulations, separate account trading would have been permitted under the exemption for trading on behalf of customers.

- The exemption for trading by foreign banking entities has been changed from a transaction-based to risk-based approach. (As under the Proposed Regulations, this exemption is not available to U.S. firms and their subsidiaries (including foreign subsidiaries). Under this new approach, a foreign banking entity may rely on the exemption only if:

  - the foreign banking entity acts as principal in the purchase or sale outside the United States,
  - the banking entity (including relevant personnel) that makes the decision to purchase or sell is not located in the United States,
  - the purchase or sale, including any related hedging transactions, is not accounted for as principal in the United States,
  - no financing for the banking entity's purchase or sale is provided by a U.S. affiliate of the foreign banking entity, and
  - the purchase or sale is not conducted with or through any U.S. entity, other than 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.

- The Final Regulations provide a new exemption for certain trading in foreign government obligations by certain banking entities. Specifically, the Final Regulations permit:

  - trading by the U.S. operations of a foreign banking entity, other than an insured depository institution, in obligations of the home chartering authority of the foreign banking entity (including obligations of any agency or political subdivision thereof), and
  - trading by a foreign bank or foreign securities broker-dealer owned by a U.S. banking entity in obligations of the foreign sovereign that charters the foreign bank or foreign broker-dealer (including obligations of any agency or political subdivision thereof).

Covered Fund Activities

- The Final Regulations define “covered fund” to include issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the “1940 Act”), as well as certain commodity pools and foreign funds. However, the Agencies made certain changes from the proposal.

  - The Agencies have not included all commodity pools within the definition of covered fund as proposed. Instead, the Agencies have included only commodity pools for which the commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC’s regulations or that could qualify as exempt pools and which have not been publicly offered to persons who are not qualified eligible persons under section 4.7 of the CFTC’s regulations.

  - A foreign fund is included within the definition of a covered only for any banking entity that is, or is controlled directly or indirectly by a banking entity, that is located in organized or established under the laws of the United States. A foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as sponsor to the foreign fund or has an ownership interest in the foreign fund. A foreign fund therefore may be a covered fund with respect the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.

  - The Final Regulations exclude from the definition of covered fund a number of entities that are not engaged in the types of investments or activities that the Volcker Rule was designed to address, such as:

    - foreign public funds (this exclusion is designed to exclude foreign funds that are similar to U.S. registered investment companies),
    - wholly-owned subsidiaries,
    - joint ventures that do not engage in investing money for others,
    - acquisition vehicles,
    - foreign pension or retirement funds,
    - insurance company separate accounts,
    - small business investment companies and public welfare investment funds, and
    - investment companies registered under the 1940 Act.

- Securitizations of “loans” (including leases and other extensions of credit) are excluded from the definition of “covered fund,” and the permissible assets in loan securitizations have been expanded to include servicing assets. However, most securities (including other asset-backed securities) are not permitted as pool assets, subject to limited exceptions for cash equivalents, securities received in lieu of debts

previously contracted with respect to the securitized loans, and certain intermediate asset-backed securities. Derivatives generally are not permitted as pool assets, other than certain interest rate caps and swaps and certain foreign currency swaps. There also are new exclusions from the definition of "covered fund" for certain asset-backed commercial paper conduits and for certain covered bond structures.

- An "ownership interest" in a covered fund is defined as any equity, partnership, or other similar interest.

    - The Final Regulations provide a list of rights that would constitute an "other similar interest."

    - The Final Regulations also provide an exclusion from the definition of "ownership interest" for "restricted profits interests," designed to allow the banking entity (or its employees and former employees) to share the profits of a covered fund's performance compensation for advisory services. This exclusion was for "carried interest" in the Proposed Regulations and the Final Regulations retain most aspects of the proposed exclusion while adding additional conditions.

- With respect to permitted covered fund sponsorship and investment:

    - The exemption for organizing and offering covered funds has been expanded to include underwriting and market-making activities that are designed not to exceed the reasonably expected near term demands of clients, customers and counterparties.

    - The Final Regulations provide greater flexibility for banking entities that hold ownership interests in an asset-backed securities issuer that is a covered fund that the banking entity organizes and offers. The banking entity is not required to offer ownership interests in the issuing entity only to customers of trust, fiduciary or investment advisory services. In addition, the Final Regulations clarify that positions a banking entity holds pursuant to the minimum credit risk retention requirements of the Dodd-Frank Act, when they are adopted, will constitute a permitted form of acquiring or retaining an ownership interest in the issuing entity.

    - The exemption for permitted covered fund activities outside the United States has been revised to provide greater flexibility to foreign banks relying on the exemption. Among other changes, the definition of "solely outside the United States" has been revised in the Final Regulations to the following:

        - the banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the United States,

        - the investment or sponsorship, including any related hedging transactions, is not accounted for as principal in the United States,
        - ownership interests in the covered fund are not targeted to residents of the United States, and
        - no financing for the banking entity's ownership or sponsorship is provided by a U.S. affiliate of the foreign banking entity.

      As under the Proposed Regulations, this exemption is not available to U.S. firms and their subsidiaries (including foreign subsidiaries).

    - The covered fund hedging exemption allows the use of ownership interests in a covered fund as a hedging instrument only if the hedging activity is directly connected to a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund.

    - The Final Regulations include an exemption for an insurance company or its affiliate to acquire or retain an ownership interest in, or act as sponsor to, a covered fund for the general account or separate account of a regulated insurance company.

  - The "Super" 23A and 23B requirements are largely unchanged from the Proposed Regulations. However, the impact of these requirements will be altered by the changes to the definition of covered fund in the Final Regulations, since transactions with funds that are not covered funds will not be subject to these restrictions.

<u>Compliance</u>

- As expected, the Federal Reserve extended the conformance period for an additional year until July 21, 2015. During the conformance period, all banking entities must make good-faith efforts to develop compliance with the rules.

- Enhanced minimum standards apply to banking entities with significant trading or covered activities or investments. Under the Final Regulations, one of the enhanced minimum standards is a requirement that the CEO of the banking entity attest in writing to the relevant agency that the banking entity has a compliance program reasonably designed to comply with the statutory Volcker Rule and the Final Regulations.

- Reporting requirements are applied in a graduated manner, with only the very largest firms required to report metrics.

- A banking entity is not required to implement a compliance program if it does not engage in activities or investments under any of the Volcker Rule's permitted activities exemptions, other than the exemption for trading in domestic government obligations.

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As noted above, we will be preparing a series of additional alerts that will discuss the Final Regulations in further detail. In the meantime, please feel free to reach out to your regular contacts at the firm if you have any questions about the matters addressed in this alert. In addition, you are welcome to contact the authors of this alert set forth below.

Andrew Kales
andrew.kales@bingham.com
+1.202.373.6788

Amy Kroll
amy.kroll@bingham.com
+1.202.373.6118

Charles Sweet
charles.sweet@bingham.com
+1.202.373.6777

Joshua Sterling
joshua.sterling@bingham.com
+1.202.373.6556