THE VOLCKER RULE PROVISIONS
(as of June 25, 2010)

The Volcker Rule provisions, named for former Federal Reserve Chairman Paul Volcker, are premised on the belief that speculative trading activities contributed in part to the financial crisis. The original House bill did not contain Volcker Rule provisions, although it did contain certain limitations on permitted activities (for example, the House bill permitted a ban on proprietary trading that poses systemic risk). In January 2010, the Obama Administration endorsed the Volcker Rule. The Senate bill imposed a prohibition on most proprietary trading by U.S. banks and their affiliates, subject to limited exceptions, and restricted covered institutions from owning, sponsoring or investing in hedge funds or private equity funds.

Discussions relating to the Volcker Rule were among the most heated. The following summarizes the key Volcker Rule provisions contained in the Dodd-Frank Bill (Title VI):

Prohibition on proprietary trading

There are important distinctions made between the activities that may be conducted by banking entities and those that may be conducted by nonbank financial companies supervised by the Federal Reserve Board.

- Except for certain permitted activities, a “banking entity” cannot (1) engage in proprietary trading, or (2) acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or private equity fund (collectively “fund activities”).

- A “nonbank financial company” that engages in proprietary trading or fund activities will be subject to additional capital requirements and quantitative limits, to be established by rule. However, if a nonbank financial company engages in any permitted activities (i.e., any of the activities that a banking entity is permitted to engage in), the capital requirements or quantitative limits applied to the nonbank financial company for those activities will be the same as those applied to banking entities engaging in such permitted activities.

Proprietary trading is defined as engaging as principal for the trading account of the banking entity or nonbank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal agencies may determine.

“Banking entities” are bank holding companies (BHCs), non-U.S. entities treated as BHCs, insured depository institutions, and affiliates or subsidiaries of the foregoing.

“Nonbank financial companies” are certain U.S. or foreign companies that, though not BHCs or insured depository institutions, predominately engage in financial activities (as defined in the Bank Holding Company Act) and which will become subject to the supervision of the Federal Reserve Board based on a determination by the Financial Council.

De Minimis Investment

A banking entity may make and retain an investment in a fund that the banking entity organizes and offers; provided, that, it seeks unaffiliated investors for the fund; within one year of a fund’s start date, the banking entity’s investments shall not exceed more than 3% of the total ownership interests in such fund; and the aggregate of investments in all such funds does not exceed 3% of the banking entity’s Tier 1 capital.

Permitted activities

The following activities are "permitted activities":

- transactions in U.S. government securities (including securities of the GSEs);
- transactions in connection with underwriting or market-making activities, to the extent designed not to "exceed the reasonably expected near term demands of clients, customers or counterparties";
- risk-mitigating hedging activities in connection with a banking entity's individual or aggregate positions, contracts or holdings that are designed to reduce the banking entity's specific risks in connection with such positions, contracts or holdings;
- customer transactions;
- SBIC investments;
- the purchase or sale of securities and derivatives by a regulated insurance company engaged in the insurance business, subject to state insurance regulation and federal safety and soundness review;
- organizing and offering a private equity or hedge fund, if the banking entity:
    - provides bona fide trust, fiduciary, or investment advisory services;
    - provides trust or related services and offers interests in the fund only in connection with providing such services only to bank customers;
    - does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds except for de minimis investments (see above);
    - observes the restrictions on affiliate transactions;
    - does not, directly or indirectly, guarantee or assume, or otherwise insure, the obligations or performance of the fund;
    - does not share a name or derivation of a name or other marketing with the fund;
    - does not permit any director or employee of the banking entity to take or retain an equity interest, partnership or other ownership interest in the fund, except for any director or employee who is directly engaged in providing investment advisory services to the fund; and
    - discloses to prospective and actual fund investors that losses sustained by the fund are not borne by the banking entity;
- certain proprietary trading that occurs solely outside of the U.S. by a banking entity that is not directly or indirectly controlled by a banking entity organized under the laws of the U.S.;
- the acquisition or retention of an ownership interest or the sponsorship of a fund by a banking entity solely outside of the U.S. if interests in the fund are not offered or sold to a U.S. resident and the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.; and
- all other activities deemed appropriate by the applicable oversight agencies that would promote the safety and soundness of the banking entity.

No activity may be deemed a permitted activity if it would (1) result in a material conflict of interest for the banking entity; (2) result in a material exposure for the banking entity to high-risk assets or high-risk trading strategies; or (3) pose a threat to the safety and soundness of the banking entity.

Permitted Services

A banking entity or a nonbank financial company may provide prime brokerage services to a sponsored fund if the provision of such services complies with other applicable restrictions of the regulations and the CEO (or equivalent officer) of the banking entity certifies annually to such compliance. Prime brokerage transactions will be subject to Section 23B.

Capital requirements

Oversight agencies will adopt additional capital requirements and quantitative limits.

Restrictions on Affiliate Transactions

A banking entity that serves as an investment adviser or sponsor to a fund or that organizes and offers interests in a fund may not enter into “covered transactions” (as defined under Section 23A of the Federal Reserve Act) with the fund and that banking entity also shall be subject to the restrictions of Section 23B of the Federal Reserve Act in respect of transactions with the fund.

Required study

Within six months of enactment, the Financial Stability Oversight Council will conduct a study and make recommendations regarding implementation of these measures. Within nine months of completion of the study, the appropriate agencies will consider the findings and adopt rules to implement these measures.

Phase-In Period

Generally, these provisions shall take effect on the earlier of: 12 months after the date of the issuance of the final rules, or two years after the date of enactment of the Dodd-Frank Bill.

Bank entities and nonbank financial companies will have two years after the effective date (or two years after the date on which the entity becomes subject to Federal Reserve Board supervision as a bank entity or a nonbank financial company) to bring their activities into compliance. This phase-in period may be extended by the Federal Reserve Board for one year at a time, with extensions not to exceed an aggregate of three years. However, the Federal Reserve Board may extend the period in order to permit compliance with a contractual obligation that was in effect on May 1, 2010.

Conflict of interest provisions (Merkley provisions)

An underwriter, placement agent, initial purchaser, sponsor (or any affiliate) of an asset-backed security (as defined under Section 3 of the Exchange Act, but, for these purposes, including synthetic asset-backed securities) shall not engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such affiliate. This prohibition will apply for a one-year period that begins on the offering date.

Within 270 days of enactment of the Dodd-Frank bill, the SEC shall promulgate rules to implement this prohibition.

The prohibition shall be subject to exceptions for the following:

- Risk-mitigating hedging activities in connection with underwriting or offering the asset-backed security; provided such activities are designed to reduce specific risk to the financial intermediary associated with positions arising in connection with the asset-backed security offering; and
- Purchases or sales of asset-backed securities made pursuant to and consistent with commitments by the financial intermediary to provide liquidity for the asset-backed security.