

# A many-headed hydra

The notorious regulation technically took effect on April 1. Covered entities must now pay closer attention to how they structure their trading activities, and their investments in fund-type vehicles

Perhaps not surprisingly, a rule crafted by five regulators that purports to stop banking entities engaging in risky activities – while also attempting to permit activities necessary to well-functioning markets – poses enormous challenges. In December 2013, over two years since the release of the proposed rule, the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Securities and Exchange Commission, and the Commodity Futures Trading Commission adopted the final Volcker Rule. Subject to exceptions, this prohibits banking entities – a broad term that includes banks, bank holding companies, foreign banks treated as bank holding companies (FBOs) and their respective affiliates – from engaging in proprietary trading and acquiring or retaining ownership interests in, or acting as sponsors to, certain hedge funds and private equity funds (Covered Funds). Broker-dealers not affiliated with banks are not subject to the rule. By statute, the rule took effect two years following adoption of the Dodd-Frank Act in July 2012 with a two-year conformance period that originally ended July 2014. The agencies have extended the conformance period by one year to July 2015 (and by three years to July 2017 for investments in certain pre-existing collateralised loan obligations). Setting aside its sheer heft (about 80 pages of rule text accompanied by approximately 900

pages of preamble or explanatory notes), the rule's complexity assures that we will be struggling to grapple with its provisions far beyond 2015.

## Proprietary trading

Proprietary trading is defined as engaging as principal for the trading account of the banking entity in the purchase or sale of a financial instrument. A 'financial instrument' includes a security, derivative, and contract of sale of a commodity for future delivery (or an option on the same). It excludes loans, a commodity that is not an 'excluded commodity', derivative or a commodity future, and foreign exchange or currency. A trading account is one that satisfies either the purpose test, market risk capital test, or status test. The purpose test addresses trading for short-term resale or to benefit from short-term price movements. The market risk capital test applies to a US bank or thrift, or a US bank or thrift holding company subject to the US banking agencies' market risk capital rules. For such entities, a trading account includes one used to trade in financial instruments that are both market risk capital rule covered positions and trading positions. The status test addresses – for a banking entity that is a securities dealer, swap dealer or securities-based swap dealer – trades that would require them to be licensed as such. All such trades are deemed to occur in a trading account. Given the breadth of these definitions, and the presumption established by the rule that the purchase or sale of a financial instrument held in a trading account for less than 60 days constitutes proprietary trading, many necessary or benign activities are prohibited.

In an attempt to avoid this result, the rule excludes certain activities from the definition of proprietary trading. This includes: repurchase and reverse repurchase and securities lending transactions; clearing agency trades; liquidity management transactions executed pursuant to a plan; and trades in which the banking entity is acting

solely as agent, broker or custodian. The prohibition also is deemed not to apply to: trading as principal in US government and agency securities; US municipal securities; trading by a foreign banking entity or foreign bank subsidiary of a US banking entity of debt of a foreign government (or of any agency or political subdivision of that foreign government) issued by the foreign country in which the foreign banking entity or foreign bank subsidiary is organised; and trading by a banking entity that is a regulated insurance company (including a foreign insurance company), whether for the insurance company's general account or for a separate account. A banking entity can conduct agency transactions as well as riskless principal activities so long as these are 'customer-driven and do not expose the banking entity to gains (or losses) on the value of the traded instruments as principal'. As a result, banking entities may be motivated to structure more transactions on an agency or riskless principal basis.

The Volcker Rule permits certain trading activities – notably, in connection with permitted underwriting activities, market making-related activities, and risk-mitigating hedging activities. But the rule defines these activities narrowly so that a banking entity cannot circumvent the proprietary trading prohibition by purporting to undertake a permitted activity. In addition, to engage in a permitted activity, a banking entity must comply with three overall conditions: it must maintain an internal compliance programme designed to ensure that it satisfies the applicable conditions; the compensation arrangements of personnel involved in these activities must not be designed to reward or create incentives to engage in prohibited proprietary trading; and the entity must be licensed or registered to engage in the permitted activity. Regardless of these exceptions, permissible activities would be prohibited if: they would involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; they would result in a material exposure by the entity to a high-risk asset or high-risk trading strategy; or they pose a threat to the safety and soundness of the entity or to the financial stability of the US.

Trading in connection with underwriting activities is permitted only if the trading desk's underwriting position is related to a 'distribution' of securities for which the banking entity is acting as underwriter. The underwriting position must be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties, and reasonable efforts must be made to sell or otherwise reduce the



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underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant security. To determine 'near-term demands', an underwriter must make reasonable judgements based on its experience with similar offerings, its knowledge of the market and market conditions, and its bookbuilding experience. Banks may seek to avoid certain types of transactions, such as bought deals, which may be more likely to result in unsold allotments that may pose a compliance challenge.

## Banking entities may be motivated to structure more transactions on an agency or riskless principal basis

The proprietary trading prohibition does not apply to purchases or sales of financial instruments by a banking entity made in connection with its market making activities. Market making activities are permitted only if the relevant trading desk:

- 'routinely stands ready' to purchase and sell one or more types of financial instruments related to its financial exposure; and
- is 'willing and available' to quote, purchase or sell those financial instruments for its own account in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market for the relevant financial instruments.

Banks are likely to consider carefully the financial instruments for which they act as market makers, scrutinise closely the benefits associated with such activity, and suspend market-making in less liquid securities.

Banking entities may engage in certain risk-mitigating hedging activities. Subject to numerous conditions, hedging activities are permitted if they are 'in connection with and related to individual or aggregated positions, contracts or other holdings' and 'designed to reduce the specific risks to the banking entity' that are 'related to such positions, contracts or other holdings'. To distinguish between these permitted hedging activities and impermissible proprietary trading, the banking entity must establish a compliance programme. The entity should determine at the inception of its trading that the hedging

activity should demonstrably reduce risk, and it cannot give rise to a significant new or additional risk that is not itself contemporaneously hedged. This exception cannot be used to address hedging activities with respect to 'generalised risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modelling or other considerations'.

Foreign banking entities are exempt from the proprietary trading prohibition to the extent the activity is conducted solely outside the United States (SOTUS Exemption). FBOs may rely on the SOTUS Exemption to engage in proprietary trading, subject to the following requirements:

- The FBO may not be directly or indirectly controlled by a US banking entity;
- The FBO must be a qualifying foreign banking organisation (QFBO) or an affiliate of a QFBO that has the preponderance of its business outside of the US;
- The FBO engaging in the trading activity (including any relevant personnel of the foreign banking entity that arrange, negotiate or execute the trades, but not those who clear or settle the trades) must be located outside the US and not be organised under US law;
- Trading decisions must be made outside of the US;
- Trades, including any related hedging transactions, must be booked, and the profit or loss must be accounted for as principal, outside of the US in an entity that is not organised under the laws of the US; and
- No financing of any trades may be provided by a US branch or affiliate of the foreign banking entity.

Trades may not be conducted with or through a US entity except:

- Trades with the foreign operations of a US entity, as long as no personnel of the US entity located in the US are involved in the arrangement, negotiation or execution of the trades;
- Trades through an unaffiliated intermediary acting as principal, provided that the trades are promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or
- Trades through an unaffiliated market intermediary acting as agent, if conducted anonymously on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or derivatives clearing organisation acting as a central counterparty.

The rule also permits FBOs to engage in

proprietary trading in their home-country government obligations.

Most banking entities are now wrestling with the burdensome task of identifying the scope of individual trading desks' activities within each affected legal entity, assessing existing trading limits and compliance requirements, reviewing compensation policies, and evaluating reporting and recordkeeping capabilities. After these initial steps have been taken, the thornier issues will need to be addressed. Will the entity choose to consolidate any of its trading desks or restructure or exit certain businesses? For example, FBOs with limited US activities may want to restructure their businesses to conduct transactions on a riskless principal or agency basis, and to conduct any principal transactions only outside of the US.

### Fund investment and sponsorship

The Volcker Rule generally prohibits a banking entity, as principal, from directly or indirectly acquiring, sponsoring, or retaining an ownership interest in a 'covered fund'. A covered fund may generally be thought of as a collective investment vehicle that would be considered an investment company under the Investment Company Act of 1940 (if that were applicable), but for exemptions available to private funds under section 3(c)(1) and section 3(c)(7) of the Act. Section 3(c)(1) excludes an issuer whose outstanding securities are beneficially owned by 100 persons or less, and which is not making or proposing to make a public offering. Section 3(c)(7) excludes an issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition, are 'qualified purchasers' and which is not making or proposing to make a public offering. A covered fund also includes certain commodity funds having characteristics similar to those of private funds, as well as foreign funds (that is, those organised abroad and whose interests are sold abroad to non-US residents) sponsored by a US banking entity or an affiliate. Covered funds do not include foreign funds that, if organised in the US would be investment companies, but for the exemption available under section 3(c)(1) or section 3(c)(7) of the Act.

The rule provides 14 enumerated exclusions from the definition of covered fund, including: foreign public funds; wholly-owned subsidiaries; joint ventures; certain acquisition vehicles; securitisation-related vehicles (discussed below); registered investment companies; and certain other entities related to insurance company separate accounts and retirement funds. Certain other types of entities are not expressly excluded

from the definition of covered fund. However, there may be specific exemptions from the definition of an 'investment company' (other than the exemptions found in section 3(c)(1) and section 3(c)(7)) under the Act available to these entities. For example, a real-estate investment trust may avail itself of an exemption under the Act and, as such, would not be a 'covered fund'. Banking entities must, therefore, review the status of each entity that they may be deemed to sponsor or in which they may hold an ownership interest to determine whether such entity constitutes a 'covered fund' and assess whether there is a permitted exclusion for such entity or an available exemption under the Investment Company Act.

## Regulators have been asked to provide greater clarity regarding the intended scope of various provisions

Banking entities may not sponsor or acquire an ownership interest in a covered fund, subject to certain exceptions. The terms 'sponsorship' and 'ownership interest' are defined broadly. Sponsorship, for example, includes serving as a general partner, managing member, trustee or commodity pool operator of a covered fund, selecting a majority of directors, trustees or management of a covered fund, or sharing with the covered fund the same name or a variation or derivation of the name. The term 'ownership interest' means any equity, partnership or 'other similar interest'. Interests that may not be ownership interests in some contexts may fall within the definition of ownership interests for purposes of the rule. The breadth of these definitions already has been a source of consternation for banking entities, and regulators have been asked to provide greater clarity regarding the intended scope of various provisions.

The prohibition on acquiring or retaining ownership interests does not apply if the banking entity acts solely as agent, broker or custodian. This is so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity (and any affiliate) does not retain a beneficial ownership interest. The prohibition also does not apply to a banking entity that acts as a trustee for a customer that is not itself a

covered fund. Banking entities may invest in or sponsor covered funds under limited circumstances. Banking entities must limit their investment to three percent of the value of the covered fund, or the number of ownership interests in the covered fund. During a limited 'seeding period', banking entities may exceed this limit. The rule exempts FBOs from the prohibition against investing in, and sponsoring, covered funds to the extent the activity is conducted solely outside the US. The exemption is subject to the following requirements:

- The FBO may not be directly or indirectly controlled by a US banking entity;
- The FBO must be a QFBO or affiliate of a QFBO that has the preponderance of its business outside of the US;
- Ownership interests in the covered fund in which the FBO invests have been sold only in an offering that does not target residents of the US;
- Investment and sponsorship decisions must be made outside of the US;
- The fund investment, including any related hedging transactions, must be booked outside of the US in an entity that is not organised under the laws of the US; and
- No financing of any fund investment may be provided by a US affiliate of the FBO.

The rule restricts banking entities from entering into covered transactions with respect to permissible covered funds. Covered transactions mean those between banking entities and their affiliates that section 23A of the Federal Reserve Act restricts. Unlike section 23A, however, the rule imposes absolute transaction prohibitions, and thus this part of the rule is referred to as Super 23A.

### Impacts on securitisation

Banking entities involved as investors in, sponsors of, or transaction parties (for example, credit or liquidity providers) with securitisation issuers may be subject to severe restrictions or required divestiture if the securitisation issuer is a covered fund.

Most securitisations of traditional loan products (such as mortgage loans, auto loans, student loans and credit card receivables) are not considered covered funds. However, certain securitisation vehicles – particularly those whose assets include securities or derivatives (as opposed to loans) – may be covered funds. Many securitisation trusts have relied on the section 3(c)(1) or section 3(c)(7) exemption under the Act. However, if another exemption is available (or the transaction can be restructured to comply with another exemption), then these will not be considered covered funds.

The rule's exclusions from the definition of covered fund include qualifying loan securitisations, qualifying asset-backed commercial paper conduits, qualifying covered bonds, and securities issued by certain wholly-owned subsidiaries of a securitisation issuer. For most securitisations that rely on section 3(c)(1) or section 3(c)(7) – including many collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and certain collateralised mortgage obligations (CMOs) – the key question will be whether the so-called loan securitisation exclusion is available. This exclusion is available only if the assets underlying the securitisation consist only of loans as opposed to securities or derivatives, with very limited exceptions for certain types of ancillary assets that support the securitisation. If the primary assets of a section 3(c)(1) or section 3(c)(7) securitisation include non-permitted securities or derivatives – as is often the case with CDOs, CLOs and CMOs – the securitisation vehicle will likely be a covered fund.

As discussed above, banking entities are prohibited from acquiring or holding ownership interests in covered funds. The definition of 'ownership interest' is sufficiently broad that it may potentially include senior, highly rated debt securities issued by securitisation vehicles, such as CDOs and CLOs, as the result of certain voting or other management control rights given to such senior classes in many transactions. As a result, banking entities are analysing whether securities they previously considered to be debt securities may nonetheless be considered prohibited 'ownership interests' for purposes of the rule.

### What's next

Many have focused on the costs and difficulties associated with implementing the required compliance systems and procedures and, for larger banks, the reporting requirements. However, it should be noted that some of these costs are scaled based on the entity's size and scope of its activities. The longer lasting structural changes to the capital markets will result from a natural inclination on the part of most banking entities to restructure their activities away from those which, based on their cost-benefit analysis, they conclude are no longer rewarding. Whether nonbank entities step into the breach and undertake market making and other such activities remains an open question. Whether greater participation by less regulated institutions ultimately results in greater financial stability.

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