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News Bulletin

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Treasury Provides More Details on the Volcker Rule

On March 3, 2010, demonstrating that the spirit of agrarian populism is alive and well, the Treasury proposed legislative language ("Proposal") to implement the so-called Volcker Rule that would limit proprietary trading by banking institutions and limit the overall size of financial companies. The Proposal would add Sections 13 and 13(a) to the Bank Holding Company Act.

Proprietary Trading

Apparently, on the theory that firms that benefit from the federal safety net should not be allowed to engage in speculative transactions that do not provide any public benefit, Section 13 would prohibit proprietary trading by:

- an insured depository institution;
- a company that controls an insured depository institution; and
- a company that is treated as a bank holding company for purposes of the Bank Holding Company Act.

Exceptions would be made for:

- the trading in United States government and agency securities;
- investments in small business investment companies; and
- investments designed primarily to promote public welfare.

The Proposal would define proprietary trading as "purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives or other financial instruments for the institution's or company's own trading book, and not on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of a customer relationship, including hedging activities related to the foregoing."

Section 13 also would prohibit these companies from sponsoring and investing in hedge funds and private equity funds. Further, although under the Proposal, these companies would continue to be able to serve as investment advisers to hedge funds and private equity funds, they would be prohibited from engaging in a covered transaction as defined in section 23A of the Federal Reserve Act with, or provide custody, securities lending and other prime brokerage services to, hedge funds or private equity funds. Nonbank financial companies would be allowed to continue to engage in proprietary trading and hedge fund and private equity activities, but if these firms are under the Board's jurisdiction, they would be subject to additional capital requirements and additional quantitative limits, with exceptions made for the trading in United States government and agency securities, and for investments in small business investment companies and investments designed primarily to promote public welfare.

Too Big to Fail

Apparently, on the theory that the failure of a larger firm is likely to pose a greater threat to overall financial stability than the failure of a smaller firm, Section 13a would address the size of large financial firms. Section 13a would prohibit any financial company from engaging in mergers or acquisitions that would result in the company holding more than 10% of the aggregate consolidated liabilities of all financial companies. Financial company is defined as any:

- insured depository institution;
- bank holding company;
- other company that controls an insured depository institution;
- nonbank financial company supervised by the Board; and
- foreign bank or company treated as a bank holding company for purposes of the Bank Holding Company Act.

Liabilities are calculated as a financial company's total risk-weighted assets, as determined pursuant to the risk-based capital rules applicable to bank holding companies, as adjusted to reflect exposures that are deducted from regulatory capital, less the company's total regulatory capital under the risk-based capital rules applicable to bank holding companies. For a foreign-based financial company, "liabilities" would equal only the total risk-weighted assets of its U.S. operations as determined pursuant to the applicable risk-based capital rules, as adjusted to reflect exposures that are deducted from regulatory capital, less the total regulatory capital of the company's U.S. operations, as determined under the applicable risk-based capital rules.

Prognosis

At this point, it is not clear that the Administration will succeed in incorporating the Volcker Rule, as proposed, in regulatory reform legislation. The House Bill has already been passed. Further, Senator Dodd has criticized the Administration's efforts as coming late in the legislative process, and Senator Dodd may have a strong interest in enacting financial reform legislation before he retires at the end of this year.

One view is that the Volcker Rule is already incorporated into the Wall Street Reform and Consumer Protection Act ("H.R. 4173" or the "House Bill"), which passed in the U.S. House of Representatives on December 11, 2009. Section 1117 of H.R. 4173 gives the Federal Reserve the authority to prohibit systemically important companies from engaging in proprietary trading.

In addition, Section 1105 of H.R. 4173 gives the proposed Financial Services Oversight Council ("Council") the authority to require a financial company that could pose a threat to financial stability or the economy to terminate activities, limit affiliates or divest businesses if the Council finds that the size of the financial company poses a grave threat to the economy.

The Senate could incorporate similar provisions into its version of regulatory reform legislation and take the view that it has addressed the issues raised by the Volcker Rule, thereby leaving the details to regulators rather than trying to incorporate the details into legislation and potentially delay enactment.

The proposed legislative text addressing the Volcker Rule can be found on our Regulatory Reform webpage at http://www.mofo.com/files/Uploads/Images/100303BHCA.pdf.

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