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Ready for the Volcker Rule? What to Look For

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Over two years after publication of a proposed regulation, a final regulation implementing the so-called "Volcker Rule" is expected to be adopted tomorrow by the five US Federal financial regulatory agencies.[1] Two of them—the Federal Reserve and the Commodity Futures Trading Commission—are expected to adopt the regulation at public meetings. According to reports, the explanation and regulatory language may be over a thousand pages long.

Assuming that the agencies go forward as announced, the most important points to look for in a final regulation are:

- **The definition of market-making**. The Volcker Rule prohibits the conduct of proprietary trading for the account of a bank but allows market-making to satisfy customer demand. What will the final regulation require banks to do in order to show that market-making is not disguised proprietary trading? What impact on market liquidity and prices will the final decision have, and do the agencies indicate any concern about this?
- **The definition of hedging**. The proposed regulation would have permitted "portfolio" hedging. News reports indicate that such hedging will be disallowed. What exactly will be required in order to acquire assets for hedging purposes? How will the final hedging limits affect product offerings and risk management practices?

1 If you are interested in the background of the Volcker Rule and the proposed regulation, you may wish to review our client memorandum, "In the Eye of the Beholder: The Volcker Rule Proposal and What It Means" (Oct. 27, 2011), available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2011/10/In%20the%20Eye%20of%20the%20Beholder%20The%20Volcker%20Rule%20Prop__/Files/View%20full%20memo%20In%20the%20Eye%20of%20the%20Beholder%20%20The%20V__/FileAttachment/IntheEyeoftheBeholderTheVolckerRuleProposalandWh__.pdf.

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- **Recordkeeping, monitoring and reporting requirements**. The proposed regulation would have imposed a host of requirements on banks intended to provide data that could be used to determine whether purported market-making is in fact disguised proprietary trading. Have those requirements been scaled back?
- **Inclusion of non-US sovereign debt**. An exception to the statutory prohibition on proprietary trading in US Government securities does not extend to non-US sovereign debt, and the proposal did not provide such an exception. Has this been changed? If not, how will the G-20 governments react? Could there be an impact on the demand for US Government securities if other governments retaliate?
- **Permissible organization of private funds for fiduciary customers**. The proposed regulation would have required banks organizing private funds to limit the amount of "seed money" they may invest both for each such fund (3 percent of total fund assets after one year) and in the aggregate. Are those limits retained? Are there any additional limitations on the permissible investor base that the bank may invite to invest? Has the definition of a US investor been clarified?
- **The scope of permissible non-US activities of foreign banks**. The proposed regulation would have implemented the statutory exception for foreign banks to engage in trading and fund activities "solely outside of the United States" (called "SOTUS") in a very restrictive way. Among other things, it would have prohibited foreign banks from utilizing most types of staff located in the United States, and would have defined a US person to include a foreign branch of a US bank for purposes of the proprietary trading prohibition. Have these limits been changed? Will the SOTUS standards drive non-US bank operations offshore?
- **Coverage of non-US mutual funds**. The proposed regulation did not provide an exception for non-US mutual funds from treatment as private funds even though they are treated outside the United States as the rough equivalent of registered funds. Has an exception been included?
- **Limits on transactions with permissible sponsored private funds**. The statute prohibits many transactions between a bank and its sponsored private funds, known colloquially as "Super 23A". Among other things, there was no explicit exemption for foreign banks' relationships with their own sponsored non-US funds.
- **CEO attestation of compliance**. According to news reports, the regulation will include a requirement that a bank's chief executive officer attest to the bank's compliance with the Volcker Rule. What will be the language of this attestation, and what will be the effect of a regulatory agency's subsequent determination that the bank is not compliant? Could there be personal liability for an inaccurate attestation?

- **Time period to conform existing operations**. The statute gave the agencies effectively two years, until July 2012, to issue final regulations and provides a July 2014 effective date, with the possibility of one-year extensions. The expectation is that the final regulation will allow for at least a full one-year conformance period. What period does the final regulation allow? Will a request for an extension have to be filed by January 20, 2014, as contemplated by the proposed regulation?
- **International implications**. It remains unclear how similar international initiatives, such as the Vickers Report in the United Kingdom and the Liikanen report in Europe, will have influenced the thinking of the regulatory agencies.[2] Will the final regulation converge towards those being adopted abroad or will yet more silos be required by global institutions?

The answers to these questions will have important implications for how US and non-US "banking entities" will react to a final rule, and whether litigation will be brought to challenge the final rule (for example, if certain of the agencies have adequately considered the costs and benefits of a final rule). If a final regulation as proposed to the agency decisionmakers is made available and acted on tomorrow, Shearman & Sterling LLP will host a one-hour webinar later this week to review the final regulation and the most important points that our clients need to consider, with a detailed memorandum to be issued and a more expansive in-person presentation to follow. Details will be sent in the near future.

[2] If you are interested in the background of the Vickers and Liikanen proposals, you may wish to review our client memorandum, "The Vickers Report and the UK Government's Response: What the Recommendations Mean for the Future of Banking in the UK" (6 March 2012), available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2012/03/The%20Vickers%20Report%20and%20the%20UK%20Governments%20Respon__/Files/View%20full%20memo%20The%20Vickers%20Report%20and%20the%20UK%20Gov__/FileAttachment/TheVickersReportandtheUKGovernmentsResponseFIA03__.pdf.