ALERTS AND UPDATES

U.S. Financial Reform: The Volcker Rule and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System

August 24, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Section 619 of the Act, also known as the "Volcker Rule," will limit proprietary trading, defined below, by U.S. banks and their affiliates ("Banking Entities") and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System ("Board").

The intended purposes of the Volcker Rule are to:

- Promote and enhance the safety and soundness of banking entities;
- Protect taxpayers and consumers by minimizing the risk that insured depository institutions and their affiliates may engage in unsafe or unsound activities;
- Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;
- Reduce conflicts of interest between the self-interests of banking entities and nonbank financial companies supervised by the Board, and the interests of their customers;
- Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system;
- Limit activities that have caused, or that might reasonably be expected to create, undue risk or loss in banking entities and nonbank financial companies supervised by the Board; and
- Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

Under the Volcker Rule, banking entities — as defined below — with a few exceptions, cannot:

- Engage in proprietary trading; or
- Acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or a private equity fund.

Under the Volcker Rule, with a few exceptions, any nonbank financial company supervised by the Board that engages in proprietary trading or that takes or retains any equity, partnership or other ownership interest in, or sponsors a hedge fund or a private equity fund, will be required, by rule, to satisfy additional capital requirements for and meet additional quantitative limits on proprietary trading and taking or retaining any equity, partnership or other ownership interest in, or sponsorship of, a hedge fund or a private equity fund, as if the nonbank financial company supervised by the Board were a banking entity.

"Proprietary trading" is defined as engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board 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 specified by rule of a federal banking agency, the U.S. Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC).

Subject to any limitations or restrictions that the appropriate federal banking agencies, the SEC and the CFTC may determine, permitted proprietary trading activities include:

- Trading in U.S. government or government agency securities;
- Trading in connection with underwriting or market-making-related activities designed not to exceed the reasonably expected near-term demands of clients, consumers or counterparties;
- Risk-mitigating hedging activities in connection with and related to individuals or aggregated positions, contracts or other holdings of banking entities designed to reduce specific risks;
- Trading securities on behalf of customers;
- Investments in small-business investment companies designed primarily to promote the public welfare;
- Transactions by a regulated insurance company for its general account.

The appropriate federal banking agencies, the SEC and the CFTC are required to issue regulations that will limit the activities permitted by the Volcker Rule. No transaction or activity may be deemed to be a "permitted activity" if the transaction or activity:

- Would involve or result in a material conflict of interest (to be defined by rule) between the banking entity and its clients, customers or counterparties. (Note that the Volcker Rule in this and the following bullet-points references only "banking entities" and not more expansively "nonbank financial companies supervised by the Board");
- Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (to be defined by rule);
- Would pose a threat to the safety and soundness of the banking entity; or
- Would pose a threat to the financial stability of the United States.

Notwithstanding the express references in the above bullet-points to "banking entity," a later section of the Volcker Rule expressly provides that "the prohibitions and restrictions under this section [of the Volcker Rule] shall apply to activities of a banking entity or nonbank financial company supervised by the Board."

The Volcker Rule defines "banking entities" as:

- Any insured depository institution;
- Any company that controls an insured depository institution or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and
- Any affiliate or subsidiary of any such entity.

A banking entity will be permitted to make and retain an investment in hedge funds and private equity funds for the purposes of establishing those funds and providing them with sufficient initial equity to permit them to attract unaffiliated investors, or for the purpose of making a *de minimis* investment in such funds. However, each investment made for the purpose of establishing such a fund must be reduced to not more than three percent of the total ownership interest in that fund within one year after the fund's date of establishment, and all of a banking entity's investments in hedge funds and private equity funds, in the aggregate, must be "immaterial" (as that term will be defined by rule) and in no event exceed three percent of the banking entity's Tier 1 capital.

Provisions to implement the Volcker Rule are subject to further study and regulatory action. By January 21, 2011, the Financial Stability Oversight Council, established by the Act and chaired by the Secretary of the Treasury, must study and make recommendations on the implementation of the Volcker Rule. Within nine months of the completion of this study, the federal banking agencies, the SEC and the CFTC, must consider the findings of the Financial Stability Oversight Council and adopt rules to carry out the provisions of the Volcker Rule ("Final Rules"). The Volcker Rule goes into effect the earlier of:

- Twelve months after the date of the issuance of the Final Rules; or
- July 21, 2012.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact John W. Kauffman, Michael W. Wong, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.