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Clients&FriendsMemo

An Analysis of the Dodd-Frank Act's Volcker Rule

October 15, 2010

On Friday, October 1, 2010, the federal "Financial Stability Oversight Council" ("**FSOC**" or "**Council**") convened for the first time.[1] The FSOC, created by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**" or the "**Act**"), is comprised of the heads of the federal financial regulatory agencies and two presidential appointees, and is tasked with establishing recommendations regarding certain of the regulations that the financial regulatory agencies are required to adopt under the Dodd-Frank Act.[2] One of the purposes of this initial meeting was to approve the issuance of a Request for Public Input (the "**Request**") soliciting comment regarding certain definitions contained in, and the general content of, Section 619 of the Dodd-Frank Act, popularly known as the "**Volcker Rule.**"[3] Public comments are due by November 5, 2010.[4]

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[1] Details on the composition of the FSOC can be found on the Council's website at http://www.treas.gov/FSOC/. The FSOC has also provided some detail on the recommendations that regulated entities may expect the Council to issue, and the time frames in which to expect them, in an "Integrated Roadmap," which you may find on the FSOC's website at the following address: http://www.treas.gov/FSOC/docs/FSOC%20Integrated%20Roadmap%20-%20October%201.pdf.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173).

[3] Section 619 of the Dodd-Frank Act requires the Council to conduct a study and make recommendations to the financial regulatory agencies as to implementation of the prohibitions of the Volcker Rule. The study is required to be completed by January 2011, and a joint agency rulemaking implementing the Volcker Rule is due within nine months thereafter. *See Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds*, 75 Fed. Reg. 61758 (Oct. 6, 2010), *available at* http://www.treas.gov/FSOC/docs/2010-25320_PI.pdf. The Volcker Request is reprinted in its entirety at the end of this Memorandum.

[4] The FSOC also issued an Advanced Notice of Public Rulemaking calling for comment regarding the Council's standards for designating a "nonbank" firm as systemically significant under Section 113 of the Dodd-Frank Act. *See Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61653 (Oct. 6, 2010), available at http://www.treas.gov/FSOC/docs/2010-25321_PI.pdf. A series of Cadwalader Memoranda analyzing various aspects of the Dodd-Frank Act is at the following address: http://www.cadwalader.com/dodd_frank_act_memo.php.

For further detail regarding designation of nonbank firms as systemically significant, please refer to Cadwalader's memo on Title I of the Dodd-Frank Act, which you may find at the following address: http://www.cadwalader.com/assets/client_friend/072010_DF4.pdf.

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The Dodd-Frank Act left much of the detail of the Volcker Rule prohibitions to be determined via regulation, and accordingly the Request solicits input regarding some of the most basic terms used in the Rule, such as the meaning of "proprietary trading." In light of the open-ended scope of the Request, and given the complexity of the Rule and the potential disruptions that its implementation may cause, this Memorandum discusses the history, legal requirements, and very significant unresolved issues posed by the Volcker Rule.

Summary of the Volcker Rule

The Volcker Rule (§ 619 of the Dodd-Frank Act), is one of the most controversial and sweeping provisions of the Act. The Rule eliminates a broad variety of securities powers (*i.e.*, fund investing and proprietary trading), some of which had been conferred on U.S. financial holding companies in 1999, others of which had been permissible since the inception of the Bank Holding Company Act in 1956 (the "**BHC Act**"), and some of which had been permissible even before that. The Volcker Rule draws no distinction between domestic and overseas activities of U.S. entities, notwithstanding prior U.S. policy (exemplified by Glass-Steagall and the International Banking Act) that generally authorized broader securities activities abroad; the Rule therefore places U.S. entities at a competitive disadvantage with their overseas competitors that may not be subject to the Rule's prohibitions. The Rule not only impacts U.S. bank holding companies ("**BHCs**") (including their broker-dealer and unregistered subsidiaries) and banks, but also foreign holding companies with either U.S. branches or U.S. bank subsidiaries, as well as nonbank bank or thrift holding companies (*e.g.*, GE Capital) – and all of their respective affiliates, wherever located.

With respect to non-U.S. activities, the Rule not only disadvantages many U.S. financial service companies, but also non-U.S. financial service companies that happen to have a U.S. banking presence, including a branch. As to non-U.S. financial companies, a significant number of issues may arise because the various exemptions in the Volcker Rule are generally specific to the U.S. markets; for example, an exemption is provided for trading in the securities issued by the U.S. government, but not in securities issued by other national governments; similarly, an exemption is provided for investments in small business investment companies registered with the SEC, but not for any similar vehicle that may exist outside of the United States.

Background of the Volcker Rule

The policy underlying the Volcker Rule is that U.S. banks, U.S. nonbank banks, and foreign branches operating in the U.S. enjoy an implied subsidy by virtue of their bank status and deposit-taking authority and play a special role in maintaining the stability of the U.S. financial system, and should not use that subsidy to engage in, and should be sheltered from, proprietary trading and fund investing activities, both of which are deemed to be risky activities. Further, the theory goes, proprietary trading and private fund investing are considered to place a financial institution in

potential conflicts of interest because such proprietary transactions are, by their nature, self-interested and may conflict with certain advisory or agency functions in which a banking entity is acting on behalf of a customer.

Some commentators have suggested that the Rule is also designed to prevent a repeat of the recent financial crisis. However, there is little evidence that the conduct regulated by the Volcker Rule – proprietary trading and fund investing – were causes of the crisis. The policy behind the Rule was seemingly accepted by Congress at face-value; the Rule was adopted without any apparent evidence that proprietary trading or fund investing activities had posed any material risk to the U.S. or international financial system or had played any role in triggering the recent financial crisis. Likewise, the Rule was adopted with apparently little consideration of the costs to entities engaged in these activities or of its competitive impact, which may be considerable.

The Volcker Rule emerged with little warning and without any material public debate. It originated in January 2009, when the Group of Thirty issued a white paper, *Financial Reform: A Framework for Financial Stability*, containing 18 recommendations for changes in global financial regulation. The Group of Thirty, an influential international consultative group chaired by Paul Volcker (formerly the Chairman of the Board of Governors of the Federal Reserve System and the current chairman of the President's Economic Recovery Advisory Board), includes many former foreign central bankers or treasury executives. Recommendation 1 of the white paper calls for limits on proprietary securities trading and private fund investing activities by large banks, citing the risk of these activities on the stability of the international banking system, as well as the potential for conflicts of interest when a bank trades for its own account.

Yet, restrictions on proprietary trading and fund investing were neither considered in the House version of financial reform legislation (HR 4173) which passed the House in December 2009, nor in the original Senate version (referred to as "**the Chairman's Mark**") circulated by Senate Banking Committee Chairman Dodd in the fall of 2009. After adoption of the Volcker Rule was endorsed by President Obama as part of the Administration reform plan in early 2010, the Rule was included in the April version of the Senate bill (S. 3217), but with little debate or legislative history to provide guidance as to its meaning or motivation. At this stage of the legislative proposal, the Volcker Rule applied only to banks, bank holding companies, and their subsidiaries, and some latitude was conferred on the banking agencies to determine its reach and exemptions. The Volcker Rule was not debated in the Senate and was largely unchanged when financial reform legislation passed the Senate in May 2010.

In the House-Senate conference process, a number of changes were made to the Volcker Rule. The language was relaxed somewhat to allow a small basket of fund investments, but the latitude conferred on the agencies to create further exemptions was narrowed. The Rule was expanded to capture "affiliates" of banks and bank holding companies, as well as affiliates of foreign entities that

operate a branch in the United States. In Congressional conference, provisions were included exempting certain proprietary trading by insurance companies, and adding a limited authority for banking entities to organize and sponsor funds in connection with pre-existing trust, advisory, or fiduciary services. Also added were broad mandates to the agencies to issue regulations barring "material conflicts of interest," "high risk assets," and "high risk trading strategies." Again, in conference, little light was shed as to the Rule's meaning or application. As a result, the final Volcker Rule contains sweeping prohibitions, with ambiguous carve-outs, and the material details were largely left for the FSOC and the banking agencies to resolve.

What Entities are Subject to the Volcker Rule?

The Rule applies primarily to "**banking entities**," a term that is broadly defined to mean: (1) FDIC-insured depository institutions (*i.e.*, U.S. banks and thrifts, including nonbank banks, but excluding certain uninsured trust banks); (2) entities that control an FDIC-insured depository institution (including a BHC, a financial holding company, a savings & loan holding company, or a holding company of a nonbank bank), wherever located; (3) entities that are treated as if they are a BHC for purposes of the International Banking Act (including a foreign holding company of a non-U.S. bank with a U.S. branch office, or a foreign holding company that has a U.S. commercial lending subsidiary operating in the United States), wherever located; and (4) any affiliate of any of the foregoing, wherever located. Thus, non-U.S. entities that are "affiliated" (*i.e.*, under 25% common control) with a U.S. bank or with a non-U.S. bank that has a U.S. branch are subject to the Volcker Rule, and these foreign entities' proprietary trading and fund investing activities are subject to the restrictions of the Rule.

The Volcker Rule does not directly restrict the trading and investing activities of systemically significant nonbank companies that are involuntarily subjected to Federal Reserve supervision under Section 113 of the Act. However, the Rule authorizes the Federal Reserve to adopt regulations imposing capital requirements and quantitative limits on these nonbank entities, which may make proprietary trading or fund investing by these entities prohibitive as well.[5]

[5] The Request specifically solicits input regarding the extraterritorial application of the Volcker Rule, including its impact on affiliates of U.S. entities operating abroad.

What Activities of Banking Entities are Regulated by the Volcker Rule?

The Rule has five principal elements applicable to banking entities:

- A ban on proprietary trading, subject to certain limited exceptions;
- A ban on investing in hedge funds or private equity funds or sponsoring such funds, subject to certain limited exceptions;
- Imposition of additional capital requirements and quantitative limits on entities engaged in proprietary trading or fund investing;
- Restrictions on certain transactions between an entity that serves as an organizer, sponsor, investment advisor, or investment manager of a private equity fund or hedge fund (or any affiliate of such entity) and the fund itself; and
- Prohibitions on any proprietary trading or fund investing that will result in a "material conflict of interest" or "high risk."

The Ban on Proprietary Trading

The Volcker Rule prohibits a banking entity from engaging in "proprietary trading." "**Proprietary trading**" is defined as

> engaging as a principal for the trading account of the banking entity ... 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, option, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the [SEC] and the [CFTC] may, by rule ... determine.

As indicated above, "proprietary trading" requires that the activity occur with respect to a "trading account" of a banking entity. "**Trading account**" is defined as

> any account used for acquiring or taking positions in the securities and instruments [listed above] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts that the appropriate Federal banking agencies, the [SEC] , and the [CFTC] may ... determine.

The language suggests that *motives* of the banking entity when *initially* acquiring the security or instrument are highly relevant in determining whether impermissible proprietary trading is occurring. For example, if the banking entity originally acquired the security or instrument with the intent to hold it and without the principal purpose of selling the instrument in the near term, but later decides to dispose of the security, the trading is arguably not prohibited by the Rule. Likewise, given that the required intent must be to sell in "**the near term**," banking entities may not be subject to the

ban when holding a security or instrument for longer than some specified period of time, *e.g*., 30 days, that is beyond "the near term." Similarly, it may be the case that the occasional trade in an account not principally used for trading activities would not be considered "proprietary trading" within the meaning of the Act, since such trading is not within a "trading account." These questions were left for the FSOC and the various agencies to address.

This ban on proprietary trading reflects a significant rollback in the authority of banks, BHCs and their affiliates, including some longstanding authority. Following the enactment of the Gramm-Leach-Bliley Act ("GLBA") in 1999, bank holding companies were expressly authorized to engage in largely unrestricted securities activities, provided the bank holding company satisfied the eligibility requirements of being a "financial holding company." Prior to 1999, banks and BHCs had the authority to engage in proprietary trading, provided that the form of security was a permissible investment for the bank or holding company. For example, national banks were free to engage in proprietary trading in the "bank eligible securities" authorized by Section 24 (Seventh) of Title 12 (including U.S. government, agency, and GSE securities; securities issued by certain foreign governments or international development banks; state, state agency or state subdivision securities; highly rated marketable debt securities; and asset backed securities). BHCs were free to engage in proprietary trading in any form of debt or equity security under Section 4(c)(6) of the Bank Holding Company Act, provided only that the bank holding company did not acquire 5% or more of a voting class of any issuer, and could engage in proprietary trading of "bank eligible securities" as well. Overseas entities that had U.S. branches in general had no U.S. restrictions on offshore proprietary trading activities. Many of these longstanding powers are eliminated or curtailed by the Volcker Rule.

Exemptions from the Ban on Proprietary Trading

The Volcker Rule contains a few express exemptions to its general ban:

(1) ***Transactions involving only a subset of "bank-eligible securities,"*** *limited to:*

- *U.S. Treasuries or U.S. Agency obligations;*
- *Obligations issued by Fannie, Freddie, Ginnie, FHLB, GNMA, FNMA, Farmer Mac, or a Farm Credit Bank; and*
- *Obligations of any State or political subdivision.*

The subset does *not* include securities issued by a *foreign* government. Thus, an overseas branch of a U.S. bank would be permitted to engage in proprietary trading of U.S. Treasury securities but would not be permitted to engage in proprietary trading in the governmental securities of its host country. Likewise, a non-U.S. financial services company with a U.S. bank affiliate or affiliated U.S. branch could not rely on this exemption to trade in its home

country's government securities (although it might be able to rely on a separate exemption under Sections 4(c)(9) and 4(c)(13), discussed *infra*). This subset of bank eligible securities does not include other types of securities in which a national bank may invest, such as highly rated marketable debt securities or asset backed securities, and the Volcker Rule makes it clear that its provisions are designed to supersede existing law. Thus, while a national bank may *invest* in debt securities or asset backed securities, it may not engage in *proprietary trading* in such securities. The subset also does not include any exception comparable to Section 4(c)(6) of the BHC Act, which authorizes a BHC to hold almost any form of debt or equity shares provided the BHC does not thereby hold 5% or more of a voting class of the shares; again, this means that while a bank holding company (or its affiliate) *may invest* in such shares, it *may not engage in proprietary trading* in such securities.

(2) ***Transactions in connection with underwriting or market-making-related activities*** *"to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"*

This provision, originally embedded within the Rule's definition of "proprietary trading" but later modified as a freestanding exception to the ban, remains one of the most discussed aspects of the Rule. While in concept the drafters intended to exclude market-making activity from the ban, it is unclear what amount of trading activity in any one security is necessary to rise to the level of permissible "market-making" for clients. Two U.S. Senators instrumental in the passage of the Volcker Rule, Senators Jeff Merkley (D-Ore.) and Carl Levin (D-Mich.), explained their view of (and rationale for) permissible "market-making" in an August 3rd letter to the banking agency heads as follows:

> Done properly, market-making is not a speculative enterprise, and firms' revenues should largely arise from bid-ask spreads and associated fees, rather than from changes in the prices of the financial instruments being traded. *Regulations seeking to distinguish market-making from proprietary trading activities will require routine data from banks on the volume of trading being conducted, the size of the accumulated positions, the length of time positions remain open, average bid-ask spreads, and the volatility of profits and losses, among other information.*[6]

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[6] Letter from Senators Jeff Merkley and Carl Levin to Ben Bernanke, Chairman of the Federal Reserve Board et al. (August 3, 2010).

Notwithstanding the various criteria recommended by Senators Merkley and Levin, it seems the banking agencies will undoubtedly face challenges in drafting clear, industry-useful regulations that draw a bright line between impermissible "proprietary trading" and permissible "market-making."

(3) *"**Risk-mitigating hedging activities** in connection with and related to individual or aggregate positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings"*

This exemption once again underscores that the Volcker Rule focuses on the *intent* of the banking entity when acquiring the security. Acquisitions and sales of securities made with the *intent* of mitigating existing position risk to the banking entity is permissible, while acquisitions and sales of securities with the *intent* of making a profit (in the near term) is impermissible. In other words, a banking entity is free to buy and sell securities and instruments if the intent is to mitigate risk (*i.e.,* to prevent a potential loss) resulting from an existing position, although the banking entity is not permitted to trade the exact same securities and instruments if the intent is to achieve a profit.

(4) ***Transactions "on behalf of customers"***

This exemption was narrowed in the conference process. The original language, embedded within the definition of "proprietary trading," effectively excluded transactions "on behalf of a customer ... *or otherwise in connection with or in facilitation of customer relationships*." The latter clause was dropped in conference due to the belief that the language created a loophole in the Rule. The remaining language – "on behalf of customers" – was retained, although it remains unclear how broad this exemption is, for example, whether it permits only customer-directed trades or brokerage transactions, or whether some lesser connection with the customer is within the scope of the provision.

(5) ***Investments in SBICs, public welfare investments, or investments in qualified rehabilitation or certified historic structure projects***

This exception to the ban on proprietary trading is likely to have limited application, inasmuch as these instruments are rarely actively traded. Regardless, the language of this provision (*i.e.,* its use of the word "investments") suggests that it was intended more as an exemption from the fund investment restrictions than as an exemption from the trading restrictions.

(6) ***Transactions by a regulated insurance company*** *(and its affiliates)* ***for its general account****, if such transactions are conducted in compliance with state insurance laws and the Federal banking agencies and the insurance commissioners have not determined that such laws are insufficient to protect the safety and soundness of the banking entity or the financial stability of the U.S.*

This exemption was added in recognition that a few banking entities may have affiliated insurance companies that are subject to state supervision and that maintain securities positions in its "general account" – *i.e.*, the portfolio of assets that is available to pay claims and benefits to which insureds or policyholders are entitled. The exemption merely reflects that this portfolio may involve trading activity that meets the definition of "proprietary trading," and that it was not the intent of Congress to prohibit such trading activity if it is otherwise satisfactorily regulated by state insurance law to the extent that such trading is necessary to conduct the ordinary business of insurance.

(7) ***Transactions in connection with the sale or securitization of loans***

This exception was also added in conference due to concerns that a strict application of the Volcker Rule (in particular, the restriction in private fund investments) could be construed to impede traditional securitization structures used by banks and BHCs.

(8) ***Trading by a banking entity under the exemption of Section 4(c)(9) of the BHC Act,*** *provided that the proprietary trading occurs solely outside the U.S. and provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the law of any State.*

BHC Act Section 4(c)(9) applies to qualifying foreign banking organizations ("**QFBOs**") – foreign entities engaged primarily in banking activities outside the United States and engaged in the United States only in activities incidental to its foreign activities. Under Section 4(c)(9), a QFBO may invest in a company not doing any business in the United States (other than activities incidental to its foreign activities), and may hold a noncontrolling (<50%) investment in a company doing business in the United States provided the company predominantly does business outside the United States. The Volcker Rule exempts a QFBO's proprietary trading activities from the ban, provided the trading "occurs solely outside the United States." While it is not clear exactly how this applies to a QFBO, it seems likely that the agencies will require that both the entity engaged in proprietary trading and the entity whose shares are the subject of the trade must be located outside the United States – thus requiring a QFBO to know the geographic footprint of a target company before acquiring *any* shares for proprietary trading purposes.

(9) ***Trading by a banking entity under the exemption of Section 4(c)(13) of the BHC Act,*** *provided that the proprietary trading occurs solely outside the U.S. and provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State*

Section 4(c)(13) generally authorizes a registered BHC to invest in a company not doing *any* business in the United States (other than activities incidental to its foreign activities). Inasmuch as Section 4(c)(13) permits investments solely in entities not doing any business in the United States, this exemption would require the trading entity to know the geographic footprint of a target company before acquiring *any* shares for proprietary trading purposes. It is unclear what is meant by the requirement that the proprietary trading occur "solely outside," but arguably the intent is that the trading entity also be situated overseas. While Section 4(c)(13) ordinarily is available to U.S. BHCs, the Volcker Rule limits this exemption to banking entities "not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State." Thus, this exemption is applicable only to the overseas proprietary trading by subsidiaries of a top-tier company organized under non-U.S. law.

(10) ***Other activity determined by regulation issued by the Federal banking agencies, the SEC, and the CFTC,*** *that would "promote and protect the safety and soundness of the banking entity and the financial stability of" the U.S.*

While this provision on its face grants latitude to the agencies to create further exceptions to the Volcker Rule, it seems unlikely that the agencies will use this clause to grant new, wholesale exemptions. Rather, the agencies will likely use this provision to eliminate some of the unintended consequences of a literal application of the statutory language or to soften the overseas impact of the Volcker Rule. That said, the Volcker Rule is drafted in a very U.S.-centric way. By its terms, the Rule's prohibitions apply to non-U.S. banks; yet the Rule allows the agencies to create other exceptions that advance the financial stability of the United States but not exceptions that advance the economic interests of a foreign bank's home country or that are neutral to United States economic considerations.

Ban on Hedge Fund / Private Equity Fund Investing

The Volcker Rule prohibits a banking entity from "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund." "**Hedge fund**" and "**private equity fund**" are collectively defined as

> an issuer that would be an investment company, as defined in the Investment Company Act … but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule … determine

To "**sponsor**" a fund is defined as any of the following:

> (i) to serve as the general partner, managing member, or trustee of the fund;
> (ii) in any manner to select or to control (or to have employees, officer, or directors who constitute) a majority of the directors, trustees, or management of the fund; or
> (iii) to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

As is the case with the ban on proprietary trading, the ban on private equity fund or hedge fund investing reflects a significant rollback in the powers of U.S. financial institutions, in particular, BHCs. Historically, even prior to the enactment of GLBA in 1999, BHCs were free to invest in funds, provided that the BHC did not acquire more than 4.9% of the voting interests in the fund, or otherwise control or obtain a controlling interest in the fund (such as serving as, or controlling the appointment of, the fund managers or by holding a substantial non-voting stake in the fund). In addition, BHCs were permitted to invest in overseas funds subject to the restrictions of the International Banking Act and Regulation K (which allows a BHC to hold up to 19.9% of the voting interests in a fund, provided the amount of the investment is within the BHC's dollar-based consent limit). After enactment of GLBA, BHCs that were able to elect "financial holding company" status were permitted to hold significantly larger investments under the newly conferred merchant banking authority. Prior to the Volcker Rule, the fund investing activities of foreign banking entities and their affiliates were largely unregulated, provided that the investing activity was by an entity operating outside the United States.

It should be noted that the Volcker Rule prohibits a banking entity from organizing or sponsoring a fund – even if the banking entity acquires no financial interest in the fund. Thus, a banking entity allowing the fund to use a variant of the banking entity's name, or a banking entity serving as the trustee, managing member or having the authority to appoint such persons, would be generally barred by the Volcker Rule, unless an exemption applied.

Exemptions from the Fund Investing / Sponsorship Ban

With respect to fund investing activities, the Volcker Rule lists generally the same exemptions as applicable to proprietary trading:

(1) ***Transactions involving only a subset of "bank-eligible securities"***

(2) ***Transactions in connection with underwriting or market-making-related activities*** *"to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"*

(3) ***"Risk-mitigating hedging activities*** *in connection with and related to individual or aggregate positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings"*

(4) ***Transactions "on behalf of customers"***

(5) ***Investments in SBICs, public welfare investments, or investments in qualified rehabilitation or certified historic structure projects***

(6) ***Transactions by a regulated insurance company*** *(and its affiliates)* ***for its general account****, if such transactions are conducted in compliance with state insurance laws and the Federal banking agencies and the insurance commissioners have not determined that such laws are insufficient to protect the safety and soundness of the banking entity or the financial stability of the U.S.*

(7) ***Transactions in connection with the sale or securitization of loans***

(8) ***Investments or sponsorship by a banking entity under the exemption of Section 4(c)(9) of the BHC Act*** *solely outside the U.S., provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the law of any State, and provided further, no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the U.S.*

While the precise scope of the exemption is not clear, it is apparent that a fund in which a QFBO invests cannot be offered or sold to U.S. residents. One such affect of this prohibition will be to bar U.S. investors from being able to participate in funds organized by major non-U.S. institutions, which may be viewed as detrimental to the interests of U.S. investors.

What is unclear is whether the fund itself is prohibited from holding securities of U.S. issuers or companies doing business in the U.S. Strictly speaking, it is not inconsistent with Section 4(c)(9) for a QFBO to take a noncontrolling investment in a fund organized and operating solely outside the United States even if the fund itself takes noncontrolling positions in U.S. issuers. However, the Volcker Rule's use of the phrase "solely outside" the United States could be read to argue that Congress meant to establish greater limitations than are normally found under Section 4(c)(9). Thus, before investing in a fund under this exemption, the QFBO may need to understand the geographic footprint (or potential footprint) of the portfolio companies within the fund.

(9) ***Investments or sponsorship by a banking entity under the exemption of Section 4(c)(13) of the BHC Act*** *solely outside the U.S., provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State, and provided further, no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the U.S.*

As in the case above, it is unclear whether the intent of Congress was to prohibit a noncontrolling investment in a fund that itself has invested noncontrolling positions in U.S. issuers. If so, the foreign bank holding company or its affiliate would need to understand the geographic footprint of the portfolio companies within the fund, in addition to obtaining assurances that the fund will not offer its shares to U.S. residents. Again, this exemption is not available to U.S. BHCs, U.S. banks, or their subsidiaries.

(10) ***Other activity determined by regulation issued by the Federal banking agencies, the SEC, and the CFTC,*** *that would "promote and protect the safety and soundness of the banking entity and the financial stability of" the U.S.*

It should be noted that, with the exception of the Section 4(c)(9) and 4(c)(13) exemptions, the above-listed exemptions authorize only *investing in* (or retaining the investment in) the fund – and do not expressly authorize *sponsorship* of the fund. Thus, for example, while a banking entity in could invest in a fund comprised solely of the narrow range of bank-eligible investment or the SBIC investments listed above, it is unclear whether the banking entity could in fact *sponsor* such a fund.

The Volcker Rule creates several additional exemptions applicable only to fund investments:

(11) *A banking entity may organize and offer a private equity fund or hedge fund* ***as part of its trust, investment advisory, or fiduciary operations.***

This provision was added in conference, and authorizes a banking entity to organize and offer a private equity fund or hedge fund (including serving as the general partner,

managing member, or trustee, or having the ability to select or control a majority of directors, trustees, or management of the fund) if all of the following conditions are met:

(a) *Trust / fiduciary / advisory purposes*: The banking entity provides *bona fide* trust, fiduciary, or investment advisory services;
(b) *Marketing to trust / fiduciary / investment advisory clients:* The fund is organized and offered in connection with such services and, further, the fund is offered **only** to persons that are customers of such services;
(c) *No ownership interest*: The banking entity does not acquire or retain an equity, partnership, or other ownership interest, other than a "*de minimis* interest" (discussed *infra*);
(d) *No covered transactions*: The banking entity complies with the restrictions of the Volcker Rule barring certain transactions with the fund (discussed *infra*);
(e) *No guarantees*: The banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations of the hedge fund or private equity fund (or any fund in which such hedge fund or private equity fund invests);
(f) *No related names*: The banking entity does not share with the hedge fund or private equity fund, for corporate, marketing, promotional purposes, the same name or a variation of the same name;
(g) *No ownership interest by bank individuals*: No director or employee of the banking entity retains any equity, partnership, or other interest in the hedge fund or private equity fund except for those directors or employees directly engaged in providing investment advisory or other services to the fund; and
(h) *Bank disclosure*: The banking entity discloses to its prospective and actual investors in the fund, in writing, that any losses of the fund are borne solely by the investors in the fund and not by the banking entity.

No guidance is provided regarding these requirements, in particular, how the fund is to be marketed. However, this provision on its face would seem to confer substantial latitude on a banking entity to continue to organize and offer private or hedge funds to its clients, provided it transfers these functions to its trust, fiduciary, or investment advisory units.

(12) *A banking entity may make and retain a* ***de minimis investment*** *in a hedge fund or private equity fund if all of the following conditions are met:*

(a) ***Organize and Offer.*** The exemption is available only with respect to funds that are ***organized and offered*** by the banking entity;
(b) ***Purpose***: The banking entity makes the investment for the purposes of either (i) establishing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment;

> (c) ***Must Seek Other Investors***: The banking entity actively seeks unaffiliated investors to reduce or dilute the investment by the banking entity to the *de minimis* amounts described below;
> (d) ***De Minimis Portion of the Fund***: Not later than one year after the establishment of the fund, the banking entity's investment in that fund must be reduced to an amount that is no more than 3% of the total ownership interests of the fund (although this one-year period may be extended for up to two additional years, upon application to the Fed);
> (e) ***De Minimis Portion of Banking Entity Assets***: The banking entity's investment in any one fund must be "immaterial to the banking entity" (a term required to be defined by rule), but in no case may the aggregate of all private equity fund or hedge fund investments by that banking entity exceed 3% of the banking entity's Tier 1 capital; and
> (f) ***Capital Deduction***: For purposes of complying with the capital standards to be adopted by the Federal banking agencies, the SEC, and the CFTC (discussed *infra*), the banking entity deducts from its total assets and tangible equity the aggregate amount of its investments in private equity funds or hedge funds, with the amount of the deduction increasing commensurate with the leverage of the fund(s).

The requirement that the *de minimis* investment be limited to funds ***"organized and offered"*** by the banking entity severely limits the scope of the *de minimis* exemption. Thus, under a strict reading of the Rule, a banking entity would not be entitled make or maintain investments in any fund it wishes, even if it stays beneath the *de minimis* thresholds. The phrase "**organized and offered**" is not defined in the Volcker Rule, but it seems clear that the intent was to limit a banking entity's *de minimis* authority only to those funds in which the banking entity had a role in establishing.

In a letter to the banking agency heads, Senators Merkley and Levin contend that the exemption should be read even more narrowly, and should allow investments solely for the purpose of aligning the banking entity's interests with those of its clients:

> This *de minimis* allowance is permitted only to enable banks or their affiliates to provide asset management services to clients, and not to open the door to proprietary trading. However, these investments, and the banks' relationships with them, cannot be allowed to jeopardize the banks. Accordingly, regulations implementing these provisions should only allow for a bank investment as necessary to seed the fund or align the interests of the bank with the fund investors. Seeding funds should be limited to the minimum amount necessary to attract investors to the investment strategy of the fund and must not serve

> principally as a proprietary investment. Regulators should issue rules treating hedge and private equity funds with large initial investments from the sponsoring banks and funds that are not effectively marketed to investors as evasions of the Merkley-Levin restrictions. Similarly, co-investments designed to align the firm with its clients must not be excessive, and should not allow for firms to evade the intent of the restrictions of this section.

Regardless, it is very likely that the scope of the *de minimis* exemption, and whether the exemption will be limited only to funds "organized and offered" by the banking entity, and the meaning of that condition, will be a focus of the public comment and rulemaking process.

As noted above, the capital requirements applicable to de minimis investments require that the banking entity deduct from its capital the amount of its investments made under this exemption, with the amount of the deduction increasing "commensurate with" the leverage of the fund. "Commensurate" is not defined by the Rule and it remains unclear how this will be applied, although the purpose of the provision is to discourage investments in highly leveraged funds.

Last, it is worth noting that there is no general exemption afforded to ***insurance company general accounts*** from the private equity and hedge fund restrictions. The special exemption afforded insurance company general accounts is limited to the "purchase, sale, acquisition or disposition of securities or other [listed] instruments," and appears limited only to proprietary trading activities. Thus, with respect to fund investing activities, the Volcker Rule appears to afford no preferential treatment to insurance entities.

What are the Compliance Deadlines?

The Volcker Rule becomes effective two years after enactment of the Dodd-Frank Act (*i.e.*, by July 21, 2012) or nine months following the joint agency rulemaking, whichever occurs first. Banking entities are expected to have ceased proprietary trading and fund investing activities, and have divested any impermissible investments, within two years thereafter (*i.e.*, by July 21, 2014 or 33 months after rulemaking). The Federal Reserve will likely treat any proprietary trading or fund investment as a grandfathered impermissible activity during this conformance period, and may prohibit the *expansion* of any existing trading or investing activities or the making of any *new* investments during that period, unless prior Federal Reserve consent is obtained – similar to the practice used by the Federal Reserve for other impermissible activities under Section 4(a) of the BHC Act.

The Federal Reserve may, by rule or order, extend this two-year conformance period for not more than one year at a time, if the Federal Reserve deems such an extension to be consistent with the purposes of the Act and not detrimental to the public interest – but no more than three one-year extensions may be granted. This language – "by rule or order" – suggests that the Federal Reserve is authorized to grant one-year extensions that are either entity-specific or industry-wide. Prior versions of the Volcker Rule required that the one-year extension be conferred on an individual banking entity "upon application by such" banking entity, but the prior language was broadened in conference, and which now appears to allow the Federal Reserve to grant an industry-wide extension upon its own initiative.

The Federal Reserve may, upon application by a banking entity, extend the compliance period with respect to any impermissible hedge fund or private equity investment that is deemed an "illiquid fund," if the investment was made by the banking entity pursuant to a contractual commitment in effect on May 1, 2010 – but in any case, the banking entity must divest the investment when the contractual commitment lapses or the extension expires, whichever occurs first. "**Illiquid fund**" is defined as

> a hedge fund or private equity fund that (i) as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments, and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

Although some authors have suggested that the three one-year extensions and the one five-year extension will necessarily be stacked to run consecutively (for a total of eight years from the effective date of the Volcker Rule or ten years from enactment), this seems unlikely to be the case except in rare circumstances. The purposes of the two extensions are different. The three one-year extensions are, in theory, available to the industry as a whole or to a specific institution upon a showing of hardship. The one five-year extension is limited only to certain forms of investments – illiquid funds – on a case-by-case basis.[7]

What are Capital Requirements and Quantitative Limits?

The Volcker Rule requires the Federal banking agencies, the SEC, and the CFTC to adopt regulations imposing additional capital requirements and quantitative limitations on banking entities

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[7] The Request specifically solicits public input regarding the divestiture period for illiquid *assets* and the implications for banking entities.

engaged in proprietary trading or hedge or private equity fund investing. No guidance was provided by in the Rule itself for these additional requirements.

In addition, the Federal banking agencies, the SEC, and the CFTC must adopt regulations imposing additional capital requirements and quantitative limitations on proprietary trading and fund investing by systemically significant nonbank financial companies that are subjected to Federal Reserve supervision under Section 113 of the Dodd-Frank Act. Again, no guidance was provided, although Congress did insert a clause requiring a limited level playing field between banking entities and Section 113 entities: if the systemically significant nonbank financial company engages in proprietary trading or fund investing within any of the listed exemptions allowed to banking entities, then the capital requirements and quantitative restrictions shall be the same as imposed on banking entities operating within the exemptions.

The Federal banking agencies, the SEC, and the CFTC must adopt separate regulations regarding capital requirements and quantitative limitations during any extended divestiture period. Thus, a banking entity could be subjected to different capital and quantitative limitations for grandfathered investments subject to divestiture, as compared with its ongoing investments made under an exemption from the ban.[8]

What are the Restriction on Transactions with Funds?

The Volcker Rule establishes special restrictions on transactions between a private equity fund or hedge fund and any banking entity that serves as an investment manager, investment adviser, organizer, or sponsor to that fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has invested in the fund (either under an exemption, such as the de minimis rule, or on a grandfathered basis). These restrictions are fairly onerous:

(a) **No Covered Transactions.** The Volcker Rule flatly bars any transaction between such fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate." Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, the private equity fund or hedge fund. This prohibition is seemingly at odds with other provisions of the Volcker Rule that expressly permit a banking entity to invest in a fund, in

[8] The Request solicits comments generally on factors and considerations that should be weighed when promulgating the capital and quantitative limits.

particular, the *de minimis* exemption, which authorizes a banking entity to invest in a fund that it has "organized." The inconsistency between these provisions will need to be resolved in the rulemaking process.

(b) **Arms' Length.** The Volcker Rule requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate." Generally speaking, this provision requires all transactions between the fund and the banking entity (or its affiliate) to be on arms' length terms.

Unlike the restrictions on proprietary trading and fund investing, this aspect of the Volcker Rule contains no express exemption for banking entities operating overseas and not affiliated with a BHC or bank organized under U.S. law. Thus, the restriction on transactions with funds appears to apply to non- U.S. entities operating solely outside the United States, if the non- U.S. entity is merely affiliated with a foreign bank with a branch in the U.S. or with a U.S. registered BHC.

Notwithstanding the foregoing prohibition on covered transactions, the Volcker Rule establishes a limited exemption for prime brokerage arrangements between (i) a banking entity that serves as an investment adviser, investment manager, or sponsor, to a private equity fund or hedge fund; and (ii) another private equity fund or hedge fund in which such fund has taken a equity, partnership, or other ownership interest, if the following conditions are met:

(a) ***Organized and Offered Funds.*** If the private equity fund or hedge fund is organized and offered by the banking entity, the banking entity is in compliance with the applicable restrictions of the Volcker Rule (see *supra*);
(b) ***CEO Certification.*** The CEO of the banking entity certifies in writing annually that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations of the hedge fund or private equity fund (or any fund in which such hedge fund or private equity fund invests);
(c) ***Determined to be Safe and Sound.*** The Federal Reserve concludes that such transaction is consistent with the safe and sound operations of the banking entity;
(d) ***Arms' Length Terms.*** The prime brokerage arrangement complies with Section 23B of the Federal Reserve Act as if the counterparty were an "affiliate" of the banking entity.

Catch-All Prohibitions

The Volcker Rule contains a "catch-all" clause designed to enable the agencies to prohibit trading or fund investing activities that technically fall within a statutory exemption but otherwise are inconsistent with the purposes of the Volcker Rule, namely, eliminating perceived risky proprietary trading and investing activities in banking entities and preventing conflicts of interest that can arise

from such proprietary activities. Thus, notwithstanding any exemption, the Volcker Rule instructs the agencies to promulgate regulations prohibiting any proprietary trading or hedge or private equity fund investment if the transaction:

> (a) would involve or result in a *material conflict of interest* between the banking entity and its clients, customers, or counterparties;
> (b) would result in a *material exposure* by the banking entity to *high risk-risk assets* or *high-risk trading strategies*;
> (c) would pose a threat to the safety and soundness to the banking entity; or
> (d) would pose a threat to the financial stability of the United States.

The terms *material conflict of interest*, *material exposure*, *high risk-risk assets*, and *high-risk trading strategies* are to be defined by regulation.[9]

Study and Rulemaking

No later than January 21, 2011, the FSOC is required to study and make recommendations regarding implementation of the Volcker Rule. Pursuant to this mandate, the FSOC issued the Request, a copy of which is attached. Within nine months after the completion of the FSOC study (*i.e.*, no later than October 21, 2011), the Federal banking agencies, the SEC, and the CFTC shall consider the findings of the FSOC study and shall adopt regulations, on a coordinated basis, implementing the Volcker Rule. However, notwithstanding these other deadlines, by January 21, 2011, the Federal Reserve is required to issue separate regulations regarding the availability of extensions (including extensions for any illiquid funds). Thus, Federal Reserve regulations applicable to extensions may in fact precede the issuance of the FSOC study on the Volcker Rule itself.

Key Dates

By ***January 21, 2011***, the FSOC must complete its study and recommendations, and the Federal Reserve is required to issue regulations regarding extensions.

Within nine months following completion of the study (*i.e., **no later than October 21, 2011)***, the Federal banking agencies, the SEC, and the CFTC are required to issue general implementing regulations.

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[9] The Request specifically seeks input on how these catch-all provisions should be crafted.

By the earlier of (i) ***July 21, 2012***, or (ii) one year after the issuance of final agency regulations, the Volcker Rule becomes effective.

Within two years following the effective date (*i.e.,* ***no later than July 21, 2014***), but subject to the possibility of extensions, banking entities are required to come into full compliance with the Volcker Rule.

* * * *

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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FSOC Request for Public Input:

FINANCIAL STABILITY OVERSIGHT COUNCIL
Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds

AGENCY:
Financial Stability Oversight Council.

ACTION:
Notice and request for information.

SUMMARY:
The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") prohibits banking entities from engaging in proprietary trading and from maintaining certain relationships with hedge funds and private equity funds. These prohibitions, commonly known as the "Volcker Rule," are contained in Section 619 of the Dodd-Frank Act. Section 619 of the Dodd-Frank Act requires the Financial Stability Oversight Council ("**FSOC**") to study and make recommendations on implementing the Volcker Rule. Under Section 619, the Office of the Comptroller of the Currency ("**OCC**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Board of Governors of the Federal Reserve System ("**Board**"), the Securities and Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission ("**CFTC**") must consider the recommendations of the FSOC study in developing and adopting regulations to implement the Volcker Rule. To assist the FSOC in conducting the study and formulating its recommendations, the FSOC is issuing this request for information through public comment.

DATES:
Comment Due Date:
November 5, 2010.

ADDRESSES:
Interested persons are invited to submit comments regarding this notice according to the instructions for "Electronic Submission of Comments" below. All submissions must refer to the document title and one of the above docket numbers. The FSOC encourages the early submission of comments.

Electronic Submission of Comments.
Interested persons must submit comments electronically through the Federal eRulemaking Portal at http://www.regulations.gov.

Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt, and enables the FSOC to make them available to the public. Comments submitted electronically through the http://www.regulations.gov Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

Note:
To receive consideration as public comments, comments must be submitted through the method specified above. Again, all submissions must refer to the docket number and title of the notice.

Public Inspection of Public Comments.
All properly submitted comments will be available for inspection and downloading at http://www.regulations.gov.

Additional Instructions.
Please note the number of the question to which you are responding at the top of each response. Though the responses will be screened for obscenities and appropriateness, in general comments received, including attachments and other supporting materials, are part of the public record and are immediately available to the public. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

FOR FURTHER INFORMATION CONTACT:
For further information regarding this interim final rule contact the Office of Domestic Finance, Treasury, at (202) 622-1703. All responses to this Notice and Request for Information should be submitted via http://www.regulations.gov to ensure consideration.

SUPPLEMENTARY INFORMATION:

I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Under section 619 of the Dodd-Frank Act, banking entities[2] are prohibited from engaging in proprietary trading and from maintaining certain

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 124 Stat. 1376 (2010).

[2] The term "banking entity" is defined in section 13(h)(1) of the Bank Holding Company Act, as amended by section 619 of the Dodd-Frank Act. The term generally means any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for the purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.

relationships with hedge funds and private equity funds. These prohibitions and other provisions of section 619 are commonly known, and referred to herein, as the "Volcker Rule." Section 619 of the Dodd-Frank Act requires the FSOC to study and make recommendations on implementing the Volcker Rule. Under Section 619, the OCC, the Board, the FDIC, the SEC and the CFTC must consider the findings of the FSOC study in developing and adopting regulations to carry out the Volcker Rule.

Section 619(b) provides certain specific guidance with respect to the FSOC study and recommendations, stating as follows:

> "(1) STUDY.—Not later than 6 months after the date of enactment of this section, the Financial Stability Oversight Council shall study and make recommendations on implementing the provisions of this section so as to—
>
> > "(A) promote and enhance the safety and soundness of banking entities;
> > "(B) protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;
> > "(C) limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities;
> > "(D) reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board, and the interests of the customers of such entities and companies;
> > "(E) limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;
> > "(F) 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 of the United States financial system; and
> > "(G) appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under subsection (a)."

II. Solicitation for Comments on the Volcker Rule Study

To assist the FSOC in conducting the study and formulating its recommendations concerning the Volcker Rule, the FSOC seeks public comment on the following questions:

1. Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to:

    (i) Promote and enhance the safety and soundness of banking entities;
    (ii) Protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;
    (iii) Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;
    (iv) Reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board,[3] and the interests of the customers of such entities and companies;
    (v) Limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;
    (vi) 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 of the United States financial system; and
    (vii) Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

[3] The term “nonbank financial companies supervised by the Board” refers to those nonbank financial companies that may be designated by the FSOC under section 113 of the Act to be supervised by the Board and subject to enhanced prudential standards.

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

(i) "Banking entity" [§ 619(h)(1)];
(ii) "Hedge fund" [§ 619(h)(2)];
(iii) "Private equity fund" [§ 619(h)(2)];
(iv) "Such similar funds" [§ 619(h)(2)];
(v) "Proprietary trading" [§ 619(h)(4)];
(vi) "Sponsor" [§ 619(h)(5)];
(vii) "Trading account" [§ 619(h)(6)];
(viii) "Short term" [§ 619(h)(6)];
(ix) "Illiquid fund" [§ 619(h)(7)];
(x) A transaction "in connection with underwriting or market making related activities * * * designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties" [§ 619(d)(1)(B)];
(xi) "Risk-mitigating hedging activities" [§ 619(d)(1)(C)];
(xii) "The purchase, sale, acquisition, disposition of securities or other instruments `on behalf of customers' " [§ 619(d)(1)(D)];
(xiii) Investments in "small business investment companies" and certain "public welfare" investments [§ 619(d)(1)(E)];
(xiv) A permitted activity by an insurance company [§ 619(d)(1)(F)]; and
(xv) Such other activities as "would promote and protect the safety and soundness of banking entities and the financial stability of the United States" [§ 619(d)(1)(J)];?

5. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should be taken into account as indicative that a transaction, class of transactions or activity:

(i) Would involve or result in a material conflict of interest between a banking entity (or a nonbank financial company supervised by the Board) and its clients, customers or counterparties;
(ii) Would result, directly or indirectly, in a material exposure by a banking entity (or a nonbank financial company supervised by the Board) to high-risk assets or high-risk trading strategies; or
(iii) Would pose a threat to the safety and soundness of a banking entity (or a nonbank financial company supervised by the Board)?

6. What factors and considerations should be taken into account in making recommendations on whether additional capital and quantitative limitations are appropriate to protect the safety and

soundness of banking entities or nonbank financial companies supervised by the Board engaged in activities permitted under the Volcker Rule?

7. With respect to proprietary trading and hedge fund and private equity fund activities, which practices, types of transactions or corporate structures in general have historically accounted for or involved increased risks or may account for or involve increased risks in the future?

8. With respect to proprietary trading and hedge fund and private equity fund activities, what practices, policies or procedures have historically been utilized that may have mitigated or exacerbated risks or losses? What practices, policies or procedures might be useful in limiting undue risk or loss in the future?

9. What factors and considerations should be taken into account in making recommendations to safeguard against evasion of the Volcker Rule?

10. How should the international context be considered when implementing the Volcker Rule? Are there any factors or considerations that should be taken into account regarding the application of the Volcker Rule to banking entities or nonbank financial companies that operate outside the United States? What issues does implementation of the Volcker Rule present with respect to the following:

(i) Domestic banking entities that have access to foreign exchanges,
(ii) foreign affiliates of domestic banking entities, and
(iii) foreign non-bank financial companies

11. What timing issues are raised in connection with the divestiture of illiquid assets affected by the prohibitions of the Volcker Rule, and how might such issues be appropriately addressed?

12. Commenters are generally invited to submit views with respect to any qualitative or quantitative factors that should be considered in connection with the Council's study of the Volcker Rule, as well as any analogous areas of law, economics, or industry practice, and any factors specific to the commenter's experience. Please comment generally and specifically, and please include empirical data and other information in support of such comments, where appropriate and available.

Dated: October 1, 2010.

Alastair Fitzpayne,
Deputy Chief of Staff and Executive Secretary, Department of the Treasury.