

LEGAL UPDATES

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Service

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The Volcker Rule Takes Effect

On December 10, 2013, the Securities and Exchange Commission (SEC) and four other federal regulatory agencies (the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Commodity Futures Trading Commission) voted to approve the final version of the Volcker Rule, which implements Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Volcker Rule will prohibit banking entities from engaging in “proprietary trading,” with certain key exceptions, and limit their ability to sponsor and invest in hedge funds and private equity funds. The controversial rule, named for former Federal Reserve Chairman Paul Volcker, aims to reduce excessive risk-taking by financial institutions that regulators argue was a major cause of the 2008 financial crisis. A copy of the final rule is published on the Federal Reserve website.

The Volcker rule applies to U.S. banking entities, which include any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1928, and any affiliate or subsidiary of these entities. Foreign banking entities will not be subject to the rule if their activities take place outside of the U.S. and are not conducted with or through any U.S. entity.

Proprietary Trading

U.S. banking entities will no longer be permitted to engage in short-term “proprietary trading” for their own account. “Proprietary trading” is defined as engaging as a principal for the “trading account” of a banking entity in any purchase or sale of financial instruments—securities, derivatives, commodity futures, and related options. A trading account is defined as any account used by a banking entity to purchase or sell financial instruments principally for the purpose of:

Short-term resale;

Benefiting from actual or expected short-term price movements;

Realizing short-term arbitrage profits; or

Hedging one or more positions resulting from the purchase or sale of financial instruments.

Exceptions to Prohibition on Proprietary Trading

In the final rule, regulators have agreed upon a number of key exceptions to the prohibition on proprietary trading. Banking entities will still be permitted to engage in proprietary trading:

With regard to U.S. government and municipal securities, and, in limited circumstances, foreign securities;

In connection with underwriting, market making-related activities; or risk-mitigating hedging; or

On behalf of customers.

Covered Funds

The Volcker Rule prohibits banking entities from holding “ownership interests” in or sponsoring “covered funds.”

Ownership interest means “any equity, partnership, or other similar interest.” Other similar interest means an interest that:

Has the right to participate in the selection or removal of certain managers, members, directors, trustees, and advisors;

Has the right to a share of the income, gains, or profits;

Has the right to receive underlying assets after all other interest has been redeemed or paid in full (excluding certain creditors’ rights);

Has the right to receive all or a portion of excess spread;

Provides that the amounts payable could be reduced based on losses arising from underlying assets;

Receives income on a pass-through basis, or has a rate of return that is determined by reference to the performance of the underlying assets; or

Any synthetic right to have, receive, or be allocated any of the rights listed above.

Covered fund means any issuer that would be an investment company as defined by the Investment Company Act of 1940, but for exemptions included under Section 3(c)(1) for 100 or fewer beneficial owners or Section 3(c)(7) for qualified purchasers. The definition includes hedge funds, private equity firms, certain commodity pools and foreign funds. This definition does not include mutual funds, SBICs, vehicles used by banks to conduct loan securitizations, and entities with a more general corporate purpose, such as joint ventures, acquisition vehicles, and wholly-owned subsidiaries.

Exceptions to Restrictions on Covered Funds

The Volcker Rule also provides important exceptions to its restrictions on covered funds. Banking entities, subject to appropriate conditions, may still sponsor or invest in covered funds in connection with:

- Organizing and offering covered funds;
- Underwriting and market-making related activities;
- Certain types of risk mitigating or hedging activities;
- Insurance company activities; or
- Activities that occur solely outside of the U.S.

What This Means to You

The Volcker Rule requires each banking entity to establish internal controls and compliance programs to monitor compliance with the rule's restrictions on proprietary trading and covered fund activities. These requirements vary depending upon the size of the banking entity and scope of its activities, which should reduce the regulatory burden on smaller entities. There are no compliance requirements for entities that do not engage in activities covered by the rule.

The rule is effective April 1, 2014, but the Federal Reserve Board has extended to July 21, 2015 the time period in which banking entities must fully conform their activities to the rule. In order for agencies to ensure compliance, banking entities must maintain documentation, and entities with significant trading operations must report certain quantitative metrics related to their trading activities to their principal supervising agency.

Contact Information

For additional information about this or any securities or corporate governance issue, please contact your Husch Blackwell attorney or any attorney in our Securities & Corporate Governance group.