

ClientAlert

Financial Markets Developments

July 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Volcker Rule

Perhaps the most contentious provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010¹ (the “Act”) is Section 619—the Volcker Rule (the “Rule”).² The Rule, which is based on the recommendations of former Federal Reserve Board Chairman Paul A. Volcker, (1) prohibits “proprietary trading” by “banking entities” except for “permitted activities” specified in the Rule, (2) limits banking entities’ ability to sponsor or invest in hedge funds or private equity funds, and (3) restricts banking entities’ ability to maintain other relationships with such funds. It also requires agencies to impose various restrictions on certain nonbank financial entities that engage in these types of activities.

1. Which entities are covered by the Rule?

The Rule applies to “banking entities” and “nonbank financial companies supervised by the Board.”

- For purposes of the Rule, the term “banking entity” includes an insured depository institution, a company that controls such an institution (e.g., a bank holding company (a “BHC”)), a company treated as a BHC under Section 8 of the International Banking Act of 1978 (the “IB Act”), and any affiliate or subsidiary of any such entity.³
 - In general, an “insured depository institution” is a bank or savings association the deposits of which are insured by the Federal Deposit Insurance Corporation (the “FDIC”). The Rule, however, excludes institutions that act exclusively in a trust or fiduciary capacity. To qualify for the exemption, such institutions must not offer FDIC-insured deposits through affiliates, accept demand deposits, or exercise borrowing or discount privileges under the Federal Reserve Act.
 - A company treated as a BHC under Section 8 of the IB Act includes a non-US company that is or controls a non-US bank with a branch or agency in the United States.
 - The terms “affiliate,” “control” and “subsidiary” all have the meanings they have in the Federal Deposit Insurance Act,⁴ with ownership of 25 percent or more of any class of the voting securities of any entity (and/or exercising other elements of “control”) constituting control of that entity and causing it to be a “subsidiary.”
- A “nonbank financial company supervised by the Board” (an “NFC”) is defined as a “nonbank financial company” that the Financial Stability Oversight Council (the “FSOC”) established by the Act has determined shall be supervised by the Board of Governors of the Federal Reserve System (the “Board”).⁵



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- In order to be a nonbank financial company (either US or foreign) for this purpose, the company must be “predominately engaged in financial activities.”⁶ Although the Board is required to adopt regulations for determining when a company is “predominately engaged in financial activities,” the Act sets as a floor that either:
 - the annual gross revenues derived by the company and its subsidiaries from financial activities (as defined in Section 4(k) of the Bank Holding Company Act (the “BHC Act”)), including the ownership or control of insured depository institutions, represent at least 85 percent of the consolidated annual gross revenues of the company.
 - the consolidated assets of the company and its subsidiaries related to financial activities, including the ownership or control of insured depository institutions, represent at least 85 percent of the consolidated assets of the company.
- For this purpose, BHCs, companies treated as BHCs under Section 8 of the IB Act, and numerous other entities, including derivatives clearing organizations and national securities exchange, are not considered to be nonbank financial companies.⁷

2. What restrictions does the Rule impose on proprietary trading by banking entities?

The Rule prohibits banking entities from engaging in proprietary trading except as noted in the responses to questions 4 through 6 below.

- “Proprietary trading” is defined as engaging as a principal for the “trading account” of a banking entity or an NFC 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 that the appropriate Federal banking agencies, the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) may by rule determine.⁸
 - “Trading account” means an account for taking positions in the instruments listed in the definition of “proprietary trading” primarily to sell in the near term or with the intent to sell to profit from near-term price fluctuations.⁹ The Federal banking agencies, the SEC and the CFTC may exercise rulemaking authority to bring other accounts within the definition of “trading account.”

3. What restrictions does the Rule impose on proprietary trading by NFCs?

The Rule’s prohibition on proprietary trading does not apply to NFCs.¹⁰

Any NFC that engages in proprietary trading, however, shall be subject to any rules issued pursuant to the Rule that impose additional capital requirements and quantitative limitations with respect to such trading as if the NFC were a banking entity. These additional limits generally will not apply to the activities described in the responses to questions 4 through 6 below.

For the “permitted activities” described in the responses to questions 4 through 6, the appropriate federal banking agencies, the SEC, and the CFTC shall adopt rules that impose additional capital requirements, quantitative limitations and diversification requirements with respect to such activities if they determine that such limits are appropriate to protect the safety and soundness of banking entities or NFCs engaged in such activities.¹¹ Thus, even though NFCs are not subject to a blanket ban on proprietary trading, they must adhere to forthcoming capital requirements and quantitative limitations, and may be subject to additional limitations on other “permitted activities.”

4. Does the Rule prohibit any of the activities listed below?

The sale or securitization of loans.

No. The Rule permits the sale or securitization of loans by a banking entity or an NFC if conducted “in a manner otherwise permitted by law.”¹²

Underwriting and market making activities.

No. The Rule permits “underwriting or market-making-related activities” to the extent they are “designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties.”¹³ Presumably, studies to be conducted by the FSOC and rules to be adopted by the appropriate agencies will better shape the contours of these terms.

Securities transactions on behalf of customers.

No. The Rule permits the “purchase, sale, acquisition, or disposition of securities and other instruments...on behalf of customers.”¹⁴

Hedging activities of a banking entity.

No. The Rule permits hedging activities “related to individual or aggregated positions, contracts or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts or other holdings.”¹⁵

5. Does the prohibition on proprietary trading apply outside of the United States?

Yes, with an exception. The Rule broadly prohibits any banking entity from engaging in proprietary trading. It does, however, permit proprietary trading conducted by a non-US banking entity pursuant to Sections 4(c)(9) or 4(c)(13) of the BHC Act, but only if “the trading occurs solely outside of the United States” and the non-US banking entity is not directly or indirectly controlled by a US banking entity.¹⁶

6. Which other activities are permitted as exceptions to the Rule’s prohibition on proprietary trading?

The purchase, sale, acquisition or disposition of:

- Obligations of the United States or its agencies, including obligations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation and Farm Credit System institutions chartered under the Farm Credit Act of 1971.¹⁷
- Obligations of any State or political subdivisions thereof.¹⁸
- Securities and other instruments “by a regulated insurance company directly engaged in the business of insurance,” and by any affiliate, for the general account of the insurance company, if:
 - The transaction complies with the insurance company investment law of the jurisdiction in which the company is domiciled.
 - The appropriate federal banking agencies, after consulting with the FSOC and relevant state and territorial insurance commissioners, have not jointly determined that a particular law, regulation or guidance “is insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States.”¹⁹

Investments in small business investment companies, investments designed primarily to promote the public welfare, and investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure.²⁰

Any other activity that the appropriate federal banking agencies, the SEC and the CFTC permit by rule after determining that it “would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”²¹

7. Are there any other restrictions on the permissible activities referred to in the responses to questions 4 through 6 above?

A transaction, class of transactions, or activity is prohibited if it:

- Would create a “material conflict of interest [as such term shall be defined by rule] between the banking entity and its clients, customers or counterparties.”
- Would result in material exposure by the banking entity to “high-risk assets” or “high-risk trading strategies” (as such terms shall be defined by rule).
- Would threaten the safety and soundness of the banking entity.²²
- Would threaten the financial stability of the United States.

The appropriate federal banking agencies, the SEC and the CFTC are required to issue regulations to:

- Implement the limitations referred to above on permitted activities.²³
- Impose “additional capital requirements and quantitative limitations, including diversification requirements, [on permitted activities if they] determine that additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.”²⁴

All of the permissible activities referred to above are subject to the restrictions in other federal and state laws, the limitations referred to within the Rule in describing them, and any restrictions or limitations that the appropriate federal banking agencies, the SEC and the CFTC may determine.

8. What restrictions does the Rule impose on the relationship of banking entities with hedge funds or private equity funds?

The Rule prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring any hedge fund or private equity fund except as noted in the responses to questions 10 and 11 below.

- “Hedge fund” and “private equity fund” are defined as “an issuer that would be an investment company, as defined in the Investment Company Act of 1940... , 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.”²⁵

- An entity “sponsors” a fund if it:
 - Serves as a general partner, trustee or managing member of the fund.
 - Selects or controls (or has agents or management who constitute) a majority of the fund’s directors, trustees or management.
 - Shares the same name, or a variation of the same name, with the fund.²⁶

The Rule also prohibits banking entities that serve as investment managers, advisers or sponsors to hedge or private equity funds, or organize and offer a fund under the exception discussed in the response to question 11 below, and all affiliates of such banking entities, from entering into covered transactions with such funds or funds that they control.²⁷

- However, if a banking entity sponsors, manages or advises a hedge or private equity fund, and that fund at least partially owns another fund, the Board may permit the banking entity to enter a prime brokerage transaction with the partially owned or subordinate fund, provided that:
 - The banking entity is in compliance with the limitations described in the response to question 11 below.
 - The banking entity’s CEO provides written certification each year that the entity does not insure, guarantee or assume any performance or obligation of the fund or any fund in which it invests.
 - The Board has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity.²⁸

9. What restrictions does the Rule impose on the relationship of NFCs with hedge funds or private equity funds?

The Rule’s prohibition on retaining an equity, partnership or other ownership interest in a hedge fund or private equity fund, or sponsoring such a fund, does not apply to NFCs.²⁹

Any NFC that engages in such activity, however, shall be subject to any rules issued pursuant to the Rule that impose additional capital requirements and quantitative limitations with respect to such activity as if the NFC were a banking entity.³⁰ In addition, if the appropriate agencies impose further capital or quantitative limitations, including diversification requirements, on the otherwise “permitted activities” discussed in the response to questions 10 and 11 below, these limitations shall apply to NFCs as though they were banking entities. The appropriate agencies are

also required to adopt additional capital charges or other restrictions on NFCs to address the same risks and conflicts of interest discussed with respect to banking entities in the response to question 8 above.³¹

10. Is there a “de minimis” investment exception to the prohibition regarding hedge funds and private equity funds?

Yes. A banking entity may make and retain investments in funds that it organizes and offers for the purposes of:

- Establishing such funds and providing them with sufficient equity in order to attract unaffiliated investors.
- Making a de minimis investment.³²

Any such investment is subject to the following limitations and restrictions:

- The banking entity must seek unaffiliated investors to reduce or dilute the entity’s investment to conform to the following limitations:
 - Within one year of establishing the fund, the entity’s investment must be reduced to no more than three percent of the total ownership interests of the fund.
 - The entity’s investments in the fund must be “immaterial” (as shall be defined by rule), and the entity’s total interests in all such private equity and hedge funds may not exceed three percent of the entity’s Tier 1 capital.³³
- For the purposes of this exception, the aggregate of the entity’s outstanding investments under this exception, including retained earnings, shall be deducted from its assets and tangible equity, and “the amount of the deduction shall increase commensurate with the leverage of” the relevant fund.

11. What other activities are permitted as exceptions to the prohibition regarding hedge funds and private equity funds?

A banking entity may organize and offer a hedge or private equity fund, may serve as a partner, trustee or managing member of the fund, and may select or control a majority of the fund’s directors, trustees or management, including by covering all necessary expenses, but only if:

- The entity provides bona fide trust, fiduciary or investment advisory services.
- The fund is organized and offered only in connection with the provision of such services and only to customers of such services of the banking entity.

- The entity acquires or retains only a de minimis ownership interest in the fund as described in the response to question 10 above.
- The banking entity complies with the restrictions on its relationships with funds described in the response to question 8 above.
- The entity does not guarantee, assume or insure the obligations or performance of the fund or of any fund in which it invests.
- The banking entity does not share with the fund the same name or a variation of the same name.
- No director or employee of the entity has any ownership interest in the fund, except for one who is directly engaged in providing investment advisory or other services to the fund.
- The entity discloses to prospective and actual investors, in writing, that any losses in the fund are borne solely by investors, and complies with any additional rules of the appropriate agencies that are designed to ensure that the fund's losses are borne solely by investors and not by the entity.³⁴

A banking entity may have ownership interests or sponsor funds pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act "solely outside of the United States," but only if no ownership interest is sold or offered for sale to a US resident and the banking entity is not controlled by a banking entity organized under state or federal law.³⁵

The appropriate federal banking agencies, the SEC and the CFTC may permit other activities by rule if they determine that allowing such activities would promote the safety and soundness of the banking entity and the financial stability of the United States.³⁶

12. Are there any other restrictions on the permissible activities referred to in the response to question 11 above?

The restrictions described in the response to question 7 also apply to these permissible activities.

13. When will the Rule become effective?

The Rule becomes effective on the earlier of 12 months after the issuance by the appropriate Federal banking agencies, the SEC and the CFTC of final rules implementing the Rule, or two years from the enactment of the Rule.³⁷ The response to question 16 below describes the time periods for the issuance of the final rules.

14. How long a period does a banking entity or nonbank financial company supervised by the Board have to bring its investments and activities into compliance with the Rule?

Except as noted in the response to question 16 below, the Rule requires compliance by no later than two years after the Rule becomes effective as described in the response to question 13 above or two years after a company becomes an NFC. The Board may grant extensions of this two-year period for not more than one year at a time and for no more than an aggregate of three years.³⁸

15. Are there special divestiture requirements regarding illiquid investment funds?

Yes. The Rule defines an "illiquid fund" as a hedge or private equity fund that, 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 makes all investments pursuant to and consistent with an investment strategy to principally invest in illiquid assets.³⁹

The Board may grant a single extension of up to five years, during which time the entity may take or retain ownership interests in, or provide capital to, illiquid funds. This period may only be extended for as long as necessary to fulfill the contractual obligation that was in effect on May 1, 2010. Once the obligation to invest in the fund terminates, or the extension period expires, the entity may not engage in prohibited activities.⁴⁰

16. What studies and rulemakings are required to implement the Rule?

The FSOC is required, within six months of the Rule's enactment, to complete a study and make recommendations on implementing the Rule that are designed to, among other things, reduce conflicts of interest between customers and their banking entities and NFCs, limit activities that have caused undue risk or loss, and provide for an appropriate delay in order to divest illiquid assets.⁴¹

Within nine months after the completion of the FSOC study, the appropriate federal banking agencies, the SEC and the CFTC are required to consider the findings of the study and adopt implementing rules.⁴²

In order to limit risks in the interim, the agencies shall issue rules that will be effective during the transition period. These rules must set additional capital requirements and other appropriate restrictions on any ownership interest in or sponsorship of a hedge or private equity fund by a banking entity.⁴³

17. Which law controls if provisions of the Rule conflict with provisions of another law?

The prohibitions and restrictions of the Rule apply to activities of a banking entity or an NFC even if such activities are permissible under another law.⁴⁴ For example, an investment by a banking entity in a hedge fund or a private equity fund that is prohibited by the Rule may not be made or maintained even though it would be permissible under the five percent exception in Section 4(c)(6) of the BHC Act.

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H.R. 4173, 111th Cong. (2010).
2. Section 619 of the Act implements the Volcker Rule by adding a Section 13 to the Bank Holding Company Act of 1956 (the "BHC Act"). References in these footnotes to the Volcker Rule will be to the relevant subsection of Section 13 of the BHC Act as set forth in Section 619 of the Act. References to other provisions of the Act will be to the relevant section of the Act.
3. BHC Act § 13(h)(1).
4. Federal Deposit Insurance Act of 1950 § 3, 12 U.S.C. § 1813.
5. BHC Act § 13(h)(3). The FSOC is intended to function as a systemic risk regulator. It can subject a nonbank financial company to Board supervision if two-thirds of the voting members of the FSOC determine that material financial distress at the company, or the nature, scope, size, concentration and mix of activities at the company, could pose a threat to the financial stability of the United States. Act § 113.
6. BHC Act § 102(a)(6).
7. Act §§ 102(a)(1), (a)(4)(A), (a)(4)(B).
8. BHC Act § 13(h)(4).
9. BHC Act § 13(h)(6).
10. BHC Act § 13(a)(2).
11. BHC Act § 13(d)(3).
12. BHC Act § 13(g)(2).
13. BHC Act § 13(d)(1)(B).
14. BHC Act § 13(d)(1)(D).
15. BHC Act § 13(d)(1)(C).
16. BHC Act § 13(d)(1)(H).
17. BHC Act § 13(d)(1)(A).
18. Id.
19. BHC Act § 13(d)(1)(F).
20. BHC Act § 13(d)(1)(E).
21. BHC Act § 13(d)(1)(J).
22. BHC Act § 13(d)(2)(A).
23. BHC Act § 13(d)(2)(B).

18. Are there any special enforcement procedures in the Rule?

Yes. The appropriate federal banking agencies, the SEC and the CFTC are required to issue regulations regarding internal controls and recordkeeping, in order to ensure compliance with the Rule.⁴⁵

Whenever such agency has reasonable cause to believe that a banking entity or NFC has evaded the Rule's requirements, the agency must order the entity or NFC, after notice and opportunity for a hearing, to terminate the activity or dispose of the investment in question.⁴⁶

24. BHC Act § 13(d)(3).
25. BHC Act § 13(h)(2).
26. BHC Act § 13(h)(5).
27. BHC Act § 13(f)(1). For the purposes of this prohibition, the term "covered transaction" is defined as in Section 23A of the Federal Reserve Act. The banking entity and its affiliate would be treated as a member bank of the Federal Reserve and the fund would be treated as an affiliate of the member bank.
28. BHC Act § 13(f)(3). For the purposes of this exception, prime brokerage transactions will be subject to Section 23B of the Federal Reserve Act as if the counterparty were an affiliate of the banking entity. BHC Act § 13(f)(3)(B). In addition, any banking entity that serves as an investment manager or adviser to a hedge or private equity fund, or that organizes or offers such a fund under the exception discussed in response to question 11 below, will also be subject to Section 23B of the Federal Reserve Act as if it were a member bank and the fund were an affiliate. BHC Act § 13(f)(2).
29. BHC Act § 13(a)(2).
30. Id.
31. BHC Act § 13(f)(4).
32. BHC Act § 13(d)(4)(A).
33. BHC Act § 13(d)(4)(B).
34. BHC Act § 13(d)(1)(G).
35. BHC Act § 13(d)(1)(I).
36. BHC Act § 13(d)(1)(J).
37. BHC Act § 13(c)(1).
38. BHC Act §§ 13(c)(2), (c)(3).
39. BHC Act § 13(h)(7).
40. BHC Act §§ 13(c)(3), (c)(4).
41. BHC Act § 13(b)(1).
42. BHC Act § 13(b)(2).
43. BHC Act § 13(c)(5).
44. BHC Act § 13(g)(1).
45. BHC Act § 13(e)(1).
46. BHC Act § 13(e)(2).

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