Banking and Finance Law Daily Wrap Up, TOP STORY—Banking agencies approve Volcker Rule regulations, (Dec. 10, 2013)

Banking and Finance Law Daily Wrap Up

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The Federal Deposit Insurance Corporation and Federal Reserve Board have unanimously approved regulations implementing section 619 of the Dodd-Frank Act. At the FDIC's Dec. 10, 2013, board meeting, Comptroller of the Currency Thomas J. Curry stated he would be signing on to the regulations on behalf of the Office of the Comptroller of the Currency. Although the preamble to the final rule provides that the final rule become effective April 1, 2014, the Fed has extended the conformance period until July 21, 2015.

The purpose of the statutory Volcker Rule, codified at 12 U.S.C. §1851, is to limit the type and amount of speculative risk that can be undertaken by banking entities that are supported by the public safety net. The final rule accomplishes this goal by generally prohibiting banking entities from:

- engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account; and
- owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as "covered funds."

Proprietary trading exemptions. As required by the Dodd-Frank Act, the final rule includes exemptions for a number of transactions. The final rule also clarifies which activities are not considered proprietary trading, provided certain requirements are met, including trading solely as an agent, broker, or custodian; through a deferred compensation or similar plan; to satisfy a debt previously contracted; under certain repurchase and securities lending agreements; for liquidity management in accordance with a documented liquidity plan; in connection with certain clearing activities; or to satisfy certain existing legal obligations.

Underwriting. A banking entity can use the underwriting exemption to act as an underwriter for a distribution of securities, including both public and private offerings. This exemption is available only if the trading desk's underwriting position is related to that distribution and the underwriting position does not exceed the reasonably expected near-term demands of customers.

Market making. The market making exemption is available to a banking entity's trading desk as long as the trading desk is routinely standing ready to purchase and sell one or more types of financial instruments. The trading desk's inventory in these types of financial instruments would have to be designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of customers based on such things as historical demand and consideration of market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk-management procedures required under the final rule.

Hedging. Certain hedging activities, that are designed to reduce, and demonstrably reduce or significantly mitigate, specific, identifiable risks of individual or aggregated positions of the banking entity are also exempted under the final rule. To use this exemption, a banking entity would be required to conduct an analysis, including correlation analysis, supporting its hedging strategy. In addition, the effectiveness of the hedges must be monitored and recalibrated as necessary on an ongoing basis. A banking entity will also be required to document, contemporaneously with the transaction, the hedging rationale for certain transactions that present heightened compliance risks. During the FDIC's meeting, an agency staff member noted that a banking entity would not be allowed to engage in so-called micro hedging.

Government obligations. The final rule will also permit a banking entity to continue to engage in proprietary trading in U.S. government, agency, state, and municipal obligations. They also permit, in more limited circumstances, proprietary trading in the obligations of a foreign sovereign or its political subdivisions.

Trading by foreign banking entities are exempted from the proprietary trading prohibition provided the trading decisions and principal risks of the foreign banking entity occur and are held outside of the United States. A U.S. banking entity may be involved in these types of transactions, as long as the transaction occurs: (1) within the foreign operations of the U.S. banking entity; (2) in cleared transactions with an unaffiliated market intermediary acting as principal; or (3) in cleared transactions through an unaffiliated market intermediary acting as agent, conducted anonymously on an exchange or similar trading facility.

Finally, trading on behalf of a customer in a fiduciary capacity or in riskless principal trades and activities of an insurance company for its general or separate account are also exempt provided certain requirements are met.

Covered funds prohibition. The final rule prohibits banking entities from owning and sponsoring hedge funds and private equity funds, referred to as “covered funds.” Under the final rule, the definition of covered funds encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act, section 3(c)(1) or 3(c)(7). The final rule also includes in the definition of covered funds certain foreign funds and commodity pools.

Certain entities with more general corporate purposes such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles, as well as SEC-registered investment companies and business development companies are excluded from the definition of covered funds, as are certain foreign funds publicly offered abroad, loan securitizations, insurance company separate accounts, and small business investment company and public welfare investments.

Exempted transactions. As with the proprietary trading prohibition, the final rule provides a number of exemptions to the covered funds prohibition. A banking entity is able, under certain conditions, to invest in or sponsor a covered fund in connection with: organizing and offering the covered fund; underwriting or market making-related activities; certain types of risk-mitigating hedging activities; activities that occur solely outside of the United States and insurance company activities.

Compliance programs. To ensure that banking entities do not take steps to evade the prohibitions in the Volcker Rule, the agencies’ regulations also establish a compliance program. For banking entities with $10 billion or more in total assets, the final rule specifies six elements that each compliance program must contain. These elements are:

1. written policies and procedures that establish trading and exposure limits for the activities conducted by the banking entity and are designed to ensure compliance with the requirements of the final rule;
2. internal controls;
3. a management framework that delineates responsibility and accountability for compliance with the final rule;
4. independent testing and audit;
5. training; and
6. recordkeeping.

For any banking entity with significant covered trading or covered fund operations, the final rule requires that the compliance program satisfy a variety of additional requirements and minimum standards generally designed to ensure that the banking entity has robust risk management processes, remediation processes, independent testing and reporting, and other compliance controls to govern its covered trading and covered fund activities.

These enhanced requirements include a banking entity's chief executive officer attesting that the banking entity has in place a compliance program reasonably designed to achieve compliance with section 1851 and the final rule.

To minimize burden, the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments is not required to establish a compliance program prior to becoming engaged in such activities or making such investments. In addition, to minimize burden on smaller banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities may satisfy the compliance program requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 1851 and the final rule and adjustments as appropriate given the activities, size, scope, and complexity of the banking entity.

To assist community banks, the banking agencies released a document that provided an overview of the final rule as it applies to banking entities with less than $10 billion in total consolidated assets.

Metrics reporting. The final rule also requires banking entities with significant trading operations to furnish the relevant banking agency a variety of metrics. The preamble to the final rule makes clear that the metrics are designed to be a tool for triggering further scrutiny by banking entities and examiners in their evaluation of whether a banking entity is engaging in prohibited proprietary trading, engaging in high risk trading strategies, or maintaining exposures to high risk assets.

In order to minimize burden and give full effect to the conformance period provisions of section 1851, the reporting requirements are applied in a graduated manner, with only the very largest firms required to report metrics. The final rule requires reporting of these metrics beginning with data for July 2014. In particular, a banking entity must comply with the metrics reporting requirements only if the banking entity has worldwide trading assets and liabilities, excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. government or any agency of the United States of $50 billion or more; with respect to a foreign banking entity, the same threshold is applied to the trading assets and liabilities of the U.S. operations of the foreign banking entity. Beginning on April 30, 2016, this threshold drops to $25 billion in applicable trading assets and liabilities; and then to $10 billion beginning on Dec. 31, 2016.

It should be noted that the final rule reduces the number of metrics to be reported from 17, in the proposed rule, to seven that provide the most useful information about a trading desk's activity. These seven metrics are:

1. risk and position limits and usage;
2. risk factor sensitivities;
3. value-at-risk and stress VaR;
4. comprehensive profit and loss attribution;
5. inventory turnover;
6. inventory aging; and
7. customer facing trade ratio—trade count based and value based.

Comment and reaction. Following adoption of the final rule, FDIC Chairman Martin J. Gruenberg stated, "I believe this final rule achieves the statutory requirement of prohibiting speculative trading and fund activities supported by the public safety net. It preserves important, legitimate market making and hedging activities. It requires the establishment of a compliance framework designed to achieve enforceability and accountability. And, it minimizes the burden placed on community banks that generally do not engage in the activities covered by the final rule."

In a statement, FDIC Vice Chairman Thomas M. Hoenig voiced his support for the final rule and noted that the final rule "will mitigate the moral hazard and misaligned incentives that accompany wide access to the safety net."

In his opening statement at the Fed's meeting, Board Chairman Ben S. Bernanke noted that "the ultimate effectiveness of the rule will depend importantly on supervisors, who will need to find the appropriate balance while providing feedback to the Board on how the rule works in practice."

Fed Vice Chairman Daniel K. Tarullo stated, "Many of us—myself included—had hoped for a final rule substantially more streamlined than the 2011 proposal. I think we need to acknowledge that it has been only modestly simplified. Much of the complexity lies in the part of the rule dealing with covered funds. A good bit of this complexity has proven hard to avoid. The part of the rule dealing with proprietary trading has been simplified somewhat, particularly by reducing the number of metrics that will be used in the reporting and analysis of trading data." He continued, "Of course, the fundamental challenge is to distinguish between proprietary trading, on the one hand, and either market-making or hedging, on the other. The difficulty in doing so inheres in the fact that a specific trade may be either permissible or impermissible depending on the context and circumstances within which that trade is made."

Congressional reaction to the final rule fell along party lines.

Regulatory overkill. Financial Services Committee Chairman Jeb Hensarling (R-Texas) called the final rule "just the latest example of Washington's regulatory overkill that ends up hurting more than it helps." He added, "Hearings in our committee also demonstrated that the Volcker Rule will make it harder for businesses and consumers everywhere to get the credit they need. And because no other country in the world has imposed a similar burden, the Volcker Rule puts our capital markets at a competitive disadvantage in today's global economy."

Key milestone. Senate Banking Committee Chairman Tim Johnson (D-SD) stated, "Today's approval of the final Volcker Rule is a key milestone in the full implementation of Wall Street Reform and these trading restrictions will help improve the integrity of our banking system."

Persistence and common sense prevail. Finally, a joint statement by Sens. Jeff Merkley (D-Ore) and Carl Levin (D-Mich), the authors of the statutory Volcker Rule, said, "We fought for the Merkley-Levin provision of the Dodd-Frank Act in order to put a strong firewall between banks and hedge fund-style high-risk trading. Today is a big step toward that goal. We are still reviewing the details of the final rule, but early indications suggest that persistence and common sense can prevail in the face of even the fiercest special interest lobbying campaigns: hedging looks tougher, market-making looks simpler, trader compensation remains appropriately structured, and CEOs are required to set the tone at the top. No regulation is ever perfect, and we will carefully monitor implementation and hold regulators and firms accountable. If problems emerge—for whatever reason—we will quickly press regulators to address them. Overall, though, the final rule looks improved over the proposal from two years earlier."

Safer financial system. In a statement released by the White House, President Barack Obama said, "Our financial system will be safer and the American people are more secure because we fought to include this protection in the law. I thank Paul Volcker, a former Chairman of the Federal Reserve and advisor I trust, for helping to create this important safeguard. I also thank Secretary Lew and the regulators who worked diligently to finalize the rule by the end of this year as we called on them to do. I encourage Congress to give these regulators adequate funding to effectively and efficiently implement the rule, which will help protect hardworking families and business owners from future crisis, and restore everyone's certainty and confidence in America's dynamic financial system."

Ongoing exercise. Treasury Secretary Jacob Lew said, "With today's approval of the Volcker Rule, regulators have taken a critical step toward completing implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act." He added, "Our work on financial regulatory reform, based on lessons from the

worst financial crisis in recent history, is an ongoing exercise in remaining vigilant against market behavior that threatens the stability of our financial system. Nevertheless, completion of this rule is an important milestone."

Groups representing the financial services industry predicted dire consequences with the adoption of the final rule.

Reduced access to capital. Financial Services Roundtable CEO Tim Pawlenty said, "Financial institutions should not engage in unreasonable risk and regulators should not stifle investments essential to growing jobs and small businesses. The Volcker rule issued today leans against striking that balance as it will reduce needed access to capital."

U.S. Chamber of Commerce Center for Capital Markets Competitiveness (CCMC) President and CEO David Hirschmann stated, "We are disappointed that regulators may have sacrificed an effective process that could have avoided adverse consequences for Main Street businesses." He added, "Since it was first proposed, we have warned that the Volcker Rule may harm the ability of businesses to raise the capital needed to grow and operate. The Volcker Rule may shut Main Street businesses out of some markets, raise the costs of capital, and place the United States at a competitive disadvantage in a global economy. That is not a winning formula for sustained economic growth and job creation."

It should be noted that in the run up to the approval of the final rule, the CCMC had urged the regulators to re-propose the Volcker Rule to allow a thorough evaluation of the rule's impact. In early November, the CCMC wrote to the regulators urging a re-proposal of the Volcker Rule (see *Banking and Finance Law Daily*, Nov. 8, 2013). A second letter cited additional, significant developments necessitating a re-proposal (see *Banking and Finance Law Daily*, Dec. 2, 2013). A Dec. 4, 2013, letter contended that the rule may have unintended but detrimental impacts upon growth, operations, and cash management.

Driving customers away. The American Bankers Association said, "the Volcker Rule will still make it too hard in too many cases for bankers to provide services that many bank customers rely upon every day, posing no risk to the financial system." The ABA added, "Customers risk facing decreased liquidity and inferior product pricing that will drive them into the arms of unregulated entities and our international competitors. We will continue to work through the many details of this rule that can have a profound impact on banks and their customers."

Finally, a couple of non-profit organizations that are advocates for financial reform also commented on the agencies' action.

Major accomplishment. Aaron Klein, director of the Bipartisan Policy Center's (BPC) Financial Regulatory Reform Initiative, stated, "To have financial regulators agree on the same final Volcker Rule regulations marks a major accomplishment after three years of difficult negotiations." He added, "We are pleased that the final regulations have appeared to follow some of BPC's Capital Markets Task Force's recommendations; specifically, our recommendations for a phased-in conformance period and the use of an iterative, metric-based approach that will adjust according to incoming data."

Major defeat for Wall Street. Dennis Kelleher, President of Better Markets, Inc., an independent nonprofit organization that promotes the public interest in the financial markets, said, "Today's finalization of the Volcker Rule ban on proprietary trading is a major defeat for Wall Street and a direct attack on the high risk 'quick-buck' culture of Wall Street that focuses on big short-terms gains regardless of the risks to others. As a result, some of the most common and dangerous gambling at taxpayer-backed banks is now prohibited." He added, "Details matter, but key principles are embedded in this rule. The rule recognizes that compliance must be robust, that CEOs are responsible for ensuring a compliance program that works, that compensation must be limited, and that banned proprietary trading cannot legally be disguised, as market making, risk mitigating hedging or otherwise. Those requirements will not end all gambling activities on Wall Street, but should limit them and reduce the risk to Main Street."

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