

As Volcker Rule Implementation Lumbers On – Some Practical Considerations

I. Introduction.

The “Volcker Rule,” enacted into law on July 21, 2010 as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), subject to certain exceptions, prohibits a “Banking Entity”¹ from engaging in proprietary trading activities or acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring an issuer that would be, an investment company under the Investment Company Act of 1940 (the “Company Act”), but for Section 3(c)(1) or 3(c)(7) thereof,² or such similar funds as determined by the appropriate regulatory agency.

By its terms, the Volcker Rule will become effective on July 21, 2012 (the “Effective Date”). However, it is now acknowledged that the regulators will not be able to provide advance guidance, as required by the law, regarding the myriad interpretative issues raised. This note provides an overview of the regulatory scheme and offers some practical considerations for Banking Entities struggling to adapt.

II. The Regulatory Implementation Framework.

The Volcker Rule required that within six months of its enactment the Financial Stability Oversight Council (“FSOC”)³ study and make recommendations on its implementation. Accordingly, on January 18, 2011, the FSOC issued its “Study & Recommendations on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds” (the “Study & Recommendations”).

As part of the implementation process, the Volcker Rule next required that the Board of Governors of the Federal Reserve System (“Board”), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (“CFTC” and, collectively, the “Agencies”) consider the Study & Recommendations and jointly adopt rules to implement the Volcker Rule (“Implementing Rules”). The deadline for such action was set as no later than nine months after the completion of the Study & Recommendations, presumably, to provide Banking Entities adequate time to develop compliance programs before the Effective Date.

The Volcker Rule further requires that a Banking Entity bring its activities, investments and relationships into conformance no later than two years after the Effective Date, *i.e.*, July 21, 2014 (the period between the Effective Date and July 21, 2014, referred to as the “Conformance Period”). Also, as part of this framework, the Board was

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required to issue its own rules to give effect to the Conformance Period requirements of the Volcker Rule. Accordingly, on February 8, 2011 the Board adopted such a final transition rule.⁴

As events have unfolded, however, the Agencies did not adopt rules to implement the Volcker Rule before the statutory deadline of October 18, 2011, but on October 12 all of the Agencies except, surprisingly, the CFTC jointly proposed a rulemaking for public comment (the "October Proposed Rulemaking"). The October Proposed Rulemaking is approximately 300 pages in length, single spaced, and it solicits comments on more than 1,400 specific questions. Among the issues addressed are the obligations of a Banking Entity to adopt and implement a compliance program by the Effective Date.

The deadline for submitting comments on the October Proposed Rulemaking was February 13 and approximately 16,700 comment letters have been filed.

On January 11, 2012, the CFTC finally issued its own proposed rulemaking. It very closely follows the text of the October Proposed Rulemaking, but poses 14 additional questions regarding specific issues under the CFTC's jurisdiction. The deadline for submitting comments is April 16, 2012.

As a result, it is improbable that the Implementing Rules will be adopted in advance of the Effective Date and, despite ongoing meetings between trade groups and large Banking Entities and the Agencies, there is great deal of uncertainty for financial institutions and financial markets regarding the impact of the Volcker Rule. Possible outcomes range from a wholesale re-proposal of the Implementing Rules to "rules-based" guidance to address specific issues, such as metrics for distinguishing permissible market making⁵ from impermissible proprietary trading.

III. A Sober Reassessment.

One might readily ask how we have come to this juncture. There may be as many answers to that question as there are to the question of what caused the financial crisis itself. However, regardless of how one views the causes of the financial crises and the effectiveness of the Volcker Rule in addressing them, a few basic observations can be made to explain the current state of affairs.

The principles underlying the Volcker Rule may be relatively easy to state, but its implementation is very difficult because it is such an ambitious piece of legislation. It intends to prohibit Banking Entities from engaging in significant trading and investment activities that they have been conducting for a long period of time, on a global basis and through increasingly integrated financial markets.⁶ Moreover, in order to achieve a more integrated and coordinated regulatory framework, the Volcker Rule mandates joint rulemaking by the banking, securities and commodities regulators and contemplates full discussion with affected Banking Entities and "international harmonization" of regulatory reforms. In effect, the Volcker Rule requires a fundamental re-examination, both domestically and internationally, of the entire structure and regulation of financial institutions and trading markets.

It is not surprising, therefore, and it should have been anticipated, that the process of implementing the Volcker Rule would be complex, difficult and lengthy. Put another way, the statutory deadlines for implementing the Volcker Rule were exceedingly aggressive when adopted and many would say unrealistic under the best of circumstances.

On February 29, 2012, in his testimony before the House Financial Services Committee, Board Chairman Ben Bernanke conceded that he does not think the Implementing Rules will be ready by the Effective Date. He added that, although he did not know the exact date when they would be finalized, the Agencies "will be working on it as fast as we can." When asked if the Board would enforce a rule that is not yet in place, he said "obviously" it would not. More broadly, Mr. Bernanke said regulators would give banks "adequate time to adjust and . . . adapt to whatever rule is put out."⁷ While these assurances may provide some temporary relief, uncertainty remains as to the impact of the Volcker Rule on existing business practices and the extent to which it will be enforced, with or without the benefit of the Implementing Rules.

IV. How to Adapt to This Uncertain Regulatory Environment?

Although it has been acknowledged that the Implementing Rules will probably not be adopted before the Effective Date, and Mr. Bernanke has indicated that the Board will be reasonable in its approach, the Effective Date has not been delayed and uncertainties remain.

At this juncture, some guidance can be derived from the Volcker Rule itself. It provides that no permitted activity may: (i) involve or result in a material conflict of interest between the Banking Entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the Banking Entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the Banking Entity or the financial stability of the United States.⁸

With regard to specific trading activities and fund activities, while some are clearly permitted by the Volcker Rule, *e.g.*, trading in U.S. government obligations, the status of many are in doubt because of questions whether they are covered at all and, if so, whether the activity is permitted pursuant to an exception. As a general proposition, therefore, Banking Entities should proceed cautiously, particularly with regard to engaging in any new activity and, working with counsel, Banking Entities should carefully monitor emerging regulatory guidance as it might be applied to their specific situation.

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Please do not hesitate to contact the author with any questions as to how these considerations might impact the trading activities and fund activities of your organization.

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¹ A “Banking Entity” is defined to mean: (i) an insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and (iv) any affiliate or subsidiary of the foregoing. Volcker Rule Section (h)(1).

² Section 3(c)(1) of the Company Act, generally, excludes from the definition of “investment company” any issuer whose outstanding securities are beneficially owned by not more than 100 persons and that is not making and does not presently propose to make a public offering of its securities.

Section 3(c)(7) of the Company Act, generally, excludes from the definition of “investment company” any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of the acquisition of such securities, are “qualified purchasers,” and which is not making and does not propose to make a public offering of such securities.

³ The voting members of the FSOC include: (i) the Secretary of the Treasury, who serves as Chairperson of the Council; (ii) the Chairman of the Board; (iii) the Comptroller of the Currency; (iv) the Director of the Bureau of Consumer Financial Protection; (v) the Chairman of the Securities and Exchange Commission; (vi) the Chairperson of the Federal Deposit Insurance Corporation; (vii) the Chairperson of the Commodity Futures Trading Commission; (viii) the Director of the Federal Housing Finance Agency; and (ix) the Chairman of the National Credit Union Administration Board.

⁴ 12 C.F.R. 225.

⁵ Volcker Rule Section (d)(1)(B).

⁶ Most significantly, the Gramm-Leach-Bliley Act, enacted in 1999, significantly loosened the restrictions of the Depression Era Glass-Steagall Act that separated commercial banking from investment banking.

⁷ Victoria McGrane, “Bernanke: ‘Volcker Rule’ Won’t Be Set by July,” Wall St. J., February 29, 2012.

⁸ Volcker Rule Section (d)(2)(A).