Dodd-Frank Act: The Volcker Rule

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) restricts a bank's investments in proprietary trading and limits its aggregate investment in any and all hedge funds and private equity funds to no more than three percent of its Tier 1 capital.

Section 619 of the Dodd-Frank Act – which President Barack H. Obama signed into law today – adds a new Section 13 to the Bank Holding Company Act, which will broadly restrict banks from engaging in proprietary trading and private fund sponsorship, management and investment activities, including investing in hedge funds and private equity funds. These provisions of the Dodd-Frank Act, known as the Volcker Rule because they are based on proposals made by Paul A. Volcker, former Federal Reserve Bank (FRB) Chairman and current White House economic adviser, apply to any FDIC-insured depository institution, any company that controls an FDIC-insured depository institution, a foreign entity treated as a bank holding company under the International Banking Act and any subsidiary or affiliate of any such entity. The Volcker Rule is subject to exceptions, limits and implementing rules, which are required to be issued by the federal financial regulators within 15 months of the enactment of the Dodd-Frank Act.

Proprietary Trading Restrictions

The Volcker Rule restricts a covered banking entity's investments in proprietary trading. "Proprietary trading" is broadly defined as engaging as a principal for the trading account of a covered 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 or contract, or any other security or financial instrument that the federal financial regulators include in the implementing rules.

Hedge Funds and Private Equity Funds Restrictions

The Volcker Rule limits a covered banking entity's sponsorship of hedge funds and private equity funds and limits aggregate investment in hedge funds and private equity funds to no more than three percent of the covered banking entity's Tier 1 capital and further limits investments in any such fund to not more than three percent of such fund. "Sponsoring" a fund includes: serving as a general partner, managing member or trustee of a fund; selecting or controlling (or having employees, officers, directors or agents

who constitute) a majority of the directors, trustees or management of a fund; or sharing a name or variation of the same name with a fund. “Hedge fund” and “private equity fund” are defined as any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Sections 3(c)(1) and 3(c)(7) of that act, or “such similar funds” as the regulators may, by rule, determine. “Tier 1 capital” is the core measure of a firm's financial strength from a regulatory perspective; it is composed of core capital, which consists primarily of common stock and disclosed reserves or retained earnings and may also include non-redeemable, non-cumulative preferred stock.

Permitted Activities

The Volcker Rule provides some limited exceptions to the restrictions imposed on proprietary trading and sponsorship of hedge funds and private equity funds:

- transactions in government securities, agency securities and state and municipal obligations;
- certain underwriting activities to meet the near-term demands of clients;
- certain risk-mitigating hedging activities on behalf of the covered banking entity;
- transactions on behalf of customers;
- investments in small business investment companies and other entities devoted to the public interest;
- certain transactions by regulated insurance companies;
- certain activities conducted outside of the United States where the firm is not controlled by a U.S. banking entity;
- in very limited circumstances, organizing and offering a fund where the fund and the covered banking entity do not share a name or variant of a name; and
- the sale or securitization of loans in a manner otherwise permitted by law.

These exceptions are subject to numerous conditions and requirements and will be subject to modification and clarification by the implementing rules. In addition, the implementing rules may include additional exceptions.

Limitations on Transactions and Relationships with Hedge Funds and Private Equity Funds

The Volcker Rule applies the FRB’s related person transaction limitations to transactions between a covered banking entity and a hedge fund or private equity fund where the covered banking entity has certain relationships with such fund. Generally, “covered transactions” under Section 23A of the Federal Reserve Act are prohibited, and the fund will be treated as an affilliate for purposes of Section 23B of that act.

Nonbank Financial Companies

Financial firms designated by the FRB as nonbank financial companies under the Dodd-Frank Act will be subject to rules to be adopted by the FRB imposing additional capital requirements and quantitative limits on proprietary trading or sponsoring or investing in hedge funds or private equity funds.

Effective Date

The Volcker Rule will not be effective until the earlier of one year after the issuance of final rules implementing the Volcker Rule and two years after the date of enactment of the Dodd-Frank Act; however, as the deadline for issuance of the final rules is not until 15 months after enactment of the Dodd-Frank Act, it appears that the effective date will most likely be two years following enactment of the Dodd-Frank Act (*i.e.*, July 21, 2012). The enactment of the Volcker Rule will be followed by a two-year transition period, after which the FRB may then grant up to three one-year extensions of the transition period and further extend the transition period for up to five years for an illiquid fund.

Key Takeaways

For some banks, the restrictions on proprietary trading and sponsorship of hedge funds and private equity funds will significantly affect their operations and require divestitures. With respect to private funds, while bank sponsorship of the funds will be eliminated, there may be some benefit for some banks. Banks have experienced increased pressure over time to commit more capital to hedge funds and private equity funds to convince clients that they have "skin in the game." The three percent ceiling prescribed by the Volcker Rule will allow a bank to resist pressure to invest in private funds once a bank has committed the maximum amount of capital permitted. The arms race stops at three percent.

There are many areas of uncertainty, which may be clarified by the implementing rules. Among these questions are the scope of many of the exceptions, the unintended application to some entities due to the extremely broad definitions of hedge fund and private equity fund, the calculation of the size of funds for the three percent test and the scope of the exceptions for foreign entities and foreign activities. Further, the implementation process for the implementing rules will be complex, likely will be contentious and could result in unintended consequences.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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