U.S. Regulators Implement the Volcker Rule

On December 10, 2013, five U.S. regulators published joint final regulations, available here, to implement the portion of the Dodd-Frank Act known as the Volcker Rule (the "**Implementing Regulations**"). The Volcker Rule generally prohibits banking entities from engaging in short-term proprietary trading and generally restricts banking entities from owning, sponsoring, or having certain interests in, or relationships with, hedge funds or private equity funds, subject to specified exceptions and clarifications, but also impacts a number of other activities by banks that have U.S. operations.

The Implementing Regulations were developed jointly by the U.S. Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, and the Securities and Exchange Commission (collectively, the "**Agencies**"), and will become effective on April 1, 2014. Beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities (including non-U.S. banks with specified levels of U.S. trading activities) will be required to report specified quantitative measurements. Covered banking entities will have until July 21, 2015 to fully conform existing operations to the requirements of the Implementing Regulations. Banking entities that engage in activities covered by the Volcker Rule will need to establish compliance programs to ensure and monitor compliance with the prohibitions and restrictions of the Volcker Rule and the Implementing Regulations.

This client alert provides only a general high level overview of selected provisions – a more detailed briefing on the Implementing Regulations will follow.

Key highlights

- Full conformance expected by July 21, 2015
- Covered banking entities with significant trading operations to report certain quantitative measurements
- Large banking entities to begin reporting quantitative measurements beginning June 30, 2014
- Covered banking entities to implement an internal compliance program

Background

In July 2010, Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new Section 13 to the Bank Holding Company Act (the "**BHCA**"), which is commonly referred to as the "Volcker Rule." It applies to "banking entities," which include: (1) any depository institution, other than certain limited purpose trust companies; (2) any company that controls an insured depository institution; (3) any foreign bank or holding company subject to the BHCA; and (4) any affiliate or subsidiary of any of these foregoing entities. As with the rest of the BHCA, the Volcker Rule applies extraterritorially to the worldwide operations of banking entities, unless there is an applicable exception to limit its scope. In 2011 and 2012, the Agencies proposed regulations to implement the Volcker Rule and provided an extended period for public comment, during which they received more than 18,000 comments.

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Prohibition on Proprietary Trading

The proprietary trading prohibition covers only positions held in a "trading account," which is defined by the Implementing Regulations as any account that is used to take positions principally for the purpose of short-term resale, benefitting from short-term price movements, locking in short-term arbitrage profits, or hedging another trading account position. The Implementing Regulations cover "financial instruments," which include any security, commodity forward, or derivative, but does not include loans, spot commodities or spot foreign exchange or currency. The purchase of a financial instrument will be presumed to be for a banking entity's trading account if it holds the instrument for fewer than 60 days (or substantially transfers the risk of the financial instrument within 60 days of the purchase). Subject to specified conditions, trading activities related to underwriting, liquidity management, market making, risk-mitigating hedging and governmental obligations will, however, be permitted. In addition, so long as trading decisions and principal risks of a non-US banking entity occur and are held outside of the United States, these rules generally will not restrict proprietary trading by non-US banking entities.

Restrictions on Relationships with Covered Funds

The Implementing Regulations generally prohibit banking entities from owning and sponsoring hedge funds and private equity funds, referred to as covered funds. The definition of "covered fund" includes any issuer that would be an investment company under the Investment Company Act of 1940, as amended, but for qualifying for exclusion under either Section 3(c)(1) or 3(c)(7) of that act, as well as specified commodity pools. Certain wholly-owned subsidiaries, joint ventures and acquisition vehicles, as well as SEC-registered investment companies and business development companies will, however, not be covered funds. In addition, non-U.S. public funds, qualifying loan securitizations, qualifying asset-backed commercial paper conduits and qualifying covered bonds are excluded from the definition of "covered funds." Subject to specified conditions, a banking entity may invest in a covered fund (or act as its sponsor) in connection with: (1) organizing the fund; (2) underwriting or market making-related activities; (3) specified risk-mitigating hedging; (4) activities that occur solely outside of the United States; and (5) insurance company activities.

Reporting and Compliance

Beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities will be required to report specified quantitative measurements, including: (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 and aging; and (6) customer facing trade ratio. Smaller banking entities will become subject to these reporting requirements in 2016.

Banking entities will generally be required to establish internal compliance programs reasonably designed to ensure and monitor compliance with the Implementing Regulations, unless they do not engage in any of the activities covered by the Volcker Rule. The design of these compliance programs will need to take the size, scope and risk of the covered activities and investments into account. Banking entities with $50 billion or more in total consolidated assets (or a non-U.S. banking entity that has total U.S. assets of $50 billion or more) will be subject to enhanced requirements, including a requirement that their Chief Executive Officers provide an attestation that the entity has a compliance program in place that is reasonably designed to achieve compliance with the Volcker Rule.

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