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The Final Volcker Rule Begins to Emerge

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We issued a client memorandum on December 9 listing the major topics to look for when the five financial regulatory agencies agreed to finalize the Volcker Rule, which generally prohibits banking organizations from engaging in proprietary trading and investing in or sponsoring private investment funds, subject to a host of exceptions and details. The agencies issued the final version of the Rule yesterday, but clearly its requirements will take years to unfold.

In the meantime, following are our preliminary responses to the questions that we posed:

- **The definition of market-making**. The scope of permissible market-making is generally broader than in the original proposal. The final Rule will rely to a greater extent than expected on a program designed by each banking organization to limit, monitor and measure its market-making activities in such a way as to show that it is not engaged in impermissible proprietary trading. Thus, while restrictions remain, and monitoring and reporting systems will be required (see below), banks will have somewhat more control over their design.

- **The definition of hedging**. The requirements surrounding permissible hedging are similarly grounded in a program designed by each bank to limit, monitor and measure its hedging activities. However, as press reports had indicated, so-called “portfolio” hedging is not permitted, and each transaction must hedge one or more “specific, identifiable” risks. In certain cases, those risks must be documented at the time of the transaction. Hedges must be subject to ongoing monitoring and “recalibration,” and banks must conduct analysis and independent testing of their hedging models. These requirements will likely impose a difficult burden on large banks.

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- **Recordkeeping, monitoring and reporting requirements**. The amount and type of data points that banks must obtain has been scaled back in number of categories of information, the size of operations for which they must be obtained, and the frequency of reporting. Again, the particular data points will depend in part on the program for market-making and hedging designed by the bank. For example, rather than seventeen data points relating to trading activities, such as profit and loss for each trading unit, fee income and the like, seven will be required for the largest banks, and reporting will be monthly rather than daily in most cases. The reported amounts are explicitly stated not to be the sole basis for determining whether a bank has crossed the line into impermissible proprietary trading.
- **Inclusion of non-US sovereign debt**. The final Rule authorizes US banks' non-US subsidiaries (but not non-US branches) to engage in proprietary trading of sovereign debt in non-US subsidiaries within that sovereign's jurisdiction; for example, the UK bank subsidiaries of US banks may engage in proprietary trading of UK Government securities. In addition, US affiliates of non-US banks may do the same with Government securities of their home countries. This liberalization may address many concerns of non-US governments about the potential effect on their home country sovereign debt markets. However, it appears that a US bank's London subsidiary would not be authorized to engage in proprietary trading in sovereign debt of other European countries.
- **Permissible organization of private funds for fiduciary customers**. The final Rule retains the limit of 3 percent, after one year, of total investments in a private fund that a bank may hold in its funds organized for fiduciary customers. The proposal's recognition that investors could become fiduciary customers by virtue of investing in such a fund is retained.
- **The scope of permissible non-US activities of non-US banks**. The final Rule is less restrictive than proposed in interpreting the exception for non-US bank activities "solely outside of the United States" (called "SOTUS"). It allows non-US banks to use the services of US exchanges to conduct transactions for anonymised order book or cleared trades, and appears to allow US personnel to give advice on particular transactions so long as the decision to engage in a transaction is made by non-US personnel.
- **Coverage of non-US mutual funds**. The final Rule states that funds organized and distributed outside the United States that are the rough equivalent of US mutual funds are generally exempt from the prohibition on banks' investing in or sponsoring private funds.
- **Limits on transactions with permissible sponsored private funds**. The final Rule does not change the proposed limits on transactions by a bank with its permissible private funds (called "Super 23A"). There is no explicit exemption for a non-US bank's

relationships with its own non-US funds, but that is because other definitional changes make clear that such funds are not covered by the Rule's prohibition on private fund involvement. The final Rule excludes "loan securitizations" from the definition of covered funds, so Super 23A would not apply to them; however, many existing CLOs have baskets for securities which would render them ineligible for this exclusion.

- **CEO attestation of compliance**. The requirement that a bank's chief executive officer attest to compliance with the Rule, as had been reported by the press, is part of the final Rule. However, the attestation is to the appropriate US regulatory agency. There is no discussion of potential civil liability or of possible actions by an agency if it determined that the attestation was not truthful.
- **Time period to conform existing operations**. As expected, the conformance period has been extended one year to July 21, 2015. The largest banks will be required to begin to submit various data on market-making activities beginning in July 2014, and the agencies' staffs will review that data prior to the conformance data.
- **International implications**. There is no significant indication in the document that international implications of the Rule had much effect on its overall design. At the open Federal Reserve meeting, Governors asked staff about the potential competitive implications of the Rule on US banks vis-a-vis foreign banks. Staff noted that there has not been a movement by other countries to adopt Volcker-like restrictions, noting that the Vickers and Liikanen proposals in the United Kingdom and European Union, respectively, would "ring-fence" proprietary trading and market-making outside of the retail bank but not exclude them from the banking organization as a whole. We therefore still face a situation in which US rules prohibit banks from conducting particular activities while UK and EU rules would instead ring-fence particular activities from retail banks. For international banking groups, these differing approaches have the potential to result in certain activities neither being prohibited under the Volcker Rule nor permitted within an EU deposit-taking institution, and hence for multiple layers of subsidiarisation.

We continue to analyze the more detailed implications and practical ramifications for our clients and will be providing updates shortly.

NOTE: The text of the Volcker Rule and explanatory memoranda are available at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm. You may wish to review our December 9 client note "Ready for the Volcker Rule? What to Look For," available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/12/ReadyfortheVolckerRuleWhattoLookForFIAFR120813.pdf, and our December 10 note providing a comparison version of the final Rule against the proposal of October 2011, available at http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/12/TheVolckerRuleAComparisonFIAFR121013.pdf

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