

## E-ALERT | Financial Institutions

March 19, 2010

### SENATE FINANCIAL REFORM LEGISLATION ADDRESSES PROPRIETARY TRADING

On March 15, 2010, Senate Banking Committee Chairman Christopher Dodd (D-CT) unveiled comprehensive financial regulatory reform legislation (“Reform Legislation”) that includes new limits on proprietary trading that are based on proposals first advanced by Former Chairman of the Federal Reserve Paul Volcker and that also are the focus of separate legislation recently introduced by Senators Jeff Merkley (D-OR) and Carl Levin (D-MI).<sup>1</sup>

The Reform Legislation addresses proprietary trading in two contexts. First, the Federal Reserve is given authority, upon the affirmative vote of at least two-thirds of the members of the Financial Stability Oversight Council (“FSOC”),<sup>2</sup> to prohibit bank holding companies and nonbank financial companies from engaging in a broad range of activities that could include proprietary trading. Second, and separately, the federal banking agencies are required through joint rulemaking, and subject to FSOC recommendations and modifications, to prohibit banking entities from engaging in proprietary trading. These statutory provisions are described in greater detail below. In general, the Reform Legislation does not affect hedge funds’ or private equity funds’ own proprietary trading activities.

- *Federal Reserve Authority to Prohibit Individual Companies from Proprietary Trading*
  - The Reform Legislation gives the Federal Reserve authority to require the “terminat[ion of] one or more activities” (a) by a bank holding company with total consolidated assets of \$50 billion or more and (b) also by a nonbank financial company supervised by the Federal Reserve<sup>3</sup> if the Federal Reserve determines that such company “poses a grave threat to the financial stability of the United States.”<sup>4</sup> Under this authority, the Federal Reserve Board

---

<sup>1</sup> For further information on the proprietary trading legislation introduced by Senators Merkley and Levin, please see our prior e-alert [Senators Merkley and Levin Introduce Proprietary Trading Legislation](#) (March 12, 2010).

<sup>2</sup> The Reform Legislation establishes the FSOC to identify risks to U.S. financial stability posed by systemically important financial firms, to promote market discipline by eliminating the expectation that the U.S. government will shield such firms from losses in the event of failure, and to respond to emerging threats to the stability of the United States financial markets. The FSOC’s voting members are the Secretary of the Treasury as chairman, Chairman of the Federal Reserve Board of Governors, Comptroller of the Currency, Director of the Bureau of Consumer Financial Protection (to be created by the Reform Legislation), Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, and a Presidentially-appointed member having insurance expertise.

<sup>3</sup> The Reform Legislation authorizes the FSOC to subject nonbank financial companies – i.e., companies that are substantially engaged in activities that are “financial in nature” (as defined in section 4(k) of the Bank Holding Company Act) and that are neither bank holding companies or bank holding company subsidiaries – to regulation and supervision by the Federal Reserve based on the factors set forth in footnote 4, *infra*.

<sup>4</sup> The Federal Reserve, in determining whether a company poses a grave threat to the financial stability of the United States, is directed to take into consideration the following factors: (A) the degree of leverage of the company; (B) the amount and nature of the financial assets of the company; (C) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; (D) the extent and type of the

could prohibit such a bank holding or nonbank financial company from engaging in proprietary trading.

- For such a prohibition to be effective, the FSOC must approve the Federal Reserve's action by a two-thirds vote of the FSOC's members. Thereafter, the Federal Reserve must provide the subject company written notice that such company is being considered for "mitigatory action." The company may request, in writing, an opportunity for a written or oral hearing before the Federal Reserve to contest the mitigatory action. Following the hearing, the Federal Reserve is required to render a final decision taking into consideration the factors listed in footnote 4.
- *Federal Banking Agency Authority to Prohibit Proprietary Trading and Sponsoring or Investing in Hedge Funds/Private Equity Funds*

### **Proprietary Trading**

- The Reform Legislation separately provides that the federal banking agencies, subject to the recommendations and modifications contained in an FSOC study (discussed below), shall "jointly prohibit proprietary trading by an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act, and any subsidiary of such institution or company."
- For this purpose, the legislation defines "proprietary trading" to mean "purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments by an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, and any subsidiary of such institution or company, for the trading book of such institution, company, or subsidiary."
- The Reform Legislation specifies that proprietary trading does not include purchasing or selling, or otherwise acquiring and disposing of these financial instruments on behalf of a customer, as part of a market making activity, or otherwise in connection with or in facilitation of customer relationships, including hedging activities related to such a purchase, sale, acquisition, or disposal.
- The Reform Legislation also expressly states that the prohibition on proprietary trading does not apply to an investment that is otherwise authorized by federal law in "obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States; obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities; and obligations of any State or any political subdivision of a State." Further, the prohibition does not apply to foreign companies the greater part of whose business is conducted outside of the United States or to companies that do no business in the United

---

off-balance sheet exposures of the company; (E) the extent and type of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (F) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (G) the recommendation, if any, of a member of the Council; (H) the operation of, or ownership interest in, any clearing, settlement, or payment business of the company; (I) the extent to which — (i) assets are managed rather than owned by the company; and (ii) ownership of assets under management is diffuse; and (J) any other factors that the Council deems appropriate.

States except as an incident to their international or foreign business (so long as the company is not controlled directly or indirectly by a U.S. person).

### **Sponsoring or Investing in Hedge Funds/Private Equity Funds**

- The Reform Legislation additionally provides that the federal banking agencies, subject to the recommendations and modifications contained in an FSOC study (discussed below), shall “jointly prohibit an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, or any subsidiary of such institution or company, from sponsoring or investment in a hedge fund or a private equity fund.”
- The Legislation treats as a “hedge fund” or a “private equity fund” any company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, and also any similar funds as determined by the federal banking agencies. Additionally, “sponsoring” is defined to encompass (1) serving as a general partner, managing member, or trustee of a fund, (2) in any manner selecting or controlling (or having employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a fund, or (3) sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.
- The Legislation’s prohibition on sponsoring or investing in a hedge fund or private equity fund also does not apply to foreign companies the greater part of whose business is conducted outside of the United States or by companies that do no business in the United States except as an incident to their international or foreign business (so long as the company is not controlled directly or indirectly by a U.S. person). Further, the prohibition does not apply to investments otherwise authorized under federal law in a small business investment company (as defined in section 103 of the Small Business Investment Act of 1958), or an investment designed primarily to promote the public welfare (as provided in 12 U.S.C. § 24(11)).
- Where an insured depository institution, a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, and any subsidiary of such institution or company serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund, such institution, company or subsidiary is prohibited from entering enter into a “covered transaction,” as such term is defined in section 23A of the Federal Reserve Act,<sup>5</sup> with such fund, and also from providing “custody, securities lending, or other prime brokerage services” to such fund. Moreover, transactions between such banking entities and their managed or advised funds are required to be on arms’ length market terms, consistent with the requirements of section 23B of the Federal Reserve Act.

### **Certain Nonbank Financial Companies**

- In the case of nonbank financial companies that the FSOC has designated for prudential regulation by the Federal Reserve, the Reform Legislation directs the Federal Reserve,

---

<sup>5</sup> Under section 23A of the Federal Reserve Act, the term “covered transaction” with respect to a fund would encompass (A) a loan or extension of credit to the fund; (B) a purchase of or an investment in securities issued by the fund; (C) a purchase of assets, including assets subject to an agreement to repurchase, from the fund (except the purchase of real and personal property as may be specifically exempted by the Board by order or regulation); (D) the acceptance of securities issued by the fund as collateral security for a loan or extension of credit to any person or company; and (E) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the fund.

subject to the recommendations and modifications contained in an FSOC study (discussed below), to adopt rules imposing additional capital requirements and specifying additional quantitative limits for such nonbank financial companies to the extent that they engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.

- The Legislation specifically states that these Federal Reserve rules shall not apply to the trading of an investment that is otherwise authorized by federal law in “obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States; obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities; and obligations of any State or any political subdivision of a State.” Such rules also are not to apply to the trading of an investment otherwise authorized under federal law in a small business investment company (as defined in section 103 of the Small Business Investment Act of 1958) or an investment designed primarily to promote the public welfare (as provided in 12 U.S.C. § 24(11)).

### FSOC Study

- As indicated, the Reform Legislation requires that, within six months after enactment, the FSOC conduct a study of the Legislation’s treatment of banking entities’ proprietary trading and investments in hedge funds and private equity funds, including the applicable definitions, to assess the extent to which such treatment would promote safety and soundness, protect taxpayers and enhance financial stability, limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities to unregulated entities, reduce inappropriate conflicts of interest, raise the cost of credit or other financial services, and limit activities that have previously caused undue risk or loss in depository institutions. The FSOC study also is to include recommendations regarding the treatment of proprietary trading and investments in hedge funds and private equity funds, including “any modifications” to the Legislation’s definitions, prohibitions, requirements, and limitations that the FSOC “determines would more effectively implement the purposes” of the Legislation with respect to such trading and investments.
- The regulations that the federal banking agencies are required to issue in order to implement the Legislation’s various definitions, prohibitions and requirements “shall reflect any recommendations or modifications” made by the FSOC in its study. The banking agencies are required to issue their final regulations no later than nine months after the issuance of the FSOC’s report. To the extent that the banking agencies’ final regulations prohibit certain forms of proprietary trading or investments in hedge funds or private equity funds, banking entities generally are required to comply with the prohibitions within two years after the regulations are issued (subject to up to three one-year extensions for individual banking institutions by their federal banking regulator).

\* \* \* \* \*

Attorneys in Covington's Financial Institutions Group advise a range of clients on recent financial services and banking developments. The Financial Institutions Group's expertise derives from advising clients on the impact of such developments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

<b>Stuart Stock</b>	202.662.5384	<a href="mailto:sstock@cov.com">sstock@cov.com</a>
<b>D. Jean Veta</b>	202.662.5294	<a href="mailto:jveta@cov.com">jveta@cov.com</a>
<b>Mark Plotkin</b>	202.662.5656	<a href="mailto:mplotkin@cov.com">mplotkin@cov.com</a>
<b>Keith Noreika</b>	202.662.5497	<a href="mailto:knoreika@cov.com">knoreika@cov.com</a>
<b>David Martin</b>	202.662.5128	<a href="mailto:dmartin@cov.com">dmartin@cov.com</a>
<b>Tim Clark</b>	212.841.1089	<a href="mailto:tclark@cov.com">tclark@cov.com</a>
<b>David Engvall</b>	202.662.5307	<a href="mailto:dengvall@cov.com">dengvall@cov.com</a>
<b>Michael Nonaka</b>	202.662.5727	<a href="mailto:mnonaka@cov.com">mnonaka@cov.com</a>

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to [unsubscribe@cov.com](mailto:unsubscribe@cov.com) if you do not wish to receive future emails or electronic alerts.

© 2010 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.