VOLCKER RULE STUDY BY THE FINANCIAL STABILITY OVERSIGHT COUNCIL

On January 18, 2011, the Financial Stability Oversight Council (the “FSOC”) issued its study of the Volcker Rule (the “FSOC Study”). The Volcker Rule, which is contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, amends the Bank Holding Company Act of 1956 to prohibit banking entities from engaging in proprietary trading and from sponsoring or investing in private equity or hedge funds, subject to certain exceptions for permitted activities.

Although Section 619 sets forth the parameters of the Volcker Rule, it left much to the rule-making process. The FSOC Study is the first significant step in that process and contains the FSOC’s recommendations with respect to the Volcker Rule’s implementation. The applicable regulators – namely, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the “Agencies”) – now have nine months from the date of the FSOC Study to adopt final rules and regulations. The Agencies are required to consider the FSOC’s recommendations in developing and adopting those rules and regulations. As a result, the FSOC Study provides important insights into what can be expected once the Volcker Rule is implemented.

The following summarizes the FSOC Study’s recommendations with respect to the Volcker Rule’s prohibition on proprietary trading and sponsoring and investing in private equity and hedge funds. The FSOC Study also includes recommendations with respect to the treatment of insurance companies under the Volcker Rule, which is outside the scope of this alert.

PROHIBITION ON PROPRIETARY TRADING

Overview

A principal focus of the FSOC Study is on providing the Agencies with guidance on how to distinguish between prohibited proprietary trading and the activities that are expressly excepted from the prohibition, particularly market-making, underwriting and risk-mitigating hedging. The FSOC acknowledges that these permitted activities play an important role in market function but is also concerned that prohibited trading could occur in the guise of these permitted activities.

The FSOC does not view the existing risk management, compliance and supervisory framework to be adequate for purposes of the Volcker Rule. As a result, the FSOC Study lays out its guidance for a comprehensive and wide-reaching compliance and supervisory regime. The FSOC Study contemplates the development of internal compliance programs by banking entities, analysis and reporting of quantitative metrics and extensive supervisory review and oversight by the Agencies, including periodic review and testing of internal controls. This regime contemplates involvement and
accountability by the Boards of Directors and CEOs of banking entities, including public attestation by CEOs that compliance standards are being met.

**Governing Principles**

The FSOC Study recommends that the Agencies focus on the following five principles in implementing the Volcker Rule’s ban on proprietary trading:

- **Prohibit Proprietary Trading.** The mandate of the Volcker Rule is clear – banking entities can no longer engage in impermissible proprietary trading. The regulatory and supervisory framework needs to give force to that mandate using all necessary tools and methods to monitor and enforce compliance.

- **Be Dynamic and Flexible.** The regulatory and supervisory framework should be sufficiently dynamic and flexible that it can be applied to new products and business practices.

- **Provide Consistency.** The regulatory and supervisory framework should be applied consistently across similar banking entities and their affiliates.

- **Distinguish Between Prohibited and Permitted Activities.** The regulatory and supervisory framework should provide banking entities with clarity about criteria for identifying impermissible proprietary trading activity. It should also facilitate predictable evaluations of outcomes so that the Agencies and banking entities can distinguish between prohibited and permitted activities.

- **Accommodate Differences in Asset Classes, Trading Desks and Markets.** The regulatory and supervisory framework should account for differences among asset classes, trading desks and markets, as necessary.

**Definition of Trading Account**

Under the Volcker Rule, a banking entity engages in proprietary trading when it acts as a principal for the “trading account” of the banking entity in transactions to purchase or sell, or otherwise acquire or dispose of, certain enumerated financial instruments. “Trading account” is defined to mean any account used for acquiring or taking positions in such financial instruments “principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements),” The Volcker Rule does not define “near term” or “short term.” The FSOC Study does not provide specific guidance with respect to how the Agencies should define “near term” and “short term” but provides the following recommendations to the Agencies:

- The liquidity of a financial instrument may influence what it means to trade in the “near term” or to take advantage of “short-term price movements.”

- Proprietary trading can occur in short, mid, and long-term financial instruments, with no little or no immediate liquidity.

- “Trading account” could be defined by reference to (i) FASB accounting standards for determining whether positions are “held for trading” or (ii) the definition of “covered positions” that are subject to federal banking agencies’ market risk capital rules.
Distinguishing Proprietary Trading and Permitted Activities

In its study, the FSOC focuses on the difficulty in distinguishing between prohibited and permitted activities. The FSOC expects “bright line” proprietary trading – i.e., trading conducted by traditional walled-off proprietary trading desks – to be easy to identify and eliminate. However, the FSOC Study is very concerned with the risk that impermissible proprietary trading could “migrate” into permitted trading activities because prohibited and permitted activities often share similar characteristics. Banking entities assume principal risk and hold financial instruments not only when they are engaged in proprietary trading but also during the normal course of certain permitted activities, such as underwriting, market making and hedging.

In order to assist Agencies in distinguishing between prohibited and permitted activities, the FSOC Study identifies indicia of “bright line” proprietary trading and of the permitted activities that are most likely to be confused with proprietary trading, namely market making, hedging and underwriting.

Bright Line Proprietary Trading

The FSOC Study notes that there is clear consensus that certain types of trading activity clearly constitute proprietary trading that is prohibited by the Volcker Rule. A requisite element of proprietary trading is that it involves the use of the banking entity’s capital and is organized and conducted to benefit from future price movements. “Bright line” proprietary trading also typically has one or more of the following characteristics:

- sole purpose of the trading activity is to generate profits from trading strategies
- no formal market making responsibility or customer exposure (or has customer exposure that is not commensurate with the level of trading in which it is engaged)
- the trading activity is physically or operationally separate from market making and other operations with customer contact
- trades are done with, or traders are provided the services of, sell-side analysts, brokers and dealers
- traders receive and use research or soft dollar credits provided by other broker-dealers
- compensation structures are similar to those of hedge fund managers and other managers of private pools of capital

Market Making

The Volcker Rule explicitly excepts market making-related activities from the prohibition on proprietary trading, so long as those activities are “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” The FSOC Study acknowledges that the size and amount of risk involved in market making can vary widely depending on the market. For
instance, market makers for less liquid markets are more likely to use a principal transaction model, in which the market maker commits capital to complete transactions, rather than an agency or riskless transaction model, in which the market maker assumes very little risk. Accordingly, in setting forth the indicia of permitted market making, the FSOC distinguishes between liquid and less liquid markets.

**Liquid Markets.** The FSOC Study identifies the following indicia of permitted market making in the context of liquid markets:

- the indicia of bona fide marketing making in equity markets identified by the SEC in its 2008 release on short-selling, specifically:
  - making continuous two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis
  - making a comparable pattern of purchases and sales of a financial instrument in a manner that provides liquidity
  - making continuous quotations that are at or near the market on both sides
  - providing widely accessible and broadly disseminated quotes

- posting quotes at a price at or above the national best bid and providing liquidity on the opposite side of the market (but not posting continually at or near the best offer, which evidences a consumption of liquidity)

**Illiquid Markets.** For less liquid markets, such as debt, derivatives or asset-backed security markets, the FSOC Study identifies the following indicia of permitted market making:

- purchasing or selling the financial instrument from or to investors in the secondary market
- holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction)
- transaction volumes and risk proportionate to historical customer liquidity and investment needs
- not accumulating positions that remain open and exposed to gains or losses for a period of time – i.e., positions are instead promptly closed out or hedged to the extent possible

**Hedging**

The Volcker Rule permits banking entities to engage in hedging, so long as it’s “risk-mitigating.” In order to be risk-mitigating, the FSOC Study takes the view that: (i) the hedge must be tied to specific risk exposure, and (ii) there must be a documented correlation between the hedge and the exposure it is meant to hedge, with a reasonable level of hedge effectiveness at the time the hedge is put in

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place. The FSOC Study identifies the following characteristics as being indicative of permitted risk-mitigating hedging activity:

- hedge is designed to reduce the key risk factors in the banking entity's existing exposure and offsets gains or losses that arise from those exposures
- hedge adjusts over time based on changes in underlying exposures
- hedge adjusts over time if market conditions alter the effectiveness of the hedge even if the hedged position(s) remain unchanged
- hedge adjusts to material changes in risk and are consistent with trading desk's hedging policy

The FSOC Study acknowledges that hedging is often done on a portfolio basis, which can be difficult to tie to specific exposure or risk. As a result, in evaluating the activities of a banking entity, the Agencies should consider:

- the nature of the risks being hedged by the banking entity
- the extent to which banks measure, monitor and control risks at a portfolio level
- the extent to which portfolio hedging is part of an entity's formal hedging strategy
- whether traders are compensated based on earnings generated by portfolio hedging activity (which would presumably indicate impermissible proprietary trading)
- the overall efficacy of portfolio hedging activities in reducing risk throughout the banking entity
- the methods available to the Agencies to ensure and determine which desk-specific positions are being hedged on an aggregate basis

The FSOC observes that banking entities often do not hedge their positions fully or consistently. In some cases, that’s because it’s not possible or cost-effective to enter into a complete hedge. In other cases, the banking entity may be making a “proactive choice” to retain risk and take on a proprietary position.

Underwriting

The Volcker Rule explicitly excepts underwriting from the prohibition on proprietary trading, so long as it is “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” The FSOC Study identifies the following as being indicantive of underwriting activity:

- assisting an issuer in capital raising
- performing due diligence
advising the issuer on market conditions and assisting in preparation of registration statement

purchasing securities from an issuer for resale to the public

participating in or organizing a syndicate of investment banks

transaction to provide a post-issuance secondary market to facilitate price discovery

The FSOC Study observes that if an issuance is oversubscribed, an underwriter may need to sell the security short in order to provide more liquidity. If an issuance is undersubscribed, the underwriter will hold more of the security on its books. Either activity is appropriate if the banking entity is indeed acting as an underwriter.

Four-Part Supervisory Framework

The FSOC Study recognizes that implementing the Volcker Rule’s prohibition on proprietary trading is not “readily achievable using the existing risk and compliance frameworks.” The FSOC Study recommends that the Agencies use the following set of regulatory tools to implement the Volcker Rule.

Programmatic Compliance Regime

The FSOC recommends that the Agencies require banking entities to develop and integrate into their existing compliance regimes a new specifically-tailored program of policies, procedures and other controls designed (i) to ensure proprietary trading does not migrate into permitted activities, and (ii) to facilitate supervision by the Agencies. In particular, the Agencies should consider requiring the following:

- **Robust Internal Policies and Procedures.** Banking entities should have new internal policies and procedures that are designed to guide trading activities in order to ensure that only permitted activities are conducted. These policies and procedures, which should be subject to review by the Agencies, should establish specific internal review and escalation procedures for violations of limits and controls. The FSOC also recommends that the Agencies consider requiring banking entities to produce and maintain a comprehensive description of the mission and strategy for all trading activity conducted by the banking entity, down to the business and trading desk level. This mission and strategy statement could be required to include, among other things:
  - the trading unit’s mandate, including a description of the activities in which it is engaged, the types of customers it serves and how revenues are generated and positions are hedged
  - a list of the financial products approved for transactions
  - a description of the compensation policy for those engaged in risk-taking activities
  - the types and levels of risk necessary to execute the articulated mission of the trading unit, including a rationale for why the unit’s risk types and levels are appropriate and necessary in light of the Volcker Rule
Internal Quantitative and Other Controls. The FSOC recommends that banking entities be required to establish internal quantitative and other controls that monitor trading activity in order to ensure that the types and levels of risk taken are appropriate and consistent with the Volcker Rule. These controls could require banking entities to establish:

- authorized risks, instruments and products to ensure trading activity remains consistent with approved policies and procedures
- revenue-tracking mechanisms to discern the nature of trading activities and the key drivers of profitability and loss (which could track (i) the nature of customer income (e.g., commissions, fees, bid/offer spread and inception booking profit & loss), (ii) risk income or income associated with changes in market variables, or (iii) volatility of daily revenue, including of customer and risk income)
- risk limits to ensure that risk-taking is appropriately constrained to prevent prohibited proprietary trading to occur (which could involve the use of “Value at Risk” models, portfolio stress testing or P&L sensitivities associated with changes in market price)
- stop-loss limits to trigger reviews and cessation of trading activity when warranted

Recordkeeping and Reporting Systems. The FSOC recommends that the Agencies consider requiring banking entities to establish recordkeeping and reporting systems that facilitate internal and external monitoring, including:

- reports analyzing data showing trends in trading activity
- reports analyzing revenue drivers over time
- systems that maintain trade-level data to facilitate internal and external review

Independent Testing. Another element of the FSOC’s recommended programmatic compliance regime involves an independent testing requirement, which could have the following characteristics:

- testing conducted by the banking entity’s internal audit department or by outside qualified third parties (e.g., auditors or consultants)
- frequency and nature of testing should vary depending on factors such as the banking entity’s size and risk profile
- testing requirements could be similar to those imposed on banking entities by Bank Secrecy Act/Anti-Money Laundering regulations
- testing could conclude include an evaluation of overall effectiveness of the banking entity’s compliance regime, as well as compliance with specific aspects of the Volcker Rule

CEO and Board Accountability. An important element of the FSOC’s recommendations include its strong recommendation that Agencies impose obligations on the Board of Directors and CEO of banking entities “to ensure they are effectively engaged in and accountable for compliance with” the Volcker Rule’s prohibition on proprietary trading.

The FSOC contemplates making the Board responsible for:

- approving the compliance program
- overseeing the structure and management of the compliance program
setting an appropriate culture of compliance
- ensuring compliance policies are followed

The CEO could be made responsible for:

- communicating and reinforcing the compliance culture established by the Board
- implementing the compliance program
- escalating compliance matters as appropriate
- reporting to the Board and the banking entity’s supervisors on effectiveness of compliance program
- attesting publicly to the ongoing effectiveness of the compliance program

Analysis and Reporting of Quantitative Metrics

Purpose and Use of Metrics. The FSOC recommends that the Agencies “strongly” consider requiring banking entities to report quantitative metrics to the Agencies. These metrics would be designed to:

- highlight trends and incidents that suggest violations of the prohibition on proprietary trading has occurred
- facilitate comparisons across banking entities, market segments and trading strategies.

The FSOC Study acknowledges that quantitative metrics have certain limitations and can produce both “false negatives” and “false positives.” The FSOC also notes that the usefulness of any particular metric may vary significantly “depending on the asset class, liquidity, trading strategy and market profile of the trading activity in question.” As a result, the FSOC recommends that the Agencies use any metric they develop to identify “potentially problematic trading activities that may require further study, rather than [as] a comprehensive, dispositive tool.”

Recommended Metrics. The FSOC identifies the following four categories of metrics as being promising for purposes of developing the supervisory framework for the Volcker Rule:

- Revenue-based Metrics. This type of metric attempts to measure revenue from specific activities relative to historical data. Impermissible proprietary trading revenue is generated principally from price movements, while revenues from permitted activities are generally derived from other sources. Day one profit & loss metrics and bid-offer pay-to-receive ratios are examples of revenue-based metrics.

- Revenue-to-Risk Metrics. This type of metric attempts to measure revenue generated per unit of risk assumed. Market makers and underwriters typically attempt to mitigate risk by quickly closing out or hedging positions; proprietary traders, on the other hand, seek to assume risk.

- Inventory Metrics. This type of metric takes into account for market makers to hold inventory but attempts to connect it to observed customer demand. The FSOC recommends that inventory metrics be calibrated by asset class, since market makers in less liquid markets will necessarily hold inventory for longer periods of time.
Customer-flow Metrics. This type of metric evaluates the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for the purpose of building inventory or hedging. Trader-initiated and customer-initiated trade volume should generally be closely correlated.

Market Making “Profiles”. The FSOC recommends that the Agencies consider using the metrics described above to develop a standard quantitative profile of market making for each specific asset class or trading desk, using historical and cross-industry information and comparisons to standalone proprietary trading operations. This would be a significant undertaking on the part of the Agencies and the FSOC suggests that the Office of Financial Research could provide assistance.

Supervisory Review and Oversight

The FSOC describes supervisory review as “the lynchpin” in effective implementation of the Volcker Rule’s prohibition on proprietary trading. The FSOC acknowledges that this will require substantial resources and expertise on the part of the Agencies, some of which are resource constrained. Nonetheless, the FSOC recommends that the Agencies consider the following supervisory elements:

- conducting periodic reviews and testing of internal controls and procedures, including establishing a set of standards upon which banking entities will be evaluated
- monitoring and reviewing trading operations on a regular basis, including through the regular review of trading data (including data used by banking entities internally) and, in the case of complex trading operations, monitoring trading activity on a daily basis
- actively engaging trading, management and control personnel in order to understand trading behavior
- reviewing quantitative metrics to identify red flags

Enforcement Procedures for Violations

The Volcker Rule itself requires that violating activity be terminated and the investment limited after notice and opportunity for a hearing. The FSOC recommends that the Agencies consider other consequences to impermissible activities, such as:

- increased oversight
- reductions in risk limits
- increased capital charges
- monetary penalties

Application of Volcker Rule to Other Permitted Activities

As is apparent from the foregoing discussion, the FSOC Study focuses primarily on permitted activities that are likely to be difficult to distinguish from prohibited proprietary trading – namely, market making, underwriting and hedging. It discusses other permitted trading activities very briefly but leaves the substance to the Agencies.
Blanket Limitations

The Volcker Rule provides that an activity that would normally qualify as a “permitted activity” under the Volcker Rule will cease to be permitted if the activity:

- would involve or result in a material conflict of interest (as defined by the applicable regulators) between the banking entity and its clients, customers, or counterparties
- would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms are defined by the applicable regulators)
- would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States

The FSOC Study discusses these provisions but does not provide much insight, except with respect to the third bullet. The FSOC Study identifies the following as indicative characteristics of a “high risk asset” or “high-risk trading strategy”:

- the introduction of new products with rapid growth
- assets or strategies that include embedded leverage
- historical volatility of the asset or strategy
- total Value at Risk of the asset or strategy
- assets whose values cannot be externally priced or whose exposure cannot be quantified
- assets whose risk cannot be adequately mitigated by effective hedging
- the application of capital and liquidity standards would not adequately account for the risk of the asset

Prohibition on Sponsoring and Investing in Private Equity and Hedge Funds

Overview

The FSOC focuses on two key issues for implementation of the Volcker Rule’s prohibition on sponsoring and investing in private equity and hedge funds:

- the scope of the definition of “private equity” and “hedge fund”
- the exception permitting banking entities to organize and offer private equity and hedge funds to customers of their investment advisory business
Governing Principles

The FSOC Study recommends that the Agencies focus on the following three principles in implementing the Volcker Rule’s prohibition on sponsoring and investing in private equity and hedge funds:

- Significant limits should be placed on the ability of banking entities to invest in hedge funds and private equity funds in order to reduce the risks banking entities face.

- A banking entity is permitted to organize and offer, or invest in, a hedge fund or private equity fund in connection with the provision of bona fide trust, fiduciary or investment advisory services to its customers.

- Relationships between banking entities and the hedge funds and private equity funds they organize and offer should not allow those funds to be used to circumvent the prohibition on proprietary trading.

Definition of Private Equity and Hedge Fund

The Volcker Rule defines “private equity fund” and “hedge fund” as any “issuer that would be an investment company . . . but for sections 3(c)(1) or 3(c)(7)” of the Investment Company Act or “such similar funds” as the Agencies shall determine. The FSOC Study views the definition of “private equity fund” and “hedge fund” as potentially both too broad and too narrow.

Too Broad. The FSOC recognizes that a wide variety of funds and other legal entities could be inappropriately captured and points specifically identifies venture capital funds, special purpose investment vehicles, and certain ERISA qualified pension funds. The FSOC recommends that the Agencies consider carefully the range of funds and other investment vehicles that rely on the exclusions contained in sections 3(c)(1) or 3(c)(7) and consider whether they should be excluded from the scope of the Volcker Rule.

Too Narrow. The FSOC observes in the FSOC Study that not every fund or investment vehicle that shares the characteristics of a traditional private equity fund or hedge fund relies on the exclusions contained in sections 3(c)(1) and 3(c)(7) of the Investment Company Act. The FSOC recommends that the Agencies consider whether to expand the definition to capture funds that do not rely on such exclusions but that resemble private equity and hedge funds, with a focus on the following investment activities and other characteristics:

- Does the fund earn an allocation based on fund performance including both realized and unrealized gains?

- What trading or investment strategy does the fund use?

- Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?

- Is the fund’s capital received from a broad group of unaffiliated investors?
Permitted Hedge Funds and Private Equity Funds

Under the Volcker Rule, a banking entity is permitted to organize and offer, and invest in, a hedge fund or private equity fund if “the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity.” The FSOC Study makes the following recommendations with respect to the implementation of this exception.

Definition of Customer

The Volcker Rule does not define the term “customers,” although the statutory language suggests that the customer’s relationship must be with a banking entity’s bona fide trust, fiduciary, or investment advisory business. The FSOC Study recommends that the Agencies develop regulations to clarify the meaning of customer, taking the following into account:

- Continuing Relationship Versus Knowledge of Financial Needs
  - a continuing relationship in which the banking entity provides financial products or services prior to the time of the offering
  - a previous relationship that provided the banking entity with sufficient knowledge of the customer’s financial needs, risk tolerance and qualifications

- Direct Versus Indirect Customer Relationships
  - a direct and substantive relationship between the banking entity and a prospective customer
  - a relationship between the banking entity and the customer’s agent or advisor or investment vehicle

- Relationship Initiated by the Potential Customer Versus by the Banking Entity
  - a relationship initiated by the potential customer or its agent to inquire about a product or service
  - a relationship initiated by the banking entity offering a product or service

The FSOC Study observes that, in addition to “customers”, the Volcker Rule refers to “clients,” which is also undefined. The FSOC observes that, under the federal securities laws, a client is different from a customer. The FSOC recommends that the Agencies consider this during the rule-making process.

Feeder Funds

The FSOC acknowledges that the Volcker Rule permits banking entities, in the context of their advisory businesses, to provide customers with access to third-party private equity or hedge funds by organizing and offering feeder funds that make investments in those third-party funds. The banking entity’s capital is typically not at risk in these structures but conflicts of interest may arise where the banking entity has other business relationships with the third-party fund. In determining the appropriateness of such relationships, the FSOC recommends that the Agencies consider:

- Whether the banking entity’s business relationships with the third-party fund should be subject to the Volcker Rule’s prohibition of covered transactions (e.g., making loans, purchasing assets, extending guarantees) as well as to the section 23B of the Federal Reserve Act arm’s length transactions requirements; and
The extent to which such arrangements could create the opportunity and incentive (i) for banking entities to protect hedge funds and private equity funds from losses, or (ii) for those funds to expose the banking entity to outsized risk, either of which would frustrate the purposes of the Volcker Rule.

Three-Percent and De Minimis Limit

Under the Volcker Rule, a banking entity is permitted to take or retain a 3% or lower de minimis investment in a hedge fund or private entity fund that the banking entity organizes and offers. The amount of any de minimis investment must be “immaterial” to the banking entity. The banking entity may initially provide up to 100% of the seed capital of the fund but after one year the banking entity may hold no more than a 3% interest in the fund. In addition, in no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3% of its Tier 1 capital. The Volcker Rule also requires the Agencies to deduct the amount of these investments from the banking entity’s capital.

In order to ensure that these permitted investments do not place banking entities at undue risk or provide loopholes for proprietary trading or other prohibited transactions, the FSOC Study recommends that the Agencies consider rules that avoid understating risk by defining “investment” in a way that best captures the banking entity’s true risk exposure. Factors to consider in this respect include:

- whether the amount invested or the amount committed should be counted in the 3% limit
- the treatment of carried interest for purposes of the de minimis calculation, including whether carried interest that remains in the fund, at the election of the party to whom it is allocated, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned
- protecting against synthetic ownership exposure that expose the banking entity to the risks and benefits of ownership that is otherwise prohibited
- whether investments by employees or directors engaged in providing services to the fund, together with other investors affiliated with the banking entity, should be included in the 3% limit

The Agencies should also consider whether the 3% de minimis calculation should be a one-time calculation at the one-year mark, or if it should reflect changes in the investor base of the fund over time. If the latter, and the changes result in a change in ownership share above 3%, Agencies should consider in what period of time banking entities should be required to sell down their interests.

Definition of Banking Entity

The Volcker Rule defines “banking entity” to include affiliates and subsidiaries of a banking entity. The FSOC observes that the Bank Holding Company Act defines “affiliate” and “subsidiary” to include any company that a banking entity controls. “Control” is, in turn, defined to include (i) ownership or control 25% or more of the outstanding shares of the voting securities of a company, directly or indirectly through one or more persons, (ii) control in any manner over the election of a majority of the company’s directors or other similar individuals, and (iii) the power to exercise, directly or indirectly, a controlling influence over the managing or policies of a company. As a result, the definition captures advised funds of a banking entity and subjects them to the Volcker Rule’s prohibitions and restrictions, even though advised funds are expressly permitted.
The FSOC observes that unless permitted advised hedge funds and private equity funds are excluded from the definition of “banking entity,” the following would result:

- a banking entity could not operate a fund of funds business where the fund of funds invests in third-party funds
- hedge funds and private equity funds that are controlled by a banking entity would not be permitted to make investments in other funds
- each fund in a family of controlled funds would be treated as a banking entity and an affiliate of each other, which would require each fund to have a unique name
- companies (i.e., even non-financial companies) controlled by a hedge fund or private equity fund that is controlled by a banking entity would themselves become banking entities subject to the restrictions of the Volcker Rule
- SEC-registered investment companies that are controlled by a banking entity would be subject to the Volcker Rule

The FSOC Study recommends that the Agencies implement the definition of “banking entity” in a way that avoids these results.

**Programmatic Compliance**

The FSOC recommends that the Agencies establish a programmatic compliance regime with respect to the Volcker Rule’s prohibition on sponsoring or investing in private equity or hedge funds that includes the following elements:

- **Investment and Risk Oversight**
  - The banking entity’s Board of Directors should approve the objectives, strategies, and policies governing permissible investments in hedge funds and private equity funds, including the necessary relationship for providing customer-focused advisory services, the type and nature of the investments, and other elements of sound investment management oversight.
  - The banking entity should actively monitor the performance and risk profile of private equity and hedge fund investments in light of the established objectives, strategies, policies, and procedures.
  - The banking entity’s policies and procedures should identify the aggregate exposure that the institution is willing and able, in light of the *de minimis* investment limitation, to accept by type and nature of investment. Adherence to such limits should take into consideration unfunded, as well as funded, commitments. Banking entities should have systems in place to ensure that impermissible investments in or transactions with hedge funds and private equity funds are prohibited.
  - A system of internal controls, with appropriate checks and balances and clear audit trails, is critical to the effective conduct of investments in permitted private equity and hedge funds.

- **Management and Public Attestation**
  - Permitted investments in private equity and hedge funds should be subject to active oversight by the banking entity and senior management.
The CEO of the banking entity should be required to attest publicly to the effectiveness of the internal compliance regime.

Transparency

Banking entities should be required to make public disclosure of certain information regarding private equity funds and hedge funds that they are permitted to invest in, organize and offer, or sponsor.

The type of information that the FSOC recommends be disclosed includes (i) the type and amount of investments, (ii) portfolio concentrations, and (iii) returns and their contributions to reported earnings and capital.

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:

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