The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 25634**

November 10, 2011

# Proposed Regulations to Implement the Volcker Rule

[25634]

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TO: SEC RULES MEMBERS No. 133-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 79-11
EQUITY MARKETS ADVISORY COMMITTEE No. 62-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 61-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 56-11
FIXED-INCOME ADVISORY COMMITTEE No. 78-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 48-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 46-11
ETF ADVISORY COMMITTEE No. 69-11
INTERNATIONAL MEMBERS No. 49-11 RE: PROPOSED REGULATIONS TO IMPLEMENT THE VOLCKER RULE

The SEC, Board of Governors of the Federal Reserve System ("FRB"), Office of the Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC") have jointly issued proposed rules to implement Section 619 of the Dodd-Frank Act, *i.e.*, the Volcker Rule. [1] Comments on the proposal are due by January 13, 2012. The most significant aspects of the proposal impacting funds are summarized below. [2]

## Overview of Volcker Rule and Proposal

The Volcker Rule generally contains two prohibitions. First, it prohibits "banking entities" from engaging in proprietary trading of any security, derivative, and certain other financial instruments for its own account, subject to certain exemptions. Second, it prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring or having certain relationships with "covered funds" (*e.g.*, a hedge fund or private equity fund), subject to certain exemptions. [3]

In addition to detailed rules implementing these two broad prohibitions, the proposal contains numerous exemptions to the Rule, as well as several appendices related to recordkeeping and reporting requirements, detailed guidance regarding trading undertaken in connection with market making activities (one of the exempted "permitted activities" discussed below), and enhanced compliance requirements for banking entities with

significant trading or covered fund activities.

The proposal also contains definitions of a number of key terms used in the Rule. Under the proposal, the term "banking entity" is defined broadly as including any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any of the foregoing. Significantly, the Release states that "[a]n entity such as a mutual fund would generally not be a subsidiary or affiliate of a banking entity under this definition if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund (which includes a registered investment company) in accordance with [Bank Holding Company] Act rules."

The Release requests comment on a number of issues relating to the definition of "banking entity," including whether there are any entities that should not be included within the definition since their inclusion would not be consistent with the language or purpose of the Volcker Rule or could otherwise produce unintended results, and specifically whether a registered investment company should be expressly excluded from the definition of banking entity. [4]

## Proprietary Trading Restrictions

The Volcker Rule prohibits a banking entity from engaging in proprietary trading of any security, derivative, and certain other financial instruments for its own account, subject to certain exemptions. [5] In general, proprietary trading includes engaging as principal for the "trading account" of a banking entity in any transaction to purchase or sell certain types of financial positions. The proposed definition of trading account identifies three types of positions that would cause an account to be a trading account. Most significantly, the definition includes positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position. [6] The proposal would adopt a rebuttable presumption that an account is a trading account if it is used to acquire or take a covered financial position that the banking entity holds for a period of 60 days or less. [7]

The definition of trading account also contains clarifying exclusions for certain positions that do not appear to involve the requisite short-term trading intent, such as positions arising under certain repurchase and reverse repurchase arrangements or securities lending transactions, positions acquired or taken for bona fide liquidity management purposes, and certain positions of derivatives clearing organizations or clearing agencies.

## Permitted Trading Activities

Notwithstanding the general prohibition against proprietary trading, the Rule provides that a banking entity may engage in certain "permitted activities." Most significantly, exemptions include those for positions taken in connection with market making activities and trading "on behalf of customers." Exemptions also exist for underwriting activities, risk-mitigating hedging activities, activities conducted solely outside of the United States by certain non-U.S. banking entities, [8] trading in U.S. government securities, [9] and trading by regulated insurance companies. For each of these permitted activities, the proposal provides a number of requirements that must be met in order for a banking entity to rely on the applicable exemption.

Although a banking entity may engage in permitted trading activities, the proposal prohibits a banking entity from relying on any exemption if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

### Market Making Activities

The proposal permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's market making-related activities, subject to a number of complex conditions. [10] The Release recognizes the potential impact of the Rule on market making-related activities and specifically requests comment on how the proposal will impact the capital markets at large, and in particular the liquidity, efficiency and price transparency of capital markets. The Release also requests comment whether there are particular asset classes that raise special concerns in the context of market making-related activity that should be considered in connection with the proposed market-making exemption.

### Trading on Behalf of Customers

The Volcker Rule does not specifically define when a transaction would be conducted "on behalf of customers" but identifies three categories of transactions that would qualify for the exemption. These categories include: (i) transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of a customer where the customer, and not the banking entity, has beneficial ownership of the related positions; (ii) riskless principal transactions; and (iii) transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders, subject to certain conditions.

In the context of the exemption for trading on behalf of customers, the Release states that "[f]or example, in the case of a banking entity acting as investment adviser to a registered mutual fund, any trading by the banking entity in its capacity of investment adviser and on behalf of that fund would be permitted pursuant to [the proposed rule], so long as the relevant criteria were met."

## Covered Fund Activities and Investments

The proposal would generally prohibit a banking entity from investing in, sponsoring, or having certain relationships with, a "covered fund." The Volcker Rule defines the terms "hedge fund" and "private equity fund" to mean "any issuer that would be an investment company, as defined in the [Investment Company Act], but for section 3(c)(1) or 3(c)(7) of that Act." The Release explains that since the Rule defines a "hedge fund" and "private equity fund" synonymously, the proposal combines these terms into the definition of a "covered fund."

Under the proposal, the term "covered fund" also would include "similar funds" that the Federal agencies may by rule determine. At this time, the agencies have proposed to include a commodity pool, as well as the foreign equivalent of any entity identified as a "covered fund," as "similar funds." [11] The Release explains that these entities have been included in the proposed rule as "similar funds" given that they are generally managed and structured similar to a covered fund, except that they are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States.

Recognizing the potential reach of the term “covered fund,” the Release requests comment whether there are any entities that are captured by the proposed rule’s definition, the inclusion of which does not appear to be consistent with the language and purpose of the statute.

## Exemptions from Covered Fund Prohibition

The proposal contains several exemptions from the covered fund prohibition. Most significantly, the proposal permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements.

The proposal also permits a banking entity to use an ownership interest in a covered fund to hedge, but only with respect to individual or aggregated obligations or liabilities of a banking entity that arise from: (i) the banking entity acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the customer’s exposure to the profits and losses of the covered fund; or (ii) a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund. The Rule also permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States.

As with the proprietary trading prohibition, the proposal prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

## Application of Volcker Rule to Securitization Vehicles or Issuers of Asset-Backed Securities

The Release notes that many issuers of asset-backed securities may be included within the definition of covered fund since they would be an investment company but for the exclusions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, or could be included within the definition of a banking entity. Specifically, given the scope of the definition of “affiliate” of a banking entity, the Release notes that the Rule’s requirements may apply to a significant portion of the outstanding securitization market, including issuers of asset-backed securities that rely on Rule 3a-7 or Section 3(c)(5) of the Investment Company Act. In recognition of these concerns, the Release requests comment on the potential effects of the Rule on the securitization industry and issuers of asset-backed securities.

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**endnotes**

[1] Section 619 of the Dodd-Frank Act added a new Section 13 to the Bank Holding Company Act of 1956. The CFTC has not yet issued its proposed rules to implement the Volcker Rule but is expected to do so shortly.

[2] The proposal can be found on the SEC's website at http://www.sec.gov/rules/proposed/2011/34-65545.pdf ("Release").

[3] While the Volcker Rule does not prohibit a nonbank financial company supervised by the FRB from engaging in proprietary trading, or from having the types of ownership interests in or relationships with a covered fund that a banking entity is prohibited or restricted from having under the Rule, the FRB (or other appropriate agency) may impose additional capital charges, quantitative limits, or other restrictions on a nonbank financial company supervised by the FRB or its subsidiaries and affiliates that are engaged in such activities or maintain such relationships.

[4] The Release also requests comment whether there are circumstances in which registered investment companies should be treated as banking entities subject to the Volcker Rule and how many registered investment companies would be covered by the proposed definition.

[5] The proprietary trading ban applies only to "covered financial positions." These include positions (including long, short, synthetic and other positions) in securities, derivatives, commodity futures, and options on such instruments, but do not include positions in loans, spot foreign exchange or spot commodities.

[6] The term "trading account" also includes all positions acquired or taken by certain registered securities and derivatives dealers in connection with their activities that require such registration and, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, all positions in financial instruments subject to the prohibition on proprietary trading that are treated as "covered positions" under those capital rules, other than certain foreign exchange and commodities positions.

[7] The presumption does not apply if the banking entity can demonstrate, based on the facts and circumstances, that the covered financial position was not acquired or taken principally for the purpose of short-term resale, benefiting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.

[8] Under the proposal, trading would be deemed to occur solely outside of the United States only if four criteria are satisfied: the banking entity conducting the purchase or sale is not organized under the laws of the United States (or a state); no party to the purchase or sale is a resident of the United States; no personnel of the banking entity "directly involved" in the purchase or sale are physically located in the United States; and the purchase or sale is executed wholly outside of the United States.

[9] The proposal would permit a banking entity to purchase or sell a covered financial position that is a U.S. government or agency obligation, an obligation, participation, or other instrument of or issued by a government-sponsored enterprise ("GSE") or Federal Home Loan Bank, or an obligation issued by any state or any political subdivision thereof. The Release notes, however, that the government obligations exemption does not extend to transactions in obligations of an agency of any State or political subdivision thereof.

[10] These conditions include, among other things: establishing an internal compliance program; ensuring that the trading desk that makes a market in a covered financial position holds itself out as being willing to buy and sell the covered financial position, for its own account, on a regular or continuous basis; ensuring that market making-related activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; ensuring that market making-related activities generate revenues primarily from fees, commissions, bid/ask spreads, or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or their hedges; and that compensation arrangements for employees performing market making-related activities must be designed not to reward proprietary risk-taking. In addition to these conditions, the proposal contains further information in Appendix B regarding permitted market making-related activities.

[11] Specifically, the proposal would include issuers that are organized or offered outside the United States and that would be investment companies but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act, if the issuer's securities were offered to one or more residents of the United States.

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