The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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FSOC Study and Recommendations on Volcker Rule

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TO: SEC RULES MEMBERS No. 17-11
EQUITY MARKETS ADVISORY COMMITTEE No. 9-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 10-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 4-11
ETF ADVISORY COMMITTEE No. 9-11 RE: FSOC STUDY AND RECOMMENDATIONS ON VOLCKER RULE

The Financial Stability Oversight Council ("FSOC") has issued a study and recommendations ("Study") relating to the "Volcker Rule" contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). [1] The Volcker Rule prohibits "banking entities" from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions. Regulatory agencies are required, not later than nine months after the completion of the study, to adopt regulations to implement the Rule's provisions and must consider the recommendations in the Study in developing and adopting these regulations. [2] The most significant aspects of the Study are summarized below.

I. Proprietary Trading Prohibition

The Volcker Rule's proprietary trading provisions prohibit a banking entity from engaging in trading activity in which it acts as a principal in order to profit from near-term price movements. The Rule, however, provides for certain exceptions to the prohibition, i.e., "permitted activities," for, among other things, market making, hedging, underwriting, and transactions in government securities. The Study outlines criteria for defining prohibited activities as well as tests to identify permitted activities.

A. Principles for Implementing the Prohibition

The Study recommends that regulatory agencies' rulemaking and implementation efforts under the Volcker Rule be guided by five fundamental principles. Specifically, regulations (and associated supervision where applicable) should: (1) clearly prohibit improper proprietary trading activity and provide banking entities with clarity about criteria for designating trading activity as impermissible proprietary trading; (2) be flexible so regulatory agencies can identify and eliminate proprietary trading as new products and business practices emerge; (3) be applied consistently across all types of banking entities and their affiliates to facilitate comparisons; (4) facilitate predictable evaluations of outcomes so regulatory agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity; and (5) be sufficiently robust to account for differences among asset classes.

B. Scope and Implementation of "Permitted Activities" Exceptions

The Study notes several challenges for regulatory agencies in implementing the permitted activities exception, most significantly, distinguishing impermissible proprietary trading activities from permissible activities such as market making, hedging, underwriting, and other transactions on behalf of customers, all of which often evidence characteristics similar to proprietary trading.

The Study focuses on market making-related activity and notes that current market making businesses often include elements of proprietary trading. The Study states that regulators therefore must be vigilant to ensure that banking entities do not conceal impermissible proprietary trading activities within larger market making operations. The Study lists a number of specific challenges for regulatory agencies in this area including that: (1) inventory that is required for market making or underwriting could also be used to conduct proprietary trading; (2) accumulation of inventory in "anticipation" of customer demand can resemble proprietary trading; (3) banking entities can engage in impermissible proprietary trading through inconsistent or incomplete hedging in the context of their market making activities; and (4) the combination of permitted activities might be used to circumvent the proprietary trading restrictions.

To assist regulatory agencies, the Study contains detailed indicia of permitted activities, especially relating to market making and hedging, which could be used to distinguish these activities from impermissible proprietary trading.

C. Implementation of the Proprietary Trading Prohibition

The Study recommends a four-part implementation and supervisory framework that would assist regulatory agencies in identifying proprietary trading activities that must be eliminated. The four parts of the framework relate to a programmatic compliance regime, an analysis and reporting of quantitative metrics, supervisory review and oversight, and enforcement procedures for violations.

1. Programmatic Compliance Regime

The Study recommends that banking entities be required to develop and integrate into current compliance regimes a new, specifically tailored program of policies, procedures and other controls designed to ensure that proprietary trading does not migrate into permitted activities. The Study delineates a number of elements that such a regime could require including: (1) the establishment of internal policies and procedures to detect and eliminate proprietary trading and ensure that only permitted activities are conducted; (2) the development and implementation of a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule policies and procedures; (3) the establishment of recordkeeping and reporting systems to facilitate both internal and supervisory monitoring of the policies, procedures and controls required under the Rule; (4) the implementation of an independent testing requirement that could mandate that testing be conducted by a banking entity's internal audit department or by outside auditors, consultants or other qualified independent parties; and (5) imposing obligations on the Board of Directors and CEO of banking entities to ensure that they are effectively engaged in and accountable for compliance with the prohibition on impermissible proprietary trading.

2. Analysis and Reporting of Quantitative Metrics

The Study recommends that regulatory agencies consider requiring banking entities to report and supervisors to review quantitative metrics that can assist regulators in identifying impermissible proprietary trading. The Study identifies four categories of quantitative metrics including: (1) revenue-based metrics (measuring daily revenue and revenue from specific trades relative to historical revenue and similar data for other banks); (2) revenue-to-risk metrics (measuring revenue generated per unit of risk assumed); (3) inventory metrics (comparing the asset value transacted to the value of assets held in inventory); and (4) customer-flow metrics (the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for the purposes of building inventory or hedging).

The Study recommends that regulatory agencies consider developing a standard quantitative profile of market making for each specific asset class or trading desk using the four types of metrics as a methodology for analyzing the metrics.

3. Supervisory Review and Oversight

The Study states that the programmatic compliance regime, together with the reporting of certain quantitative metrics, will provide a strong foundation for robust supervisory review and oversight of compliance with the Volcker Rule. The Study outlines several components of a supervisory review program that regulatory agencies should consider incorporating including: (1) the periodic review and testing of banking entities' internal compliance controls and procedures; (2) conducting regular monitoring of trading activity to identify impermissible activity and to inform the scope and frequency of periodic targeted supervisory reviews; (3) engaging in regular dialogue with relevant management, trading and control personnel to understand and evaluate specific trading behavior by banking entities in light of the Volcker Rule; and (4) making use of quantitative metrics reported to them by banking entities to identify issues that require additional review.

4. Enforcement Procedures for Violations

The study discusses the investigation process and enforcement procedures that supervisors undertake when they identify evidence of a potential violation of the Volcker Rule. The Study notes that the Rule requires that if a violation is identified through the examination process, the activity must be terminated and the investment be liquidated.

D. Statutory Limitations on Permitted Activities

The Study notes that while the Volcker Rule permits certain activities, the statute also imposes limits on these activities. Specifically, under the Volcker Rule, permitted activities are prohibited if they involve or would result in a material conflict of interest (e.g., banking entities conducting transactions that place the entities' own interests ahead of its obligations to its customers and counterparties), a material exposure by the banking entity to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of a banking entity, or a threat to the financial stability of the United States.

II. Sponsorship of and Investments in Hedge Funds and Private Equity Funds

The Volcker Rule generally prohibits banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring a hedge fund or private equity fund. Similar to the proprietary trading provisions, there are a number of permitted activities exempted from the prohibition. For example, banking entities are permitted to organize and offer or invest in hedge funds and private equity funds, up to a de minimis investment limit, to facilitate customer-focused advisory services. Similar to the permitted activities provisions in the proprietary trading section of the Volcker Rule, these banking entities are allowed to invest in or organize and offer hedge funds and private equity funds as long as engaging in such activity does not result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to the financial stability of the United States.

A. Implementation of Prohibited Activities

The Study states that regulatory agencies should consider several key issues with respect to implementing the prohibition including, most significantly, the scope of the definition of "private equity fund" and "hedge fund." The Study states that the scope of prohibited investments needs to be clarified and recommends that regulatory agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 and consider whether it is appropriate to narrow the statutory definition by rule in some cases.

Similarly, the Study states that regulatory agencies consider using their authority to expand these definitions by rule to funds that do not rely on the Section 3(c)(1) and 3(c)(7) exclusions but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund. The Study notes that regulatory agencies can bring such funds within the scope of the Volcker Rule by deeming them "similar funds" within the meaning of the statute. In determining which funds should be brought within the scope of the Volcker Rule as "similar funds," the Study states that regulatory agencies should consider the investment activities and other characteristics of these funds, including compensation structure, trading and investment strategy, use of leverage, and investor composition.

B. Implementation of Permitted Activities

The Study discusses several issues relating to the implementation of permitted activities. Most significantly, regulatory agencies should consider developing and issuing regulations to clarify the meaning of "customer" in the context of the permitted activity exception for customer-focused advisory services. In determining the nature of a customer relationship that may constitute a permitted activity, the Study states that regulatory agencies should take into account, among other things, whether there is a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the offering, whether there is a direct or indirect customer relationship, or whether the relationship is initiated by the potential customer or the banking entity.

The Study also discusses several issues concerning the calculation of the de minimis investment permitted activity. The Study states that regulatory agencies should be careful to ensure that the exception does not place banking entities at undue risk or provide loopholes for proprietary trading or other prohibited transactions. Most significantly, regulatory agencies should consider defining “investment” in a manner that will best capture the banking entity’s true risk exposure.

C. Clarifying the Term “Banking Entity”

The Study notes that commenters on the FSOC’s request for information on the Volcker Rule argued that unless permitted hedge funds and private equity funds are excluded from the definition of “banking entity,” several unintended consequences would be created under the Rule including that SEC-registered investment companies that are controlled by a banking entity would become subject to the Volcker Rule.

The Study recommends that regulatory agencies carefully consider the impact of certain other regulatory definitions on the Volcker Rule’s definition of “banking entity” and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule.

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endnotes

[1] The Study can be found on the FSOC’s website at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[2] Final regulations to implement the Volcker Rule must be completed by October 21, 2011.