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FINANCIAL REGULATORY REFORM

Dodd-Frank's Limitations on Risk Taking:
An Analysis of the Volcker Rule's Restrictions on Proprietary Trading and Investments in and Sponsorship of Hedge Funds and Private Equity Funds

President Obama on July 21, 2010 signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), thereby effecting the most sweeping changes to the U.S. financial regulatory system since the 1930s.

While for the most part Dodd-Frank is focused on the "new"— establishing brand new regulatory bodies such as the Financial Stability Oversight Council (the "Council") and the Bureau of Consumer Financial Protection and mandating a host of new regulations[1]— in one important area, Dodd-Frank arguably is very much focused on the "old"— attempting to re-impose many of the limitations on bank and bank holding company activities that were in effect prior to the Gramm-Leach-Bliley Act of 1999. Central to that area, of course, is the so-called "Volcker Rule" found in Section 619 of Dodd-Frank, which adds a new Section 13 to the Bank Holding Company Act of 1956 ("BHCA")[2] that, with certain exceptions for "*permitted activities*," prohibits a "*banking entity*" from engaging in "*proprietary trading*" and from acquiring or retaining an ownership interest in or "*sponsoring*" a "*hedge fund*" or a "*private equity fund*."[3]

This OnPoint analyzes the implications of the Volcker Rule for investment managers, with particular attention devoted to the key terms, the implementation timeline and the likely impact on a banking entity's existing proprietary trading and hedge and private equity fund operations. As will be evident from this review, there are many areas where the statutory language must be clarified before the Volcker Rule's restrictions reasonably can be implemented and its impact fully known. Congress has delegated to the regulatory agencies the responsibility for writing regulations to implement the Volcker Rule's restrictions. This will be no easy task as there is a clear tension present in the Volcker Rule's final provisions between an apparent desire on the one hand to demonstrate how tough Congress could be on the banking industry and on the other hand to limit the harm that these reforms could cause the banking industry and indirectly the economy.

Key Terms

Banking Entity

As indicated above, the Volcker Rule's prohibitions apply to any "*banking entity*," a term which is defined very broadly to include not just any insured depository institution ("bank"),

1 See Analysis of Financial Regulatory Reform Legislation for American Bankers Association for a detailed review of Dodd-Frank in its entirety and our other recent *DechertOnPoints* for an in-depth analysis of key portions of the legislation of interest to the investment management industry.

2 For ease of reference, new Section 13 of the BHCA will be referred to herein as the Volcker Rule and subsection references will be deemed to refer to subsections of the new Section 13 of the BHCA.

3 Subsection (a)(1).

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but also any company that controls a bank, and any subsidiary or affiliate of such company.[4] This definition is much more expansive than it might appear, encompassing not only traditional bank holding companies ("BHCs") under the BHCA, and savings and loan holding companies ("SLHCs") under the Home Owners Loan Act ("HOLA"), but also companies that are not BHCs or SLHCs because the insured depository institutions they control are neither banks nor savings associations (e.g., industrial loan banks and credit card banks). Significantly, limited purpose trust companies are expressly excluded from the definition of insured depository institution for the purpose of the Volcker Rule.[5] But for that exclusion (which was not present in earlier formulations of the Volcker Rule), many large investment managers that own such trust companies would have been subject to the Volcker Rule's restrictions.

The reach of the Volcker Rule is also potentially very broad because of the manner in which the definition of banking entity incorporates not only "subsidiaries" (which are typically defined as companies controlled by the banking entity) but also "affiliates" of the banking entity. This aspect of the Volcker Rule conceivably could have a number of unintended consequences.

In this respect, the BHCA defines an affiliate of a company to include any company that is under common control[6] with another company.[7] As a result, if an individual is a controlling shareholder of a BHC or SLHC, then any other company that individual controls, no matter how far outside the BHC structure and how unrelated to an uninsured depository institution, would nevertheless be subject to the Volcker Rule's prohibition on proprietary trading and investing in or sponsoring hedge or private equity funds. Coupled with the very broad definitions of hedge and private equity funds (discussed below), this could substantially inhibit the willingness of successful entrepreneurs to bring their expertise and capital to the banking industry. It would also put another nail in the coffin of the various silo structures that private equity investors have sought to employ in bank acquisitions as a means to avoid application of the BHCA or the HOLA to their other holdings. Even before adoption of the Volcker Rule, silo structures had been disfavored by the federal bank regulators.

In light of these consequences, one would hope that the scope of the definition of banking entity is narrowed as part of the rulemaking contemplated by subsection (b)(2) so as to not limit the activities of independent companies that happen to be controlled by individuals that also control a BHC or SLHC. Subsection (b)(2) allocates the authority to adopt rules implementing the Volcker Rule among: (i) the appropriate federal banking agencies, jointly, with respect to insured depository institution; (ii) the Board of Governors of the Federal Reserve System ("Board") with respect to any company that controls an insured depository institution; (iii) the Commodity Futures Trading Commission ("CFTC") with respect to any entity for which it is the primary financial regulatory agency (e.g., futures commission merchants, commodity pool operators and commodity trading advisors); and (iv) the Securities and Exchange Commission ("SEC") with respect to any entity for which it is the primary financial regulatory agency (e.g., broker-dealers, investment companies and investment advisers) (collectively, the "financial regulatory agencies"), and appoints the Chairperson of the Council as the person responsible for coordination of the regulations adopted by these different agencies. Interestingly, all of this suggests that, despite the best of intentions, the door may be open for different agencies to take different approaches to the rulemaking.

Proprietary Trading

Subsection (h)(4) defines "*proprietary trading*" to mean engaging as a principal for the trading account of the banking entity in any transaction to acquire or dispose of any security, derivative, futures contract or option on such instruments or any other security or financial instrument that the financial regulatory agencies may determine by rule to be covered ("covered instruments"). This definition is potentially very broad, but its scope is fortunately limited by the trading account reference.

Subsection (h)(6) defines "*trading account*" as an account where positions are taken "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 clear implication of this emphasis on

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4 Subsection (h)(1). "Banking entity" also includes any foreign bank that is treated as a bank holding company under the International Banking Act of 1978 (typically because they have a branch or agency office in the United States), and any affiliate of such foreign bank. *Id.*

5 *Id.*

6 Control of a company for BHCA purposes exists when a person owns or controls 25% or more of the company's voting securities, has the ability to elect a majority of the company's board of directors or the ability to exercise a controlling influence over the management of the company. *See* 12 C.F.R. 225.2(e).

7 *See* 12 U.S.C. 1841(k).

short-term trading is that investments acquired with a longer investment horizon, such as, for example, direct private equity or merchant banking investments, will not be subject to the proprietary trading restrictions.

The scope of the proprietary trading restrictions could nonetheless benefit from clarification as part of the contemplated rulemaking. In addition to confirming that longer term investments are not covered by these restrictions (and perhaps setting a specific holding period that would be deemed not to constitute "near term" activity), clarification of whether loans are to be considered securities for purposes of the Volcker Rule would be helpful. In this respect, the securities laws sometimes treat loans as securities and other times do not, depending upon the context in which the question arises. Treating loans as securities subject to the Volcker Rule could complicate traditional banking activities, although subsection (g)(2) (the "securitization carve-out") lessens the potential impact by expressly providing that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans.

Hedge Fund and Private Equity Fund

Subsection (h)(2) defines the terms "*hedge fund*" and "*private equity fund*" identically to mean an issuer that would be an investment company under the Investment Company Act of 1940 ("1940 Act"), but for the exclusions provided by Section 3(c)(1) (maximum of 100 beneficial owners) or Section 3(c)(7) (investors limited to qualified persons) of the 1940 Act (the "private fund exclusions"), or such similar funds as the financial regulatory agencies may by rule determine. Once again, the definition is extremely broad, encompassing many more entities than would ordinarily be considered hedge funds or private equity funds.

To appreciate this fully, one must recognize that the 1940 Act itself defines an investment company very broadly to include, among others, an issuer that (i) is engaged primarily in the business of investing, reinvesting or trading in securities, or (ii) is engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As relevant to the Volcker Rule's restrictions, many bank-sponsored securitization vehicles would meet the definition of an investment company, but for the private fund exclusions. Fortunately, the securitization carve-out in subsection (g)(2) largely addresses this concern, although not all securitizations may be protected since the carve-out only references securitizations of loans and may not extend to other types of debt obligations. One would expect, for example, that a banking entity could acquire pools of loans and securitize them by issuing various types of collateralized loan obligations ("CLOs"), but that the banking entity could not acquire a pool of CLOs and securitize them by issuing collateralized debt obligations ("CDOs"). This is also an area where clarification will hopefully be provided through the rulemaking process.

Interestingly, not all "covered instruments" the direct short-term trading of which may be limited by the proprietary trading restrictions, will qualify as "securities" or "investment securities" for purposes of the 1940 Act. For example, commodity pools that invest exclusively in commodity futures contracts are not investment companies, and do not need to rely on Sections 3(c)(1) or 3(c)(7) to avoid that status. Accordingly, such commodity pools would not be considered private equity or hedge funds under the Volcker Rule unless the financial regulatory agencies extend the definition during the rulemaking process.

Apart from its breadth, the Volcker Rule's definition of hedge and private equity funds is troubling because it appears to exalt form over substance, which seems especially peculiar for a statutory provision limiting the risk-taking activities of banking entities. The risk associated with investing in a hedge fund or a private equity fund depends more on the investment strategy of, and investments made by, the fund than whether the fund qualifies for the 1940 Act's private fund exclusions. Moreover, to the extent that a hedge fund invests exclusively in investments that could be acquired and held directly by a banking entity, it would seem incongruous to prohibit the banking entity from doing indirectly that which it can do directly. That, however, in the absence of clarifying action by the financial regulatory agencies as part of the contemplated rulemaking, would appear to be the result.

Implementation Time Line

Before turning to a discussion of the likely impact of the Volcker Rule on a banking entity's existing proprietary trading, and hedge fund and private equity fund operations, a review of the implementation time line is in order.

The starting point for this timeline is the date of enactment, July 21, 2010. Six months from that date (E+6),

the Council is required to have completed its study and made its recommendations on implementing the Volcker Rule.[8] Within nine months from completion of the study (E+15), the financial regulatory agencies are required to adopt rules to carry out the Volcker Rule's provisions.[9] Given the requirements of the Administrative Procedures Act for public comment, one hopes that the financial regulatory agencies will publish proposed rules well in advance of this deadline, although given the tremendous amount of new rulemaking proceedings called for by Dodd-Frank, it is not inconceivable that either the deadlines will be missed or that the financial regulatory agencies will seek to achieve technical compliance with the deadlines by issuing interim final rules and a request for comments simultaneously.

Subject to the possibility of extensions in specific cases by the Board, subsection (c)(1) provides that the effective date of the Volcker Rule will be the earlier of 12 months after the issuance of the final rules noted above (potentially E+27 if the maximum time is used) or two years after enactment (E+24). To avoid a situation where the Volcker Rule becomes effective before adoption of final rules by the financial regulatory agencies, there will be substantial pressure on the agencies to issue final rules clarifying the application of the Volcker Rule by the end of the two-year period after enactment of the Act.

Subsection (c)(2), which is titled "Conformance Period for Divestiture," provides banking entities a two-year period after effectiveness in which to bring their activities and investments into compliance with the requirements of the Volcker Rule, for a total of four years after enactment. Moreover, the Board may, by rule or order, extend this two-year period for not more than one year at a time, up to an aggregate of three years of extensions, if the Board determines such extensions are consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.

In addition, subsection (c)(3) provides the Board authority, upon the application of a banking entity, to extend on a one-time basis the period in which the banking entity may retain its interest in, or provide additional capital to, an "illiquid fund" for up to five years, but only "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." Subsection (h)(7) defines an "*illiquid fund*" as:

> a hedge or private equity fund that – (i) as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments; and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

Most existing traditional private equity funds would appear likely to qualify as illiquid funds. Depending upon the nature of their investment strategies and the presence of a "contractual commitment" to invest in illiquid assets, many hedge funds may also qualify as illiquid funds.

If the maximum number of extensions is granted, banking entities will have until seven years after enactment (up to five years after effectiveness) to bring into compliance their proprietary trading and hedge and private equity fund activities, except in the case of illiquid funds, which potentially could have up to 12 years after enactment (up to ten years after effectiveness) to come into compliance.[10]

The Volcker Rule's compliance approach and time frames are consistent with the Board's approach generally to bringing non-conforming activities or investments into compliance with the BHCA, as well as with the practices of the banking agencies with respect to disposition of impermissible assets acquired through foreclosure or otherwise in the course of collecting on debts previously contracted. In such cases, the general rule is two years to dispose of the non-conforming assets, with the possibility of up to three one-year extensions, while illiquid assets such as real estate may benefit from a potentially longer (up to ten years in total) divestiture period.

This approach to compliance dates appears to represent a welcome recognition by Congress that imposing major

8 Subsection (b)(1).

9 Subsection (b)(2).

10 It is not clear whether the five-year extension for illiquid funds is in addition to or in lieu of the possible three one-year extensions. Significantly, subsection (c)(6) specifically directs the Board to conduct a special rulemaking and issue rules within six months from enactment to implement subsections (c)(2) and (3). Hopefully, this rulemaking will answer this question and more generally provide clarity around the circumstances under which a banking entity may qualify for an extension.

changes to a banking entity's investment authority and requiring rapid divestiture of previously permissible investments could have a significant negative impact on the value of those investments.

Impact on a Banking Entity's Existing Operations

Prior to the effective date of the Volcker Rule, which as noted above will be no later than two years after enactment, banking entities will not be directly limited in their proprietary trading, hedge fund or private equity fund activities. That said, it is recommended and expected that most banking entities will use this time to plan for and reconfigure their operations as necessary to come into compliance with the Volcker Rule as soon as possible. In part this is because any new activities or investments made after the effective date must comply fully with the Volcker Rule (except perhaps for new investments in illiquid funds under the authority of subsection (c)(3)). In addition, while there is the possibility for extensions of the time period in which a banking entity must conform its existing activities, there is no assurance that any such extensions will be granted.

What then are the activities that are prohibited by the Volcker Rule?

First, the short answer. Subsection (a)(1) provides that, subject to certain exceptions:

> a banking entity shall not:
>
> (A) engage in proprietary trading; or
>
> (B) acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or private equity fund.

Applying the definitions discussed earlier, this means that the banking entity, except as otherwise permitted: (A) may not engage in short-term trading of any securities, derivatives or futures contracts for its own account, and (B) may not acquire or retain an equity or ownership interest in, or sponsor, any investment vehicle that would be an investment company but for its reliance on Sections 3(c)(1) or (7) of the 1940 Act. Subsection (h)(5) provides that the term "*sponsor*" means: (A) to serve as a general partner, managing member, or trustee of a fund, (B) to select or control a majority of the directors, trustees or management of a fund, or (C) to share the same name or a variation of the same name with the fund.

A more complete answer requires a discussion of the ten separate exceptions found in subsection (d), entitled "Permitted Activities." Briefly, subsection (d)(1) provides that, to the extent permitted by any other provision of Federal or State law, a banking entity may engage in the following permitted activities, notwithstanding the general prohibitions on proprietary trading and investing in or sponsoring hedge and private equity funds, but subject to the general limitations in subsections (d)(2) and (d)(3):

1. The purchase and sale of obligations of the United States or any agency thereof; obligations of certain government-sponsored enterprises (e.g., FNMA, FHLMC and the Federal Home Loan Banks); obligations of any State or of any political subdivision thereof.

2. The purchase and sale of covered instruments in connection with underwriting or market-making-related activities, subject to certain limitations.

3. Risk-mitigating hedging activities.

4. The purchase and sale of covered instruments on behalf of customers.

5. Investments in small business investment companies ("SBICs"), certain investments designed primarily to promote the public welfare, or investments that are qualified rehabilitation expenditures.

6. The purchase and sale of covered instruments by a regulated insurance company directly engaged in the business of insurance for the general account of the insurance company, subject to compliance with applicable insurance law and if the Council and the relevant insurance commissioners have *not* jointly determined that a particular insurance law or regulation is insufficient to protect the safety and soundness of the banking entity.

7. Organizing and offering a private equity or hedge fund, including activities that would constitute sponsoring the fund, subject to a number of specific requirements discussed in greater detail below.

8. Proprietary trading conducted by banking entities not directly or indirectly controlled by a U.S. entity, provided that the trading is conducted solely outside the United States.

9. Hedge and private equity fund activities conducted by banking entities not directly or indirectly controlled by a U.S. entity, conducted solely outside the United States, provided that no ownership interest is sold to a U.S. resident.

10. Such other activity as the financial regulatory agencies may determine by rule would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.[11]

The first of the permitted activities[12] effectively restores to banks some, but not all, of the authority they previously had to acquire "investment securities" for their own account.[13] The bank may acquire any such securities without regard to the limits on proprietary trading to the extent permitted under otherwise applicable banking law. In light of the emphasis in the definition of proprietary trading, on the short-term nature of the trading, it would appear reasonable for the bank to be able to acquire other eligible investment securities as well, provided that they are acquired for long-term investment only and not placed in the bank's trading book.

The fifth of the permitted activities[14] is potentially of interest to banking entities that currently sponsor private equity funds. Prior to the Gramm-Leach-Bliley Act, many BHCs conducted a limited form of private equity business through SBIC subsidiaries. While not as flexible as today's BHC-sponsored private equity funds, SBICs may provide a limited alternative/replacement for the private equity fund authority that is effectively being repealed by the Volcker Rule.

Of all the permitted activities, the seventh[15] provides the greatest potential to minimize the impact of the Volcker Rule on banks' existing hedge and private equity fund operations. That said, as discussed below, there are strict limitations on this authority, which are likely to lessen its attractiveness and ultimate utility to banking entities.

More specifically, subsection (d)(1)(G) authorizes a banking entity to sponsor, organize and offer a hedge fund or private equity fund, but only if:

(i) the banking entity provides bona fide trust, fiduciary, or investment advisory services;

(ii) the fund is organized and offered only in connection with such services and only to customers of such services of the banking entity;

(iii) the banking entity does not acquire any ownership interest in the fund except for a *de minimis* investment that complies with the requirements of subsection (d)(4), which permits a banking entity sponsor of a hedge or private equity fund to provide seed capital sufficient to attract unaffiliated investors or to make a *de minimis* investment in the fund, provided that the banking entity actively seeks unaffiliated investors and in any event reduces its ownership interest in the fund within one year (with possibly a two-year extension) to not more than three percent of the fund's total ownership interests. In addition, in no event may the aggregate of all such investments by the banking entity exceed three percent of the banking entity's Tier 1 capital;

(iv) the banking entity complies with the restrictions of subsection (f)(1) and (2). Subsection (f)(1) prohibits the banking entity and any affiliate of such entity,[16] from entering into any transaction with the fund that would be a covered transaction as that term is defined in Section 23A of the Federal Reserve Act as if the banking entity and its affiliate were a member bank and the fund were an affiliate thereof. Taken literally, this section effectively prohibits the banking entity from acquiring any interest in the fund, in direct contradiction to subsection (d)(4)'s explicit authorization. Again, this is an area that would benefit tremendously from rulemaking by the financial regulatory agencies. Subsection (f)(2) subjects the banking entity to Section 23B of the Federal Reserve Act as if it were a member bank and the fund were an affiliate thereof. The primary effect of this is to require that

11 Subsections (d)(1)(A) – (J).

12 Subsection (d)(1)(A).

13 See, e.g., 12 C.F.R. Part 1, which spells out the general authority of national banks to acquire various types of investment securities.

14 Subsection (d)(1)(E).

15 Subsection (d)(1)(G).

16 This reference to affiliates of the banking entity is potentially redundant since the definition of banking entity already includes any affiliate of the banking entity, further demonstrating, as discussed above, the need for regulatory clarification of the scope of the definition of banking entity and/or affiliate.

service arrangements between the banking entity and the fund be on an arm's-length basis;[17]

(v) the banking entity does not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the fund;

(vi) the banking entity does not share a name or a variation of the same name with the fund;

(vii) no director or employee of the banking entity acquires an equity interest in the fund, except for a director or employee that is directly involved in providing investment advisory or other services to the fund; and

(viii) the banking entity discloses in writing to prospective and actual investors that any losses in the fund are borne solely by investors and otherwise complies with any rules adopted by the financial regulatory agencies to ensure such losses are not borne by the banking entity.

While the subsection (d)(1)(G) exceptions are a welcome relief from the flat prohibition on investments in and sponsorship of funds contained in earlier versions of the Volcker Rule, the impression is one of unnecessary overkill; it is almost as if Congress asked the financial regulatory agencies for a list of their favorite fund-related restrictions and included them all in the legislation without having thought through all their implications.

In this respect, clauses (i) and (ii) appear very similar to the requirements of Section 3(c)(3) of the 1940 Act, which excludes common trust funds from the definition of investment company, but only for "bona fide" trust relationships. Although that concept works well for common trust funds, it does not translate easily to sales of hedge or private equity funds to customers of the banking entity's *bona fide* trust, fiduciary, or investment advisory services. Apart from potentially disadvantaging smaller banking entities with a smaller trust, fiduciary and investment advisory client base, this requirement may lead to potential conflicts of interest between the banking entity's exercise of its fiduciary duty to its customers and its role as sponsor of the fund. While this type of conflict can be consented to by most clients, if the client is subject to ERISA, as is often the case with investors in hedge and private equity funds, the conflict may not be so easily resolved.

Clause (iii) appears to have been an effort to address the banking industry's concerns that hedge fund and private equity fund managers will not be successful in attracting investors if they do not demonstrate a willingness to invest along with the other investors in the fund. The general authorization to provide initial seed capital, coupled with a requirement to reduce the banking entity's position to a certain level within one year, has its parallel in the authority under the Board's Regulation Y for financial holding companies ("FHCs") to sponsor and organize mutual funds.[18] The only problem is that the cap of three percent of a fund's total investments is smaller by almost a factor of ten than the 24.99% level of a sponsored mutual fund's shares that FHCs are permitted to retain, and probably will be much too small to satisfy the expectations of most hedge and private equity fund investors.

Clause (iv) may have come in some form from the Board, which is primarily responsible for implementation of Sections 23A and 23B. Unfortunately, clause (iv) appears to be more restrictive than Section 23A that, with the exception of purchases of low quality assets from an affiliate, generally imposes limits, not prohibitions, on covered transactions. Clause (iv)'s prohibition on covered transactions with a fund, which would include investments in securities issued by the fund, is seemingly inconsistent with clause (iii)'s authorization of *de minimis* investments in a fund. As a result, the Volcker Rule seemingly takes away with one hand what it just gave with the other.

Finally, clauses (v), (vi) and (viii) appear to have been lifted straight from the banking agencies' guidelines on *retail* sales of non-deposit investment products (emphasis added). The contemplated disclosures are very similar to those required to be provided in connection with sales of mutual funds to potentially less sophisticated bank depositors to apprise them of the risks of investing in registered investment companies. Why Congress thought it necessary to require virtually identical disclosures to potential investors in hedge and private equity funds is puzzling, especially since those investors by definition must meet relatively high sophistication standards under the securities laws in order for the fund to qualify for the private fund exclusions.

[17] Significantly, subsection (f)(3) effectively authorizes the Board to exclude prime brokerage transactions between a banking entity and a hedge or private equity fund in which the fund invests.

[18] *See* 12 C.F.R. 225.86(b)(3).

Notwithstanding these musings (or more accurately grumblings) about the limitations imposed on a banking entity's ability to sponsor a hedge or private equity fund, the requirements may not be too difficult to comply with (assuming the financial regulatory agencies resolve the conflict between clauses (iii) and (iv)).

In addition to the above limitations on the authority granted by subsection (d)(1)(G), subsections (d)(2) and (d)(3) establish general limitations on all of the subsection (d)(1) Permissible Activities. Apparently in reaction to the SEC's now-settled enforcement action against Goldman Sachs based on the Abacus CDO transaction, subsection (d)(2) prohibits any otherwise permitted activity if it:

> (i) would involve or result in a material conflict of interest (as such term shall be defined by rule . . .) between the banking entity and its clients, customers, or counterparties; or (ii) 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 shall be defined by rule . . .).

Subsection (d)(3) authorizes the financial regulatory agencies to adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements in connection with the permitted activities.

While most of this review has appropriately focused on the impact of the Volcker Rule on "banking entities," nonbank financial companies must also heed these restrictions to a certain extent, as subsections (a)(2) and (f)(4) both contemplate that the financial regulatory agencies will impose additional capital requirements and other restrictions on "nonbank financial companies supervised by the Board" (i.e., designated by the Council as significant) with respect to their proprietary trading and hedge or private equity fund activities.

As reflected in the above discussion, the Volcker Rule will severely curtail the short-term proprietary trading and hedge and private equity fund activities of "banking entities," which term is broadly defined. The Volcker Rule contains a number of inconsistencies and some apparent mistakes, all of which should, and hopefully will, be clarified by the financial regulatory agencies before the restrictions take effect. Fortunately, there are reasonably long periods before effectiveness of the Volcker Rule and before banking entities must comply with the new requirements.

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