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Proposed "Volcker Rule" Regulations Provide Banks a Broad Exemption for Liquidity Management

by Michael Ouimette

On October 11, 2011, the Federal Financial Regulators[1] published for public comment a jointly proposed regulation implementing the so-called "Volcker Rule" requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Volcker Rule generally contains two prohibitions, both of which are subject to certain exemptions. First, it generally prohibits insured depository institutions, bank holding companies, and their subsidiaries or affiliates ("Banking Entities") from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for their own accounts. Second, it generally prohibits Banking Entities from owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund.

Included among the relatively extensive proposed regulations is a proposed exemption of particular interest to Banking Entity treasury departments and departments performing similar functions. These departments generally conduct asset and liquidity management activities on behalf of the Banking Entity that were not conducted through traditional trading floors but nevertheless are subject to the broad reach of the Volcker Rule. The proposed regulations include a broad exemption from the proprietary trading restrictions for "liquidity management activities," permitting Banking Entities to engage in short-term investment in financial instruments beyond those specifically authorized by the Volcker Rule. The proposed regulations, however, only apply to short-term liquidity asset management, are subject to comment and revision and may not address all industry concerns.

[1] The Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Securities and Exchange Commission. The Commodity Futures Trading Commission is also expected to propose separate regulations implementing the Volcker Rule.

Under the proposed regulations, Banking Entities that wish to take advantage of the liquidity management exemption will be required to meet certain criteria, including the implementation of a documented liquidity management plan.

Comments on the proposed regulations are due by January 13, 2012. The Volcker Rule will become effective on July 21, 2012, although various provisions will be phased in later.

Proprietary Trading Prohibition

The Volcker Rule, as implemented by the proposed regulations, prohibits Banking Entities from engaging in proprietary trading, which is broadly defined as engaging as principal for the trading account of the Banking Entity in any transaction to purchase or sell a covered financial position. While the Volcker Rule and the proposed regulations include exemptions for market making, underwriting, risk-mitigating hedging activities and certain other activities and asset classes, there has been significant industry concern that various asset management and liquidity activities conducted by treasury departments on behalf of Banking Entities, or departments performing similar functions, would not be captured by those exemptions and could potentially be prohibited by the Volcker Rule. This is especially true in light of other provisions of the proposed regulations that create a rebuttable presumption that any account used to acquire or take a covered financial position that is held for sixty days or less is a trading account unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes.

Liquidity Management Activities

Among other exemptions, the proposed regulations exclude from the definition of "trading account" certain positions that do not appear to involve the requisite short-term trading intent, including "positions acquired or taken for bona fide liquidity management purposes." This proposed clarifying exclusion is intended to make clear that, where the purpose for which a Banking Entity acquires or takes a position is to ensure that it has sufficient liquid assets to meet its short-term cash demands, and the related position is held as part of the Banking Entity's liquidity management process, that transaction falls outside of the types of transactions described in the proposed regulation's definition of trading account (and would thus fall outside of the Volcker Rule's proprietary trading restrictions). The Federal Financial Regulators noted that maintaining liquidity management positions is a critical aspect of the safe and sound operation of certain Banking Entities, and does not involve the requisite short-term trading intent that forms the basis of the statutory definition of "trading account." In the context of bona fide liquidity management activity that would qualify for the clarifying exclusion, the Federal Financial Regulators noted that a Banking Entity's purpose for acquiring or taking these types of positions is not to benefit from short-term profit or short-term price movements, but rather to ensure that it has sufficient, readily-marketable assets available to meet its expected short-term liquidity needs.

In order to prevent abuse, the Federal Financial Regulators have proposed that Banking Entities wishing to take advantage of this exemption must adopt "liquidity management plans." As proposed, such liquidity management plans would be required to meet five criteria:

- The plan would be required to specifically contemplate and authorize any particular instrument used for liquidity management purposes, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the position may or must be used.
- The plan would have to require that any transaction contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the Banking Entity, and not for the purpose of short-

term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position acquired or taken for such short-term purposes.

- The plan would have to require that any positions acquired or taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which are not expected to give rise to appreciable profits or losses as a result of short-term price movements.
- The plan would be required to limit any position acquired or taken for liquidity management purposes, together with any other positions acquired or taken for such purposes, to an amount that is consistent with the Banking Entity's near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan.
- The plan would be required to be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Banking Entity's primary banking regulator.

Although the proposed regulations do not require prior regulatory approval of these plans, the Federal Financial Regulators would review these liquidity plans and transactions effected in accordance with these plans through supervisory and examination processes to ensure that the applicable criteria are met and that any position acquired or taken in reliance on the clarifying exclusion for liquidity management transactions is fully consistent with such plans.

Request for Comments

The Federal Financial Regulators have requested industry comments with respect to the liquidity management exception. Among other topics, the Federal Financial Regulators have requested feedback as to whether current liquidity management programs meet the five proposed criteria for liquidity management programs, whether liquidity management programs are used for purposes other than ensuring that the Banking Entity has sufficient assets available to it that are readily marketable to meet expected short-term liquidity needs, and information regarding costs or other burdens that would arise if the proposed regulations did not contain an exclusion for positions acquired or taken for liquidity management purposes.

What to Do

Banking Entities should conduct a review of their treasury operations and determine if any activities present proprietary trading concerns under the Volcker Rule. Banking Entities should also consider whether and to what extent treasury activities that present proprietary trading concerns would be permissible under the proposed liquidity management exemption. Banking Entities are encouraged to submit comments to their appropriate Federal Financial Regulator if they believe that the proposed regulations do not sufficiently address treasury activities conducted for liquidity management purposes.

If you have questions, please contact the Pillsbury attorney with whom you regularly work, or the author:

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