

January 20, 2012

## Volcker Rule

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### Regulatory Testimony Raises Concerns over the Scope of the Volcker Rule Exemptions for Covered Funds

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#### SUMMARY

At a joint hearing on the Volcker Rule held by two subcommittees of the House Committee on Financial Services on January 18, a panel of regulators was asked whether the agencies intended to exempt insurance companies from Volcker Rule restrictions on hedge funds and private equity funds (referred to in the proposed regulations as “covered funds”). In response, the Chairman of the SEC made the following statement: “[I]t’s quite clear on proprietary trading that insurance companies can engage in trading, but not investing in covered accounts, covered funds ... the statute does exempt from the proprietary trading ban trading by an insurance company for its general account, and -- but it does not do that for insurance company investments in covered funds . . . [i]n order for us to create that exemption, we would have to meet a very high threshold to show that it would promote the safety and soundness of the banking institution or the financial stability of the United States.” None of the other regulatory agency witnesses responded to this particular question, nor did any of them comment on the SEC Chairman’s response. The Chairman’s response raises a concern, insofar as it suggests that the apparent position in the proposed rule may continue to be taken on the insurance company exemption in the final rule. Moreover, it would be particularly troubling because, if the same interpretative approach were applied to other key Volcker Rule exemptions, it could severely limit the permissible underwriting and market making activities of banking entities in shares of covered funds and the customer driven transactions of banking entities in such shares.

## DISCUSSION

Among the exemptions (or “permitted activities”) under the Volcker Rule is an exemption for activities conducted by an insurance company through its general account.<sup>1</sup> This exemption permits transactions by a regulated insurance company directly engaged in the business of insurance for the general account of the company, and by an affiliate of such regulated insurance company if solely for the general account of the regulated insurance company, provided that they are conducted in compliance with applicable state insurance company investment laws, and those state laws have not been determined by appropriate federal banking agencies to be insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.

The implementing regulations promulgated jointly by the bank regulators and the SEC incorporate this statutory exemption in Subpart B, a section of the proposed regulations that relates solely to the Volcker Rule’s restrictions on proprietary trading. The text of the proposed regulations applicable to investments by insurance companies in covered funds (Subpart C), however, does not discuss the application of the statutory exemption to those investments.

We and a number of others who have studied the Volcker Rule exemptions believe that an analysis of the plain language of the insurance company exemption, as well as its legislative history, strongly supports the conclusion that covered funds should fall within its scope. Again, because the language and structure of the exemptions for underwriting, market making and customer driven transactions are similar to the insurance company exemption, the Chairman’s remarks could have broader implications.

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<sup>1</sup> See Section 619(d)(1)(F) of the Volcker Rule.

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