SULLIVAN & CROMWELL LLP

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Volcker Rule

U.S. Agencies Approve Final Volcker Rule, Detailing Prohibitions and Compliance Regimes Applicable to Banking Entities Worldwide

EXECUTIVE SUMMARY

On December 10, 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together, the "Agencies") approved a final rule (the "Final Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), commonly referred to as the "Volcker Rule."

The Volcker Rule—one of the centerpieces of the Dodd-Frank Act—imposes broad prohibitions and restrictions on proprietary trading and investing in or sponsoring hedge funds or private equity funds by banking organizations and their affiliates. As originally released (prior to publication in the *Federal Register*), the Final Rule and the detailed "Supplementary Information," which is critical to understanding and interpreting the Final Rule, were more than 950 pages in total and included more than 2,800 footnotes.

In general, although many of the most unclear or troublesome provisions of the Agencies' proposed rule (the "Proposed Rule") have been addressed, there remain numerous interpretive issues and implementation challenges. The Final Rule is a sweeping regulation, with broad extraterritorial application, that will fundamentally shape how banking organizations do business. Although the Volcker Rule was principally directed at restricting the activities of certain large banking organizations, its restrictions apply to all banking organizations regardless of size, with limited accommodations for smaller banking organizations in the form of a simplified compliance program. Many of the Final Rule's effects may become apparent only over several years as the Agencies exercise their substantial discretion to interpret and administer the Volcker Rule in practice.

In connection with the Final Rule, the Federal Reserve exercised its independent authority to grant a blanket one-year extension of the Volcker Rule conformance period for all banking organizations. As a result, banking organizations will have until July 21, 2015 to comply fully with most requirements of the Final Rule. An important exception applies for banking organizations with significant trading activities, which will be required to report quantitative metrics on their trading activities beginning as soon as July 2014. The extension order also requires banking organizations to use good faith efforts during the conformance period to conform to the Final Rule (and promptly terminate or divest any "stand-alone" proprietary trading operations).

This memorandum summarizes the requirements of the Final Rule and the related guidance in the Supplementary Information.[1]

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1 Please see our Memorandum to Clients, dated December 13, 2013, "Agencies Approve Long-Awaited Final Rule; Most Requirements to Take Effect on July 21, 2015," for an initial overview of certain key requirements of the Final Rule and comparisons to the corresponding provisions of the Proposed Rule.

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1. BACKGROUND

The Dodd-Frank Act, enacted on July 21, 2010, added a new Section 13 to the Bank Holding Company Act of 1956 (the "BHC Act").[2] Section 13—commonly referred to as the "Volcker Rule"—prohibits a "banking entity" from:

(1) engaging in "proprietary trading"; or

(2) engaging in the following activities with respect to a "hedge fund" or a "private equity fund":

- acquiring or retaining any equity, partnership or other ownership interest in the fund;
- sponsoring (that is, controlling) the fund; or
- engaging in a wide range of "covered transactions" with the fund if the banking entity or any affiliate is an investment adviser or sponsor to the fund.[3]

The prohibitions are subject to certain exemptions for permitted activities.

As discussed in Part 2.A of this Memorandum, the Volcker Rule has sweeping worldwide application in large part because of the broad definition of "banking entity," which generally includes any insured depository institution, any depository institution holding company, any foreign company subject to the International Banking Act of 1978 (the "IBA") and any affiliate of any of the foregoing.

Since the Volcker Rule was enacted, intense interest has been focused not only on what it will ultimately require, but also on when its requirements will be effective and what transition periods will be available for compliance. All the Agencies are charged with adopting rules to carry out the statutory requirements, a process that began with the Proposed Rule[4] and has now culminated in the release of the Final Rule.[5] Section 13 gave the Federal Reserve sole

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[2] The BHC Act is codified at 12 U.S.C. § 1841 *et seq.*, and Section 13 is codified at 12 U.S.C. § 1851. References in this Memorandum to Section 13 are to Section 13 of the BHC Act.

[3] This last restriction is referred to as "Super 23A" and is discussed in Part 8 of this Memorandum.

[4] OCC, Federal Reserve, FDIC and SEC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Proposed Rule*, 76 Fed. Reg. 68846 (Nov. 7, 2011); CFTC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 77 Fed. Reg. 8332 (Feb. 14, 2012). The CFTC's proposed rulemaking was substantially similar to the other Agencies'. References and citations in this Memorandum to the Proposed Rule are to the common rule text issued by the Agencies other than the CFTC.

[5] OCC, Federal Reserve, FDIC and SEC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, __ Fed.

authority to grant extensions of the statutory conformance period, which the Federal Reserve exercised in issuing an extension order (the "Conformance Period Order") in connection with the release of the Final Rule.[6]

1.A. History of Rulemaking

Section 13 directed the Financial Stability Oversight Council (the "FSOC") to conduct a study, to be issued no later than six months after enactment of the Dodd-Frank Act, with recommendations on how to implement the Volcker Rule so as to "promote and enhance the safety and soundness of banking entities," "protect taxpayers and consumers and enhance financial stability," "appropriately accommodate the business of insurance within an insurance company" and "appropriately time the divestiture of illiquid assets," among other things.[7]

On January 18, 2011, the FSOC released its study of the Volcker Rule (the "FSOC Study").[8] The FSOC Study recognized that the purpose of the Volcker Rule's exemptions for permitted activities was "to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation,"[9] a point that many commenters echoed throughout the rulemaking process.

Reg. _____ (_____); CFTC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, __ Fed. Reg. _____ (_____).

All five Agencies adopted the same text of the rule itself. The Agencies other than the CFTC issued one Supplementary Information document (that is, associated commentary explaining and interpreting the rule) and the CFTC issued a second Supplementary Information document. The CFTC's Supplementary Information is largely similar to the other Agencies', but contains some additional discussion of the CFTC's jurisdiction over swap dealing activities.

References and citations in this Memorandum to the Final Rule and the Supplementary Information are to the common rule text and the Supplementary Information issued by the Agencies other than the CFTC, respectively. The Supplementary Information, which as of the preparation of this Memorandum had not yet been published in the *Federal Register*, has circulated in multiple versions with slightly different paginations. Citations in this Memorandum are to a version that has been archived at http://www.sullcrom.com/files/upload/bhca-1.pdf.

6 Federal Reserve, *Order Approving Extension of Conformance Period* (Dec. 10, 2013).

7 BHC Act § 13(b)(1).

8 FSOC, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Jan. 2011).

9 *Id*. at 1.

On the other hand, the FSOC Study also advanced two key precepts that have fundamentally shaped the proprietary trading restrictions under the Volcker Rule. The first was a strong concern that prohibited trading activities were pervasively embedded in, and could be disguised by, permitted activities such as market making. Thus, although "major banking entities [had already] taken or announced steps to sell, spin off, or close down their standalone 'bright line' proprietary trading businesses," the FSOC Study expressed skepticism that this would produce Volcker Rule compliance, and counseled "remaining vigilant. . . for any reemergence of these operations" in other forms.[10]

Second, the FSOC Study concluded that discriminating between prohibited trading and permitted activities "is not readily achievable using current risk management frameworks" and recommended that the Volcker Rule require an extraordinary array of new policies and procedures, reporting and recordkeeping requirements, internal controls, independent testing and quantitative metrics.[11]

The influence of these two precepts is evident in the Final Rule, which requires a comprehensive compliance program that is primarily oriented not simply toward eliminating prohibited lines of business, but toward identifying a subset of prohibited activities that are in some cases extremely difficult to distinguish from permitted activities.[12]

The FSOC Study's discussion of covered funds was less extensive, but endorsed the goals of preventing banking entities from making investments that are "completely divorced from serving the needs of their customers" and from "having incentives or opportunities to inappropriately provide support to investors in such funds or otherwise transfer the government subsidy inherent in the federal safety net for banks to speculative proprietary investments."[13]

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[10] *Id*. at 17, 27.

[11] *Id*. at 31-46, 63-70. The FSOC Study also recommended requiring a public CEO attestation as to the ongoing effectiveness of the internal compliance regime. *Id*. at 36. This requirement was not included in the Proposed Rule, but is included in the Final Rule. *See* Part 10 of this Memorandum.

[12] This approach has not been free from controversy, even within the Agencies. *See, e.g.*, SEC Commissioner Daniel M. Gallagher, *Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule* (Dec. 10, 2013) ("What we face [in the Final Rule], therefore, is the prospect of banning the market-making practices so central to our capital markets in order to make sure we capture every last activity that could potentially be characterized as prop trading. One could say, in fact, that to ensure that the final 1% of potentially proprietary trading be hunted down and eliminated, the agencies are willing to place at risk 99% of all market-making activities.").

[13] FSOC Study at 56. The FSOC Study did suggest that the Agencies "carefully evaluate the range of funds and other legal vehicles that rely on exclusions contained in section 3(c)(1) or 3(c)(7) [of the 1940 Act] and consider whether it is appropriate to narrow [this] statutory definition by rule in some cases," referring to the Agencies' exemptive authority under BHC Act § 13(d)(1)(J). FSOC Study at 62. This suggestion was generally not implemented in the Proposed Rule, but is implemented in the Final Rule to a much greater extent. *See* Part 5.B of this Memorandum.

Under Section 13, the Agencies were then required to "consider the findings" of the FSOC Study and "adopt rules" within nine months after the FSOC Study.[14]

On October 11, 2011, the OCC, Federal Reserve, FDIC and SEC issued the Proposed Rule. The CFTC issued a substantially similar notice of proposed rulemaking in January 2012. The Proposed Rule and the related Supplementary Information were nearly 300 pages as initially released and posed hundreds of questions to commenters. Public comments on the Proposed Rule were due on February 13, 2012. The Agencies received over 18,000 comments, including more than 600 unique comment letters.[15]

On December 10, 2013, the Agencies issued the Final Rule. In doing so, the Agencies did not conduct a formal costs and benefits analysis, which the Agencies concluded is not legally required because the Final Rule is promulgated under the BHC Act (which generally does not require such an analysis).[16]

1.B. Statutory Effective Dates and Past Guidance on Conformance

Section 13 provides that the Volcker Rule "shall take effect" on the earlier of July 21, 2012 and one year after issuance of the Final Rule.[17] Consequently, the Volcker Rule has been effective since July 21, 2012.

With respect to compliance with its requirements, Section 13 provides:

> [A] banking entity. . . shall bring its activities and investments into compliance with the requirements of [Section 13] not later than 2 years after the date on which the requirements become effective [i.e., by July 21, 2014]. . . . The [Federal Reserve] may, by rule or order, extend this two-year period for not more than one year at a time, if, in the judgment of the [Federal Reserve], such an extension is consistent with the purposes of [Section 13] and would not be detrimental to the public interest. The

14 Section 13 also directs the Agencies to apply "capital requirements" and "additional quantitative limits"—sometimes referred to as "Volcker Lite"—for any proprietary trading or covered fund activities of nonbank financial companies supervised by the Federal Reserve under the Dodd-Frank Act. BHC Act §§ 13(a)(2), 13(f)(4). These provisions would be relevant, as the Agencies point out, only to the extent that such a nonbank financial company is both engaged in activities covered by the Volcker Rule and not already affiliated with an insured depository institution (which confers "banking entity" status, as discussed in Part 2.A of this Memorandum). Supp. Info. 1. The provisions could become more relevant in the future, however, if additional nonbank financial companies were designated or if an existing designated nonbank financial company were to "de-bank."

15 Supp. Info. 4.

16 *See id*. at 11 & n. 35.

17 BHC Act § 13(c)(1).

> extensions made by the [Federal Reserve] under the preceding sentence may not exceed an aggregate of 3 years.[18]

Section 13 also provides for a five-year additional extension of the conformance period for a limited group of "illiquid funds."[19]

On February 9, 2011, the Federal Reserve released a final rule (the "Conformance Rule") with respect to the two-year "conformance period" and applications for additional extensions, including the required timing and content of such applications and the criteria that would be used to evaluate them.[20]

The Conformance Rule did not address practical expectations with respect to banking entities' conduct during the conformance period. On April 19, 2012, as no final regulations appeared to be on the horizon before the July effective date, the Federal Reserve issued guidance on the conformance period. This guidance stated that banking entities were expected to engage in "good-faith planning efforts, appropriate for their activities and investments, to enable them to conform their activities and investments to the requirements of [Section 13] and the final implementing rules by no later than the end of the conformance period," that is, July 21, 2014.[21] As discussed in Part 2 of this Memorandum, the Federal Reserve's Conformance Period Order generally extended the deadline for conforming activities and investments to July 21, 2015.

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[18] *Id*. § 13(c)(2).

[19] *Id*. § 13(c)(3).

[20] Federal Reserve, *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, 76 Fed. Reg. 8265 (Feb. 14, 2011). By supplying restrictive definitions, the Federal Reserve's conformance period rule also considerably narrowed the potential five-year extension for "illiquid funds." *See* our Memorandum to Clients, dated February 11, 2011, "Federal Reserve Adopts Final Rule Implementing Volcker Rule Conformance Periods"; *see also* Part 2.C of this Memorandum.

[21] Federal Reserve, *Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, 77 Fed. Reg. 33949 (June 8, 2012). *See* our Memorandum to Clients, dated April 20, 2012, "Federal Reserve Issues Statement of Policy Clarifying the Conformance Period under the Volcker Rule."

2. COVERAGE OF THE VOLCKER RULE AND REGULATORY COORDINATION

The starting point of any firm's Volcker Rule analysis will be whether it is subject to the Volcker Rule and, if so, when it must be in compliance with the Final Rule's requirements.

The question of timing is particularly relevant now that the Final Rule has been released. Although the Federal Reserve has extended the general conformance period to July 21, 2015, some requirements are effective earlier, and the amount of compliance and reporting that will ultimately be required will vary significantly across banking entities. Banking entities should seek to understand the Volcker Rule categories into which they fall as soon as possible.

In addition, the Final Rule has been adopted by each of the five Agencies, and each of the five Agencies has authority to administer and enforce the Final Rule with respect to different types of banking entities. A banking entity and its affiliates may together be under the Volcker Rule jurisdiction of multiple Agencies. The Final Rule contains no mechanism for banking entities to seek coordinated guidance from the Agencies on interpretive or implementation matters. It remains to be seen how regulatory coordination on these critical issues will be achieved.

2.A. Coverage of the Volcker Rule

The Volcker Rule applies to any "banking entity." Consistent with the statutory definition,[22] the Final Rule defines "banking entity" to mean:

(1) any "insured depository institution," meaning any bank or savings association the deposits of which are insured by the FDIC pursuant to the Federal Deposit Insurance Act (the "FDIA");[23]

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22 *See* BHC Act § 13(h)(1).

23 Specifically: "*Insured depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act. . . but does not include an insured depository institution that is described in section 2(c)(2)(D) of the BHC Act." Final Rule § _.2(r).

BHC Act § 2(c)(2)(D) describes certain "institution[s] that function[] solely in a trust or fiduciary capacity," which may have FDIC-insured deposits, but are not treated as "insured depository institutions" for purposes of the Volcker Rule.

FDIA § 3(c)(2) provides that "[t]he term 'insured depository institution' means any bank or savings association the deposits of which are insured by the [FDIC] pursuant to this Act." FDIA § 3(c)(3) provides that "[t]he term 'insured depository institution' includes any uninsured branch or agency of a foreign bank or a commercial lending company owned or controlled by a foreign bank *for purposes of section 8 of this Act*" (emphasis added). Section 8 of the FDIA specifically concerns enforcement powers of the federal banking agencies to bring cease-and-desist proceedings for unsafe or unsound practices or violations of law, among other things. Thus, "insured depository

(2) any company that controls an insured depository institution, such as a bank holding company or a savings and loan holding company;

(3) any company that is treated as a bank holding company for purposes of Section 8 of the IBA (generally a foreign bank that has a U.S. branch or agency);[24] and

(4) any "affiliate" or "subsidiary" of the foregoing, except that the following are excluded if they are not separately captured under clauses (1)–(3):

- a "covered fund";
- a portfolio company held under BHC Act authority for merchant banking investments or investments by an insurance company;[25] and
- a "portfolio concern" controlled by a small business investment company (an "SBIC").[26]

"Banking entity" also excludes the FDIC in its corporate capacity or as conservator or receiver under the FDIA or Title II of the Dodd-Frank Act.[27]

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institution" does not generally include uninsured U.S. branches or agencies of a foreign bank. Such branches and agencies will nonetheless generally be "banking entities" for purposes of the Volcker Rule because of their affiliation with a foreign bank that is treated as a bank holding company for purposes of IBA § 8.

24 This prong of the definition will generally capture a foreign bank that has a U.S. branch or agency. IBA § 8(a) provides that, "[e]xcept as otherwise provided in this section (1) any foreign bank that maintains a branch or agency in a State [i.e., any State of the United States or the District of Columbia], (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary shall be subject to the provisions of the [BHC Act], and to sections 105 and 106 of the Bank Holding Company Act Amendments of 1970 in the same manner and to the same extent that bank holding companies are subject to such provisions."

25 BHC Act § 4(k) describes the authority of financial holding companies to engage in activities that are not banking but are "financial in nature." Subject to several conditions, this authority may extend to holding an ownership interest "as part of a bona fide underwriting or merchant or investment banking activity" in a company that engages in activities that are impermissible for the financial holding company itself (e.g., industrial businesses). *Id*. § 4(k)(4)(H); *see also* Subpart J of the Federal Reserve's Regulation Y. The authority may also extend to holding an ownership interest in such a company by an insurance company. BHC Act § 4(k)(4)(I).

26 Specifically: "any portfolio concern, as defined under 13 CFR 107.50, that is controlled by a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958." Final Rule § _.2(c)(2)(ii). This exclusion prevents certain small businesses that may receive financial or managerial assistance from a banking entity from becoming subject to the Volcker Rule.

The Final Rule defines the terms “affiliate” and “subsidiary” to have the same meanings as under Section 2 of the BHC Act.[28] Accordingly, banking entity status under the Volcker Rule may result from being “controlled” by, or under “common control” with, another banking entity under BHC Act principles. BHC Act “control” determinations can be fact-intensive—especially with respect to the “controlling influence” prong of the relevant definitions—and “control” may exist at relatively low ownership levels.

“Covered funds” are excluded from the definition of “banking entity” even though they may be affiliated with banking entities. As discussed in Part 5 of this Memorandum, “covered funds” are those with respect to which a banking entity’s ownership, sponsorship or other relationships are specifically restricted by the Volcker Rule. If a covered fund were also a banking entity, it would itself become subject to the Volcker Rule’s restrictions. For example, a banking entity might permissibly own a small interest in a hedge fund that it sponsors and is deemed to control under BHC Act principles. If that hedge fund were a banking entity, it would not be allowed to engage in proprietary trading. The Volcker Rule limits the banking entity’s investment in the hedge fund, but is not necessarily intended to prevent the hedge fund itself from engaging in proprietary trading. Hence, covered funds are excluded from the definition of banking entity. Some funds, however, are not covered funds, and these funds would be banking entities if they are deemed to be affiliated with banking entities.

Similarly, like covered funds, companies in which a banking entity invests under merchant banking authority are generally not intended to be subject to the Volcker Rule. These companies are recognized to be different from banking entities, and banking entities’ investments in them are already highly regulated. Certain of the covered fund provisions of the Volcker Rule, however, may affect how banking entities structure merchant banking investments.[29]

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[27] *Id*. § _.2(c).

[28] *Id*. §§ _.2(a), _.2(dd). Under the BHC Act, “the term ‘affiliate’ means any company that controls, is controlled by, or is under common control with another company,” and “[a]ny company has control over a bank or over any company if—(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the [Federal Reserve] determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.” BHC Act §§ 2(k), 2(a)(2).

“Subsidiary” has a similar definition: “‘Subsidiary’, with respect to a specified bank holding company, means (1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by such bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company with respect to the management of policies of which such bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the [Federal Reserve], after notice and opportunity for hearing.” BHC Act § 2(d).

[29] *See* Part 5.B of this Memorandum.

2.B. Thresholds for Compliance Programs and Reporting

If a banking entity is subject to the Volcker Rule, then it is, in general, subject to all the requirements of the Volcker Rule with respect to prohibited and permitted activities. The policies and procedures, recordkeeping, internal controls and other compliance requirements that are necessary, however, vary significantly depending on the size of the banking entity and its level of trading activities.

The Volcker Rule compliance category into which a banking entity falls will, to a large extent, determine the compliance infrastructure that the banking entity must build by July 21, 2015. Furthermore, in the case of banking entities with significant trading activities, some reporting requirements are effective before that date.

Part 10 of this Memorandum provides a detailed discussion of compliance programs under the Volcker Rule. Broadly speaking, a banking entity may be subject to compliance at one of five levels:

(1) ***None***, for banking entities that engage in no restricted activities.

(2) ***Light***, for smaller banking entities, which requires only that such banking entities include in their existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule.

(3) ***Standard***, for banking entities that engage in restricted activities and do not fall into any of the other categories, which requires that such banking entities implement and maintain a compliance program that meets several minimum requirements summarized in the **Annex** to this Memorandum.

(4) ***Enhanced***, for larger banking entities and banking entities with significant trading activities, which adds to the Standard program additional and more detailed policies and procedures, internal controls, independent testing and other requirements, as well as an annual CEO certification requirement.

(5) ***Enhanced Plus Metrics***, for banking entities with significant trading activities, which adds to the Enhanced program the calculation and reporting of quantitative trading metrics.

The following table summarizes the applicable criteria for these compliance programs and the dates on which the corresponding compliance requirements will become effective.

Fig. 2.B: Criteria for Compliance Programs

Compliance Program	Criteria for This Level	Effective Dates
None	No proprietary trading (other than permitted trading in U.S. government obligations) or covered fund activities or investments.	N/A
Light	Total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years.	July 21, 2015
Standard	Not qualifying for any other level and not currently required to report quantitative trading metrics.	July 21, 2015
Enhanced (Includes CEO Certification)	(1) **For a U.S. banking entity:** total consolidated assets of $50 billion or more as of the previous calendar year-end; **For a foreign banking entity:** “total U.S. assets” of $50 billion or more as of the previous calendar year-end, “including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States”;	July 21, 2015
	(2) Currently required to report quantitative trading metrics (this is an independent trigger for the Enhanced compliance program for banking entities that do not meet the total consolidated assets threshold); or	Later of July 21, 2015 and becoming subject to reporting of metrics
	(3) Notified by the relevant Agency.	Later of July 21, 2015 and being notified
Enhanced (Includes CEO Certification) Plus Metrics	(1) **For a U.S. banking entity:** total “trading assets and liabilities,” together with affiliates and subsidiaries, but excluding trading assets and liabilities “involving obligations of or guaranteed by the United States or any agency of the United States,” the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $10 billion; **For a foreign banking entity:** trading assets and liabilities of “the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States. . .),” excluding trading assets and liabilities “involving obligations of or guaranteed by the United States or any agency of the United States,” the average gross sum of which, over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $10 billion; or	For the Enhanced program, later of July 21, 2015 and becoming subject to reporting of metrics. For reporting of metrics, based on level of trading assets and liabilities: $50 billion: June 30, 2014 $25 billion: April 30, 2016 $10 billion: December 31, 2016
	(2) Notified by the relevant Agency.	Later of time noted above and being notified

2.B.1. Measurement of "Trading Assets and Liabilities"

As noted in Figure 2.B above, the thresholds for calculating and reporting quantitative trading metrics generally depend on amounts of "trading assets and liabilities."[30] The Final Rule uses this phrase, but neither the Final Rule nor the Supplementary Information provides a definition of these assets and liabilities or instructions for how to measure them.

Federal Reserve Form FR Y-9C, on which bank holding companies and savings and loan holding companies report their consolidated financial condition, may be instructive because it contains schedules with line items for "Trading Assets" and "Trading Liabilities."[31] In addition, Call Reports of insured depository institutions also include these line items.[32] It

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[30] *See* Final Rule § _.20(d).

[31] Federal Reserve, *FR Y-9C Instructions: Line Item Instructions for Consolidated Balance Sheet for Holding Companies: Schedule HC* (2013). The instructions for these line items read as follows:

> **Trading assets.** Trading activities typically include (a) regularly underwriting or dealing in securities; interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts; other financial instruments; and other assets for resale; (b) acquiring or taking positions in such items 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; or (c) acquiring or taking positions in such items as an accommodation to customers or for other trading purposes. Assets and other financial instruments held for trading shall be consistently valued at fair value. . . .
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> Pursuant to ASC Topic 825, Financial Instruments. . . all securities within the scope of ASC Topic 320, Investment – Debt and Equity Securities. . . that a holding company has elected to report at fair value under a fair value option with changes in fair value reported in current earnings should be classified as trading securities. . . . [H]olding companies may classify [other assets] as trading if the holding company applies fair value accounting, with changes in fair value reported in current earnings, and manages these assets as trading positions, subject to the controls and applicable regulatory guidance related to trading activities. . . .
>
> Do not include in this item the carrying value of any available-for-sale securities, any loans that are held for sale (and are not classified as trading in accordance with the preceding instruction), and any leases that are held for sale. . . .
>
> Trading assets also include derivatives with a positive fair value resulting from the ''marking to market'' of interest rate, foreign exchange rate, commodity, equity, and credit derivative contracts held for trading purposes as of the report date. . . .
>
> **Trading liabilities.** Report the amount of liabilities from the reporting holding company's trading activities. Include liabilities resulting from the sales of assets that the reporting holding company does not own (see Glossary entry for "short position") and revaluation losses from "marking to market" derivative contracts into which the reporting holding company has entered for trading, dealer, customer accommodation, and similar purposes.
>
> In addition, for purposes of this report, holding companies may classify liabilities as trading if the holding company applies fair value accounting, with changes in fair value reported in current earnings, and manages these assets as trading positions, subject to the controls and applicable regulatory guidance related to trading activities.

[32] *See Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041): Schedule RC-D: Trading Assets and Liabilities* (Dec. 2011), which also includes similar instructions for the relevant line items.

remains to be seen whether the Agencies will provide interpretive guidance on these terms' meanings in the context of the Final Rule.

"Trading assets and liabilities" are not the only assets and liabilities potentially restricted by the Volcker Rule. Rather, the Final Rule uses trading assets and liabilities as a proxy for the significance of a banking entity's trading activities in determining whether a banking entity must calculate and report quantitative trading metrics.

2.C. Key Compliance Dates and Further Extensions of the Conformance Period

In general, no later than July 21, 2015, banking entities must both bring their activities into compliance with the Volcker Rule and design and implement the extensive compliance infrastructure required by the Final Rule. As noted in Figure 2.B above, banking entities with trading activities that meet certain specified thresholds will be required to report quantitative metrics on a different schedule beginning between July 2014 and January 2017.

As discussed in Part 1.B of this Memorandum, the Federal Reserve may grant up to two additional one-year extensions of the conformance period. Under the Federal Reserve's Conformance Rule, applications for such extensions must be made at least 180 days before the expiration of the applicable conformance period (in other words, January 21, 2015 for the second one-year extension of the conformance period to July 21, 2016, and January 21, 2016 for the third one-year extension of the conformance period to July 21, 2017).[33]

The factors that the Federal Reserve may consider in evaluating an application for an extension may include, to the extent applicable, the following:

(1) whether the activity or investment:

- involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;
- would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; or
- would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States;

(2) market conditions;

(3) the nature of the activity or investment;

33 12 CFR § 225.181(c).

(4) the date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;

(5) the contractual terms of the banking entity's interest in the fund;

(6) the degree of control held by the banking entity over investment decisions of the fund;

(7) the types of assets held by the fund;

(8) with respect to the type of assets held by the fund, whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory or contractual restrictions on the offer, sale or transfer of such assets have expired;

(9) the date on which the fund is expected to wind up its activities and liquidate or its investments may be redeemed or sold;

(10) the total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or to the financial stability of the United States;

(11) the cost to the banking entity of disposing of the activity or investment within the applicable period;

(12) whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty; and

(13) the banking entity's prior efforts to divest or conform the activity or investments, including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity, partnership or other ownership interest in, or provide additional capital to, the illiquid fund.[34]

Many of these factors explicitly contemplate applications for extensions of time to divest or conform investments in private equity or similar funds, which can be expected to be a significant source of such applications, although extensions are not limited to these investments.

Banking entities may also apply for an additional five-year extension of the conformance period for "illiquid funds," but the Conformance Rule's requirements for this extension may

[34] 12 CFR § 225.181(d). As noted above, our Memorandum to Clients on the Conformance Rule also provides additional information.

be prohibitive in many cases. In particular, with respect to an investment in a private equity or similar fund, a banking entity will generally be required to have tried and failed to obtain consent from the fund manager to transfer the investment.[35] Many illiquid investments are illiquid not because fund managers refuse to consent to their transfer, however, but because it can be difficult to find attractive selling opportunities in secondary markets.

The following table summarizes certain key compliance and application dates under the Final Rule and the Conformance Rule.

Fig. 2.C: Certain Key Compliance and Application Dates

"Promptly"	Banking entities must terminate or divest any "stand-alone" proprietary trading.
2014	
April 1	This is the effective date of the Final Rule, although there are various transition rules, described below.
June 30	Banking entities with $50 billion or more of covered trading assets and liabilities become subject to reporting of quantitative metrics. For 2014, these metrics must be reported for each calendar month within 30 days of the end of the month.
2015	
January 21	Applications are due for the second of the Federal Reserve's three one-year extensions of the conformance period (i.e., from July 21, 2015 to July 21, 2016).
January 31	Banking entities with $50 billion or more of covered trading assets and liabilities must begin reporting quantitative metrics *within 10 days of the end of the month*.
July 21	**The "blanket" Volcker Rule conformance period extension ends, and banking entities are required to have conformed their activities and implemented their compliance programs if they have not received additional extensions.**
2016	
January 21	Applications are due for the third of the Federal Reserve's three one-year extensions of the conformance period (i.e., from July 21, 2016 to July 21, 2017).
April 30	Banking entities with $25 billion or more of covered trading assets and liabilities become subject to reporting of quantitative metrics, which are to be reported quarterly within 30 days after the end of each calendar quarter.
July 21	If sought and obtained, a banking entity's second one-year extension of the Volcker Rule conformance period ends.
December 31	Banking entities with $10 billion or more of covered trading assets and liabilities become subject to reporting of quantitative metrics, which are to be reported quarterly within 30 days after the end of each calendar quarter.
2017	
July 21	If sought and obtained, a banking entity's third one-year extension of the Volcker Rule conformance period ends.

35 *See* 12 CFR § 225.181(b)(3)(iii)(B).

2.D. Conduct During the Conformance Period

The Federal Reserve's Conformance Period Order, which extends the conformance period to July 21, 2015, articulates the following expectations for banking entities' conduct during the conformance period:

> During the conformance period, each banking entity is expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of [the Volcker Rule] by no later than the end of the conformance period. Good faith efforts include evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period. In addition, banking entities that have stand-alone proprietary trading operations are expected to promptly terminate or divest those operations. Moreover, banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted.[36]

Practical supervisory expectations for progress on a conformance plan over the next 18 months are not yet known. With respect to the compliance program in particular, the Final Rule explains that "each banking entity must establish the compliance program required for that entity. . . as soon as practicable and in no case later than the end of the conformance period. The Agencies expect that during this period a banking entity will develop and implement the compliance program requirements of the final rule as part of its good-faith efforts to fully conform its activities and investments to the requirements of [the Volcker Rule]."[37]

Banking entities with the most significant trading activities (that is, $50 billion dollars or more in covered trading assets and liabilities as measured under the Final Rule) will be required to report quantitative trading metrics before their full compliance programs are required to be in place and before they are required to have fully conformed their activities.[38] This early metrics-reporting period will serve as a trial run after which "[t]he Agencies will review the data collected and revise this [metrics] collection requirement as appropriate based on a review of the data collected prior to September 30, 2015" (a time by which no banking entities with less than $50 billion in covered trading assets and liabilities would have had to

[36] Conformance Period Order at 3 (footnote omitted).

[37] Supp. Info. 775 (footnote omitted).

[38] "While these banking entities will be required to begin to report and record quantitative measurements by June 30, 2014, they will not be required to implement an enhanced compliance program by this date. Instead. . . a banking entity must establish a compliance program as soon as practicable and in no event later than the end of the conformance period." *Id*. at 787.

report metrics).[39] It remains to be seen how this ongoing process will affect trading operations.

2.E. Regulatory Authority and Coordination

The Final Rule has been adopted by the OCC, Federal Reserve, FDIC, SEC and CFTC. This result comports with the requirement of Section 13 that implementing regulations be issued by:

(1) "the appropriate Federal banking agencies,"[40] jointly, with respect to insured depository institutions;

(2) the Federal Reserve, with respect to any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of Section 8 of the IBA, and any subsidiary of any of the foregoing for which no other Agency is the "primary financial regulatory agency";[41]

(3) the CFTC, with respect to any entity for which the CFTC is the "primary financial regulatory agency";[42] and

39 Final Rule Appendix A § 1.

40 Under the FDIA, the "appropriate Federal banking agency" is: (i) the OCC with respect to: (a) any national banking association; (b) any Federal branch or agency of a foreign bank; and (c) any Federal savings association; (ii) the FDIC with respect to: (a) any state-chartered FDIC-insured bank that is not a member of the Federal Reserve System; (b) any foreign bank having an FDIC-insured branch; and (c) any state-chartered savings association; and (iii) the Federal Reserve with respect to: (a) any state-chartered bank that is a member of the Federal Reserve System; (b) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act that is made applicable under the IBA; (c) any foreign bank that does not operate an insured branch; (d) any agency or commercial lending company other than a Federal agency; (e) supervisory or regulatory proceedings arising from the authority given to the Federal Reserve under IBA § 7(c)(1), including such proceedings under the Financial Institution Supervisory Act of 1966; (f) any bank holding company and any subsidiary (other than a depository institution) of a bank holding company; and (g) any savings and loan holding company and any subsidiary (other than a depository institution) of a savings and loan holding company. FDIA § 3(q). More than one Agency may be an "appropriate Federal banking agency" for a particular banking entity. *Id*.

41 "Primary financial regulatory agency" is a definition from the Dodd-Frank Act. An "appropriate Federal banking agency" of a banking entity is also the banking entity's "primary financial regulatory agency," "except to the extent that an institution is or the activities of an institution are otherwise described" in lists of entities for which the SEC, CFTC, state insurance commissioners or the Federal Housing Finance Agency (the "FHFA") are defined to be the "primary financial regulatory agency." Dodd-Frank Act § 2(12)(A).

42 The CFTC is the "primary financial regulatory agency" for, among other things, registered swap dealers, futures commission merchants, commodity pool operators, commodity trading advisors and introducing brokers, in each case, "with respect to the activities" requiring registration. *Id*. § 2(12)(C).

(4) the SEC, with respect to any entity for which the SEC is the "primary financial regulatory agency."[43]

The Agencies are empowered to order termination of any activity or investment that violates or functions as an evasion of the Volcker Rule.[44] Section 13 also provides that nothing in the Volcker Rule may be "construed to limit the inherent authority of any Federal agency or State regulatory authority under otherwise applicable provisions of law."[45]

Many banking organizations contain affiliated entities and engage in activities that will fall under the jurisdiction of different Agencies. As a result, multiple Agencies could be responsible for supervising and administering the Volcker Rule with respect to a banking entity, its subsidiaries and affiliates and even its individual trading desks. As one of many examples, a broker-dealer subsidiary of a bank holding company could be subject to supervision both by the SEC and by the Federal Reserve as the prudential supervisor of the bank holding company's operations.

How this regulatory coordination will work in practice remains one of the key unanswered questions associated with the Volcker Rule. The Agencies are, in general, directed to "provide for consistent application and implementation of the applicable provisions of [the Volcker Rule] to avoid providing advantages or imposing disadvantages to the companies affected."[46] The Agencies noted that they "plan to coordinate their examination and enforcement proceedings under [the Volcker Rule], to the extent possible and practicable, so

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[43] The SEC is the "primary financial regulatory agency" for, among other things, registered brokers, dealers and security-based swap dealers, investment companies and investment advisers, in each case, "with respect to the activities" requiring registration (or, in the case of registered investment advisers, "with respect to the investment advisory activities of such company and activities that are incidental to such advisory activities"). *Id*. § 2(12)(B).

[44] *See* BHC Act § 13(e)(2); Final Rule § _.21(b). Each of the Agencies has authority to issue an order of termination under BHC Act § 13(e)(2). Under the Final Rule, banking entities themselves must also, upon "discovery" of a Volcker Rule violation, "promptly terminate the activity and, as relevant, dispose of the investment." Final Rule § _.21(a).

[45] BHC Act § 13(g)(3). Violations of Section 13 and the Final Rule may be subject to sanctions under several other statutes. These include BHC Act § 8(a), which makes it a crime for anyone to knowingly violate any provision of the BHC Act (including Section 13). The Federal Reserve has authority under BHC Act §§ 5(b) and 8(b) to issue orders and assess civil money penalties against any company that violates Section 13 or the Final Rule, or individuals who participate in a violation. In addition, each federal banking agency has authority under FDIA § 8 to issue cease-and-desist orders and assess civil money penalties against the institutions for which it is the "appropriate Federal banking agency" and their institution-affiliated parties to enforce compliance with any law or regulation, including Section 13 and the Final Rule.

Apart from noting that "the Agencies may rely on their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law," the Supplementary Information does not specifically discuss authority other than Section 13 under which the SEC or CFTC might impose Volcker Rule-related sanctions. Supp. Info. 858.

[46] BHC Act § 13(b)(2)(B)(ii).

as to limit duplicative actions and undue costs and burdens for banking entities," but also acknowledged that there may be "overlapping jurisdictional authority."[47]

Numerous issues with respect to regulatory coordination remain uncertain, including:

(1) the extent to which the Agencies will engage in joint decision-making;

(2) the level of agreement or process required to resolve issues that are subject to the jurisdiction of multiple Agencies;

(3) the regulatory contacts to whom interpretive questions should be directed;

(4) the confidentiality of a banking entity's questions and the Agencies' responses; and

(5) the conduct of supervisory examinations.

[47] Supp. Info. 862. Two examples given of "overlapping jurisdictional authority" are inter-affiliate trading activities ("To include in a trading desk's financial exposure either positions held at an affiliated legal entity. . . a banking entity must be able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section 13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions. . . . Similarly, the supervisors and examiners of any Agency that has supervisory authority over the banking entity that holds financial instruments that are being included in another trading desk's financial exposure for purposes of the market-making exemption must have the same level of access to the records of the trading desk.") and enterprise-wide compliance programs ("If a banking entity establishes an enterprise-wide program. . . that program will be subject to supervisory review and examination by any Agency vested with rule writing authority under section 13 of the BHC Act with respect to the compliance program and the activities or investments of each banking entity for which the Agency has such authority."). *Id.* at 204-05 (footnote omitted), 801.

3. PROPRIETARY TRADING – PROHIBITION AND KEY DEFINITIONS

"Proprietary trading" was traditionally understood to refer to trading desks within a firm that were allocated a specified amount of the firm's capital and tasked with investing the capital to the firm's profit—not with servicing the firm's customers or with other functions such as asset–liability management.[48] These "stand-alone" proprietary trading operations were clearly targeted by the Volcker Rule and so had been shut down by many banking entities even before the Final Rule was released.[49]

Under the Volcker Rule, however, "proprietary trading" has a significantly broader definition, which captures many activities that would not traditionally have been referred to as proprietary trading. Accordingly, banking entities will need to undertake a careful review to ensure that they have identified all potential Volcker Rule proprietary trading within their organizations.

Specifically, the prohibition on proprietary trading under the Final Rule means that a banking entity may not engage as principal in:

(1) any purchase or sale of one or more ***"financial instruments"***

(2) for the ***"trading account"*** of the banking entity,

(3) unless:

- the activity is ***excluded*** from the definition of "proprietary trading," or
- an ***exemption*** is available and its requirements are satisfied.[50]

The three prongs of this core prohibition are discussed in turn below.

The prohibition is applicable when a banking entity is trading as principal—that is, purchasing or selling for its own account. The prohibition does not apply to trading by a banking entity that is acting solely as agent, broker or custodian.[51]

48 The FSOC Study referred to such activities as "'bright line' proprietary trading," which it stated were, among other things, "[o]rganized to conduct trading activities for the sole purpose of generating profits from trading strategies," without "formal market making responsibilities or customer exposure (or customer exposure that is not commensurate with the level of trading)." FSOC Study at 27.

49 *See id*.

50 Final Rule § _.3(a).

51 *See id*. § _.3(d)(7).

3.A. "Financial Instruments" Subject to the Proprietary Trading Restrictions

Summary

Included as "Financial Instrument"	Excluded from "Financial Instrument"
• Securities • Swaps, including foreign exchange swaps, and security-based swaps • Forwards and futures, including foreign exchange forwards, even if intended to be physically settled • Other foreign exchange and commodity transactions that are not "spot" transactions • Options on any of the foregoing	• Loans ("any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative") • "Spot" commodity transactions (except for certain commodities such as interest rate or credit risk indexes) • "Spot" foreign exchange transactions

The proprietary trading restrictions of the Volcker Rule apply to trading activity in an instrument that qualifies as a "financial instrument."[52]

The Final Rule defines "financial instrument" as:

(1) a ***security***, including an option on a security;

(2) a ***derivative***, including an option on a derivative; or

(3) a contract of sale of a ***commodity for future delivery*** (that is, a future), or an option on such a contract;

but ***excludes***:

(1) a ***loan***, defined as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative";[53]

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52 *See* Final Rule § _.3(c).

53 *See id.* § _.2(s). The scope of this definition is discussed in Part 3.A.1 of this Memorandum.

(2) ***physical commodities***, such as energy, metals and agricultural commodities, other than (i) any "excluded commodity" as defined in Section 1a(19) of the Commodity Exchange Act (the "CEA")[54] and (ii) any derivative, future or forward; and

(3) ***foreign exchange and currency***.[55]

For purposes of this definition, "*security*" means a security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (the "Exchange Act").[56]

"*Derivative*" is defined as:

(1) any swap, as defined in Section 1a(47) of the CEA, or security-based swap, as defined in Section 3(a)(68) of the Exchange Act;

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[54] Specifically: "The term 'excluded commodity' means—(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure; (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and (II) associated with a financial, commercial, or economic consequence." CEA § 1a(19).

[55] Final Rule § _.3(c). As the Supplementary Information explains: "[L]oans, commodities, and foreign exchange or currency are not included within the scope of instruments subject to [the Volcker Rule]. The exclusion of these types of instruments is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities, and foreign exchange or currency—none of which are referred to in [the relevant section of the Dodd-Frank Act]—are outside the scope of transactions to which the proprietary trading restrictions apply. For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion." Supp. Info. 54.

[56] Specifically: "The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." Exchange Act § 3(a)(10).

(2) any purchase or sale of a commodity, other than any "excluded commodity," for deferred shipment or delivery that is intended to be physically settled (in other words, a forward contract on a physical commodity);

(3) any foreign exchange forward (as defined in Section 1a(24) of the CEA) or foreign exchange swap (as defined in Section 1a(25) of the CEA);[57]

(4) certain retail foreign currency transactions and other retail commodity transactions with futures-like features, as described in Sections 2(c)(2)(C)(i) and 2(c)(2)(D)(i) of the CEA, respectively;[58] and

(5) any transaction authorized under Section 19 of the CEA;[59]

but ***excludes***:

(1) any consumer, commercial or other agreement, contract or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance or other action as not within the definition of swap, as defined in Section 1a(47) of the CEA, or security-based swap, as defined in Section 3(a)(68) of the Exchange Act;[60] and

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[57] Although foreign exchange forwards and foreign exchange swaps are otherwise generally excluded from the definition of "swap" under the CEA and of "security-based swap" under the Exchange Act, the Agencies "believe that these instruments appear to be, or operate in economic substance as, derivatives (which are by statute included within the scope of instruments subject to the prohibitions of [the Volcker Rule]). If these instruments were not included within the definition of financial instrument, banking entities could use them to engage in proprietary trading that is inconsistent with the purpose and design of [the Volcker Rule]." Supp. Info. 54.

[58] These sections of the CEA serve to extend the CFTC's jurisdiction (and thus anti-fraud authority) to certain retail contracts that are worded as spot transactions, but actually function like futures contracts. The sections do not cover true spot transactions in which delivery must occur within a short time. *See* CFTC, *Retail Commodity Transactions Under Commodity Exchange Act*, 76 Fed. Reg. 77670, 77671 (Dec. 14, 2011).

[59] CEA § 19 authorizes certain otherwise-prohibited transactions in silver, gold or platinum "under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract."

[60] Examples of "agreements, contracts or transactions" in this category include floating-rate loans and home-heating-oil agreements with price-protection caps.

> (2) any identified banking product, as defined in Section 402(b) of the Legal Certainty for Bank Products Act of 2000, that is subject to Section 403(a) thereof.[61]

With respect to derivatives, references in the Final Rule to "purchases" and "sales" include "the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require."[62]

3.A.1. The Definition of "Loan" under the Volcker Rule

As noted above, activities with respect to "loans" are generally not covered by the prohibition on proprietary trading.[63] For this purpose, "loan" is defined as "any loan, lease, extension of credit, or secured or unsecured receivable *that is not a security or derivative*." Thus, the approach of the Final Rule is to use a broad baseline definition to include many extensions of credit, but also a broad carve-out through the exclusion of securities and derivatives.

A banking entity must evaluate whether a loan is a security or a derivative under federal securities laws or federal laws applicable to derivatives. The Supplementary Information explains:

> The Agencies note that the parties' characterization of an instrument as a loan is not dispositive of its treatment under the federal securities laws or federal laws applicable to derivatives. The determination of whether a loan is a security or a derivative for purposes of the loan definition is based on the federal securities laws and the Commodity Exchange Act. Whether a loan is a "note" or "evidence of indebtedness" and therefore a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan. For example, loans that are structured to provide payments or returns based on, or tied to, the performance of an asset, index or commodity or provide synthetic exposure to the credit of an underlying borrower or an underlying security or index may be securities or derivatives depending on their terms and the circumstances of their creation, use, and distribution.[64]

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61 These "identified banking products" generally include bank deposits, banker's acceptances, letters of credit issued by or loans made by a bank, debit accounts at banks arising from credit cards or similar arrangements and certain loan participations.

62 Final Rule §§ _.2(u), _.2(x).

63 The definition of "loan" is also relevant for the covered fund provisions of the Volcker Rule, particularly the exclusion from the covered fund restrictions for certain issuers of asset-backed securities based on loans. *See* Part 5.B of this Memorandum.

64 Supp. Info. 529-30 (footnote omitted).

The applicable law—not summarized here—is complex.[65] The definition in the Final Rule does make clear, however, that instruments widely acknowledged to be securities, such as traditional corporate bonds, will not be excluded from the prohibition on proprietary trading solely by virtue of having debt-like features.

[65] *See, e.g.*, *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

3.B. Transactions Subject to the Proprietary Trading Restrictions

Summary

Included as "Proprietary Trading"	Excluded from "Proprietary Trading"
• **Purchases or sales principally for the purpose of short-term resale, benefiting from short-term price movements, realizing short-term arbitrage profits or hedging such a purchase or sale (the "Purpose Test," presumed to be satisfied in the case of a position held for fewer than 60 days)** • **Purchases or sales that are both covered positions and trading positions (or hedges of other covered positions) under the banking agencies' market risk capital rules (the "Market Risk Capital Rule Test")** • **Purchases or sales by security, swap or security-based swaps dealers in connection with the activities that require them to be so registered (the "Status Test")**	• **Positions arising under repurchase, reverse repurchase or securities lending agreements** • **"Liquidity management" (but narrowly defined)** • **Certain transactions by a derivatives clearing organization or clearing agency, or their members** • **Certain transactions in connection with failures to deliver or judicial or administrative proceedings** • **Transactions solely as agent, broker or custodian** • **Certain transactions in connection with pension or other compensation plans** • **Positions in connection with collecting a debt previously contracted**

As noted above, proprietary trading is defined as engaging as principal in any purchase or sale of one or more financial instruments "for the 'trading account' of the banking entity."

"Trading account" is one of the most confusing concepts in the Volcker Rule. As the Agencies point out, the term comes directly from Section 13: "[T]he term 'trading account' is a statutory concept and does not necessarily refer to an actual account. Trading account is simply nomenclature for the set of transactions that are subject to the final rule's restrictions on proprietary trading."[66] Hence, the definition is circular.

[66] Supp. Info. 38 n. 124.

In practical terms, the relevant question is not, "Is this trading activity for the trading account of the banking entity?" but rather, "Is this trading activity defined to be proprietary trading?" Generally, trading activity will be proprietary trading if:

(1) it satisfies at least one of the Purpose Test, the Market Risk Capital Rule Test and the Status Test; and

(2) it is not specifically excluded from the definition of proprietary trading.

(i) Purpose Test and 60-Day Rebuttable Presumption

A purchase or sale of a financial instrument satisfies the "Purpose Test," and is therefore a "trading account," if it is principally for the purpose of:

(1) short-term resale;

(2) benefiting from actual or expected short-term price movements;

(3) realizing short-term arbitrage profits; or

(4) hedging one or more positions resulting from the purchases or sales of financial instruments described in clauses (1)–(3).[67]

The Final Rule includes a rebuttable presumption that any purchase or sale of a financial instrument that is held for fewer than 60 days (or an instrument of which the banking entity substantially transfers the risk within 60 days) meets the Purpose Test and is therefore proprietary trading. The presumption can be rebutted if the banking entity can demonstrate, based on all the facts and circumstances, that the instrument, either individually or together with a group of related positions, was not purchased or sold principally for any of the purposes described in the Purpose Test. There is no safe harbor or reverse presumption that positions held for 60 days or more are not proprietary trading positions.[68]

The purchase or sale of a financial instrument must be evaluated under the Purpose Test regardless of whether the resulting position is a trading security for GAAP or other financial or reporting purposes.[69]

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[67] Final Rule § _.3(b)(1)(i). Hedges are included on the Agencies' assumption that "a banking entity generally intends to hold the hedging position for only so long as the underlying position is held." Supp Info. 39.

[68] Supp. Info. 46-47. The Supplementary Information does not offer much guidance on how the presumption might be rebutted in practice. One example given is that "trading in a financial instrument for long-term investment that is disposed of within 60 days because of unexpected developments (e.g., an unexpected increase in the financial instrument's volatility or a need to liquidate the instrument to meet unexpected liquidity demands) *may* not be trading activity covered by the [Volcker Rule]." *Id*. at 47 (emphasis added). Even this example is worded so as not to definitively state whether these circumstances would rebut the presumption

[69] *Id*. at 43-44.

(ii) Market Risk Capital Rule Test

A purchase or sale of a financial instrument satisfies the "Market Risk Capital Rule Test," and is therefore a "trading account," if:

(1) under the federal banking agencies' market risk capital rules, it is both a "covered position" and a "trading position" (or hedges another "covered position");[70] and

(2) the banking entity holding the position, or any affiliate of the banking entity, is an insured depository institution, bank holding company or savings and loan company that calculates risk-based capital under the market risk capital rules.[71]

For this purpose, a "trading position" is generally a position held "for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or to lock in arbitrage profits."[72] A "covered position" is determined under a much more complicated definition. "Covered position" generally includes "trading positions" and hedges of other covered positions, but only if they are counted as trading assets or trading liabilities for regulatory reporting purposes; and includes certain positions that create exposure to foreign exchange or commodity price risks, regardless of whether they are counted as trading assets or trading liabilities; but excludes certain other positions, including hedges of trading positions, credit derivatives and positions held for securitization, under certain circumstances.[73]

For those banking entities that are subject to the market risk capital rules, the Market Risk Capital Rule Test may largely overlap with the Purpose Test, since both are primarily oriented around short-term trading intent.[74] It is not clear what positions, if any, would satisfy the Market Risk Capital Rule Test without also satisfying the Purpose Test. To the extent that a banking entity has already determined that a position is a "trading position" and a "covered position" under the market risk capital rules, however, it will not need to separately analyze that position under the Purpose Test.

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70 *See* 12 CFR Pt. 3, Appendix B (OCC); 12 CFR Pt. 208, Appendix E and 12 CFR Pt. 225, Appendix E (Federal Reserve); 12 CFR Pt. 325, Appendix C (FDIC). The market risk capital rules, which require calculation of risk-based capital charges for certain "covered positions" based on internal models, generally apply to banking entities whose trading activity (defined as the gross sum of trading assets and liabilities, on a worldwide consolidated basis) equals 10% or more of total assets or $1 billion or more.

71 Final Rule § _.3(b)(1)(ii).

72 *See, e.g.*, 12 CFR Pt. 225, Appendix E § 1.

73 *See, e.g.*, *id*.

74 The Supplementary Information explains that this overlap "reinforces the consistency between governance of the types of positions that banking entities identify as 'trading' for purposes of the market risk capital rules and those that are trading for purposes of the [Volcker Rule]." Supp. Info. 40.

(iii) Status Test

A purchase or sale of a financial instrument satisfies the "Status Test," and is therefore a "trading account," if and to the extent that:

(1) the banking entity engaging in the purchase or sale is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer or security-based swap dealer, and the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

(2) the banking entity engaging in the purchase or sale is engaged in the business of a dealer, swap dealer or security-based swap dealer outside the United States, and the instrument is purchased or sold in connection with the activities of such business.[75]

The Supplementary Information explains that "this provision applies only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily *all* of the activities of that banking entity."[76] The Agencies acknowledge that this distinction may be difficult to draw in practice, but "believe that financial instruments purchased or sold by registered dealers in connection with their dealing activity are generally held with short-term intent and should be captured within the trading account."[77]

The three tests for trading account status are broad, overlapping and at least partially subjective.[78] For many positions, it may be difficult to conclude that they are not in or for "trading accounts," especially if they are held in legal entities such as a registered broker-dealer.

75 Final Rule § _.3(b)(1)(iii).

76 Supp. Info. 42.

77 *Id*. at 41.

78 The Supplementary Information states, "To the extent that an overlap exists between the [three tests], the Agencies believe they are mutually reinforcing, strengthen the rule's effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the trading account." *Id*. at 40.

3.C. Activities Excluded from the Definition of "Proprietary Trading"

The following activities are specifically excluded from the definition of "proprietary trading" under the Final Rule, notwithstanding that they may satisfy one or more of the three tests.[79] The exclusion for transactions in connection with "liquidity management" is discussed in Part 3.C.1 of this Memorandum.

(i) Transactions under Repurchase and Reverse Repurchase and Securities Lending Agreements

Proprietary trading does ***not*** include:

(1) any purchase or sale of one or more financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand, with the same counterparty; or

(2) any purchase or sale of one or more financial instruments by a banking entity that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties.[80]

The Supplementary Information explains limitations on the scope of these exclusions:

> To avoid evasion of the rule. . . only the transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement are excluded. For example, the collateral or position that is being financed by the repurchase or reverse repurchase agreement is not excluded and may involve proprietary trading. The Agencies further note that if a banking entity uses a repurchase or reverse repurchase agreement to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion. Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.[81]

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79 *See* Final Rule § _.3(d).

80 *Id*. §§ _.3(d)(1)-(2).

81 Supp. Info. 59-60 (footnotes omitted).

(ii) Transactions of Derivatives Clearing Organizations and Clearing Agencies

Proprietary trading does ***not*** include any purchase or sale of one or more financial instruments by a banking entity that is a "derivatives clearing organization"[82] or a "clearing agency"[83] in connection with clearing financial instruments.[84]

This exclusion "prevents the final rule from inadvertently hindering the Dodd-Frank Act's goal of promoting central clearing of financial transactions," but is "narrowly tailored" and may be relied upon "only [by] central counterparties. . . and only with respect to their clearing and settlement activity."[85]

(iii) "Excluded Clearing Activities" of Members of Clearing Agencies, Derivatives Clearing Organizations and Designated Financial Market Utilities

Proprietary trading does ***not*** include "excluded clearing activities" by a banking entity that is a ***member*** of a clearing agency, derivatives clearing organization or "designated financial market utility."[86]

"Excluded clearing activities" are:

(1) any purchase or sale:

- necessary to correct trading errors made by or on behalf of a customer; or
- related to the management of the default or threatened imminent default of a customer;

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[82] "Derivatives clearing organization" is defined as a derivatives clearing organization that is registered or exempt from registration under CEA § 5(b) or a foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC. Final Rule § _.3(e)(5).

[83] "Clearing agency" has the same meaning as under Exchange Act § 3(a)(23), which includes "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities," but excludes, among other things, "any bank, broker[] [or] dealer. . . if such bank, broker[] [or] dealer. . . would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking, brokerage[] [or] dealing. . . or solely by reason of acting on behalf of a clearing agency or a participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants." Final Rule § _.3(e)(2).

[84] *Id*. § _.3(d)(4).

[85] Supp. Info. 68-69.

[86] Final Rule § _.3(d)(5). "Designated financial market utility" means a financial market utility that the FSOC has designated as systemically important under Title VIII of the Dodd-Frank Act. *See id*. § _.3(e)(8); Dodd-Frank Act § 803(4).

provided in each case that such purchase or sale is conducted in accordance with, as applicable, the CEA, CFTC regulations and the rules or procedures of a derivatives clearing organization, clearing agency or designated financial market utility;

(2) any purchase or sale related to the management of a default or threatened default of a clearing agency, derivatives clearing organization or designated financial market utility; and

(3) any purchase or sale required by the rules or procedures of a clearing agency, derivatives clearing organization or designated financial market utility to mitigate risk to such entity that would result from the clearing by a member of security-based swaps that reference the member or its affiliate.[87]

This exclusion reflects the view that "certain core clearing-related activities" are "not conducted for the purpose of profiting from short-term price movements" and "provide important benefits to the financial system."[88] The Supplementary Information emphasizes, however, that "[t]his exclusion applies only to excluded clearing activities of clearing members. It does not permit a banking entity to engage in proprietary trading and claim protection for that activity because trades are cleared or settled through a central counterparty."[89] In particular, whether the exclusion would be available "when a clearing member is required by rules of a clearing agency, derivatives clearing organization, or designated financial market utility to purchase or sell a financial instrument as part of establishing accurate prices. . . depends on the facts and circumstances."[90]

(iv) Transactions in Connection with Failures to Deliver and Judicial or Administrative Proceedings

Proprietary trading does ***not*** include any purchase or sale of one or more financial instruments so long as the transaction:

(1) satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing or settlement activity; or

(2) the transaction satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding.[91]

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87 Final Rule § _.3(e)(7).

88 Supp. Info. 71.

89 *Id*. at 73-74.

90 *Id*. at 73 (footnote omitted).

91 Final Rule § _.3(d)(6).

(v) Transactions Solely as Agent, Broker or Custodian

As noted above, proprietary trading does ***not*** include any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker or custodian.[92]

(vi) Pension and Similar Deferred Compensation Plans

Proprietary trading does ***not*** include any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as ***trustee*** for the benefit of persons who are or were employees of the banking entity.[93]

This provision, which mirrors a similar exclusion from the covered funds prohibitions (but had not been included in the Proposed Rule), reflects the Agencies' belief that "purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute."[94]

(vii) Transactions in Connection with Collecting Debts Previously Contracted

Proprietary trading does ***not*** include any purchase or sale of one or more financial instruments in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument "as soon as practicable" and in any event no later than is permitted by the appropriate financial supervisory agency.[95] This exclusion was added to allow the acquisition and disposal of collateral upon customer default or other failure.[96]

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[92] *Id*. § _.3(d)(7).

[93] *Id*. § _.3(d)(8).

[94] Supp. Info. 78.

[95] The Federal Reserve and the FDIC each generally provide for a two-year divestiture period, which may be extended by the respective Agency for three additional one-year periods. *See* 12 CFR §§ 6.2(b)(3), 225.138(b)(4), 238.12(b)(4). The OCC provides for a five-year divestiture period, which may be extended by the OCC for up to an additional five years. *See id*. § 1.7(b).

[96] *See* Supp. Info. 79.

3.C.1. The "Liquidity Management" Exclusion and Asset–Liability Management Activities under the Volcker Rule

Many banking entities engage in activities known as "asset–liability management," or "ALM." ALM activities, which are often (though not always) centralized in a treasury or similar function, are varied, but are usually directed toward mitigating liquidity, interest rate, foreign exchange or other risks to the banking entity, including through management of the banking entity's cash and cash equivalents.

These activities may involve short-term trading in instruments such as U.S. Treasury securities, interest rate swaps and foreign exchange swaps. Unlike traditional proprietary trading, however, ALM activities are not intended to increase exposure to short-term price movements—generally the opposite. As a result, some commenters on the Proposed Rule argued that the Final Rule should contain a broad carve-out for ALM activities.[97]

The Final Rule rejected this suggestion, determining "not to expand th[e] liquidity management provision [in the Proposed Rule] to broadly allow asset-liability management, earnings management, or scenario hedging," and declining to add a separate exclusion or exemption for ALM activities.[98] Rather, the exclusion for liquidity management is in fact more limited than it was under the Proposed Rule.[99] Under the Final Rule, the exclusion for liquidity management covers only any purchase or sale of a ***security*** by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan that meets several requirements.[100]

[97] *See id*. at 61-62.

[98] *Id*. at 66.

[99] The Proposed Rule contained an exclusion for liquidity management that was largely similar to, but in some ways less restrictive than, the exclusion in the Final Rule. *See* Proposed Rule § _.3(b)(2)(iii)(C).

[100] Final Rule § _.3(d)(3).

Specifically, the documented liquidity management plan must:

(1) specifically authorize the particular ***securities***[101] to be used, the amount, types and risks of these securities that are consistent with liquidity management and the circumstances in which the particular securities may or must be used;

(2) require that the transaction authorized be principally for the purpose of liquidity management and not for short-term trading purposes;

(3) require that any securities purchased or sold be ***highly liquid***[102] and limited to securities that are not ***reasonably expected***[103] to give rise to appreciable profits or losses as a result of short-term price movements;

(4) limit any securities (together with any other instruments purchased or sold for liquidity management purposes) to an amount that is consistent with the banking entity's ***near-term funding needs***;[104]

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[101] Although the Proposed Rule did not limit this exclusion to particular financial instruments, the Final Rule narrowed the exclusion to cover only securities, "in keeping with the liquidity management requirements proposed by the Federal banking agencies." Supp. Info. 64. The reference is presumably to the liquidity-related provisions of the Federal Reserve's proposed enhanced prudential standards for certain large banking organizations under Dodd-Frank Act §§ 165-66, and to the federal banking agencies' proposed U.S. implementation of a quantitative liquidity coverage ratio ("LCR") as part of the "Basel III" capital and liquidity framework. *See* Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012); OCC, Federal Reserve and FDIC, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring*, 78 Fed. Reg. 71818 (Nov. 29, 2013). Both of these sets of rules would require covered banking entities to maintain certain stocks of highly liquid assets.

[102] The Agencies "decline to identify particular types of securities that will be considered highly liquid" for purposes of the Volcker Rule. Supp. Info. 64 n. 241. The enhanced prudential standards and LCR proposals cited above generally include in "highly liquid" assets obligations of or guaranteed by certain sovereigns and government-sponsored enterprises and, in some cases, other instruments such as highly liquid corporate bonds issued by non-financial companies. *See Enhanced Prudential Standards*, 77 Fed. Reg. at 609; *Liquidity Coverage Ratio*, 78 Fed. Reg. at 71823-29.

[103] "This requirement. . . is not intended to prevent firms from recognizing profits (or losses) on instruments purchased and sold for liquidity management purposes. Instead, this requirement is intended to underscore that the purpose of these transactions must be liquidity management. Thus, the timing of purchases and sales, the types and duration of positions taken and the incentives provided to managers of these purchases and sales must all indicate that managing liquidity, and not taking short-term profits (or limiting short-term losses), is the purpose of these activities." Supp. Info. 65.

[104] The Supplementary Information notes that "[t]he Agencies plan to construe 'near-term funding needs' in a manner that is consistent with the laws, regulations, and issuances related to liquidity risk management" and refers to the LCR proposal. Supp. Info. 65 n. 242. The purpose of the LCR is to ensure that a banking entity holds sufficient "high-quality liquid assets" to cover cumulative net outflows as of the worst day during a 30-day stress scenario, which may provide a reference

(5) include written policies and procedures, internal controls, analysis and independent testing to ensure that the purchase and sale of securities that are not permitted by the exemptions for domestic and foreign government obligations provided in the Final Rule[105] are for the purpose of liquidity management and in accordance with the plan; and

(6) be consistent with the Agencies' supervisory requirements, guidance and expectations regarding liquidity management.

This exclusion may prove to be helpful for smaller banking entities or those with simpler liquidity management. The exclusion does not permit many common tools used to manage liquidity and other risks, such as interest rate swaps or credit-index swaps, which are not securities. The exemption for risk-mitigating hedging activity may be available for many ALM activities, but that exemption's requirements, including contemporaneous documentation of hedging, potentially across a banking entity's worldwide operations, may prove to be burdensome to the treasury or other centralized functions of banking entities that have historically been responsible for ALM activities.[106]

3.D. Definition of "Trading Desk"

Many of the substantive and compliance-related requirements for permitted proprietary trading under the Final Rule are determined in relation to a banking entity's "trading desks." A "trading desk" is defined as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof."[107]

The "trading desk" is a familiar concept to business units of banking entities engaged in market making or other dealing activity, although a banking entity's historical designations of trading desks may or may not align with the Final Rule's definition. Underwriting and risk-mitigating hedging business units, however, may not previously have thought of

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point for "near-term funding needs" (and, in particular, suggests that "near-term" is longer than "overnight" or a day or two). *See Liquidity Coverage Ratio*, 78 Fed. Reg. at 71822.

105 The exemptions for trading in domestic and foreign government obligations are discussed in Parts 4.D and 4.E of this Memorandum, respectively.

106 The liquidity management exclusion could, in theory, be combined with the risk-mitigating hedging exemption in connection with a banking entity's ALM activities. It is not clear to what extent this would be simpler to implement than if the banking entity simply used the risk-mitigating hedging exemption, however. *See* Part 4.C of this Memorandum.

107 Final Rule § _.3(e)(13).

themselves as constituting one or more trading desks.[108] Particularly for larger banking entities with significant trading operations, trading desk designations will be an important determinant of the desk-level policies and procedures that must be adopted and the quantitative metrics, including with respect to underwriting, that must be calculated and reported.

The Supplementary Information emphasizes that trading desks are defined by function, not by the geographic location of traders or the legal entities into which they book trading positions.[109]

[108] With respect to underwriting, the Final Rule provides that "[t]he trading desk should be managed and operated as an individual unit and should reflect the level at which the profit and loss of employees engaged in underwriting activities is attributed. . . . A trading desk engaged in underwriting activities would not necessarily be an active market participant that engages in frequent trading activities." Supp. Info. 103.

[109] "For example, the Agencies expect a banking entity may determine the foreign exchange options desk to be a trading desk; however, the Agencies do not expect a banking entity to consider an individual Japanese Yen options trader (i.e., the trader in charge of all Yen-based options trades) as a trading desk, unless the banking entity manages its profit and loss, market making, and hedging in Japanese Yen options independently of all other financial instruments. . . . The geographic location of individual traders is not dispositive. . . . [A] trading desk may manage a financial exposure that includes positions in different affiliated legal entities." *Id*. at 192-93 & n. 706.

4. PERMITTED PROPRIETARY TRADING ACTIVITIES

Part 3 of this Memorandum described exclusions from the definition of proprietary trading—that is, activities that are deemed ***not*** to be proprietary trading. The Volcker Rule also contains exemptions for activities that ***are*** deemed to be proprietary trading, but may be ***permitted*** if the related requirements, including with respect to compliance, are satisfied. These activities are described below.

4.A. Underwriting Activities

A banking entity's underwriting activities, conducted in accordance with the following criteria, are permitted under the Final Rule.[110]

(1) The trading desk's ***underwriting position*** must be related to a ***distribution*** of securities in which the banking entity is acting as an ***underwriter***.

- An "*underwriting position*" is the set of long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which the banking entity or an affiliate is acting as an underwriter.
- A "*distribution*" includes an offering of securities: (i) whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and methods;[111] or (ii) made pursuant to an effective registration statement under the Securities Act.

[110] *See* Final Rule § _.4(a).

[111] "Indicators of special selling efforts and selling methods include delivering a sales document (e.g., a prospectus), conducting road shows, and receiving compensation that is greater than that for secondary trades but consistent with underwriting compensation." Supp. Info. 104-05.

The Proposed Rule required that a qualifying distribution be "distinguished from ordinary trading transactions by the *magnitude of the offering* and the presence of special selling efforts and selling methods." Proposed Rule § _.4(a)(3) (emphasis added). This definition was similar to a definition in the SEC's Regulation M, and the Agencies noted that they "would expect to rely on the same factors considered under Regulation M in assessing" whether the magnitude and special selling efforts requirements were met. 76 Fed. Reg. at 68867. The magnitude requirement is not included in the Final Rule, however, as "the Agencies have determined that the requirement to have special selling efforts and selling methods is sufficient to distinguish between permissible securities offerings and prohibited proprietary trading." Supp. Info. 104.

- An "*underwriter*" is either: (i) a person who ***has an agreement*** with an issuer or selling security holder to purchase securities for distribution or to otherwise engage in or manage a distribution for or on behalf of the issuer or selling security holder; or (ii) a person who has ***agreed to participate*** or ***is participating*** in a distribution of such securities for or on behalf of the issuer or selling security holder.[112]

(2) The amount and types of the securities in the trading desk's underwriting position must be designed not to exceed the ***reasonably expected near-term demands of clients, customers or counterparties***, and reasonable efforts must be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity and depth of the market for the relevant type of security.

(3) The banking entity must establish, implement, maintain and enforce an ***internal compliance program*** meeting specified requirements with respect to underwriting activity, which are discussed in Part 10 of this Memorandum.

(4) The ***compensation arrangements*** of persons performing the banking entity's underwriting activities must be designed not to reward or incentivize prohibited proprietary trading.[113]

(5) The banking entity must be ***licensed or registered*** to engage in underwriting activity ***if and to the extent required*** by applicable law.[114]

Overall, in comparison to the Proposed Rule—which included an exemption that covered core aspects of directly underwriting large offerings of securities, but caused concern about banking entities' ability to participate in smaller offerings, to engage in price stabilization or other syndicate activities or to hold an unsold allotment—the Final Rule more clearly accommodates the usual range of activities and selling efforts commonly understood to constitute underwriting. This reflects the Agencies' view that underwriting activities are

[112] This formulation clarifies that the Final Rule does not require that "members of the underwriting syndicate or the lead underwriter have a written agreement with all selling group members for each offering or that they be in privity of contract with the issuer or selling security holder." Supp. Info. 108.

[113] "The Agencies do not intend to preclude an employee of an underwriting desk from being compensated for successful underwriting, which involves some risk-taking." *Id*. at 132.

[114] The Supplementary Information clarifies that "this provision does not require a banking entity to register in order to qualify for the underwriting exemption if the banking entity is not otherwise required to register by applicable law." *Id*. at 135.

generally beneficial and relatively unlikely to be used as a disguise for prohibited proprietary trading.

The Supplementary Information provides some additional guidance on activities that would or would not be covered by the underwriting activity exemption, the highlights of which are summarized in the table below.

Selected Guidance on the Underwriting Activity Exemption

Activities Covered by the Exemption

"Activities that may be permitted under the underwriting exemption include stabilization activities, syndicate shorting and aftermarket short covering, holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so, and helping the issuer mitigate its risk exposure arising from the distribution of its securities (e.g., entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders)." (112, footnotes omitted)

but

"The Agencies emphasize that the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position applies to the entirety of the trading desk's underwriting position. . . . This provision of the final exemption would [also] require reasonable efforts to reduce any portion of the syndicate short position attributable to the banking entity that is acting as an underwriter." (125)

Expectations of Demand

"A banking entity is not required to engage in book-building or similar marketing efforts to determine investor demand for the securities pursuant to this requirement, although such efforts may form the basis for the trading desk's reasonable expectation of demand. . . . [T]he expectation of demand does not require a belief that the securities will be placed immediately. The time it takes to carry out a distribution may differ based on the liquidity, maturity, and depth of the market for the type of security." (121)

but

"[A] trading desk must have a reasonable expectation of demand from other market participants. . . . A banking entity may not structure a complex instrument on its own initiative using the underwriting exemption." (120 & n. 443)

Bridge Loans

"Bridge financing arrangements can be structured in many different ways, depending on the context and the specific objectives of the parties involved. As a result, the treatment of securities acquired in lieu of or to refinance a bridge loan and the subsequent sale of such securities under the final rule depends on the facts and circumstances. A banking entity may meet the terms of the underwriting exemption for its bridge loan activity, or it may be able to rely on the market-making exemption." (107)

ETFs

"[T]he Agencies believe that many [Authorized Participant ("AP")] activities, such as conducting general creations and redemptions of ETF shares, are better suited for analysis under the market-making exemption because they are driven by the demands of other market participants rather than the issuer, the ETF. Whether an AP may rely on the underwriting exemption for its activities in an ETF will depend on the facts and circumstances, including, among other things, whether the AP meets the definition of 'underwriter' and the offering of ETF shares qualifies as a 'distribution.'" (110, footnote omitted)

Hedging of Underwriting Positions

"If a trading desk retains an underwriting position for a period of time after the distribution, the trading desk must manage the risk of its underwriting position in accordance with its inventory and risk limits and authorization procedures. . . . [H]edging transactions undertaken in connection with such risk management activities must be conducted in compliance with the hedging exemption in § _.5 of the final rule." (124)

4.B. Market Making-Related Activities

A banking entity's market making-related activities, conducted in accordance with the following criteria, are permitted under the Final Rule.[115]

(1) The trading desk that establishes and manages the ***financial exposure*** must ***routinely stand ready to purchase and sell***[116] one or more types of financial instruments related to its financial exposure and be willing and available to quote, purchase and sell, or otherwise enter into long and short positions in, those types of financial instruments for its own account, ***in commercially reasonable amounts***[117] and ***throughout market cycles***[118] on a

[115] *See* Final Rule § _.4(b).

[116] The Supplementary Information provides an extensive discussion of the nature of this requirement, which ranges from "very regular or continuous quoting and trading activities on both sides of the market" in the most liquid instruments to "trad[ing] only intermittently or at the request of particular customers" in the least liquid instruments. Supp. Info. 208-09. Engaging in block trades "from time to time" may satisfy this requirement, whether or not the banking entity meets all the terms of the "qualified block positioner" definition under SEC Rule 3b-8(c) under the Exchange Act. *Id*. at 209 & n. 735.

[117] "In the context of this requirement, 'commercially reasonable amounts' means that the desk generally must be willing to quote and trade in sizes requested by other market participants. For

basis appropriate for the liquidity, maturity and depth of the market for the relevant types of financial instruments.

- "*Financial exposure*" means the aggregate risks of one or more financial instruments and any associated loans, commodities or foreign exchange or currency held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.

(2) The amount, types and risks of the financial instruments in the trading desk's ***market-maker inventory*** must be designed not to exceed, on an ongoing basis, the ***reasonably expected near term demands of clients, customers or counterparties***, based on:

- the liquidity, maturity and depth of the market for the relevant types of financial instruments; and

- ***demonstrable analysis of historical customer demand***,[119] current inventory of financial instruments and market and other factors regarding the amount, types and risks of or associated with financial instruments in which the trading desk makes a market, including through block trades.

- "*Market-maker inventory*" means all of the positions in the financial instruments for which the trading desk stands ready to make a market that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.

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trading desks that engage in block trading, this would include block trades requested by customers, and this language is not meant to restrict a trading desk from acting as a block positioner." *Id*. at 212 (footnote omitted).

[118] Thus, "a trading desk must act as a market maker on an appropriate basis throughout market cycles and not only when it is most favorable for it to do so. For example, a trading desk should be facilitating customer needs in both upward and downward moving markets." *Id*. (footnote omitted).

[119] The types of information that could be used in this analysis include: "(i) recent trading volumes and customer trends; (ii) trading patterns of specific customers or other observable customer demand patterns; (iii) analysis of the banking entity's business plan and ability to win new customer business; (iv) evaluation of expected demand under current market conditions compared to prior similar periods; (v) schedule of maturities in customers' existing portfolios; and (vi) expected market events, such as an index rebalancing, and announcements." *Id*. at 258. "[E]vidence of customer demand for each of the significant risks associated with" a complex structured product could also be considered. *Id*.

- "*Clients, customers and counterparties*" are "market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services." A trading desk or other organizational unit of a second entity is not a "client, customer or counterparty" of a trading desk of the first entity, however, if the second entity has $50 billion or more in total trading assets and liabilities (as measured for purposes of the Final Rule's quantitative trading metrics reporting requirements), unless: (i) the first trading desk documents how and why the second trading desk should be treated as a "client, customer, or counterparty" of the trading desk; or (ii) the purchase or sale is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.[120]

(3) The banking entity must establish, implement, maintain and enforce an ***internal compliance program*** meeting specified requirements with respect to market making-related activity, which are discussed in Part 10 of this Memorandum. To the extent that any risk, position or other limit in the internal compliance program is exceeded, the trading desk must take action to bring the trading desk into compliance with the limit as promptly as possible.

(4) The ***compensation arrangements*** of persons performing the banking entity's market making-related activities must be designed not to reward or incentivize prohibited proprietary trading.[121]

(5) The banking entity must be ***licensed or registered*** to engage in market making-related activity ***if and to the extent required*** by applicable law.[122]

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[120] Final Rule § _.4(b)(3). This requirement will generally prevent trading among the largest dealers *with no other permissible purpose* from qualifying for the exemption on the basis that it is trading with a "counterparty." The Supplementary Information explains a range of other circumstances in which interdealer trading may be permitted under this exemption, however. *See* the table at the end of this Part.

[121] "The Agencies note that the Agencies do not intend to preclude an employee of a market-making desk from being compensated for successful market making, which involves some risk-taking." *Id*. at 289.

[122] "This provision is not intended to expand the scope of licensing or registration requirements under relevant U.S. or foreign law that are applicable to a banking entity engaged in market-making activities. Instead, this provision recognizes that compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities." *Id*. at 293.

The Supplementary Information provides some additional guidance on activities that would or would not be covered by the market making-related activity exemption, the highlights of which are summarized in the table below.

Selected Guidance on the Market Making-Related Activity Exemption

Trade-by-Trade Analysis

"[T]he final market-making exemption does not require a trade-by-trade analysis, which was a significant source of concern from commenters [on the Proposed Rule] who represented, among other things, that a trade-by-trade analysis could have a chilling effect on individual traders' willingness to engage in market-making activities." (167)

Inventory Management

"[Demonstrable analysis of historical customer demand] may, where appropriate, take into account prior and/or anticipated cyclicality. . . . [T]he Agencies recognize that historical trends may not always determine the amount of inventory a trading desk may need to meet reasonably expected near term demand and it may under certain circumstances be appropriate to build inventory in anticipation of a reasonably expected near term event that would likely impact customer demand." (257 nn. 931, 933)

but

"[A]cquiring a position in a financial instrument in response to reasonably expected customer demand would not include creating a structured product for which there is no current customer demand and, instead, soliciting customer demand during or after its creation." (241, n. 892)

"A trading desk may not maintain an exposure in its market-maker inventory, irrespective of customer demand, simply because the exposure is hedged and the resulting financial exposure is below the desk's financial exposure limit." (242)

Interdealer Trading

"The Agencies recognize that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of its inventory management activities and that interdealer trading provides certain market benefits, such as more efficient matching of customer order flow, greater hedging options to reduce risk, and enhanced ability to accumulate or exit customer-related positions." (252)

"Provided it is consistent with the requirements of the market-making exemption, including the near term customer demand requirement, a trading desk may trade for purposes of determining how to price a financial instrument a customer seeks to trade with the trading desk or to determine the depth of the market for a financial instrument a customer seeks to trade with the trading desk." (253 n. 919)

but

"[Interdealer trading] is an activity that will bear some scrutiny by the Agencies and should be monitored by banking entities to ensure it reflects market-making activities and not impermissible proprietary trading." (253)

Primary Dealers

"[W]ith respect to a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of the market-making exemption as well as the underwriting exemption." (247-48)

ETFs

"The Agencies recognize that banking entities currently conduct a substantial amount of AP creation and redemption activity in the ETF market and, thus, if the rule were to prevent or restrict a banking entity from acting as an AP for an ETF, then the rule would impact the functioning of the ETF market. . . . Some firms, whether or not an AP in a given ETF, may also actively engage in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another. . . . Because customers take positions in ETFs with an expectation that the price relationship will be maintained, such trading can be considered to be market making-related activity." (249-50, footnote omitted)

4.C. Risk-Mitigating Hedging Activities

The prohibition on proprietary trading does not apply to the risk-mitigating hedging activities of a banking entity in connection with and related to ***individual or aggregated positions, contracts or other holdings*** of the banking entity and designed to reduce the ***specific risks*** to the banking entity in connection with and related to such positions, contracts or other holdings, provided that the activity satisfies all the following criteria.[123]

(1) The hedging activity, at inception, including any adjustments to the hedging activity, must be designed to reduce or otherwise significantly mitigate, and ***must actually demonstrably reduce or otherwise significantly mitigate***, one or more ***specific, identifiable risks***, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk or similar risks, arising in connection with and related to identified positions, contracts or other holdings of the banking entity, based upon the facts and

[123] *See* Final Rule § _.5.

circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;

(2) The hedging activity must not give rise, at the inception of the hedge, to ***any significant new or additional risk*** that is not itself hedged contemporaneously.

(3) The hedging activity must be subject to continuing review, monitoring and management by the banking entity that, among other things, requires ***ongoing recalibration***[124] of the hedging activity by the banking entity.

(4) The banking entity must establish, implement, maintain and enforce an ***internal compliance program*** meeting specified requirements with respect to hedging activity, which are discussed in Part 10 of this Memorandum, and the hedging activity must be ***conducted in accordance*** with this program.

(5) The ***compensation arrangements*** of persons performing the hedging activity must be designed not to reward or incentivize prohibited proprietary trading.[125]

The Final Rule carefully notes that although "[t]he term 'portfolio hedging' is not used in the [Dodd-Frank Act]. . . . the Agencies are of the view that the statutory language is clear on its face that a banking entity may engage in risk-mitigating hedging in connection with aggregated positions of the banking entity."[126] On the other hand, risk-mitigating hedging activity under this exemption "cannot be designed to: reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity."[127]

[124] The Final Rule, including the Supplementary Information, contains notably little guidance on how this requirement must be satisfied.

[125] "For instance, an incentive compensation plan that rewards an employee engaged in activities under the hedging exemption based primarily on whether that employee's positions appreciate in value instead of whether such positions reduce or mitigate risk would appear to be designed to reward prohibited proprietary trading rather than risk-reducing hedging activities." Supp. Info. 357 (footnote omitted).

[126] *Id*. at 345.

[127] *Id*. at 346.

The documentation required in connection with permitted hedging activity is potentially extensive. The Final Rule requires additional documentation for hedges that:

(1) are established at a different level of organization than the specific trading desk establishing the related hedge positions, contracts or other holdings;

(2) are effected by the specific trading desk establishing or directly responsible for the underlying positions, contracts or other holdings through a financial instrument, exposure, technique or strategy that is not specifically identified in its written policies and procedures as one that it may use for hedging; or

(3) are established to hedge aggregated positions across two or more trading desks.

Enhanced documentation must be established contemporaneously with the hedging transaction. The documentation must, at a minimum, document the trading desk or other business unit that is establishing and responsible for the hedge, the risk-mitigating purpose of the transaction and the risks of the individual or aggregated positions, contracts or other holdings that the transaction is designed to reduce. These requirements are discussed in Part 10 of this Memorandum.

The Supplementary Information provides some additional guidance on activities that would or would not be covered by the risk-mitigating hedging activity exemption, the highlights of which are summarized in the table below.

Selected Guidance on the Risk-Mitigating Hedging Activity Exemption

Trade-by-Trade Analysis

"Section 13(d)(1)(C) of the BHC Act specifically authorizes risk-mitigating hedging activities in connection with and related to 'individual or aggregated positions, contracts or other holdings.' Thus, the statute does not require that exempt hedging be conducted on a trade-by-trade basis, and permits hedging of aggregated positions." (319, footnote omitted)

Correlation Analysis

"[The Final Rule] incorporates the concept in the proposed rule that a hedge should be correlated (negatively, when sign is considered) to the risk being hedged. However, the Agencies recognize that some effective hedging activities, such as deep out-of-the-money puts and calls, may not be exhibit [*sic*] a strong linear correlation to the risks being hedged. . . . It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods." (332)

but

"If correlation cannot be demonstrated, then the Agencies would expect that [the banking entity's] analysis would explain why not." (332)

<u>Hedging of Aggregated Positions</u>

"When undertaking a hedge to mitigate the risk of an aggregation of positions, the banking entity must be able to specifically identify the risk factors arising from this set of positions. . . . [T]he banking entity needs to identify the positions being hedged with sufficient specificity so that at any point in time, the specific financial instrument positions or components of financial instrument positions held by the banking entity that comprise the set of positions being hedged can be clearly identified." (346)

"These limits and requirements are designed to prevent the type of activity conducted by banking entities in the past that involved taking large positions using novel strategies to attempt to profit from potential effects of general economic or market developments and thereby potentially offset the general effects of those events on the revenues or profits of the banking entity." (327)

<u>Anticipatory Hedging</u>

"Like the proposal, the final rule does not prohibit anticipatory hedging. . . . [Required] policies and procedures should specifically address when anticipatory hedging is appropriate and what policies and procedures apply to anticipatory hedging." (354)

but

"The final rule also requires ongoing recalibration. . . . If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, under these provisions, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce the risk associated with that position as soon as reasonably practicable." (355, footnote omitted)

4.C.1. Market Making-Related Hedging

The Final Rule "does not require that market making-related hedging activities separately comply with the requirements found in the risk-mitigating hedging exemption if conducted *or directed* by the same trading desk conducting the market-making activity."[128] Instead, "banking entities [may] determine how best to manage the risks of trading desks' market making-related activities through reasonable policies and procedures, internal controls, independent testing, and analysis, rather than requiring compliance with the specific requirements of the hedging exemption."[129]

Thus, provided that a market making trading desk operates within its appropriately established policies and procedures and risk limits, it need not always contemporaneously and specifically document the purpose of, or specific risks reduced by, every position taken as (or functioning partly as) a hedge, nor undertake "ongoing recalibration" of such positions. This provision of the Final Rule appears likely to be helpful to those banking entities whose market making trading desks typically hedge their own risks, including by directing other trading desks to establish hedging positions that are booked into the market making trading desks' own profit and loss.

On the other hand, it is also common for the risks of market making trading desks to be hedged by other trading desks or at a different level of the business. In this case, the more detailed requirements of the risk-mitigating hedging exemption will apply, which "the Agencies understand. . . will result in additional documentation or other potential burdens."[130]

4.D. Trading in Domestic Government Obligations

The Final Rule contains an exemption from the prohibition on proprietary trading for the purchase or sale of a financial instrument that is:

(1) an obligation of, or issued or guaranteed by, the United States;

(2) an obligation, participation or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage

[128] *Id*. at 282 (emphasis added).

[129] *Id*. at 283. As the Agencies note, "a trading desk's compliance program must include written policies and procedures, internal controls, independent testing and analysis identifying and addressing the products, instruments, exposures, techniques, and strategies a trading desk may use to manage the risks of its market making-related activities, as well as the actions the trading desk will take to demonstrably reduce or otherwise significant mitigate the risks of its financial exposure consistent with its required limits." *Id*. at 282.

[130] *Id*. at 284.

Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971;

(3) an obligation of any U.S. state or any political subdivision thereof, including any municipal security; or

(4) an obligation of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the FDIA or Title II of the Dodd-Frank Act.[131]

This exemption does *not* extend to trading in derivatives on the foregoing, as the Agencies perceived "no compelling reasons why derivatives on exempt government obligations pose little or no risk to the financial system as compared to derivatives on other financial products for which proprietary trading is generally prohibited."[132] On the other hand, in recognition of the fact that "the markets for Treasury securities and Treasury futures are fully integrated," and that "trading in these derivative instruments is essential to ensuring the continued smooth functioning of market-making related activities in Treasury securities," the Supplementary Information acknowledges that, "depending on the relevant facts and circumstances, banking entities would be permitted to acquire a very large long or short position in Treasury derivatives."[133]

Furthermore, the Supplementary Information clarifies that "a banking entity may rely on the market-making exemption for its activities as primary dealer to the extent those activities are outside the scope of the underwriting exemption," indicating that a banking entity will generally be able to use derivatives to facilitate or reduce the risks of its primary dealer activities.[134]

Banking entities that are required to report quantitative trading metrics must include trading under this exemption in the covered trading activity for which its trading desks calculate their metrics.[135]

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[131] Final Rule § _.6(a).

[132] Supp. Info. 365.

[133] *Id*. at 366-67.

[134] *Id*. at 367.

[135] *See* Final Rule Appendix A § II.

4.E. Trading in Foreign Government Obligations

Like Section 13, the Proposed Rule contained an exemption for trading in domestic government obligations, but no exemption for trading in any foreign government obligations.[136] This disparity was immediately one of the most controversial features of the Proposed Rule:

> The treatment of proprietary trading in foreign sovereign obligations prompted a significant number of comments. Many commenters, including foreign governments, foreign and domestic banking entities, and various trade groups, argued that the final rule should permit trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments. Representatives from foreign governments such as Canada, Germany, Luxembourg, Japan, Australia, and Mexico specifically requested an exemption for trading in obligations of their governments and argued that an exemption was necessary and appropriate to maintain and promote financial stability in their markets. Some commenters also requested an exemption for trading in obligations of multinational central banks, such as Eurobonds issued or guaranteed by the European Central Bank.[137]

Taking into account these comments, the Agencies determined to provide "a limited exemption. . . for trading in foreign sovereign obligations under certain circumstances."[138] The exemption is in two parts.

Specifically, the Final Rule provides an exemption from the prohibition on proprietary trading for:

(1) the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of such foreign sovereign, by a banking entity, so long as:

- the banking entity is organized under, or is directly or indirectly controlled by a banking entity that is organized under, the laws of a foreign sovereign, and is not directly or

[136] The exemption for trading in domestic government obligations is largely prescribed by the statute. *See* BHC Act § 13(d)(1)(A). The Agencies could, however, and in the Final Rule ultimately did, determine that an exemption for trading in foreign government obligations would be permitted on the basis that it would "promote and protect the safety and soundness of [a] banking entity and the financial stability of the United States." *See id*. § 13(d)(1)(J).

[137] Supp. Info. 369 (footnotes omitted).

[138] *Id*. at 375.

indirectly controlled by a top-tier banking entity that is organized under the laws of the United States;

- the financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign banking entity referred to above is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign;[139] and
- the purchase or sale as principal is not made by an insured depository institution;[140] or

(2) the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign, by a foreign entity that is owned or controlled by a banking entity organized or established under the laws of the United States or any U.S. state, so long as:

- the foreign entity is a foreign bank (as defined in Section 211.2(j) of the Federal Reserve's Regulation K)[141] or is regulated by the foreign sovereign as a securities dealer;
- the financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign entity is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

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[139] "In the case of a foreign banking entity that is owned or controlled by a second foreign banking entity domiciled in a country other than the home country of the first foreign banking entity, the final rule would permit the eligible U.S. operations of the first foreign banking entity to engage in proprietary trading [under this exemption] only in the sovereign debt of the first foreign banking entity's home country, and would permit the U.S. operations of the second foreign banking entity to engage in proprietary trading [under this exemption] only in the sovereign debt of the home country of the second foreign banking entity," although other exemptions may be available depending on the circumstances. *Id*. at 375 n. 1366.

[140] Final Rule § _.6(b)(1).

[141] Specifically: "*Foreign bank* means an organization that: (1) Is organized under the laws of a foreign country; (2) Engages in the business of banking; (3) Is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations; (4) Receives deposits to a substantial extent in the regular course of its business; and (5) Has the power to accept demand deposits." 12 CFR § 211.2(j).

- the financial instrument is owned by the foreign entity and is not financed by an affiliate that is located in the United States or organized under the laws of the United States or of any U.S. state.[142]

Under a literal reading of the Final Rule, the exemption in clause (1) above is available to all foreign banking entities, not only to their U.S. affiliates. The title of the relevant section of the Final Rule (that is, _.6(b)(1)) is "Affiliates of foreign banking entities in the United States," and the Supplementary Information describes the purpose of the exemption as to "permit[] the *U.S. operations* of foreign banking entities to engage in proprietary trading in the United States in the foreign sovereign debt of the foreign sovereign."[143] If the exemption were available only to U.S. affiliates of foreign banking entities, however, it would have the odd result of more strictly limiting a foreign bank's trading of home country sovereign debt *in the home country* relative not only to a U.S. branch or agency of that foreign bank, but also to a foreign bank or securities dealer subsidiary of a U.S. bank in the home country.

The Final Rule does not contain an exemption for trading in obligations of multilateral development banks, which the Agencies considered but "do not believe. . . will help enhance the markets for these obligations and therefore promote and protect the safety and soundness of banking entities and U.S. financial stability."[144]

As with trading in domestic government obligations, banking entities that are required to report quantitative trading metrics must include trading under this exemption in the covered trading activity for which its trading desks calculate their metrics.[145]

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[142] Final Rule § _.6(b)(2). It is not clear how the no-financing requirement would be satisfied or compliance would be demonstrated.

[143] Supp. Info. 375 (emphasis added).

[144] *Id*. at 389.

[145] *See* Final Rule Appendix A § II.

4.F. Trading on Behalf of Customers

The prohibition on proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity:

(1) acting as ***trustee*** or in a ***similar fiduciary capacity***, so long as:

- the transaction is conducted for the account of, or on behalf of, a customer; and
- the banking entity does not have or retain beneficial ownership of the financial instruments; or

(2) acting as ***"riskless principal"***[146] in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.[147]

The Proposed Rule had included additional references to investment advisers and commodity trading advisors. The Final Rule explains that, "[a]fter further consideration, the Agencies do not believe an express reference to investment advisers is necessary because investment advisers generally act in a fiduciary capacity on behalf of clients in a manner that is separately covered by other exclusions and exemptions in the final rule."[148]

In addition, "the final rule deletes the proposal's express exemption for commodity trading advisors because the legal relationship between a commodity trading advisor and its client depends on the facts and circumstances of each relationship. Therefore, the Agencies determined that it was appropriate to limit the discussion to fiduciary obligations generally and to omit any specific discussion of commodity trading advisors."[149]

[146] "Riskless principal" is more than a term of art, although it has historically been interpreted slightly differently under different Agencies' bodies of authority. The wording of the Final Rule confirms that "[a]cting as riskless principal does not include acting as underwriter or market maker in the particular financial instrument and is generally understood to be equivalent to agency or brokerage transactions in which all of the risks associated with ownership of financial instruments are borne by customers." Supp. Info. 398. The Agencies will apply their "generally equivalent standards" in evaluating conduct under this exemption. *Id*.

[147] Final Rule § _.6(c).

[148] Supp. Info. 396.

[149] *Id*.

4.G. Trading by a Regulated Insurance Company

The prohibition on proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity that is an "insurance company"[150] or an affiliate of an insurance company if:

(1) the insurance company or its affiliate purchases or sells the financial instruments solely for:

- the ***general account***[151] of the insurance company; or
- a ***separate account***[152] established by the insurance company;

(2) the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the U.S. state or jurisdiction in which such insurance company is domiciled; and

(3) the appropriate Federal banking agencies, after consultation with the FSOC and the relevant insurance commissioners of the U.S. states and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation or written guidance described in clause (2) above is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.[153]

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150 "Insurance company" means "a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the [Volcker Rule]." *Id*. § 2(q).

151 "General account" means "all of the assets of an insurance company except those allocated to one or more separate accounts." *Id*. § 2(p).

152 "Separate account" means "an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company." *Id*. § 2(bb).

153 *Id*. § _.6(d). "The Federal banking agencies have not at this time determined, as part of the final rule, that the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. The Federal banking agencies expect to monitor, in conjunction with the FSOC, the insurance company investment laws, regulations, and written guidance of States or jurisdictions to which exempt transactions are subject and make such determinations in the future, where appropriate." Supp. Info. 407 n. 1475.

The distinction between an insurance company's general account and separate accounts—even though they both qualify for the exemption—reflects the structure of Section 13, which specifically exempts trading for the general account of a regulated insurance company and also separately exempts trading on behalf of customers, which the Agencies have interpreted to cover separate accounts.[154]

Regulated insurance companies that are covered by the Volcker Rule will be required to establish and maintain compliance programs, although the extent of the programs may depend on their activities and whether there appears to be any potential for evasion of the proprietary trading prohibition.[155] Given that "[t]he terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity,"[156] it may be possible for some regulated insurance companies with mostly or entirely exempt trading activities to develop streamlined programs.

4.H. Trading Activities of Foreign Banking Entities

Section 13 provides a statutory exemption for "[p]roprietary trading conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) [of the BHC Act], provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more [U.S] States."[157] Translating this language into a comprehensive rulemaking—and in particular defining "solely outside of the United States," frequently referred to as "SOTUS"—has been one of the highest-profile tasks associated with the Volcker Rule, especially in view of the provision's importance to non-U.S. banking entities.

The "SOTUS" exemption in the Proposed Rule was extremely limited. It required, among other things, that "[n]o party to the purchase or sale [be] a resident of the United States" and that "[t]he purchase or sale [be] executed wholly outside of the United States."[158] As the Agencies acknowledged, the Proposed Rule therefore "effectively precluded a foreign banking entity from engaging in proprietary trading through a transaction that had *any* connection with the United States, including: trading with any party located in the United

[154] *See* BHC Act §§ 13(d)(1)(D), 13(d)(1)(F); Supp. Info. 406.

[155] The only banking entities that are categorically exempt from the compliance program are those that "do[] not engage in activities or investments pursuant to" the provisions of the Final Rule "other than trading activities permitted pursuant to § _.6(a)"—which is the exemption for trading in domestic government obligations, whereas the exemption for trading by regulated insurance companies is § _.6(c). In addition, the Supplementary Information states that "the Agencies expect insurance companies to have appropriate compliance programs in place for any activity subject to section 13 of the BHC Act," although it is not entirely clear whether this reference includes exempt trading. Supp. Info. 408; *see also* Final Rule § _.20(f)(1).

[156] Final Rule § _.20(a).

[157] BHC Act § 13(d)(1)(H).

[158] Proposed Rule § _.6(d)(3).

States; allowing U.S. personnel of the foreign banking entity to be involved in the purchase or sale; or executing any transaction in the United States (on an exchange or otherwise)."[159]

In the Final Rule, by contrast, the Agencies have "allow[ed] foreign banking entities to use U.S. infrastructure and trade with certain U.S. counterparties in certain circumstances, which will promote and protect the safety and soundness of banking entities and U.S. financial stability" by, among other things, not pushing trading offshore or fragmenting markets without any commensurate reduction in the principal risks taken by U.S. banking entities themselves.[160]

Specifically, the Final Rule provides that the prohibition on proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity if:

(1) the banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute the purchase or sale) is ***not***:

- ***located*** in the United States; or
- ***organized under the laws*** of the United States or of any U.S. state;[161]

(2) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any U.S. state;

(3) the purchase or sale by the banking entity is made "pursuant to paragraph (9) or (13) of Section 4(c) of the BHC Act," meaning that:

- with respect to a banking entity that is a "foreign banking organization,"[162] the banking entity meets the qualifying foreign banking organization ("QFBO") requirements of Section 211.23(a), 211.23(c) or 211.23(e) of the Federal Reserve's Regulation K;[163] or

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[159] Supp. Info. 409 (footnote omitted).

[160] *Id*. at 418-19. The Agencies concluded that these activities are not technically "solely outside of the United States," and therefore not mandatorily exempted by BHC Act § 13(d)(1)(H), but are within the purview of the Agencies' exemptive authority under BHC Act § 13(d)(1)(J).

[161] "Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. Personnel in the United States also cannot serve as decision makers in transactions conducted under this exemption. Personnel that engage in back-office functions, such as clearing and settlement of trades, would not be considered to arrange, negotiate, or execute a purchase or sale for purposes of this provision." Supp. Info. 422 n. 1521.

[162] For purposes of the Final Rule, "foreign banking organization" means any company organized under the laws of a foreign country or a territory of the United States (but excluding Puerto Rico, Guam, American Samoa, the Virgin Islands and the Northern Mariana Islands) that engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such

- with respect to a banking entity that is not a "foreign banking organization,"[164] the banking entity is not organized under the laws of the United States or of any U.S. state, and the banking entity, on a fully consolidated basis, meets at least two of the following requirements: (i) total assets of the banking entity held outside the United States exceed total assets of the banking entity held in the United States; (ii) total revenues derived from the business of the banking entity outside the United States exceed total revenues derived from the business of the banking entity in the United States; and (iii) total net income derived from the business of the banking entity outside the United States

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company, including, without limitation, foreign commercial banks, foreign merchant banks and other foreign institutions that engage in banking activities usual in connection with the business of banking in the countries where such foreign institutions are organized or operating, that: (i) operates a branch, agency or commercial lending company subsidiary in the United States; (ii) controls a bank in the United States; or (iii) controls an Edge corporation acquired after March 5, 1987. Final Rule § _.2(n); *see also* 12 CFR § 211.21(o) (Federal Reserve's Regulation K), 12 U.S.C. § 3101(7) (IBA).

[163] Under § 211.23(a) of Regulation K, a QFBO must "(1) Meet at least two of the following requirements: (i) Banking assets held outside the United States exceed total worldwide nonbanking assets; (ii) Revenues derived from the business of banking outside the United States exceed total revenues derived from its worldwide nonbanking business; or (iii) Net income derived from the business of banking outside the United States exceeds total net income derived from its worldwide nonbanking business; and (2) Meet at least two of the following requirements: (i) Banking assets held outside the United States exceed banking assets held in the United States; (ii) Revenues derived from the business of banking outside the United States exceed revenues derived from the business of banking in the United States; or (iii) Net income derived from the business of banking outside the United States exceeds net income derived from the business of banking in the United States." The regulation provides some additional guidance on how to measure assets, revenues and net income for this purpose. It also provides limited exemptions for a foreign bank that meets the foregoing requirements but whose ultimate parent does not (§ 211.23(c)) and provides a process to apply to the Federal Reserve for a determination of eligibility (§ 211.23(e)).

[164] The Supplementary Information explains that this prong is necessary because the Volcker Rule "also applies to foreign companies that control a U.S. insured depository institution but that are not currently subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company" (but not a branch, agency, commercial lending company, bank or Edge corporation). Supp. Info. 414. The Final Rule continues: "This test largely mirrors the [QFBO test], except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States. This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the prohibition on proprietary trading." *Id*. at 414-15 (footnote omitted).

exceeds total net income derived from the business of the banking entity in the United States;

(4) the banking entity (including relevant personnel) that ***makes the decision*** to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any U.S. state;

(5) the purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any U.S. state;

(6) no financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any U.S. state;[165] and

(7) the purchase or sale is not conducted ***with or through*** any ***"U.S. entity,"*** other than:

- a purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale;

- a purchase or sale with an ***"unaffiliated market intermediary"*** acting as ***principal***, provided that the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

- a purchase or sale through an ***"unaffiliated market intermediary"*** acting as ***agent***, provided that the purchase or sale is conducted "anonymously"[166] on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

165 The Supplementary Information provides that "[t]his provision is not intended to restrict the ability of a U.S. branch or affiliate of a foreign banking entity to provide funds collected in the United States to its foreign parent for general purposes," but is otherwise not specific as to how this requirement would be satisfied or compliance would be demonstrated. *Id*. at 422 n. 1522.

166 "*Anonymous* means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale." Final Rule § _.3(e)(1).

- "*U.S. entity*" means any entity that is, or is controlled by, or is acting on behalf or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any U.S. state. For purposes of this exemption, a U.S. branch, agency or subsidiary of a foreign banking entity is considered to be located in the United States, but the foreign bank that operates or controls that branch, agency or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency or subsidiary.

- "*Unaffiliated market intermediary*" generally means an unaffiliated entity, acting as an intermediary, that is an SEC-registered broker, dealer or security-based swap dealer, a CFTC-registered swap dealer or futures commission merchant or, in each case, exempt from registration or excluded from regulation as such.[167]

On the whole, the Final Rule focuses more on the location of the banking entity that is taking principal risk and less on the location of each mechanical step in the execution of transactions, particularly cleared transactions. Nonetheless, the strict prohibition on the participation of any U.S.-located front-office personnel in trading activity remains in the Final Rule, thereby potentially prohibiting a class of trading activities undertaken in the United States for the account of non-U.S.-located foreign bank affiliates, even "where the risk of the trading activity is taken or held outside of the United States and does not implicate the U.S. safety net."[168]

[167] Final Rule § _.6(e).

[168] Supp. Info. 410 (summarizing comments on the Proposed Rule).

5. "COVERED FUND" ACTIVITIES AND INVESTMENTS – PROHIBITION AND KEY DEFINITIONS

Like the prohibition on "proprietary trading," which affects activities far outside any previous understanding of that term, the restrictions on "covered funds"—the Final Rule's term for any fund that it covers—apply to many entities and investment activities that would not traditionally have been referred to as "hedge funds" or "private equity funds."

Specifically, under the Final Rule, a banking entity may not, as principal, directly or indirectly:

(1) acquire or retain any ***"ownership interest"*** in, or ***"sponsor"***

(2) a ***"covered fund"***

(3) unless the activity is ***permitted*** under the Final Rule.[169]

As in the case of the prohibition on proprietary trading, this prohibition applies solely to a banking entity's actions as principal and does not prohibit the acquisition or retention of an ownership interest in a covered fund by a banking entity:

(1) acting solely as agent, broker or custodian, so long as:

- the activity is conducted for the account of, or on behalf of, a customer; and
- the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest;

(2) through a deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity (or an affiliate thereof);

(3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such ownership interest for longer than the period permitted by the relevant Agency;[170] or

[169] Final Rule § _.10(a)(1). Additional "Super 23A" restrictions are discussed in Part 8 of this Memorandum.

[170] *Id*. § _.10(a)(2)(iii). This activity, as described, appears to involve acting as principal and not as agent, but it is included in the same list of exemptions from the prohibition as other non-principal

(4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as:

- the activity is conducted for the account of, or on behalf of, the customer; and
- the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.[171]

activities. The Agencies' guidance with respect to holdings in connection with debts previously contracted is summarized in Part 3.C(vii) of this Memorandum.

[171] Final Rule § _.10(a)(2).

5.A. Definition of "Covered Fund"

Summary

Included as "Covered Fund"	Excluded from "Covered Fund"
• **Issuers that would be "investment companies" *but for* Section 3(c)(1) or 3(c)(7) of the 1940 Act** • **Certain commodity pools managed as private funds** • **For *U.S. banking entities only*, "foreign funds"**[172]	• **Issuers that are able to rely on an exemption *other than* Section 3(c)(1) or 3(c)(7)** • **RICs, BDCs and "foreign public funds"** • **Other vehicles including joint ventures and certain loan securitizations** • **For *foreign banking entities only*, foreign funds offered and sold solely outside the United States (that are not covered commodity pools)**

Some commenters on the Proposed Rule suggested that the Agencies attempt to provide qualitative, characteristics-based definitions of "hedge fund" and "private equity fund," so as not to capture those vehicles that are not part of an investment fund management business. The Final Rule does not follow this suggestion, and instead adopts an expansive definition of "covered fund" that does not attempt to separately describe what would be a hedge fund and what would be a private equity fund.[173] Although this definition does capture many hedge funds and private equity funds, it also captures many other kinds of commonly used vehicles and would—but for specific exclusions discussed in Part 5.B of this Memorandum—capture certain other vehicles such as joint ventures and wholly owned subsidiaries.

Specifically, under the Final Rule, a "*covered fund*" is:

> (1) any issuer that would be an "investment company," as defined in the Investment Company Act of 1940 (the "1940 Act"), ***but for*** Section 3(c)(1) or 3(c)(7) of the 1940 Act;[174]

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[172] As explained below, "foreign fund" and "foreign *public* fund" are distinct concepts.

[173] *See id*. § _.10(b).

[174] An "investment company"—for example, a mutual fund—is subject to extensive regulation under the 1940 Act. While "investment company" determinations can be complex, as a threshold matter, a company may be an investment company if it issues or proposes to issue any security and "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of

(2) certain commodity pools, as discussed in Part 5.A.1 of this Memorandum; and

(3) for a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any U.S. state (but ***not*** a foreign banking entity outside the United States), any entity that:

- is organized or established outside the United States and the ownership interests of which are offered and sold "solely outside the United States";[175]

- is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and

- has as its sponsor that banking entity (or an affiliate thereof), or has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

The Final Rule does not include a particular defined term for a fund under this clause (3), but such funds are referred to in this Memorandum as "foreign funds." [176]

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investing, reinvesting, or trading in securities" or "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." 1940 Act § 3(a)(1). This threshold definition captures many hedge funds and private equity funds.

The definition also contains exceptions, however, for, among other things, funds that do not make public offerings and whose outstanding securities are owned by not more than 100 persons (i.e., § 3(c)(1)) or are owned by "qualified purchasers" (i.e., § 3(c)(7)), which generally means owners of $5 million or more in investments. Many hedge funds and private equity funds have been structured to avail themselves of these exceptions and have therefore not been required to register as investment companies under the 1940 Act. *See id*. §§ 2(a)(51), 3(c)(1), 3(c)(7).

[175] This usage of "solely outside the United States" is not defined in either the Final Rule or the Supplementary Information, and the phrasing is different from the related concept of "not offered for sale or sold to a resident of the United States," which is included in the exemption for permitted covered fund activities and investments outside the United States. *See* Part 7.C of this Memorandum. A reading of the Supplementary Information suggests that "solely outside the United States" in this context means "in a manner not subjecting the issuer to U.S. securities laws."

[176] The definition of "covered fund" does not contain a concept of a "foreign fund" that is a commodity pool (i.e., a commodity pool that does not actually involve a CFTC-registered commodity pool operator but would if the arrangement involved U.S. persons).

The primary purpose of the "foreign funds" inclusion is to capture—with respect to U.S. banking entities only—funds that are not actually relying on Section 3(c)(1) or 3(c)(7) of the 1940 Act because they are organized in non-U.S. jurisdictions and do not make offers or sales to U.S. persons.[177] The Agencies were concerned that "a definition of covered fund that did not include foreign funds would allow U.S. banking entities to be exposed to risks and engage in covered fund activities outside the United States that are specifically prohibited in the United States."[178] At the same time, the Agencies determined that applying the restrictions of covered fund status to a foreign banking entity's activities, outside the United States, with a foreign fund that is not subject to U.S. securities laws, would be inconsistent with the goal of limiting the Volcker Rule's "extra-territorial application to the activities of foreign banks outside the United States."[179]

An issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the 1940 Act is a covered fund for both U.S. and foreign banking entities, however, regardless of its jurisdiction of organization. Hence, "foreign funds" are not "covered funds" for foreign banking entities *if* they are not actually relying on Section 3(c)(1) of 3(c)(7) of the 1940 Act (or otherwise captured by the "commodity pool" prong of the definition).[180]

The Final Rule confirms that an issuer, including a foreign fund, that can rely on *another* exception to the definition of "investment company" under the 1940 Act will not be a covered fund even if the entity could *also* rely on Section 3(c)(1) or 3(c)(7).[181]

The concept of an entity that would be an investment company *but for* Section 3(c)(1) or 3(c)(7) of the 1940 Act presents new interpretive challenges. In some investment structures, it may not be evident whether a particular vehicle would meet the threshold definition of "investment company," but the question may not historically have been of great importance because the vehicle would clearly be able to rely on Section 3(c)(1) or 3(c)(7). That question is now, of course, central to determining whether or not the vehicle is a "covered fund" under the Final Rule.

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[177] Within respect to foreign funds, the Supplementary Information uses the phrase "reliance on the exclusions in section 3(c)(1) or 3(c)(7)" to include complying with SEC guidance, based on the principles of § 3(c)(1) and § 3(c)(7), on U.S. activities that will not constitute a "public offering" under 1940 Act § 7(d). Supp. Info. 486; *see also, e.g.*, Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997); Touche, Remnant & Co., SEC No-Action Letter (Aug. 27, 1984).

[178] Supp. Info. 485.

[179] *Id*.

[180] This approach represents a notable departure from the Proposed Rule, which generally treated as a covered fund, for both U.S. *and* foreign banking entities, any issuer "that is organized or offered outside of the United States that would be a covered fund. . . were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more [U.S.] States." Proposed Rule § _.10(b)(1)(iii).

[181] *See* Final Rule §§ _.10(c)(12)(ii), _.10(b)(2).

5.A.1. Commodity Pools Included in the Definition of "Covered Fund"

Section 13 provides that "[t]he terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company. . . but for section 3(c)(1) or 3(c)(7) of [the 1940 Act], or *such similar funds* as the [Agencies] may, by rule. . . determine."[182] The inclusion of certain commodity pools in the definition of "covered fund" reflects the Agencies' exercise of this statutory authority to designate "similar funds."[183]

Specifically, under the Final rule, "covered fund" includes the following commodity pools:

(1) a pool for which the commodity pool operator[184] has ***claimed an exemption under 17 CFR § 4.7***, which provides relief from certain registration and recordkeeping requirements under the CEA for commodity pools that are offered and sold solely to "qualified eligible persons"[185] in private offerings (an "Exempt Pool"); or

(2) a pool that is ***"substantively similar"*** to an Exempt Pool in that it meets the following three criteria (a "Similar Pool"):

- a ***commodity pool operator is registered*** with the CFTC in connection with the operation of the commodity pool;
- ***substantially all*** participation units of the pool are owned by "qualified eligible persons"; and
- participation units of the pool have not been ***publicly offered*** to persons who are not "qualified eligible persons."[186]

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[182] BHC Act § 13(h)(2).

[183] A "commodity pool" is "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests," generally including swaps, futures and other related instruments included in the definition of "financial instrument" discussed in Part 3.A of this Memorandum. CEA § 1a(10).

[184] A "commodity pool operator" is generally any person "engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests," again generally including swaps, futures and other related financial instruments. CEA § 1a(11).

[185] "Qualified eligible persons" meet certain sophistication and net worth requirements. *See* 17 CFR § 4.7(a)(2).

[186] Final Rule § _.10(b)(1)(ii); Supp. Info. 491. Note that the terms "Exempt Pool" and "Similar Pool" are not used by the Final Rule. Rather, they are used in this Memorandum to explain the definitional requirements of commodity pool covered funds.

The Agencies believe that Exempt Pools "are appropriately considered covered funds because, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools sell their participation units in restricted offerings that are not registered under the Securities Act of 1933 and are offered only to investors who meet certain heightened qualification standards."[187]

The alternative definition for Similar Pools is intended to ensure that a commodity pool that is "substantively similar" to an Exempt Pool cannot escape covered fund status "merely by not electing exempt pool status,"[188] or by taking other actions that render Exempt Pool status unavailable while nonetheless preserving some of the core private-fund-like attributes of an Exempt Pool.

The following table summarizes the relationship between the prerequisites for Exempt Pool status and the corresponding prongs of the Similar Pool definition, as well as the Agencies' rationale for including each prong of the Similar Pool definition.

Fig. 5.A.1: Comparison of "Exempt Pool" Requirements and Alternative Definition of "Similar Pool"

Prerequisite for "Exempt Pool" under 17 CFR § 4.7(b)	Requirement of Alternative Definition of "Similar Pool"	Rationale as Explained in Supplementary Information
Only a commodity pool operator registered with the CFTC can claim the exemption.	A commodity pool operator is registered with the CFTC in connection with the operation of the commodity pool.	"[I]f the Agencies had included only pools for which exempt pool status had been elected, covered fund status. . . could easily be avoided merely by not electing exempt pool status under section 4.7. . . . The [first prong of the alternative definition] is that a commodity pool operator for the pool is registered pursuant to the [CEA] in connection with the operation of that commodity pool. This element is present for all pools that are exempt pools under section 4.7 because exempt pool status can only be elected by registered commodity pool operators." (491)
Offers and sales of participations must be made ***solely*** to "qualified eligible persons."	***Substantially all*** participation units of the pool are owned by "qualified eligible persons."	"Although section 4.7 requires that all participation units be owned by qualified eligible persons, this element of the [definition] has been modified to include pools for which 'substantially all' participation units are owned by qualified eligible persons to prevent avoidance of covered fund status by distributing a small number of participation units to persons who are not qualified eligible persons." (492 n. 1720)

[187] Supp. Info. 490.

[188] *Id*. at 491.

Offers and sales of participations must be made in a ***private offering*** that is exempt under Section 4(2) of the Securities Act or under the SEC's Regulation S.	Participation units of the pool have ***not been publicly offered*** to persons who are not "qualified eligible persons."	"Consistent with CFTC regulations. . . the term 'offer' as used in [the alternative definition] has the same meaning as in contract law, such that, if accepted the terms of the offer would form a binding contract. This aspect of the alternative definition is intended to limit the ability for commodity pools to avoid classification as covered funds through an offer. . . to non-qualified eligible persons 'in name only' where there is no actual offer." (492-93, internal quotations and footnote omitted)[189]

5.B. Entities Excluded from the Definition of "Covered Fund"

In response to comments received on the Proposed Rule, the Agencies have excluded several types of entities from the definition of "covered fund" under the Final Rule.[190] Some types of entities, such as joint ventures and wholly owned subsidiaries, that were included as *permitted* covered funds in the Proposed Rule, are now *excluded* from the definition of "covered fund" in the Final Rule. Banking entities will generally prefer this approach, since an entity that is not a covered fund is not subject to the potentially onerous "Super 23A" restrictions discussed in Part 8 of this Memorandum. On the other hand, an entity that is not a covered fund, but *is* a "subsidiary" or "affiliate" of a banking entity under BHC Act principles, will itself be a "banking entity" and will therefore be subject to the Volcker Rule's proprietary trading and covered fund restrictions.

Unless the Agencies jointly determine otherwise, "covered fund" does ***not*** include the following types of entities. The Agencies "expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve," however, and

[189] Moreover, the Agencies explain that "unless the pool operator can show that the pool's participation units have been actively and publicly offered to non-affiliated parties that are not qualified eligible persons whereby such non-qualified eligible persons could in fact purchase a participation unit in the commodity pool, a pool that features the other elements listed in the alternative definition would be a covered fund. Such a showing will not turn solely on whether the commodity pool has filed a registration statement to offer its participation units under the Securities Act of 1933 or whether the commodity pool operator has prepared a disclosure document consistent with. . . the CFTC's regulations. Rather, the pool operator would need to show that a reasonably active effort, based on the facts and circumstances, has been undertaken by brokers and other sales personnel to publicly offer the pool's participation units to non-affiliated parties that are not qualified eligible persons." *Id*. at 493 (footnote omitted).

[190] These exclusions are relevant for issuers that would be "covered funds" but for the relevant exclusion. The exclusions are not relevant for issuers that would not be "covered funds" in the first place, most notably funds that are not actually relying on § 3(c)(1) or § 3(c)(7) because they are organized in non-U.S. jurisdictions and do not make offers or sales to U.S. persons.

"will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate."[191]

The exclusion for "loan securitizations" is discussed in Part 5.B.1 of this Memorandum.

(i) "Foreign Public Funds"

"Covered fund" excludes a "foreign public fund," defined as any issuer that:

(1) is organized or established outside the United States;

(2) is authorized to offer and sell ownership interests to retail investors[192] in the issuer's home jurisdiction; and

(3) sells ownership interests predominantly[193] through one or more "public offerings" outside the United States.

- "*Public offering*" means a "distribution" of securities outside the United States to investors, including retail investors, that complies with all applicable requirements in the jurisdiction and does not restrict availability to investors having a minimum net worth or net investment assets (except in connection with any suitability requirements under applicable local law).[194] Disclosure documents must also be publicly filed in the jurisdiction.[195]

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191 *Id*. at 502. "The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13." *Id*.

192 "The reference to retail investors, while not defined, should be construed to refer to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors, professional investors or high net worth investors who may be permitted to invest in complex investments or private placements in various jurisdictions. Retail investors would therefore be expected to be entitled to the full protection of securities laws in the home jurisdiction of the fund, and the Agencies would expect a fund authorized to sell ownership interests to such retail investors to be of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund." *Id*. at 505.

193 "The Agencies generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States." *Id*. at 506.

194 *Id*. at 507. For this purpose, "distribution" has the same meaning as under the underwriting activity exemption discussed in Part 4.A of this Memorandum. Final Rule § _.10(c)(1)(iii). Specifically: "a *distribution* of securities means: (i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933." *Id*. § _.4(a)(3).

195 Final Rule § _.10(c)(1). The Supplementary Information notes that "[d]isclosure documents may be made publicly available in a variety of means, such as through a public filing with a regulatory

The Supplementary Information notes that this exclusion is designed to treat foreign public funds consistently with similar U.S. mutual funds and to limit the extraterritorial application of the Volcker Rule, including by permitting U.S. banking organizations and their foreign affiliates to carry on traditional asset management businesses outside the United States.[196] This exclusion, which was added in the Final Rule, will avoid or limit disruption to foreign fund operations that are subject to regulation like U.S. mutual funds and would otherwise have to conform with the Volcker Rule's many requirements, including rebranding so as not to share a name with a sponsoring banking entity.

For a U.S. banking entity, or an entity controlled directly or indirectly or sponsored by a U.S. banking entity, to rely on this exclusion with respect to foreign public funds that it sponsors, ownership interests in the issuer must be sold "predominantly" to persons other than the banking entity, the issuer, their affiliates and their directors and employees.[197] This additional condition reflects the Agencies' belief that "a foreign public fund sponsored by a U.S. banking entity may present heightened risks of evasion."[198] The condition does not apply to foreign public funds in which a U.S. banking entity invests but for which it does not act as a sponsor.[199]

(ii) Wholly Owned Subsidiaries

"Covered fund" excludes a wholly owned subsidiary, defined as an entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that:

> (1) up to 5% of the entity's outstanding ownership interests may be held by employees or directors of the banking entity or such affiliate (including former employees or directors if their ownership interest was acquired while employed by or in the service of the banking entity); and

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agency or through a website that provides broad accessibility to persons in such jurisdiction." Supp. Info. 507.

196 Supp. Info. 508.

197 Final Rule § _.10(c)(1)(ii).

198 Supp. Info. 508.

199 "The Agencies believe it is less likely that a U.S. banking entity effectively could evade section 13 by investing in third-party foreign public funds that the banking entity does not sponsor. In those cases it is less likely that the U.S. banking entity would be able to control the investments of the fund, and the fund thus likely would be a less effective means for the banking entity to engage in proprietary trading through the fund." *Id*. at 508-09.

(2) subject to the 5% limit, up to 0.5% of the entity's outstanding ownership interests may be held by a third party if the ownership interest is acquired or retained by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.[200]

This provision is "designed to exclude from the covered fund definition vehicles that are formed for corporate and organizational convenience," and "reduce the disruption to operations of banking entities that commenters asserted would result" from the Proposed Rule's approach of treating many wholly owned subsidiaries as covered funds.[201] In addition, the Agencies noted that "a wholly-owned subsidiary of a banking entity—although excluded from the definition of covered fund—still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of [the Volcker Rule]."[202]

(iii) Joint Ventures

A joint venture between a banking entity or its affiliates and unaffiliated persons is excluded from the definition of "covered fund," provided that the joint venture:

(1) consists of no more than 10 unaffiliated co-venturers;

(2) engages in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and

(3) is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[203]

The Supplementary Information notes that, as a result of this exclusion, banking entities will continue to be able to share the risks and costs of financing their banking activities through joint ventures, such as by sharing the risks from non-performing loans, credit card receivables, consumer loans, commercial real estate loans or automobile loans, which may allow banking entities to more efficiently manage the risks of their operations.[204]

The joint venture exclusion does not, however, allow a banking entity to participate in activities that are not already permitted for it. Furthermore, because a qualifying joint venture is not a covered fund, it will be a banking entity if it is controlled by any banking

[200] Final Rule § _.10(c)(2).

[201] Supp. Info. 514 (footnote omitted).

[202] *Id*. at 515 (footnote omitted).

[203] Final Rule § _.10(c)(3).

[204] Supp. Info. 516, 518.

entity, meaning that the joint venture itself will be subject to the prohibitions on proprietary trading and covered fund activities under the Final Rule.

Although the Supplementary Information includes relatively little commentary on clause (3) in the definition above, it does specifically note that this requirement has the effect of precluding the use of the joint venture exclusion to engage in merchant banking activities.[205]

(iv) Acquisition Vehicles

Acquisition vehicles are excluded from the definition of "covered fund" so long as they are formed solely for the purpose of engaging in a bona fide merger or acquisition transaction and exist only for the period necessary to effectuate the transaction.[206]

(v) Foreign Pension or Retirement Funds

A plan, fund or program providing pension, retirement or similar benefits is excluded from the definition of "covered fund" if it is:

(1) organized and administered outside the United States;

(2) a broad-based plan for employees or citizens that is subject to regulation under the laws of the jurisdiction in which it is organized and administered; and

(3) established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision of a foreign sovereign.[207]

(vi) Insurance Company Separate Accounts

The Final Rule provides an exclusion from the definition of "covered fund" for insurance company separate accounts, provided that no banking entity other than the insurance company participates in the account's profits and losses.[208]

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[205] Merchant banking investments must, by definition, be "held for a period of time to enable the sale or disposition thereof on a reasonable basis." BHC Act § 4(k)(4)(H)(iii). The Supplementary Information cites this provision of the BHC Act in noting that merchant banking activities "involve[] acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment." Supp. Info. 518-19.

[206] Final Rule § _.10(c)(4).

[207] *Id*. § _.10(c)(5). The Supplementary Information notes that this exclusion is similar to the treatment provided to U.S. pension funds by virtue of the exception from the definition of investment company under 1940 Act § 3(c)(11) for certain broad-based employee benefit plans, and further notes that the exclusion will be available even if some of the beneficiaries of the fund reside in the United States or subsequently become U.S. residents. Supp. Info. 523.

[208] Final Rule § _.10(c)(6). "Separate account" has the same definition discussed in Part 4 above. *See id*. § _.2(bb); *see also* Part 7.D of this Memorandum.

(vii) Bank-Owned Life Insurance

The Final Rule also provides an exclusion from the definition of "covered fund" for an insurance company separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities are beneficiaries, provided that no banking entity that purchases the policy controls the investment decisions regarding the underlying assets or holdings of the separate account, or participates in the profits or losses of the separate account other than in compliance with applicable supervisory guidance regarding bank-owned life insurance.[209]

(viii) Qualifying Asset-Backed Commercial Paper Conduits

Section 13 contains a "rule of construction" that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity. . . to sell or securitize loans in a manner otherwise permitted by law."[210] To give effect to this statutory requirement, the Final Rule adopts exclusions from the definition of "covered fund" for certain issuers of asset-backed commercial paper, certain issuers of "covered bonds" and certain loan securitizations.[211]

The Final Rule provides an exclusion from the definition of "covered funds" for an issuer of asset-backed commercial paper (a "conduit"), if:

(1) the issuer holds ***only***:

- ***loans*** and other assets permissible under the loan securitization exclusion; and
- ***asset-backed securities*** supported solely by assets that are permissible for loan securitizations and acquired by the asset-backed commercial paper conduit as part of an initial issuance either directly from the issuer of the asset-backed securities or directly from an underwriter in the distribution of the asset-backed securities;[212]

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[209] Final Rule § _.10(c)(7). The Supplementary Information notes that, "[w]hen made in the normal course, investments by banking entities in BOLI separate accounts do not involve the types of speculative risks [the Volcker Rule] was designed to address," but the Agencies nonetheless "expect this exclusion to be used by banking entities in a manner consistent with safety and soundness." Supp. Info. 527.

[210] BHC Act § 13(g)(2).

[211] The exclusions for qualifying "covered bonds" and loan securitizations are discussed in Parts 5.B(ix) and 5.B.1 of this Memorandum, respectively.

[212] Final Rule § _.10(c)(9)(i)(A)(2). The Supplementary Information explicitly confirms that "[a]sset-backed securities purchased by an ABCP conduit in the secondary market will not be permitted" for purposes of this exclusion. Supp. Info. 568.

(2) the asset-backed commercial paper conduit issues only asset-backed securities comprising a residual interest and securities with a legal maturity of ***397 days or less***;[213] and

(3) a ***"regulated liquidity provider"*** must have entered into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued by the asset-backed commercial paper conduit (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.

- "*Regulated liquidity provider*" is defined as: (i) a depository institution as defined in Section 3(c) of the FDIA; (ii) a bank holding company, or a subsidiary thereof; (iii) a savings and loan holding company, provided that all or substantially all the holding company's activities are permissible for a financial holding company under Section 4(k) of the BHC Act, or a subsidiary thereof; (iv) a foreign bank whose home country supervisor (as defined in the Federal Reserve's Regulation K) has adopted capital standards consistent with the Basel Accord, and that is subject to such standards, or a subsidiary thereof; or (v) the United States or a foreign sovereign.[214]

The Supplementary Information notes that, in addition to giving effect to the statutory rule of construction, this exclusion is intended to facilitate reasonable access to credit by consumers and businesses through the issuance of asset-backed commercial paper backed by consumer and business receivables.[215]

(ix) Qualifying "Covered Bonds"

To accommodate structures involving so-called "covered bonds"—full-recourse debt instruments issued by a non-U.S. entity that are fully secured or "covered" by a pool of high-quality collateral—the Final Rule provides an exclusion from the definition of "covered fund" for an issuer that is a "permitted cover pool."[216] To qualify for this exclusion, the permitted cover pool must own or hold "a dynamic or fixed pool of loans or other assets," all of which

[213] Final Rule § _.10(c)(9)(i)(B). "The Agencies chose a maximum term of 397 days for these securities because this time frame corresponds to the maximum maturity of securities allowed to be purchased by money market funds under Rule 2a-7 of the [1940 Act]." Supp. Info. 567.

[214] Final Rule § _.10(c)(9). For a sovereign nation to qualify as a regulated liquidity provider, the liquidity must be unconditionally guaranteed by the sovereign, which would include its departments and ministries, including the central bank. Supp. Info. 556.

[215] Supp. Info. 570.

[216] Final Rule § _.10(c)(10). The term "permitted cover pool" is not used in the Final Rule itself, but is used in the Supplementary Information. *See* Supp. Info. 573-75.

must be permissible under the loan securitization exclusion discussed in Part 5.B.1 of this Memorandum, for the benefit of the holders of "covered bonds."

For purposes of this exclusion, a "*covered bond*" means:

(1) a debt obligation issued by a foreign banking organization,[217] the payment obligations of which are fully and unconditionally guaranteed by a permitted cover pool; or

(2) a debt obligation of a permitted cover pool, provided that the payment obligations are fully and unconditionally guaranteed by a foreign banking organization and the permitted cover pool is a wholly-owned subsidiary of the foreign banking organization.[218]

Notwithstanding the Agencies' recognition that certain foreign covered bond programs (and their related cover pools) are permitted by their respective home-jurisdiction laws to own residential mortgage-backed securities and other non-loan assets, the Supplementary Information notes that the exclusion for cover pools is intended to permit banking entities to engage in lending and related financing activities and, therefore, does not permit the pool to hold securities or other non-loan assets.[219]

(x) Small Business Investment Companies and Public Welfare Investments

A "covered fund" does not include SBICs and companies that have received notice from the Small Business Administration to proceed to qualify for a license as an SBIC (which notice or license has not been revoked).[220]

This exclusion also covers an issuer, the business of which is to make investments that are:

(1) designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as providing housing, services or jobs), of the type permitted for national banks under the National Bank Act;[221] or

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[217] The definition of "foreign banking organization" for purposes of the Final Rule is discussed in Part 4.H of this Memorandum.

[218] Final Rule § _.10(c)(10)(ii).

[219] Supp. Info. 574-75.

[220] Final Rule § _.10(c)(11)(i).

[221] *Id*. § _.10(c)(11)(ii)(A). Under the National Bank Act, a national bank "shall not make any such investment if the investment would expose the [bank] to unlimited liability," for example, and such investments are subject to certain aggregate limits determined by the OCC. 12 U.S.C. § 24 (Eleventh). OCC regulations also provide specific examples of qualifying public welfare investments under the National Bank Act, including with respect to affordable housing projects, economic development and job creation investments, investments in "community and economic development entities" and other public welfare investments. *See* 12 CFR § 24.6.

(2) "qualified rehabilitation expenditures" with respect to a "qualified rehabilitated building" or "certified historic structure," as such terms are defined in Section 47 of the Internal Revenue Code of 1986 or a similar U.S. state historic tax credit program.[222]

These types of investments often play a significant role in banking entities' Community Reinvestment Act objectives, particularly in the case of regional and community banking organizations. The discussion in the Supplementary Information suggests that the exclusion for public welfare investments does not extend to investments outside the United States.[223]

(xi) Registered Investment Companies and Business Development Companies

A "covered fund" does not include:

(1) an issuer that is registered as an investment company under Section 8 of the 1940 Act (a "RIC"), or that is formed and operated pursuant to a written plan to become a RIC, and that complies with the leverage-related requirements of Section 18 of the 1940 Act; and

(2) an issuer that has elected to be regulated as a business development company (a "BDC") pursuant to Section 54(a) of the 1940 Act and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company, and that complies with the leverage-related requirements of Section 61 of the 1940 Act.[224]

For an issuer that will become a RIC or a BDC, the written plan generally must describe the banking entity's plan to market the vehicle to third-party investors and convert it into a RIC or a BDC, respectively, within the one-year "seeding period" for an organized and offered covered fund.[225]

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[222] Final Rule § _.10(c)(11)(ii). "Qualified rehabilitated buildings" are certain buildings first placed in service before 1936, and "certified historic structures" are listed in the National Register or certified as being of historical significance to a registered historic district. 26 U.S.C. §§ 47(c)(1), 47(c)(3).

[223] The Agencies note that, after reviewing comment letters requesting that the exemption be extended to investments outside the United States, they believe that the Final Rule "gives effect to the statutory exemption of these investments in a way that appropriately facilitates *national* community and economic development objectives." Supp. Info. 579 (emphasis added).

[224] Final Rule § _.10(c)(12).

[225] *See id*. § _.20(e)(3); *see also* Part 6.B of this Memorandum.

As noted above, entities that are not covered funds may still be subject to the prohibitions of the Volcker Rule if they are "affiliates" or "subsidiaries" of banking entities. The Supplementary Information confirms that Federal Reserve guidance on when a banking entity "controls" a RIC—and when the RIC is therefore an "affiliate" or "subsidiary" of the banking entity—will apply in the Volcker Rule context. This guidance may permit a banking entity to avoid "controlling" a RIC despite providing investment advisory services or having director and officer interlocks, provided that the banking entity owns less than 25% of the voting shares of the RIC.[226] To the extent the RIC is not controlled, it will not be subject to the Volcker Rule (unless it qualifies as a banking entity independently, such as by controlling an insured depository institution).

(xii) Issuers That May Rely on Other 1940 Act Exemptions

The Final Rule expressly excludes from the definition of "covered fund" an issuer that may rely on an exclusion or exemption from the definition of "investment company" under the 1940 Act other than Sections 3(c)(1) and 3(c)(7).[227]

Such issuers would include, for example, certain real estate investment trusts ("REITs") and other funds primarily engaged in acquiring mortgages and other liens on and interests in real estate that may rely on Section 3(c)(5)(C), certain bank collective trust funds that may rely on Section 3(c)(3) and certain issuers of asset-backed securities that may rely on Rule 3a-7.[228]

[226] The Supplementary Information provides that "a financial holding company may own more than 5 percent (and less than 25 percent) of the voting shares of a registered investment company for which the holding company provides investment advisory, administrative, and other services and has a number of director and officer interlocks, without controlling the fund for purposes of the BHC Act." Supp. Info. 500. For bank holding companies that are not financial holding companies, and are therefore restricted to a narrower set of activities, the Federal Reserve generally permits ownership of up to 5% of voting shares of a RIC, and up to less than 25% of the voting shares of a RIC that limits its investments to those permissible for the bank holding company itself, without a finding of "control." *Id*. at 499.

[227] Final Rule § _.10(c)(12)(ii).

[228] Rule 3a-7 provides an exemption from investment company registration for certain issuers of "fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow" from "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." 17 CFR § 270.3a-7. Limitations on the creditworthiness of securities issued, investor eligibility requirements and other terms also apply, which are intended to provide investor protection safeguards in the context of vehicles that could generally not satisfy the leverage or other requirements of the 1940 Act applicable to registered investment companies. *See id*.; *see also* SEC, *Treatment of Asset-Backed Issuers Under the Investment Company Act*, 76 Fed. Reg. 55308, 55310-11 (Sept. 7, 2011).

The Rule 3a-7 exemption may be helpful in many contexts, but, because of its restricted terms, is not available for all asset-backed securities transactions, which may be subject to the covered fund restrictions of the Volcker Rule unless another exclusion applies.

(xiii) FDIC as Receiver or Conservator

The Final Rule provides an exclusion from the definition of "covered fund" for an issuer that is formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver under the FDIA or the "orderly liquidation authority" under Title II of the Dodd-Frank Act.[229]

(xiv) Other Excluded Issuers

The Final Rule also provides that the Agencies may act jointly to provide an exclusion from the definition of "covered fund" for an issuer that all the Agencies determine is consistent with the purposes of the Volcker Rule.[230] The Agencies recognized that "an overly broad definition of covered fund may impose significant burdens on banking entities that are in conflict with the purposes of section 13" and "are working to establish a process within which to evaluate requests for exclusions and expect to provide additional guidance on this matter as the Agencies gain experience with the final rule."[231]

5.B.1. The Exclusion for "Loan Securitizations"

As noted above, Section 13 provides that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity. . . to sell or securitize loans in a manner otherwise permitted by law."[232] To give effect to this statutory requirement, the Final Rule adopts an exclusion from the definition of "covered fund" for an issuer of asset-backed securities, the assets or holdings of which are composed ***solely*** of:

(1) ***loans***, using the same definition of "loan" discussed in Part 3.A.1 of this Memorandum (that is, "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative");[233]

(2) ***rights or other assets*** designed to assure the servicing or timely distribution of proceeds to holders of the asset-backed securities, and rights or other assets that are related and incidental to purchasing or otherwise acquiring and holding the loans in the loan

[229] Final Rule § _.10(c)(13).

[230] *Id*. § _.10(c)(14). Any such determination will promptly be made public. *Id*. § _.10(c)(14)(ii).

[231] Supp. Info. 583-84 (footnote omitted).

[232] BHC Act § 13(g)(2).

[233] For purposes of this exclusion, the loan securitization must own the loan directly; a synthetic exposure to a loan, such as through holding a credit default swap or another derivative, does not satisfy the conditions of the exclusion. Supp. Info. 543-44.

securitization, provided that such rights or assets are not securities or derivatives that are not specifically permitted;[234]

(3) securities that are either ***cash equivalents*** or received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities, but ***no other securities (or interests in an equity or debt security)***;[235]

(4) ***interest rate or foreign exchange derivatives*** the written terms of which directly relate to the loans, asset-backed securities or contractual rights or other assets, and which reduce the interest rate or foreign exchange risks related to the loans, asset-backed securities or other contractual rights or other assets, but ***no other derivatives (or commodity forward contracts)***;[236] and

(5) certain special units of beneficial interest and collateral certificates issued by a special purpose vehicle.[237]

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[234] The Supplementary Information notes that the "servicing assets are permissible in an excluded loan securitization transaction only to the extent that they arise from the structure of the loan securitization or from the loans supporting a loan securitization. If such servicing assets are sold and securitized in a separate transaction, they will not qualify as permissible holdings for the loan securitization exclusion." For example, mortgage insurance policies supporting the mortgages in a loan securitization are permissible servicing assets, but a separate securitization of the payments on those mortgage insurance policies would not qualify. *Id*. at 547 & n. 1889.

[235] Final Rule §§ _.10(c)(8)(ii)(A), _.10(c)(8)(iii). The Supplementary Information explains that "the Agencies interpret 'cash equivalents' to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. Depending on the specific funding needs of a particular securitization, 'cash equivalents' might include deposits insured by the [FDIC], certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper." Supp. Info. 548-49 (footnotes omitted).

[236] Final Rule §§ _.10(c)(8)(ii)(B)-(C), _.10(c)(8)(iv). The Agencies "would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding principal balance of the asset-backed securities. . . . For example, a $100 million securitization cannot be hedged using an interest rate hedge with a notional amount of $200 million." Supp. Info. 552 & n. 1903.

[237] Final Rule § _.10(c)(8). The special units of beneficial interest and collateral certificates must be issued by a special purpose vehicle that itself meets the requirements of the loan securitization exclusion and that (together with the issuer) is established under the direction of the same entity that initiates the loan securitization. Furthermore, the special units of beneficial interest and collateral certificates must: (i) be used for the sole purpose of transferring to the issuer for the loan securitization the economic risks and benefits of the assets that are permissible for loan securitizations and must not directly or indirectly transfer any interest in any other economic or financial exposure; and (ii) be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization. *Id*. § _.10(c)(8)(v).

The requirements of this exclusion reflect the Agencies' attempt to balance "the need, in administering a loan securitization transaction on an ongoing basis, to hold various assets other than the loans that support the asset-backed securities," with the decision not to adopt "a broad exclusion for all securitization vehicles," which the Agencies did not believe was required by the statute.[238]

These strict requirements may limit the availability of the exclusion, and—together with the expanded definition of "ownership interest" discussed in Part 5.C of this Memorandum—may raise issues for banking entities' investments in securities issued by common securitization vehicles.[239] Collateralized loan obligation ("CLO") and collateralized debt obligation ("CDO") issuers, in particular, may hold securities and derivatives that would disqualify them from the loan securitization exclusion.[240]

The Supplementary Information notes that these assets are permissible so that "a securitization backed by certain intermediate asset-backed securities [such as certain equipment financing transactions and master trust structures] will qualify for the loan securitization exclusion. The Agencies recognize that securitization structures that use these types of intermediate asset-backed securities are essentially loan securitization transactions, because the intermediate asset-backed securities in the asset pool are created solely for the purpose of facilitating a securitization and once created, are issued directly into a securitization vehicle rather than to any third party investor." Supp. Info. 556 (footnote omitted).

[238] Supp. Info. 540.

[239] The Supplementary Information specifically notes that "[t]he Agencies are not adopting specific exclusions for other securitization vehicles identified by commenters, including insurance-linked securities, collateralized loan obligations, and corporate debt re-packagings. . . . Moreover, the Agencies note in response to commenters that resecuritizations of asset-backed securities and CDO-squared and CDO-cubed securitizations could be used as a means of evading the prohibition on the investment in the ownership interests of covered funds." *Id*. at 541.

[240] On the other hand, some CLOs may qualify (or be able to be restructured to qualify) for the exclusion. In a guide to the "Community Bank Applicability" of the Volcker Rule released contemporaneously with the Final Rule, the federal banking agencies stated that "[c]ertain CLOs structures [sic] have a limited amount of underlying exposure that consists of securities and/or other non-loan assets. These CLO structures could be covered funds if the non-loan exposures are impermissible assets as described in [the loan securitization exclusion] of the Final Rule. However, CLOs are allowed to divest of impermissible assets during the conformance period and avoid becoming a covered fund." Federal Reserve, FDIC and OCC, *The Volcker Rule: Community Bank Applicability* 3 n. 1 (Dec. 10, 2013). This statement confirms that some CLO issuers may be able to be restructured to qualify for the loan securitization exclusion, although the feasibility of such restructurings is uncertain.

5.B.2. Entities Expressly Not Excluded and Potential Alternatives

The Agencies note in the Supplementary Information that they specifically declined to exclude from the definition of "covered fund" a number of vehicles, including financial market utilities, venture capital funds, credit funds, cash management vehicles, cash collateral pools and employee securities companies. This does not mean that such vehicles necessarily *are* covered funds, but it means that a banking entity would need to identify a different exclusion from the definition for such a vehicle, or potentially "organize and offer" the vehicle in the manner permitted by the Final Rule, which is discussed in Part 6 of this Memorandum.

The Supplementary Information provides some additional guidance on these vehicles and potential alternative exemptions or arrangements with respect to such vehicles, the highlights of which are summarized in the table below.

Selected Guidance on Entities Expressly Not Excluded

Financial Market Utilities

"[T]he Agencies have not provided an exclusion from the covered fund definition for FMUs because these kinds of entities do not generally appear to rely on section 3(c)(1) or 3(c)(7) of the [1940 Act], and therefore do not appear to need an exclusion. For example, section 3(b)(1) of the [1940 Act] excludes from the definition of investment company—and thus from the definition of a covered fund—entities primarily engaged in a business other than that of an investment company." (586-87, footnote omitted)

Cash Collateral Pools

"[S]ome cash collateral pools may not be covered funds because they rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Banking entities may determine to register cash collateral pools with the SEC as investment companies or to operate them as separate accounts to exclude the pools from the covered fund definition or, if the pools remain covered funds, to organize and offer them in compliance with the requirements of § _.11 of the final rule." (589, footnote omitted)

Pass-Through REITs

"The Agencies are not providing a specific exclusion from the definition of covered fund for pass-through REITs because the Agencies are concerned that such an exclusion could enable banking entities to structure non-loan securitization transactions using a pass-through entity in a manner inconsistent with the final rule's treatment of similar vehicles that invest in securities. Furthermore, banking entities have alternative manners in which they may issue or hold REIT preferred securities, including through REITs directly, which do not raise the same concerns about evasion." (591, footnote omitted)

Municipal Securities Tender Option Bond Transactions

"As tender option bond vehicles are considered issuers of asset-backed securities subject to the risk retention requirements of section 15G of the Exchange Act, banking entities may look to the provisions of the final rule governing the limits applicable to banking entities' interests in and relationships with those funds. Under the final rule, as in the statute, a banking entity that conducts the activities described in section 13(f) of the BHC Act is subject to the restrictions on transactions with a tender option bond vehicle, including guaranteeing or insuring the performance of the tender option bond vehicle, contained in section 13(f) of the BHC Act. As a result, a banking entity is not permitted to provide credit enhancement, liquidity support, and other similar services if it serves in a capacity covered by section 13(f) with the tender option bond program." (596-97, footnote omitted)

Venture Capital Funds

"While the final rule does not provide a separate exclusion for venture capital funds. . . . [o]ther provisions of the final rule or the statute may facilitate, or at least not impede, other forms of investing that may provide the same or similar benefits. For example, in addition to permitting a banking entity to organize and offer a covered fund in section 13(d)(1)(G), section 13 of the BHC Act does not prohibit a banking entity, to the extent otherwise permitted under applicable law, from making a venture capital-style investment in a company or business so long as that investment is not through or in a covered fund." (601, footnotes omitted)

Credit Funds

"The Agencies. . . are unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of section 13. . . . Moreover. . . some credit funds may be able to rely on another exclusion from the definition of covered fund in the final rule such as the exclusion for joint ventures or the exclusion, discussed above, for loan securitizations." (603)

Employee Securities Companies

"[T]he final rule does not provide a specific exclusion. . . because the Agencies believe that these vehicles may avoid being a covered fund by either complying with the conditions of another exclusion. . . or seeking and receiving an exemption available under section 6(b) of the Investment Company Act." (604)

5.C. Definition of "Ownership Interest"

The covered fund restrictions prohibit a banking entity from acquiring or retaining "ownership interests" in covered funds. The Final Rule includes a complex definition of "ownership interest" that requires detailed consideration of several specific factors. Determining whether a particular interest is an "ownership interest" may therefore be an involved exercise.

Specifically, the Final Rule defines "ownership interest" to mean any ***equity interest***, any ***partnership interest*** or any ***"other similar interest"*** that, on a current, future or contingent basis:

(1) has the right to ***participate in the selection or removal of a general partner***, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(2) has the right under the terms of the interest to ***receive a share of the income, gains or profits of the covered fund*** (with a limited exception for "carried interest" allocations described below);

(3) has the right to ***receive the underlying assets of the covered fund*** after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(4) has the right to receive all or a portion of ***"excess spread"*** (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(5) provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be ***reduced based on losses*** arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(6) ***receives income on a pass-through basis*** from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

(7) represents ***any synthetic right*** to have, receive or be allocated any of the rights in the foregoing clauses (1)–(6).[241]

The Agencies note that "[t]he definition is centered on equity interests. . . and similar interests, and would not generally cover typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate." [242] Between equity interests and "typical extensions of credit," however, lie many securities considered to be debt in other contexts, whose treatment under the definition of "ownership interest" may lead to surprising results for banking entities.

This has become clear in the case of CLOs and CDOs. Broadly speaking, the definition of "ownership interest" under the Proposed Rule appeared to be intended to exclude interests with predominantly debt-like features. Under the Proposed Rule, "ownership interest" was defined as "any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest." [243] As the Agencies explained, this definition "would also have included a debt security or other interest in a covered fund as an ownership interest *if* it exhibited *substantially the same characteristics* as an *equity* or other ownership interest."[244] Although it was not clear how to apply the Proposed Rule's definition of "ownership interest" to all interests in securitization structures, the definition and commentary could be read to intend to exclude many typical CLOs and CDOs.

The Final Rule provides the more detailed definition of "ownership interest" described above, however, which focuses more on specific features of the instrument in question and less on traditional debt–equity distinctions. In addition, the Agencies declined to provide clarity on the application of "ownership interest" to securitization structures:

> [M]any commenters on securitizations under the proposed rule made arguments regarding the difficulty of applying the proposal's definition of ownership interest to securitization structures, contending that the definition should not include debt instruments with equity features, or that the final rule should provide a safe harbor under which the use of a standardized, pre-specified securitization structure would not give rise to an ownership interest. The Agencies are not adopting a separate definition of ownership interest for securitization transactions, providing for differing treatment of financial instruments, or providing a safe harbor as requested by some commenters. . . . The determination of whether an interest is an ownership interest under the final rule will depend on the features and

[241] Final Rule § _.10(d)(6)(i); Supp. Info. 609.

[242] Supp. Info. 607-08.

[243] Proposed Rule § _.10(b)(3).

[244] Supp. Info. 605 (emphases added).

> characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights. . . . The Agencies understand that the definition of ownership interest in the final rule may include interests in a covered fund that might not be considered an ownership interest or equity interest in other contexts.[245]

This discussion is careful not to reach conclusions about specific instruments. On the other hand, the broadened definition of "ownership interest" in the Final Rule, combined with the Agencies' conscious decision not to provide any guidance about interests in securitizations that would *not* be "ownership interests," has caused concern that a wide range of debt securities issued by securitization vehicles, including CLOs and CDOs, may in fact be "ownership interests" under the Final Rule.

Finally, as noted above, "carried interest" performance allocations—termed "restricted profit interests" in the Final Rule—are not "ownership interests" so long as:

(1) the interest is held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor or other service provider;

(2) the sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

(3) all such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund, and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;

(4) any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the

[245] *Id*. at 611-12 (footnotes omitted).

banking entity's per-fund and aggregate ownership limits as discussed in Part 6 of this Memorandum; and

(5) the interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members or through the intestacy of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory or other services to the fund.[246]

5.C.1. Agency Relief for Certain TruPS-Backed CDOs

"Trust preferred securities," or "TruPS," are securities issued by a trust that acquires debt issued by a banking organization or insurance company and makes payments on the securities based on interest and principal payments on the debt. Prior to the Dodd-Frank Act, TruPS were an attractive source of funding because, among other things, they were generally treated as debt capital for U.S. tax purposes (thereby providing a tax deduction for interest payments), but were of a long enough term and were subordinated enough (generally including deferral features) that they could be included in Tier 1 capital, up to certain limits, for purposes of certain regulatory capital calculations.[247]

A "TruPS-backed CDO" is a security representing a right to certain payments from a pool of TruPS issuances. Just as TruPS were popularly issued as capital, TruPS and TruPS-backed CDOs were (and are) popularly held by banking entities as investments.

After the Volcker Rule, whether a banking entity may continue to own a TruPS-backed CDO depends on whether that CDO is an "ownership interest" and on whether the issuer of the CDO is a "covered fund." For the reasons discussed in Part 5.C of this Memorandum, while the Proposed Rule was outstanding, many banking entities' working assumption was that issuers of TruPS-backed CDOs would likely be covered funds, but that the TruPS-backed CDOs that they owned would likely not be ownership interests. When the Final Rule was released, however, the broadened definition of "ownership interest" led many of the same banking entities to be concerned that many TruPS-backed CDOs would indeed be captured by the definition, largely only because of the limited right of holders of CDOs to participate in

[246] Final Rule § _.10(d)(6)(ii).

[247] Section 171 of the Dodd-Frank Act, referred to as the "Collins Amendment," eliminated this favorable capital treatment for TruPS issuances and required existing instruments to be phased out of regulatory capital except for the smallest issuers. *See* Dodd-Frank Act § 171(b).

the voting or approval process for the removal or replacement of the manager of the issuer in certain circumstances.[248]

As a result, banking entities were concerned that they would be required to divest their holdings of TruPS-backed CDOs by the end of the conformance period and, therefore, potentially be required under generally accepted accounting principles to take an immediate write-down of any of these securities with a fair value less than their carrying value, either by moving them from a held-to-maturity classification to an available-for-sale classification or by recognizing an other-than-temporary impairment.

On January 14, 2014, after an earlier "FAQ"[249] and subsequent statement[250] by some of the Agencies, the Agencies issued an Interim Final Rule (the "IFR")[251] that provides that the Final Rule's covered fund restrictions do not apply to ownership in or sponsorship of an issuer of TruPS-backed CDOs if several conditions are met. Most notably, the banking entity must have acquired the relevant interest before the release of the Final Rule on December 10, 2013 and must reasonably believe that the offering proceeds received by the issuer were invested primarily in "Qualifying TruPS Collateral." "Qualifying TruPS Collateral" is defined as "any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, as of the end of any reporting period within 12 months immediately preceding the issuance of such trust preferred security or subordinated debt instrument, had total consolidated assets of less than $15,000,000,000 or issued prior to May 19, 2010 by a mutual holding company."[252] The

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[248] As noted above, an interest is an "ownership interest" if it has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event). Final Rule § _.10(d)(6)(i)(A).

[249] *See* Federal Reserve, FDIC and OCC, *FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule* (Dec. 19, 2013).

[250] *See* OCC, Federal Reserve, FDIC and SEC, *Statement regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Rules Implementing Section 619 of the Dodd-Frank Act* (Dec. 27, 2013). *See also* our Memorandum to Clients, dated December 27, 2013, "Agencies Reviewing Applicability of Volcker Rule to TruPS-Backed CDOs; Intent Appears to Be to Forestall Immediate Write-Downs."

[251] OCC, Federal Reserve, FDIC, SEC and CFTC, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, __ Fed. Reg. _____ (_____). *See also* our Memorandum to Clients, dated January 14, 2014, "Agencies Issue Interim Final Rule Exempting Certain TruPS-Backed CDOs from the Volcker Rule's Prohibition on Banking Entities' Holding Ownership Interests in or Sponsoring Covered Funds." The IFR will be open for comment for 30 days after its publication in the *Federal Register*.

[252] IFR § _.16(b).

federal banking agencies also provided a non-exclusive list of issuers of TruPS-backed CDOs that qualify for this exemption.[253]

As noted above, TruPS-backed CDOs are not the only instruments whose status under the Volcker Rule is uncertain because of the changes to the definition of "ownership interest." TruPS-backed CDOs have become the most visible such asset class, however, because many banking entities did not expect to have to treat them as ownership interests in covered funds; they are widely held by smaller community banking organizations; and they are relatively less volatile and relatively closer to traditional bank debt instruments than the riskier "hedge funds" and "private equity funds" at which the Volcker Rule is nominally targeted.[254]

5.D. Definition of "Sponsor"

The Volcker Rule also restricts a banking entity from "sponsoring" a covered fund. Sponsorship may be permitted, but only in accordance with the ownership limits and other requirements (such as not guaranteeing the covered fund's performance) discussed in Part 6 of this Memorandum.

The Final Rule defines "sponsor" to include an entity that:

(1) serves as a ***general partner, managing member, trustee or commodity pool operator*** of a covered fund;

(2) in any manner ***selects or controls*** (or has employees, officers or directors or agents who constitute) a ***majority of the directors, trustees or management*** of a covered fund; or

(3) shares with a covered fund, for corporate, marketing, promotional or other purposes, ***the same name or a variation of the same name***.[255]

Although the Agencies declined to include "an exemption from the definition of sponsor for a banking entity that selects the initial directors, trustees, or management of a fund. . . . a banking entity that does not *continue* to select or control a majority of the board of directors

[253] Federal Reserve, FDIC and OCC, *Agencies Release Non-Exclusive List of Qualified Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities* (Jan. 14, 2014). This list is included for reference in our related Memorandum to Clients.

[254] As discussed in Part 5.C of this Memorandum, many CLOs, for example, are also potentially affected by the changes to the definition of "ownership interest" for the same reasons TRuPS-backed CDOs were. CLOs may share many of the same characteristics as TRuPS-backed CDOs, although they may be closer to qualifying for the loan securitization exclusion because they typically hold primarily loans rather than securities.

[255] Final Rule § _.10(d)(9).

would not be considered to be a sponsor under this part of the definition *once that role or control terminates*."[256] Thus, a banking entity that initially organizes a fund need not necessarily continue to sponsor it.

In response to comments on the Proposed Rule, the Agencies note that they "determined not to adopt a separate definition of sponsor for issuers of covered funds that are issuers of an asset-backed security."[257] A banking entity that plays any of numerous possible administrative roles with respect to such an issuer will be required to evaluate the activities and responsibilities of such roles under the general definition of "sponsor."[258] Administrative activities in and of themselves, however, will not cause a banking entity to be deemed to be a sponsor.[259]

The term "trustee" is subject to significant gloss in the Final Rule and the Supplementary Information. The Supplementary Information provides that "in context, the term trustee in the definition of the term sponsor refers to a trustee with investment discretion."[260] Under the Final Rule, "trustee" is defined to ***exclude***:

(1) a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to Section 403(a)(1) of the Employee Retirement Income Security Act of 1974; and

(2) a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in clause (1).[261]

On the other hand, "trustee" ***includes*** any entity that ***directs*** a person described in clauses (1)–(2) above, or that has authority and discretion to manage and control the investment decisions of a covered fund for which such a person serves as trustee.[262]

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[256] Supp. Info. 631-32 (emphasis added). "In the case of a covered fund that will have a self-perpetuating board of directors or a board selected by the fund's shareholders, this would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity." *Id*. at 632.

[257] *Id*. at 636.

[258] Administrative roles within securitization structures cited by commenters on the Proposed Rule included: "servicers; backup servicers and master servicers; collateral agents and administrators; custodians; indenture trustees; underwriters, distributors, placement agents; arrangers, structuring agents; originators, depositors, securitizers; 'sponsors' under the SEC's Regulation AB; administrative agents; and securities administrators and remarketing agents." *Id*. at 634-35 (footnotes omitted).

[259] *Id*. at 633.

[260] *Id*. at 632.

[261] Final Rule § _.10(d)(10)(i).

[262] *Id*. § _.10(d)(10)(ii).

The following table summarizes additional guidance from the Supplementary Information on when a trustee is excluded from, or included in, the definition of "sponsor."

Guidance on Application of the Definition of "Sponsor" to Trustees[263]	
Excluded (Not a "Sponsor")	**Included (Is a "Sponsor")**
• **No investment discretion, but required to ensure that underlying assets are appropriately segregated for the benefit of the trust** • **No investment discretion, but authorized to replace investment adviser with unaffiliated party when investment adviser resigns** • **Irrevocably delegates all investment discretion to unaffiliated party** • **With respect to an issuer of asset-backed securities, a directed trustee acting solely in accordance with directions prepared by unaffiliated party** • **With respect to an issuer of asset-backed securities, a trustee making decisions, including investment of funds prior to an event of default, solely according to written contract or written direction of unaffiliated party** • **Custodians or administrators, unless they otherwise meet the definitional qualifications**	• **In general, has the right to exercise investment discretion for the covered fund** • ***Directs* a trustee that does not exercise investment discretion with respect to the covered fund** • **Shares the same name or a variation of the same name with the covered fund for corporate, marketing, promotional or other purposes**

[263] Supp. Info. 632-38.

With respect to the name-sharing prohibition, the Agencies acknowledge that the prohibition "will require some banking entities to rebrand their covered funds, which may prove expensive and will limit the extent to which banking entities may continue to benefit from brand equity they have developed," but also suggest that, "to the extent that a banking entity would otherwise come under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that bears the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity this assistance could pose."[264]

[264] *Id*. at 633-34.

6. PERMITTED ORGANIZING AND OFFERING OF A COVERED FUND

Summary

Organizational Requirements	Ownership Limitations
• **Covered fund must be organized and offered in connection with providing bona fide trust, fiduciary, investment advisory or commodity trading advisory services to customers** • **Banking entity must not guarantee the covered fund's performance (requires related disclosure to investors)** • **Covered fund must not share a name with the banking entity** • **Banking entity must comply with "Super 23A" with respect to the covered fund**	• **Banking entity generally may not own more than 3% of the covered fund after a one-year "seeding period"** • **Aggregate value of all ownership interests in covered funds must not exceed 3% of the banking entity's Tier 1 capital and must also be *deducted from* the banking entity's Tier 1 capital** • **Ownership of covered fund by directors and employees of the banking entity limited to those providing services to the covered fund**

The Final Rule describes the requirements that must be met to qualify for the statutory exemption for activities conducted in connection with ***"organizing and offering"*** a covered fund, including generally acting as a sponsor of the fund, provided that certain criteria and limits on ownership are satisfied.[265] The Supplementary Information notes that the purpose

[265] *See* BHC Act § 13(d)(1)(G). With respect to an "organized and offered" covered fund, the Final Rule allows a banking entity to serve as a general partner, managing member, trustee or commodity pool operator of the covered fund or in any manner select or control (or have employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of the covered fund, including any expense necessary for the foregoing. Final Rule § _.11(a). This definition is the same as the definition of "sponsor" discussed in Part 5.D of this Memorandum, except that it excludes the name-sharing prohibition, which is specifically and separately included as a prohibition for organized and offered covered funds.

of this exemption is to permit banking entities to engage in certain traditional asset management and investment advisory businesses.[266]

Issuers of asset-backed securities, which are discussed in Part 6.C of this Memorandum, may be organized and offered under a specific exemption that is subject to most (but not all) of the conditions generally applicable to permitted organizing and offering of a covered fund.

6.A. General Requirements for Organizing and Offering

The Final Rule generally follows the statutory language of Section 13 in requiring that eight conditions be met to qualify for the "organizing and offering" exemption:

(1) The banking entity (or an affiliate thereof) must provide ***bona fide trust, fiduciary, investment advisory or commodity trading advisory services***.[267]

(2) The covered fund must be organized and offered only ***in connection with the provision of such services*** and only to persons that are ***customers***[268] of such services of the banking entity (or an affiliate thereof), pursuant to a ***written plan***[269] or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund.

(3) The banking entity and its affiliates must not acquire or retain an ownership interest in the covered fund except in accordance with the per-fund and aggregate funds limitations discussed in Part 6.B of this Memorandum.

[266] Supp. Info. 20-21, 638 n. 2181. The Final Rule also clarifies that an entity that serves *only* as investment adviser, without making any investment or conducting any activity covered by the prohibition in BHC Act § 13, would not be covered by the covered fund prohibitions and thus would not need to rely on the organizing and offering exemption to conduct its investment advisory activity. Final Rule § _.11(a); Supp. Info. 641.

[267] The Supplementary Information notes—without specifically identifying such services—that a wide range of customer-oriented services may qualify as bona fide trust, fiduciary, investment advisory or commodity trading advisory services, and that the precise services may vary across different types of banking entities. Supp. Info. 644 n. 2197.

[268] The Supplementary Information confirms that the customer relationship need not be pre-existing and can be formed by and through the organization and offering of the fund. *Id*. at 643.

[269] The written plan must be "credible and indicate that the banking entity has conducted reasonable analysis" to show that the fund is organized and offered for permissible purposes and not to evade the Volcker Rule. *Id*. at 644.

(4) The banking entity and its affiliates must comply with the requirements of ***"Super 23A"*** discussed in Part 8 of this Memorandum.

(5) The banking entity and its affiliates must not, directly or indirectly, ***guarantee, assume or otherwise insure*** the obligations or performance of the covered fund or of any covered fund in which such covered fund invests.[270]

(6) The covered fund ***must not***, for corporate, marketing, promotional, or other purposes, ***share the same name or a variation of the same name*** with the banking entity (or an affiliate thereof) or use the word "bank" in its name.[271]

(7) No ***director or employee*** of the banking entity (or an affiliate thereof) may ***take or retain an ownership interest*** in the covered fund, except for any director or employee of the banking entity or such affiliate who is ***directly engaged*** in providing investment advisory, commodity trading advisory or "other" services to the covered fund at the time the director or employee takes the ownership interest.[272]

(8) The banking entity must ***clearly and conspicuously disclose***, in writing, to any prospective and actual investor in the covered fund

[270] This condition is designed to prevent a banking entity from bailing out a covered fund in which it has an interest. It does not prohibit a banking entity from providing borrower default indemnification to a lending client in connection with a securities lending transaction involving a covered fund because that is not a guarantee of the covered fund's performance, but rather a guarantee to the client of the obligations of a counterparty. *Id.* at 648.

[271] This condition prohibits an organized and offered covered fund from sharing a name with an investment management affiliate of a banking entity, even if that affiliate does not share a name with an affiliated insured depository institution or holding company or any other affiliate. *See id*. at 648-53. The practical effect of this restriction remains far-reaching with respect to banking entities' covered fund activities, and will require significant rebranding.

[272] "Other" services include those provided by "directors or employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services." *Id*. at 656-57. The Supplementary Information also notes that, "[i]n response to comments, the final rule has been modified to make clear that a former director or employee may retain an interest in a covered fund if the director or employee acquired the interest while serving as a director or employee of the banking entity and providing investment advisory or other services to the covered fund." *Id*. at 657.

Although the inclusion of "other" services is helpful, questions remain about how to determine, and document, compliance with this condition. Furthermore, "employee," as defined in the Final Rule, "includes a member of the immediate family of the employee." Final Rule § _.2(i). This definition may also provide helpful flexibility in some contexts, but could conceivably make it more difficult for a banking entity to track its compliance with this condition of the organizing and offering exemption over time.

(such as through disclosure in the covered fund's offering documents):

- that any losses in such covered fund will be borne solely by investors in the covered fund and not by the banking entity or its affiliates; therefore, the banking entity's losses in such covered fund will be limited to losses attributable to the ownership interests in the covered fund held by the banking entity and any affiliate in its capacity as investor in the covered fund or as beneficiary of a restricted profit interest held by the banking entity or any affiliate;

- that such investor should read the fund offering documents before investing in the covered fund;

- that the ownership interests in the covered fund are not insured by the FDIC, and are not deposits or obligations of or endorsed or guaranteed in any way by any banking entity (unless that happens to be the case); and

- the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund.[273]

[273] Final Rule § _.11(a).

6.B. Limitations on, and Capital Deduction for, Permitted Investments in Covered Funds

The Final Rule establishes two separate limits on a banking entity's ownership interest in covered funds:

(1) the banking entity's ownership interest in a single covered fund that it organizes and offers generally may not exceed ***3% of the total outstanding "ownership interests" of the covered fund*** at any time more than one year after the "date of establishment" of the fund (the "Per-Fund Limitation"); and

(2) the aggregate value of the banking entity's ownership interests held under the organizing and offering and underwriting and market-making exemptions may not exceed ***3% of the banking entity's Tier 1 capital***, derived according to a specific calculation (the "Aggregate Funds Limitation").[274]

Additionally, all covered fund interests held under the organizing and offering and underwriting and market-making exemptions must be ***deducted on a dollar-for-dollar basis*** from the banking entity's actual Tier 1 capital for regulatory capital purposes.[275]

(i) Seeding Period

The one-year "seeding period" from the "date of establishment" of a covered fund is intended to permit the banking entity that establishes the fund to provide sufficient initial equity to permit the fund to establish a track record and attract unaffiliated investors.[276] The "date of establishment" of a covered fund, other than an issuer of asset-backed securities, is "[t]he date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund."[277]

[274] *Id*. § _.12(a). Note that the terms "Per-Fund Limitation," "Aggregate Funds Limitation" and (below) "Per-Fund Attributed Interest," "Total Attributed Interests" and "Notional Tier 1 Capital" are not used by the Final Rule. Rather, they are used in this Memorandum to assist in explaining the related calculations.

[275] *Id*. § _.12(d). The Supplementary Information states that the federal banking agencies recognize that otherwise applicable regulatory risk-based capital rules "impose[] risk weights and deductions that do not correspond" to the dollar-for-dollar deduction under the Final Rule and "intend to review the interaction. . . and expect to propose steps to reconcile the two rules." Supp. Info. 699.

[276] Supp. Info. 674.

[277] Final Rule § _.12(a)(2)(iv). The conditions for organizing and offering an issuer of asset-backed securities are discussed in Part 6.C of this Memorandum.

During the seeding period, the banking entity must, under a documented plan, *actively* seek unaffiliated investors to reduce its ownership interest to no more than the Per-Fund Limitation for the covered fund.[278] The Final Rule authorizes the Federal Reserve to extend the seeding period for up to two additional years.[279]

The Aggregate Funds Limitation applies at all times, however, including during the seeding period (and extensions with respect to the Aggregate Funds Limitation are not available).

(ii) Calculation of Investment Limitations and Capital Deduction

The rules for calculating the ownership limitations and capital deduction are complicated and involve different valuations of the same ownership interests. These rules are summarized in the table below.

[278] *Id*. § _.12(a)(2)(i)(A).

[279] This extension provision addresses the fact that it could take longer than one year to establish a track record or attract unaffiliated investors. Any application for such an extension must: (i) be submitted in writing at least 90 days before the expiration of the applicable time period; (ii) provide the reasons why the banking entity believes the extension should be granted; and (iii) provide a detailed explanation of the banking entity's plan for reducing or conforming its investment. In addition, any extension request must address several factors that are similar to the factors required to be addressed under the Federal Reserve's Conformance Rule. *Id*. §§ _.12(e)(1)-(2); *see also* Part 2.C of this Memorandum. The Federal Reserve may impose conditions on any extension granted to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or otherwise further the purposes of the Volcker Rule. Supp. Info. 718.

Fig. 6.B.1: Calculation of Ownership Limits and Capital Deduction

Limitation or Deduction	Ownership Interests Considered	Valuation of Ownership Interests	Divided By	Required Result
Per-Fund Limitation	Per-Fund Attributed Interests (see below)	Total ***number*** of ownership interests represented by Per-Fund Attributed Interests	Total number of ownership interests held by all entities	≤ 3%[280]
		Aggregate ***fair market value*** of all investments and capital contributions to fund represented by Per-Fund Attributed Interests[281]	Aggregate fair market value of all investments and capital contributions by all entities	≤ 3%
Aggregate Funds Limitation	Total Attributed Interests (see below)	Sum of amounts paid or contributed with respect to Total Attributed Interests, on ***historical cost basis***[282]	Notional Tier 1 Capital (see below)	≤ 3%
Deduction from Tier 1 Capital	Total Attributed Interests	For ***each*** interest: (1) historical cost basis ***plus*** earnings received; or (2) fair market value, ***if*** fair market value is greater ***and*** the banking entity accounts for profits and losses of the interest in its financials	N/A	Calculated amount must be deducted from actual Tier 1 capital for regulatory capital purposes

280 The Final Rule requires that a banking entity calculate the Per-Fund Limitation based on *both* the total number of ownership interests and the value of its investments and capital contributions in a covered fund. Final Rule § _.12(b)(2). Note that this requirement applies differently for issuers of asset-backed securities. *See* Part 6.C of this Memorandum.

281 A banking entity should determine fair market value in a manner that is consistent with its determinations for financial statement purposes, which should also be consistent with valuations reported by the relevant covered fund unless the banking entity determines otherwise for financial statement purposes and documents the reasons why. If fair market value cannot be determined, the banking entity should use the historical cost basis of all investments in and contributions made by the banking entity to the covered fund. Once a valuation methodology is chosen, however, the banking entity must calculate the value of all investments in the covered fund in the same manner. Final Rule §§ _.12(b)(2)(ii)-(iii); Supp. Info. 682.

282 "Historical cost basis" means "the sum of all amounts paid or contributed by the banking entity to a covered fund in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest), less any amounts received as a redemption, sale or distribution of such ownership interest or restricted profit interest. Under the final rule, any reduction of the historical cost would not generally include gains or losses, fees, income, expenses or similar items." Supp. Info. 694.

Amounts in this table are determined without regard to committed funds not yet called for investment. The ownership limitations must be calculated as of the last day of each calendar quarter, although if a banking entity becomes aware that it has exceeded the Per-Fund Limitation at any time, it is expected to take steps to ensure prompt compliance.[283]

For purposes of these calculations, a banking entity's "Per-Fund Attributed Interests" and "Total Attributed Interests" are determined as indicated in the following table:

Fig. 6.B.2: Calculation of Per-Fund Attributed Interests and Total Attributed Interests

Category of Ownership Interests	Ownership Interests Included
Per-Fund Attributed Interests for Each Banking Entity for Each Covered Fund	Any ownership interest held directly by the banking entity in an organized and offered covered fund, determined without regard to committed funds not yet called for investment, and without duplication of investments in: (1) feeder funds within a master–feeder structure; or (2) constituent funds within a fund-of-funds structure[284]
	Any ownership interest held by affiliates, other than by: (1) RICs, BDCs and foreign public funds, provided that the banking entity owns less than 25% of, and provides investment advisory or other services to, the affiliate; and (2) permissibly held covered funds
	Amounts paid or contributed by the banking entity, its affiliates or its employees in connection with obtaining a "restricted profit interest" in the covered fund[285]
	Investments in the covered fund by directors and employees to the extent financed, directly or indirectly, by the banking entity[286]

[283] *Id*. at 688-89. In general, banking entities are expected to monitor investments in covered funds regularly. *Id*. at 695.

[284] This amount includes certain interests held in connection with underwriting or market making-related activities. *See* Part 7.A of this Memorandum.

With respect to a master–feeder structure, a banking entity's ownership interest for this purpose is the sum of: (i) any direct investment in the master fund; and (ii) the pro rata share of any interest in the master fund that is indirectly held through a feeder fund. With respect to a fund-of-funds structure, a banking entity's ownership interest for this purpose is the sum of: (i) any direct investment in the underlying fund; and (ii) the pro rata share of any ownership interest in the underlying fund that is indirectly held through the fund-of-funds. Final Rule § _.12(b)(4).

[285] Supp. Info. 683. These payments and contributions by employees are included even if the banking entity does not finance them. This requirement may be of little practical effect since employees do not usually make capital contributions specifically to receive a share of a "restricted profit interest," and such contributions would most likely be nominal.

[286] The Supplementary Information suggests that "personal investments," made "truly with personal resources, and. . . not funded by the banking entity," would generally not be attributed to the

Total Attributed Interests for Each Banking Entity	**For banking entities required to calculate and report Tier 1 capital:** Per-Fund Attributed Interest for each covered fund, ***excluding*** investments by affiliates that are not ***subsidiaries***[287] **For other banking entities:** Per-Fund Attributed Interest for each covered fund, ***excluding*** investments by affiliates that are not subsidiaries ***of the next entity up the chain that calculates and reports Tier 1 capital***
	Any ownership interest in a covered fund held by the banking entity or its affiliates in connection with underwriting and market making-related activities, to the extent not already included

If a banking entity directly makes an investment alongside a covered fund organized and offered by the banking entity, the Final Rule does not, in general, require the banking entity to count this "parallel investment" in calculating its Per-Fund Limitation for the covered fund. This represents a departure from the Proposed Rule, which the Agencies determined was appropriate because "banking entities rely on a number of investment authorities and structures to meet the needs of their clients and make investments under a variety of authorities that are not coordinated with investments made by covered funds owned or advised by the banking entity."[288]

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banking entity. *Id*. at 709. Nonetheless, the Supplementary Information also expresses a concern that employee investments may be used to skirt the ownership limitations. The Agencies intend to "monitor" such investments and will consider the following factors in determining whether to attribute employee ownership interests to the banking entity: (i) the existence of financing or guarantee arrangements; (ii) whether the benefits of the acquisition and retention of the ownership interests (e.g., dividends) inure to the benefit of the banking entity, rather than the director or employee; (iii) whether the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity; and (iv) whether the investment decision is made by the banking entity, rather than the director or employee. *Id*. at 709-10.

287 The Final Rule provides generally that, for both the Per-Fund Limitation and the Aggregate Funds Limitation, "the amount and value of a banking entity's permitted investment in any single covered fund shall include any ownership interest held. . . directly by the banking entity, including *any affiliate* of the banking entity." Final Rule § _.12(b)(1)(i) (emphasis added). A banking entity that calculates and reports Tier 1 capital uses its own Tier 1 capital calculation as the denominator in its 3% Aggregate Funds Limitation calculation, whereas a banking entity that does not calculate and report Tier 1 capital will use the capital of a higher-tier parent entity (if there is one). *See* Figure 6.B.3 below. Thus, attributing covered fund investments of non-subsidiary affiliates makes sense for the non-reporting banking entity (since it is effectively deemed to have the total capital of its higher-tier parent), but would not make sense for the reporting banking entity.

The Supplementary Information confirms this reading, providing that "[i]n the case of a depository institution that is itself a reporting banking entity and that is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in covered funds held by the depository institution (including the investments by its *subsidiaries*) may not exceed three percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution." Supp. Info. 714 (emphasis added).

288 Supp. Info. 711.

On the other hand, the Agencies "continue to believe that the potential for evasion. . . may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors."[289] If a banking entity that sponsors a covered fund offers co-investment opportunities to investors, the banking entity should not make additional side-by-side co-investments with the fund unless the value of such co-investments is less than 3% of the value of the total amount co-invested by other investors. Furthermore, if a banking entity makes side-by-side investments in substantially the same positions as a covered fund, then the value of such investments must also be included for purposes of determining the value of the banking entity's investment in the covered fund.[290]

Finally, a banking entity's "Notional Tier 1 Capital" for purposes of determining the Aggregate Funds Limitation is determined as indicated in the following table:

Fig. 6.B.3: Calculation of Notional Tier 1 Capital for Aggregate Funds Limitation

<table>
<tr><th colspan="3">Type of Banking Entity</th><th>Notional Tier 1 Capital (as of End of Most Recent Calendar Quarter for U.S. Entities)</th></tr>
<tr><td rowspan="4">U.S.</td><td colspan="2">Banking entities reporting Tier 1 capital</td><td>Tier 1 capital reported by the entity itself</td></tr>
<tr><td rowspan="3">Non-reporting banking entities</td><td>Subsidiaries of a reporting depository institution</td><td>Tier 1 capital reported by the controlling depository institution</td></tr>
<tr><td>Subsidiaries of a BHC or company treated as a BHC</td><td>Tier 1 capital reported by the top-tier reporting affiliate</td></tr>
<tr><td>All other non-reporting banking entities</td><td>Total amount of shareholders' equity of the top-tier affiliate within the organization, as determined under applicable accounting standards</td></tr>
<tr><td rowspan="2">Foreign</td><td colspan="2">Foreign banking entities</td><td>Consolidated Tier 1 capital of the entity as calculated under home country standards[291]</td></tr>
<tr><td colspan="2">U.S.-located or -organized affiliates of foreign banking entities</td><td>Determined according to calculation rules for U.S. entities</td></tr>
</table>

289 *Id*.

290 *Id*. at 711-12.

291 The Agencies note that they may revisit this approach based on the Federal Reserve's implementation of the enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies. *Id*. at 715-16 (footnote omitted); *see also* Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (Dec. 28, 2012).

The Final Rule clarifies that it does not require a foreign banking entity that makes a covered fund investment in the United States, either directly or through a branch or agency, to deduct the aggregate value of the investment from the foreign bank's Tier 1 capital as calculated under applicable home country standards. On the other hand, any U.S. subsidiary of a foreign banking entity that is required to calculate Tier 1 capital under U.S. risk-based capital regulations must deduct the aggregate value of investments held through that subsidiary.[292]

6.C. Organizing and Offering an Issuer of Asset-Backed Securities

As part of the Agencies' statutory authority to exempt activities that promote safety and soundness,[293] the Final Rule permits a banking entity to organize and offer a covered fund that is an issuer of asset-backed securities,[294] with some important modifications to the requirements applicable to organizing and offering other covered funds. These modifications take into account the risk-retention requirements of Section 15G of the Exchange Act, which was added by Section 941 of the Dodd-Frank Act, and "address the unique circumstances and ownership structures presented by securitizations."[295]

The exemption for issuers of asset-backed securities is subject to the same requirements that generally apply to organizing and offering covered funds, except that a banking entity (or any affiliate) may organize and offer a covered fund that is an issuer of asset-backed securities even if:

(1) the banking entity and its affiliates do not provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services; or

(2) the issuer of asset-backed securities is not organized and offered in connection with the provision of such services to customers.[296]

Ownership interests held under this exemption are generally subject to the Per-Fund Limitation and Aggregate Funds Limitation and must be deducted from regulatory capital as

[292] Supp. Info. 701.

[293] *See* BHC Act § 13(d)(1)(J).

[294] To organize and offer an issuer of asset-backed securities means acting as the "securitizer," as that term is used in Exchange Act § 15G(a)(3), for the issuer, or acquiring or retaining an ownership interest in the issuer in compliance with § 15G and the regulations issued thereunder. Final Rule § _.11(b)(2).

[295] Supp. Info. 661.

[296] With respect to any securitization vehicle that retains a banking entity to serve as collateral manager and provide investment advice, the collateral manager would be required to comply with all the provisions of the organizing and offering exemption to acquire and retain an ownership interest in such securitization vehicle. *Id*. at 664.

discussed in Part 6.B of this Memorandum.[297] To reconcile the Volcker Rule with the risk-retention requirements of Section 15G of the Exchange Act, the Final Rule allows a banking entity to acquire and retain the amount of interests in an issuer of asset-backed securities—that is, 5%—required under Section 15G and the regulations issued thereunder.[298]

Furthermore, a banking entity's Per-Fund Limitation with respect to the banking entity's ownership interest in an issuer of asset-backed securities is calculated based only on the value of such ownership interest in relation to the value of all ownership interests in the issuer, not on a class-by-class or tranche-by-tranche basis.[299] Recalculation of ownership for purposes of the Per-Fund Limitation is not required unless the covered fund sells additional securities.[300]

The Supplementary Information notes that the Agencies will review the interaction between the Final Rule and the rules under Section 15G, some of which have been proposed but not yet finalized.[301] Finally, the Supplementary Information notes that the Agencies "are not revising the [Final Rule] to permit banking entities to own ownership interests required to be retained pursuant to risk-retention-type requirements under foreign law."[302] The Final Rule may, however, permit foreign banking entities to comply with foreign law requirements that govern their securitization activities or investments outside of the United States by virtue of the exclusion of certain foreign funds and foreign public funds from the definition of "covered

[297] For purposes of determining the relevant seeding period, the "date of establishment" of an issuer of asset-backed securities is "[t]he date on which the assets are initially transferred into the issuing entity of asset-backed securities." Final Rule § _.12(a)(2)(iv)(B). *See* Part 6.B(i) of this Memorandum.

[298] *See* OCC, Federal Reserve, FDIC, SEC, FHFA and Department of Housing and Urban Development, *Credit Risk Retention*, 76 Fed. Reg. 24090 (April 29, 2011). The Final Rule provides that, with respect to a securitization that is subject to Exchange Act § 15G and for which effective implementing regulations have been issued, the Per-Fund Limitation is calculated as of the date and pursuant to the methodology applicable pursuant to the requirements of § 15G and the implementing regulations issued thereunder. Final Rule § _.12(b)(3)(i).

With respect to a securitization: (i) executed after the effective date of the Final Rule and prior to the adoption and implementation of the rules promulgated under § 15G; or (ii) as to which such implementing rules do not apply, the Per-Fund Limitation is calculated as of the date on which the assets are initially transferred into the issuer of the asset-backed securities or such earlier date on which the transferred assets have been valued for purposes of transfer to the issuer. The aggregate value of the outstanding ownership interests in such a securitization will be the fair market value of the assets transferred to the issuer of the securitization and any other assets otherwise held by the issuer at the time, determined in a manner that is consistent with its determination of the fair market value of those assets for financial statement purposes. *Id*. §§ _.12(b)(3)(ii)-(iii); Supp. Info. 689-91.

[299] Supp. Info. 690.

[300] Final Rule § _.12(b)(3)(ii); Supp. Info. 688 n. 2306.

[301] *See* Supp. Info. 686.

[302] *Id*. at 687.

funds" and the exemption for activities occurring solely outside the United States, which is discussed in Part 7.C of this Memorandum.[303]

[303] *Id*.

7. OTHER PERMITTED COVERED FUND ACTIVITIES AND INVESTMENTS

The Final Rule permits banking entities to engage in certain covered fund activities in connection with underwriting and market making, risk-mitigating hedging and activities solely outside the United States.[304] The Final Rule also permits regulated insurance companies to invest in and sponsor covered funds.[305]

7.A. Underwriting and Market Making with Respect to Covered Funds

In general, a banking entity may engage in underwriting and market making-related activities involving covered fund interests, subject to the same conditions that apply to the underwriting and market making-related activities exemptions from the prohibition on proprietary trading, which are discussed in Parts 4.A and 4.B of this Memorandum.

For purposes of calculating a banking entity's Per-Fund Limitation, Aggregate Funds Limitation and Tier 1 capital deduction, however, the banking entity must include certain covered fund interests held in connection with underwriting and market making-related activities as discussed in Part 6.B of this Memorandum.

Specifically, with respect to the Per-Fund Limitation for a particular covered fund, the banking entity must include any ownership interest in the covered fund acquired or retained in connection with underwriting or market making-related activities if the banking entity:

(1) sponsors or advises the covered fund;

(2) invests in the covered fund as permitted under the organizing and offering exemption; or

(3) guarantees, assumes or otherwise insures the obligations or performance of the fund or of any other covered fund in which the first covered fund invests.[306]

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[304] Final Rule §§ _.11(c), _.13(a)-(b). *See also* BHC Act §§ 13(d)(1)(B) (underwriting and market making), 13(d)(1)(C) (risk-mitigating hedging), 13(d)(1)(I) (activities conducted solely outside the United States).

[305] Final Rule § 13(c); *see also* BHC Act § 13(d)(1)(F) (regulated insurance company investments).

[306] The Supplementary Information notes that a right to put the ownership interest in the covered fund to the banking entity would be considered a guarantee for this purpose. The restriction does not apply to arrangements not designed to guarantee the obligations or performance of the covered fund, however, such as entering into a liquidity facility or providing a letter of credit for a covered fund. Supp. Info. 670.

This requirement has the potential to constrain a banking entity's market making-related activities, and to some extent its underwriting activities, with respect to its sponsored or advised covered funds. Because the Per-Fund Limitation does not apply during a covered fund's seeding period, "a banking entity will have more flexibility to underwrite and make a market in the ownership interests of such a covered fund in connection with organizing and offering the covered fund" during this time."[307]

In addition, for purposes of calculating a banking entity's Aggregate Funds Limitation and the associated regulatory capital deduction, a banking entity must include the aggregate value of its ownership interests in *all* covered funds acquired and retained in connection with underwriting and market making-related activities, including those that were not required to be included in the Per-Fund Limitation with respect to any particular covered fund.

7.B. Risk-Mitigating Hedging Activities with Respect to Covered Funds

Under the Final Rule, the covered fund prohibition does not apply "with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund."[308] The compensation arrangement must relate solely to the covered fund and must provide that any losses incurred by the banking entity on the ownership interest will be "offset by corresponding decreases in amounts payable" under the compensation arrangement.[309]

Although this exemption covers common compensation arrangements that provide portfolio management and other personnel with synthetic or indirect exposure to covered funds, the exemption is extremely limited and provides no coverage for other types of risk-mitigating hedging activities. Banking entities will not, for example, be permitted to make hedging investments in covered funds in connection with specific customer demand for swaps or covered fund-linked notes.[310]

[307] *Id*. at 668.

[308] Final Rule § _.13(a)(1).

[309] *Id*. § _.13(a)(2)(iii).

[310] This type of customer-driven activity would generally have been permissible under the Proposed Rule, which provided an exemption for a banking entity "acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund." Supp. Info. 719. In drafting the Final Rule, however, "the Agencies have determined that transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity" and is therefore now prohibited. *Id*. at 722.

In comparison to the general hedging exemption from the prohibition on proprietary trading, the compliance requirements for this narrower hedging exemption are slightly less comprehensive and do not appear to require contemporaneous documentation or "ongoing recalibration" of the hedging transaction.[311]

7.C. Activities Conducted Solely Outside the United States

As with proprietary trading "solely outside of the United States," Section 13 provides a statutory exemption for "[t]he acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to paragraph (9) or (13) of section 4(c) [of the BHC Act] solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more [U.S.] States."[312]

To implement this "SOTUS" exemption, the Final Rule provides that the covered fund prohibitions do not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity if:

(1) the banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is ***not***:

- ***located*** in the United States;
- ***organized under the laws*** of the United States or of any U.S. state; or

[311] *See* Final Rule § _.13(a)(2). This may reflect a judgment that this hedging exemption would be comparatively difficult to use as a cover for prohibited activities. Permitted risk-mitigating hedging activities in connection with covered funds do, however, remain subject to requirements related to establishing and maintaining an internal compliance program, demonstrably reducing specific, identifiable risks, not introducing any significant new or additional risks that are not themselves hedged contemporaneously and engaging in "continuing review" (though, as noted, not to the degree required with respect to the general hedging exemption from the prohibition on proprietary trading). *Id*. at 725.

[312] BHC Act § 13(d)(1)(I). The Supplementary Information explains that "the purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities and investments, while preserving national treatment and competitive equality among U.S. and foreign banking entities within the United States." Supp. Info. 726.

- directly or indirectly controlled by a banking entity that is located in the United States or organized under the laws of the United States or of any U.S. state;[313]

(2) the activity or investment by the banking entity is "pursuant to paragraph (9) or (13) of Section 4(c) of the BHC Act," which is a test of the extent to which the banking entity's businesses are outside the United States and is evaluated in the same manner discussed in Part 4.H of this Memorandum with respect to proprietary trading;

(3) no ownership interest in the covered fund is ***"offered for sale or sold"*** (defined as described below) to a ***"resident of the United States"*** (defined to mean a "U.S. person" as defined in the SEC's Regulation S);[314]

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[313] For purposes of this exemption, a U.S. branch, agency or subsidiary of a foreign bank, or any subsidiary thereof, is deemed to be located in the United States, but a foreign bank of which that branch, agency or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency or subsidiary. Final Rule § _.13(b)(5).

[314] Specifically: "(1) 'U.S. person' means: (i) Any natural person resident in the United States; (ii) Any partnership or corporation organized or incorporated under the laws of the United States; (iii) Any estate of which any executor or administrator is a U.S. person; (iv) Any trust of which any trustee is a U.S. person; (v) Any agency or branch of a foreign entity located in the United States; (vi) Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and (viii) Any partnership or corporation if: (A) Organized or incorporated under the laws of any foreign jurisdiction; and (B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in [17 CFR] § 230.501(a)) who are not natural persons, estates or trusts. (2) The following are not 'U.S. persons': (i) Any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States; (ii) Any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if: (A) An executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and (B) The estate is governed by foreign law; (iii) Any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person; (iv) An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country; (v) Any agency or branch of a U.S. person located outside the United States if: (A) The agency or branch operates for valid business reasons; and (B) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; and (vi) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans." 17 CFR § 230.902(k).

(4) the banking entity (including relevant personnel) that ***makes the decision*** to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any U.S. state;[315]

(5) the investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any U.S. state; and

(6) no financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any U.S. state.[316]

The Final Rule further provides that, for purposes of condition (3) above, "[a]n ownership interest in a covered fund is not offered for sale or sold to a resident of the United States. . . only if it is sold or has been sold *pursuant to an offering that does not target* residents of the United States."[317] This condition, in turn, may be satisfied if the covered fund "conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States."[318]

[315] The Supplementary Information clarifies that U.S. personnel of a foreign banking entity may provide investment advice and recommend investment selections to the manager or general partner of a covered fund so long as that investment advisory activity does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States. Supp. Info. 738.

[316] Final Rule § _.13(b).

[317] *Id*. § _.13(b)(3) (emphasis added). The Agencies note that this interpretation, which was not included in the Proposed Rule, is responsive to commenters who "argued that there was a substantial risk that foreign funds offered by foreign banking entities would not be able to rely on the exemption due to the presence of a limited number of investors who are residents of the United States." Supp. Info. 742. The phrasing of the interpretation is counterintuitive on first read, but appears to be intended to indicate that the Agencies view themselves as construing the statutory language of BHC Act § 13(d)(1)(I) (which requires that "no ownership interest. . . [be] offered for sale or sold to a resident of the United States," without any reference to "targeting"), rather than exercising their authority under BHC Act § 13(d)(1)(J) to exempt additional activities.

[318] Supp. Info. 743-44. The Final Rule also notes that foreign banking entities should take precautions not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a non-U.S. resident). Fund sponsors must examine the

Furthermore, in determining whether an ownership interest in a covered fund is offered for sale to a resident of the United States, "the Agencies expect that activities related to certain complex fund structures should be integrated. . . . For example, a banking entity may not be able to rely on the ["SOTUS"] exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity."[319] This discussion suggests that a foreign banking entity that does not organize and offer or advise the fund in question would not be subject to this particular limitation.

7.C.1. Comparison of Selected Covered Fund Restrictions on Domestic and Foreign Banking Entities

Whether and to what extent a foreign banking entity may need to rely on the "solely outside the United States" exemption depends on the interplay of several provisions of the Final Rule. The covered fund provisions of the Final Rule variously discuss:

(1) funds organized or established outside the United States;

(2) "foreign funds" offered and sold solely outside the United States (a type of covered fund applicable only to U.S.-organized or -located banking entities);

(3) "foreign public funds" (a foreign analogue to RICs that is not a covered fund); and

(4) activities of foreign banking entities outside the United States.

The classification of a particular fund—whether it is a "covered fund" in the first place and, if so, whether a foreign banking entity may transact with it under the "solely outside the United States" exemption—may also depend on whether the fund's interests are offered and sold *solely* outside the United States, pursuant to offerings that do not *target* U.S. residents, or otherwise.

The following table summarizes the relationships between these provisions, which are important in analyzing the Volcker Rule treatment of various types of foreign funds with respect to domestic and foreign banking entities.

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facts and circumstances of their particular offerings and confirm that they do not target residents of the United States. *Id*. at 744.

[319] *Id*. at 744-45.

Fig. 7.C.1: Selected Covered Fund Restrictions on Domestic and Foreign Banking Entities

	Fund Organized or Established Outside United States (Other Than a "Foreign Public Fund")[320]			
Type of Banking Entity	**Offered and Sold Solely Outside United States**	**Some U.S. Investors, but Not "Targeted" by Offering**	**Offering "Targeted" to U.S. Residents**	**"Foreign Public Fund"**
U.S.-organized or -located banking entity	The fund ***is*** a "covered fund" because, although it may not actually be relying on § 3(c)(1)/(7), it is a "foreign fund" specifically included within the definition of "covered fund" for a ***U.S.*** banking entity	The fund ***is*** a covered fund because it is either actually relying on § 3(c)(1)/(7) or else is still a "foreign fund" and therefore included for a U.S. banking entity	The fund ***is*** a covered fund because it is presumably relying on § 3(c)(1)/(7) in connection with the "targeted" offering	***Not*** a covered fund – specifically excluded from definition
Foreign banking entity outside the United States	The fund is ***not*** a "covered fund" because it is ***not*** actually relying on § 3(c)(1)/(7) and it is not otherwise included in the definition of "covered fund" for a ***foreign*** banking entity	The fund would be a covered fund if it is actually relying on § 3(c)(1)/(7), but the foreign banking entity's activities ***may*** qualify for the "solely outside the United States" exemption if all criteria are satisfied	The fund ***is*** a covered fund because it is presumably relying on § 3(c)(1)/(7) in connection with the "targeted" offering, and the foreign banking entity's activities will ***not*** qualify for the "solely outside the United States" exemption because the offering targets U.S. residents	***Not*** a covered fund – specifically excluded from definition

320 For simplicity, this example assumes that the fund in question: (i) would need to rely on § 3(c)(1) or § 3(c)(7) of the 1940 Act if it were offered and sold in the United States; (ii) raises money from investors primarily for the purpose of trading in securities (thus satisfying one of the prongs of the definition of "foreign fund"); (iii) is not a commodity pool included within the definition of "covered fund"; and (iv) is not eligible for any other specific exclusion from the definition of "covered fund."

7.D. Covered Fund Interests and Activities by a Regulated Insurance Company

Under the Final Rule, an insurance company (or an affiliate of an insurance company) may acquire or retain an ownership interest in, or act as sponsor to, a covered fund if:

(1) the insurance company or its affiliate acquires and retains the ownership interest solely for the ***general account*** of the insurance company or for one or more ***separate accounts*** established by the insurance company, using the same definitions discussed in Part 4.G of this Memorandum;

(2) the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the U.S. state or jurisdiction in which such insurance company is domiciled; and

(3) the appropriate Federal banking agencies, after consultation with the FSOC and the relevant insurance commissioners of the U.S. states and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation or written guidance described in clause (2) is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[321]

The Supplementary Information notes that the exemption for insurance company activities and investments, which was not included in the Proposed Rule, is supported by the language of Section 13 and more fully carries out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance.[322] As discussed in Part 5.B(vi) of this Memorandum, there is a separate exclusion from the definition of "covered fund" for insurance company separate accounts themselves.

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[321] Final Rule § _.13(c).

[322] Supp. Info. 749.

8. "SUPER 23A" – LIMITATIONS ON RELATIONSHIPS WITH CERTAIN COVERED FUNDS

In addition to regulating ownership and sponsorship of covered funds, Section 13 also regulates other relationships between banking entities and certain sponsored or advised covered funds, such as extensions of credit to such a covered fund. This part of the Final Rule is referred to as "Super 23A" because it restricts certain transactions referred to in Section 23A of the Federal Reserve Act—to an even greater degree than Section 23A itself does.[323]

Outside the Volcker Rule context, the primary purpose of Section 23A is to "protect[] the federal safety net" provided to U.S. insured depository institutions by FDIC deposit insurance and access to the discount window.[324] This protection takes the form of restricting (though not flatly prohibiting) transactions with affiliates that could have the effect of unduly concentrating risk in the insured depository institution. By analogy, the purpose of Super 23A in the Volcker Rule context is to ensure that the risk exposures of banking entities to permitted covered funds remain limited to those amounts discussed in the previous Parts of this Memorandum.

Under Section 13, Super 23A applies to a banking entity with respect to a covered fund for which it serves, directly or indirectly, as the ***investment manager, investment adviser, commodity trading advisor or sponsor***, or that it ***organizes and offers*** (and to other covered funds controlled by the first covered fund).[325] As discussed in Part 5.B of this Memorandum, the Proposed Rule's general approach to the covered fund provisions was to define "covered fund" broadly, then provide that limited types of covered funds, such as certain joint ventures, would be *permitted* covered funds in which banking entities could acquire and retain ownership interests. A problem with this approach was that a banking entity would then often be required to observe the Super 23A restrictions with respect to a permitted covered fund even though its ownership was not actually restricted (often because the banking entity would meet the definition of "sponsor").

The Final Rule's approach is different: more types of entities are deemed not to be covered funds in the first place, so the Super 23A restrictions are not applicable with respect to those entities. In general, this change will provide banking entities with significant additional flexibility to engage in otherwise permissible activities under the Final Rule. Nonetheless, Super 23A remains a significant feature of the Final Rule and will need to be analyzed in the context of many common transactions with covered funds.

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[323] As described below, whereas Section 23A imposes quantitative and qualitative limits on certain "covered transactions," Super 23A operates as a blanket prohibition.

[324] Federal Reserve, *BHC Supervision Manual* § 2020.0.1 (Jan. 2008).

[325] BHC Act § 13(f)(1). Super 23A does not prohibit a banking entity from transacting (e.g., in a commercial or investment banking capacity, among others) with a covered fund with which it does not have any of these relationships.

8.A. Prohibition on "Covered Transactions" with Certain Covered Funds

Section 23A of the Federal Reserve Act defines "covered transaction" to mean the following with respect to an "affiliate" of a "member bank":[326]

(1) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;

(2) a purchase of or an investment in securities issued by the affiliate;

(3) a purchase of assets *from* the affiliate, except such purchase of real and personal property as may be specifically exempted by the Federal Reserve;

(4) the acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan or extension of credit to any person or company;

(5) the issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;

(6) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or

(7) a "derivative transaction," as defined in paragraph (3) of Section 5200(b) of the Revised Statutes of the United States,[327] with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.[328]

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[326] The terms "affiliate" and "member bank" are defined in the Federal Reserve Act, although the definitions are not critical for the Volcker Rule because the Super 23A requirements are determined by assuming that the banking entity is a "member bank" and that the covered fund in question is an "affiliate." "Affiliate" as defined in Section 23A does include "any investment fund with respect to which a member bank or affiliate thereof is an investment adviser," so Section 23A may be applicable in the investment advisory context even in the absence of the Volcker Rule and Super 23A. "Member bank" generally means a national bank and a state-chartered bank that is a member of the Federal Reserve System; FDIA § 18(j) extends Section 23A (and Section 23B) to state-chartered banks that are not members of the Federal Reserve System.

[327] This paragraph (3), which was added as part of the Dodd-Frank Act and relates to certain lending limits in other contexts, defines "derivative transaction" to include "any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indicates, or other assets." 12 U.S.C. § 84(b)(3).

[328] Federal Reserve Act § 23A(b)(7). Other transactions not included in the definition of "covered transaction" are outside the scope of the Super 23A restrictions.

As noted above, rather than require a categorical prohibition on all covered transactions, Section 23A establishes certain quantitative limits on, and exemptions applicable to, covered transactions—none of which are incorporated either in Section 13 or in the Final Rule.[329] Instead, the Final Rule requires that:

(1) no banking entity that:

- serves, directly or indirectly, as the ***investment manager, investment adviser, commodity trading advisor or sponsor*** to a covered fund, or

- ***organizes and offers*** a covered fund or continues to hold an ownership interest in an organized and offered issuer of asset-backed securities,

and no affiliate of the banking entity, may:

(2) enter into a transaction with the covered fund, or with any other covered fund that is controlled by the covered fund, that would be a ***covered transaction as defined in Section 23A*** of the Federal Reserve Act as if the banking entity and its affiliate were a "member bank" and the covered fund were their "affiliate" under Section 23A.[330]

[329] The Final Rule clarifies that Super 23A does not incorporate the "attribution rule" from Section 23A, under which any transaction by a member bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate. *See id*. § 23A(a)(2). Super 23A therefore applies only to covered transactions between a banking entity or its affiliate, on the one hand, and a covered fund for which the banking entity serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or which it sponsors or organizes and offers, or a covered fund controlled by such fund, on the other hand.

The Final Rule also clarifies that acquiring and retaining an ownership interest in a covered fund as expressly permitted by the Final Rule is not a prohibited covered transaction. Final Rule § _.14(a)(2)(i).

[330] Final Rule § _.14(a)(1). Both Section 13 and the Final Rule provide that a banking entity may not "*enter into*" such a covered transaction. BHC Act § 13(f)(1); Final Rule § _.14(a)(1) (emphasis added). The better reading of this language is that it prohibits entering into *new* covered transactions, not continuing to engage in activities pursuant to existing covered transactions entered into in the past. (By contrast, Section 13 and the Final Rule provide that a banking entity may not "acquire *or retain*" an ownership interest in a covered fund except pursuant to an exemption. BHC Act § 13(a)(1)(B); Final Rule § _.10(a)(1) (emphasis added).) The date after which new covered transactions would be prohibited is unclear, although a logical date would be July 21, 2012, the statutory effective date of the Volcker Rule. *See* Part 1.B of this Memorandum. The practical effect of an ability to continue activities under then-existing covered transactions may be limited, since any significant modification or amendment to the terms of such a covered transaction would likely be deemed to be a new covered transaction for purposes of Super 23A.

The scope of Super 23A is surprisingly broad and can implicate many activities that are parts of common structures for private funds, including, for example, a banking entity affiliate's providing bridge financing to a private equity fund.

Section 13 and the Final Rule provide an exemption from Super 23A for "prime brokerage" transactions under the following conditions:

(1) the transaction must be between a banking entity and a covered fund in which a *different* covered fund managed, sponsored or advised by the banking entity (or an affiliate thereof) has taken an ownership interest;[331]

(2) the transaction must be provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing or data, operational and administrative support;[332]

(3) the banking entity must be in compliance with the Per-Fund Limitations and Aggregate Funds Limitations with respect to a covered fund organized and offered by the banking entity (or an affiliate thereof);

(4) the chief executive officer (or equivalent officer)[333] of the banking entity must certify in writing annually to the relevant Agency (with a duty to update the certification if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the covered fund or of any covered fund in which the covered fund invests;[334]

(5) the Federal Reserve must not have determined that the transaction is inconsistent with the safe and sound operation and condition of the banking entity; and

(6) the transaction must comply with Section 23B of the Federal Reserve Act as if the counterparty to the transaction were an

[331] In other words, prime brokerage transactions may be provided under this exemption not to "first-tier" covered funds (those that the banking entity manages, sponsors or advises), but only to "second-tier" covered funds (e.g., portfolio funds in the "fund-of-funds" context).

[332] *See* Final Rule § _.10(d)(7).

[333] "In the case of the U.S. operations of foreign banking entities, the senior officer of the foreign banking entity's U.S. operations or the chief executive officer of the U.S. banking entity may provide the required attestation." Supp. Info. 762.

[334] Final Rule § _.14(a)(2)(ii)(B). Note that this certification is in addition to and not in substitution for the annual CEO certification required for a banking entity that is subject to the Enhanced compliance regime under the Final Rule. *See* Part 10.D of this Memorandum.

"affiliate" of the banking entity, as discussed in Part 8.B of this Memorandum.[335]

8.B. Applicability of Section 23B of the Federal Reserve Act

In addition to the Super 23A requirements, the Final Rule also requires that:

(1) a banking entity that:

- serves, directly or indirectly, as the ***investment manager, investment adviser, commodity trading advisor or sponsor*** to a covered fund, or

- ***organizes and offers*** a covered fund or continues to hold an ownership interest in an organized and offered issuer of asset-backed securities,

(2) will be subject to ***Section 23B*** of the Federal Reserve Act, as if the banking entity were a "member bank" and the covered fund were an "affiliate" under Section 23B.[336]

Therefore, unlike Super 23A—which is based on a key definition ("covered transactions") from Section 23A, but does not otherwise reference what Section 23A actually requires—this provision of the Final Rule simply provides that the requirements of Section 23B will be applicable in the circumstances indicated.

As the Federal Reserve has explained:

> [T]he principal restrictions of Section 23B. . . . include (1) a requirement that most transactions between an IDI [insured depository institution, read "member bank"] and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on an IDI's purchase, as fiduciary, of assets from an affiliate unless certain criteria are met; (3) a restriction on an IDI's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that an IDI will be responsible for the obligations of its affiliates.[337]

[335] Final Rule §§ _.14(a)(2)(ii), _.14(c).

[336] *Id*. § _.14(b).

[337] Federal Reserve, *BHC Supervision Manual* § 2020.1.15 (Jul. 2009).

Although these restrictions may be important in the context of a particular covered fund or transaction, they have generally been viewed as more manageable and less controversial than Super 23A, given that they do not categorically prohibit classes of transactions and may require less in the way of adjustments to existing business practices. Whereas Super 23A was "among the most commented upon aspects of the covered funds section" of the Proposed Rule, commenters "generally did not raise any issues" regarding the Proposed Rule's implementation of the Section 23B-related provisions.[338]

[338] Supp. Info. 751, 764.

9. LIMITATIONS ON PERMITTED ACTIVITIES (PRUDENTIAL BACKSTOPS)

Section 13 provides that no transaction, class of transactions or activity may be deemed a "permitted activity"—under either the proprietary trading provisions or the covered fund provisions—if it would:

(1) involve or result in a material conflict of interest (as defined by the Agencies by rule) between the banking entity and its clients, customers or counterparties;

(2) result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as defined by the Agencies by rule);

(3) would pose a threat to the safety and soundness of such banking entity; or

(4) would pose a threat to the financial stability of the United States.[339]

The Agencies refer to these provisions of the Volcker Rule as the "prudential backstops."[340]

The Final Rule contains two different sections implementing the prudential backstops, one for proprietary trading activities and one for covered fund activities.[341] The sections are identical, however, except for their respective cross-references to the permitted activities sections to which they relate.

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[339] BHC Act § 13(d)(2).

[340] In both Section 13 and the Final Rule, the prudential backstops are phrased as exceptions to exemptions from the prohibitions of the Final Rule. In other words, the Final Rule is not clear on its face with respect to whether, for example, an activity that is not proprietary trading (and therefore does not need to rely on an exemption from the prohibition on proprietary trading) could be prohibited under the prudential backstops. The Supplementary Information suggests that the Agencies believe that it could be so prohibited, however. *See, e.g.*, Supp. Info. 448 ("Under the final rule, a banking entity that engages in *any transaction, class of transactions, or activity* that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to the transaction, class of transactions, or activity, must address and mitigate the conflict of interest, where possible, through either timely and effective disclosure or informational barriers.") (emphasis added, footnote omitted). Moreover, the Agencies are generally empowered to order a banking entity to terminate activities that they believe to function as an evasion of the Volcker Rule and retain other statutory authority over banking entities. *See* Part 2.E of this Memorandum.

[341] Final Rule §§ _.7, _.15.

The Final Rule's provisions with respect to material conflicts of interest and high-risk assets or high-risk trading strategies are discussed below.[342]

9.A. Material Conflicts of Interest

Under the Final Rule, a "material conflict of interest" exists between a banking entity and its clients, customers or counterparties if:

(1) the banking entity engages in any transaction, class of transactions or activity that would involve or result in the banking entity's interests being ***materially adverse*** to those of its client, customer or counterparty, ***unless***

(2) prior to effecting the ***specific*** transaction or class or type of transactions or engaging in the ***specific*** activity, the banking entity:

- has made ***clear, timely and effective disclosure*** of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer or counterparty to meaningfully understand the conflict of interest, and such disclosure is made in a manner that provides the client, customer or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer or counterparty created by the conflict of interest; or

- has established, maintained and enforced ***information barriers*** that are memorialized in written policies and procedures, such as physical separation of personnel, or functions or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[343]

These provisions of the Final Rule are notable for embedding several ultimately subjective standards without much elaboration on how they should be evaluated. The Supplementary Information provides that the mere fact that the buyer and seller are on opposite sides of a

[342] The Final Rule's provisions with respect to threats to the safety and soundness of the banking entity or to the financial stability of the United States were taken verbatim from Section 13, and "the Agencies did not receive any comments" on these provisions during the notice-and-comment period. Supp. Info. 463; *see also id.* at 765.

[343] Final Rule § _.7(b); *see also id*. § _.15(b).

transaction and have differing economic interests does not necessarily mean that there is a material conflict of interest.[344] Otherwise, the Supplementary Information does not provide any specific examples of material conflicts of interest, instead noting that "[i]n all cases, the question. . . will depend on an evaluation of the specific facts and circumstances" and that "[c]oncerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants."[345]

(i) Clear, Timely and Effective Disclosure

The Supplementary Information provides the following guidance on the requirements for an effective disclosure of a conflict of interest:

Guidance on Effective Disclosures of Conflicts of Interest[346]

Must/May	Must Not
• **Must be "clear, timely and effective"**	• **Must not be "general or generic," "omit[] details" or be "hidden in a large volume of needless information"**
• **Must be provided "sufficiently close in time" to the client's, customer's or counterparty's decision to engage in the transaction or activity**	• **Must not be "periodic. . . such as at the beginning of a trading relationship or on an annual basis" or "far in advance of a particular transaction"**
• **Need not necessarily be written or acknowledged**	• **Conversely, must not be given "without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information"**
• **Will allow a transaction or activity to continue if the client, customer or counterparty is provided an *opportunity* to substantially mitigate the materially adverse effect; does not require actual full negation**	• **Must not be based on "[advance] consent or waivers alone"**

[344] Supp. Info. 454 (footnote omitted).

[345] *Id*. at 456-57.

[346] *Id*. at 450-54.

(ii) Information Barriers

With respect to information barriers, the Final Rule stipulates that a banking entity may not rely on an information barrier "if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty."[347]

Furthermore, the Supplementary Information provides that "[i]f a conflict occurs to the detriment of a client, customer, or counterparty despite an information barrier, the Agencies would also expect the banking entity to review the effectiveness of its information barrier and make adjustments, as necessary, to avoid future occurrences, or review whether such information barrier is appropriate for that type of conflict."[348]

It is fundamentally unclear how establishing an information barrier that meets these requirements would help a banking entity to comply with the Final Rule if it did not already. In particular, it is unclear how segregating access to information within an organization could help to prevent conflicts of interest between the counterparty and *the organization as a whole*, as the Final Rule requires. Information barriers are frequently established within an organization precisely when a conflict of interest is foreseeable, but can be appropriately tolerated, for various legal and business purposes, if certain procedures are observed. The conflicts-of-interest provisions of the Final Rule, however, appear to be oriented toward outcomes rather than process.

9.B. High-Risk Assets and High-Risk Trading Strategies

The Final Rule defines "high-risk asset" and "high-risk trading strategy" as follows:

> (1) "*High-risk asset*" means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.
>
> (2) "*High-risk trading strategy*" means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.[349]

[347] Final Rule § _.7(b)(2)(ii); *see also id*. § _.15(b)(2)(ii).

[348] Supp. Info. 456 n. 1613.

[349] Final Rule § _.7(c); *see also id*. § _.15(c).

With one exception,[350] the Agencies do not identify particular high-risk assets or trading strategies and note that such determinations depend on the facts and circumstances, including "the amount of capital at risk in a transaction, whether or not the transaction can be hedged, the amount of leverage present in the transaction and the general financial condition of the banking entity."[351] The Supplementary Information notes that a trading strategy or asset may be high-risk to one banking entity but not another, or may be high-risk to a banking entity under some market conditions but not others.[352]

The Agencies do, however, intend to develop additional guidance regarding best practices for addressing potential conflicts of interest, high-risk assets and trading strategies and activities that pose significant risks to the safety and soundness of the banking entity or to the financial stability of the United States as the Agencies and banking entities gain experience with implementing the Volcker Rule.[353]

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[350] As discussed in Section 7.B of this Memorandum with respect to risk-mitigating hedging in the covered fund context, "the Agencies have determined that transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity" and is therefore now prohibited. Supp. Info. 722.

[351] *Id*. at 463.

[352] *Id*. at 462.

[353] *Id*. at 435.

10. ADDITIONAL DISCUSSION OF COMPLIANCE PROGRAM AND CERTIFICATION REQUIREMENTS

The Final Rule provides that "[e]ach banking entity shall develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance" with the Volcker Rule.[354] Although "[t]he terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity,"[355] it is evident that the compliance program for large banking entities will be extensive. The Supplementary Information does allow that if a banking entity engages only in proprietary trading, it would not be expected to implement the same detailed compliance program for covered fund activities and investments, and vice versa.[356]

The required compliance program may be implemented on an enterprise-wide basis or at a business-unit level, as long as the program satisfies all requirements and can be effectively administered. In either case, the banking entity may use common policies and procedures to the extent that they are appropriate for more than one trading desk.[357] If an enterprise-wide program is established, the program will be subject to supervisory review by the appropriate Agency of each banking entity within the organization, and the organization will be expected to provide each appropriate Agency with access to all records related to the enterprise-wide program pertaining to any banking entity supervised by the Agency.[358]

The compliance program—referenced throughout this Memorandum—is the backbone of the Volcker Rule. Determining whether a particular transaction is permitted or prohibited may, of course, be a challenge in itself, but for some banking entities the Volcker Rule's primary lasting effect may be a massive overlay of policies and procedures, internal controls, testing and other elements of a compliance program that functions simply to police the absence of prohibited activities in which the banking entity does not engage.[359]

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[354] Final Rule § _.20(a).

[355] *Id*.

[356] Supp. Info. 790-91.

[357] *Id*. at 800-01.

[358] *Id*. at 801.

[359] In particular, banking entities may find it challenging to demonstrate the absence of prohibited proprietary trading in a manner that can be audited. This challenge will be exacerbated for a banking entity that is subject to the Enhanced compliance program, which must permit a "qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties," to test for "significant deficiencies or material weaknesses in its compliance program." Final Rule Appendix B § IV. "Material weaknesses" and "significant deficiencies" are terms that are currently used only with respect to the auditing of internal controls over financial reporting. *See* Public Company Accounting Oversight Board, *Auditing Standard No. 5* (June 2007).

10.A. Comparison of Required Compliance Programs

Part 2.B of this Memorandum summarizes the thresholds and effective dates for the different permutations of the compliance program that may be required depending on a banking entity's size and its level of trading activities. The following discussion provides additional details on, and comparisons of, the five levels of compliance programs under the Final Rule.

As noted above, a banking entity must establish the compliance program "as soon as practicable and in no case later than the end of the conformance period."[360]

(i) None

A banking entity that does not engage in proprietary trading (other than permitted trading in domestic government obligations) or covered fund-related activities or investments may satisfy the requirement to establish a compliance program by establishing the required compliance program prior to becoming engaged in such activities or making such investments.[361]

(ii) Light

A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in proprietary trading (other than permitted trading in domestic government obligations) or covered fund-related activities or investments may satisfy the requirement to establish a compliance program by including in its existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.[362]

(iii) Standard

A banking entity that engages in proprietary trading (other than permitted trading in domestic government obligations) or covered fund-related activities or investments, and is too large to qualify for the Light program but is not required to implement the Enhanced program, must implement and maintain a compliance program that meets several minimum requirements described in the Final Rule.[363] These requirements, and a comparison to the corresponding requirements of the Enhanced program, are summarized in the **Annex** to this Memorandum.

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[360] *Id*. at 775 (footnote omitted); *see also* Conformance Period Order at 3.

[361] Final Rule § _.20(f)(1).

[362] *Id*. § _.20(f)(2). If a banking entity exceeds the $10 billion threshold for the first time as of the end of a particular year, it is not clear how quickly the banking entity would be expected to establish the Standard compliance program to which it would then be subject.

[363] *Id*. § _.20(b).

(iv) Enhanced

In addition to implementing the Standard program, a banking entity must implement and maintain a significantly more comprehensive "enhanced" program if the banking entity:

(1) is currently required to report quantitative trading metrics (see below);

(2) has reported total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has "total U.S. assets" as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity "operating, located or organized" in the United States); or

(3) has been notified in writing by the relevant Agency that it must implement and maintain the Enhanced program.[364]

The requirements of the Enhanced program, which requires additional and more detailed policies and procedures and other requirements—as well as an annual CEO certification requirement—are included in Appendix B to the Final Rule. These requirements, and a comparison to the corresponding requirements of the Standard program, are summarized in the **Annex** to this Memorandum.

(v) Enhanced Plus Metrics

In addition to implementing the Enhanced program, a banking entity is required to calculate and report certain quantitative measurements on its trading activities to the relevant Agencies if the banking entity:

(1) for a ***U.S. banking entity***, has total "trading assets and liabilities," together with its affiliates and subsidiaries, but excluding trading assets and liabilities "involving obligations of or guaranteed by the United States or any agency of the United States," the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $10 billion;

(2) for a ***foreign banking entity***, has trading assets and liabilities of "the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States. . .)," excluding trading assets and liabilities "involving obligations of or guaranteed by the United States or any agency of the United States," the average gross sum of which, over the

[364] *Id*. § _.20(c).

previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $10 billion; or

(3) has been notified in writing by the relevant Agency that it must calculate and report the quantitative trading metrics.[365]

The details of the quantitative trading metrics that are required to be calculated and reported are included in Appendix A to the Final Rule and are briefly summarized below. The metrics, which must be calculated at the trading desk level, are required for each trading desk engaged in trading under the exemptions for underwriting, market making-related and risk-mitigating hedging activities, trading in domestic government obligations and trading in foreign government obligations.[366]

The metrics do not have any specific numerical thresholds and are not intended to be used as a dispositive tool for determining compliance with the Volcker Rule, but rather as a way to monitor trends and identify activities for further review.[367] In addition to the metrics initially required to be reported, a banking entity may need to develop and implement other quantitative metrics as part of its compliance program, although these additional metrics will not be subject to the same reporting.[368] The Agencies also state that they will review all metrics-related data collected prior to September 30, 2015 (which will necessarily come only from the banking entities with trading assets and liabilities of $50 billion or more) and revise the collection requirement as they determine to be appropriate.[369]

The metrics must be *calculated* each trading day and *reported* to the relevant Agency or Agencies either monthly, for a banking entity with $50 billion or more in covered trading assets and liabilities, or quarterly, for a banking entity with less than $50 billion in covered trading assets and liabilities.[370] Monthly reporters must provide the metrics within 30 days after the end of the month until the monthly report for January 2015, at which time the reports must be provided within 10 days after the end of the month. Quarterly reporters must

[365] *Id*. § _.20(d).

[366] *See* Final Rule Appendix A §§ I-II. A banking entity may also optionally calculate and report metrics with respect to trading under exclusions from the definition of “proprietary trading” (such as qualifying trading under a documented liquidity management plan) or the exemptions for trading on behalf of customers, trading by a regulated insurance company or trading activities of foreign banking entities outside the United States. *See id*.

Banking entities with $10 billion or more, but less than $50 billion, in covered trading assets and liabilities will be subject to an extended phase-in of the metrics reporting requirement. *See* Part 2.B of this Memorandum.

[367] Supp. Info. 828.

[368] *See* Final Rule Appendix A § I.

[369] *Id*.

[370] *See id*.

provide the metrics within 30 days after the end of each calendar quarter. The Agencies can also require banking entities to report on another schedule.[371]

The "metrics" that must be reported are the following.[372] Note that each "metric" includes, in most cases, numerous related calculations, many of which refer to each other. For those banking entities with larger trading operations, it will likely be a significant undertaking not only to collect the sheer amount of data that will be needed to calculate the metrics, but to calculate, compile, appropriately audit and submit metrics within 10 days after the end of each month.

(1) ***Risk and Position Limits and Usage:*** "Risk and Position Limits" are "the constraints that define the amount of risk that a trading desk is permitted to take at a point in time, as defined by the banking entity for a specific trading desk." "Usage" represents "the portion of the trading desk's limits that are accounted for by the current activity of the desk." Risk and Position Limits "also must include appropriate metrics for the trading desk limits including, at a minimum, the 'Risk Factor Sensitivities' and 'Value-at-Risk and Stress Value-at-Risk' metrics except to the extent any of the 'Risk Factor Sensitivities' or 'Value-at-Risk and Stress Value-at-Risk' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk."

(2) ***Risk Factor Sensitivities:*** Risk Factor Sensitivities are "changes in a trading desk's Comprehensive Profit and Loss that are expected to occur in the event of a change in one or more underlying variables that are significant sources of the trading desk's profitability and risk." Reported Risk Factor Sensitivities must be "sufficiently granular to account for a preponderance of the expected price variation in the trading desk's holdings." The Final Rule provides an extensive listing of minimum requirements for Risk Factor Sensitivities for different asset classes, which frequently include sensitivities to changes in prices of underlying positions (delta), volatility (vega), correlation, credit spreads, interest rates, foreign exchange rates and the passage of time, "expressed in a manner that demonstrates any significant non-linearities."

(3) ***Value-at-Risk and Stress VaR:*** "Value-at-Risk" (or "VaR") is "the commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on current market conditions," and "Stress VaR" is "the percentile measurement of the

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[371] *Id*. § _.20(d)(3).

[372] The summaries of the metrics and the quotations in the summaries are taken from Final Rule Appendix A § IV.

risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on market conditions during a period of significant financial stress." A banking entity is generally expected to calculate 1% 1-day VaRs as well as calculations of VaR and Stress VaR that are consistent with any regulatory capital requirements to which the banking entity is subject. These metrics must be applied to each trading desk's holdings and cannot aggregate the holdings of multiple trading desks.

(4) ***Comprehensive Profit and Loss Attribution:*** This metric requires "an analysis that attributes the daily fluctuation in the value of a trading desk's positions to various sources," based on a division of profit and loss into three categories:

- profit and loss attributable to a trading desk's existing positions that were also positions held by the trading desk as of the end of the prior day ("existing positions");
- profit and loss attributable to new positions resulting from the current day's trading activity ("new positions"); and
- residual profit and loss that cannot be specifically attributed to existing positions or new positions."

The banking entity must also calculate the "volatility of comprehensive profit and loss (i.e., the standard deviation of the trading desk's one-day profit and loss, in dollar terms)" for at least a 30-, 60- and 90-day lag period from the end of each month.

The Comprehensive Profit and Loss for existing positions must be further attributed to "changes in (i) the specific Risk Factors and other factors that are monitored and managed as part of the trading desk's overall risk management policies and procedures; and (ii) any other applicable elements, such as cash flows, carry, changes in reserves, and the correction, cancellation, or exercise of a trade." The Comprehensive Profit and Loss from new positions, however, "may be reported in the aggregate and does not need to be further attributed to specific sources."

(5) ***Inventory Turnover:*** This metric is "a ratio that measures the turnover of a trading desk's inventory. The numerator of the ratio is the absolute value of all transactions over the reporting period. The denominator of the ratio is the value of the trading desk's inventory at the beginning of the reporting period."[373] This ratio is calculated each trading day for backwards-looking 30-, 60- and 90-day periods.

(6) ***Inventory Aging:*** "Inventory Aging" "generally describes a schedule of the trading desk's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held. . . . Inventory Aging must include two schedules, an asset-aging schedule and a liability-aging schedule. Each schedule must record the value of assets or liabilities held over all holding periods."

(7) ***Customer-Facing Trade Ratio:*** This metric is "a ratio comparing (i) the transactions involving a counterparty that is a customer of the trading desk to (ii) the transactions involving a counterparty that is not a customer of the trading desk." The ratio is calculated each trading day, using both trade count and trade value, for backwards-looking 30-, 60- and 90-day periods.[374]

10.B. Compliance Requirements Specific to Certain Permitted Proprietary Trading Activities

As discussed in Part 4 of this Memorandum, the Final Rule includes exemptions from the prohibition on proprietary trading for certain permitted activities, including underwriting activity, market making-related activity and risk-mitigating hedging activity.

The terms of each of these three exemptions require that the banking entity establish and maintain the generally required Volcker Rule compliance program *and that the program include certain features related specifically to the exemption in question*. Embedding these specific compliance requirements within the exemptions themselves reflects the Agencies'

[373] For the Inventory Turnover, Inventory Aging and Customer-Facing Trade Ratio metrics, "value" means the following for derivatives: for derivatives other than options and interest rate derivatives, gross notional value; for options, delta-adjusted notional value; and for interest rate derivatives, 10-year bond-equivalent value.

[374] "Customer" has the same definition as under the market making-related activity exemption discussed in Part 4.B of this Memorandum. That is, "customer" is defined as "a market participant that makes use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services," but generally does not include other large dealers with $50 billion or more in trading assets and liabilities. Transactions conducted anonymously on an exchange (or similar facility) that permits trading by a broad range of market participants would be considered transactions with customers.

view that the compliance requirements are "core elements" of the exemptions.[375] The exemption-specific compliance requirements do not represent a new or fundamentally different compliance program, however—they are rather features that the general compliance program must include for banking entities that engage in certain permitted activities.

For banking entities that are subject to the Enhanced program, the exemption-specific compliance requirements overlap with the requirements of Appendix B to the Final Rule (though the exemption-specific requirements are phrased differently in places, and a banking entity will, of course, wish to consult them in designing its compliance program). For a banking entity that is subject to the Standard or Light program but engages in underwriting, market making-related or risk-mitigating hedging activity, however, the exemption-specific requirements may be more meaningful and may require more attention to ensure that the banking entity's compliance program is responsive to the particular requirements.

The following table summarizes the exemption-specific requirements.

[375] Supp. Info. 128.

Fig. 10.B.1: Exemption-Specific Compliance Requirements for Proprietary Trading

Underwriting	Market Making-Related	Risk-Mitigating Hedging
Expressly requires that the banking entity's compliance program address: • the instruments that each trading desk may trade as part of its underwriting activities; • position, risk and aging limits on each trading desk, based on the nature and amount of the activities, including reasonably expected near term demands of customers; • internal controls for monitoring and analysis of each trading desk's compliance with its limits; and • procedures for approval of any trade that would exceed a trading desk's limits and independent review of any such approval.[376]	Expressly requires that the banking entity's compliance program address: • ***all*** of the items noted under "Underwriting," ***plus***: • actions that each trading desk will take to demonstrably reduce or otherwise significantly mitigate the risks of its financial exposure consistent with its limits; • instruments that each trading desk may use for risk-management purposes; and • strategies that each trading desk may use to manage the risks of its market making-related activities and inventory and procedures for ensuring that these strategies remain effective.[377]	Expressly requires that the banking entity's compliance program address: • policies and procedures regarding the positions, techniques and strategies used for hedging, including position and aging limits; • internal controls, as well as monitoring, management, authorization and escalation procedures; and • analysis and independent testing to ensure the hedging activities may reasonably be expected to, and actually do, demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk being hedged.[378]

[376] Final Rule § _.4(a)(2)(iii).

[377] *Id*. § _.4(b)(2)(iii).

[378] *Id*. § _.5(b)(1).

10.C. Compliance Requirements Specific to Documentation of Certain Covered Fund Activities

A banking entity with total consolidated assets of more than $10 billion as reported on December 31 of the previous two calendar years—that is, a banking entity that is subject to the Standard or Enhanced program—must also maintain specific documentation with respect to covered fund activities, when applicable:

(1) documentation of the exclusions or exemptions other than Section 3(c)(1) or 3(c)(7) of the 1940 Act relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliates) in determining that the fund is not a covered fund;

(2) for each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund for foreign public funds, foreign pension or retirement funds, loan securitizations, qualifying asset-based commercial paper conduits or qualifying covered bonds, documentation supporting the banking entity's determination that the fund is not a covered fund;

(3) for each seeding vehicle that will become a RIC or an SEC-regulated BDC, a written plan documenting:

- the banking entity's determination that the seeding vehicle will become such a RIC or BDC;
- the period of time during which the vehicle will operate as a seeding vehicle; and
- the banking entity's plan to market the vehicle to third-party investors and convert it into a RIC or BDC within the time period required under the Final Rule; and

(4) for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any U.S. state,[379] if the aggregate amount of ownership interests in foreign public funds owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any U.S. state) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar

[379] For purposes of this provision, a U.S. branch, agency or subsidiary of a foreign banking entity is located in the United States, but the foreign bank that operates or controls that branch, agency or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency or subsidiary. *Id*. § _.20(e)(5).

> quarter, documentation of the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized, calculated as of the end of each calendar quarter, which documentation must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters.[380]

10.D. Board, CEO and Senior Management Accountability

For a banking entity that is subject to the Enhanced compliance program (but not the Standard or Light program), the banking entity's chief executive officer must, annually, attest in writing to the appropriate Agency that the banking entity has in place "processes to establish, maintain, enforce, review, test and modify the compliance program. . . in a manner reasonably designed to achieve compliance" with the Final Rule.[381] In the case of a U.S. branch or agency of a foreign banking entity, "the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the United States operations of the foreign banking entity who is located in the United States."[382]

In the absence of further extensions of the conformance period, a banking entity will be required to have completed its compliance program and conformed its activities to the requirements of the Final Rule by July 21, 2015. The Final Rule does not specify when the first CEO certification would be due.

The Enhanced compliance program contains several other "tone at the top" requirements designed to ensure board and senior management involvement in Volcker Rule compliance. These requirements, which are described in the **Annex** to this Memorandum, include approving the overall compliance program. The board of directors of a banking entity must also "ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with [the Final Rule] in light of the organization's business activities and the expectations of the board of directors" and "ensure that senior management has established appropriate incentives and adequate resources to support compliance" with the Final Rule.[383]

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[380] *Id*. § _.20(e).

[381] *Id*. at Appendix B § III. Note that this certification is in addition to and not in substitution for the CEO certification required for a banking entity to avail itself of the prime brokerage exemption from Super 23A in the covered fund context. *See* Part 8.A of this Memorandum.

[382] Final Rule Appendix B § III.

[383] *Id*.

*   *   *

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Annex – Selected Requirements of "Standard" and "Enhanced" Compliance Programs under the Final Rule[384]

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
1. Policies and Procedures	The compliance program must include written policies and procedures reasonably designed to document, describe, monitor and limit proprietary trading—including permitted proprietary trading—and covered fund activities and investments to ensure that such activities comply with the Final Rule.	**Proprietary Trading** (1) *Written Policies and Procedures for Trading Desks:* Policies and procedures must be instituted for each trading desk and include a description of: • how the trading desk maps to the organizational structure responsible for managing the desk, the mission and strategy of the desk, authorized activities and the types of clients, customers and counterparties with whom the desk is authorized to trade; • types and amount of risks allocated to the trading desk, how the risks allocated to each desk will be measured and why the allocated risk levels are appropriate to the activities authorized for the desk; • limits on holding periods and risks associated with financial instruments, procedures for setting new limits or granting exceptions and the process for independent review of the exceptions and related analysis; • compensation arrangements for employees associated with the trading desk; and • the process for identifying and approving new products, trading strategies and hedging strategies.

[384] The Standard program is described in Final Rule § _.20(b). The Enhanced program is described in Final Rule Appendix B. Part 10 of this Memorandum discusses additional compliance requirements that may apply in connection with certain permitted activities under the Volcker Rule.

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
		(2) *Risks and Risk Management Processes:* A risk management program must, at a minimum, describe: • the supervisory and risk management structure governing all trading activity; • processes for: (i) developing, documenting, testing, approving and reviewing all models used for valuing, identifying and monitoring the risks of trading activity and related positions; (ii) developing, documenting, testing, approving and reviewing the limits established for each trading desk; and (iii) purchasing or selling a security pursuant to the liquidity management plan; and • management review, processes for exceptions and adjustments to limits and independent testing. (3) *Hedging Policies and Procedures:* Policies and procedures regarding the use of risk-mitigating hedging instruments and strategies must, at a minimum, describe: • the positions, techniques and strategies each trading desk may use and the process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies conducted in reliance of the risk-hedging exemption; • the manner in which the banking entity will identify risks in connection with positions and determine that such risks have been properly and effectively hedged; • the manner in which, the personnel responsible for and the organizational level where hedging management and monitoring occur; and • risk management processes to control unhedged or residual risks. (4) *Other Compliance Matters:* The compliance program must also: • identify the activities of each trading desk conducted as permitted proprietary trading and document how the activity meets the requirements of any specific

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
		exemption; • explain the process for documenting and reviewing actions taken pursuant to the liquidity management plan; • describe how the banking entity monitors for and prohibits material conflicts of interest and exposure to high-risk assets and trading strategies; • establish policies for monitoring and prohibiting potential or actual material conflicts of interest; and • establish responsibility for reporting and recordkeeping. **Covered Fund Activities and Investments** (1) *Identification of Covered Funds and Covered Fund Activities and Investments:* The compliance program must provide a process for identifying and documenting covered funds that each unit within the banking entity's organization sponsors, organizes and offers or in which each such unit invests. The compliance program must also map each organizational unit that is permitted to hold an interest in or sponsor any covered fund to the organizational structure that oversees the unit's activities. (2) *Explanation of Compliance:* The compliance program must describe how the banking entity monitors and prohibits: • potential or actual material conflicts of interest; • activities that may threaten the safety and soundness of the banking entity; and • material exposure to high-risk assets or high-risk trading strategies. (3) *Description and Documentation of Covered Fund Activities and Investments:* For each organizational unit engaged in covered fund activities and investments, the compliance program must document:

<table>
<tr><th>Requirement</th><th>Standard Compliance Program</th><th>Additional Requirements and Standards
under the Enhanced Compliance Program</th></tr>
<tr><td></td><td></td><td>• the activities that the unit is authorized to conduct;
• the entity’s plan for actively seeking unaffiliated investors such that any investment by the entity conforms to seeding period limits or is exempt from such limits; and
• how the unit complies with restrictions on covered fund activities and investments.

General

(1) Remediation of Violations: The compliance program must be reasonably designed to effectively monitor and identify any activity that may indicate a violation of the Final Rule, as well as take prompt action to remedy such violation. There must be prompt notification to the appropriate management, including senior management and the board of directors, of any material weaknesses or significant deficiencies in the design or implementation of the program.</td></tr>
<tr><td>2. Internal Controls</td><td>The compliance program must have a system of internal controls reasonably designed to monitor compliance with, and prevent the occurrence of activities prohibited by, the Final Rule.</td><td>Proprietary Trading

(1) Limits and Internal Controls: The banking entity must establish and enforce risk limits appropriate for each desk and these limits must be based on probabilistic and non-probabilistic measures of potential loss measured under normal and stress market conditions. At a minimum, internal controls must monitor limits on:
• the financial instruments authorized to be traded;
• the types and levels of risks taken by each trading desk; and
• the types of hedging instruments and strategies used, and the amount of risk effectively hedged.

(2) Analysis and Quantitative Metrics: Banking entities must perform robust analysis and quantitative measurement of their trading activities that is reasonably designed to ensure consistency with the compliance program and monitor and prevent prohibited</td></tr>
</table>

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
		proprietary trading. Analysis and models used to limit risk must be tested and reviewed by management to ensure that activities and limits do not understate risk and exposure. This review should include periodic and independent back-testing. Quantitative measurements must include those metrics that banking entities must report under Appendix A of the Final Rule, if applicable, as well as additional metrics specifically tailored to each trading desk. The compliance program must also include, at a minimum: • policies, procedures and controls reasonably designed to ensure the accuracy and integrity of quantitative metrics and ongoing monitoring and review of the metrics; • establishment of numerical thresholds for each trading desk, analysis of measurement results and escalation procedures for heightened review; and • immediate review and investigation of a trading desk's activities, escalation to senior management, timely notification to the appropriate Agency, remedial action and documentation of steps taken when the quantitative metrics, together with the facts and circumstances, suggest a reasonable likelihood that the trading desk has violated any part of the Final Rule. **Covered Fund Activities and Investments** (1) *Internal Controls:* Internal controls must be reasonably designed to ensure that the banking entity's covered fund activities and investments comply with the appropriate limits on risk established by the entity. The internal controls must be reasonably designed to effectively monitor and identify for analysis any activity that may violate the covered fund provisions of the Final Rule. The internal controls must also: • monitor and limit the entity's individual and aggregate investments in covered funds; • monitor seed capital investments; • calculate the individual and aggregate levels of ownership interests in covered

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
		funds; • make required disclosures to investors in any covered fund organized and offered or sponsored by the entity; • monitor for and prevent any prohibited relationship or transaction between the entity and a covered fund; and • establish appropriate management review and supervision.
3. Management Framework	The compliance program must have a management framework that delineates responsibility and accountability for compliance with the Final Rule, including appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified by the compliance program or management as requiring attention.	Each banking entity must have an appropriate governance and management framework that, at a minimum, meets the following requirements: (1) *Board of Directors:* The board of directors (or a committee thereof) must approve the compliance program, set an appropriate culture of compliance and ensure that appropriate policies regarding the management of trading activities and covered fund activities and investments are adopted. The board (or a committee thereof) must also ensure that senior management is fully capable, qualified and properly motivated to manage compliance, including ensuring senior management has established appropriate incentives and adequate resources to support compliance. (2) *Senior Management:* Senior management must approve the compliance program, set an appropriate culture of compliance and ensure that appropriate policies regarding the management of trading activities and covered fund activities and investments are adopted. Senior management is also responsible for implementing and enforcing the approved compliance program and for taking corrective action when failures in compliance are identified. Senior management and control personnel overseeing compliance with the Final Rule must review the compliance program periodically and report to the board (or a committee thereof) on the effectiveness of the program with a frequency appropriate to the size, scope and risk profile of the banking entity's trading activities and covered fund activities and investments, but in any event at least annually.

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
		(3) *Business Line Managers:* Business line managers with responsibility for one or more trading desks must be accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desks. (4) *Management Procedures:* The banking entity must establish, monitor and enforce a governance framework that, at a minimum, must include: • the designation of appropriate senior management (or committees of senior management) to be responsible for each trading desk and organizational unit engaged in covered fund activities and investments; • a description of the management system; and • procedures for determining compensation arrangements for traders engaged in market-making, underwriting or hedging activities.
4. Independent Testing	Independent testing and audit of the effectiveness of the compliance program must be conducted periodically by qualified personnel of the banking entity or a qualified outside party.	Independent testing must be conducted by a "qualified independent party," which may include the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants or other qualified independent parties. This testing must evaluate the effectiveness of: • the compliance program overall; • the internal controls and analysis of breaches of internal controls; and • management procedures. Testing must occur at a frequency appropriate to the size, scope and risk profile of the banking entity's trading activities and covered fund activities and investments, but in any event at least annually.

Requirement	Standard Compliance Program	Additional Requirements and Standards under the Enhanced Compliance Program
5. CEO Certification	None required.	The banking entity's CEO must, annually, attest in writing to the appropriate Agency that the banking entity has in place "processes to establish, maintain, enforce, review, test and modify the compliance program. . . in a manner reasonably designed to achieve compliance" with the Final Rule. In the case of a U.S. branch or agency of a foreign banking entity, this attestation may be provided for the entire U.S. operations of the banking entity by the senior management officer of U.S. operations who is located in the United States.
6. Training	The compliance program must include training for trading personnel, managers and other appropriate personnel to effectively implement and enforce the program.	The banking entity must conduct "adequate training" to appropriate personnel and managers to effectively implement the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking entity's trading activities and covered fund activities and investments.
7. Record-keeping	The banking entity must create records sufficient to demonstrate compliance with the Final Rule, provide the records to the appropriate Agency promptly upon request and retain the records for at least five years or such longer period as required by the appropriate Agency.	Same.