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Legal Report

Proposed Regulations Implementing the Volcker Rule

The US bank and securities regulatory agencies have issued for public comment their much anticipated proposal to implement the Volcker Rule provisions of the Dodd-Frank Act. The proposal provides key details—and raises many new questions—regarding the proprietary trading and covered fund prohibitions at the core of the Volcker Rule, as well as the restrictions and conditions that will apply to banking entities that engage in permitted trading and fund activities pursuant to its key exemptions. This Legal Report summarizes the proposal and highlights select issues of concern to many financial services firms, including observations regarding the extraterritorial reach of the proposal and its potential impact on the securitization markets.

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Introduction

The federal banking agencies on October 11, 2011, and the Securities and Exchange Commission ("SEC") on October 12, 2011, issued for public comment their long-awaited proposed regulations (the "Proposal") to implement section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule.[1] Section 619 added a new section 13 to the Bank Holding Company Act of 1956 ("BHCA") that generally prohibits any banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to exemptions for certain permitted activities. It also provides for restrictions on such activities conducted by a nonbank financial company supervised by the Board of Governors of the Federal Reserve System ("FRB").

Consistent with the approach recommended by the Financial Stability Oversight Council ("FSOC"), the Proposal adopts a multi-faceted approach to implementing the section 13 prohibitions that relies on:

- Detailed descriptions of prohibited and permitted activities;
- Detailed and potentially highly burdensome compliance requirements; and
- For banking entities with large volumes of trading activity, detailed quantitative analysis and reporting obligations.

In addition to rules implementing the core prohibitions and exemptions of the Volcker Rule, the Proposal also includes three appendices devoted to recordkeeping and reporting requirements, including numerous quantitative data reporting obligations for banking entities with significant trading activities (Appendix A), detailed guidance regarding trading undertaken in connection with market making activities (Appendix B), and enhanced compliance requirements for banking entities with significant trading or covered fund activities (Appendix C).

The Proposal also includes more than 380 specific questions posed by the Agencies for public comment, reflective not only of the magnitude and complexity of the prohibitions established by the Volcker Rule, but also a possible lack of consensus among the regulatory agencies regarding how those prohibitions should be implemented.

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1 The Proposal was issued by the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Securities and Exchange Commission ("SEC") (collectively, the "Agencies"). The Commodities Futures Trading Commission ("CFTC") did not join the Proposal but its staff has been consulted by the other agencies.

The Proposal does not alleviate a host of issues and concerns raised by the Volcker Rule:

- Will the constraints on bank trading and fund activities harm the liquidity of US markets, weaken the competitiveness of the banking industry, contribute to job losses in the United States and result in markets and jobs moving offshore or into the shadow banking system?
- Will the Proposal impair the asset-backed securitization market?
- Will the compliance burdens detailed in the Proposal contribute to the further concentration of banking, as only the largest banks decide it is worthwhile to make the necessary investment to comply with its complex exemptions and risk the inevitable enforcement actions?
- Will some non-US banks shut down their US banking operations so they can escape the Volcker Rule?
- What about the extraterritorial impact on non-US banks subject to the Volcker Rule that engage in trades, exempt or not, with US counterparties from their non-US locations?
- Will some US banks seriously consider moving their headquarters and trading operations offshore so they can continue to compete in the global marketplace?

Given the significance of these questions, banking entities should take full advantage of the opportunity to file comments on the Proposal. The comment period will run for approximately 90 days, ending on January 13, 2012.

This legal report addresses the following topics: the definition of covered banking entity (pages 2-3), the prohibition on proprietary trading and the exemptions thereto (pages 4-15), the prohibition on covered funds activities and the exemptions thereto (pages 15-22), the new compliance structure that banking entities will have to develop by the effective date, July 21, 2012 (pages 22-24), the extraterritorial impact on US and non-US banks alike (pages 24-25), and a detailed discussion of the impact of the proposal on asset-backed securitization (pages 25-27).

Entities Subject to the Proposal

The Proposal applies separately to "banking entities" and to nonbank financial companies supervised by FRB (such companies, "Systemic Nonbanks").

COVERED BANKING ENTITIES

The Proposal applies to "banking entities," a term not previously defined and not used elsewhere in the BHCA. "Banking entity" is defined as:

- **Any Insured Depository Institution.** This includes any bank, thrift, industrial loan company or other entity whose deposits are insured by the FDIC.

- **Any Company that Controls an Insured Depository Institution.** This includes any bank holding company ("BHC"), any thrift holding company, and any non-US bank that has a US insured depository institution subsidiary.
- **Any Company Treated as a BHC for purposes of the International Banking Act of 1978.** This includes any non-US bank that has a US branch, agency, or commercial lending company subsidiary and the parent company of such a non-US bank.
- **Any Affiliate or Subsidiary of the Foregoing.** This would include any company that controls, is controlled by, or is under common control with the foregoing banking entities.[2] Thus, it would include broker-dealers, insurance companies, commodities and derivatives firms, investment advisers, investment funds, and any other entities that are affiliated with the foregoing entities.

The Proposal applies to these banking entities on a global basis, including affiliates and subsidiaries wherever located. It would *not* apply to financial groups that do not have banking operations in the United States, although such groups could be designated as Systemic Nonbanks.

TREATMENT OF FUNDS AS AFFILIATES

An investment fund that is controlled by a banking entity generally would be treated as a banking entity subject to the prohibitions of the Volcker Rule. The preamble to the Proposal explains that **mutual funds**, however, typically would not be considered subsidiaries or affiliates of a banking entity, provided that the banking entity provides only advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages the mutual fund in accordance with what is permissible under the BHCA.[3]

In addition, the Proposal would specifically exclude from the definition of banking entity an affiliate or subsidiary of a banking entity if the affiliate or subsidiary is (i) a covered fund that is permitted under the *bona fide* asset management exemption or (ii) any entity controlled by such a covered fund. Thus, such covered funds would not be treated as "banking entities" for purposes of the proprietary trading ban or the ban on investing in other covered funds. This treatment will permit fund of fund structures in which bank-controlled covered funds may invest in other, nonexempt covered funds. The Proposal requests comments on whether **securitization vehicles** would be affiliates of banking entities and whether the Agencies should consider excluding them as well.

2 Under the Bank Holding Company Act of 1956 ("BHCA"), one company generally is deemed to control another if it (i) owns, controls, or has the power to vote 25 percent or more of the outstanding shares of any class of voting securities of the other company, (ii) controls in any manner the election of a majority of the directors, trustees, or general partners of the other company, or (iii) has the power to exercise, directly or indirectly, a "controlling influence" over the management or policies of the other company, as determined by FRB after notice and opportunity for hearing.

3 *See, e.g.*, 12 U.S.C. 1843(c)(6), (c)(8), and (k); 12 C.F.R. 225.28(b)(6), 225.86(b)(3). The Proposal also asks for comment on whether a registered investment company should be expressly excluded from the definition of banking entity.

SYSTEMIC NONBANKS

The core prohibitions of the Volcker Rule do not apply to Systemic Nonbanks supervised by FRB, which will be designated as such by FSOC. Section 13 of the BHCA authorizes FRB to impose additional capital requirements, quantitative limits, and other restrictions with respect to proprietary trading and covered fund activities on Systemic Nonbanks, but does not prohibit those activities. The Proposal does not elaborate on this authority.

Prohibition Against Proprietary Trading

PROPRIETARY TRADING DEFINED

Section 13 broadly prohibits any banking entity from engaging in proprietary trading. The Proposal defines "proprietary trading" substantially as it is defined in the statute, namely as "engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions." The Proposal defines in greater detail "trading account" and "covered financial position."

TRADING ACCOUNT

The proprietary trading prohibition applies only to trades as principal "for the trading account." Investment securities and other instruments held by banks and other banking entities outside of the trading account (e.g., securities held for long-term investment purposes) should not be subject to the proprietary trading prohibition. The Proposal would adopt the following three-prong definition for "trading account":

- Any account used by a banking entity to acquire or take a covered financial position for the purpose of: (i) short-term resale; (ii) benefiting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more such positions. The preamble notes that this language is substantially similar to the language used in the Market Risk Capital Rule for a "trading position," and that the Agencies propose to interpret this language in a similar manner. The Proposal would adopt a **rebuttable presumption** that an account is a trading account if it is used to acquire or take a covered financial position that the banking entity holds for a period of 60 days or less. The presumption does not apply if the banking entity can demonstrate, based on the facts and circumstances, that the covered financial position was not acquired or taken principally for the purpose of short-term resale, benefiting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.
- Any account used by a banking entity subject to the Market Risk Capital Rule to acquire or take a covered financial position that is treated as a "covered position" under that Rule, other than certain foreign exchange and commodity positions. The Market Risk Capital Rule defines "covered position" to include all positions in a bank's "trading account," as defined for Call Report purposes. This prong of the trading account definition also covers any account used by

a nonbank affiliate of a BHC to acquire a covered financial position that would be a "covered position" as defined in the Market Risk Capital Rule applicable to the BHC affiliate.[4]

- Any account used by a banking entity that is a US-registered securities dealer, swap dealer, or security-based swap dealer, or is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to acquire or take positions in connection with its dealing activities.

TRADING ACCOUNT EXCLUSIONS: REPOS, SECURITIES LENDING, AND LIQUIDITY MANAGEMENT

The Proposal provides that an account would not be deemed a trading account to the extent it is used to acquire or take a covered financial position that arises under a repurchase or reverse repurchase agreement or under a securities borrowing or lending agreement. In terms of economic substance, such positions generally are not taken based on expected or anticipated movements in asset prices. Therefore, as described in the Proposal, these are not the types of transactions intended to be covered by the proprietary trading ban. An account used for the purpose of *bona fide* liquidity management also would be excluded from the definition of trading account, provided that transactions are conducted in accordance with a documented liquidity management plan that:

- Specifically contemplates and authorizes any particular instrument used for liquidity management purposes;
- Requires that transactions covered by it be principally for the purpose of managing the liquidity of the banking entity, and not for trading account purposes;
- Requires that positions taken for liquidity management purposes be highly liquid and limited to financial instruments not expected to give rise to appreciable profits or losses as a result of short-term price movements;
- Limits positions acquired for liquidity management purposes to amounts consistent with the banking entity's near-term funding needs, as estimated and documented pursuant to methods specified in the plan; and
- Is consistent with applicable supervisory requirements, guidance and expectations regarding liquidity management.

The Proposal also provides that the definition of trading account would not include accounts used by a banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act ("CEA") or a clearing agency registered with the SEC under 17A of the Securities Exchange Act of 1934 ("Exchange Act") in connection with clearing derivatives or securities transactions.

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4 Because non-US banking entities generally are not subject to the Market Risk Capital Rule (which is defined by reference to the capital rules of the US bank regulatory agencies), but may be subject to similar rules in their home jurisdictions, the precise applicability of this prong to such non-US institutions is not clear.

COVERED FINANCIAL POSITIONS

The proprietary trading ban applies only to "covered financial positions," which are defined by the Proposal to include the following categories of positions:

- A security, including an option on a security;
- A derivative, including an option on a derivative; and
- A contract of sale of a commodity for future delivery, or an option on such a contract.

The terms "security" and "commodity" are defined by reference to existing definitions under the Exchange Act and CEA, respectively. The Proposal would broadly define "derivative" to include not only "swaps" (as defined in the CEA) and "security-based swaps" (as defined in the Exchange Act), but also several other types of transactions not within the scope of those definitions that "appear to be, or operate in economic substance as, derivatives," including foreign currency swaps and forwards.[5] The Proposal would exclude from the definition of derivative consumer, commercial, and other agreements determined by the SEC and CFTC not to be swaps or security-based swaps, including certain insurance products, as well as certain identified banking products such as deposit accounts, savings accounts, and certificates of deposit.

EXCLUSION FOR LOANS

The Proposal specifically provides that loans are not included within the definition of covered financial position and, therefore, proprietary trading in loans would not be prohibited. While "loan" is defined broadly for purposes of the Proposal, encompassing any loan, lease, extension of credit, or secured or unsecured receivable, it does not include asset-backed securities, which would be subject to the prohibition.[6]

Permitted Trading Activities

Notwithstanding the general prohibition against proprietary trading, section 13 provides that a banking entity may engage in certain "permitted activities" subject to limitations set forth in the statute and those established by rule. Key exemptions from the proprietary trading prohibition include those for positions taken in connection with underwriting activities, market making activities,

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5 Specifically, the Proposal would characterize the following as derivatives, and thus covered financial positions: (i) any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as defined in the CEA); (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the CEA; (iv) any agreement, contract, or transaction in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the CEA; and (v) any transaction authorized under section 19 of the CEA.

6 The preamble draws an ambiguous distinction between a position that "is a loan" (which is eligible for the exclusion from the definition of covered financial position) and a position that "is *in* a loan" (which is not eligible for the exclusion). In the context of commodities, foreign exchange, and currency, it is clear that "positions in" such items refer to derivatives. We believe the language should be similarly interpreted in the loan context, such that "position in a loan" should be interpreted to refer to derivatives and, possibly, asset-backed securities. Because loan participations are generally treated like whole loans for bank regulatory purposes, loan participations should be treated as loans for purposes of this exemption. However, it might be prudent to seek clarification of the meaning of this language in comments on the Proposal.

risk-mitigating hedging activities, and, for certain non-US banking entities, trading activities conducted solely outside of the United States. Additional permitted activities include trading in US government securities, trading on behalf of customers, and trading by regulated insurance companies.

UNDERWRITING EXEMPTION

The Proposal permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's underwriting activities, subject to satisfaction of the following conditions:

- **Compliance Regime.** The banking entity must establish an internal compliance program as required by Subpart D of the Proposal, including written policies and procedures, internal controls, and independent testing. Under Subpart D, banking entities with significant Volcker Rule activities, generally including any banking entity that has (on a worldwide, consolidated basis) $1 billion or more in gross trading assets and liabilities or $1 billion in "covered fund" investments as described below, are also subject to the additional compliance obligations set forth in Appendix C of the Proposal. Banking entities that have, together with affiliates and subsidiaries, worldwide consolidated trading assets and liabilities the average gross sum of which is equal to or greater than $1 billion ("Significant Trading Entities") are also subject to quantitative recordkeeping and reporting obligations under Appendix A of the Proposal. The recordkeeping and reporting obligations applicable to Significant Trading Entities under Appendix A, as well as the compliance program requirements of Subpart D and Appendix C, are described further below.
- **Securities Only.** The covered financial positions permissible under this exemption are only those involving securities.
- **"Distribution" and "Underwriter."** The purchase or sale must be effected solely in connection with a "distribution of securities" (whether or not subject to registration under the Securities Act of 1933) for which the banking entity is acting as "underwriter." The Proposal defines the terms "distribution of securities" and "underwriter" substantially as they are defined in the SEC's Regulation M. In order to qualify as a distribution for purposes of the Proposal, the offering must be distinguished from ordinary trading transactions by the "magnitude" of the offering and the presence of "special selling efforts." The preamble confirms that in circumstances where an underwriter holds for investment purposes securities that it could not sell in the distribution, it would be permitted to dispose of such securities at a later time without violating the proprietary trading ban, provided that the securities had initially been purchased in connection with an underwriting.
- **Dealer Registration.** The banking entity must have the appropriate US dealer registration (unless exempt) or, if engaged in business as a dealer outside of the United States, must be subject to substantive regulation in the non-US jurisdiction.
- **Near Term Demand of Customers.** Underwriting activities must be designed not to exceed the "reasonably expected near term demands of clients, customers, or counterparties." This requirement restates the limitation placed on the underwriting exemption in section 13. The Agencies request comment on the degree to which a banking entity can accurately predict the

near term demands of clients, customers, and counterparties with respect to an offering, and how principal risk retained in connection with underwriting activities to support near term client demand can be distinguished from positions taken for speculative purposes.

- **Revenues.** Underwriting activities must be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income that is not attributable to appreciation in the value of covered financial positions or the hedging of such positions.
- **Compensation.** Compensation arrangements for employees performing underwriting activities must be designed not to reward proprietary risk-taking.

Like similar conditions that apply with respect to the market making and risk-mitigating hedging activities exemptions, these criteria are intended to ensure that a banking entity relying on the underwriting exemption is engaged in *bona fide* underwriting activities and that it conducts those activities without taking speculative, proprietary positions either as part of, or mischaracterized as, underwriting activity.

MARKET MAKING EXEMPTION

The Proposal permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's market making-related activities, again subject to satisfaction of certain conditions:

- **Compliance Regime.** The banking entity must establish an internal compliance program as required by Subpart D of the Proposal and, if applicable, Appendix C, including written policies and procedures, internal controls, and independent testing. A banking entity that is a Significant Trading Entity must also comply with the quantitative recordkeeping and reporting obligations under Appendix A to the Proposal (discussed below).
- ***Bona Fide* Market Making.** The trading desk that makes a market in a covered financial position must hold itself out as being willing to buy and sell (including entering into long and short positions in) the covered financial position, for its own account, on a regular or continuous basis. The Agencies note that the nature of a market maker's activities may vary depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for a particular covered financial position. For example, *bona fide* market making in liquid positions, such as equity securities or other exchange-traded instruments, would generally require a banking entity to make continuous, two-sided quotes and hold itself out as willing to buy and sell on a continuous basis. Making a market in less liquid positions would generally require a banking entity to hold itself out as "willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis."
- **Near Term Demand of Customers.** Market making-related activities must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. According to the preamble, in order for a banking entity's expectations regarding near-term customer demand to be considered reasonable, they should be based on more than a simple

expectation of future price appreciation and an accompanying generic increase in marketplace demand. A banking entity's expectation should instead be based on the unique customer base of the banking entity's specific market-making business lines and the near term demands of those customers based on particular factors beyond a general expectation of price appreciation.

- **Dealer Registration.** The banking entity must have the appropriate US dealer registration (unless exempt) or, if engaged in business as a dealer outside of the United States, must be subject to substantive regulation in the non-US jurisdiction.
- **Revenues.** Market making-related activities must be designed to generate revenues primarily from fees, commissions, bid/ask spreads, or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or their hedges.
- **Compliance with Appendix B.** Market making-related activities must be consistent with the commentary provided in Appendix B of the Proposal (discussed below).
- **Compensation.** Compensation arrangements for employees performing market making-related activities must be designed not to reward proprietary risk-taking.

The Proposal clarifies that a purchase or sale of a covered financial position also will be deemed to be made in connection with a banking entity's market making-related activities if the position is purchased or sold to reduce the specific risks to the banking entity arising from individual or aggregated positions acquired pursuant to the market making exemption and the purchase or sale meets the requirements generally applicable to risk-mitigating hedging activities (discussed below). The Proposal also clarifies that block positioning and anticipatory market making are permissible, subject to various requirements.

The preamble to the Proposal characterizes the market making exemption as particularly difficult to implement (and potentially prone to abuse) given the difficulties the Agencies expect to encounter in distinguishing principal positions that appropriately support market making-related activities from positions taken for short-term, speculative purposes. In order to address the complexities associated with the market making exemption, the Proposal adopts a multi-faceted approach that relies not only on the seven criteria identified above, but also on detailed commentary in Appendix B of the Proposal regarding how the agencies proposed to identify permitted market making-related activities and, for banking entities with significant trading activities, additional quantitative reporting and recordkeeping requirements.

- **Appendix B.** The commentary set forth in Appendix B of the Proposal applies to all banking entities that are engaged in market making-related activities in reliance on the market making exemption, regardless of the volume of activity. Appendix B describes how the regulators plan to distinguish permitted market making-related activities from prohibited proprietary trading. Among other things, the guidance identifies six factors that would cause a banking entity to be considered, "absent explanatory circumstances," to be engaged in prohibited proprietary trading rather than permitted market making-related activity. The six factors are:

Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;

Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;

Trading activity in which a trading unit (i) generates only very small or very large amounts of revenue per unit of risk taken, (ii) does not demonstrate consistent profitability, or (iii) demonstrates high earnings volatility;

Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near term customer demands;

Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads; and

The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.

RISK-MITIGATING HEDGING ACTIVITIES EXEMPTION

The Proposal would permit a banking entity to purchase or sell a covered financial position in order to reduce the specific risks to the banking entity related to its *individual* or *aggregated* positions, contracts, or other holdings, subject to the satisfaction of criteria described below. Thus, hedging risks on a portfolio basis would be permissible as well as dynamic hedging and limited anticipatory hedging.[7] However, the preamble notes that banking entities "should be prepared to identify the specific position or portfolio of positions that is being hedged and demonstrate that the hedging transaction is risk-reducing in the aggregate."

As with the underwriting and market making exemptions, a banking entity must establish the internal compliance program as required by Subpart D of the Proposal (and Appendix C, if applicable) in order to rely on the hedging exemption, including written policies and procedures, internal controls, and independent testing. In the case of a banking entity that is a Significant Trading Entity, trading conducted pursuant to the hedging exemption also may be subject to the recordkeeping and reporting requirements in Appendix A. Other conditions include:

- ***Bona Fide* Hedging.** The purchase or sale of a covered financial position must hedge or mitigate one or more specific risks to the banking entity, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, and basis risk.
- **Reasonable Correlation.** The hedge must be "reasonably correlated" to the risk being hedged. The preamble notes that full correlation is not required, but only "reasonable"

7 Dynamic hedging refers to the rebalancing of a banking entity's current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other holdings. Anticipatory hedging involves hedging a risk to which a banking entity is not currently exposed, but to which is expects to become exposed in the future.

correlation, and that reasonableness may depend on factors including the nature of the underlying risks and the availability of alternative hedging options. The Agencies specifically point out that the Proposal neither refers to nor relies upon accounting standards that address circumstances in which one transaction may be considered a hedge of another transaction, due to the fact that such standards (i) are designed for financial statement purposes rather than to identify proprietary trading, and (ii) could change in the future without consideration of the potential impact on section 13.

- **No New Material Exposures.** A hedge position taken pursuant to the exemption may not give rise, at the inception of the hedge, to significant new exposures that are not hedged contemporaneously (such as overhedging, correlation trading and pairs trading strategies).
- **Monitoring.** The hedge must be subject to continuing review, monitoring, and management by the banking entity, consistent with its written hedging policies and procedures, to ensure that the banking entity maintains a reasonable level of correlation between the hedge and the underlying risk and mitigates any significant exposure arising out of the hedge after inception.
- **Compensation.** Compensation arrangements for employees performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.
- **Documentation Requirement for Certain Hedges.** In circumstances where a hedging position is taken in a unit of the banking entity that is different from the unit that took the underlying risk position, the banking entity must document the risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings that the transaction is designed to reduce. This documentation requirement must be satisfied at the time the hedge position is taken.

TRADING OUTSIDE THE UNITED STATES

The Proposal would permit certain non-US banking entities to engage in proprietary trading that occurs "solely" outside of the United States. US-based banking entities, and non-US banking entities that are controlled by US-based banking entities, would not be eligible for this exemption.

- **Non-US Banking Entities Eligible for the Exemption.** The foreign trading exemption may be relied upon only by a banking entity that is not directly or indirectly controlled by a banking entity that is organized under US law. In addition, the banking entity relying on the exemption must conduct the activity pursuant to section 4(c)(9) of the BHCA.[8] Thus, the foreign trading exemption is available only to banking entities that are organized under non-US law and controlled only by entities organized under non-US law.

8 The Proposal only addresses when a transaction will be deemed to have been conducted pursuant to section 4(c)(9). To date, FRB has applied the authority contained in section 4(c)(13) solely to the foreign activities of US banking organizations, which are unable to rely on the foreign trading exemption. Trading would be deemed to have been conducted under section 4(c)(9) if (i) in the case of a covered banking entity that is a foreign banking organization, the banking entity is a qualifying foreign banking organization ("QFBO") and is conducting the purchase or sale in compliance with subpart B of Regulation K (12 C.F.R. 211.20 et seq.); or (ii) in the case of a covered banking entity that is not a foreign banking organization, the covered banking entity meets a new test set forth in the Proposal that mirrors the existing QFBO test but does not require such a foreign entity to demonstrate that more than half of its business is banking conducted outside the United States.

- **Trading "Solely" Outside the United States.** Under the Proposal, trading would be deemed to occur solely outside of the United States only if four criteria are satisfied:

  The banking entity conducting the purchase or sale is not organized under the laws of the United States (or a state);

  No party to the purchase or sale is a resident of the United States, as defined in the Proposal;

  No personnel of the banking entity "directly involved" in the purchase or sale are physically located in the United States; and

  The purchase or sale is executed wholly outside of the United States.

According to the preamble, these criteria—which reflect a narrow interpretation of the foreign trading exemption in section 13—are intended to ensure that a transaction executed in reliance on the foreign trading exemption does not involve US counterparties, US trading personnel, US execution facilities, or risks retained in the United States.

A US resident is defined for purposes of section 13 as:

- Any natural person resident in the United States;
- Any partnership, corporation, or other business entity organized or incorporated under US law;
- Any estate of which any executor or administrator is a US resident;
- Any trust of which any trustee or beneficiary is a US resident;
- Any agency or branch of a non-US entity located in the United States;
- Any discretionary or non-discretionary account or similar account held by a dealer or fiduciary for the benefit or account of a US resident;
- Any discretionary account or similar account held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a US resident; or
- Any partnership or corporation organized or incorporated under the laws of any non-US jurisdiction formed by or for a US resident principally for the purpose of engaging in proprietary trading or covered fund activities pursuant to the exemptions provided for non-US trading and non-US covered fund activities.

The final prong of the US resident definition is likely intended to operate as an anti-evasion measure, essentially preventing US residents (or persons acting on their behalf) from establishing companies in non-US jurisdictions "principally" in order to trade with non-US banking entities solely outside of the United States. It and the other definitional elements are patterned after those used to define "US Person" under the SEC's Regulation S.

GOVERNMENT SECURITIES

The Proposal would permit a banking entity to purchase or sell a covered financial position that is a US government or agency obligation, an obligation, participation, or other instrument of or issued by a government-sponsored enterprise ("GSE") or Federal Home Loan Bank, or an obligation issued by any state or any political subdivision thereof. Pass-through or participation certificates issued and guaranteed by GSEs in connection with their securitization activities would be covered by the exemption. Foreign government securities would not be eligible for this exemption.

TRADING ON BEHALF OF CUSTOMERS

The Proposal would permit a banking entity to purchase or sell a covered financial position on behalf of customers in only three situations:

- The purchase or sale (i) is conducted by a banking entity acting as investment adviser, commodity trading adviser, trustee, or in a similar fiduciary capacity for a customer, (ii) is conducted for the account of the customer, and (iii) involves only covered financial positions beneficially owned by the customer;
- The banking entity is acting as riskless principal in a customer-driven transaction; or
- The banking entity is a regulated insurance company that purchases or sells a covered financial position for a separate account of policyholders.

TRADING BY A REGULATED INSURANCE COMPANY

The Proposal also permits a banking entity that is a regulated insurance company, or its affiliate, to purchase or sell a covered financial position for the insurance company's general account, subject to certain conditions. Among other things, a banking entity relying on this exemption must be regulated by a state or foreign insurance regulator, and its trading activity must be conducted in compliance with, and subject to, insurance company investment laws and regulations.

Reporting and Recordkeeping Requirements for Trading Activities

As noted above, the Proposal would require banking entities that are Significant Trading Entities to comply with quantitative measurement, recordkeeping, and reporting requirements set forth in Appendix A of the Proposal. Specifically, a banking entity would be a Significant Trading Entity subject to Appendix A if the banking entity, together with its affiliates and subsidiaries, has trading assets and liabilities the average gross sum of which, on a worldwide consolidated basis, is equal to or greater than $1 billion.[9] Entities that do not meet this threshold would not be subject to Appendix A.

9 The test for determining whether a banking entity is a Significant Trading Entity and thus subject to Appendix A applies globally not only to US banking entities, but also to non-US banking entities.

The Proposal would adopt a tiered approach that requires banking entities with total trading assets of $5 billion or more to report the largest number of quantitative measurements, while banking entities with less significant trading activities (i.e., between $1 billion and $5 billion) would have fewer or no reporting requirements. Banking entities with gross trading assets and liabilities of $5 billion or more would report quantitative measurements for all trading units engaged in trading activity pursuant to the exemptions for underwriting, market making, risk-mitigating hedging activities, and trading in certain government obligations. Banking entities with gross trading assets and liabilities between $1 billion and $5 billion would report quantitative data only for trading units engaged in market making related activities, and would be required to report only a subset of the quantitative measurements required of banking entities with larger volumes of trading activity.

The quantitative measurement and reporting of trading activity, which is to be done at the "trading unit" level, is intended to assist banking entities and the regulators in determining whether trading activity is consistent with permitted trading activities in scope, type, and profile, or consistent with prohibited proprietary trading. In addition, the requirements are intended to help identify trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. The Proposal does not include numerical thresholds that would trigger further review of a banking entity's proprietary trading activities, but the Agencies have requested comment on whether such thresholds should be adopted.

Limitations on Permitted Trading Activities

Notwithstanding the exemptions provided for permitted trading activities, the Proposal implements section 13 by not permitting any transaction, class of transactions, or activity—including a permitted activity—to the extent that it would (i) involve a material conflict of interest between the banking entity and its clients, customers or counterparties,[10] (ii) result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy, or (iii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

The preamble identifies several examples of material conflicts of interest that may arise in connection with permitted trading activities. A banking entity's improper use in its trading operations of nonpublic information about a particular company acquired through its lending, investment advisory, or underwriting activities is one example. Where a material conflict of interest exists, the transaction would be prohibited even if otherwise eligible for a trading exemption, unless the banking entity effectively mitigates the conflict through (i) timely and effective disclosure, or (ii) informational barriers.

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10 The SEC has separately issued proposed new Rule 127B under the Securities Act of 1933 to implement the prohibition under section 621 of the Dodd-Frank Act on material conflicts of interest in connection with certain securitizations. Rule 127B includes exceptions for certain risk-mitigating hedging and *bona fide* market-making activities. The SEC also requested comments on whether the treatment of risk-mitigating hedging activities and market-making related activities in Rule 127B should be consistent with or differ from the Volcker Rule. We expect that the Agencies will try to harmonize the definitions of these exceptions in the final rules.

The Agencies believe risks of material conflicts of interest are of particular concern in the context of complex, structured transactions or those involving illiquid or difficult-to-value assets. However, the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a material conflict of interest with respect to transactions related to *bona fide* underwriting, market making, risk-mitigating hedging or other permitted activities, assuming the activities are conducted in a manner that is consistent with the Proposal and applicable securities and banking laws and regulations.

Under the Proposal, "high-risk asset" is defined as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. "High-risk trading strategy" is defined as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.

Prohibition Against Covered Fund Activities

The Proposal would generally prohibit or restrict a banking entity from investing in, sponsoring, or having certain relationships with, a covered fund. Specifically, the Proposal implements the provisions in section 13 of the BHCA that:

- Prohibit a banking entity from sponsoring or acquiring "ownership interests" in a private equity fund or a hedge fund (defined as a "covered fund" in the Proposal);
- Provide certain exemptions from this prohibition; and
- Prohibit a banking entity from making loans or entering into other "covered transactions" with a covered fund for which a banking entity acts as sponsor, *investment manager* or *investment adviser*, and require that any permitted transactions with covered funds be on "market terms."[11]

COVERED FUNDS

Under the Proposal, a "covered fund" is any issuer that relies solely on the section 3(c)(1) or 3(c)(7) exclusion from the definition of "investment company" under the Investment Company Act of 1940 (the "1940 Act"). An issuer that appropriately relies on any other exclusion from the definition of investment company under the 1940 Act would not be a covered fund, even if it could also rely on 3(c)(1) or 3(c)(7).[12] Accordingly, funds that can rely on exemptions like section 3(c)(5)(C) or Rule 3a-7 under the 1940 Act, or that do not come within the definition of "investment company" (e.g., because the fund invests solely in owned real estate), would not be covered funds. In addition, SEC-registered investment companies would not be covered funds.

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11 "Covered transactions" in this context generally include loans to funds, purchases of fund assets or securities, or financial guarantees to, or on behalf of, funds.

12 An issuer that could qualify for multiple exclusions from the definition of "investment company" would be free to choose an exclusion other than 3(c)(1) or 3(c)(7) to avoid designation as a covered fund.

The exception to this rule would be any fund that is designated by regulation as a "**similar fund**." The Proposal identifies **commodity pools** and the **foreign equivalent** of any entity identified as a covered fund as "similar funds" that would also be subject to the Volcker Rule, even though they may not need to rely on section 3(c)(1) or section 3(c)(7).

With respect to equivalent foreign funds, the Proposal would reach issuers that are organized or offered outside the United States and that *would be* investment companies but for section 3(c)(1) or 3(c)(7) of the 1940 Act, if the issuer's securities were "offered to one or more residents, of the United States." Accordingly, this would seem to capture all foreign funds that, if they were subject to the 1940 Act, would need to rely on sections 3(c)(1) or 3(c)(7), possibly including foreign funds registered for public sale in their home jurisdiction.

OWNERSHIP INTERESTS

The Proposal defines "ownership interest" to mean any equity, partnership, or other similar interest (including equity security, warrant, option, general and limited partnership interest, or other similar interest) in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. The proposed definition focuses on the attributes of the interest and whether it would provide a banking entity with economic exposure to the profits and losses of a covered fund. Accordingly, to the extent a debt security or other interest of a covered fund exhibits substantially the same characteristics as an equity or other ownership interest, such an instrument would be considered an ownership interest. **Carried interest** (i.e., interest received as performance compensation) is not included in the definition of ownership interest, provided that it is received as compensation for services rendered to the fund (for example, by an investment adviser), and certain other conditions are met.

DEFINITIONS OF SPONSORSHIP AND TRUSTEE

Under the Proposal, the definition of "**sponsor**" focuses on the ability to control decision-making and operational functions of the fund. A sponsor would include an entity that: (i) acts as a general partner, managing member, trustee, or commodity pool operator of a covered fund, (ii) in any manner selects or controls a majority of the directors, trustees, or management of a covered fund, or (iii) shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes. A "**trustee**" includes any banking entity that directs the actions of a directed trustee, or any person who possesses authority or discretion to manage and control the assets of a covered fund. However, the term sponsor excludes directed trustees and any other trustee that does not exercise investment discretion.

Permitted Covered Fund Activities

As with the ban on proprietary trading, the Proposal identifies certain covered fund activities and investments that are permitted subject to regulatory restrictions. These include exemptions for certain asset-backed securities activities, the use of certain corporate vehicles, traditional asset management and advisory businesses involving covered funds, fund activities conducted "solely" outside of the United States by non-US banking entities, investments in Small Business Investment Companies

("SBICs") and other public interest fund vehicles, risk-mitigating investments in covered funds, and exemptions for certain activities determined to protect safety and soundness and the financial stability of the United States.

The Proposal would exclude from the scope of the general prohibition the acquisition or retention of an ownership interest in a covered fund held by (i) a banking entity in a **fiduciary** capacity, (ii) a banking entity in its capacity as a **custodian**, **broker**, or **agent** for an unaffiliated third party; (iii) certain **qualified employee benefits plans** under ERISA,[13] or (iv) a **director or employee of a banking entity** in his or her personal capacity who is directly engaged in providing advisory or other services to the covered fund, provided that the banking entity does not extend credit for the acquisition of such ownership interest.

EXEMPTIONS FOR JOINT VENTURES, ACQUISITION VEHICLES, AND LIQUIDITY MANAGEMENT SUBSIDIARIES

The Proposal would exempt from the general prohibition an ownership interest in, or acting as sponsor to, the following common corporate organizational vehicles that may fall within the definition of "covered fund":[14]

- A **joint venture**, in the form of an operating company (an undefined term), that would not engage in any activity or investment prohibited by the Volcker Rule;
- An **acquisition vehicle** used solely to effectuate an acquisition or merger of one entity with or into the banking entity or one of its affiliates;
- A wholly-owned subsidiary of the banking entity that (i) engages principally in providing *bona fide* **liquidity management** services (described above on page 5), and (ii) is carried on the balance sheet of the banking entity; and
- A covered fund that is an issuer of asset-backed securities, the assets of which are solely comprised of loans, contractual rights or assets directly arising from those loans, and certain related derivatives.[15]

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13 Section 401 of the Internal Revenue Code of 1956 (26 U.S.C. § 401); section 2(g)(2) of the BHCA (12 U.S.C. § 1841(g)(2)).

14 The Proposal gives effect at least in part to legislative history of the Dodd-Frank Act, which identifies certain common corporate structures that Congress did not intend to be captured by the prohibition. 56 CONG. REC. H5226 (daily ed. June 30, 2010) (colloquy between Barney Frank, Chairman of the House Financial Services Committee (D-MA) and Rep. James Himes (D-CT)). The study conducted by FSOC noted that the general definition appeared to sweep in "a wide variety of funds and other legal entities that rely on the exclusions" that are used by the statute to define hedge funds and private equity funds, "including special purpose acquisition vehicles and certain ERISA qualified employee pension funds." FSOC, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds (January 18, 2011), at 61. The Proposal also seeks comment on whether venture capital funds should be excluded from the definition of "covered fund."

15 This exemption augments the authority regarding the sale and securitization of loans discussed below on pages 20-21 and permits a banking entity to hold an ownership interest in securitization vehicles that the banking entity does not organize and offer, or for which it does not act as sponsor.

ASSET MANAGEMENT EXEMPTION

A banking entity may organize and offer a covered fund if the following eight conditions are satisfied:

- The banking entity provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.[16]
- The covered fund is organized and offered only in connection with such services and only to **customers** of the banking entity. The preamble to the Proposal provides that the customer relationship does not need to be pre-existing for purposes of the exemption. The Proposal requires the banking entity to develop a credible plan outlining how it intends to provide the advisory or other services to its customers through organizing and offering the fund.
- Any ownership interest in the covered fund held by a banking entity (or one of its subsidiaries or affiliates) in connection with organizing or offering the covered fund must be *de minimis* (discussed below).
- The banking entity complies with the restrictions on covered transactions under section 23A of the Federal Reserve Act ("FRA"), and certain requirements (including the "market terms" requirement) of section 23B (discussed below).
- The banking entity may not guarantee or otherwise insure the performance of the covered fund.
- The covered fund may not share the name of the banking entity, or use the word "bank" in its name.
- Only those directors/employees directly engaged in providing advisory or other services to the covered fund may take an ownership interest in the covered fund.
- The banking entity makes certain disclosures to investors in the covered fund, including that its liability is limited to those losses attributable to its ownership interest in its capacity as investor.

DE MINIMIS INVESTMENTS IN COVERED FUNDS

Banking entities are permitted to make investments in the covered funds that they organize and offer to their customers under the asset management exemption for purposes of either: (i) establishing the covered fund and providing it with initial equity, or (ii) making a *de minimis* investment in the covered fund.[17] Such an investment is subject to three principal limitations. **First**, a banking entity's investment in a single covered fund is limited to 3 percent of the total outstanding ownership interests of such fund. A banking entity may only exceed the 3 percent per fund limit for purposes of

16 The proposal does not specify what services would qualify as *bona fide* fiduciary services. Instead, it largely restates the language of section 13(d)(1)(G)(i) of the BHCA and "reflects the intention that so long as a banking entity provides trust, fiduciary, investment advisory, or commodity trading advisory services..., the requirements of the rule would generally be deemed to be satisfied."

17 A banking entity must organize and offer any covered fund in which it invests.

establishing a fund and providing the fund with sufficient initial equity.[18] Additionally, the regulation requires a banking entity to actively seek unaffiliated investors to reduce its ownership interest following establishment of a fund. **Second**, no more than 3 percent of the losses of a covered fund may be attributed to the banking entity. **Third**, the aggregate value of all ownership interests held by a banking entity in all covered funds may not exceed 3 percent of its tier 1 capital.

- **Per Fund Investment Limit.** The Proposal requires a banking entity to determine its compliance with the 3 percent per fund investment limit based on the value of the banking entity's investment in a covered fund (the numerator), divided by the amount of all ownership interests held in that covered fund (the denominator). For purposes of this calculation, the numerator includes (i) any interests in the fund held directly by the banking entity or through any entity controlled, directly or indirectly, by the banking entity, plus (ii) the amount of any covered fund held by any entity (other than certain operating companies) that is not controlled by the banking entity but in which the banking entity owns, controls, or holds the power to vote more than 5 percent of the voting shares. Calculation of a banking entity's ownership interest in a covered fund must be determined no less frequently than at the end of every quarter.
- **Aggregate Permitted Investments in All Covered Funds.** The aggregate limitation on investments in all covered finds may not exceed 3 percent of the tier 1 capital of a banking entity, as reported at the end of the most recent calendar quarter. For purposes of this calculation, a depository institution that reports tier 1 capital (or a subsidiary thereof) generally must apply the tier 1 capital of the depository institution. Bank holding companies and their subsidiaries would be required to use the bank holding company's tier 1 capital. In the case of depository institution that calculates and reports its own tier 1 capital and is a subsidiary of a BHC, the aggregate of all investments in all covered funds held by the depository institution (including investments by its subsidiaries) may not exceed 3 percent of either the tier 1 capital of the depository institution or of the BHC. Reporting companies other than BHCs that control an insured depository institution would use the tier 1 capital of the top-tier reporting entity in the organization. Finally, banking entities that do not report tier 1 capital and are not controlled by a depository institution, a BHC, or a company treated as a BHC would calculate the 3 percent limit based on the total amount of the top-tier parent company's shareholders' equity on a consolidated basis.
- **Capital Deduction.** The Proposal would require that any amounts invested in covered funds organized and offered by a banking entity be deducted dollar for dollar from tier 1 capital.

18 A banking entity's ownership interest may not exceed 3 percent one year after the date of establishment of the fund (unless a longer time period, up to two additional years, is granted by FRB).

INVESTMENTS IN COVERED FUNDS FOR RISK-MITIGATING HEDGING PURPOSES

The Proposal would permit a banking entity to acquire and retain ownership interests in a covered fund for hedging purposes in two situations: (i) when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, and (ii) to cover a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund. A banking entity must satisfy numerous requirements in order to engage in such activities, the majority of which are substantially similar to those imposed for purposes of permissible hedging activities in the proprietary trading context discussed above on pages 10-11. The requirements include, among others: (i) that the transaction is designed to reduce the specific risks to the banking entity in connection with the position taken, (ii) greater equivalency between the reference asset and hedging instrument than the correlation required under the proprietary trading exemption, and (iii) that the banking entity must establish a contemporaneous record documenting the risk-mitigating purposes of the transaction and identifying the risks that the transaction is designed to reduce.

EXEMPTION FOR COVERED FUND ACTIVITIES CONDUCTED SOLELY OFFSHORE

Certain qualifying non-US banking entities that are not directly or indirectly controlled by a US banking entity would be permitted to acquire or retain an ownership interest in, or act as sponsor to, a covered fund if such activity occurs “solely outside of the United States.” Under the Proposal, an activity occurs “solely outside of the United States” if:

- The banking entity engaging in the activity is not organized under the laws of the United States;
- No subsidiary, affiliate, or employee of the non-US banking entity involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and
- No ownership interest is offered for sale or sold to a resident of the United States.

Accordingly, covered funds sponsored by non-US banking entities that meet these conditions would not be affected by the Volcker Rule’s general prohibition on investing in or sponsoring covered funds. However, non-US banking organizations that utilize US operations in connection with covered fund activities directed outside of the United States (e.g., providing fund services to Latin America from the United States) would be subject to the Proposal’s general prohibition. The preamble notes, however, that the provision of administrative services to a fund (e.g., clearing, settlement, or recordkeeping) by a US employee incident to permitted foreign fund investments would be permitted.

SALE OR SECURITIZATION OF LOANS AND OTHER ASSET-BACKED SECURITIES EXEMPTIONS

The Proposal would permit:

- A banking entity to hold an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of:

(i) loans, (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities, and (iii) interest rate or foreign exchange derivatives that materially relate to the loans or contractual rights or assets and that are used solely for hedging purposes. Investment or sponsorship pursuant to this exemption would not be subject to the *de minimis* or other limitations imposed in connection with the asset management exemption. However, the types of derivatives that may be included in the assets of the issuer is limited (i) quantitatively, to include only those derivatives where the notional amount of the derivative is tied to the outstanding principal balance of the loans supporting the asset-backed securities of such issuer, either individually or in the aggregate, and (ii) functionally, solely to hedge risks that result from a mismatch between the loans and the related asset-backed securities. According to the preamble, **credit default swaps** would not be permitted.

- A banking entity to hold an ownership interest in, or act as sponsor to, an issuer of asset-backed securities, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a "securitizer" or "originator."[19] This exemption would ensure that the Volcker Rule is consistent with the risk retention requirements adopted by the SEC.

FINANCIAL STABILITY AND SAFETY AND SOUNDNESS EXEMPTION

The Proposal would permit banking entities to acquire or retain an ownership interest in, or act as sponsor to, certain **bank owned life insurance** ("**BOLI**") separate accounts, provided that the banking entity that purchases the insurance policy (i) may not control the investment decisions regarding the underlying assets or holdings of the separate account, and (ii) must hold its ownership interests in the separate account in compliance with applicable supervisory guidance. In addition, a banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund in the ordinary course of collecting a **debt previously contracted** in good faith.

SBICs

The Proposal would also permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, one or more SBICs, a public welfare investment, or certain qualified rehabilitation expenditures.

Limitations on Relationships with Covered Funds

The Proposal implements section 13(f) of the BHCA, which generally prohibits a banking entity from entering into a "covered transaction," as defined under section 23A of the FRA, with a covered fund for which the banking entity or any affiliate acts as investment manager, investment adviser, sponsor or commodity trading advisor, or that the banking entity or its affiliate organizes or offers pursuant to

19 This category of permitted investment in a covered fund implements a separate requirement added by section 941 of the Dodd-Frank Act (codified as section 15G of the Exchange Act, 15 U.S.C. 78o-11), which requires a banking entity to maintain a certain minimum interest in certain sponsored or originated asset-backed securities.

the asset management exemption (so-called "Super 23A"). This prohibition goes beyond the scope of the general prohibition on investing in and sponsoring a covered fund in that it also applies to funds advised by the banking entity. Covered transactions broadly include loans and extensions of credit to, purchases of assets from, investments in securities issued by, and financial guarantees on behalf of, an affiliate. The definition also includes certain other transactions that expose the bank to the credit or investment risks of the covered fund.

The Proposal would not incorporate the exemptions for certain types of covered transactions under section 23A (e.g., intraday extensions of credit) and would therefore be more restrictive than section 23A as ordinarily applied. In addition, the Proposal would not incorporate the attribution rule, 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.

The Proposal does not generally exempt from Super 23A transactions with covered funds that are otherwise permissible for banking entities to invest in or sponsor. However, the Proposal does provide that a banking entity may acquire or retain an ownership interest in a covered fund (including an interest in securities issued by a related covered fund) that is permissible in accordance with the other provisions of the Proposal, even though the purchase of securities would be a covered transaction.

The Proposal would also apply the "market terms" and other requirements of section 23B of the FRA to permissible transactions (i.e., non-covered transactions) between a banking entity and a covered fund for which it serves, directly or indirectly, as investment manager or adviser, or which it sponsors or organizes and offers, as if such banking entity were a member bank and such covered fund were an affiliate thereof.

Prime brokerage transactions between a banking entity and a covered fund in which a covered fund managed, sponsored, or advised by such banking entity pursuant to the asset management exemption has taken an ownership interest would also be permitted, subject to section 23B.[20]

Limitations on Permitted Covered Fund Activities

As noted above, the Proposal would prohibit a banking entity from engaging in permitted activities to the extent such activities would involve a material conflict of interest, result in a material exposure of the banking entity to high-risk assets or trading strategies, or pose a threat to the banking entity's safety and soundness or US financial stability. These limitations apply with respect to permitted covered funds activities to the same extent as permitted trading activities.

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20 The Proposal defines a "prime brokerage transaction" as one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.

Section 13 Compliance Requirements

The Proposal requires certain banking entities to establish and maintain a program designed to ensure and monitor compliance with both the prohibitions and restrictions on covered trading activities and covered fund activities and investments. The Proposal adopts a tiered approach to implementing the compliance program mandate depending on a banking entity's level of covered activity.

BANKING ENTITIES WITH NO COVERED ACTIVITIES

A banking entity that does not engage in covered trading activities and covered fund activities and investments would be required to adopt compliance policies and procedures designed to prevent the banking entity from becoming engaged in such activities and making such investments.

MINIMUM COMPLIANCE REQUIREMENTS FOR BANKING ENTITIES ENGAGED IN COVERED ACTIVITIES

A banking entity engaged in covered trading activities or covered fund activities and investments would be required to establish, maintain, and enforce a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on such activities and investments. At a minimum, the required compliance program would be required to address the following six elements:

- Written policies and procedures to ensure compliance;
- Internal controls to identify noncompliance;
- A framework delineating management accountability;
- Independent testing for effectiveness;
- Training for appropriate personnel; and
- Recordkeeping and maintenance of records for at least five years.

Each banking entity would be expected to tailor a compliance program that is suitable for its size, scope, and complexity.

The Proposal does not require the CEO of a banking entity to certify the effectiveness of the bank's compliance procedures, as had been recommended by the FSOC study, but it does request comment on this issue.

ADDITIONAL COMPLIANCE REQUIREMENTS FOR BANKING ENTITIES WITH SIGNIFICANT COVERED ACTIVITIES

A banking entity with significant covered trading activities or covered fund activities and investments would be required to meet additional compliance standards specified in Appendix C of the Proposal. A banking entity must comply with the standards specified in Appendix C under two circumstances:

- If, with respect to its covered trading activities, the banking entity has, together with its affiliates and subsidiaries, aggregate trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is equal to or greater than $1 billion or equals 10 percent or more of its total assets; or
- If, with respect to its covered fund activities and investments, the banking entity either (i) has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds the average value of which is equal to or greater than $1 billion or (ii) sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds the average total assets of which are equal to or greater than $1 billion.

Appendix C incorporates by reference the six elements that must be included in the compliance program for all entities engaged in covered activities (described above). In addition, Appendix C would require a banking entity with significant covered trading activities or significant covered fund activities and investments to (i) craft internal policies and procedures detailing the scope of its covered activities and the manner in which such activities are conducted, (ii) adopt internal controls that identify and monitor its investments in, and relationships with, covered funds and incorporate the quantitative measurements calculated and reported under Appendix A, as well as other analysis and measurements specifically tailored to the business, risks, practices, and strategies of its trading units, (iii) set an appropriate "tone at the top," and (iv) perform enhanced independent testing, training for employees, and recordkeeping.

Effective Dates

The proprietary trading and covered fund activities restrictions of section 13 take effect on July 21, 2012. In addition, the preamble states that banking entities will be expected to comply with the recordkeeping and reporting requirements set forth in the Proposal (and Appendices thereto), as applicable, beginning on the July 21, 2012 effective date. Banking entities will generally have an additional two years (i.e., until July 2014) to conform activities and investments. The preamble indicates that the Agencies will expect banking entities to fully conform all investments and activities as soon as practicable after the conformance period begins.

Extraterritoriality

The Volcker Rule, as implemented by the Proposal, has significant extraterritorial impacts on both US and non-US banks.

US BANKING ENTITIES

The Volcker Rule imposes its prohibitions on the global operations and affiliates of banking entities for which the top-tier company is a US entity. The global operations will be subject to the full programmatic compliance program detailed in the Proposal. Non-US covered funds that might be exempt form the 1940 Act because they have no US contacts can still be picked up by the covered funds prohibition if the they are the foreign equivalent of a US fund that relies on sections 3(c)(1) or

3(c)(7) of the 1940 Act. Moreover, US-based banking entities will not enjoy the exemption for proprietary trading or covered funds activities conducted solely offshore.

The Volcker Rule thus creates a strong incentive for US banking entities engaged in covered activities to explore the legal, reputational, and cost ramifications in restructuring their operations to be based outside the United States, or to exit the banking business in the United States. Restructuring to move offshore could have major impacts on US jobs and markets.

NON-US BANKING ENTITIES

Although non-US banking entities may take advantage of the exemptions for activities conducted solely outside the United States, the Proposal would have a significant extraterritorial impact on such entities due to the highly restrictive nature of these exemptions. For example, the prohibition on engaging in proprietary trading activities with US residents (including non-US affiliates established by US residents for the purpose of trading) will disrupt the normal non-US trading, market making, underwriting, and hedging activities of non-US banks. Moreover, the prohibition on the use of US-based execution facilities would, if interpreted broadly, prohibit non-US banks from engaging in non-US trading that requires execution on a US exchange. In addition, the restrictions on covered transactions may apply to transactions offshore with non-US covered funds.

Moreover, the non-US operations of non-US banks will also be subject to massive compliance burdens under the Volcker Rule. First, compliance with the conditions that trading be conducted solely outside the United States will require implementation of detailed compliance policies and procedures on a global basis. Second, to the extent that non-US banks engage in market making and other permitted activities outside the United States with US counterparties, such entities will have to comply with the programmatic compliance regimes required by the Proposal that apply to US banks and the US operations of non-US banks.

ABCP Conduits and Other Securitization Vehicles

The covered funds prohibitions raise a number of particular issues for the use by banking entities of securitization vehicles such as ABCP conduits or issuers of asset-backed securities. The issues are (i) whether the banking entity is prohibited from sponsoring or investing in ownership interests in securitization vehicles if they are covered funds, (ii) whether the banking entity will be subject to the covered transactions prohibitions (i.e., Super 23A) with respect to transactions with securitization vehicles for which it acts as sponsor or investment adviser,[21] and (iii) whether

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21 As discussed above, the Proposal would prohibit a banking entity from entering into a "covered transaction" for Super 23A purposes with an ABCP conduit or securitization vehicle that is a covered fund for which the banking entity or any affiliate acts as an investment adviser, investment manager, or sponsor. In addition, the market terms requirements of section 23B would apply to any transaction between a banking entity and such a conduit or securitization vehicle. In this section we discuss Super 23A and not traditional section 23A, which would, of course, apply to any securitization vehicle that is an affiliate under section 23A.

The Super 23A prohibitions, when applicable, could pose significant problems in the securitization context, where sponsoring banks typically provide support to issuers in various ways that would constitute Super 23A covered transactions. For example, this prohibition would preclude a banking entity from extending credit (e.g., making servicing advances or providing liquidity securitization vehicles themselves are "affiliates" of banking entities subject to the Volcker prohibitions in (i) and (ii). We have summarized below the status of various securitization vehicles based on their treatment under the 1940 Act.

ISSUERS THAT MAY RELY ON 1940 ACT EXEMPTIONS OTHER THAN SECTIONS 3(c)(1) OR 3(c)(7)

- An issuer that can rely on a 1940 Act exemption other than sections 3(c)(1) or 3(c)(7) of the 1940 Act—e.g., section 3(c)(5) or Rule 3a-7—would not be a covered fund. Thus, banking entities could invest in and sponsor such vehicles.
- The banking entity would not be subject to the Super 23A covered transactions prohibitions under the Volcker Rule with respect to transactions with such securitization vehicles because they are not covered funds.
- However, if such a securitization vehicle were an affiliate of the sponsoring banking entity, the securitization vehicle itself would be treated as a banking entity subject to the ban on proprietary trading and the investment in or sponsorship of covered funds. Under the BHCA definition of affiliate, however, most ABCP conduits and certain securitization vehicles would not be affiliates and therefore would not be banking entities.

ISSUERS THAT MAY RELY ONLY ON THE SECTIONS 3(c)(1) OR 3(c)(7) EXEMPTIONS UNDER THE 1940 ACT AND ARE NOT OTHERWISE EXEMPT FROM THE VOLCKER RULE

- Any securitization vehicle that must rely upon the exemptions in section 3(c)(1) or 3(c)(7) of the 1940 Act would be a covered fund. If the vehicle is not otherwise exempt under the Proposal, banking entities could not invest in or sponsor such a vehicle.
- A banking entity will be subject to the covered transactions prohibitions with respect to transactions with such securitization vehicles that are advised by the banking entity or any affiliate because the vehicles are covered funds.
- Affiliate analysis as to whether the securitization vehicle is a banking entity is not applicable because a banking entity may not sponsor or invest in the covered fund.

ISSUERS THAT MAY RELY ONLY ON THE SECTIONS 3(c)(1) OR 3(c)(7) EXEMPTIONS UNDER THE 1940 ACT BUT ARE EXEMPT UNDER THE LOAN SECURITIZATION EXEMPTION IN THE PROPOSAL

- A banking entity may acquire an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) loans, (ii) contractual rights or assets directly arising from those loans supporting the

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facilities) to a covered fund. Absent a specific exemption from this prohibition, conduits and other securitization vehicles that are covered funds could find it very difficult to operate under the framework set forth in the Proposal.

asset-backed securities, and (iii) interest rate or foreign exchange derivatives that materially relate to the loans or contractual rights or assets and that are used solely for hedging purposes.

- Except with respect to the banking entity's ownership interest, the covered transactions prohibitions under the Volcker Rule would, as currently drafted, appear to apply to transactions by the banking entity with such securitization vehicles that are sponsored or advised by the banking entity or any affiliate because the vehicles are still covered funds.
- If such a securitization vehicle were an affiliate of the sponsoring banking entity, the securitization vehicle itself would be treated as a banking entity subject to the ban on proprietary trading and the investment in or sponsorship of covered funds. Under the BHCA definition of affiliate, however, most ABCP conduits and certain securitization vehicles would not be affiliates and therefore would not be banking entities.

ISSUERS THAT MAY RELY ONLY ON THE SECTIONS 3(c)(1) OR 3(c)(7) EXEMPTIONS UNDER THE 1940 ACT BUT ARE OTHERWISE EXEMPT FROM THE VOLCKER RULE UNDER THE RETAINED INTEREST EXEMPTION IN THE PROPOSAL

- A banking entity also may acquire or retain an ownership interest in, or act as a sponsor to, a covered fund that is an issuer of asset-backed securities with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a "securitizer" or "originator" in accordance with the risk retention requirements of section 941 of the Dodd-Frank Act.
- Except with respect to the retained interest, the covered transactions prohibitions under the Volcker Rule would, as currently drafted, appear to apply to such securitization vehicles that are sponsored or advised by the banking entity or any affiliate because the vehicles are still covered funds.
- If such a securitization vehicle were an affiliate of the sponsoring banking entity, the securitization vehicle itself would be treated as a banking entity subject to the ban on proprietary trading and the investment in or sponsorship of covered funds. Under the BHCA definition of affiliate, however, most ABCP conduits and certain securitization vehicles would not be affiliates and therefore would not be banking entities.

For more information about the proposed regulations or any other matter raised in this Legal Report, please contact any of the following lawyers.

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