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Legal Report

Final Regulation Implementing the Volcker Rule

The US federal financial regulators recently approved the much-anticipated joint final regulation implementing the Volcker Rule, a key element of the 2010 Dodd-Frank financial reform legislation, which is intended to curtail the proprietary trading and private fund activities of US and non-US banking groups. The final regulation represents, in certain respects, a significant improvement upon the proposal released in fall 2011, particularly as it relates to limiting the extraterritorial impact of the regulation on non-US banking organizations. On the other hand, the final regulation leaves important questions from the proposal unresolved and creates new issues of its own, not least among them the manner in which Volcker Rule compliance will be supervised and enforced for complex banking organizations subject to the jurisdiction of multiple US regulators.

This report summarizes the final regulation, including a banking entity's obligations in advance of the termination of the Volcker Rule conformance period, now scheduled for July 2015, and highlights select issues of concern for many financial services firms.

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Final Regulation Implementing the Volcker Rule

Introduction

On December 10, 2013, the five US federal financial regulators (the "Agencies") approved joint final regulations (the "Final Regulation") 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.[1] Section 619 added a new Section 13 to the Bank Holding Company Act of 1956 (the "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 a private equity fund, subject to exemptions for certain permitted activities.

Over 70 pages in rule text and nearly 900 pages of supplementary information (the "Preamble"), the Final Regulation made numerous changes to the regulations proposed in October 2011 (the "Proposal"), which was subject to an unprecedented number of comment letters.[2] These changes address many of the concerns raised in the comment letters, while leaving some questions unanswered and raising a number of new issues. In many respects the Final Regulation is an improvement over the Proposal. For example, the Final Regulation substantially mitigates concerns about the extraterritorial impact of the Volcker Rule, and adopts a more flexible approach to certain key exemptions. On the other hand, some changes will result in a regulation that is potentially more restrictive than the Proposal, such as the requirement for hedging to be tied to "specific, identifiable" risks with ongoing "recalibration" and extensive documentation requirements. This Legal Report provides an initial assessment of the Final Regulation and notes a number of new interpretive issues that will likely need to be clarified by further guidance.

At this early juncture, it is evident that the Final Regulation will place a substantial compliance burden on many banking entities. Moreover, it is not yet clear how the Agencies will ultimately implement the authority to supervise and examine certain banking entities. For example, the CFTC has stated in its release that it will be the primary regulator for registered swap dealers, whereas many swap dealers will

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[1] The Agencies are the Board of Governors of the Federal Reserve System (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"). The FRB, FDIC, OCC, and SEC issued a joint release, and the CFTC issued a separate release with text that, with exceptions noted herein, is generally identical to the joint release; the rule text itself is common to all of the Agencies. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,536 (Jan. 31, 2014) [hereinafter *Joint Release*]; Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,808 (CFTC Jan. 31, 2014). Page number references in the Legal Report are to the Federal Register version of the Agencies' *Joint Release*, unless otherwise indicated.

[2] For a discussion of the Proposal, see our Legal Report available at http://www.mayerbrown.com/files/Publication/a6d43d75-7678-415c-b3b1-c58568822db0/Presentation/PublicationAttachment/5e87615e-2010-416c-a5fe-000fd90af705/11723.PDF.

already be subject to the primary jurisdiction of one of the other Agencies, such as the OCC in the case of national banks and the FRB in the case of foreign banks.[3]

Fortunately, there will be a period of time in which to resolve some of this uncertainty. While the Final Regulation has a technical "effective date" of April 1, 2014, no specific provisions of the Volcker Rule will actually go into effect on that date. Rather, as result of an FRB order issued in connection with the approval of the Final Regulation, the Volcker Rule conformance period has been extended for all banking entities until July 21, 2015 (although certain banking entities with large trading operations will be required to begin reporting trading metrics during the conformance period). The key requirement for all banking entities during the conformance period will be to continue making good faith efforts to be in a position to comply with the Final Regulation by the end of the conformance period. The FRB order includes two specific additions to this general good faith conformance obligation: (i) a directive to "promptly" shut down stand-alone prop trading desks and (ii) a directive "not to expand activities and make investments during the conformance period *with an expectation that additional time to conform those activities or investments will be granted*."[4]

This Legal Report addresses the following topics: the scope of the Final Regulation, in particular the definition of "banking entity" (pages 2–4); the prohibition on proprietary trading and the exemptions thereto (pages 4–14); the prohibition on covered fund activities and the exemptions thereto (pages 14–32); the "Super 23A" prohibition on covered transactions with certain covered funds (pages 33–34); the limitations on permitted activities, including conflicts of interest (pages 34–35); and the extensive compliance program requirements that banking entities are required to implement by the end of the conformance period, including metrics reporting obligations for entities with significant trading activities (pages 35–43).

Banking Entities Subject to the Volcker Rule

The Volcker Rule applies to every "banking entity," which is defined in Section _.2(c)(1) of the Final Regulation as:[5]

(i) **Any Insured Depository Institution**. This includes any bank, thrift, industrial loan company, or other entity the deposits of which are insured by the FDIC.

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3 *See* 79 Fed. Reg. at 5,813 (CFTC release).

4 FRB, "Order Approving Extension of Conformance Period," available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf (emphasis added).

5 Citations in this Legal Report to the text of the Final Regulation adopt the convention employed in the pre-Federal Register publication draft, which is to refer to sections with a "_" preceding the subsection designation, e.g., "Section _.2(c)(1)." Each Agency will ultimately use its own section designation based on where the Final Regulation appears in its section of the Code of Federal Regulations. The subsection numbers should be consistent for all of the Agencies.

(ii) **Any Company That Controls an Insured Depository Institution**. This includes any bank holding company ("BHC"), any savings and loan holding company ("SLHC"), and any foreign bank or company that has a US insured depository institution subsidiary.

(iii) **Any Company Treated as a BHC for purposes of the International Banking Act of 1978 (the "IBA")**. This includes any foreign bank that has a US branch, agency, or commercial lending company subsidiary and the parent company of such a foreign bank.

(iv) **Any Affiliate or Subsidiary of the Foregoing**. This includes any company, on a global basis, that controls, is controlled by or is under common control with the foregoing, as defined in the BHCA.[6] Thus, it includes, wherever located, broker-dealers, insurance companies, commodities and derivatives firms, investment advisers, investment funds, and any other entity that is affiliated with one of the foregoing entities.

The Final Regulation does *not* apply to financial groups that do not contain a US depository institution or a foreign bank with a US branch or agency.

Exclusion of Covered Funds. Section _.2(c)(2) of the Final Regulation excludes from the definition of banking entity any covered fund that is not itself an insured depository institution, a company that controls an insured depository institution, or a company treated as a BHC under the IBA. Accordingly, covered funds controlled by a banking entity are not prohibited by the Volcker Rule from engaging in proprietary trading or covered fund activities (e.g., investing in other covered funds in a fund of funds structure).

Non-Covered Funds as Banking Entities. A fund that is *not* a covered fund, including any entity that is excluded from the definition of covered fund by Section _.10(c) of the Final Regulation (discussed below, pages 17-21), would be a banking entity subject to all of the restrictions of the Volcker Rule if it is affiliated with a banking entity for BHCA purposes. The Preamble confirms that SEC-registered investment companies and SEC-regulated business development companies would not be considered subsidiaries or affiliates of a banking entity "solely by virtue of being advised or organized, sponsored and managed by a banking entity in accordance with the BHCA."[7] It also notes FRB precedents that certain director/officer interlocks with and investments in less than 25 percent of the voting shares of such SEC-regulated funds would not constitute control. However, to the extent that other entities covered by the Section _.10(c) exclusions may be controlled by a banking entity, these excluded entities—which might include, for example, securitization vehicles and asset-backed commercial paper ("ABCP") conduits that

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[6] Under the 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.

[7] *Joint Release* at 5,676.

are bank affiliates—would themselves be prohibited from engaging in proprietary trading or covered fund activities unless a specific Volcker Rule exemption is available.

Exclusion of Merchant Banking Investments. A portfolio company held pursuant to merchant banking authority under the BHCA is not a covered fund, nor is any "portfolio concern" controlled by a small business investment company ("SBIC") as defined in the Small Business Investment Act of 1958, unless such portfolio entities trigger any of the first three definitions of banking entity listed above.[8]

Nonbank Financial Companies Supervised by the FRB. Section 13 of the BHCA authorizes the FRB to impose additional capital requirements, quantitative limits and other restrictions with respect to proprietary trading and covered fund activities on nonbank financial companies that are not "banking entities," but that become subject to FRB supervision upon designation by the Financial Stability Oversight Council (the "FSOC") as systemically important financial institutions ("SIFIs"). The Final Regulation does not address the extent to which the Volcker Rule restrictions might be applied to SIFIs.

Proprietary Trading Activities

Prohibition on Proprietary Trading

Section 13 of the BHCA broadly prohibits any banking entity from engaging in proprietary trading. Section _.3(a) of the Final Regulation defines "proprietary trading" as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."[9] In rejecting many of the requests in the comment letters that the proposed definitions of proprietary trading, trading account, and financial instrument be narrowed, the Agencies generally take the view that these concerns are best addressed in the context of the exclusions and exemptions from proprietary trading.

Definition of "Financial Instrument"

The Final Regulation replaces the term "covered financial position" used in the Proposal with the term "financial instrument," but defines it in substantially the same manner. A financial instrument includes any security, any derivative,[10] any contract of sale of a commodity for future delivery, and any option on

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8 In addition, the Final Regulation excludes the FDIC acting in a corporate capacity or as a conservator or receiver.

9 The Final Regulation defines what is a "purchase" and "sale" for a variety of financial instruments. For example, with respect to a derivative, purchases and sales include the execution, termination (prior to scheduled maturity), assignment, exchange, or similar conveyance of, or extinguishing of rights or obligations under, as derivative, as context may require.

10 The definition of "derivative" in the Final Regulation is substantively unchanged from the Proposal. Among other things, it excludes any "identified banking product" as defined in the Legal Certainty for Bank Products Act of 2000. The Agencies declined to adopt the suggestion of many commenters that foreign exchange swaps and forwards that are generally exempt from the definition of "swap" under Title VII of the Dodd-Frank Act also be excluded from the definition of "derivative" and, thus, be treated as non-financial instruments for Volcker Rule purposes.

any of the foregoing instruments. The definition of financial instrument specifically excludes loans (including any leases, extensions of credit, or secured or unsecured receivables that are not securities or derivatives), certain commodities (i.e., those defined as excluded commodities under the Commodity Exchange Act of 1936 (the "CEA")), and foreign exchange or currency. In this context, "foreign exchange or currency" is not further defined or interpreted by the Agencies.

Definition of "Trading Account"

Substantially as proposed, Section _.3(b) of the Final Regulation adopts a three-pronged definition of "trading account," and an activity need only fall within one prong of the definition to constitute proprietary trading.

Intent Test. The Final Regulation first defines the trading account as any account used to buy or sell a financial product principally for the purposes of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging positions resulting from any of the above transactions.

Market Risk Capital Rule Test. The trading account also includes any account used for the purchase or sale of a financial instrument that is both a "covered position" for purposes of the US market risk capital rule and a "trading position" (including hedges of those positions). This test applies to any banking entity that is, or that has an affiliate that is, an insured depository institution, BHC, or SLHC that calculates risk-based capital ratios under the market risk rule.

Status Test. The trading account also includes any account used for the purchase or sale of financial instruments by a banking entity that is licensed or registered, or required to be licensed or registered, as a dealer, swap dealer, or security-based swap dealer, and the purchase or sale is being made in connection with the entity's dealing activities. This prong also applies to banking entities engaged in business as a dealer, swap dealer, or security-based swap dealer outside of the United States.

Rebuttable Presumption. The purchase of a financial instrument by a banking entity is presumed to be for its trading account if the banking entity holds the position for fewer than sixty days or substantially transfers the risk of the position within sixty days of the purchase. A banking entity may rebut the presumption by demonstrating that it did not purchase the financial instrument principally for any of the short-term trading purposes described above in connection with the trading account "intent test." There is no opposite presumption for positions held longer than sixty days.

Excluded Activities

Section _.3(d) of the Final Regulation expressly excludes the following activities from the definition of proprietary trading:

Repurchase and Reverse Repurchase Transactions. The proprietary trading ban does not apply to a repurchase or reverse repurchase agreement in which a banking entity has simultaneously agreed,

in writing, to both purchase and sell a stated asset, at stated prices, on stated dates or on demand, with the same counterparty. The Agencies agree that repos are the equivalent of secured loans. The collateral or position that is being financed by a repo, however, is not excluded from the definition of proprietary trading.

Securities Lending and Borrowing. Securities lending and borrowing transactions are not proprietary trading, provided that 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 interest 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. The same rationale and limits apply to securities borrowing and lending transactions as to repos.

Liquidity Management. Securities transactions conducted in accordance with a documented liquidity management plan are also excluded from the definition of proprietary trading, provided that the plan:

(i) Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of the securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may be used;

(ii) Requires that any purchase or sale of securities under the plan be principally for the purpose of managing the liquidity of the banking entity, and not for prohibited short-term trading purposes;

(iii) Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities that the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;

(iv) Limits securities purchased or sold for liquidity management purposes to an amount that is consistent with the banking entity's near-term funding needs, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis, and independent testing to ensure compliance; and

(vi) Is consistent with supervisory requirements, guidance, and expectations regarding liquidity management applicable to the banking entity.

In a footnote, the Agencies state that they plan to construe "near-term funding needs" in a manner consistent with applicable laws, regulations and issuances related to liquidity risk management including

liquidity coverage ratio requirements.[11] They also declined the request of commenters to expand the exclusion to cover asset-liability management activities more generally.

Clearing Organization Transactions. Purchases and sales of financial instruments by a banking entity that is a derivatives clearing organization ("DCO") or a clearing agency are excluded from the definition of proprietary trading, under the rationale that the banking entity provides clearing as a service to third parties and not to profit from short-term resale or short-term price movements.

Clearing Activities. A banking entity may engage in "excluded clearing activities" if the banking entity is a member of a DCO, clearing agency or designated financial market utility. Excluded clearing activities include purchases and sales by a banking entity arising in connection with errors, defaults, or threatened defaults by one or more participants in the clearing process of a DCO, clearing agency, or designated financial market utility.

Trading as Agent, Broker or Custodian. A banking entity purchasing and selling financial instruments solely as an agent, broker, or custodian is not engaged in proprietary trading. The Preamble provides that this exclusion includes agency, brokerage, and custodial transactions on behalf of an affiliate, but notes that the exclusion does not exempt an affiliate on whose behalf transactions are carried out from complying with the Volcker Rule (i.e., to the extent such affiliate is engaged in proprietary trading as principal).

Trading in Satisfaction of Delivery Obligations. The Final Regulation adds an exclusion that permits a banking entity to purchase or sell a financial instrument (i) to satisfy an existing delivery obligation of the banking entity or its customers in connection with delivery, clearing, or settlement activity or (ii) to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding.

Trading on Behalf of Employee Benefit Plans. The Final Regulation permits a banking entity to purchase and sell financial instruments through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity, if the banking entity is acting as trustee acting for the benefit of persons who were or are employees of the banking entity.

Debt Collection Activities. The Final Regulation permits a banking entity to purchase or sell a financial instrument if the banking entity effects the sale or purchase in the ordinary course of collecting a debt previously contracted in good faith, so long as the banking entity divests itself of the financial instrument as soon as practicable and in compliance with its regulator's maximum retention period.

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[11] *See Joint Release* at 5,555 n.242.

Permitted Trading Activities

Permitted Market-Making Activities

The Final Regulation makes substantial revisions to the Proposal in exempting market-making-related activities from the prohibition on proprietary trading. The Agencies have discarded lengthy guidance from the Proposal discussing indicia of market-making in favor of streamlined rule text. Under Section _.4(b) of the Final Regulation, a trading desk, which may operate across one or more legal entities, must "routinely stand ready" to trade and be "willing and available" to quote and otherwise enter into trades "through market cycles" on a basis appropriate given the liquidity, maturity, and market depth of the financial instruments for which it acts as market-maker. This exemption does not require trade-by-trade analyses, but instead a banking entity must monitor (i) "financial exposure"—i.e., the aggregate risks of financial instruments and any associated loans, commodities, or foreign exchange or currency held as part of its market-making-related activities—and (ii) for each trading desk, its "market-maker inventory." Consistent with the Proposal, the amount, types, and risks of the financial investments in the market-maker inventory must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties based on, among other things, demonstrable analysis of historical demand.

In another change from the Proposal, the Final Regulation permits market-making related hedging under Section _.4(b) without requiring a banking entity to separately comply with the risk-mitigating hedging exemption set forth in Section _.5. Moreover, the Proposal would have required market-making to generate revenues primarily from fees, commissions, bid/ask spreads, or other income not attributable to appreciation in value in covered financial positions (or hedges thereto), which a number of comment letters had identified as problematic for certain types of market-making activities. This revenue requirement has not been incorporated in the Final Regulation, although compensation arrangements for market-making personnel must be designed so that they do not reward or incentivize prohibited proprietary trading.

Compliance Obligations. A banking entity relying on the market-making exemption must establish and maintain an appropriate compliance program as required by subpart D of the Final Regulation (discussed below, pages 35–43) that (i) addresses the conditions noted above, including identification of the financial instruments that the trading desk is permitted to buy and sell as market-maker and the products and strategies it may use for risk management purposes; (ii) sets limits for each trading desk based on the desk's market-making activities; (iii) implements controls and ongoing monitoring for compliance with the limits; and (iv) establishes authorization procedures for any trade that would exceed the limits. These compliance requirements generally apply at the "trading desk" level of an organization, and thus will potentially require tailoring depending upon the characteristics of a particular trading desk's activities.

Interdealer Limitation. The Final Regulation defines clients, customers, and counterparties in the context of the market-making exemption to exclude large trading desks of other banking entities—i.e., entities with $50 billion or more in total trading assets and liabilities—unless the trading desk documents

why such an entity should be treated as a customer or the transactions are anonymously conducted on an exchange that permits trading on behalf of a broad range of market participants. The Agencies expressed concern that the market-making exemption could be used to facilitate interdealer trading, activities which will "bear some scrutiny" by the Agencies going forward.

Clarifications in the Preamble. The Agencies note that, if a banking entity's primary dealer activities for a sovereign government fall outside of the underwriting exemption in Section _.4(a) of the Final Regulation, discussed below, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of applying the market-making exemption. Further, the Agencies also state that the market-making exemption generally may be used by so-called "authorized participants" who create and redeem shares of, and engage in various trading activities in connection with, exchange-traded funds ("ETFs"). Commenters had been unsure whether such ETF transactions would be exempt under the proposed market-making or underwriting exemptions.

Permitted Underwriting Activities

Section _.4(a) of the Final Regulation adopts the underwriting exemption from the proprietary trading prohibition substantially as proposed, but the scope of the exemption has been broadened to apply to members of an underwriting syndicate and selling group members (rather than a single, lead underwriter), smaller offerings based on a change to the definition of "distribution," and selling security holders (in addition to issuers). The exemption also now permits banking entities to engage in stabilizing activities and to retain unsold allotments.

In brief, a banking entity may permissibly engage in proprietary trading activities under the underwriting exemption if:

(i) It is acting as an "underwriter" for a "distribution" of securities of an issuer or selling security holder;

(ii) Its trading desk's "underwriting position" is related to the distribution;

(iii) The amount and type of the securities of the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;

(iv) Reasonable efforts are 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;

(v) The banking entity establishes and maintains a compliance program that addresses various underwriting-related requirements;

(vi) Compensation arrangements for relevant personnel are designed not to reward or incentivize prohibited proprietary trading; and

(vii) The banking entity is licensed or registered to engage in the underwriting activity.

Although the Final Regulation still defines the term "distribution" by reference to the SEC's concept of "special selling efforts and selling methods" from Regulation M, it does not require compliance with the "magnitude" requirement from that same regulation. Accordingly, the exemption is now available for distributions of smaller size than those historically meeting the Regulation M definition of distribution. The Agencies also note that offerings that qualify as distributions include, among others, private placements in which resales may be made in reliance on the SEC's Rule 144A or other available exemptions, as well as commercial paper being offered as a security.

Compliance Obligations. As under the market-making exemption, a banking entity relying on the underwriting exemption must establish and maintain an appropriate compliance program as required by subpart D of the Final Regulation that (i) addresses the conditions noted above; (ii) sets limits for each trading desk based on the desk's underwriting activities; (iii) implements controls and ongoing monitoring for compliance with the limits; and (iv) establishes authorization procedures for any trade that would exceed the limits.

Permitted Risk-Mitigating Hedging Activities

Section _.5 of the Final Regulation implements the exemption for risk-mitigating hedging activities, which generally permits a banking entity to trade financial instruments in order to hedge specific risks to the banking entity arising in connection with the individual or aggregated positions, contracts, or other holdings of the banking entity. The Final Regulation circumscribes the risk-mitigating hedging exemption originally described in the Proposal and imposes significant additional documentation and compliance-oriented obligations. However, the retention of the reference to hedging of "aggregated position" indicates that some degree of portfolio hedging remains permissible, provided that the risks being hedged are sufficiently identifiable and other specific requirements of the exemption (e.g., related to documentation) are satisfied.

Under the Final Regulation, in order for a position to qualify as permitted hedging, the putative hedge must, from inception, demonstrably (via some type of analysis) reduce or mitigate the specific identifiable risks of specific identifiable positions or aggregated positions.[12] In contrast, the Proposal only required that a hedge be reasonably correlated to a risk or risks being mitigated. In any event, a hedge must not itself give rise to any significant new or additional risk that is not contemporaneously hedged, and banking entities are required to engage in ongoing recalibration of hedging activities to ensure continuing compliance with the conditions of this exemption. Compensation arrangements for risk-mitigating hedging personnel must be designed so that they do not reward or incentivize prohibited proprietary trading.

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[12] A specific identifiable risk may include market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or other similar risk.

These new conditions reflect the Agencies' view that hedging should be connected to "identifiable" positions and risks, as opposed to being conducted on a macro basis. Notably, the Agencies state that it would be inconsistent with Congressional intent to permit hedging 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."[13] Accordingly, the Preamble provides that the hedging exemption may not be used for "scenario hedging," "revenue hedging" or general asset-liability management.

In at least one aspect, the Final Regulation liberalizes the proposed exemption. Anticipatory hedging remains permissible if conducted in accordance with the conditions noted above, but now such hedging need not be conducted "slightly" before a banking entity becomes exposed to a specific, identifiable risk. The Agencies effectively agreed with commenters' concerns that this now-deleted modifier was potentially unduly limiting.

Compliance Obligations. A banking entity relying on the risk-mitigating hedging exemption is subject to compliance obligations similar to those that apply for underwriting and market-making, including establishing and maintaining a compliance program as required by subpart D of the Final Regulation. The Final Regulation imposes additional documentation requirements for hedges that are created or maintained (i) to hedge aggregated positions across two or more trading desks, (ii) in a financial instrument not previously listed among the products used for hedging by the hedging trading desk, or (iii) at a different trading desk from the trading desk that established the underlying positions creating the risks being hedged. These additional records must be maintained for a period no less than five years.

Permitted Trading Activities of Foreign Banking Entities

The Final Regulation modifies the proposed exemption for trading activities conducted by foreign banking entities solely outside of the United States ("SOTUS"). In response to comments, some key aspects of the Proposal have been revised or eliminated, including the definition of "resident of the United States" and the requirement that a transaction be executed wholly outside the United States in order to be covered by the exemption. Under Section _.6(e) of the Final Regulation, foreign banking entities may engage in "foreign trading activities" under the following conditions:

(i) The banking entity is not organized, or directly or indirectly controlled by another banking entity that is organized, under US law;

(ii) The banking entity engages in the transaction pursuant to the authority in Section 4(c)(9) or Section 4(c)(13) of the BHCA, which is deemed to be satisfied if the banking entity is either a qualifying foreign banking organization ("QFBO") under Regulation K or, if it is a

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[13] *Joint Release* at 5,635.

not a foreign banking organization under Regulation K, it meets at least two of three tests showing a foreign predominance in its operations;[14]

(iii) The banking entity, including any personnel of the banking entity arranging, negotiating or executing the purchase or sale, or deciding to make the purchase or sale, is not located in the United States;

(iv) The transaction, including any related risk-mitigating hedging, is not accounted for as principal on the books of any US-located or US-organized branch or affiliate of the foreign banking entity;

(v) No financing for the banking entity's purchase or sale is directly or indirectly provided by any US-located or US-organized branch or affiliate; and

(vi) The banking entity's purchase or sale is not conducted with or through any US entity, except as discussed below.

Permissible US Counterparties. A foreign banking entity is permitted to trade with the foreign operations of a US entity, such as the non-US branch of a US bank, provided that no personnel of the counterparty that are located in the United States are involved in the arrangement, negotiation, or execution of the transaction. In addition, a foreign banking entity is permitted to trade with any unaffiliated US market intermediary acting as principal, provided that the trade is promptly cleared and settled through a clearing agency or DCO. The exemption also permits a foreign banking entity to trade through an unaffiliated US market intermediary acting as agent, if the transaction is anonymously conducted on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or DCO.[15]

Permitted Trading in US Government Obligations

Section _.6(a) of the Final Regulation permits a banking entity to purchase and sell, anywhere in the world, obligations issued or guaranteed by the United States or an agency thereof, Ginnie Mae, Fannie Mae, Freddie Mac, Farmer Mac, a Federal Home Loan Bank, or a Farm Credit System Institution. This represents an expansion of the proposed exemption because it permits trading in obligations guaranteed but not issued by the United States. The Final Regulation also permits a banking entity to purchase and sell obligations of any US state or any political subdivision thereof, including municipal securities. The

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[14] The three tests, of which a non-QFBO banking entity must satisfy at least two to be eligible for the foreign banking entity exemption, are (i) whether the banking entity holds more than 50 percent of its assets outside of the United States; (ii) whether the banking entity derives more than 50 percent of its revenue from business outside of the United States; and (iii) whether the banking entity derives more than 50 percent of its net income from business outside of the United States.

[15] An unaffiliated market intermediary is defined as (i) a broker, dealer, or security-based swap dealer registered with the SEC or exempt from registration or (ii) a swap dealer or futures commission merchant registered with the CFTC or exempt from registration.

Final Regulation does not permit a banking entity to buy or sell derivatives referencing US government obligations in reliance on this exemption.

Permitted Trading in Foreign Government Obligations

Many foreign governments and other foreign entities filed comment letters requesting that an exemption for foreign sovereign obligations be adopted similar to the exemption for US government obligations. Section _.6(b) of the Final Regulation includes a new exemption to address these concerns. As detailed below, separate exemptions have been adopted for the US operations of foreign banking entities and certain foreign affiliates of US banking entities.

US Operations of a Foreign Banking Entity. Under Section _.6(b)(1) of the Final Regulation, a banking entity organized under, or directly or indirectly controlled by a banking entity organized under, the laws of a foreign sovereign may purchase and sell obligations issued or guaranteed by the entity's "home country" foreign sovereign or any agency or political subdivision of the foreign sovereign. The exemption is not available to any banking entity (i) that is directly or indirectly controlled by a top-tier banking entity organized under US law or (ii) that is an insured depository institution. Although the exemption in Section _.6(b) is not by its terms limited solely to US operations of foreign banking entities, the Preamble indicates that trading in foreign sovereign obligations by the non-US operations of a foreign banking entity would be conducted pursuant to the foreign trading exemption set forth in Section _.6(e) of the Final Regulation (discussed above, pages 11-12) rather than the Section _.6(b)(1) exemption.[16] Thus, these exemptions when read together appear to be intended to permit a foreign banking entity to trade in home-country government obligations in almost all circumstances.

Foreign Affiliates of a US Banking Entity. Section _.6(b)(2) of the Final Regulation permits a foreign affiliate of a US banking entity to purchase or sell an obligation of, or issued or guaranteed by, a foreign sovereign or any agency or political subdivision of a foreign sovereign if (i) the foreign affiliate is a foreign bank under FRB's Regulation K or is regulated by the foreign sovereign as a securities dealer; (ii) the financial instrument is issued by the entity's "host country" foreign sovereign, or by a political subdivision of the host country foreign sovereign (including any multinational central bank of which the foreign sovereign is a member); and (iii) the financial instrument is owned by the foreign affiliate and is not financed by an affiliate located in the United States or organized under US law. The Section _.6(b)(2) exemption does not appear to be available to foreign branches of US banks.

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[16] Provided that the requirements of the Section _.6(e) exemption are satisfied, a foreign banking entity is permitted to trade in the obligations of any foreign sovereign under that exemption (i.e., in addition to any other financial instrument), so trading would not be limited to "home country" sovereign obligations as under Section _.6(b)(1). This would include, for example, the trading of German Bunds by the Frankfurt branch of a Japanese bank. We also note that trading by a foreign banking entity under Section _.6(e) is not subject to mandatory metrics reporting obligations under Appendix A of the Final Regulation, which do apply to trading under Section _.6(b)(1) (as well as trading pursuant to the market-making, underwriting, hedging, and US Government obligations exemptions).

Permitted Trading on Behalf of Customers

Section _.6(c) of the Final Regulation permits banking entities to purchase and sell financial instruments on behalf of, or for the account of, customers in two separate ways:

In a Fiduciary Capacity. A banking entity is permitted to purchase or sell a financial instrument if it (i) is acting as a trustee or in a similar fiduciary capacity; (ii) is conducting the transaction on behalf of, or for the account of, a customer; and (iii) does not have or retain beneficial ownership of the financial instrument.

As a Riskless Principal. A banking entity is permitted to purchase or sell a financial instrument as a riskless principal (i) after receiving an order to purchase or sell from a client and (ii) if it does so to offset a contemporaneous sale to or purchase from the customer.

Permitted Trading by Regulated Insurance Companies

Section _.6(d) of the Final Regulation permits a banking entity that is an insurance company or an affiliate of an insurance company to purchase or sell financial instruments for (i) the general account of the insurance company or (ii) a separate account established by the insurance company. The purchase or sale must be made in compliance with applicable insurance company investment laws of the jurisdiction in which the insurance company is domiciled. The exemption is not available if the federal banking agencies have determined, after consultation with the FSOC and the relevant insurance commissioners, that the insurance company investment laws of the jurisdiction in question are insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.

Covered Fund Activities

Prohibition on Covered Fund Activities

Section _.10 of the Final Regulation implements the prohibition under Section 13 of the BHCA against acquiring or retaining an ownership interest in, sponsoring or having certain other relationships with, a covered fund. While the prohibition itself is substantially unchanged from the Proposal, the Final Regulation incorporates significant changes to the definition of "covered fund," which in the aggregate substantially limit the scope of the prohibition. As a result, the Final Regulation more faithfully implements the statutory intent to restrict banking entity activities related to "hedge funds" and "private equity funds," while also more appropriately limiting the Volcker Rule's extraterritorial impact. Like the Proposal, the Final Regulation provides several exemptions that permit a banking entity to invest in or sponsor covered funds under certain circumstances. The Final Regulation generally prohibits a banking entity from entering into "covered transactions" with certain covered funds (i.e., the so-called "Super 23A"

prohibitions), although some of the most harmful potential effects of Super 23A under the Proposal have been remedied, or at least mitigated, by the substantial narrowing of the definition of "covered fund" in the Final Regulation.

Definition of "Covered Fund"

The Proposal defined "covered fund" very broadly and provided targeted exemptions for certain permitted activities. The Agencies have taken a different approach in the Final Regulation, defining covered fund more narrowly in the first instance and also providing 14 key exclusions from that definition (i.e., before turning to the exemptions for permitted activities). Thus, the analysis of covered fund status under the Final Regulation involves two basic questions: (i) does the entity come within the three-prong threshold definition of covered fund and (ii) if so, does it qualify for an exclusion? We address below the definition of covered fund under the Final Regulation, as well as the impact of the final definition on the foreign fund activities of foreign banking entities.

Private Investment Companies. As under the Proposal, the first prong of the definition of covered fund includes "an issuer that would be an investment company, as defined in the Investment Company Act of 1940, *but for* section 3(c)(1) or 3(c)(7) of that Act."[17] These two exclusions are traditionally used by a wide variety of entities, including most private investment funds with US investors.

Commodity Pools. The second prong of the covered fund definition applies to commodity pools. As defined under the CEA, a "commodity pool" is an investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.[18] While the Proposal included *all* commodity pools in the definition of covered fund, the final definition includes only those commodity pools for which either:

(i) The commodity pool operator (the "CPO") of the pool has claimed an exemption under CFTC Rule 4.7 (which applies to registered CPOs whose pools are available only to sophisticated investors); or

(ii) The CPO is registered with the CFTC in connection with the operation of such pool, substantially all of the interests in the pool are owned by "qualified eligible persons,"[19] and

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17 Final Regulation, Section _.10(b)(1)(i). The exclusion in Section 3(c)(1) of the Investment Company Act of 1940 (the "1940 Act") is generally available to issuers whose outstanding securities are beneficially owned by not more than 100 persons, while the exclusion in Section 3(c)(7) is generally available to issuers the outstanding securities of which are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers." In each case, the issuer may not make a public offering in the United States.

18 Commodity interests include, among other things, commodity options, commodity futures, security futures, and, as a result of the Dodd-Frank Act, swaps. The definition of commodity pool has historically been given a broad interpretation by the CFTC, and the addition of swaps to the definition of "commodity interests" has had the attendant result of a wide variety of entities potentially being classified as commodity pools even based on only a *de minimis* level of swaps activity.

19 As defined in CFTC Rules 4.7(a)(2) and (3).

units in the pool have not been publicly offered to persons who are not "qualified eligible persons."[20]

Foreign Funds – US Banking Entities. The Agencies have replaced the third prong of the covered fund definition, which under the Proposal included the "foreign equivalent" of any covered fund, with a more tailored definition that would apply *only* to a banking entity that is, or is directly or indirectly controlled by a banking entity that is, located in or organized under the laws of the United States or of any State (for ease of reference, we refer to any such entity as a "US-Controlled Banking Entity").[21] For these US-Controlled Banking Entities, a covered fund includes an entity that:

(i) Is organized outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(ii) Is or holds itself out as being an entity or arrangement that raises money from investors for the purpose of investing or trading in securities; and

(iii) Is sponsored by the US-Controlled Banking Entity (or an affiliate) or has issued an ownership interest that is owned directly or indirectly by the US-Controlled Banking Entity (or an affiliate).

The Final Regulation specifies that an issuer would not be a covered fund under this third prong of the covered fund definition if the issuer can rely—or would be able to rely, if it were subject to US securities laws—on an exemption or exclusion from the definition of "investment company" *other than* the exclusions contained in Sections 3(c)(1) and 3(c)(7) of the 1940 Act. Accordingly, funds that can rely on other exclusions, such as Section 3(c)(5)(C) (available to many real estate funds) or Rule 3a–7 (available to certain securitization vehicles) would not be captured by this prong of the definition. The revised third prong of the definition means that a fund could potentially be treated as a covered fund with respect to a US-Controlled Banking Entity but *not* with respect to a foreign banking entity.

Foreign Funds – Foreign Banking Entities. The private investment company prong of the covered fund definition under the Final Regulation (i.e., the first prong discussed above) applies only to funds that actually rely on Section 3(c)(1) or (7). A fund that is organized outside the United States and that has no US investors generally would *not* need to rely on any exclusion or exemption from investment company status under the 1940 Act, including Section 3(c)(1) or (7), and, therefore, would not be a covered fund on that basis. Because the third prong of the definition no longer requires a foreign banking entity to analyze

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[20] Thus, only commodity pools whose CPOs are registered with the CFTC will constitute covered funds. As a result, many pools whose CPOs rely on exemptions from registration (such as the *de minimis* exemption provided in CFTC Rule 4.13(a)(3)) would not be covered funds unless they otherwise satisfy another prong of the definition. The final commodity pool prong of the definition in the Final Regulation also eliminates the need for many banking entities to contend with questions regarding whether certain entities that engage in swap transactions are (or "would be") commodity pools.

[21] For these purposes, the Final Regulation makes clear that a US branch, agency, or subsidiary of a foreign banking entity *is* located in the United States, but that the foreign banking entity itself is not considered to be in the United States merely because it operates or controls such a branch, agency, or subsidiary.

whether a foreign fund "would rely" on these exemptions if it were offered in the United States, with respect to a foreign banking entity, most foreign funds without US investors will not be covered funds.

A foreign fund that has no US investors as result of its initial offering may, however, later come to have US investors. For example, a US person may invest in a foreign fund that is publicly listed outside the United States in the secondary market, an existing non-US investor in a foreign fund may transfer its interest in the fund to a US person, or a non-US investor in a foreign fund may relocate to the United States and continue to acquire additional interests the foreign fund. In these types of scenarios, the foreign fund potentially would need to rely on Section 3(c)(1) or (7) under the 1940 Act. SEC staff has provided limited guidance in this area suggesting that a fund that "does not use US jurisdictional means in connection with the offer or sale of any of its securities … [is not required to rely on Section 3(c)(1) or (7)] if US residents purchase the [fund's] securities in transactions that occur outside the United States."[22] Ultimately, the question of whether a foreign fund with these types of limited US nexus issues relies on Section 3(c)(1) or (7) will depend on the specific facts. In the event that a foreign fund does rely on Section 3(c)(1) or (7), a banking entity sponsoring or investing in the fund may need to rely on the exclusion available to "foreign public funds" (if applicable) or the exemption for covered fund activities solely outside the United States, each of which is discussed below.

Excluded Funds

Section _.10(c) of the Final Regulation provides 14 exclusions from the definition of "covered fund." Thus, even if an entity relies on Section 3(c)(1) or (7) of the 1940 Act or is a commodity pool meeting the criteria set forth above, the entity is not a covered fund if it falls within an exclusion. A banking entity may, therefore, not only invest in or sponsor the excluded entity without needing to comply with a Volcker Rule exemption but it also may engage in covered transactions with the entity without regard to the Super 23A prohibition. As noted above (pages 3–4), the primary drawback of falling under a covered fund exclusion is that the entity is potentially subject to being treated as a banking entity in its own right (and thus subject to the Volcker Rule proprietary trading and covered fund restrictions).

The entities discussed below have been excluded from the definition of covered fund. The Agencies have also reserved the right to revoke any of these exclusions and to add additional entities to the list of exclusions. The Agencies specifically declined to exclude financial market utilities, venture capital funds, pass-through REITs, municipal tender option bond vehicles, credit funds, cash management vehicles and cash collateral pools.

Registered Investment Companies and Related Entities. The Final Regulation provides an exclusion from the definition of covered fund for any issuer is that is a registered investment company under the 1940 Act, as well as any issuer that has elected to be treated as a regulated business development company pursuant to the 1940 Act. This—along with the narrowed scope of commodity

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[22] *Goodwin, Proctor & Hoar*, SEC No-Action Letter (Feb. 28, 1997).

pools included in the definition of covered fund—resolves an ambiguity under the Proposal that could have caused certain US registered investment companies to be covered funds under certain circumstances.

The Final Regulation also excludes entities that are in the seeding stage prior to registration. It is relatively common for some funds that intend to register (or to be regulated as a business development company) to operate for a limited period of time as an unregistered fund either for purposes of initial seeding, or to develop a track record prior to registration. The Final Regulation permits these entities to remain excluded from the definition of covered fund during this seeding period provided that the entity is formed and operated pursuant to a written plan to be registered or regulated (as applicable), and further provided that the entity complies with the restrictions on leverage that apply to registered investment companies or regulated business development companies, as applicable.

Foreign Public Funds. In response to requests from many commenters, the Final Regulation includes an exclusion for certain funds that are available to the public in non-US jurisdictions. Thus, any foreign fund that is otherwise picked up by the definition of covered fund (e.g., it is sold or offered in the United States under Section 3(c)(1) or (7)) will be excluded if it meets the following requirements:

(i) The fund is organized or established outside the United States;

(ii) The fund is authorized to offer and sell ownership interests to "retail investors" in the issuer's home jurisdiction;[23] and

(iii) The fund sells ownership interests predominantly through one or more public securities offerings outside of the United States. The Preamble states that "predominantly" for these purposes would be satisfied if 85 percent or more of the interests are sold to investors that are not residents of the United States. The Final Regulation specifies that in order to be considered a "public" offering for these purposes (i) the distribution must comply with local requirements; (ii) the distribution may not restrict availability to investors having a minimum level of net worth or assets;[24] and (iii) the issuer must file *publicly available* offering disclosure documents with the appropriate regulatory authority in the jurisdiction.

The Final Regulation restricts the use of the foreign public fund exclusion by US-Controlled Banking Entities in order to avoid potential evasion of the Volcker Rule. Specifically, a US-Controlled Banking Entity may sponsor a fund that makes use of this exclusion only if ownership interests are sold predominantly (i.e., at least 85 percent) to persons *other than* the sponsoring US-Controlled Banking Entity, the issuer itself, or the affiliates, directors or employees of the foregoing.

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[23] Although the Final Regulation does not define "retail investors," the Preamble indicates that it should be construed to mean members of the general public who generally lack the sophistication of institutional investors and high net worth investors and who therefore would be entitled to the full protection of local securities laws.

[24] The Preamble makes clear that general suitability requirements imposed under local law would not jeopardize a fund's status under this exclusion.

Wholly-Owned Subsidiaries. Recognizing that internal structuring entities were not intended to be captured by the term covered fund, the Final Regulation excludes entities all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate), including, for example, intermediate holding companies. The Final Regulation further permits that up to 5 percent of the entity's ownership interests may be held by current and former employees or directors of the banking entity, so long as the former employees and directors acquired their ownership interest while they were at the banking entity.[25] In addition, up to 0.5 percent of the entity's ownership interests can be held by a third party for the purpose of establishing corporate separateness as may be required under foreign law or to address bankruptcy, insolvency, or similar concerns.[26] Such wholly-owned subsidiaries would of course be banking entities subject to the prohibitions of the Volcker Rule.

Joint Ventures. While the Proposal provided a limited exemption from the prohibition against covered fund activities for joint ventures that are operating companies, the Final Regulation expands the scope of what it means to be a joint venture and excludes eligible joint ventures from the definition of covered fund. An entity is considered a joint venture for these purposes if it: (i) has no more than ten unaffiliated co-venturers; (ii) is in the business of engaging in activities that are permissible for the banking entity *other than* investing in securities for resale or other disposition;[27] and (iii) is not, and does not hold itself out as being, an entity that raises money from investors primarily for the purpose of investing or trading in securities. By removing the requirement that joint ventures must be operating companies, the Final Regulation permits the use of joint ventures for a variety of other uses, such as risk sharing. Joint ventures may not rely on this exclusion if they are engaged in merchant banking activities as defined under the BHCA.

Acquisition Vehicles. Similar to joint ventures, while the Proposal provided an exemption from covered fund prohibitions for entities engaging in merger and acquisition activities, the Final Regulation instead excludes these entities from the definition of covered fund. Specifically, the Final Regulation provides that entities formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction and existing only for the period necessary to effectuate the transaction are not covered funds.

Foreign Pension or Retirement Funds. While US pension funds typically may rely on an exclusion from the definition of "investment company" provided in Section 3(c)(11) of the 1940 Act, that exclusion is not available to foreign pension and retirement funds which can cause them to instead rely on the exclusions in Section 3(c)(1) or (7) to the extent that they have US person beneficiaries. In order to avoid

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[25] To the extent that a current or former director or employee transfers his or her interest to a third party, this exclusion would cease to be available.

[26] Any amounts owned by a third party pursuant to this provision are counted against the five percent that may be owned by current and former employees and directors.

[27] The precise set of activities that may be engaged in by a joint venture will depend on the status of the banking entity that is participating in the joint venture. For example, while an insured depository institution's activities may be circumscribed by relevant statutes and rules, an affiliated investment adviser, broker-dealer, or insurance company may be subject to completely different restrictions, or no restrictions at all.

treating these foreign pension and retirement funds as covered funds, the Final Regulation excludes a fund that is (i) organized and administered outside the United States; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of its local jurisdiction; and (iii) established for the benefit of citizens or residents of one or more foreign countries (or any political subdivisions thereof). A pension or retirement fund that meets these conditions would not be a covered fund even if some beneficiaries reside in the United States or become US residents.

Insurance Company Separate Accounts and Bank-Owned Life Insurance. Insurance company separate accounts are generally considered under US law to be issuing securities to the policyholder and, therefore, may need to register under the 1940 Act or else rely on Section 3(c)(1) or (7).[28] In order to avoid treating these separate accounts as covered funds, the Final Regulation excludes them so long as no banking entity other than the insurance company that established the separate account may participate in the account's profits and losses. The Final Regulation also provides an exclusion from the definition of covered fund for bank-owned life insurance.

Loan Securitizations and Qualifying ABCP Conduits. The Final Regulation excludes loan securitizations and ABCP conduits that are backed by "loans" and certain other qualifying assets, including contractual servicing rights associated with those loans, and interest rate and certain foreign exchange derivatives used for hedging purposes. Securitization vehicles relying on this exclusion generally are not permitted to own securities, including asset-backed securities.

Securitizations that rely on the exemption from "investment company" status found in Rule 3a-7 under the 1940 Act are not covered funds in the first instance under the Final Regulation, and, therefore, will not need to rely on this separate exclusion. However, many securitizations, including most securitizations organized outside the United States that make offers and sales to US investors, typically instead rely on Section 3(c)(1) or (7) under the 1940 Act.

As noted above, a securitization vehicle or ABCP conduit that relies on the Section _.10(c) exclusions would potentially be subject to regulation as a banking entity in its own right, to the extent it is deemed to be controlled by a banking entity for BHCA purposes. Please refer to our Legal Update concerning the impact of the Volcker Rule on securitizations for more information.

Qualifying Covered Bond Structures. The Final Regulation excludes from the definition of covered fund entities that hold loans and certain other assets for the benefit of holders of covered bonds that are issued by or guaranteed by foreign banks. Please refer to our Legal Update concerning the impact of the Volcker Rule on securitizations for more information.

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[28] Section _.2(bb) of the Final Regulation defines a separate account as "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."

SBICs and Public Welfare Investment Funds. The Final Regulation generally permits activities involving SBICs, but rather than provide an exemption as originally contemplated in the Proposal, the Final Regulation excludes SBICs from the definition of covered fund.

The Final Regulation also more broadly excludes issuers that are in the business of making certain investments that are designed primarily to promote the "public welfare" (e.g., certain investments for housing, services and jobs for low- and moderate-income communities or families) or certain expenditures related to the rehabilitation of historic sites under state and federal law.

Issuers in Conjunction with FDIC Receivership or Conservatorship. Finally, the Final Regulation excludes issuers formed by or on behalf of the FDIC for purposes of disposing of assets that the FDIC acquires in the course of acting as conservator or receiver under the Federal Deposit Insurance Act or the Dodd-Frank Act.

Ownership Interests Held as Principal

To the extent that an entity is a covered fund as defined in the Final Regulation and is not covered by an exclusion, a banking entity is generally prohibited from acquiring or retaining any "ownership interest" in the covered fund as principal. There are two key components to this prohibition: the definition of "ownership interest," and the carve-out for interests not held as principal.

Ownership Interest. Similar to the Proposal, Section _.10(d)(6) of the Final Regulation defines "ownership interest" to mean any equity, partnership, or "other similar interest." The Final Regulation provides that "other similar interest" includes an interest that (i) has the right to participate in the selection or removal of a general partner, director, investment manager, or similar entity (excluding certain creditor's rights); (ii) has the right to receive a share of the fund's income, gains, or profits; (iii) has the right to receive underlying assets of the fund after all other interests have been redeemed or paid in full (excluding certain creditor's rights); (iv) has the right to receive excess spreads under certain circumstances; (v) has exposure to certain losses on underlying assets; (vi) receives income on a pass-through basis; or (vii) has a synthetic right to receive rights in the foregoing. Accordingly, while a debt interest generally would not be considered an ownership interest, to the extent that a debt security or other interest in a covered fund exhibits substantially the same characteristics as an equity or other ownership interest (e.g., certain control rights, or a right, however remote, to receive a portion of the fund's profits or gains), it would be considered an ownership interest.[29]

Carried Interest. The definition of ownership interest specifically excludes "restricted profit interests" (i.e., carried interest). The Final Regulation defines restricted profit interests to include interests held by a covered fund's investment manager, investment adviser, commodity trading advisor, or other service provider, for which the purpose and effect of the interest is to allow the holder to share in the profits of the

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[29] Among other things, residual interests in tender option bond structures and senior securities of collateralized debt obligations may raise concerns under the definition of ownership interest.

covered fund as performance compensation for the services rendered to the fund, and provided that certain other conditions are met.

Non-Principal Capacities. Even if an ownership interest is held by a banking entity, the Final Regulation provides that the prohibition does not apply in situations where the banking entity is acting solely as agent, broker, or custodian. Similarly, a banking entity may hold ownership interests in covered funds as trustee, or in another similar fiduciary capacity, on behalf of customers that are not themselves covered funds. However, each of the foregoing exemptions are limited to situations where the activity is conducted for the account of, or otherwise on behalf of, a customer, and the banking entity (and its affiliates) do not have or retain beneficial ownership. Thus, in the normal course, banking entities will be permitted to act as broker, custodian, nominee, or trustee for a customer account that holds interests in covered funds.

Under the Final Regulation, ownership interests in covered funds may be held in deferred compensation, pension plans, and certain other employee compensation plans established by a banking entity, if the banking entity holds the ownership interest as trustee for the benefit of the plan's participants who are or were employees of the covered banking entity (or affiliate).

Workout Structures. Finally, to address situations where a banking entity may take possession of covered fund ownership interests as a result of exercising a lien, or otherwise in connection with collecting on an outstanding debt, the Final Regulation permits such acquisitions so long as the banking entity divests the ownership interest as soon as practicable and in no event beyond the holding period permitted by the relevant Agency.

Acting as "Sponsor"

Banking entities are generally prohibited from "sponsoring" covered funds absent an exemption. Under Section _.10(d)(9) of the Final Regulation, as in the Proposal, the definition of "sponsor" focuses on the ability to control decision-making and operational functions of the fund. Specifically, a sponsor would include an entity that:

(i) Acts as a general partner, managing member, trustee of a covered fund (or serves as a CPO of a pool that is a covered fund due to its commodity pool status);

(ii) In any manner selects or controls a majority of the directors, trustees, or management of a covered fund (including having employees, officers, directors or agents who constitute that majority); or

(iii) Shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes.

Status of Trustees. The Final Regulation specifically excludes from the definition of "trustee" for these purposes (i) directed trustees, (ii) trustees under foreign law that are subject to substantially similar fiduciary standards as directed trustees, and (iii) any other trustee that does not exercise investment

discretion. The Preamble clarifies that a trustee would not be a sponsor based solely on the power to replace an investment adviser with an unaffiliated investment adviser. It also indicates that a trustee that has "formal but unexercised power to make investment decisions" or that acts only upon the instruction or direction of another party would not be considered a sponsor.[30] A "trustee" would include any person that directs the actions of a "directed trustee" and any person who possesses authority and discretion to manage and control the assets of a covered fund for which a directed trustee serves as trustee.

Permitted Covered Fund Activities

Like the Proposal, the Final Regulation identifies a number of covered fund activities that are permitted, subject to regulatory restrictions. However, some changes have been made from the Proposal. As discussed above, certain activities that would have been permitted activities under the Proposal are now addressed by exclusions from the definition of covered fund. Other permitted covered fund activities have been expanded or modified. Generally, the Final Regulation permits banking entities to invest in or sponsor a covered fund in connection with (i) organizing and offering a covered fund for customers as a bona fide fiduciary, including a variation of the exemption tailored to an issuer of asset-backed securities that is not eligible for the loan securitization exclusion; (ii) underwriting or market-making activities; (iii) risk-mitigating hedging activities; (iv) activities occurring solely outside of the United States; and (v) regulated insurance company activities. Each of these permitted activities is subject to certain specific conditions described below, as well as the prohibition on covered transactions under Super 23A (discussed below, pages 33–34) and to limitations on conflicts of interest (discussed below, pages 34–35).

Asset Management Exemption

Section _.11(a) of the Final Regulation allows a banking entity to acquire or retain an ownership interest in, or act as sponsor to, a covered fund in connection with organizing and offering the fund if certain conditions are met. The exemption under the Final Regulation is substantially the same as under the Proposal, but some changes have been made in response to comments. The final conditions are as follows:

(i) The banking entity provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.

(ii) The covered fund is organized and offered only in connection with the provision of such services and only to persons that are customers of such services of the banking entity or its affiliate, pursuant to a written plan outlining how such services will be provided to its customers through the covered fund. The Preamble notes that the banking entity's relationship with the customers does not need to be pre-existing and can be established in connection with the organization and offering of the covered fund. The Final Regulation

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[30] *See Joint Release* at 5,711, 5,713.

clarifies that the banking entity may also provide distribution, brokerage and other services to the covered fund.

(iii) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except a *de minimis* ownership interest permitted under Section _.12 of the Final Regulation. This restriction is discussed below.

(iv) The banking entity and its affiliates comply with the Super 23A restrictions with respect to the fund (discussed below, pages 33–34).

(v) The banking entity and its affiliates do not guarantee, assume or otherwise insure the obligations or performance of the covered fund or other covered funds in which it invests.

(vi) The covered fund does not share the same name or a variation of the same name with the banking entity or its affiliates, and does not use the word "bank" in its name. Despite many comments objecting to the name-sharing restriction, the Final Regulation is identical to the Proposal in this respect.[31] The scope of the application of this condition has, however, been reduced by other changes in the Final Regulation, in particular the substantial narrowing of the definition of covered fund as applied to foreign funds.

(vii) No director or employee of the banking entity or an affiliate receives an ownership interest in the covered fund, except for a director or employee that is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time of receipt.[32] In response to comments, the Agencies clarified that the services provided to the fund by a director or employee are not limited to investment advisory or investment management services. Services that enable the provision of investment advisory or investment management services—such as oversight and risk management, deal origination, due diligence, administrative or other support services (presumably including legal and compliance services)—will also make a director or employee eligible to invest in the fund for purposes of this condition.

(viii) The banking entity makes certain disclosures to prospective and actual investors in the covered fund, including that losses will be borne by investors and not the banking entity, that investors should read the fund documents prior to investing, and that interests in the fund are not FDIC-insured, as well as disclosure describing the role of the banking entity in sponsoring or otherwise providing services to the fund.

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[31] For example, some comments pointed out that the name-sharing restrictions would be incompatible with regulatory requirements in some foreign jurisdictions, which occasionally require that the fund's name indicate the connection with the fund's sponsor.

[32] The Agencies commented that this also permits former directors and employees to receive an ownership interest in a covered fund under certain circumstances. However, the Final Regulation may result in attribution of an ownership interest held by a director or an employee (current or former) to the banking entity for purposes of the *de minimis* investment limitations.

Asset-Backed Securitization Exemption

As described above, Section _.10(c)(8) of the Final Regulation excludes certain securitizations that are backed by loans and a very limited group of related assets. For securitizations that are not eligible for the Section _.10(c)(8) exclusion and are not able to rely on Rule 3a-7 or some other exemption under the 1940 Act, Section _.11(b) of the Final Regulation establishes an asset-backed securitization exemption, the primary purpose of which is to permit a banking entity that is a securitizer to satisfy its "skin-in-the-game" obligations under Section 15G of the Securities Exchange Act of 1934 (the "1934 Act"). Section _.11(b) of the Final Regulation provides that a banking entity is not prohibited from acquiring or retaining an ownership interest in, or sponsoring, a covered fund that is an issuer of asset-backed securities in connection with organizing and offering such fund if conditions (iii) through (viii) of the asset management exemption, described above, have all been met.

The Final Regulation also clarifies that, for purposes of the asset-backed securitization exemption, organizing and offering a covered fund that is an issuer of asset-backed securities means acting as the "securitizer" of the issuer, as that term is used in Section 15G(a)(3) of the 1934 Act, or acquiring an ownership interest in the issuer as required by Section 15G. This is intended to address the activities that would be included as organizing and offering a securitization, which may differ from organizing and offering other covered funds in that the entity that organizes and offers the securitization may not always provide advisory services to the issuer. The Agencies acknowledged this by not requiring conditions (i) and (ii) from the asset management exemption to be satisfied for purposes of the asset-backed securitization exemption.

Please refer to our Legal Update concerning the impact of the Volcker Rule on securitizations for more information.

Underwriting and Market-Making Exemption

The Proposal did not address how Section 13(d)(1)(B) of the BHCA, which provides an exemption for underwriting and market-making-related activities from both the proprietary trading and covered fund prohibitions of the Volcker Rule, would be implemented with respect to covered funds. Some commenters contended that the absence of such an exemption in the Proposal could have a negative impact on the ability of banking entities to engage in customer-driven underwriting and market-making in securities issued by many structured finance vehicles that may rely on Section 3(c)(1) or (7) of the 1940 Act, such as collateralized loan obligation issuers and non-US ETFs. In response, the Agencies provided an exemption in Section _.11(c) of the Final Regulation for underwriting and market-making-related activities involving a covered fund as long as they are conducted in accordance with the requirements of the underwriting and market-making exemptions described in Sections _.4(a) and _.4(b), respectively. Those exemptions are described in more detail above (pages 8-10). In addition, under certain circumstances, ownership interests in a covered fund held pursuant to the underwriting and market-making exemptions will count toward the *de minimis* investment limitations and the required capital deduction described below.

Investment Limitations and Required Capital Deduction

Like the Proposal, the Final Regulation allows a banking entity to retain an ownership interest in a covered fund that it organizes and offers under Section _.11 for purposes of establishing the fund—including providing it with seed capital to attract unaffiliated investors—and for holding a *de minimis* investment in the fund, generally not to exceed three percent after the seeding period ends. However, there have been some significant changes in the Final Regulation. The Section _.11 exemptions are the asset management, asset-backed securitization, and underwriting and market-making exemptions described above.

Per Fund and Aggregate Limits. The Final Regulation imposes a cap on the ownership interests that a banking entity may hold pursuant to Section _.11 in any particular covered fund (the "per fund limit") and in all covered funds in the aggregate (the "aggregate fund limit"). The per fund limit for a banking entity and its affiliates in any covered fund is three percent of the total number or value of the outstanding ownership interests in the fund, calculated as described below under "**Calculation of Per Fund Limit**." For a covered fund that is an issuer of asset-backed securities, the per fund limit is three percent of the total fair market value of the ownership interests of the fund, unless a greater percentage is required by Section 15G of the 1934 Act, in which case the limit is that percentage.[33] The aggregate fund limit for a banking entity and its affiliates is three percent of the banking entity's Tier 1 capital, calculated as of the last day of each calendar quarter and as described below under "**Calculation of Aggregate Fund Limit**."

Calculation of Per Fund Limit. For purposes of the per fund limit for a covered fund (other than an issuer of asset-backed securities), a banking entity must calculate both the aggregate number of the outstanding ownership interests and the aggregate value of the outstanding ownership interests in a given fund. It must comply with the per fund limit under both calculations. The aggregate number is calculated by counting the total number of ownership interests held in the fund divided by the total number of ownership interests held by all entities in the fund, as of the last day of each calendar quarter.[34] The aggregate value is calculated by taking the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity and dividing it by the value of all investments in and capital contributions made to the fund by all entities, as of the last day of each calendar quarter.[35]

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[33] This measurement is calculated according to a complex set of rules in Section _.12(b)(3) of the Final Regulation.

[34] The ownership interests are measured without regard to committed funds not yet called for investment.

[35] The investments and capital contributions are measured without regard to committed funds not yet called for investment. The Final Regulation requires that once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards. The Preamble notes that a banking entity should determine fair market value in a manner that is consistent with its determination of the fair market value of its assets for financial statement purposes and that the fair market value would be determined in a manner consistent with the valuations reported by the relevant covered fund unless the banking entity determines otherwise for purposes of its financial statements. If fair market value cannot be determined, then the value will be the historical cost basis of all investments and capital contributions made by the banking entity to the covered fund.

Master-feeder fund investments and fund-of-funds investments are required to calculate the per fund limit differently. If the principal investment strategy of a fund (acting as a "feeder fund") is to invest substantially all of its assets in another single covered fund (referred to as a "master fund"), then the per fund limit for the banking entity is measured only by reference to the value of the master fund. This would include both any investment by the banking entity in the master fund, as well as the banking entity's pro rata share of any ownership interest in the master fund that is held through the feeder fund.

If a banking entity organizes and offers a covered fund for the purpose of investing in other covered funds (a "fund-of-funds") and the fund-of-funds invests in another permissible covered fund, then the banking entity's per fund limit in the other fund will include any investment made by the banking entity directly in the other fund and the banking entity's pro rata share of any ownership interest held through the fund-of-funds.

Ownership interests in a covered fund held by a banking entity pursuant to the underwriting and market-making exemptions will count toward the three percent-per-fund limit if the banking entity is also relying on the asset management exemption, the asset-backed securities exemption, or is guaranteeing or otherwise insuring the performance of the covered fund or any covered fund in which the covered fund invests.[36]

Calculation of Aggregate Fund Limit. The aggregate fund limit is three percent of a banking entity's Tier 1 capital. For this purpose, the aggregate fund limit includes the sum of all amounts paid or contributed by the banking entity to acquire or retain an ownership interest in a covered fund, plus any amounts paid by the banking entity or one of its employees to obtain a restricted profit interest permitted under the Final Regulation, measured on a historical cost basis.[37] In addition, the aggregate value of all ownership interests held by a banking entity and its affiliates in all covered funds held under the asset management, asset-backed securitization, underwriting or market-making exemptions in Section _.11 of the Final Regulation will count toward the aggregate limit of three percent of the banking entity's Tier 1 capital.

Under the Final Regulation, the calculation of Tier 1 capital differs depending on the type of banking entity. For banking entities required to report Tier 1 capital, the Tier 1 capital for purposes of the aggregate fund limit will be the amount of Tier 1 capital reported to the banking entity's primary financial regulatory agency as of the last day of the most recent calendar quarter. For banking entities that are not required to report Tier 1 capital, the Tier 1 capital for purposes of the aggregate fund limit will be as follows:

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36 The Preamble indicates that during a covered fund's seeding period, the banking entity will have more flexibility to underwrite and make a market in the ownership interests of the fund in connection with organizing and offering it because it can go above the three percent limit during this period.

37 The Agencies reasoned that a historical cost basis measurement in this case would prevent banking entities from increasing their aggregate investments in covered funds that are losing value. This helps achieve the statutory purpose of preventing banking entities from bailing out failing funds.

(i) If the banking entity is controlled, directly or indirectly, by a depository institution that is required to report Tier 1 capital, the Tier 1 capital will be that reported by the depository institution to its primary financial regulatory agency as of the last day of the most recent calendar quarter;

(ii) If the banking entity is not controlled, directly or indirectly, by a depository institution that is required to report Tier 1 capital, but is a subsidiary of a bank holding company, the Tier 1 capital will be the Tier 1 capital will be that reported by the top-tier affiliate of the banking entity to its primary financial regulatory agency as of the last day of the most recent calendar quarter; and

(iii) For other banking entities (aside from foreign banking entities and their US affiliates), the Tier 1 capital will be equal to the total amount of shareholders' equity of the top-tier affiliate within the organization as of the last day of the most recent calendar quarter.

For foreign banking entities, the Tier 1 capital for purposes of the aggregate fund limit will be the consolidated Tier 1 capital as calculated under applicable home country standards, unless the banking entity is located in the United States or organized under the laws of the United States, in which case the Tier 1 capital will be calculated as described above.

Attribution. For purposes of calculating the per fund limit and the aggregate fund limit, the Final Regulation requires banking entities to include ownership interests held by the banking entity and by the banking entity's affiliates. The ownership interests held by affiliates are attributed to the banking entity. SEC-regulated business development companies and foreign public funds will not be considered affiliates for this purpose as long as the banking entity (i) does not own, control or have the power to vote 25 percent or more of the voting shares of the company or fund and (ii) provides investment advisory or certain other services to the company to the company or fund in compliance with applicable limitations. Covered funds also will not be considered affiliates for this purpose. Ownership interests held by a director or employee of a banking entity will be attributed to the banking entity if it extends financing to allow the director or employee to acquire the ownership interests and the financing is used for that purpose.

Seeding Period. Section _.12(a)(2)(i) of the Final Regulation requires that a banking entity holding an ownership interest in order to establish and seed a fund must actively seek unaffiliated investors to reduce the aggregate amount of all ownership interests of the banking entity in the covered fund.[38] By one year after the date of establishment of the fund, the banking entity must have conformed its ownership interest in the fund to the per fund limit. The seeding period exception does not apply to the aggregate fund limit. The Proposal did not define the "date of establishment" of a fund. Under the Final Regulation, the "date of

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[38] The Preamble notes that this requirement includes developing and documenting a plan for offering shares in the covered fund to other investors and conforming the banking entity's investments to the *de minimis* limits.

establishment" of a covered fund is generally the date on which the investment adviser to the fund begins making investments pursuant to the written investment strategy for the fund, but for an issuer of asset-backed securities, it is the date on which the assets are initially transferred into such issuer.

Upon application of a banking entity, the FRB has the authority to extend the seeding period for up to two additional years if the FRB finds an extension to be consistent with safety and soundness and in the public interest. Such applications much be submitted at least 90 days before the expiration of the seeding period, must provide appropriate reasons for the application and must explain the banking entity's plan for reducing the permitted investment in a covered fund. The Final Regulation lists a variety of factors that the FRB may consider in reviewing an application to extend the seeding period. In addition, the Final Regulation permits the FRB to impose conditions on the banking entity under certain circumstances during any extension of the seeding period.

Capital Deduction. In addition to its other prohibitions and limitations, the Volcker Rule imposes a capital deduction on banking entities that hold ownership interests in covered funds. For purposes of calculating compliance with applicable regulatory capital requirements, a banking entity is required to deduct from its Tier 1 capital the greater of (i) the sum of all amounts paid or contributed by the banking entity to acquire or retain an ownership interest in a covered fund, plus any amounts paid by the banking entity or one of its employees to obtain a restricted profit interest permitted under the Final Regulation, measured on a historical cost basis, plus any earnings received or (ii) the fair market value of its ownership interests in a covered fund, plus any amounts paid by the banking entity or one of its employees to obtain a restricted profit interest permitted under the Final Regulation, if the banking entity accounts for the profits or losses of the fund investment in its financial statements. The capital deduction is required whenever the banking entity calculates its Tier 1 capital, either quarterly or at any time that the appropriate federal banking agency requests.

The aggregate value of all ownership interests held by a banking entity and its affiliates in all covered funds held under the asset management, asset-backed securitization, underwriting or market-making exemptions in Section _.11 of the Final Regulation will count toward the deduction from Tier 1 capital for purposes of regulatory capital requirements.

The Agencies recognized in the Preamble that the minimum regulatory capital requirements in the final capital rule published in 2013 by the federal banking agencies imposes risk weights and deductions that do not correspond to the deduction for covered investments imposed by the Volcker Rule. The Agencies anticipate proposing steps to reconcile the two rules after they have reviewed the interaction of the requirements of the two rules.

Risk-Mitigating Hedging Exemption

Section _.13(a) of the Final Regulation exempts certain very limited hedging activities from the covered fund prohibitions of the Volcker Rule. The covered fund prohibitions will not apply to an ownership interest in a covered fund held 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 its affiliate) that directly provides investment advisory, commodity trading advisory or other services to the covered fund. The Final Regulation eliminates the hedging exemption in the Proposal for banking entities that act as intermediary on behalf of a customer to facilitate exposure to the profits and losses of the covered fund.[39] In order to avail itself of the employee compensation hedging exemption, a banking entity must comply with a number of requirements including the establishment and enforcement of the internal compliance program required by subpart D of the Final Regulation.

Exemption for Covered Fund Activities Solely Outside the United States

Section _.13(b) of the Final Regulation broadens the exemption in the Proposal that permitted certain covered fund activities that are solely outside the United States (the so-called "SOTUS exemption"). At the same time, the need for foreign banking entities to rely on the SOTUS exemption will likely be significantly reduced because of the changes to the definition of covered fund and the exclusion of foreign public funds (discussed above, pages 15-19). The SOTUS exemption may be most important in circumstances where sales of interests in a foreign fund in the secondary market cause the fund to need to rely on either Section 3(c)(1) or (7) of the 1940 Act and, thus, to become a covered fund for purposes of the Volcker Rule.

In order to be eligible for the SOTUS exemption, the following four conditions must be satisfied:

Not Organized or Controlled in the United States. The banking entity must not be organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States. Neither a foreign subsidiary controlled by a banking entity organized under US law nor a foreign branch of a banking entity organized under US law will be eligible for the SOTUS exemption.

Business Primarily Conducted Outside the United States. The covered fund activity in question must be pursuant to Section 4(c)(9) or 4(c)(13) of the BHCA. This condition will be satisfied if the banking entity is a QFBO under the FRB's Regulation K. If the banking entity is not a foreign banking organization (for example, because it controls only a savings association or an industrial loan company), then it will satisfy this condition if it is not organized under US law and it meets certain financial tests designed to ensure that it generally conducts the majority of its business outside the United States as delineated in above (page 12, note 14).

No Offers or Sales to US Residents. No ownership interest in the covered fund may be offered for sale or sold to a resident of the United States. This condition will be met if the covered fund is sold or has been sold pursuant to an offering that does not "target" residents of the United States. The Preamble notes that absent circumstances otherwise indicating a nexus with residents of the United States, the sponsor of

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[39] The Preamble notes that after review of the comments, the Agencies considered this exemption to be a high-risk strategy that could threaten the safety and soundness of the banking entity.

a foreign fund would not be viewed as targeting residents of the United States for purposes of the SOTUS exemption if it (i) conducts an offering directed to residents of one or more countries other than the United States; (ii) 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 (iii) includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States. In addition, the Final Regulation changes the definition of "resident of the United States" to have the same meaning as "US Person" under the SEC's Regulation S.

Sponsorship/Investment Outside the United States. The activity or investment must occur solely outside of the United States. With respect to this condition, the Final Regulation differs from the Proposal in that it adopts a "risk-based approach" rather than a "transaction-based approach." The Preamble noted this approach is designed to ensure that the principal risk of a given activity eligible for this exemption will remain solely outside of the United States. In the Final Rule, this condition has the following requirements:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition of an ownership interest in the covered fund, is not (and is not controlled directly or indirectly by) a banking entity that is located in the United States or organized under US law;

(ii) The banking entity (and its relevant personnel) that makes the decision to acquire the ownership interest or act as sponsor is not located in the United States or organized under US law;

(iii) The investment in or sponsorship of the covered fund 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 US law; and

(iv) 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 US law.

Notably, the Final Regulation eliminated the proposed requirement that US personnel or affiliates not be involved in the offer or sale of the fund.[40] Moreover, the Preamble notes that the US personnel and operations of a foreign banking entity can act as investment adviser to a covered fund as long as that does not result in the US personnel participating in the control of the covered fund or offering or selling an interest to a US resident. Finally, administrative services or similar functions can be provided by US personnel to the covered fund as an incident to the SOTUS activity.

Complex Fund Structures. There is some ambiguity concerning the manner in which multi-tiered fund structures (including master-feeder structures and parallel funds) are treated under the SOTUS

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[40] As stated above, however, personnel that make the decision to acquire the ownership interest or act as sponsor cannot be located in the United States.

exemption. The Preamble notes that the Agencies expect activities related to certain "complex fund structures" should be "integrated" to determine whether an ownership interest is offered for sale to a US resident. It appears that the Agencies may have in mind an investment in a fund otherwise eligible for the SOTUS exemption that is organized or operated for the purpose of investing in another covered fund that targets US residents. It is not clear, however, whether the Agencies are concerned only about evasion or also expect integration with respect to certain multi-tiered fund structures under other circumstances.

Exemption for Covered Fund Activities by a Regulated Insurance Company

The Proposal did not address how Section 13(d)(1)(F) of the BHCA, which provides an exemption for certain activities of a regulated insurance company from both the proprietary trading and covered fund prohibitions of the Volcker Rule, would be implemented with respect to covered funds. In response to comments, the Agencies modified the Final Regulation to provide an exemption from the covered fund investment prohibition for insurance companies and their affiliates. The exemption generally tracks the corresponding exemption from the proprietary trading prohibition. For an insurance company to be eligible for the exemption, the following conditions must be satisfied: (i) the insurance company must retain the ownership interest solely for the general account of the insurance company or for a separate account established by the insurance company; (ii) the acquisition or retention of the ownership interest must comply with applicable insurance laws and regulations in the jurisdiction where the insurance company is domiciled; and (iii) the federal banking agencies, after consulting with the FSOC and the relevant insurance regulators, must not have jointly determined that the relevant insurance laws or regulations fail to sufficiently protect the safety and soundness of the banking entity or the financial stability of the United States.

Limitations on Lending and Other Financial Relationships with Covered Funds (Super 23A)

Section _.14 of the Final Regulation implements so-called Super 23A with a few important changes from the approach in the Proposal. Super 23A refers to new Section 13(f) of the BHCA, which generally prohibits a banking entity, directly or indirectly, from entering into a "covered transaction," as defined under Section 23A of the Federal Reserve Act (the "FRA"), with a covered fund for which the banking entity or any affiliate acts as sponsor, investment manager, or investment adviser.

Scope. The general approach in the Final Regulation to the definition of covered funds reduces significantly the kinds of issuers that are treated as covered funds subject to the Super 23A prohibition. It will continue to apply to private equity funds and hedge funds and to issuers that otherwise fall within the definition of covered fund. It will also apply to covered funds that benefit from an exemption from the sponsorship and investment prohibitions, including the asset management and SOTUS exemptions. However, Super 23A will not apply to issuers that have now been excluded from the definition of covered fund under Section _.10(c) of the Final Regulation (discussed above, pages 17-21).

Direct or Indirect. One commenter argued that a banking entity that delegates the responsibility for acting as sponsor, investment manager, or investment adviser to a third party should not be subject to Super 23A. In the preamble, the financial agencies state that such a banking entity would continue to be subject to Super 23A if it retains the ability to select or remove or otherwise control the sponsor, investment adviser or investment manager.

Definition of "Covered Transaction." The definition of covered transaction continues to be based on the definition in Section 23A itself and includes (i) loans and other extensions of credit to the covered fund (including a purchase of assets subject to repurchase); (ii) purchases of assets from and investments in securities issued by the covered fund; (iii) issuance of financial guarantees on behalf of a covered fund; (iv) securities borrowing or lending that that results in a credit exposure to the covered fund; and (v) a derivatives transaction that results in credit exposure to the covered fund. In one helpful clarification, the Preamble states that covered transactions under the Final Regulation do not include loans to third parties that are secured by obligations issued by a covered fund. However, the Final Regulation does not adopt the request of many commenters that it incorporate the exemptions for covered transactions that are set forth in Section 23A itself (e.g., intraday extensions of credit). Like the Proposal, the Final Regulation would *not* incorporate the "attribution rule" under Section 23A, which provides that any transaction by a US 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.

Exempt Investments. The Final Regulation confirms that a banking entity may acquire or retain an ownership interest in a covered fund that is permitted in accordance with the other provisions of the Final Regulation, including the seed capital investments permitted under the asset management exemption, the SOTUS exemption and the risk retention investment required for securitization vehicles that are sponsored by banks or their affiliates.

Market Terms Condition. The Final Regulation would also apply the "market terms" and other requirements of Section 23B of the FRA to transactions between a banking entity and a covered fund sponsored, advised, or managed by the banking entity or any affiliate, effectively requiring that any permissible transactions with a sponsored or advised fund (i.e., non-covered transactions) are conducted on an arm's-length basis. These requirements generally mean that a transaction must be on terms that are substantially the same, or at least as favorable to the banking entity, as those prevailing at the time for comparable transactions between unaffiliated third parties.

Prime Brokerage Transactions. A banking entity may enter into a prime brokerage transaction with a sponsored or advised covered fund so long as (i) a covered fund managed, sponsored, or advised by such banking entity under Section _.11 of the Final Regulation has taken an ownership interest in the covered fund (the second-tier fund) and (ii) the CEO of the banking entity certifies annually that the banking entity does not guarantee the obligations of the second-tier fund or any covered fund in which the second-tier fund invests (in the case of a foreign banking entity, this certification may be provide by the senior manager in charge of US operations). Such transactions would be subject to Section 23B. "Prime brokerage transaction" is defined as any transaction that would be a covered transaction and that is

provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, data, operational, and administrative support.

Conflicts of Interest and Other Limitations on Permitted Activities

Sections _.7 and _.15 of the Final Regulation implement the statutory requirement that a banking entity may not engage in permitted proprietary trading or covered fund activities to the extent they 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 to US financial stability. These limitations apply with respect to permitted covered funds activities to the same extent as permitted trading activities.

Conflicts of Interest. A "material conflict of interest" between a banking entity and its customers or counterparties exists if the bank engages in any transaction or other activity that would involve its interest being adverse to the interests of the customer/counterparty with respect to the transaction or activity, unless the banking entity takes one of two actions prior to effecting the transaction or activity. First, it may make timely and effective disclosure of the conflict of interest, which provides the customer the opportunity to negate or substantially mitigate any materially adverse effect arising from the conflict. Second, the banking entity may have in place information barriers reasonably designed to prevent the conflict of interest from having a materially adverse effect on the customer. The banking entity may not rely on the second solution if it has knowledge or should have knowledge that despite the barrier the conflict of interest may have a materially adverse effect on a customer.

Extraterritorial Impact. The potential extraterritorial impact of this provision has been substantially mitigated by the decision in the Final Regulation to eliminate the "foreign equivalent" prong of the covered fund definition (thus exempting non-US funds that do not actually rely on Section 3(c)(1) or (7) of the 1940 Act) and to exclude foreign public funds from the definition of "covered fund." As result of these changes to the Proposal, the universe of foreign funds subject to the conflict of interest restrictions has been significantly reduced.

Compliance Program & Quantitative Trading Metrics

Overview

Compliance obligations are a critical aspect of the Final Regulation, and the process of developing and implementing a Volcker Rule compliance program is likely to be a significant challenge for many large banking entities over the coming 12-18 months. While a number of Volcker Rule permitted activities are explicitly conditioned upon the satisfaction of compliance-oriented obligations embedded in the text of

the relevant exemption, the bulk of the Volcker Rule compliance and reporting framework is set forth separately, beginning with Section _.20 of the Final Regulation. The compliance program requirements under the Final Regulation are generally similar in structure to those included in the Proposal, although the final requirements reflect an effort on the part of the Agencies to tailor the requirements to the size and characteristics of a banking entity's activities. The Final Regulation includes a few important substantive changes, perhaps most notably a greater emphasis on senior management oversight of, and responsibility for, Volcker Rule compliance.

Compliance Program Categories

No Compliance Program. Banking entities with no proprietary trading or covered fund activities other than trading in US Government obligations are not subject to a compliance program requirement under the Final Regulation. Unlike the Proposal, the Final Regulation does not require these entities to establish policies and procedures designed to prevent them from becoming engaged in activities subject to the Volcker Rule.

Limited Compliance Program. Banking entities with total consolidated assets of $10 billion or less may satisfy their compliance program obligations by incorporating appropriate references to Section 13 of the BHCA and the Final Regulation into existing policies and procedures. Unlike with respect to the enhanced compliance program, where foreign banking entities are expressly permitted to count only US assets (discussed below), the Final Regulation does not include any statement with respect to the relevant measure of assets for foreign banking entities considering their eligibility for the limited compliance program.

Standard Compliance Program. Banking entities with total consolidated assets of between $10 billion and $50 billion that are not engaged in significant trading activities requiring metrics reporting under Appendix A of the Final Regulation are subject to the standard Volcker Rule compliance program set forth in Section _.20 of the Final Regulation.

Enhanced Compliance Program. Banking entities with $50 billion or more in total consolidated assets or, in the case of a foreign banking entity, total US assets of $50 billion or more, are subject to enhanced compliance program requirements set forth in Appendix B of the Final Regulation. Banking entities required to report quantitative trading metrics under Appendix A of the Final Regulation are also subject to the enhanced compliance program requirement (i.e., even if they do not exceed the relevant $50 billion total asset threshold).

Enhanced Compliance Program, Plus Metrics Reporting. Banking entities with significant trading activities are required to measure, maintain records, and periodically report certain quantitative measurements or "metrics" related to certain trading activities under Appendix A. As noted above, each banking entity subject to metrics reporting under Appendix A is automatically subject to the enhanced compliance program requirements of Appendix B as well. Metrics reporting is to be phased in, beginning with banking entities having trading assets and liabilities the average gross sum of which (excluding

trading in US Government obligations) exceeds $50 billion. In the case of a foreign banking entity, the test is whether the average gross sum of trading assets and liabilities of the combined US operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies "operating, located or organized in" the United States) exceeds $50 billion.

Trading Assets and Liabilities. While "trading assets and liabilities" is not defined in the Final Regulation, the Preamble indicates that the measure should include even those trading assets and liabilities that do not involve "financial instruments" subject to the Volcker Rule, such as loans. For foreign banking entities, the trading assets and liability measure may be complicated by the directive to include trading assets and liabilities of subsidiaries and affiliates that are "operating in" the United States as part of the calculation. The Preamble does not clarify when a foreign banking entity would be characterized as operating in the United States for these purposes, nor does it address whether all trading assets and liabilities of such a foreign entity would be included or only its US activities (assuming the entity's trading activities can be bifurcated in this manner). Based on traditional bank regulatory interpretations of these terms, the best reading seems to be that trading assets and liabilities booked at US offices and subsidiaries should be included, but not assets and liabilities booked outside the US. However, it is possible that the Agencies may expect foreign banking entities to include transactions of non-US locations to the extent that US personnel or affiliates are involved in the transactions.

Implementation Schedule

Compliance Program. Each banking entity required to establish a compliance program under Section _.20 of the Final Regulation is required to do so "as soon as practicable and in no case later than the end of the conformance period." The Agencies have indicated they regard the development and implementation of a Volcker Rule compliance program a key aspect of a banking entity's "good faith" obligations during the conformance period.

The fact that the deadline for fully implementing a Volcker Rule compliance program is not until the end of the conformance period may have implications for Volcker Rule activities occurring during the course of the conformance period, particularly for activities carried out under the exemptions for market-making and risk-mitigating hedging. As discussed above (pages 8-11), the ability of a banking entity to engage in these and other Volcker Rule permitted activities under the Final Regulation is often explicitly conditioned upon satisfying certain compliance obligations. Accordingly, it makes little sense to characterize an activity as complying or not complying with the requirements of the market-making exemption, for example, without considering whether the relevant compliance infrastructure is in place. Banking entities will, therefore, need to be sensitive to how certain activities carried out during the remainder of the conformance period are likely to be perceived from a "good faith" and supervisory perspective, to the extent that the compliance framework for those activities is yet to be implemented.

Metrics Reporting. For banks with more than $50 billion in gross trading assets and liabilities, the metrics reporting obligations under Appendix A of the Final Regulation take effect June 30, 2014. Although the Final Regulation is not entirely clear, it appears to suggests that the first actual reporting

deadline for these largest banking entities would be August 30, 2014 (i.e., taking into account the monthly reporting period for these entities and initial reporting deadline of 30 days after month-end). As noted above, the metrics reporting obligations will be phased in for banking entities with significant trading activities not rising to the $50 billion level, as that threshold reduces to $25 billion beginning April 30, 2016, and to $10 billion beginning December 31, 2016.

Standard Compliance Program

Six Elements. Each banking entity with between $10 billion and $50 billion in total consolidated assets that engages in any Volcker Rule activities or investments (other than trading in US Government securities) is required under Section _.20 of the Final Regulation to develop and implement the standard compliance program, which consists at a minimum of the following six elements:

(i) Written policies and procedures reasonably designed to document, describe, monitor and limit Volcker Rule activities and investments;

(ii) Internal controls reasonably designed to monitor Volcker Rule compliance;

(iii) A management framework delineating responsibility and accountability for Volcker Rule compliance;

(iv) Independent testing and audit of the effectiveness of the Volcker Rule compliance program conducted "periodically" by qualified personnel of the banking entity or by a qualified third party;

(v) Volcker Rule training for trading personnel, managers, and any other appropriate personnel of the banking entity; and

(vi) Maintenance of records sufficient to demonstrate Volcker Rule compliance, which must be provided promptly upon Agency request and retained for a minimum of five years.

Management Oversight. The Final Regulation places greater emphasis on the role of management in Volcker Rule compliance, including a specific requirement, not included in the Proposal, under the "management framework" requirement for appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters.

Documentation of Fund Activities. In addition to the six elements noted above, the standard compliance program for each banking entity with more than $10 billion in total consolidated assets includes additional documentation requirements for fund sponsorship activities. Significantly, these documentation requirements extend to funds that are not covered funds. Banking entities sponsoring funds that are not covered funds are required to document the alternative 1940 Act exemption(s) being relied upon and/or the banking entity's determination that the fund is not a covered fund pursuant to one

of the exclusions noted above. The documentation requirements do not appear to apply to funds in which a banking entity is merely a third-party investor, but not the sponsor.

Large Investments in Foreign Public Funds. Each banking entity that is, or is controlled by a banking entity that is, located in or organized under US law is required to document ownership interests in funds held pursuant to the foreign public funds exemption in Section _.10(c)(1) of the Final Regulation, to the extent that the aggregate of such investments exceeds $50 million. A US branch, agency or subsidiary of a foreign banking entity is subject to this requirement. The obligation does not extend to foreign banking entities outside the United States.

Enhanced Compliance Program

Overview. The enhanced compliance program requirements under Appendix B of the Final Regulation include a highly prescriptive and, in certain respects, exceedingly granular set of minimum standards related to a covered banking entity's trading and covered fund activities, which apply in addition to the minimum requirements of the standard compliance program in Section _.20. In addition to heightened requirements related to covered trading and covered fund activities, Appendix B prescribes additional minimum standards related to management oversight, independent testing, training and recordkeeping. The enhanced compliance program requirements should be tailored to the size and characteristics of the banking entity's covered activities. Thus, if a banking entity's Volcker Rule activities consist of substantial proprietary trading activities but minimal covered fund activities (or vice versa), there appears to be sufficient flexibility under Appendix B to develop and implement a compliance program consistent with those activities (and not necessarily one that incorporates all of the elaborate requirements under Appendix B for activities in which the banking entity either does not engage or engages in on a more limited basis).

Proprietary Trading Standards. A banking entity subject to Appendix B is required to develop and implement extensive written policies and procedures for each "trading desk" addressing 12 different subject areas, including the authorized financial instruments for each desk and the exemption under which it trades, the types of activities and strategies permitted for the desk, risk limits and related analyses, processes for new products and strategies, and compensation arrangements, among others. The banking entity is required to have a documented risk management program for trading activities, including a description of the governance, approval, reporting, escalation, review and other processes the banking entity will use to ensure that trading activity is conducted in compliance with the Volcker Rule. Risks, instruments and products must be authorized at the trading desk level, with limits applied and monitored at the trading desk level as well. Finally, the banking entity is required to develop extensive written policies and procedures regarding the use of hedging instruments and strategies, again at the trading desk level.

Trading Desk. For many institutions, the task of developing and implementing an enhanced compliance program for proprietary trading activities will begin with the identification and mapping of trading desks across the organization. The Final Regulation defines a "trading desk" 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." As noted above, many of the key requirements imposed under Appendix B apply at this granular trading desk level. The Final Regulation permits the use of common policies and procedures, internal controls and other infrastructure for more than one trading desk where appropriate, but differences across desks must be carefully documented.

Covered Funds Standards. Appendix B includes similarly extensive requirements with respect to identifying and documenting all covered funds the banking entity sponsors or organizes and offers, and all covered funds in which the banking entity invests, including a specific mapping of units within the banking entity that are permitted to sponsor and invest in covered funds. The covered funds standards also include provisions related to heightened internal control standards, including with respect to Super 23A compliance.

Remediation. Both the proprietary trading and covered funds portions of the enhanced compliance program requirements include procedures for identifying, documenting and remedying violations of the Volcker Rule. These remediation procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program.

Management Oversight. A banking entity subject to Appendix B is required to establish a governance and management framework intended to prevent Volcker Rule violations. The provisions of Appendix B implementing this requirement impose significant obligations on the board and senior management of a banking entity subject to the enhanced compliance program requirements. In particular, the banking entity must adopt a written compliance program approved by the board of directors, an appropriate committee of the board, or equivalent governance body, as well as senior management. The board and senior management are expressly charged with "setting and communicating an appropriate culture of compliance."

CEO Attestation. In one of the more highly publicized features of the Final Regulation, Appendix B requires that the CEO of each banking entity subject to its requirements must, annually, attest in writing to the banking entity's primary regulator that the banking entity "has in place processes to establish, maintain, enforce, review, test and modify the compliance program established under" Appendix B and Section _.20 "in a manner reasonably designed to achieve compliance" with the Volcker Rule. The Final Regulation leaves open a number of additional questions regarding the CEO attestation requirement, including the timing for the first attestation and the manner in which it is to be provided. Because the attestation requirement is part of the enhanced compliance program requirement in Appendix B, the attestation should not be required at least until the end of the conformance period when Appendix B takes effect.

Applicability to Foreign Banking Entities. Appendix B and the Preamble include confusing and contradictory statements regarding how the CEO attestation requirement would apply to certain foreign banking entities. Appendix B itself provides that "[i]n the case of a US branch or agency of a foreign banking entity, the attestation may be provided for the entire US operations of the foreign banking entity

by the senior management officer of the United States operations." In describing this provision, however, the Preamble suggests a somewhat different scope, stating that the US senior officer attestation option is available "[i]n the case of the US operations of a foreign banking entity, *including* a US branch or agency" (emphasis added). For a foreign banking entity that operates in the United States through a bank subsidiary rather than a branch or agency, the Appendix B statement is potentially inapplicable. The Preamble language, on the other hand, would permit the senior US officer of the foreign banking entity's operations in the United States (e.g., the CEO of its top-tier US holding company) to provide the attestation for all US operations. Given that only the US operations of a foreign banking entity are considered in determining whether Appendix B applies, including for a foreign banking entity that operates in the United States through a US bank subsidiary rather than a branch or agency, it would seem that the same option to provide the CEO attestation solely with respect to US operations should be available in either case. However, in light of the ambiguities of the Final Regulation, more guidance may be required from the Agencies on this issue.[41]

Beyond the CEO attestation requirement, the manner in which the enhanced compliance program requirements apply to foreign banking entities (including in particular, the non-US operations of a foreign banking entity) is far from clear under the Final Regulation. The fact that only the combined US assets of a foreign banking entity are considered for purposes of determining applicability of the enhanced compliance program, as well as the provision for CEO attestation with respect only to the US operations of a foreign banking entity, each seem to suggest that Appendix B has limited or no applicability to the non-US operations of a foreign banking entity. The Preamble discussion of the enhanced compliance program requirements for proprietary trading also makes particular reference to a foreign banking entity's non-US operations, noting that a foreign banking entity trading outside the United States in reliance on Section _.6(e) "will be expected to provide information regarding the compliance program implemented to ensure compliance with the requirements of that section, ...but will only be expected to provide trading information regarding activity conducted within the United States."[42] This suggests that compliance obligations in respect of non-US trading, at least that which is carried out under Section _.6(e) of the Final Regulation, are less robust than would otherwise be required under Appendix B. Beyond these statements and the inferences one might draw from them, however, there is no definitive statement with respect to whether and to what extent the enhanced compliance program requirements of Appendix B would apply to the non-US operations of a foreign banking entity (including its non-US subsidiaries and affiliates). The plain language of Section _.20 could be interpreted to mean that, once a foreign banking entity becomes subject to Appendix B by virtue of its combined US assets calculation, the banking entity as a whole (which, in most cases, will be the top-tier entity in a large foreign banking organization) *and* its

[41] Moreover, neither Appendix B itself nor the Preamble explicitly states that the CEO attestation provided by the senior officer in the United States pertaining solely to its US operations is the only attestation required for a foreign banking entity subject to Appendix B. In other words, while the US officer attestation provision would seemingly suggest that no attestation is required with respect to non-US operations, the Final Regulation does not actually confirm that point. As discussed below, this also raises questions regarding the extent to which the heightened Appendix B standards should be interpreted as applying to the non-US activities of a foreign banking entity.

[42] *Joint Release* at 5,757.

non-US subsidiaries and affiliates are in scope of the enhanced compliance program requirements. One would hope for additional guidance from the Agencies on this issue during the conformance period.

Quantitative Metrics

Overview. Appendix A of the Final Regulation imposes quantitative measurement, reporting, and recordkeeping obligations on banking entities that engage in significant trading activities. As noted above, the metric reporting requirements are subject to a phase-in period, beginning June 30, 2014, for the few banking entities whose trading assets and liabilities exceed the $50 billion threshold. Each banking entity subject to Appendix A is required to (i) furnish periodic reports to its primary regulator regarding a variety of quantitative measurements of its “covered trading activities,” and (ii) create and maintain records documenting the preparation and content of those reports.

Once the phase-in period is complete, banking entities with $50 billion or more in gross trading assets and liabilities will be subject to monthly reporting, within 10 days of the end of the month. Banking entities subject to Appendix A but which have less than $50 billion in gross trading assets and liabilities will be subject to quarterly reporting, within 30 days of the end of the quarter. The Agencies intend to review and, as necessary, revise the specific metric reporting requirements prior to September 30, 2015, based on experience with the earliest group of reporting entities.

Covered Trading. The metrics reporting and recordkeeping obligations of Appendix A pertain only to “covered trading,” which includes proprietary trading carried out under any of five exemptions: (i) underwriting; (ii) market-making; (iii) risk-mitigating hedging; (iv) trading in US Government obligations; and (v) trading in foreign sovereign obligations.[43] Thus, the scope of trading activities that are actually subject to metrics recordkeeping and reporting under Appendix A is substantially narrower than the general “trading assets and liabilities” measure that is used for purposes of the Appendix A threshold calculations.

Appendix A generally requires that data regarding covered trading activities be collected and reported at the trading desk level. While reporting of trading data occurs only periodically, banking entities subject to Appendix A are required to calculate metrics on a daily basis.

Metrics. The Final Regulation reduces the total number of metrics that a banking entity is required to calculate and report from 17 to seven. In addition to the reduction in number, the Preamble notes the Agencies’ expectation that the burden associated with Appendix A will also be reduced because the metrics included in the Final Regulation either are already routinely calculated by covered banking entities, or are based on underlying data that is already routinely calculated. The final metrics include:

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43 A banking entity is permitted, but not required, to include trading carried out under various other exemptions in its metrics reporting.

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

The Final Regulation expressly provides that "[t]he quantitative measurements that must be furnished pursuant to this appendix [A] are *not* intended to serve as a dispositive tool for the identification of permissible or impermissible activities" (emphasis in original).

Supervisory and Enforcement Jurisdiction

Section _.21 of the Final Regulation, which has been adopted substantially as proposed, implements Section 13(e)(2) of the BHCA, which authorizes each Agency to order a banking entity subject to its jurisdiction to terminate activities or investments that violate or function as an evasion of the Volcker Rule. The Final Regulation does not further delineate the jurisdictional authority of each Agency as had been requested by some commenters, and the Agencies also declined to adopt suggestions from the industry that primary interpretive authority be vested in the FRB in order to facilitate consistent approach to the regulation of Volcker Rule activities. While acknowledging industry concerns regarding overlapping jurisdictional authority, the Preamble states that "the Agencies plan to coordinate their examination and enforcement proceedings under Section 13, to the extent possible and practicable."[44] Thus, a banking entity falling under the jurisdiction of multiple agencies, such as a national bank that is registered as a swap dealer, will likely need to contend with the complexities associated with answering to multiple Agencies with different mandates and areas of expertise. The CFTC's assertion of authority to act as a primary Volcker Rule supervisory authority for swap dealers in its version of the Preamble would seem to foreshadow examination and enforcement overlap for banking entities subject to the jurisdiction of multiple Agencies. ◆

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44 *Joint Release* at 5,774.

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