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U.S. Regulators Propose Regulations to Implement the Volcker Rule

On Tuesday, October 11, the Federal Reserve and the Federal Deposit Insurance Corporation (the "FDIC") unveiled proposed regulations to implement the Volcker Rule (the "Proposed Regulations") that will be issued jointly by the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency, and the U.S. Securities and Exchange Commission (the "SEC") (collectively, the "Agencies"). Enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Volcker Rule generally prohibits banking organizations from conducting proprietary trading and from sponsoring or acquiring an interest in a hedge fund or a private equity fund. In the Proposed Regulations, the Agencies attempt to take the very broad concepts of the Volcker Rule and create a workable framework for doing business under its prohibitions and exceptions. This is no simple task. The complete package from the Agencies is 298 pages long and includes nearly 400 specific questions that the Agencies hope will be answered in the public comment process. Comments are due by January 13, 2012. The Volcker Rule becomes effective on July 21, 2012.

In this document, we provide a general overview of the proposal and encourage the broadest possible participation in this rulemaking process. In many instances the Agencies have interpreted the scope of permitted activities narrowly. We note, in particular, the narrow interpretation of the exemption for proprietary trading conducted outside the United States by non-U.S. banking organizations and the constraints imposed by the Proposed Regulations on fund co-investment activities. The Agencies clearly want and need, however, thoughtful comments on the proposal. The Volcker Rule will transform a significant segment of the financial services industry. The best opportunity to limit the compliance burden and ensure reasonable implementation is to provide input now.

Background

Section 619 of the Dodd-Frank Act added a new Section 13 to the Bank Holding Company Act (the "BHCA") to codify the Volcker Rule. It applies to "banking entities," which include: (i) any depository institution, other than certain limited

Highlights

The Volcker Rule generally prohibits proprietary trading and investing in hedge funds or private equity funds.

The Regulators recognize the complexity of implementing the Volcker Rule.

The proposal package is 298 pages long and contains 400 questions.

Comments are due by January 13, 2012

The Volcker Rule will become effective on July 21, 2012.

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purpose trust companies; (ii) any company that controls an insured depository institution; (iii) any foreign bank or holding company subject to the BHCA; and (iv) any affiliate or subsidiary of any of these foregoing entities. As with the rest of the BHCA, the Volcker Rule applies extraterritorially to the worldwide operations of banking entities, unless there is an applicable exception to limit its scope.

The Dodd-Frank Act provides that the Volcker Rule would go into effect no later than July 21, 2012. If regulations had been finalized sooner, it could have gone into effect sooner, but now July 21, 2012 will be the effective date. The Dodd-Frank Act also provides for a transition period of two years during which a banking entity could come into compliance with the Volcker Rule (the "Conformance Period"). The significant point made by the Agencies in regard to the Conformance Period is that it is intended only to permit a banking entity to unwind previously existing activities that are impermissible under the Volcker Rule. The Conformance Period does not permit a banking entity to engage in any new activity or make any new investment in a covered private equity or hedge fund without complying with the Volcker Rule. Consequently, the July 21, 2012 effective date for the Volcker Rule has real and fairly clear meaning in terms of new investments in covered funds. The Proposed Regulations are less clear with respect to new proprietary trading transactions and existing positions and investments. The preamble to the Proposed Regulations states that "a banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance . . . as soon as practicable within the conformance period" and that "a trading entity may not expand its activity to include prohibited proprietary trading after the effective date . . . ." Although unclear, the implication of this language is that trading units that currently engage in proprietary trading must be wound down during the Conformance Period but need not stop entering into new proprietary trades on the effective date.

Prohibition on Proprietary Trading

The term “proprietary trading” is defined under the Volcker Rule as engaging as a principal for the trading account of a banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC and the U.S. Commodity Futures Trading Commission (the "CFTC") may determine by rule. Largely restating the statutory provisions of the Volcker Rule, the Proposed Regulations define "proprietary trading" to mean acting in a principal capacity by a banking entity for its *trading account* in any purchase or sale of a *covered financial position*. The Proposed Regulations then further clarify the meaning of a "covered financial position" and a "trading account."

Covered Financial Position

Borrowing the language from the statute, the Proposed Regulations define a "covered financial position" as any long, short, synthetic or other position in a security, derivative, contract of sale of a commodity for future delivery, or option on such positions. Loans, commodities (other than securities), foreign exchange, and currency are specifically excluded from the definition. Perhaps most significantly, the Proposed Regulations clarify the meaning of the term "derivative." The term "derivative" would include any swaps or security-based swaps, as defined under the Commodity Exchange Act (the "CEA") and the Securities Exchange Act of 1934 (the "Exchange Act"), respectively, as well as forward contracts and foreign exchange forwards and swaps. Other terms contained within the definition of a "Covered Financial Position" are generally defined with reference to existing law. The proposed definition also clarifies that transactions that the CFTC and SEC have jointly defined as not swaps or securities-based swaps, and certain identified banking products are outside the definition.

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Trading Account

Under the Volcker Rule, a "trading account" is generally defined to mean any account taking covered financial positions principally for the purpose of selling in the near-term or to resell in order to profit from short-term price movements, as well as such other accounts determined by the Agencies. Under the Proposed Regulations, any account used to hold a covered financial position of 60 days or less is *presumed* to be a trading account. This presumption is rebuttable by the banking entity by establishing that the financial position was not taken *principally* for short-term trading purposes. In addition, the Proposed Regulations provide a three-pronged definition of a "trading account." The satisfaction of any one of the three prongs is sufficient to trigger the application of the rule.

1. ***Short-Term Purpose.*** An account is a "trading account" if it is used to take positions for the purpose of: (i) short-term resale; (ii) benefiting from short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more such positions. The Agencies note in the Proposed Regulations that actual resale of the position is not required – the mere intent to engage in any form of transaction on a short-term basis is enough to fall within the definition. For example, an account holding derivatives intended to benefit from short-term price movements, like those that are closed out or for which variation margin is exchanged, would fall under this definition.

   The meaning of "short-term" remains undefined, but the Proposed Regulations emphasize that the term should be construed in a manner consistent with the approach taken under the Market Risk Capital Rules ("MRCR") established by the bank regulatory agencies as part of the regulatory capital adequacy framework applicable to banks and bank holding companies, which in turn cross-reference the definition of "trading account" used in Call Reports. The Proposed Regulations specify that a variety of factors should be considered in determining a transaction's purpose, including quantitative measurements of trading activity and supervisory reviews of compliance practices.

2. ***Market Risk Capital Rules.*** An account containing MRCR covered positions, other than foreign exchange derivatives, commodity derivatives and futures, is a "trading account." The stated purpose of this prohibition is to prevent banks from engaging in "regulatory arbitrage" by labeling positions as short-term trading for purposes of capital requirements, but not for purposes of the prohibition on proprietary trading.

3. ***Dealer Accounts.*** Any account that acquires a covered financial position is a "trading account" if maintained by one of the following covered banking entities: (i) a securities or municipal securities broker-dealer registered with the SEC; (ii) a registered government securities dealer; (iii) a swap dealer registered with the CFTC; (iv) a security-based swap dealer registered with the SEC; and (v) any dealer outside the United States if the position is acquired in connection with a dealer activity.

The Proposed Regulations except from the definition of a "trading account" certain accounts that are used solely for an economic purpose and substance that is separate from obtaining profit from anticipated or actual price movements. An account would not be treated as a "trading account" to the extent that the account acquires or take positions in:

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1. ***Repurchase or Reverse Purchase Agreements.*** Accounts used solely to take positions under repurchase or reverse repurchase agreements are excluded from the definition of a trading account.
2. ***Securities Lending Transactions.*** Accounts used solely to acquire covered financial positions that arise under a securities lending transaction under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loan security on agreed terms are not deemed trading accounts.
3. ***Liquidity Management Positions.*** Accounts used solely to take positions for the purpose of bona fide liquidity management activities are not considered trading accounts. To qualify for this exception, the transaction must be conducted in accordance with a documented liquidity management plan (subject to Agency review) that: (i) specifically contemplates and authorizes any particular instrument used for liquidity management purposes; (ii) requires that the principal purpose of any contemplated and authorized transaction be for liquidity management purposes; (iii) requires that any position be highly liquid and limited to financial instruments that are not expected to give rise to short term price movements; (iv) requires that any liquidity positions be limited to be consistent with near-term funding amounts; and (v) is consistent with the relevant Agency's guidance on liquidity management.
4. ***Accounts of Derivatives Clearing Houses.*** Accounts used by a derivatives clearing organization registered under the CEA or by a clearing agency registered under the Exchange Act to provide clearing services would not be trading accounts.

Exemptions to The Prohibition on Proprietary Trading

The Volcker Rule provides that the general prohibition on proprietary trading activities does not apply with respect to: (i) trading of securities and other instruments in connection with underwriting or market making-related activities; (ii) risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings; (iii) trading activities conducted solely outside of the United States by companies that are not directly or indirectly controlled by a company organized under U.S. law; (iv) trading on behalf of customers; (v) trading of certain government obligations; and (vi) certain trading activities by regulated insurance companies. The Proposed Regulations elaborate on these exemptions as outlined below.

Permitted Underwriting Activities

The proposed underwriting exemption would permit a banking entity to purchase or sell a covered financial position in connection with its underwriting activities, if the following requirements are satisfied:

1. ***Internal Compliance Program.*** The banking entity must establish an internal compliance program, including policies and procedures, internal controls, and independent testing, reasonably designed to ensure compliance with the underwriting exemption. The Proposed Regulations contain detailed programmatic compliance requirements discussed below under the heading "Mandatory Compliance Program."
2. ***Transaction in a Security.*** The covered financial position being purchased or sold must be a security.

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3. ***Distribution of Securities.*** The transactions must be effected solely in connection with a distribution of securities for which the banking entity acts as an underwriter.
   - *Distribution Definition* - the Proposed Regulations define "distribution" by reference to Regulation M under the Exchange Act. Accordingly, the offering must meet Regulation M's "magnitude" (e.g., number of shares sold, percentage of outstanding shares, etc.) and "special selling efforts and selling methods" (e.g., delivery of prospectus or other sales documents) requirements.
   - *Underwriter Definition* – the proposed regulation defines "underwriter" in accordance with Regulation M (*e.g.*, assistance with capital raising, organizing a syndicate, or marketing securities), but also includes a person who has an agreement with another underwriter to engage in the distribution of securities for, or on behalf of, an issuer or selling security holder.
4. ***Appropriate Registrations.*** The banking entity must be appropriately registered as a dealer, or otherwise exempt, or engaged in the business of a dealer outside the U.S. and subject to substantive non-U.S. regulation of its business.
5. ***Near-Term Needs.*** The underwriting activities of the banking entity must be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties.
6. ***Transaction Revenues.*** The banking entity's underwriting activities must be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income, and not from appreciation in the value of covered financial positions held related to such activities or related hedges.
7. ***Risk-Neutral Compensation.*** The compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking. For example, incentive structures that reward market value appreciation of underwritten securities are prohibited.

Permitted Market-Making Activities

Under the Proposed Regulations, the purchase or sale of a covered financial position in connection with market making-related activities and related hedging transactions would generally be exempt so long as the banking entity meets specific requirements that are designed to distinguish *bona fide* market making-related activities that provide intermediation and liquidity services to customers from trading designed to generate profits through speculative risk-taking. The following requirements must be met for this exemption to be available:

1. ***Internal Compliance Program.*** The banking entity must establish an internal compliance program designed to ensure that banking entities relying on the market-making exemption are engaging in bona fide market making-related activities.
2. ***Hold Itself Out as a Market-Maker.*** The trading desk or other organizational unit that purchases or sells a particular covered financial position must hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position for its own account on a regular, and with respect to liquid positions, on a continuous basis. For example, with respect to liquid positions, the unit would be expected to maintain competitive, continuous two-sided quotes that are widely accessible and broadly disseminated.

3. ***Clients Near-Term Needs.*** The market making related-activities of the trading desk or other organizational unit must be designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties.
4. ***Dealer Registration.*** The banking entity must be appropriately registered as a dealer, or otherwise exempt, or engaged in the business of a dealer outside the U.S. and subject to substantive non-U.S. regulation of its business.
5. ***Revenues/Fee Structure.*** The market making-related activities of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions held in its trading accounts or the hedging of such positions.
6. ***Risk-Neutral Compensation..***The compensation arrangements of persons performing market making-related activities at the banking entity must be designed not to encourage or reward proprietary risk taking.
7. ***Adhere to Market-Making Guidance.*** The market making-related activities must be consistent with a commentary provided in Appendix B to the Proposed Regulations, which is designed to distinguish prohibited proprietary trading from permitted marking making-related activities (e.g., how and to what extent a market maker hedges the risk of its market-making transactions).

Under the Proposed Regulations, a banking entity's market making-related hedging activities would also be permissible where: (i) the purchase or sale of a covered financial position is conducted to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption; and (ii) the hedging transaction must meet the criteria specified in the general exemption for risk-mitigating hedging activity discussed below.

Permitted Hedging Activities

The hedging exemption set forth in the Proposed Regulations would permit a banking entity to purchase or sell a covered financial position if: (i) the transaction is made in connection with, and related to, individual or aggregated positions, contracts, or other holdings of a banking entity; and (ii) is designed to reduce the specified risk to the banking entity in connection with and related to such positions, contracts or other holdings. Notably, the Proposed Regulations would permit hedging of risks on a portfolio basis. A banking entity should be prepared to identify, however, the specific portfolio of positions that is being hedged and to demonstrate that the hedging transaction is risk reducing in the aggregate. Reliance on the hedging exemption is premised on:

1. ***Internal Compliance Program.*** The banking entity must establish an internal compliance program including policies and procedures, internal controls, and independent testing, reasonably designed to ensure compliance with the hedging exemption.
2. ***Adherence to Internal Controls.*** A transaction effected in reliance on the hedging exemption must be effected in accordance with the requisite policies, procedures, and internal controls.

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3. ***Risk-Mitigating Purpose.*** The transaction must hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to an individual position or a portfolio of positions.
4. ***Reasonable Correlation to Intended Risk.*** The transaction must be reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate.
5. ***Limited Additional Risk Exposure.*** The hedging transaction at its inception does not give rise to significant exposures that are not themselves hedged in a contemporaneous transaction.
6. ***Continuous Review/Monitoring.*** Transactions conducted in reliance on the exemption must be subject to continuing review, monitoring, and management after the hedge is established.
7. ***Risk-Neutral Compensation.*** The compensation arrangement of persons performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.
8. ***Documentation of Certain Hedging Positions.*** Where a hedging transaction is effected in reliance on the hedging exemption at a level of the organization that is different from the level of the organization establishing the hedged positions, the covered banking entity must document the risk-mitigating purpose of the transaction at the time the transaction is effected and identify the risks of the individual or aggregated positions, contracts, or other holdings of the banking entity that each hedging transaction is intended to reduce.

Permitted Trading Outside the United States

The Volcker Rule provides that the prohibition on proprietary trading does not apply to purchases and sales of covered positions if: (i) the covered banking entity is not directly or indirectly controlled by a banking entity organized in the United States; (ii) the transaction complies with Section 4(c)(9) or (13) of the BHCA; and (iii) the transaction occurs solely outside the United States (the "Foreign Bank Exemption"). The Proposed Regulations interpret the statutory provisions in a way that significantly narrows the Foreign Bank Exemption and expands the extraterritorial application of the proprietary trading prohibitions.

Under the Proposed Regulations, a transaction will only occur "outside the United States" if: (i) the covered banking entity is not organized under the laws of the United States; (ii) no party to the transaction is a resident of the United States; (iii) no personnel of the covered banking entity directly involved in the transaction are physically located in the United States (excluding any strictly ministerial or administrative functions); and (iv) the transaction is wholly executed outside the United States. To satisfy the statutory requirement that the exempted transaction comply with Section 4(c)(9) or (13) of the BHCA, the Proposed Regulations would also require each non-U.S. banking entity to meet certain tests that require that most of its assets and revenues are generated outside the United States to be able to avail itself of the exemption.

Most significantly, under the Proposed Regulations a transaction would not be deemed to have occurred solely outside the United States if a party to the transaction is a resident of the United States. Thus, the Proposed Regulations clarify that any covered position that a non-U.S. covered banking entity establishes with a U.S. resident on a cross-border basis would not

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be exempted under the Foreign Bank Exemption. This interpretation will likely have a very significant impact on cross-border transactions where a non-U.S. covered entity is transacting in a principal capacity with residents of the United States. The Proposed Regulations are not entirely clear in this respect but, it appears that a non-U.S. banking entity would have to establish an internal compliance program and controls and otherwise comply with the requirements of potentially applicable exemptions in order to be able to transact as a principal with residents of the United States, *e.g.*, in a dealer or underwriting capacity. The definition of resident of the United States is similar, but not identical to, the definition of "U.S. Person" in Regulation S issued under the U.S. Securities Act of 1933. Accordingly, this interpretation may have a profound impact on cross-border securities and derivatives transactions by foreign banking organizations with U.S. institutional investors and financial intermediaries. In addition, the preamble to the Proposed Regulations specifically notes that the involvement of any execution facilities located in the United States would preclude a transaction from qualifying for the Foreign Bank Exemption. Thus, because the use of any U.S. trading facilities would be prohibited, the purchase of an asset by a non-U.S. banking entity on a U.S. exchange (such as, for instance, the New York Stock Exchange) would disqualify the transaction from the exemption. This would raise issues for foreign banking organizations seeking to engage in proprietary trading outside the United States in any asset class that trades on a U.S. exchange.

Permitted Trading on Behalf of Clients

A covered banking entity is permitted to trade on behalf of its customers if: (i) it is acting as an adviser or in a similar fiduciary capacity is trading for the customer's account, and the customer will be the beneficial owner; (ii) it is acting as a "riskless principal" in the transaction; or (iii) it is a regulated insurance company and the transaction is for a separate account established in connection with one or more insurance policies. The preamble to the Proposed Regulations notes that acting in a fiduciary capacity alone would not be sufficient to qualify for this exemption, if the covered banking entity is subject to trading gains or losses with respect to the transaction.

Permitted Trading of Government Obligations

The prohibition on proprietary trading will not apply to purchases or sales of covered financial positions that are obligations of the United States government or any agency thereof, obligations of any State or subdivision thereof and agency securities. Agency securities include obligations, participations or other instruments issued by, among others, Ginnie Mae, Fannie Mae and Freddy Mac. As proposed, this exemption would not apply to derivatives on government obligations, state or municipal agency obligations or the obligations of any foreign government, but the Agencies have requested comments on whether such derivatives or obligations should also be exempted.

Permitted Trading by Regulated Insurance Companies

The Proposed Regulations also permit a covered banking entity that is a regulated insurance company to trade for the general account of such entity if: (i) the trade is conducted in accordance with all applicable insurance laws and regulations; and (ii) the appropriate Federal banking agencies after consultation with the Financial Stability Oversight Council and the relevant insurance regulators have not jointly determined that this exemption is inapplicable.

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Limitations on Permitted Proprietary Trading Activities

The Proposed Regulations prohibit any proprietary trading that may otherwise be permitted, if the relevant transaction, class of transactions, or activity would: (i) involve or result in a material conflict of interest between the covered banking entity and its clients, customers or counterparties; (ii) result directly or indirectly in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.

Material Conflict of Interest

The Proposed Regulations provide that a material conflict of interest exists if the trading activity would involve or result in the covered banking entity's interest being materially adverse to the interest of its client, customer, or counterparty with respect to such trading. Conflicts of interests may be mitigated, however, through disclosure or information barriers.

1. ***Disclosure.*** A transaction that may involve or result in a material conflict of interest will be permitted if the covered banking entity makes timely and sufficient disclosure of such conflict of interest. Such disclosure must indicate the conflict of interest and provide any other information necessary to permit a reasonable client or counterparty to understand such conflict of interest. In addition, the disclosure must be made in a manner that would permit the customer or counterparty to negate or substantially mitigate any materially adverse effect on the client or counterparty created by such conflict of interest. The Proposed Regulations provide that any disclosure must be specific to the transaction, and may not be general or generic. In the preamble to the Proposed Regulations, however, the Agencies ask if a one time or general disclosure for certain types of transactions or to certain highly sophisticated clients or counterparties should be permitted, or if no disclosure is necessary for some other clients or counterparties. The Agencies have also indicated that any such disclosure must be given sufficiently close to the time that the client or counterparty would make its trading decision and not "far in advance" of such decision.

2. ***Information Barriers.*** A covered banking entity may also enter into a transaction that involves or could result in a material conflict of interest if it has established, maintained, and enforced information barriers that are designed to prevent the conflict of interest from resulting in a materially adverse effect on a customer. Such information barriers, which must be in the form of written policies, include physical separation of personnel or limitations on types of activity. The covered banking entity may not rely on this exemption, however, if it is aware that the conflict of interest will, notwithstanding the information barriers, result in a materially adverse effect on the customer.

High Risk Asset and Strategy/Threat to Financial Stability

The Proposed Regulations prohibit any proprietary trading that would cause the covered banking entity to have exposure to high-risk assets or a high-risk trading strategy. A high-risk strategy is defined as a trading strategy that would significantly increase the likelihood that such covered banking entity would suffer a substantial financial loss or would fail. A high-risk

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asset is defined as an asset that, if held by the covered banking entity, would also cause such a result. Transactions that pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States are also excluded from any exemption to the prohibition on proprietary trading.

Quantitative Reporting and Recordkeeping Requirements

The Proposed Regulations require any covered banking entity that has $1 billion or more in trading assets and liabilities on a worldwide consolidated basis to comply with certain quantitative measurements reporting requirements included in Appendix A to the Proposed Regulations, as well as with any other reporting and recordkeeping rules the Agencies may impose.[1] The covered banking entity would also have to maintain records documenting the preparation of the required reports and information sufficient to verify their accuracy for a period of five years.

The Proposed Regulations require covered banking entities to report quantitative measurements with respect to each "trading unit." The definition of "trading unit" in the Proposed Regulations covers multiple levels of a covered banking entity, including: (i) each discrete unit that participates in the execution of any covered trading activity; (ii) each organizational unit used to structure or control risk taking; (iii) all trading operations collectively; and (iv) each trading desk. The covered banking entity will therefore be required to provide reporting with respect to individual desks, intermediate divisions and trading operations as a whole.

Quantitative Measurements Reporting

The Proposed Regulations require each covered banking entity with gross trading assets and liabilities over $5 billion to provide 17 quantitative measurements for each market-making trading unit and 5 quantitative measurements relating to general risk and profitability of trading units engaged in other types of activities. A covered banking entity that has between $1 billion and $5 billion of gross trading assets and liabilities will be required to report 8 quantitative measurements for each market-making trading unit and will not be required to report quantitative measures for trading units engaged in other covered activities.

The quantitative measurements are intended to assess, among other things, whether a trading unit is engaged in permitted activities or is materially exposed to high-risk assets or trading strategies, a trading unit's volatility of profitability, and revenue generated per unit of risk. The Proposed Regulations anticipate that many of the quantitative reporting methods are already used by covered banking entities, though not for the purpose of compliance with the prohibition on proprietary trading. Therefore the Agencies propose to use the Conformance Period to carefully review the data provided pursuant to these reporting rules and propose changes as necessary.

The Agencies ask whether the rules should include any specific numerical thresholds for quantitative measurements. The consequence of such thresholds would be that a breach would require a review and report to the relevant Agency. No such thresholds are currently included in the Proposed Regulations. The Agencies note that, if implemented, such thresholds would not function as definitive measurements of permitted conduct.

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[1] In addition every covered banking entity would be subject to record retention and reporting requirements incorporated in the Mandatory Compliance Program outlined below. The quantitative measurement reporting requirements must also be incorporated in the Mandatory Compliance Program.

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Frequency of Reporting

The Proposed Regulations would require covered banking entities to calculate each quantitative measurement daily with respect to each trading unit. These calculations are required to be reported to the Agencies on a monthly basis, within 30 days of the end of the relevant month. Covered banking entities will also be required to maintain records that would allow the Agencies to determine the accuracy of such calculations for a period of five years.

Prohibition on Sponsoring or Investing in Covered Funds

The Volcker Rule generally prohibits "sponsoring" or acquiring any equity, partnership, or other ownership interest in a "hedge fund" or a "private equity fund." The Proposed Regulations clarify the statutory prohibitions and definitions by, among other things: (i) clarifying which funds will be "covered funds" subject to the prohibition; (ii) defining "ownership interest" and "sponsor;" and (iii) detailing the exceptions for (a) covered funds organized and offered by a covered banking entity with a *de minimis* investment not exceeding 3% and (b) sponsoring or investing in covered funds solely outside the United States.

Covered Funds Subject to the Prohibition

1. ***"But For" Test.*** The Proposed Regulations generally define "covered fund" to mean an entity that would be an "investment company" within the meaning of the Investment Company Act of 1940 (the "Investment Company Act") but for the exemptions set forth in Section 3(c)(1) (for funds with 100 or fewer owners) and Section 3(c)(7) (for funds held solely by qualified purchasers) of the Investment Company Act. Therefore, an entity that relies on an exemption other than (or in addition to) Section 3(c)(1) or Section 3(c)(7) – for example, a real estate fund relying on Section 3(c)(5)(C) or a "static" CLO or other ABS issuer eligible for exemption under SEC Rule 3a-7 – would not be a covered fund under the Proposed Regulations.
2. ***Commodity Pools.*** A commodity pool the CEA, because it is deemed under the Proposed Regulations to be "similar" to an entity whose Investment Company Act exemption satisfies the "but for" test, is included in the definition of a covered fund.
3. ***Non-U.S. Funds.*** The covered fund definition also encompasses non-U.S. entities which, if organized and offered under the laws of the United States, or to any U.S. resident, would be either an entity whose Investment Company Act exemption satisfies the "but for" test or a commodity pool under the CEA.

Definition of "Ownership Interest"

1. ***Generally.*** The Proposed Regulations broadly define an "ownership interest" in a covered fund to mean any equity, partnership, or other similar interest, whether voting or nonvoting (including any share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) or any derivative based on such interest. The preamble to the Proposed Regulations makes clear that "other similar instrument" includes any debt security that has substantially the same characteristics – such as voting rights or exposure to the covered fund's profits and losses – as an equity interest.

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2. ***Carried Interest.*** The definition of ownership interest excludes any "carried interest" in a covered fund, defined in the Proposed Regulations as any interest held by a covered banking entity (or any of its affiliates, subsidiaries or employees) in a covered fund for which the covered banking entity (or any of its affiliates, subsidiaries or employees) serves as investment manager, investment adviser or commodity trading adviser, if –

   - the sole purpose and effect of the interest is to allow the banking entity (or such affiliate, subsidiary or employee) to share in the profits of the covered fund as performance compensation for services provided to the covered fund, provided that the banking entity (or such affiliate, subsidiary or employee) may be subject to a "clawback" obligation to return profits previously received;

   - all such profit, once allocated, is distributed to the banking entity (or such affiliate, subsidiary or employee) promptly after being earned or, if not so distributed, the reinvested profit does not share in the subsequent profits and losses of the covered fund;

   - the banking entity (or such affiliate, subsidiary or employee) does not make any payment to the covered fund in connection with acquiring or retaining the interest; and

   - the interest is not transferable except to another affiliate or subsidiary of the banking entity.

In the private equity funds market, "carried interest" is most often used to describe the profits interest of a general partner in a fund organized as a limited partnership. Because the Proposed Regulations treat the general partner of a covered fund as "sponsoring" the fund, it appears likely that the exclusion of carried interest from the definition of ownership interest will be relevant mainly in the context of the exception for covered funds organized and offered by a covered banking entity with a *de minimis* investment not exceeding 3% (see below).

Definition of "Sponsor"

The Proposed Regulations provide that to "sponsor" a covered fund means to serve as its general partner, managing member, trustee (other than a trustee that does not exercise investment discretion, such as a "directed trustee" under ERISA), or commodity pool operator; in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of its directors, trustees, or management; or to share with the covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Permitted Covered Fund Activities

Exception for Covered Funds Organized and Offered by a Covered Banking Entity in the Course of Providing Asset Management Services

1. ***General Requirements***. The Volcker Rule's much-discussed "3%" exception is much dealt with in the Proposed Regulations, with uncertain results. The authority to make *de minimis* investments in a covered fund remains limited to the banking entity that "organizes and offers" the covered fund and does not appear to permit passive *de minimis* investments in funds organized and offered by unrelated third parties. Eligibility for the exception requires the covered banking entity to satisfy eight separate conditions:

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- the banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;
- the covered fund is organized and offered (i) only in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and (ii) only to persons that are customers to whom the banking entity provides such services;
- the banking entity does not acquire or retain an ownership interest in the covered fund other than a de minimis investment (as further described below);
- the banking entity complies with the Volcker Rule's "Super 23A" limitations on covered fund relationships;
- the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any other covered fund in which the covered fund invests;
- the covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and does not use the word "bank" in its name;
- no director or employee of the banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and
- the banking entity clearly and conspicuously makes specified written disclosures to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents).

2. ***Bona Fide Services Provided to Customers.*** The condition that the covered fund be organized and offered only to customers to whom the covered banking entity provides bona fide asset management services does not require pre-existing customer relationships. The customer relationships may be established in connection with the offering of interests in the covered fund, so long as the banking entity has "a credible plan or similar documentation outlining how the covered banking entity intends to provide advisory or similar services to its customers" with the covered fund offering. The preamble to the Proposed Regulations suggests that any "credible plan" should be "consistent with past practice" followed by the banking entity in its asset management business.

3. ***Calculation of De Minimis Investment.***
   - ***General limitations.*** Under the Proposed Regulations, a covered banking entity relying on the asset management exception generally may not acquire or retain an ownership interest in any covered fund other than a *de minimis* investment not exceeding 3% of the fund's total outstanding ownership interests. However, the banking entity may provide "seed" capital to a newly-established covered fund amounting to as much as 100% of the fund's outstanding ownership interests for up to one year after the fund is organized (with the possibility of up to two years extension) so long as the banking entity actively seeks unaffiliated investors to reduce through redemption, sale, dilution or otherwise the banking

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entity's aggregate investment to an amount not exceeding 3% of the fund's outstanding ownership interests. The Proposed Regulations also provides that the aggregate value of the banking entity's ownership interests in all covered funds held in reliance on the asset management exception may not exceed 3% of the banking entity's Tier 1 capital.

- ***Calculating the investment amount per covered fund.*** The Proposed Regulations stipulate that a covered banking entity's aggregate investment in a covered fund includes (i) 100% of the ownership interests owned by the banking entity and any of its controlled affiliates and (ii) a pro rata share of the ownership interests owned by any other covered fund organized and offered by the banking entity, where the banking entity does not control such other covered fund but owns or controls more than 5% of its voting shares. In addition, if the banking entity has a binding obligation or "knowing participation in a joint activity or parallel action toward a common goal" to make co-investments alongside or in parallel with the covered fund, the Proposed Regulations appears to require such co-investments to be counted toward the limit on the banking entity's investment in the covered fund – without any guidance on how this "apples and oranges" calculation should be done.

Permitted Sponsoring or Investing in Covered Funds Solely Outside the United States

1. ***General Requirements.*** The Proposed Regulations do little to mitigate the extraterritorial impact of the Volcker Rule's covered funds provisions or to address the inexplicably narrow scope of the exception for sponsoring or investing in covered funds solely outside the United States. The exception requires that –

    - the covered banking entity is not directly or indirectly controlled by a banking entity organized under U.S. federal or state law;

    - the activity is conducted pursuant to Section 4(c)(9) (exempting "shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States") or Section 4(c)(13) (exempting "shares of, or activities conducted by, any company which does no business in the United States except as an incident to its international or foreign business") of the BHCA;

    - no ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

    - the activity occurs solely outside the United States.

2. ***Offers or Sales to a U.S. Resident.*** The prohibition on marketing to U.S. residents was intended to ensure a "level playing field" between U.S. and non-U.S. banking entities competing for asset management business in the United States, by keeping non-U.S. banking entities able to sponsor covered funds outside the United States from offering their fund products in the U.S. market. However, in the case of a non-U.S. banking entity that seeks merely to participate as a passive investor in a non-U.S. covered fund sponsored by an unrelated third party, alongside other passive investors who happen to be U.S. residents, there appears to be no policy justification whatsoever

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for the prohibition (notwithstanding the unfortunately plain language of the statute). The Proposed Regulations neglect this critical distinction.

3. ***Solely Outside the United States.*** The Proposed Regulations narrow what it means to conduct an activity “solely outside the United States” and they thereby extend the extraterritorial reach of the Volcker Rule. Not only must the covered banking entity be organized under non-U.S. law and avoid offers and sales of covered funds to U.S. residents, but in addition no subsidiary, affiliate, or employee of the banking entity (other than an employee performing only “back office” functions) that is involved in offers or sales of covered funds – even to non-U.S. residents – may be incorporated or physically located in the United States.

Exception for Loan Securitizations

The Proposed Regulations create an exception permitting a covered banking entity to acquire or retain any ownership interest in, or to sponsor, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) loans; (ii)contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (a) materially relate to the terms of such loans or contractual rights or assets and (b) are used for hedging purposes with respect to the securitization structure.

In its current form, the exception for loan securitizations would not permit even “plain vanilla” CLO and similar securitization structures. Among other things, the exception appears not to permit an ABS-issuing covered fund to invest cash balances in government securities, commercial paper and other high-quality, short-term cash equivalents or to acquire or hold securities received in a restructuring of a troubled borrower (though the DPC authority clarification noted below may permit such investments).

Permitted Investments in SBICs and Related Funds

The Proposed Regulations essentially re-state the statutory exemptions that permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to: (i) one or more Small Business Investment Companies ("SBICs"); (ii) a public welfare investment funds that generally invest to promote the welfare of low- and moderate-income communities in the United States; or (iii) certain qualified rehabilitation investments in historic structures in the United States.

Permitted Risk-mitigating Fund Investment Hedging Activities

The Volcker Rule provides a general exemption from the prohibition on acquisition of an interest in a covered fund for risk-mitigating hedging activities. The Proposed Regulations clarify that in the context of covered fund activities this exemption is very limited. According to the Agencies, fund interests typically may not be used to hedge specific contract and positions. The only two scenarios where the Proposed Regulations would permit investments in covered funds to be made under the hedging exemption are: (i) where a banking entity is acting as an intermediary of a client (that is not a banking entity) to facilitate the exposure by the customer to the profits and losses of the covered fund in a manner similar to a "riskless principal" capacity; and (ii) where the banking entity invests in a fund to mitigate exposure to a compensation arrangement with an employee that directly provides investment services to such fund.

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The requirements for the availability of the hedging exemption in the covered fund activities context are substantially similar to the requirements for the hedging exemption in the context of proprietary trading activities (outlined above). There are certain material differences with respect to these requirements, however, including: (i) the limitation on the types of permitted hedges to the two types noted above; (ii) a required greater equivalency between the reference asset and the hedging instrument than the correlation required in the proprietary trading context; and (iii) the imposition of a documentation requirement on all funds-related hedging (as opposed to documenting just hedges established at different levels of the organization as in the proprietary trading context).

Permitted Investments in BOLI and Certain Other Covered Funds

The Agencies have noted that certain types of entities may meet the definition of a covered fund to the extent they rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act but do not engage in the type and scope of activities intended to be restricted or prohibited by the Volcker Rule. Accordingly, the Proposed Regulations will permit a banking entity to acquire or retain an ownership interest in or act as sponsor to:

(i) **bank owned life insurance ("BOLI")** accounts, which typically are structured as investment accounts that are excluded from the definition of an investment company by virtue of Section 3(c)(1) or 3(c)(7) of the Investment Company Act;

(ii) a **joint venture** between the banking entity and any other person, provided that the joint venture is an operating company and does not engage in any activity or any investment not permitted under the Proposed Regulations;

(iii) an **acquisition vehicle**, provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates; and

(iv) a wholly-owned **liquidity management subsidiary** of the banking entity that is engaged principally in providing *bona fide* liquidity management services as permitted in the context of proprietary trading.

DPC Authority. The Proposed Regulations clarify that a banking entity will be permitted to acquire any ownership interest in covered funds in the ordinary course of collecting a debt previously contracted in good faith, if the banking entity divests the ownership interest within applicable time periods provided for by the applicable Agency regulation.

Risk Retention Rules Clarification. The Proposed Regulations also clarify that, to avoid conflict with the risk retention requirements of the Dodd-Frank Act, banking entities will be permitted to acquire or retain an ownership interest in or act as sponsor to an issuer of asset-backed securities, but only with respect to the applicable minimum risk retention requirement applicable to a "securitizer" or "originator" under Section 15G of the Exchange Act.

Limitations on Relationships with Covered Funds

"Super 23A" Restrictions

Largely restating the statutory provisions, the Proposed Regulations would prohibit "covered transactions" as that term is defined in Section 23A of the Federal Reserve Act between a covered banking entity and any of its affiliates and a covered fund that is: (i) advised by the banking entity or any of its affiliates; or (ii) organized and offered, or sponsored by the banking entity or any of its affiliates. Section 23A generally imposes certain limitations on covered transactions between banks and their affiliates. The Volcker Rule prohibits outright covered transactions between a banking organization and a covered fund (including any funds controlled by such fund) with which the banking organization has an advisory or other permitted relationship. Covered transactions under Section 23A include, among other things, extensions of credit, purchases of assets, and guarantees. In addition, transactions between a banking entity and a covered fund, with which the banking entity

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has an advisory or other permitted relationship, must be conducted on market terms as required under Section 23B of the Federal Reserve Act.

Prime Brokerage Exemption

The Volcker Rule and the Proposed Regulations would permit prime brokerage transactions by a covered banking entity with a covered fund, irrespective of the Super 23A restrictions, provided that: (i) the covered banking entity and its affiliates are in compliance with the covered fund activity prohibitions of the rules; (ii) the chief executive officer of the top-tier affiliate of the covered banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; and (iii) the Federal Reserve has not determined that such prime brokerage transactions are inconsistent with the safety and soundness of the banking entity. The Proposed Regulations define a “prime brokerage transaction” to mean one or more products or services provided by the banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, and data, operational, and portfolio management support.

Limitations on Permitted Covered Fund Activities

Similarly to the limitation on permitted proprietary trading activities, the Proposed Regulations would prohibit any covered fund activities that may otherwise be permitted, if the relevant transaction, class of transactions, or activity would: (i) involve or result in a material conflict of interest between the covered banking entity and its clients, customers or counterparties, (ii) result directly or indirectly in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States. The definitions of "material conflict of interest," "high risk asset," "high risk strategy," and the manner in which conflict of interest may be negated or substantially mitigated are substantially the same as in the context of proprietary trading (as outlined above).

Mandatory Compliance Program

Basic Elements of the Compliance Program

The Proposed Regulations would require every banking entity that engages in covered trading or covered fund activities to develop and implement a Compliance Program designed to ensure and monitor compliance with the Volcker Rule.[2] Banking entities that do not engage in activities that are prohibited or restricted by the Volcker Rule need not implement a separate Compliance Program but must ensure that their existing compliance policies and procedures include measures designed to prevent the banking entity form engaging in prohibited or restricted activities.

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[2] A banking entity may establish a Compliance Program on an enterprise-wide basis, provided that the program: (i) by its terms and operation applies to each entity within the banking organization; (ii) meets the programmatic compliance standards of the rule; (iii) addresses the business structure, size, and complexity of the overall organization as well as the particular activities, risks, and applicable legal requirements of individual entities within the organization; and (iv) is periodically independently tested to ensure effectiveness at both the enterprise-wide and individual entity level.

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The basic elements of the mandatory Compliance Program are:

1. ***Policies and Procedures*** designed to document and monitor trading and covered fund activities;
2. ***Internal Controls*** designed to identify and prevent non-compliance;
3. ***Management Structure*** that assigns responsibility and accountability for compliance;
4. ***Independent Testing*** of the Compliance Program;
5. ***Training*** for appropriate personnel; and
6. ***Records*** retention for no less than 5 years sufficient to demonstrate compliance.

Banking entities that do not engage in activities that are prohibited or restricted by the Volcker Rule need not implement a separate Compliance Program but must ensure that their existing compliance policies and procedures include measures designed to prevent the banking entity from engaging in prohibited or restricted activities.

Compliance Program Standards

The Proposed Regulations state that the Compliance Program should be tailored to the size and complexity of the activities and business structure of the banking entity. The Compliance Program of every banking entity would have to, at a minimum, include the basic elements outlined above. In addition, the Proposed Regulations contain detailed compliance standards, which apply to the Compliance Program of a banking entity that: (i) engages in proprietary trading, and has, together with its affiliates, total worldwide consolidated trading assets equal to (a) $1 billion or more or (b) 10 percent or more of its total assets; or (ii) engages in covered fund activities and has, together with its affiliates (a) an aggregate investment in covered funds of $1 billion or more or (b) sponsors or advises covered funds with assets of $1 billion or more. The detailed programmatic compliance standards elaborate on the basic elements of the Compliance Program as outlined below.

Policies and Procedures

The compliance policies and procedures related to proprietary trading generally must: (i) specify how the banking entity determines which of its accounts are "trading accounts;" (ii) identify each trading unit within the organization and the business division or other organizational structure that overseas its activities; (iii) include a comprehensive description of the nature of the business of each trading unit, including strategy for revenue generation, authorized products, hedging strategies, expected holding periods and risks of trading positions, types of clients and counterparties, and compensation structure of the employees of the trading unit; (iv) include trader mandates that inform each trader of the prohibitions and restrictions imposed by the Volcker Rule and set parameters for permitted trading; (v) include a comprehensive description of the risks associated with each trading unit; (vi) include hedging policies and procedures addressing instruments, techniques, strategies, and related risk management and compliance processes; (vii) contain a detailed explanation of how each trading unit will comply with the Volcker Rule prohibitions and restrictions; and (viii) require prompt documentation and remediation of any violation.

The compliance policies and procedures related to covered fund activities generally must: (i) specify how the banking entity identifies covered fund activities; (ii) identify each asset management unit within the organization and the business division or other organizational structure that overseas its activities; (iii) include a comprehensive description of the nature of the business of each asset management unit, including a strategy for revenue generation related to covered fund activities, authorized activities for the asset management unit and the types of customers to which such services are provided, and the extent of any co-investment activities of the banking entity (including its directors or employees) in covered funds; (vii)

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contain a detailed explanation of how each asset management unit will comply with the Volcker Rule prohibitions and restrictions; and (viii) require prompt documentation and remediation of any violation.

Internal Controls

The proposed regulation requires each banking entity to establish internal controls that are designed to ensure that the trading and covered fund activities of each trading and asset management unit are conducted in accordance of the banking entity's compliance policies and procedure. Further, the internal controls must: (i) effectively monitor trading and covered fund activities; (ii) be reasonably designed to prevent violations; and (iii) contain procedures for remedying violations. Among other things, the internal controls must include: (i) risk limits applicable to each trading unit based on measures of potential loss (e.g., value-at-risk and notional exposures); (ii) quantitative measurement and analysis of covered trading activities; (iii) calculation of the individual and aggregate ownership interests in covered funds and monitoring the amount and timing of seed capital investments; and (iv) surveillance of the Compliance Program effectiveness.

Management Structure

Under the Proposed Regulations, a banking entity must establish a management structure that: (i) makes appropriate personnel responsible and accountable for the effective implementation of the Compliance Program; (ii) establishes clear reporting line with a chain of responsibility; (iii) requires board and management review and approval of the program; and (iv) incorporates management procedures designed to achieve compliance with the rule. More specifically the required management procedures must include: (i) the designation of at least one person for each trading unit with management responsibilities; (ii) procedures for review by a manager of the activities of each trading unit and the quantitative measurements required for programmatic compliance; (iii) description of the titles, qualifications, and locations of managers and the specific responsibilities of each person with respect to each trading unit; and (iv) procedures for determining compensation arrangements designed not to reward proprietary risk taking. In addition, the management structure must include managers with authority and responsibility for effective implementation and enforcement of the Compliance Program for each trading and asset management unit. The Proposed Regulations make senior management responsible for reinforcing a culture of compliance and for implementing and enforcing the Compliance Program. Senior management must report to the board of directors (or similar body) on the effectiveness of the Compliance Program. The board (or similar body) must ensure that senior management is qualified and motivated to manage compliance and that senior management has established appropriate incentives to support compliance with the Volcker Rule.

Independent Testing

The Proposed Regulations require independent testing to be performed by the banking entity's internal audit department, outside auditors, consultants or other qualified independent parties. The frequency with which such testing shall be conducted must be based on the size, scope and risk profile of the banking entity's covered trading and covered fund activities, but shall be no less than every 12 months.

Training

Banking entities would be required by the Proposed Regulations to provide relevant training to mangers, trading, and other appropriate personnel. The frequency of such training should be based on the size and the risk profile of the banking entity's covered trading and covered fund activities.

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Recordkeeping

The Proposed Regulations also require the retention of records sufficient to demonstrate compliance and support the operations and effectiveness of the Compliance Program. Such records must be retained for a period of no less than 5 years in a form that allows prompt production of such records upon request by the regulators.

This client memorandum does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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