SULLIVAN & CROMWELL LLP

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Volcker Rule

Agencies Release Proposed Rule Implementing the Volcker Rule

SUMMARY

On October 11, 2011, the federal banking agencies issued a 298-page notice of proposed rulemaking to implement the so-called "Volcker Rule" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Securities and Exchange Commission issued its notice today. The Volcker Rule imposes broad restrictions on proprietary trading and investing in and sponsoring private equity and hedge funds by banking organizations. Although it is widely understood that the Volcker Rule affects larger U.S. banking organizations and non-U.S. banking organizations, other financial organizations with trading operations, asset management business or other operations that pool assets will need to consider its implications carefully. The agencies are seeking comment from the public on all aspects of their highly complex proposal and have included over 1,300 questions on nearly 400 topics in the proposal. The comment period ends on January 13, 2012.

Among the proposal's key aspects are:

- ***Prohibition on proprietary trading.***
  - ***Scope of the prohibition.*** The definition of "trading account" (which governs which transactions may constitute proprietary trading and is defined in part by reference to accounts in which short-term trading is conducted) is quite broad and goes beyond definitions used for accounting and regulatory reporting purposes.
    - The proposal includes a rebuttable presumption that a position held for 60 days or less is a short-term trade subject to the prohibition.
    - A wide range of securities and derivatives, including swap agreements, security-based swaps, many foreign exchange and physically settled commodity contracts and foreign government securities, are subject to the prohibition, but transactions in actual commodities and loans (including leases, receivables and other extensions of credit) and repo/reverse repo and securities lending transactions are not.

  - ***Exemptions for market-making, underwriting and hedging transactions.*** Permissible market-making, underwriting and hedging activities are subject to a number of requirements and limitations.
    - Because market making is especially difficult to distinguish from proprietary trading, the agencies propose to require detailed and comprehensive reporting by larger participants of risk, profitability and other metrics. A subset of these metrics applies to underwriting, risk-mitigating hedging and trading in U.S. government and municipal obligations. According to the agencies, the metrics are not intended to produce conclusive evidence of prohibited activity. The agencies ask for guidance on appropriate metrics and intend to develop requirements based on experience over time.
  - ***Limited exemptions for customer transactions.*** Permissible trades on behalf of customers are more limited than many commenters suggested. In particular, although riskless principal transactions are within the scope of the exemption, the exemption requires that the purchase and sale occur "contemporaneously."
  - ***Compensation review required.*** To engage in permitted market making, underwriting and risk-mitigating hedging, compensation arrangements must be designed not to encourage or reward proprietary risk-taking and instead should be designed primarily to reward customer revenues, customer service and risk management (as applicable). A trading unit that primarily rewards proprietary risk taking will be considered to be engaged in prohibited proprietary trading.
- ***Prohibition on investing in or sponsoring hedge funds and private equity funds.***
  - ***Scope of funds covered.*** Commodity pools and foreign equivalents of hedge funds and private equity funds are covered by the prohibition. Several types of vehicles, including funds held as fiduciary, ERISA-qualified pension plans, bank-owned life insurance separate accounts, certain loan securitizations and a very limited number of types of corporate organizational vehicles are excluded. Although the agencies recognize that the statutory definition of fund sweeps too broadly, the proposal contains only limited changes to the definition and does not implement the Congressional directive from the legislative history of the Volcker Rule that the implementing rules not disrupt the way banking firms structure their normal investment holdings.
  - ***Exemptions for organized and offered funds, hedging and debts previously contracted.*** The exemption for organized and offered funds largely tracks the statutory language and allows for client relationships to be formed by and through the organization and offering of a fund. The hedging exemption is very limited, allowing hedging of direct exposures to covered funds in customer-driven transactions and to cover certain compensation arrangements. Interests in funds may be acquired in satisfaction of debts previously contracted. The agencies declined to apply the statutory market-making exemption to funds in the proposal.
  - ***Restrictions on relationships with covered funds.*** The prohibition on "covered transactions" (as defined in Federal Reserve Act Section 23A) involving a banking entity and certain covered funds does not adopt the exemptions or the attribution rule under Federal Reserve Act Section 23A.
- ***Activities outside of the United States.*** The proposal will impose significant restrictions on foreign banks' global activities.
- ***Conflicts of interest.*** Material conflicts of interest that would otherwise cause a transaction to be prohibited can generally be overcome with effective and specific pre-transaction disclosure or information barriers. The proposal offers little guidance on what constitutes a material conflict of interest.
- ***High-risk activities.*** Particular impermissible high-risk trading strategies and high-risk assets that would otherwise prohibit transactions are not identified.

- ***Compliance programs.*** New, comprehensive compliance programs at all levels of larger banking organizations will be required.
- ***No CEO attestation.*** A banking entity's board of directors and senior management, including the CEO, will be responsible for approving the required compliance programs, but the proposal does not require a formal public attestation of compliance by the CEO. As required by the Volcker Rule, a limited CEO certification is required if the banking entity offers prime brokerage services to certain covered funds.

The Volcker Rule, and therefore the proposal, takes an approach to these activities that has not been replicated by any other country. Although the Vickers Report, recently released in the United Kingdom, proposes the separation of securities activities (and wholesale banking more generally) from retail banking through separate entities, that approach is less restrictive than the absolute prohibitions of the Volcker Rule.

The proposal does not attempt to analyze whether the activities in question contributed significantly to the financial crisis of 2007–2008 or are otherwise unsafe or unsound. This is presumably because the agencies believe that they have only limited discretion in view of the statutory mandate. Nonetheless, commenters may wish to focus on these issues, as they should provide relevant background for the exercise of the discretion that the agencies do have.

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I. BACKGROUND AND ORGANIZATION OF MEMORANDUM

A. BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which was signed into law on July 21, 2010, added a new Section 13 to the Bank Holding Company Act of 1956 (the "BHC Act").[1] Section 13, referred to as the "Volcker Rule," prohibits a subject "banking entity" from:

- Engaging in "proprietary trading";
- Acquiring or retaining any ownership interest in or sponsoring a "hedge fund or a private equity fund"; and
- Engaging in a wide range of transactions with a hedge fund or private equity fund as to which it is an investment advisor or a sponsor.

Although the Volcker Rule's prohibitions do not apply to systemically important nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the appropriate agencies must impose additional capital charges, quantitative limits or other restrictions on these companies if they engage in activities prohibited under the Volcker Rule. No such restrictions have yet been proposed.

As directed in the Dodd-Frank Act, the Financial Stability Oversight Council (the "FSOC") released a study of the Volcker Rule on January 18, 2011, and made recommendations regarding its implementation to the Federal Reserve, the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC," and together with the Federal Reserve and the FDIC, the "federal banking agencies"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"). The Dodd-Frank Act further directs these agencies to issue rules implementing the Volcker Rule within nine months after the completion of the FSOC study and to consult and coordinate with each other regarding regulations and implementation.[2] Separately, on February 9, 2011, the Federal Reserve released a final rule, effective April 1, 2011, implementing the conformance periods for entities engaged in prohibited proprietary trading or private equity or hedge fund activities.[3] The Federal Reserve stated in the preamble to the conformance period final rule that the conformance periods give banking entities a period after the effective date of the Volcker Rule to bring

1 The BHC Act is codified at 12 U.S.C. § 1841 *et seq.*, and Section 13, the Volcker Rule, is codified at 12 U.S.C. § 1851.

2 12 U.S.C. § 1851(b)(2).

3 Conformance Period for Entities Engaged in Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8,265 (Feb. 14, 2011).

their activities, investments and relationships that were commenced, acquired, or entered into before the Volcker Rule's effective date into compliance with the Volcker Rule.[4]

On October 11, 2011, the federal banking agencies, and today, the SEC (the SEC together with the federal banking agencies, the "Agencies"), issued a notice of proposed rulemaking, which includes an extensive preamble (the "Preamble") as well as the text of the proposed rule (the "Proposed Rule") to be adopted by the Agencies to implement the Volcker Rule.[5] Comments on the Proposed Rule are due by January 13, 2012.

The Volcker Rule will become effective on July 21, 2012, regardless of the status of the rulemaking process. Compliance with the Volcker Rule will be phased in through July 2014 and, in some cases, for extension periods thereafter.

The Agencies note that banking entities must begin complying with applicable reporting and recordkeeping and compliance program requirements, including reporting of quantitative measurements, as of the Proposed Rule's effective date of July 21, 2012, even though prohibited activities and investments may not be fully conformed by that date. Moreover, the Preamble states that the Agencies expect banking entities to conform fully all investments and activities to the requirements of the Proposed Rule "as soon as practicable" within the conformance periods provided. Banking entities should therefore promptly begin their analysis of, and planning with respect to, potentially prohibited activities and investments.[6]

B. ORGANIZATION OF MEMORANDUM

This memorandum generally follows the organization of the Proposed Rule. Part II discusses the definition of "banking entity" in Subpart A of the Proposed Rule, which identifies the entities subject to the Proposed Rule's prohibitions. Part III discusses Subpart B of the Proposed Rule, which implements the prohibition on proprietary trading by banking entities. Part IV discusses Subpart C of the Proposed Rule, which implements the prohibition on acquiring or retaining ownership interests in, or sponsoring, hedge funds or private equity funds. Part V discusses Subpart D of the Proposed Rule, which sets out compliance program requirements for banking entities subject to the Volcker Rule and remedial actions

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4 *See* our Memorandum to Clients, dated February 11, 2011, "Federal Reserve Adopts Final Rule Implementing Volcker Rule Conformance Periods." As described in that memorandum, the conformance periods are generally narrowly defined.

5 Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds (to be codified at 12 C.F.R. Pts. 44, 248 and 351 and 17 C.F.R. Pt. 255). The Agencies consulted with staff of the CFTC in formulating the Proposed Rule, but the CFTC has not yet scheduled the release of its own proposed rule.

6 Although banking entities must begin furnishing quantitative measurements for all trading units or asset management units as of the effective date, the Agencies state that quantitative measurements furnished for proprietary trading activities that are conducted in reliance on the conformance period would not be used to identify prohibited proprietary trading during that period.

for violations of the Volcker Rule. Subpart E of the Proposed Rule, which was adopted only by the Federal Reserve, incorporates, with non-substantive conforming changes, the text of the conformance period final rule previously adopted by the Federal Reserve. The conformance period final rule is not described in this memorandum.

II. DEFINITION OF "BANKING ENTITY"

The prohibitions in the Volcker Rule apply to any "banking entity." Consistent with the statutory definition, the Proposed Rule broadly defines the term "banking entity" to mean any insured depository institution,[7] any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 and any affiliate or subsidiary of any of the preceding entities.[8] Importantly, the Proposed Rule clarifies that the definition of banking entity does not include any affiliate or subsidiary of a banking entity that is a hedge fund or a private equity fund (defined in the Proposed Rule collectively as "covered funds") permissibly organized, offered and held by the banking entity or any entity controlled by such a covered fund.[9] Without this clarification, a covered fund that a banking entity has permissibly organized and offered, and which it has sponsored or in which it has invested, would be a banking entity and would itself become subject to the Volcker Rule. Also, the Volcker Rule would otherwise have created an absolute prohibition against organized and offered funds of funds. On its face, this exclusion applies to permissibly organized and offered funds and does not expressly exclude covered funds otherwise permissibly held.[10]

Although registered investment companies are not expressly excluded from the definition, the Preamble clarifies that a mutual fund or other registered investment company would generally not be a subsidiary or affiliate of a banking entity if the banking entity provides only advisory or administrative services to, has certain limited investments in, or organizes, sponsors and manages, the mutual fund in accordance with

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7 "Insured depository institution" is defined by reference to the Federal Deposit Insurance Act but excludes an insured depository institution described in Section 2(c)(2)(D) of the BHC Act (the "trust company exemption").

8 Proposed Rule Section __.2(e). Sections __.2(a) and (bb) of the Proposed Rule define the terms "affiliate" and "subsidiary" to have the same meaning as in Sections 2(d) and (k) of the BHC Act. The terms "affiliate" and "subsidiary" in the BHC Act incorporate the definition of "company" in Section 2(b) of the BHC Act, which includes "any other trust unless by its terms it must terminate within twenty-five years or not later than twenty-one years and ten months after the death of individuals living on the effective date of the trust." However, the Federal Reserve interprets the limitation on a bank holding company's acting as a fiduciary for a trust that is a company under Section 2(b) of the BHC Act as applying "only where the trust is also a bank holding company." *See* 48 Fed. Reg. 23,420, 23,429 (May 25, 1983).

9 Proposed Rule Section __.2(e)(4).

10 For example, it would appear that a non-U.S. hedge or private equity fund of funds sponsored by a foreign banking organization and that is exempt because it is offered and sold only to non-U.S. residents would nevertheless be a banking entity and would itself be prohibited from investing in other covered funds that do not qualify for the foreign exemption.

BHC Act rules. The Proposed Rule does not address the application of the definition to other types of entities that would not necessarily be treated as "affiliates" of bank holding companies in other contexts.

III. PROPRIETARY TRADING

A. PROHIBITION ON PROPRIETARY TRADING

The Proposed Rule prohibits a banking entity from engaging as principal for its "trading account" in the purchase or sale of one or more instruments that are defined as a "covered financial position."[11] Such purchases and sales are deemed to be proprietary trading and are prohibited unless specifically permitted by the Proposed Rule. Proprietary trading, as defined in the Proposed Rule, does not include acting solely as agent, broker or custodian for an unaffiliated third party.

1. Covered financial position

The Proposed Rule broadly defines a covered financial position as any long, short, synthetic or other position in:

- A security (as defined in the Securities Exchange Act of 1934 (the "Exchange Act")), including an option on a security;
- A derivative, including an option on a derivative; or
- A contract of sale of a commodity for future delivery (as defined in the Commodity Exchange Act, which uses the term to refer to a listed exchange-traded futures contract), or an option on such a contract.

A covered financial position excludes any position that is itself a loan (which is defined to include any lease, extension of credit or secured or unsecured receivable), a commodity, or foreign exchange or currency, and these positions are therefore not subject to the proprietary trading restriction. The term includes options, derivatives or futures related to these instruments. Consistent with the reference to "extension of credit" in the definition of loan, the Preamble states that the definition is expansive and encompasses "a broad array of loans and similar credit transactions, but does <u>not</u> include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans." Neither the Proposed Rule nor the Preamble addresses the treatment of a loan transaction that encompasses equity interests or features.

"Derivatives." The Proposed Rule defines the term "derivative" broadly to include any swap or security-based swap, as defined under the Dodd-Frank Act, and also includes a number of categories of instruments that are excluded from the definitions of "swap" and "security-based swap," such as: physically settled commodity forward contracts; foreign exchange swaps and forwards; agreements, contracts or transactions in foreign currency or in commodities other than foreign currency (as described

[11] Proposed Rule Section __.3.

in Sections 2(c)(2)(C)(i) and 2(c)(2)(D)(i) of the Commodity Exchange Act, respectively); and transactions authorized under Section 19 of the Commodity Exchange Act.[12] The term "derivative" does not include: (a) any consumer, commercial or other agreement, contract, or transaction that the CFTC and SEC have interpreted as not within the definition of swap or security-based swap; or (b) any identified banking product, as defined in Section 402(b) of the Legal Certainty for Bank Products Act of 2000, that is subject to Section 403(a) of that Act.[13]

Under this definition of "derivative," "foreign exchange forward" and "foreign exchange swap" transactions, as defined under the Dodd-Frank Act, and forward contracts on physical commodities, are included in the definition, and are therefore considered "covered financial positions," despite the fact that such instruments are, or may be, otherwise excluded from regulation as "swaps" under the Dodd-Frank Act. In addition, as noted, the Proposed Rule incorporates within the definition of a "derivative" those transactions "described in" Sections 2(c)(2)(C)(i) and 2(c)(2)(D)(i) of the Commodity Exchange Act. Section 2(c)(2)(C)(i) covers certain transactions in foreign currencies, and Section 2(c)(2)(D)(i) covers certain transactions in commodities other than foreign currencies. Each of Section 2(c)(2)(C)(i) and 2(c)(2)(D)(i) excludes from its scope spot transactions in which delivery occurs within two days and commercial forward transactions that are entered into in connection with a "line of business." It is unclear if the Proposed Rule is intended to exclude these types of transactions from the definition of "derivatives," or if the cross-references to the enumerated sections of the Commodity Exchange Act were intended only to describe the transaction types without incorporating the exclusions. Hopefully, clear guidance will be provided in the final rule.

2. Trading account

The proposed definition of trading account includes any of the following accounts used by a banking entity to acquire or take covered financial positions:

- Accounts used for short-term trading purposes;

[12] Section 19 of the Commodity Exchange Act prohibits the offering, entering into, or execution of transactions for the delivery of any commodity pursuant to standardized contracts that are, in substance, margin accounts, margin contracts, leverage accounts or leverage contracts, except for transactions in silver, gold or platinum authorized by the CFTC. These types of transactions, referred to generically as "leverage contracts," are a form of over-the-counter trading instruments, often marketed to retail investors, that may be entered into only pursuant to a regulatory regime promulgated by the CFTC pursuant to Section 19. Leverage contracts have not been widely offered, and very limited use has been made of the CFTC's regime for such contracts.

[13] These "identified banking products" generally include bank deposits, banker's acceptances, letters of credit issued by or loans made by a bank, debit accounts at banks arising from credit cards or similar arrangements and certain loan participations. A loan participation for this purpose is a participation in a loan that a bank or non-broker-dealer bank affiliate funds, participates in, or owns that is sold either to an "eligible contract participant," or to other persons that have the opportunity to review and assess any material information, including information regarding the borrower's creditworthiness, and have the capability to evaluate the information available, as determined under generally applicable banking standards. *See* Dodd-Frank Act Section 725(g)(2).

- Accounts that are subject to the federal banking agencies' market risk capital rules (the "Market Risk Capital Rules");[14] or
- Accounts used by a securities, municipal securities or government securities dealer, swap dealer, security-based swap dealer or an account used by a person engaged in the business of a dealer, swap dealer or security-based swap dealer outside the U.S.[15]

a. Accounts used for short-term trading purposes

The first category of trading account is any account used by a banking entity to acquire or take covered financial positions for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits or hedging any of these positions.[16]

The Preamble states that any account used with the intent to engage in any transaction on a short-term basis to benefit from a short-term price movement would be a trading account even if resale did not occur. The "intent" standard may be difficult to apply in practice. For instance, an identical transaction at two different covered banking entities may result in different treatment based on the trader's subjective intent. It would appear that detailed policies and procedures may be necessary to establish a lack of "intent." Although the Proposed Rule does not further define the elements of the definition of this category of trading account, the Preamble notes that the Agencies propose to interpret the language in the definition in accordance with the similar language of the definition of "trading position" in the Market Risk Capital Rules, as proposed to be amended. The Preamble indicates that all relative value type arbitrage transactions would be treated as short-term transactions.

The Proposed Rule includes a rebuttable presumption that any account used to acquire or take a covered financial position that is held for 60 days or less is presumed to be a trading account, unless the banking entity can demonstrate, based on all the facts and circumstances, that the position, either individually or in the aggregate, was not acquired principally for short-term trading purposes. The Preamble suggests that the acquisition of a security, with the documented, demonstrable intent to hold it for investment purposes and to treat it as such for financial reporting purposes, would generally not be considered to

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14 The current Market Risk Capital Rules are located at 12 C.F.R. Pt. 3, Appendix B (OCC), 12 C.F.R. Pt. 208, Appendix E and 12 C.F.R. Pt. 225, Appendix E (Federal Reserve), and 12 C.F.R. Pt. 325, Appendix C (FDIC), as applicable. Proposed amendments to the Market Risk Capital Rules are located at 76 Fed. Reg. 1,890 (Jan. 11, 2011). The Market Risk Capital Rules, both in their current form and after giving effect to the proposed amendments, apply to banks and bank holding companies whose trading activity (defined as the gross sum of trading assets and liabilities, on a worldwide consolidated basis) equals 10% or more of total assets or $1 billion or more.

15 Proposed Rule Section __.3(b)(2)(i)(A)–(C).

16 The Agencies rejected formally incorporating the accounting standards governing trading securities into the definition of trading account on the basis that: (i) the prohibition on proprietary trading applies to certain financial instruments to which the trading security accounting standards may not apply; (ii) these accounting standards allow companies to elect to classify assets as trading securities even where the assets would not otherwise meet the definition of trading security; and (iii) these accounting standards could change in the future without consideration of the potential impact on the Proposed Rule.

have been acquired with short-term trading intent if later, unexpected developments caused it to be sold in 60 days or less. The exact contours of this "change in circumstances" interpretation are unclear.

b. Accounts that are subject to the Market Risk Capital Rules

The second category of trading account is any account used by a banking entity to acquire or take covered financial positions that are "covered positions" under the Market Risk Capital Rules, if the banking entity, or any affiliate that is a bank holding company, calculates risk-based capital under the Market Risk Capital Rules.[17] The Market Risk Capital Rules define a covered position to include all positions in a bank's "trading account."[18] Those positions are subject to a risk-based capital charge that is based, at least in part, on the banking organization's internal risk management models for calculating expected losses in the account. The Preamble underscores that this second category of trading account is based on the Market Risk Capital Rules as proposed to be amended, and more specifically the definition of "covered position" contained therein. To the extent that the proposed revisions affecting the definition of "covered position" are not adopted, or are adopted in a form other than as proposed, the Agencies would expect to take that into account in determining whether or how to include the proposed second category of the trading account definition for purposes of the final rule to implement the Volcker Rule.

c. Accounts used by securities, municipal securities or government securities dealers, swap dealers or security-based swap dealers

The third category of trading account includes any account used to acquire or take one or more covered financial positions by a banking entity that is a registered dealer or municipal securities dealer, swap dealer or security-based swap dealer,[19] a government securities dealer that is registered with the SEC or has filed notice with an appropriate regulatory agency, or a banking entity engaged in the business of a dealer, swap dealer or security-based swap dealer outside of the U.S., in each case to the extent that the covered financial position is acquired or taken in connection with such dealer-related activities.

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[17] Foreign exchange derivatives, commodity derivatives, and contracts of sale of a commodity for future delivery that are Market Risk Capital Rules "covered positions" are excluded for purposes of this prong of the definition of trading account, because all such instruments are covered positions under Market Risk Capital Rules regardless of short-term trading intent. But accounts holding such instruments may still constitute trading accounts if they are used for short-term trading purposes.

[18] *See* 12 C.F.R. Pt. 3, Appendix B (OCC), 12 C.F.R. Pt. 208, Appendix E and 12 C.F.R. Pt. 225, Appendix E (Federal Reserve), and 12 C.F.R. Pt. 325, Appendix C (FDIC).

[19] The rules relating to swap dealers and security-based swap dealers have been proposed by the SEC and CFTC but have not been finalized.

d. Excluded positions

i. Positions under certain repurchase and reverse repurchase arrangements and securities lending transactions

The Agencies recognize that repurchase and reverse repurchase agreements are, in substance, secured loans rather than short-term trades. Securities lending transactions are excluded on the basis that these transactions can be used to operate in economic substance and function as a means to facilitate securities transaction settlements and are not based upon expected or anticipated market moves. Accordingly, an account will not be a trading account to the extent that such account is used to establish or acquire one or more covered financial positions that arise under:

- A repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty; or
- A transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.

ii. Positions acquired or taken for liquidity management purposes

An account will not be a trading account to the extent that such account is used to establish or acquire a position for the purpose of *bona fide* liquidity management. To be eligible for this exclusion, such positions must be taken in accordance with a documented liquidity management plan that, among other things:

- Specifically authorizes the particular instrument to be used, its market, credit and other risk profile, and the liquidity circumstances under which it may be used;
- Requires any position acquired or taken for liquidity management purposes to be highly liquid and limited to financial instruments that are not expected to give rise to appreciable profits or losses as a result of short-term price movements;[20] and
- Requires any position acquired or taken for liquidity management purposes to be limited to an amount that is consistent with the banking entity's near-term funding needs.

The requirement in the first bullet point above appears to require a highly detailed liquidity plan that specifically addresses when, why and how each specific highly liquid instrument may be used to hedge liquidity risk. Further, "near-term funding needs" is not defined nor does the Preamble provide any guidance on this term.

[20] The Preamble states that any instance in which positions characterized as taken for liquidity purposes do give rise to appreciable profits or losses (which are not defined or quantified) as a result of short-term price movements will be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be viewed as prohibited proprietary trading under the Proposed Rule.

In December 2010, the Basel Committee on Banking Supervision released its final framework for liquidity regulation entitled *Basel III: International framework for liquidity risk measurement, standards and monitoring* (the "Basel III liquidity framework"). One of the Basel III liquidity framework's requirements is the Liquidity Coverage Ratio, or "LCR," defined as the ratio of the "stock of liquid assets" to net cash outflows over a 30-day time horizon. Neither the Proposed Rule nor the Preamble addresses the relationship between the stock of liquid assets for LCR purposes and the trading account exclusion for *bona fide* liquidity management – most importantly, whether assets that qualify for the LCR's numerator are definitionally within the exclusion. The federal banking agencies have not yet published proposed regulations implementing the Basel III liquidity framework in the U.S. for banking organizations.

iii. Positions of derivatives clearing organizations and clearing agencies

An account will not be a trading account to the extent that it is used to acquire or take one or more covered financial positions by a banking entity that is a CFTC-registered derivatives clearing organization or an SEC-registered clearing agency in connection with clearing derivatives or securities transactions. This exclusion is limited to entities operating as clearing houses that are within the definition of a "banking entity" by virtue of their affiliation with a bank or bank holding company.

B. PERMITTED ACTIVITIES

The Volcker Rule permits several activities that are exemptions from the proprietary trading prohibition, including exemptions for market making, underwriting and hedging. The Proposed Rule describes detailed requirements applicable to them. Two requirements common to the market-making, underwriting and hedging exemptions are an internal compliance program that addresses the features and risks unique to each particular activity and compensation policies that are designed not to reward proprietary risk-taking.[21]

- ***Internal compliance program.*** The banking entity must have established the internal compliance program discussed in Part V below, including any applicable quantitative measurements for the banking entity and each of its trading units,[22] to assist both banking entities and the Agencies in assessing whether the quantitative profile of a trading unit (*e.g.*, the types of revenues it generates and the risks it retains) is consistent with permitted market-making, underwriting or hedging activities. With respect to hedging activity, the program must require continuing review, monitoring and management after the hedge is established to ensure that a reasonable level of correlation is maintained and that any significant exposure arising out of the hedge after inception is mitigated.
- ***Compensation incentives.*** The compensation arrangements of persons performing permitted market-making, underwriting or hedging activities must be designed not to reward proprietary risk-

[21] Proposed Rule Section __.4(a); Section __.4(b); Section __.5.

[22] Appendix A to the Proposed Rule defines a "trading unit" as each of the following units of organization of a banking entity: (i) each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity, (ii) each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units described in paragraph (i), (iii) all trading operations, collectively, and (iv) any other unit of organization specified by the Agencies with respect to a particular banking entity.

taking. As widely reported, a trading unit that primarily rewards proprietary risk-taking will be considered to be engaged in prohibited proprietary trading. Although a banking entity may appropriately take into account revenues that reflect the effectiveness with which personnel have managed principal risk retained or underwriting risk, the Agencies state that a banking entity relying on the market-making or underwriting exemptions should provide compensation incentives that primarily reward customer revenues (such as fees, commissions and bid/ask spreads) and the success of bringing securities to market for a client.[23] Similarly, the Agencies state that compensation arrangements for personnel engaged in hedging activities should reward success in reducing risk and not speculation in the value of a covered financial position. The conditions on incentives will require many banking entities to review and revise the compensation structures of their trading units. In light of the way the criteria for permitted activities work together, however, it is possible that some of the core compensation principles for trading units may be retained.

1. Permitted market making-related activities

The prohibition on proprietary trading does not apply to the purchase or sale of a covered financial position in connection with the banking entity's market making-related activities.

a. Criteria applicable to permitted market making-related activities

In order to rely on this exemption, the activity must satisfy all of the following criteria, in addition to the common compliance and compensation criteria described above:

- ***Bona fide market making.*** The specific trading desk or other organizational unit that conducts the purchase or sale must hold itself out as willing to buy and sell, including through entering into long and short positions in, the specific covered financial position for its own account on a regular or continuous basis. The specific requirements of this criterion vary, depending on the liquidity of the position.
    - ***Relatively liquid positions.*** For relatively liquid positions, such as equity securities or other exchange-traded instruments, the Preamble notes that a trading desk's market making-related activity should generally include:
        - Making continuous, two sided quotes and holding itself out as willing to buy and sell on a continuous basis;
        - A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;
        - Making continuous quotations that are at or near the market on both sides; and
        - Providing widely accessible and broadly disseminated quotes.[24]

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[23] Appendix A to the Proposed Rule discusses how the Agencies propose to assess whether the compensation incentives provided to trading personnel relying on the market-making exemption are consistent with market making-related activities. In particular, the Agencies intend to evaluate the extent to which incentives reward movements in the price of retained principal positions and risks, the extent to which incentives reward customer revenues and the incentives provided by other banking entities to similarly situated personnel.

[24] These requirements are largely derived from the SEC's interpretation of *bona fide* market making for purposes of Regulation SHO. Release No. 34-58,775, *Amendments to Regulation SHO* [2008 Transfer Binder] Fed. Sec. L. Rep. ¶ 88,296, at 87,292–294 (Oct. 14, 2008). In this Release, the SEC notes that *bona fide* market making would not generally include activities that are related to speculative selling strategies or investment purposes and are disproportionate to usual market-making patterns or practices, quotations continually posted at or near the best offer but not at or near the best bid, and continually executing short sales away from posted quotes.

- ***Less liquid positions.*** For less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, the Preamble notes that appropriate indicia of market making-related activities will vary, but should generally include:
  - Holding itself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;[25]
  - With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers or counterparties in the secondary market; and
  - Transaction volumes and risk proportionate to historical customer liquidity and investment needs.
- ***Block positioning and anticipatory customer demand.*** The *bona fide* market making-related activity described in the Proposed Rule includes block positioning if undertaken to intermediate customer trading.[26] Among other things, this exemption would appear to include activity as a "block positioner" in a transaction in restricted and control securities under Rule 144 under the Securities Act of 1933 (the "Securities Act"), and it does not appear that the Agencies intend these Rule 144 transactions to be treated as "underwritings". In addition, the Preamble notes that *bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers or counterparties. It is unclear how the covered banking entity will be able to show clear and demonstrable trading intent and what policies and procedures would be needed to support this activity.[27]
- ***Registration under securities or commodities laws.*** The banking entity must be registered as a securities dealer, municipal securities dealer, government securities dealer, swap dealer or security-based swap dealer, or be exempt from registration or excluded from regulation as a dealer, under applicable securities or commodities laws.[28] If the banking entity is engaged in these activities outside of the U.S. in a manner for which no U.S. registration is required, the banking entity must be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located. This is intended to ensure that market making-related activities are subject to appropriate regulation and that banking entities do not simultaneously characterize a transaction as market making-related for purposes of the exemption while characterizing it in a different manner under applicable securities or commodities laws.
- ***Near-term demands of clients, customers and counterparties.*** The market making-related activities must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties. The Preamble notes that:

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25 The Preamble notes that in highly illiquid markets, covered financial instruments may "trade only by appointment."

26 Although the term "block positioner" is not defined in the Proposed Rule, the Preamble notes that the SEC's definition of "qualified block positioner" in Rule 3b-8(c) under the Exchange Act, which the Agencies cite in the Preamble, may serve as guidance, although it is not proposed as part of the rule text. Under Rule 3b-8(c), a qualified block positioner must, among other things: (i) engage in the activity of purchasing long or selling short, from time to time, from or to certain customers a block of stock with a current market value of $200,000 or more, from a customer to facilitate a sale or purchase by such customer; (ii) determine in the exercise of reasonable diligence that the block could not be sold to or purchased from others on equivalent or better terms; and (iii) sell the shares comprising the block as rapidly as possible under the circumstances.

27 Neither the Preamble nor the text of the Proposed Rule provides any guidance with respect to the scope of the anticipatory customer demand exemption. The Agencies specifically ask how demand is anticipated with respect to market making-related activities and how an approach may vary by asset class.

28 A banking entity may be required to be a registered securities dealer if it engages in market-making transactions involving security-based swaps with persons that are not eligible contract participants.

- The reasonableness of a banking entity's expectations regarding near-term customer demand should be based on more than a simple expectation of future price appreciation and the resulting generic increase in marketplace demand. Rather, the expectation should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near-term demands of that customer base based on particular factors beyond a general expectation of price appreciation.[29]

- The Preamble provides additional commentary regarding how the Agencies expect a firm relying on the market-making exemption to manage principal positions and how the Agencies propose to assess whether such positions are consistent with the Proposed Rule. For instance, an entity providing liquidity on an organized trading facility or exchange would be considered to be engaged in market making if it is passively providing liquidity by submitting resting orders that interact with the orders of others in non-directional or market neutral trading and the entity is registered as a market maker (if the facility or exchange registers market makers). In contrast, activities by entities that primarily take liquidity on an organized trading facility or exchange, rather than provide liquidity, would not qualify for the market-making exemption, even if conducted by a registered market maker.

- ***Revenues from fees, commissions, bid/ask spreads or other similar income.*** 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 it holds in trading accounts or the hedging of such positions.

b. Consistency with Appendix B commentary

The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale must be consistent with the commentary in Appendix B of the Proposed Rule, which provides guidance to help distinguish permitted market making-related activities from prohibited proprietary trading. This guidance includes the following six factors that would cause a banking entity to be considered, absent explanatory circumstances, to be engaged in prohibited proprietary trading, and not permitted market making-related activity:

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

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

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

[29] The Agencies use the term "customer" throughout the discussion of market making-related activity. Appendix B to the Proposed Rule notes, however, that a market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. In the context of market making in a security that is executed on an organized trading facility or an exchange, a "customer" is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a covered financial position in an over-the-counter market, a "customer" generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services. In certain cases, depending on the conventions of the relevant market (*e.g.*, the over-the-counter derivatives market), the "customer" may be considered or referred to as a "counterparty."

- Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making desk to provide liquidity services or (ii) holds principal positions in excess of reasonably expected near-term customer demands;
- Trading activity in which a trading unit routinely pays rather than earns fees, commissions or spreads; and
- The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.

The enumerated factors are subject to certain facts and circumstances that may explain why a trading activity may meet one or more factors but does not involve prohibited proprietary trading. Appendix B provides a range of examples of such explanatory facts and circumstances. The Preamble does not contemplate explanatory facts and circumstances for the compensation incentives factor, given that the choice of compensation incentives provided to trading personnel is under the full control of the banking entity.

The Agencies solicit comment on whether they should incorporate numerical thresholds for certain quantitative measurements with the aim of providing banking entities with a clear standard regarding trading activity that presents a quantitative profile sufficiently questionable to warrant further review and explanation to the relevant Agency. The Agencies' questions focus primarily on whether it would be appropriate and effective to include a numerical threshold for some measurements and provide illustrative examples of potential thresholds and how such thresholds would work.

In addition, for each of these six factors, the Proposed Rule provides general guidance as to:

- The types of facts and circumstances on which the relevant Agency may base any determination that a banking entity's trading activity met the relevant factor; and
- Which quantitative measurements the relevant Agency would use to help assess the extent to which a banking entity's activities met the relevant factor.

c. Market making-related hedging

The purchase or sale of a covered financial position for hedging purposes will qualify for the market-making exemption if it meets the following two requirements, in addition to the other criteria for hedging (including the common compliance and compensation criteria described above):

- ***Reduces specific risks associated with market making.*** The purchase or sale must be conducted in order 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.
- ***Satisfies criteria applicable to hedging.*** The hedging transaction must also meet the criteria specified in the general exemption for risk-mitigating hedging activity (including portfolio hedging) for purposes of the proprietary trading prohibition.

2. Permitted underwriting activities

The Proposed Rule permits a banking entity to purchase or sell a covered financial position in connection with the banking entity's underwriting activities if the activities satisfy all of the following criteria, in addition to the common compliance and compensation criteria described above:

- ***"Security" required.*** The covered financial position must be a security, which is defined in the Proposed Rule by reference to Section 3(a)(10) of the Exchange Act;
- ***"Distribution" and "underwriter" required.*** The transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter.[30] In determining whether a banking entity is acting as an underwriter, the Preamble notes that the Agencies will consider whether the banking entity assists an issuer in capital raising, performs due diligence, advises on market conditions, purchases securities for an issuer, selling security holder or underwriter for resale, assists in preparing offering documents, participates in organizing a syndicate, markets the securities and provides post-issuance secondary market liquidity;
    - In order to qualify as a "distribution" for purposes of the Proposed Rule, as with Regulation M,[31] the offering must include two elements – "magnitude" and "special selling efforts and selling methods." The Proposed Rule does not define the terms "magnitude" and "special selling efforts and selling methods," but the Preamble notes that the Agencies expect to rely on the same factors considered under Regulation M. The number of securities to be sold and the percentage of the outstanding securities, public float, and trading volume that those securities represent are all relevant to an assessment of "magnitude" under Regulation M, while preparation and delivery of a sales document, conducting road shows and the payment of commissions larger than ordinary broker's commissions are generally indicative of "special selling efforts and selling methods."
    - "Magnitude" is a means to distinguish a distribution from ordinary trading and does not imply that a distribution must be large or registered. Therefore, this factor would not necessarily preclude small offerings, and the exemption for permitted underwriting activities should be available for unregistered offerings conducted under Rule 144A or other exemptions, as long as the offerings meet the test for distribution. While the Preamble indicates that the magnitude requirement of the distribution test is not intended to preclude private placements from the scope of the exemption, some private placements would not meet this requirement, and the SEC has requested comment on whether private placements are adequately covered.
- The banking entity must have the appropriate dealer registration, if applicable, or be subject to substantive regulation as a dealer in the non-U.S. jurisdiction where it is located;

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[30] The definition of "underwriter" in the Proposed Rule has two categories. The first includes a person who has an agreement with an issuer or selling security holder to purchase securities for distribution or to otherwise engage in or manage a distribution on behalf of the issuer or selling security holder. The second includes a person who has an agreement with any such underwriter, such as a dealer under a selected dealer agreement, to engage in a distribution of securities on behalf of an issuer or selling security holder. Unlike the term "distribution participant" as used in Regulation M under the Exchange Act, the definition of "underwriter" is limited to those who have agreements with the issuer (or selling security holder) or with others that do and does not appear to include persons further down the chain of distribution, such as those who receive a reallowance of the selling concession. Nor does the definition appear to include persons who participate in a distribution without an "agreement" (a term that is not defined) or who might be "prospective underwriters" under Regulation M.

[31] The Proposed Rule does not actually adopt the definitions under Regulation M as developed by the SEC, thus creating the possibility that they may be interpreted differently from those under Regulation M.

- The underwriting activities of the banking entity with respect to the covered financial position must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties. The Preamble provides no guidance on how this requirement would be satisfied in connection with an offering where little, if any, marketing occurs before the agreement to purchase the securities from the issuer or selling security holder, or where some marketing has occurred but the "underwriting book" is not fully subscribed at the time of the agreement to purchase, or where offerings are done "at-the-market"; and
- The revenues generated by the underwriting activities must be primarily from fees, commissions, underwriting spreads (including any "gross spread") or other income, and not from appreciation in the value of covered financial positions it holds related to such activities or the hedging of such covered financial positions. It does not appear that this requirement is meant to prevent traditional syndicate trading activity, such as short sales and related short covering transactions, although the creation of a short position in excess of an overallotment option is not addressed in the Preamble.[32]

Comment is specifically requested on the application of the underwriting exemption to structured securities, such as trust preferred securities and tender offer bonds, that may include the purchase of a security and the repackaging of the security through an intermediate entity.

3. Permitted risk-mitigating hedging activities

The prohibition on proprietary trading does not apply to the purchase or sale of a covered financial position if the transaction is made in connection with, and related to, individual or aggregated positions, contracts or other holdings of a banking entity, and is designed to reduce the specific risks to the banking entity in connection with, and related to, such positions, contracts or other holdings.

a. Criteria applicable to risk-mitigating hedging activities

In order to rely on this exemption, the activity must satisfy all of the following criteria, in addition to the common compliance and compensation criteria described above:

- ***Specific risk required.*** The transaction must hedge 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 individual or aggregated positions, contracts or other holdings of a banking entity;
    - Risks can be hedged on a portfolio basis, but a banking entity should be prepared to identify the specific position or portfolio of positions that is being hedged and demonstrate that the hedging transaction is risk-reducing in the aggregate, as measured by appropriate risk management tools.
    - Dynamic hedging is permissible so long as changes to the hedge position are reasonably correlated to the material changes in the risks that are being hedged.
    - A banking entity relying on the exemption should be able to demonstrate that the banking entity is already exposed to the specific risks being hedged; generally, the purported hedging of risks to which the banking entity is not actually exposed would not meet the terms of the exemption, but pre-hedging slightly before the banking entity became exposed to a risk would be permitted if the hedge is consistent with appropriate risk management practices, meets the terms of the hedging exemption and does not involve the potential for speculative profit.

[32] As noted above, the Preamble lists a number of factors to be considered in determining whether a banking entity is acting as an underwriter as part of a distribution of securities, and one of these factors is "[t]ransacting to provide a post-issuance secondary market and to facilitate price discovery."

    - The Preamble specifies that a banking entity's compliance policies and procedures must include clearly articulated trader mandates for each trader to ensure that the decision of when and how to hedge is consistent with such policies and mandates, and not fully left to a trader's discretion. The Agencies appear to be responding to an FSOC concern that the flexibility to hedge a position presents a potential avenue to evade the proprietary trading prohibition. The Proposed Rule requires the internal compliance program to include written policies and procedures regarding how the banking entity will determine that the risks generated by each trading unit have been effectively and properly hedged and the instruments, techniques, and strategies that may be used for hedging.

- ***Reasonable correlation required.*** The transaction must be reasonably correlated,[33] 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 that the transaction is intended to hedge or otherwise mitigate; and
    - Whatever "reasonable correlation" might require in any particular set of circumstances, it does not require perfect correlation or even necessarily the closest available correlation.
    - The Preamble notes that a hedge typically should be unwound as risk exposure is reduced or increased as risk exposure increases, as selective hedging may indicate prohibited proprietary trading.
- ***No new significant exposures created.*** The hedging transaction must not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction, although the Agencies recognize that any hedging transaction will inevitably give rise to certain types of new risk, such as counterparty credit risk or basis risk.
    - However, the Preamble notes that over-hedging, correlation trading or pairs trading that generates profits through speculative, proprietary risk-taking would fail to meet this standard.

b. Documentation requirement for certain hedges

If a hedge is established at a different level of organization than the level establishing the related hedge positions,[34] contracts or other holdings, the banking entity must, at a minimum, document the risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts or other holdings that the transaction is designed to reduce. Such documentation must be established at the time the hedging transaction is effected, not after the fact.

4. Other permitted trading activities

The Proposed Rule permits a banking entity to engage, subject to certain conditions, in trading in certain government obligations, trading on behalf of customers, trading by insurance companies for their general account and trading outside of the U.S. by certain foreign banking entities.[35]

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[33] What constitutes reasonable correlation will vary depending on the underlying risks and the availability of alternative hedging options. The Preamble notes that the Proposed Rule does not rely on or refer to accounting standards, such as FASB ASC Topic 815.

[34] The Preamble indicates that a hedge could be established at a different level of the organization if a supervisor of multiple trading desks established a portfolio hedge for a risk common to the trading desks.

[35] Proposed Rule Section __.6.

a. Permitted trading in government obligations

The Proposed Rule permits the purchase or sale of a covered financial position that is an obligation of the U.S. or any agency thereof or any State or any political subdivision thereof (including both general obligations and limited obligations, such as revenue bonds), or an obligation, participation or other instrument of or issued by certain U.S. government-sponsored enterprises. The Proposed Rule does not extend the exemption to transactions in any obligations of any non-U.S. government or any obligations of an agency of any State or any agency of a political subdivision thereof. The category of securities covered by the exemption is significantly narrower than the category of bank-eligible securities under 12 U.S.C. Section 24 (Seventh). In addition, this exemption does not extend to derivatives on government obligations, unless otherwise excluded from the definition of "covered financial position."

b. Permitted trading on behalf of customers

The Proposed Rule permits a banking entity to purchase or sell a covered financial position on behalf of customers if the transaction is one of the three following types:

- Trading relating to fiduciary activity;[36]
- Riskless principal trades;[37] and
- Trading by an insurance company directly engaged in the business of insurance, subject to regulation by a State insurance regulator or foreign insurance regulator, and in compliance with insurance company investment laws and regulations, solely for a separate account[38] established in connection with one or more insurance policies, where all profits and losses are allocated to the separate account (rather than the banking entity).[39]

This exemption is more limited than many observers expected.

[36] This is defined as activity that (i) is conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee or in a similar fiduciary capacity for a customer; (ii) is conducted for the account of that customer; and (iii) involves solely covered financial positions of which the banking entity's customer, and not the banking entity or any subsidiary or affiliate of the banking entity, is beneficial owner. The Preamble notes that a transaction in the form of one of these fiduciary relationships would fall outside the exemption if gains or losses from trading activity inure to the benefit or detriment of the banking entity. It is unclear whether a performance fee would constitute a "benefit" from the trading activity for these purposes.

[37] The Agencies note in the Preamble that the full text of the exemption for riskless principal trading generally mirrors that used in the Federal Reserve's Regulation Y, OCC interpretive letters, and the SEC's Rule 3a5-1 under the Exchange Act.

[38] Under the Proposed Rule, "separate account" means an account established and maintained by an insurance company subject to regulation by a State insurance regulator or a foreign insurance regulator 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.

[39] The Preamble notes that fees unrelated to investment performance would be permissible.

c. Permitted trading by a regulated insurance company for its general account

The Proposed Rule permits a banking entity that is an insurance company directly engaged in the business of insurance, and subject to regulation by a State or foreign insurance regulator, or an affiliate of such an insurance company, to purchase or sell a covered financial position in compliance with insurance company investment laws and regulations[40] if the banking entity or its affiliate is trading solely for the general account[41] of the insurance company.

d. Permitted trading outside of the United States

The Proposed Rule permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the U.S.

i. Foreign banking entities eligible for the exemption

Under the Proposed Rule, to be eligible for the exemption, a banking entity (i) must not be directly or indirectly controlled by a banking entity that is organized under the laws of the U.S. or one or more States and (ii) must conduct the activity pursuant to Sections 4(c)(9) or 4(c)(13) of the BHC Act.[42] The Proposed Rule notes that a banking entity complies with the latter requirement if:

- With respect to a foreign banking organization,[43] it qualifies as such and is conducting the activity in compliance with Subpart B of the Federal Reserve's Regulation K; or
- With respect to a non-foreign banking organization, it meets a test that largely mirrors the "qualifying foreign banking organization" test under Section 4(c)(9) and Section 211.23(a) of the Federal Reserve's Regulation K.[44]

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40 However, the federal banking agencies may determine, after consultation with the FSOC and state insurance commissioners, that such laws and regulations are insufficient to protect the safety and soundness of the banking entity or the financial stability of the U.S.

41 Under the Proposed Rule, "general account" means, with respect to an insurance company, all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State or foreign law.

42 Sections 4(c)(9) and 4(c)(13) of the BHC Act are exceptions to the restrictions on nonbanking activities and investments with respect to (i) shares held by or activities of a company organized under the laws of a foreign country if it conducts most of its business outside the U.S. and (ii) shares or activities of a company if it does no business in the U.S. except as an incident to its international or foreign business, respectively, subject to determination by the Federal Reserve in both cases.

43 "Foreign banking organization" is defined in the Federal Reserve's Regulation K, 12 C.F.R. § 211.21(o).

44 The test in the Proposed Rule is that the banking entity must meet at least two of the following three requirements – namely, that (i) a majority of the foreign entity's assets are held outside of the U.S. and that a majority of its (ii) revenues and (iii) income are derived from its business outside of the U.S. The Proposed Rule does not specify measurement periods for the three requirements. It is possible that the Agencies will apply the measurement periods for the similar test in Regulation K, which requires annual measurement based on consolidated or combined financial statements. A "qualifying foreign banking organization" under Regulation K loses that status if it fails the test for two consecutive years, at which time (i) it may continue to engage in activities or retain investments commenced or acquired before the end of the first fiscal year for which its annual report reflects

The result of applying Section 4(c)(9) of the BHC Act and Subpart B of the Federal Reserve's Regulation K, which is an extraordinarily complex regulatory framework, may be to limit significantly the scope of this exemption.

ii. Trading solely outside of the United States

The Proposed Rule provides that, for purposes of the exemption, a transaction will be considered to have occurred solely outside of the U.S. only if four conditions are met:

- The transaction must be conducted by a banking entity that is not organized under the laws of the U.S. or of one or more States;[45]
- No party to the transaction may be a resident of the U.S.;[46]
- No personnel of the banking entity who are directly involved in the transaction (which, according to the Agencies, would generally not include persons performing purely administrative, clerical, or ministerial functions) may be physically located in the U.S.; and
- The transaction must be executed wholly outside of the U.S.

The highly restrictive character of these conditions may have significant commercial consequences: foreign banks with substantial trading operations outside the U.S. may reconsider retaining their branch, agency or subsidiary bank operations in the U.S.; the development of exchanges and other trading platforms outside the U.S. for trading in U.S. securities and other instruments subject to the Volcker Rule will be encouraged; and there could be significantly reduced capacity to purchase or sell securities of U.S. companies.

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nonconformance, but (ii) must terminate or divest activities commenced or investments made after that date within three months of the filing of the second annual report, subject to extensions by the Federal Reserve. *See* 12 C.F.R. § 211.23. Whether an entity qualifies for this test may change over time depending on changes in the income or size of the entity. A large global loss combined with positive income in the U.S., for example, could cause a foreign banking entity not to qualify.

45 The Preamble states that subsidiaries and branches of banking entities organized under the laws of the U.S. or of one or more States (wherever organized or licensed) may not rely on the exemption.

46 Although the elements of the definition of "Resident of the United States" in the Proposed Rule are similar to the elements of the definition of "U.S. Person" under the SEC's Regulation S under the Securities Act, the definition in the Proposed Rule expands the Regulation S definition by including "[a]ny person organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States" and removing several exclusions from the Regulation S definition. These exclusions include: (i) discretionary accounts or similar accounts held for the benefit of a non-U.S. person by a dealer or fiduciary organized or incorporated in the U.S., (ii) estates of which any professional fiduciary acting as executor or administrator is a U.S. person if an executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate and the estate is governed by foreign law, and (iii) trusts of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person. The definition in the Proposed Rule does not seem to exempt natural persons who are only temporarily or occasionally resident in the U.S.

C. REPORTING AND RECORDKEEPING REQUIREMENTS APPLICABLE TO TRADING ACTIVITIES

1. Quantitative measurements

A banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities whose average gross sum (on a worldwide consolidated basis) is equal to or greater than $1 billion must comply with the reporting and recordkeeping requirements in Appendix A to the Proposed Rule.[47]

The purpose of Appendix A is to assist the relevant Agency and banking entities in evaluating and monitoring the scope, type and profile of banking entities' covered trading activities.

Appendix A includes definitions that clarify how and when calculations must be made, as well as a definition of "trading unit" that governs the level of a banking entity's organization at which it must calculate quantitative measurements. The proposed definition of "trading unit" is intended to capture multiple layers of a banking entity's organizational structure, including individual trading desks, intermediate divisions that oversee a number of trading desks, and all trading operations in the aggregate.

2. Scope of required quantitative measurements

The Proposed Rule requires banking entities with the most extensive trading activities to report the largest number of quantitative measurements, while banking entities with less extensive trading activities have fewer or no reporting requirements. This tiered approach is intended to reflect the heightened compliance risks of banking entities with extensive trading activities and limit the regulatory burden imposed on banking entities with relatively small or no trading activities, which appear to pose significantly less compliance risk.

Banking entities with gross trading assets and liabilities of $5 billion or more, as well as the trading units of such banking entities engaged in market making-related activity, are required to report the measurements described in Appendix A of the Proposed Rule, which relate to risk management, source of revenue, revenues relative to risk, customer-facing activities, and payment of fees, commissions and spreads.[48] For all trading units of such banking entities engaged in underwriting, risk-mitigating hedging

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47 Proposed Rule Section __.7.

48 These measurements are Value-at-Risk ("VaR"), Stress VaR, VaR Exceedance, Risk Factor Sensitivities, Risk and Position Limits, Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, Comprehensive Profit and Loss Attribution, Pay-to-Receive Spread Ratio, Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss, Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Inventory Risk Turnover, Inventory Aging and Customer-Facing Trade Ratio.

or trading in certain government obligations, Appendix A requires the reporting of certain measurements, which relate to risk-management and source of revenue.[49]

Banking entities with gross trading assets and liabilities between $1 billion and $5 billion engaged in market-making activities are required to report a subset of the quantitative measurements,[50] and banking entities with gross trading assets and liabilities of less than $1 billion are not required to report any measurements.

The Agencies state in the Preamble that they intend to take a "heuristic approach" to implementation that recognizes that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience and possible revision during the automatic two-year conformance period. Further, the Agencies note that not all of the quantitative measurements in the Proposed Rule may ultimately be adopted.

3. Frequency of calculation and reporting of quantitative measurements

Under the Proposed Rule, each required quantitative measurement must be calculated for each trading day and reported to the relevant Agency on a monthly basis. Calculation periods vary, depending on the measurement, from one trading day to increments that include 30, 60, 90 and 360 days. The banking entity must create and retain records documenting the preparation and content of any of these quantitative measurements, including records for individual trades and positions, for a period of five years.

4. Compliance program required

Appendix C to the Proposed Rule includes minimum standards for an internal compliance program to ensure and monitor compliance with the Proposed Rule and is further described in Part V below. The Agencies may also impose additional reporting and recordkeeping requirements.

D. LIMITATIONS ON PERMITTED TRADING ACTIVITIES

The Proposed Rule places certain limitations on the permitted trading activities in which a banking entity may engage. Even if otherwise a permitted trading activity, no transaction, class of transactions or activity is permissible if the transaction, class of transactions or activity would involve a material conflict of interest between the banking entity and its clients, customers or counterparties, result in a material

49 These measurements are VaR, Stress VaR, Risk Factor Sensitivities, Risk and Position Limits, Comprehensive Profit and Loss, and Comprehensive Profit and Loss Attribution.

50 These measurements are VaR, Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, Comprehensive Profit and Loss Attribution, Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss, and Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

exposure by the banking entity to a high-risk asset or a high-risk trading strategy, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the U.S.[51]

1. Material conflicts of interest

A material conflict of interest between a banking entity and its clients, customers or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to those of its client, customer or counterparty. The Preamble notes that the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests does not necessarily mean that there is a material conflict of interest, with respect to transactions related to the permitted activities. The Preamble gives the following examples of material conflicts of interest: misuse of client information to the detriment of the client, and frontrunning by the banking entity or another client of the banking entity.

Transactions entailing a material conflict of interest are prohibited, unless the banking entity has appropriately addressed and mitigated the conflict of interest, where possible, and subject to specific requirements provided in the Proposed Rule, through either (i) timely and effective disclosure, or (ii) information barriers.

- ***Timely and effective disclosure.*** In order to constitute timely and effective disclosure, the banking entity, prior to engaging in the specific activity for which a conflict may arise, must make clear, timely and effective disclosure of the conflict or potential conflict of interest in a manner sufficient to permit a reasonable client, customer or counterparty to understand the conflict and to allow the client, customer or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect from the conflict or potential conflict. In this regard, the Preamble notes that general or generic disclosure would not be sufficient.
- ***Information barriers.*** The information barriers must be memorialized in written policies and procedures. These may include physical separation of personnel or functions, or limitations on types of activity, that are reasonably designed to prevent the conflict of interest from involving a materially adverse effect on a client, customer or counterparty. A banking entity may not rely on such information barriers if the banking entity knows or should reasonably know that, notwithstanding the establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer or counterparty. The Preamble and Proposed Rule do not identify a particular standard to determine whether a banking entity "knows or reasonably should know" facts known to individuals within the organization. The Preamble notes that a banking entity should have processes to review, test and modify information barriers on a continuing basis and that adjustments should be made if a conflict occurs to the detriment of a client.

2. High-risk assets and high-risk trading strategies

A "high-risk asset" is defined as an asset or group of assets that, if held by the banking entity, would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. A "high-risk trading strategy" is defined as a trading strategy that, if engaged in by the banking entity, would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. The Agencies do not attempt to identify particular high-risk assets or trading strategies.

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[51] Proposed Rule Section __.8.

Rather, banking entities are expected to include policies and procedures in their compliance programs for identifying and avoiding exposure to such strategies.[52]

The Agencies request comment on whether any assets or trading strategies should be considered high risk *per se*. While the required policies and procedures must take into account a variety of considerations when an asset is acquired or a trading strategy is implemented, left unclear is the extent to which the realization of a loss may result in a determination after the fact that the asset or trading strategy was high risk.

IV. HEDGE FUNDS AND PRIVATE EQUITY FUNDS

A. GENERAL PROHIBITION ON ACQUIRING OR RETAINING AN OWNERSHIP INTEREST IN AND HAVING CERTAIN RELATIONSHIPS WITH A COVERED FUND

1. Prohibition

The Proposed Rule prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining an equity, partnership or other ownership interest in, or sponsoring, a covered fund, unless otherwise permitted under the Proposed Rule.[53]

This general prohibition applies solely to a banking entity's actions "as principal" and thus, according to the Preamble, does not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund by:

- A banking entity in good faith in a fiduciary capacity;
- A banking entity in good faith in its capacity as a custodian, broker or agent for an unaffiliated third party;
- A "qualified plan," as defined in Section 401 of the Internal Revenue Code, if the ownership interest would be attributed to the banking entity solely because of interests held for the benefit of shareholders, members or employees of a company;[54] or

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[52] Policies and procedures must take into account potential and actual exposure to the following:

- Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;
- Assets whose changes in values cannot be adequately mitigated by effective hedging;
- New products with rapid growth, including those that do not have a market history;
- Assets or strategies that include significant embedded leverage;
- Assets or strategies that have demonstrated significant historical volatility;
- Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and
- Assets or strategies that result in large and significant concentrations to sectors, risk factors or counterparties.

[53] Proposed Rule Section __.10(a).

[54] *See* Section 2(g)(2) of the BHC Act (12 U.S.C. § 1841(g)(2)), regarding attribution. In addition, several commenters on the FSOC study requested that employee pension and benefit plans not be

- A director or employee of a banking entity who acquires the interest in a personal capacity and who is directly engaged in providing services to the covered fund, unless the banking entity, directly or indirectly, extended credit for the acquisition of such ownership interest.

Although the Proposed Rule does not expressly incorporate the statutory exemption for purchases and sales "on behalf of customers," the inclusion of "as principal" in the Proposed Rule appears to permit a variety of customer transactions.[55]

2. Definitions

"Covered fund." The Proposed Rule adopts a single definition of "covered funds" that follows the statute's approach of jointly defining "hedge fund" and "private equity fund" by including (i) any issuer that would be an "investment company," as defined in the Investment Company Act of 1940 (the "1940 Act"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, and (ii) such "similar funds" as the Agencies may by rule determine.[56] The Preamble confirms that an issuer that can rely on another exception to the definition of investment company under the 1940 Act will not be a covered fund even if the entity would also meet the criteria in Section 3(c)(1) or 3(c)(7).

The Proposed Rule also includes in the definition two types of funds that the Agencies have determined are "similar funds": (i) commodity pools, as defined in the Commodity Exchange Act, and (ii) any issuer organized or offered outside of the U.S. that would be a covered fund, were it organized or offered under the laws of, or offered to a resident of, the U.S. or one or more States. Presumably, the Agencies mean for "similar funds" to include foreign funds that, were they organized or offered under the laws, or offered to one or more residents, of the U.S., would typically be organized and offered pursuant to the exceptions in Section 3(c)(1) or 3(c)(7) of the 1940 Act. As the Proposed Rule is drafted, however, it is unclear how it will apply to many other types of foreign funds, such as mutual funds or other publicly offered collective investment vehicles that are subject to substantive regulation in their home jurisdictions or, more generally, any foreign fund that, by its characteristics, would be an "investment company" but could not qualify for the exceptions under Section 3(c)(1) or 3(c)(7).

The Preamble acknowledges that the definition would capture several types of entities that are not usually thought of as private equity funds or hedge funds, such as joint ventures, acquisition vehicles, certain wholly owned subsidiaries and other widely used corporate structuring vehicles, and certain securitization vehicles. Certain of these entities have been exempted from the covered fund prohibitions, as described further below.

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subject to the restrictions relating to covered funds, but consideration should be given to whether the exclusion of "qualified plans" is broad enough to include all contemplated employee plans.

55 The Proposed Rule does not, however, include an exemption for the acquisition or retention of ownership interests in covered funds pursuant to the market-making exemption in the statute.

56 Proposed Rule Section __.10(b)(1). The Proposed Rule does not attempt to distinguish between hedge fund or private equity fund based on characteristics.

"Ownership interest." The Proposed Rule defines "ownership interest" to mean, with respect to a covered fund, any equity, partnership or other similar interest in a covered fund, whether voting or nonvoting, as well as any derivative of such interest.[57] Although not addressed in the Proposed Rule, the Preamble notes, without additional guidance, that a debt security or other interest of a covered fund could be considered an ownership interest if it exhibits substantially the same characteristics as an equity or other ownership interest, such as voting rights or profits participation.

Consistent with the historical view of the Federal Reserve under the BHC Act, the right to receive carried interest by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which such person serves investment adviser or commodity trading advisor, is excluded from the definition of ownership interest if it meets certain requirements under the Proposed Rule.[58] One requirement is that the profits allocable to carried interest, once allocated, are distributed 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.[59]

"Sponsor." The Proposed Rule defines "sponsor" to include an entity that (i) serves as a general partner, managing member, trustee[60] or commodity pool operator of a covered fund, (ii) selects or controls (or has employees, officers or directors or agents who constitute) a majority of the directors,

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[57] Proposed Rule Section __.10(b)(3).

[58] The requirements are: (i) the sole purpose and effect of the interest is to allow the covered banking entity (or the affiliate, subsidiary or employee thereof) to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the covered banking entity (or the affiliate, subsidiary or employee thereof), provided that the covered banking entity (or the affiliate, subsidiary or employee thereof) may be obligated under the terms of such interest to return profits previously received; (ii) all such profit, once allocated, is distributed to the covered banking entity (or the affiliate, subsidiary or employee thereof) promptly after being earned or, if not so distributed, the reinvested profit of the covered banking entity (or the affiliate, subsidiary or employee thereof) does not share in the subsequent profits and losses of the covered fund; (iii) the covered banking entity (or the affiliate, subsidiary or employee thereof) does not provide funds to the covered fund in connection with acquiring or retaining this interest; and (iv) the interest is not transferable by the covered banking entity (or the affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary thereof.

[59] Although carried interest need not be distributed to the recipient, the prohibition on earning profits and losses on any reinvestment in the partnership will likely require changes in the way that many covered funds operate, such as with respect to holdbacks intended to cover future losses or reinvested amounts.

[60] The Proposed Rule defines "trustee" (which is a part of the definition of "sponsor") to exclude a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in Section 403(a)(1) of the Employee Retirement Income Security Act of 1974. This carve-out for "trustee" does not include any banking entity that directs such a person, or that has authority and discretion to manage and control the assets of a fund for which such a person serves as trustee.

trustees or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.[61]

B. EXEMPTION FOR ORGANIZING AND OFFERING A COVERED FUND

The Proposed Rule permits a banking entity to organize and offer a covered fund, including generally acting as a sponsor[62] of the fund, provided that certain criteria are met.[63] The Agencies note that the purpose of this exemption is to permit banking entities to engage in certain traditional asset management and advisory businesses. The Proposed Rule generally follows the statutory language in requiring that eight conditions be met to qualify for the exemption,[64] with the following changes or clarifications:

- ***"Customers of such services."*** The covered fund must be organized and offered (A) only in connection with the provision of *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services[65] and (B) only to persons that are customers of such

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61 Proposed Rule Section __.10(b)(5),(6).

62 The Proposed Rule allows a banking entity to serve as a general partner, managing member, trustee, or commodity pool operator of the covered fund or in any manner select or control (or have employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any expense necessary for the foregoing. This definition is the same as "sponsor" except that it excludes the name-sharing prong because name-sharing is specifically and separately included as a prohibition for organized and offered funds.

63 Proposed Rule Section __.11.

64 Section 13(d)(1)(G) of the BHC Act permits a banking entity to organize and offer a covered fund (including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund) if: (i) the banking entity provides *bona fide* trust, fiduciary, or investment advisory services; (ii) the fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds except for a *de minimis* investment subject to and in compliance with [the limits in Section 13(d)(4)]; (iv) the banking entity complies with the restrictions under [Sections 13(f)(1) and (2)]; (v) the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests; (vi) the banking entity does not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name; (vii) no director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and (viii) the banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules of the appropriate federal banking agencies, the SEC, or the CFTC, as provided in [Section 13(b)(2)], designed to ensure that losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity.

65 The Agencies note that a wide range of customer-oriented services may qualify as *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and that the precise services may vary across different types of banking entities. Because of this variation, the Proposed Rule

services of the banking entity, pursuant to a credible plan (or similar documentation) outlining how the banking entity intends to provide advisory or similar services to its customers through organizing or offering the fund. The customer relationship therefore need not be pre-existing, for banking law purposes, and can be formed by and through the organization and offering of the fund. No guidance is provided about the requirements of a "credible plan."

- ***Limitations on names.*** In addition to the statutory provision prohibiting a covered fund from sharing the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), the Proposed Rule prohibits a covered fund from using the word "bank" in its name.
- ***Limitation on ownership by directors and employees.*** The statute permits a director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund to take or retain an equity interest in the covered fund. To address the concern that a banking entity might attempt to use such director or employee investments in a covered fund to evade ownership limitations imposed on the banking entity itself, the Preamble notes that the ownership interest of a director or employee will generally be attributed to the banking entity if the banking entity (A) extends credit for the purpose of allowing the director or employee to acquire the ownership interest, (B) guarantees the director's or employee's purchase or (C) guarantees the director or employee against loss on the investment.
- ***Disclosure requirements.*** The Proposed Rule adds additional required disclaimers to the disclosures mandated by statute and clarifies that the disclosures may be in the fund's offering documents.

C. LIMITS ON PERMITTED INVESTMENTS IN ORGANIZED AND OFFERED COVERED FUNDS

The Proposed Rule limits a banking entity's ownership interest in a covered fund that it organizes and offers to a *de minimis* amount, as follows: (i) the ownership interests of the banking entity in such a covered fund generally may not exceed 3% of the total outstanding ownership interests of the fund at any time more than one year after the date of establishment of the fund;[66] and (ii) the aggregate value of all ownership interests of a banking entity in such covered funds may not exceed 3% of its Tier 1 capital.[67]

1. Calculation of the *de minimis* investment in the covered fund

Method and Frequency of Calculation. The percentage of a banking entity's ownership interests in a covered fund is deemed to be based on two tests, one that is value-based and one that is ownership-based. The limit is based on the greater of (i) the value of any investments or capital contributions made

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does not identify specific services but largely mirrors the statutory language, so that the provision of any of these types of services would satisfy the requirement.

66 Even during the year after the date of establishment, the banking entity may only exceed the 3% per fund limit for the purposes of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors. The banking entity must actively seek unaffiliated investors to reduce the banking entity's ownership interest.

67 Proposed Rule Section __.12. In covered funds that redeem interests periodically, such as is typically the case with hedge funds, redemptions by third parties could cause the banking entity's interest to exceed the 3% fund ownership limit. Such funds will likely need to modify their fund documents to prevent this. In addition, as proposed, the 3% of Tier 1 capital aggregate limit could be violated as a result of growth in the value of an investment in a covered fund or as a result of a loss suffered by the banking entity that reduces its Tier 1 capital.

with respect to all ownership interests by the banking entity in a covered fund, divided by the value of all investments or capital contributions made by all persons in that covered fund, and (ii) the total number of ownership interests held by the banking entity in a covered fund divided by the total number of ownership interests held by all persons in that covered fund, in each case without regard to committed funds not yet called for investment.[68] Implicit in this limitation, according to the Preamble, is that the banking entity's investment in the fund also may not result in more than 3% of the losses of the covered fund being allocated to the banking entity's investment.

The Proposed Rule requires that a banking entity calculate its investments in the same manner and according to the same standards used by the covered fund for determining the aggregate value of the fund's assets and ownership interests in the covered fund. According to the Preamble, in cases where a fund calculates its value or stands ready to issue or redeem interests frequently (*e.g.*, daily), a banking entity must calculate its per-fund limitation no less frequently than the fund performs such calculation or issues or redeems interests. The calculation of the amount of the banking entity's per-fund limitation must be made no less frequently than at the end of every quarter.[69]

Holdings by affiliated and other entities. Under the Proposed Rule, the amount and value of a banking entity's investment in any single covered fund are (i) the total amount or value held by the banking entity directly and through any entity that is controlled, directly or indirectly, by the banking entity, plus (ii) the *pro rata* amount or value of any covered fund held by any covered fund[70] that is not controlled, directly or indirectly, by the banking entity but in which the banking entity owns, controls, or holds with the power to vote more than 5% of the voting shares.[71]

Committed co-investments. The Proposed Rule also requires inclusion in a banking entity's per-fund limitation of an investment where a banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement). The Agencies note that this provision is meant to prevent evasion of the limitations through committed co-investments.[72]

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68 Proposed Rule Section __.12(b). It is unclear how the "number of ownership interests" test will be applied to existing funds that have different classes or series of interests with different denominations or to partnerships, limited liability companies or other entities that do not divide their ownership interests into discrete units.

69 Proposed Rule Section __.12.

70 The text of the Preamble refers to holdings of any entity instead of any covered fund. The operation of the Proposed Rule as drafted is unclear.

71 The *pro rata* attribution is inconsistent with Section 2(g)(1) of the BHC Act, which does not attribute to a banking entity the holdings of an entity that it does not control.

72 The "acting in concert" definition is adapted from the Federal Reserve's definition of acting in concert under the Change in Bank Control Act, where a determination is made on a case-by-case basis

2. Aggregate permitted investments in all covered funds

For the purpose of calculating the aggregate limitation for all of a banking entity's ownership interests in covered funds, the limit is calculated as of the end of each calendar quarter, and a banking entity's investments in all covered funds must be valued pursuant to applicable accounting standards. Under the Proposed Rule, depository institutions that report regulatory capital and their subsidiaries will use the depository institution's Tier 1 capital, and bank holding companies and their subsidiaries will use the bank holding company's Tier 1 capital. Other reporting companies that control an insured depository institution (and its nonreporting subsidiaries) will use the Tier 1 capital of the top-tier entity. In the case of a reporting depository institution that is a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in all covered funds held by the depository institution, directly or indirectly, may not exceed 3% of either the Tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution. Banking entities that do not report Tier 1 capital will use the shareholders' equity of the top-tier entity under applicable accounting standards. In each case, the amounts will be as reported as of the last day of the most recently ended calendar quarter.

3. Deduction of an investment in a covered fund from Tier 1 capital

The Proposed Rule requires a banking entity to deduct the aggregate value of permitted investments in covered funds held under the *de minimis* exemption from the assets and Tier 1 capital of the banking entity. The Preamble clarifies that the deduction applies only to permitted organized and offered funds, not to investments in covered funds permitted by another exemption (*e.g.*, debts previously contracted). The capital deduction appears quite punitive and could impose a substantial burden on asset management activities.

In addition, the statute requires that the amount of the deduction increase commensurate with the leverage of the covered fund, but the Proposed Rule does not include any leverage adjustment. Instead, the Preamble asks how, if at all, the deduction should be increased.

4. Extension of time to divest an ownership interest in a single covered fund

The Proposed Rule authorizes the Federal Reserve, upon application by a banking entity, to extend for up to two additional years the period of time within which a banking entity must reduce its ownership interests in a covered fund to meet the 3% per-fund limit.[73] Under the Proposed Rule, the Federal

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based on all the facts and circumstances. Factors that the Federal Reserve has traditionally considered include whether investors have made their investment decisions independently and the details of how the transaction came together, whether investors have a history of investing together, and the extent of their relationships with each other, contractual or otherwise. Consequently, this standard may limit a banking entity's ability to invest alongside a covered fund that it organized and offered but does not control.

[73] Any such application must: (i) be submitted in writing at least 90 days before the expiration of the applicable time period; (ii) provide the reasons why the banking entity believes the extension should be granted; and (iii) provide a detailed explanation of the banking entity's plan for reducing or

Reserve would consider requests for an extension in light of all relevant facts and circumstances, and requests must include substantially similar information as required for requests for extensions of the general conformance period. The Federal Reserve may impose conditions on any extension granted.

D. OTHER PERMITTED COVERED FUND ACTIVITIES AND INVESTMENTS

The Proposed Rule implements additional statutory exemptions permitting investment by a banking entity in a covered fund.[74]

1. SBICs, public welfare investments and qualified rehabilitation expenditures

The Proposed Rule permits a banking entity to acquire or retain any ownership interest in, or act as sponsor to, small business investment companies, public welfare investments and qualified rehabilitation expenditures. The Proposed Rule goes beyond the statutory language, which permits investments in these types of entities, by also permitting a banking entity to act as a sponsor to such investments.

2. Permitted risk-mitigating hedging activities

The Proposed Rule permits a banking entity to acquire or retain an ownership interest in a covered fund if the transaction is made in connection with risk-mitigating hedging activities: (i) when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund; or (ii) directly connected to a compensation arrangement with an employee who directly provides investment advisory or other services to that fund. The exemption with respect to covered funds includes many of the requirements for the risk-mitigating hedging exemption from the proprietary trading prohibition but adds a number of additional limiting criteria.

- ***Offsetting exposure to the same covered fund.*** The Proposed Rule requires that the acquisition or retention of an ownership interest in a covered fund hedge or otherwise mitigate an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that (i) arises out of a transaction conducted solely to accommodate a specific customer request or (ii) is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to that covered fund. This requires greater equivalency between the reference asset and hedging instrument than the correlation required under the proprietary trading exemption.[75]

- ***Documentation requirement.*** The banking entity must document the risk-mitigating purpose of any such transaction in the same way described in Part III.B.3.b above, at the same time as the hedge as effected, not after the fact.

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conforming its investment(s). In addition, any extension request by a banking entity must address each of a list of particular matters, to the extent they are relevant.

[74] Proposed Rule Section __.13.

[75] Banking entities that have programs that offer notes to customers with returns linked to the performance of an underlying covered fund will need to ensure that any covered fund interests acquired to hedge the customer exposure meet the requirements of this exemption.

3. Non-U.S. banking entity ownership interest in a foreign covered fund

The Proposed Rule permits foreign banking entities to invest in foreign covered funds. The Agencies note that the purpose of this statutory exemption appears to be to limit the extraterritorial application of the rule to foreign firms that engage outside of the U.S. in activities permitted under relevant foreign law, while preserving national treatment and competitive equality among U.S. and foreign firms within the U.S.

a. Foreign banking entities eligible for the exemption

Under the Proposed Rule, to be eligible for the exemption, a banking entity must meet the same criteria under Sections 4(c)(9) and 4(c)(13) of the BHC Act as are required for the exemption from the proprietary trading prohibition, as described in Part III.B.4.d above.

b. Investments solely outside of the United States

The Proposed Rule tracks the statute in requiring that (i) no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S. and (ii) the activity occurs solely outside of the U.S. Under the Proposed Rule, an activity will be considered to have occurred solely outside of the U.S.[76] if (A) the banking entity engaging in the activity is not organized under the laws of the U.S. or a State, (B) no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the U.S. or a State and (C) no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S.[77]

The Agencies note that under the Proposed Rule, foreign banking entities may not structure a transaction or activity so as to be "outside of the United States" for risk and booking purposes while simultaneously engaging in transactions within U.S. markets that are prohibited for U.S. banking entities. The Preamble notes, however, than an employee or entity in the U.S. with no customer relationship and involved solely in providing administrative services or so-called "back office" functions to the fund (such as clearing and settlement or maintaining and preserving records of the fund) as incident to permitted foreign fund investments would not be deemed to be involved in the offer or sale of an ownership interest.[78]

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76 Hedge funds and private equity funds controlled from outside of the U.S. that wish to continue offering interests to non-U.S. banking entities may need to restructure their funds to fit within the exemption under the Proposed Rule. It is uncertain, however, whether the Proposed Rule will be interpreted so that hedge funds and private equity funds controlled from the U.S. – even if managed by a non-U.S. general partner or manager – can be structured so that their offerings fall outside of the definition of "resident of the United States" in the Proposed Rule.

77 The "solely outside of the United States" requirement in Section __.13(c)(1)(iv), as defined in the Proposed Rule in Section __.13(c)(3), repeats the separate requirement in Section __.13(c)(1)(iii) that no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S. No guidance was provided as to whether this limitation applies only to the initial distribution of covered fund interests by the sponsor, to resales of the interests by the foreign banking entity or to any offer or sale of the interests by any person at any time during the life of the fund.

78 The Agencies do not address portfolio management functions that are carried out in the U.S.

4. Sale and securitization of loans

The Proposed Rule permits a banking entity to acquire and retain an ownership interest in, and sponsor, a covered fund that is an issuer of asset-backed securities,[79] if the assets or holdings of the covered fund are solely composed of: (i) loans;[80] (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.[81] The Proposed Rule appears to exclude from this exemption covered fund issuers of asset-backed securities if the issuer's assets include third-party credit enhancements – for example, letters of credit or financial guarantees.

The types of derivatives that may be included in the assets is limited; the Agencies note that the phrase "materially relate to terms of such loans" is intended to limit quantitatively the notional amount of the derivatives permitted in a "securitization of loans" to the outstanding principal balance of the loans supporting the asset-backed securities of such issuer, either individually or in the aggregate. Additionally, such derivatives must be used solely to hedge risks that result from a mismatch between the loans and the related asset-backed securities.

E. EXEMPTIONS FOR ACTIVITIES PROMOTING SAFETY AND SOUNDNESS

The Proposed Rule also includes several exemptions authorized under Section 13(d)(1)(J) of the BHC Act, which permits a banking entity to engage in any covered funds activity that the Agencies and the CFTC determine promotes and protects the safety and soundness of a banking entity and the financial stability of the U.S.[82]

1. Bank-owned life insurance separate accounts

The Agencies note that investments in bank-owned life insurance policies ("BOLI") that cover key employees, in accordance with supervisory policies established by the federal banking agencies, are typically structured as investments in separate accounts that are excluded from the definition of "investment company" under the 1940 Act by virtue of section 3(c)(1) or 3(c)(7) of that Act.

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79 "Asset-backed securities" is not specifically defined in the Proposed Rule but will presumably follow the definition added to Section 3 of the Exchange Act by the Dodd-Frank Act.

80 As noted in Part III.A.1 above, for purposes of the Proposed Rule, "loans" include leases, receivables and other extensions of credit.

81 This provision is authorized by the statutory "rule of construction" in Section 13(g)(2) of the BHC Act that nothing in Section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Federal Reserve to sell or securitize loans in a manner otherwise permitted by law.

82 Proposed Rule Section __.14. These exempted activities also repeat the permitted activity acquiring or retaining an ownership interest in, or sponsoring, an asset-backed issuer described in Part IV.D.4 above. The Agencies ask specifically whether certain additional entities should be excluded from the definition of covered fund: (A) venture capital funds; (B) non-U.S. funds or entities; and (C) loan funds other than the exempted asset-backed issuers.

The Proposed Rule permits a banking entity to acquire and retain these BOLI investments, as well as act as sponsor to a BOLI separate account. In order for a banking entity to invest in or sponsor a BOLI separate account, the banking entity that purchases the insurance policy may not control the investment decisions regarding the underlying assets or holdings of the separate account and must hold its ownership interests in the separate account in compliance with applicable supervisory guidance provided by the appropriate federal regulatory agency regarding BOLI.[83]

2. Common corporate organizational vehicles that fall within the definition of a covered fund

The Proposed Rule permits a banking entity to acquire or retain an ownership interest in, or act as sponsor to, certain specified entities that are often part of corporate structures and that do not raise the type of concerns that the Volcker Rule was intended to address but that nevertheless may be captured by the definition of "hedge fund" or "private equity fund" in the statute. The entities carved out under the Proposed Rule are:

- A joint venture between the banking entity or its affiliate and any other person, provided that the joint venture is an operating company (which is not defined) and does not engage in any activity or any investment not permitted under the Proposed Rule;
- 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
- A wholly owned subsidiary of the banking entity that is (A) engaged principally in providing *bona fide* liquidity management services described under Section __.3(b)(2)(iii)(C) of the Proposed Rule, and (B) carried on the balance sheet of the banking entity.

The Proposed Rule also permits a banking entity to comply with the provision of the Dodd-Frank Act that requires a banking entity to maintain a certain minimum interest in certain sponsored or originated asset-backed securities.

Notwithstanding that the Agencies recognize that the statutory definition of "covered fund" sweeps too broadly, the Proposed Rule contains only limited changes to the covered fund prohibitions for common corporate structures, such as wholly owned or majority-owned subsidiaries, controlled subsidiaries and joint ventures used to hold ordinary course investments, or other investment, financing and capital-raising vehicles[84] that would be unnecessarily prohibited by the Volcker Rule.[85] The Proposed Rule does not

83 *See* Bank-Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance (Dec. 7, 2004).

84 Certain banking entities may have formed subsidiaries to raise Tier 1 capital that rely on the exceptions under Section 3(c)(1) or (7) of the 1940 Act.

85 The Agencies seek comments on whether additional covered funds activities should be exempted.

implement the Congressional directive from the legislative history of the Rule that the implementing rules not disrupt the way banking firms structure their normal investment holdings.[86]

3. Debts previously contracted and extended time periods

The Proposed Rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to a covered fund in those instances where the ownership interest is acquired or retained by the banking entity (i) 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, or (ii) pursuant to and in compliance with the two-year conformance period (and any extensions authorized) under the Proposed Rule.

F. REPORTING AND RECORDKEEPING REQUIREMENTS

The Proposed Rule requires a banking entity engaged in covered fund activities and investments to comply with (i) the internal controls, reporting, and recordkeeping requirements required under Section __.20 and Appendix C of the Proposed Rule, as applicable, and (ii) such other reporting and recordkeeping requirements as the relevant supervisory Agency may deem necessary to appropriately evaluate the banking entity's compliance with Subpart C of the Proposed Rule.[87]

G. LIMITATIONS ON RELATIONSHIPS WITH A COVERED FUND

1. Prohibition on "covered transactions" as defined in Section 23A of the Federal Reserve Act

The Proposed Rule prohibits transactions with a covered fund that would be "covered transactions" as defined in Section 23A of the Federal Reserve Act.[88] The Proposed Rule, like the statute, does not incorporate any of the exemptions in Section 23A for certain types of covered transactions. The Proposed Rule does not appear to incorporate the "attribution rule" from Section 23A, under which any transaction by a member bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate. The prohibition therefore applies only to covered transactions directly involving a banking entity or its affiliate, on the one hand, and a covered fund that it sponsors or organizes or offers or a covered fund controlled by such fund, on the other hand.

The Agencies confirm that the Proposed Rule incorporates the exemption from the definition of "covered transaction" contained in Section 23A of the Federal Reserve Act for "such purchase of real and personal property as may be specifically exempted by the [Federal Reserve] by order or regulation." Any

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86 This point was raised in the colloquy between U.S. House of Representatives Financial Services Committee Chairman Barney Frank and U.S. Representative Jim Himes. 156 Cong. Rec. H5226 (daily ed. June 30, 2010).

87 Proposed Rule Section __.15.

88 Proposed Rule Section __.16(a).

transaction that is specifically exempted by the Federal Reserve pursuant to this specific authority would not be deemed to be a covered transaction as defined in Section 23A.

The Proposed Rule clarifies that a banking entity may acquire or retain an ownership interest in a covered fund in accordance with the requirements of Subpart C of the Proposed Rule without violating the covered transaction prohibition.

The Proposed Rule permits a banking entity to enter into any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored or advised by such banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, subject to certain conditions. The Proposed Rule defines a "prime brokerage transaction" as one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution or financing, data, operational and portfolio management support.[89] This definition does not expressly include or exclude any specific type of transaction, but merely lists these examples.

To engage in a prime brokerage transaction with a covered fund, (A) a banking entity must be in compliance with the Proposed Rule's limitations on organizing and offering covered funds, (B) the chief executive officer (or equivalent) of the top-tier affiliate of the banking entity must make an annual written certification that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests and (C) the Federal Reserve must not have determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

2. Requirement that permitted transactions be subject to the standards of Section 23B of the Federal Reserve Act

The Proposed Rule applies Section 23B of the Federal Reserve Act to certain transactions (including prime brokerage transactions) and investments between a banking entity and a covered fund for which it serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or which it sponsors or organizes and offers, as if such banking entity were a member bank and such covered fund were an affiliate thereof.[90]

H. LIMITATIONS ON EXEMPTIONS TO THE COVERED FUND RESTRICTIONS

The Proposed Rule prohibits permitted covered funds activities involving material conflicts of interest or exposure to high-risk assets or trading strategies to the same extent as prohibited for permissible proprietary trading activities. *See* Part III.D above.

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89 Proposed Rule Section __.10(b)(4).

90 Proposed Rule Section __.16(b).

V. COMPLIANCE PROGRAM REQUIREMENTS; VIOLATIONS

A. COMPLIANCE PROGRAM

1. No program for banking entities not engaged in covered activities

Under the Proposed Rule, if a banking entity does not engage in covered trading activities or covered fund activities or investments (together, "covered activities"), it will be deemed to satisfy the compliance program requirement if its existing compliance policies and procedures include measures that are designed to prevent the banking entity from engaging in covered activities and require the banking entity to develop a program that complies with applicable requirements before engaging in covered activities.[91]

2. Minimum program requirement for banking entities engaged in covered activities

If a banking entity engages in covered activities, it must establish a program reasonably designed to ensure and monitor compliance with the Volcker Rule, as appropriate for the size, scope and complexity of its activities and structure.[92] A compliance program is required, at a minimum, to include:

- Internal written policies and procedures reasonably designed to document, describe and monitor covered activities;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance, and to prevent the occurrence of prohibited activities;
- A management framework that delineates responsibility and accountability for compliance;
- Independent testing for the effectiveness of the program conducted by qualified personnel of the banking entity or a qualified outside party;
- Training for trading personnel, managers and other appropriate personnel to effectively implement and enforce the compliance program; and
- Making records sufficient to demonstrate compliance, providing such records to the appropriate Agency upon request and keeping such records for at least five years.

The Preamble notes that a banking entity's compliance program should be carefully tailored to reflect the unique manner in which the entity operates, as well as the particular compliance risks and challenges that it faces.

3. Additional standards for banking entities with significant covered activities

The Proposed Rule would subject banking entities with "significant" covered trading activities or covered fund activities or investments to more burdensome compliance program requirements. The following banking entities would be subject to these requirements:

- Banking entities that have an average gross sum of trading assets and liabilities equal to or greater than $1 billion or 10% of total assets (which is the test for being subject to the Market

[91] Proposed Rule Section __.20(d).

[92] Proposed Rule Section __.20.

Risk Capital Rules for trading book capital calculations, both as currently in effect and as proposed to be amended);

- Banking entities that have an average value of investments in covered funds equal to or greater than $1 billion; and
- Banking entities that sponsor or advise covered funds that have an average total assets equal to or greater than $1 billion.

A banking entity may also be subject to these requirements if the appropriate Agency deems it appropriate.

4. Appendix C

Appendix C of the Proposed Rule sets forth the minimum standards that banking entities with significant covered activities are required to comply with.

a. Internal policies and procedures

Internal policies and procedures relating to covered trading activities must, among other things:

- Specify how the banking entity evaluates its covered financial positions and determines which of its accounts are trading accounts;
- Identify trading units and organizational structure;
- Describe the mission (*i.e.*, the nature of the business conducted) and the strategy (*i.e.*, business model for the generation of revenues);
  - Must include a description of how revenues are intended to be generated by the trading unit; the trading unit's authorized instruments and products; authorized hedging strategies and instruments; expected holding period of, and market risk associated with, covered financial positions in its trading account; and certain information relating to market making.
- Establish trader mandates for each trading unit and set forth appropriate parameters for each trader engaged in covered trading activities;
- Describe risks and risk management processes, including articulating the amount of risk allocated to each trading unit;
- Describe hedging policies and procedures;
  - Such policies and procedures must include the manner in which the covered banking entity will determine that the risks generated by each trading unit have been properly hedged and the instruments, techniques and strategies the banking entity will use to hedge risk and independent testing of hedging strategies.
- Describe and document a comprehensive explanation of how the mission and strategy of each trading unit, and its related risk levels comply with Appendix C; and
- Address remediation of violations.

Internal policies and procedures relating to covered fund activities or investments must among other things:

- Specify how the banking entity identifies covered funds that the banking entity sponsors, organizes and offers, or in which it invests;

- Identify asset management units and organizational structure;
- Describe the mission (*i.e.*, the nature of the business conducted) and the strategy (*i.e.*, business model for the generation of revenues);
- Describe the activities the asset management unit is authorized to conduct; extent of co-investment activities in covered funds offered to customers; and practices with respect to seed capital investments; and
- Address remediation of violations.

b. Internal controls

Internal controls relating to covered trading activities serve to ensure compliance with the written policies and procedures, and must, among other things:

- Ensure that trading activity of each trading unit falls within the authorized risks, instruments and products as documented in the policies and procedures and trader mandates;
- Establish and enforce risk limits appropriate for each trading unit, including limits based on probabilistic and non-probabilistic measures of potential loss measured under normal and stress market conditions;
- Perform robust analysis and quantitative measurement of its trading activities, using the metrics in Appendix A, as well as additional metrics to the extent necessary; and
  - This requires heightened review of any measurement that raises any question regarding compliance with the Volcker Rule or Appendix C.
  - This requires immediate review and investigation of the trading unit's activities, escalation to senior management with oversight responsibilities for the applicable trading unit, timely notification to the appropriate Agency, appropriate remedial action, and documentation of the investigation findings and remedial action taken when the quantitative measurement, considered together with the facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of the Volcker Rule or Appendix C.
- Monitor program effectiveness and take prompt action to address any deficiencies. Any actions taken to remedy deficiencies and violations shall be documented and maintained as a record.

Internal controls relating to covered fund activities serve to ensure compliance with the written policies and procedures, and must:

- Monitor and limit individual and aggregate investments in covered funds;
- Monitor the amount and timing of seed capital investments; calculating levels of ownership interests in covered funds; and making the appropriate written, required disclosures;
- Monitor and limit sponsorship of, and relationship with, covered funds; and
- Monitor program effectiveness and take prompt action to address any deficiencies. Any actions taken to remedy deficiencies and violations shall be documented and maintained as a record.

c. Responsibility and accountability for the compliance program

Each banking entity must have an appropriate management framework reasonably designed to ensure that: (i) appropriate personnel are made responsible and accountable for the effective implementation and enforcement of the compliance program; (ii) a clear reporting line with a chain of responsibility is delineated; and (iii) the board of directors and CEO reviews and approves the compliance program. The Proposed Rule does not require a formal public written attestation of compliance by the CEO, a requirement that was recommended in the FSOC study, but the Agencies request comment on whether one should be required. The proposed management framework must include, at a minimum:

- Board of director approval of the compliance program;
- Enforcement of the trader mandates;
- Enforcement of management procedures which:
    - Designate at least one person with authority to carry out the management responsibilities for each trading unit;
    - Provide for written procedures relating to the management of the covered activities, including the review by a manager of activities of the trading unit and its quantitative measurements, and procedures for determining compensation arrangements for traders engaged in market-making, underwriting or hedging activities.
- Identification of managers with responsibility for one or more trading units or asset management units that are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading unit or asset management unit.
- Senior management is responsible for communicating and reinforcing the culture of compliance, as established by the board of directors, and implementing and enforcing the approved compliance program. Senior management must also ensure that effective corrective action is taken when failures in compliance are identified. Senior management and control personnel charged with overseeing compliance should report to the board, or an appropriate committee thereof, on the effectiveness of the compliance program and compliance matters with a frequency appropriate to the size, scope, and risk profile of the covered banking entity's covered trading activities and covered fund activities or investments, which shall be at least once every twelve months.
- The board of directors and CEO are responsible for setting an appropriate culture of compliance and establishing clear policies regarding the management of covered activities. The board of directors must ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with this part in light of the organization's business activities. The board of directors must also ensure that senior management has established appropriate incentives to support compliance, including the implementation of a compliance program meeting the requirements of Appendix C into management goals and compensation structures across the covered banking entity.

B. VIOLATIONS

If a banking entity engages in an activity or makes an investment in violation of the Volcker Rule or the Proposed Rule or in a manner that functions as an evasion thereof, including through any abuse of permitted activities or investment, the banking entity must terminate the activity or dispose of the investment.

If the applicable Agency finds reasonable cause to believe that a banking entity has engaged in a prohibited activity or made a prohibited investment, the Agency may direct the banking entity to restrict or terminate the activity or dispose of the investment. This enforcement authority is in addition to the federal banking agencies' general enforcement powers with respect to violations of the BHC Act.

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