December 23, 2013

# Federal Agencies Approve Final Volcker Rule

## Executive Summary

On December 10, 2013, the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Office of the Comptroller of the Currency, the Securities and Exchange Commission (the "**SEC**") and the Commodities Futures Trading Commission (the "**CFTC**") jointly issued the final rule implementing Section 619 of the Dodd-Frank Act, also known as the "Volcker Rule." [1] The final rule prohibits banking entities from (i) owning, sponsoring, or having certain relationships with hedge funds and private equity funds (referred to as "**covered funds**"); and (ii) engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account.

In response to over 18,000 comment letters received, the final rule contains certain significant changes from the proposed rule, including the following. The final rule:

- excludes from the definition of "covered fund" certain entities with more general corporate purposes such as wholly owned subsidiaries, joint ventures and acquisition vehicles, as well as SEC-registered investment companies and business development companies, certain foreign funds publicly offered outside the United States, loan securitizations, insurance company separate accounts and small business investment company and public welfare investments;

- limits the category of foreign funds that are considered "covered funds" to non-U.S. funds that are sponsored or owned, directly or indirectly, by U.S. banking entities (other than foreign public funds) and that would rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), if offered in the United States;

- limits the category of commodity pools that are considered "covered funds" to certain exempt commodity pools under CFTC regulations (as well as pools that have features that are substantially similar to exempt pools);

- narrows the exemption permitting banking entities to engage in risk mitigating hedging activities, requiring that the hedge from inception demonstrably reduce or otherwise significantly mitigate

[1] For the full text of the final rule, see http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf.

the specific, identifiable risk of a specific, identifiable position, in order to prevent the exemption from being used to engage in scenario hedging or to conduct prohibited proprietary trading;

- clarifies that non-U.S. banking entities engaged in trading activities outside of the United States are allowed to conduct proprietary trades on U.S. exchanges and clearing facilities;

- expressly excludes a number of additional activities from the definition of proprietary trading, including the purchase or sale of financial instruments by a banking entity that is acting solely as agent, broker or custodian, and the purchase or sale of financial instruments through certain deferred compensation, stock-bonus, profit-sharing or similar plans;

- removes the requirement contained in the proposed rule that market making activities be designed to generate revenue primarily from fees or other customer revenues not attributable to appreciation in the value of the final positions; and

- requires larger banking entities to establish an enhanced, more detailed compliance program, including a requirement that the CEO annually attest in writing that the larger banking entity has in place a compliance program reasonably designed to achieve compliance with the final rule.

The final rule regulates "**banking entities**," which are defined principally in terms of certain relationships to an "insured depository institution," a bank that receives FDIC deposit insurance. Covered banking entities include insured depository institutions themselves; bank holding companies and entities that control insured depository institutions; and affiliates or subsidiaries of the foregoing banking entities. Thus, the entire corporate organizational structure associated in these ways with an insured depository institution or bank holding company is subject to the final rule.

The final rule will become effective on April 1, 2014, but the Federal Reserve has extended the general conformance period (the time by which banking entities must conform their activities and investments to the final rule) to July 21, 2015.

## Restrictions on Sponsoring or Investing in Covered Funds

### Prohibition on Acquiring or Retaining an Ownership Interest in and Having Certain Relationships with a Covered Fund

The final rule prohibits a banking entity from, as principal, directly or indirectly, acquiring or retaining any "**ownership interest**" in a "**covered fund**" or "**sponsoring**" a covered fund, subject to certain exemptions.

A “**covered fund**” means:

- an issuer that would be an investment company under the Investment Company Act, but for the exceptions provided by Section 3(c)(1) or Section 3(c)(7) of that Act;

- a commodity pool that has claimed an exemption under Section 4.7 of the CFTC’s regulations, or for which the commodity pool operator has claimed exempt pool status under Section 4.7 of the CFTC’s regulations, with substantially all participation units owned by “qualified eligible persons” and which participation units have not been publicly offered; and

- a foreign fund that is sponsored or owned, directly or indirectly, by U.S. banking entities (other than foreign public funds).

If an issuer may rely on an exclusion or exemption from the definition of “investment company” under the Investment Company Act other than the exceptions contained in Sections 3(c)(1) and 3(c)(7), it is not considered a covered fund.

Specifically excluded from the definition of “covered fund” are the following, which litany reflects Congressional concerns with banking entities’ exposure to, and relationships with, investment funds that explicitly are excluded from SEC regulation as investment companies, as well as a desire on the part of the agencies to exclude from coverage certain funds and other entities that might technically rely on Section 3(c)(1) or 3(c)(7) but whose activities do not implicate the concerns of the Volcker Rule:

- ***foreign public funds*** (issuers organized or established outside the United States, the ownership interests of which are authorized to be offered and sold to retail investors in the issuer’s home jurisdiction and are sold predominantly through one or more public offerings outside the United States);
- ***wholly owned subsidiaries of banking entities*** (except that up to 5% may be held by directors, employees and certain former directors and employees of the banking entity, and up to 0.5% of the 5% can be held by a third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency or other concerns);
- ***joint ventures*** (between the banking entity or an affiliate and no more than 10 unaffiliated co-venturers, provided it is in the business of engaging in activities that are permissible for the banking entity other than investing in securities for resale or other disposition, and it does not raise money from investors primarily for investing in securities for resale or other disposition or otherwise trading in securities);
- ***acquisition vehicles*** (formed solely for the purpose of engaging in *bona fide* merger or acquisition transactions, which exist only for the period necessary to effect a transaction);

- ***foreign pension or retirement funds*** (organized outside the United States, that are broad-based plans for employees or citizens subject to local regulation, and established for the benefit of citizens or residents of one or more non-U.S. jurisdictions);
- ***insurance company separate accounts*** (provided that no banking entity other than the insurance company that established the separate account participates in the account's profits and losses);
- ***bank owned life insurance separate accounts*** (provided that the separate account is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which such banking entity(ies) is a beneficiary; additionally, if the banking entity is relying on this exclusion, the banking entity that purchases the insurance policy must not control the investment decisions regarding the underlying assets of the separate account and must participate in the profits and losses of the separate account in compliance with applicable guidance regarding banking owned life insurance);
- ***loan securitizations*** (provided that the underlying assets are comprised solely of (i) loans; (ii) any rights or other assets (x) designed to assure the servicing or timely distribution of proceeds to security holders or (y) related or incidental to purchasing or otherwise acquiring, and holding the loans; (iii) certain interest rate or foreign exchange derivatives; and (iv) certain special units of beneficial interests and collateral certificates);
- ***asset-backed commercial paper conduits*** (that hold only (i) loans or other assets that would be permissible in a loan securitization; and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities; additionally, a qualifying asset-backed commercial paper conduit must issue only asset-backed securities, comprising of a residual and securities with a term of 397 days or less and in addition, a "regulated liquidity provider," as defined in the final rule, must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term asset-backed securities issued by the qualifying asset-backed commercial paper conduit in the event that funds are required to redeem the maturing securities);
- ***qualifying covered bonds*** (certain entities that own or hold a dynamic or fixed pool of assets that covers the payment obligations of covered bonds, provided that the assets in the cover pool must satisfy the conditions in the loan securitization exclusion, except for the requirement that the securities they issue are asset-backed securities);
- ***SBICs and public welfare investment funds*** *(*an issuer that is an SBIC (or that has received from the Small Business Administration notice to proceed to qualify for a license as an SBIC, which notice or license has not been revoked) or the business of which is to make investments that are: (i) designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as providing housing,

services, or jobs); or (ii) qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure);

- ***registered investment companies and business development companies*** (as well as vehicles that the banking entity operates (i) pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or business development company within the time period provided by the final rule for seeding a covered fund; and (ii) consistently with the leverage requirements under the Investment Company Act that are applicable to registered investment companies and SEC-regulated business development companies);
- ***issuers in conjunction with FDIC's receivership*** (an issuer that is an entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver); and
- ***other excluded issuers*** that the "appropriate Federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent" with the purposes of the Bank Holding Company Act of 1956, as amended (the "**BHC Act**").

"**Ownership interest**" means any equity, partnership or "other similar interest" in a covered fund. "**Other similar interest**" means an interest that: (i) has the right to participate in selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (but would not include rights of creditors to exercise remedies upon a default or other similar acceleration event); (ii) has the right to receive a share of the income, gains or profits of the covered fund (whether or not pro rata); (iii) has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (but would not include rights of creditors to exercise remedies upon a default or other similar acceleration event); (iv) has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests); (v) provides that the amounts payable by the covered fund could be reduced based on losses arising from the underlying assets of the covered fund such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; (vi) receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund (but would not include an interest that is entitled to receive dividend amounts calculated at a fixed or at a floating rate based on an index or interbank rate); or (vii) has any synthetic right to receive any of the rights described in (i) through (vi).

The final rule recognizes that banking entities that serve as an investment adviser or provide other services to a covered fund are routinely compensated for such services through receipt of a restricted profit interest (termed "carried interest" in the proposed rule). As such, "ownership interest" specifically excludes "**restricted profit interest**" held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser or commodity trading advisor, provided that: (i) the sole purpose and effect of the interest is to allow the recipient (or an employee or former employee thereof) to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the recipient (or employee/former employee); (ii) all such profit, once allocated, is distributed to the recipient (or employee/former employee) promptly after being earned or, if not so distributed, is retained by the covered fund for the purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the recipient (or employee/former employee) does not share in the subsequent investment gains of the covered fund; (iii) any amounts invested in the covered fund are otherwise within the investment limits of the final rule (as more fully described below); and (iv) the interest is not transferable by the recipient (or employee/former employee) except to an affiliate thereof, to immediate family members or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the recipient (or employee/former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory or other services to the fund.

A banking entity "**sponsors**" a covered fund when it: (i) serves as a general partner, managing member, trustee,[2] or commodity pool operator of a covered commodity pool; (ii) selects or controls a majority of the directors, trustees, or management of the covered fund; or (iii) shares the same name or a variation thereof with the covered fund for corporate, marketing, promotional or other purposes.

**Permitted Organizing and Offering, Underwriting and Market Making with Respect to a Covered Fund**

*General.* A banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including as general partner, managing member, trustee or commodity pool operator of the covered fund and in any manner selecting or controlling a majority of the directors, trustees, or management of the covered fund, including any necessary expenses, only if:

- the banking entity (or its affiliate) provides bona fide trust, fiduciary, investment advisory or commodity trading advisory services;

[2] The definition of "trustee" excludes a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee under ERISA.

- the covered fund is organized and offered only in connection with the provision of such services and only to customers[3] of such services pursuant to a credible documented plan;
- the banking entity complies with the provisions of the final rule on permitted investments in a covered fund, described below;
- the banking entity complies with the provisions of the final rule on limitations on its relationship with a covered fund, described below;
- 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 covered fund invests;
- the covered fund does not share the same name or a variation thereof with the banking entity and does not use the word “bank” in its name;
- only the banking entity’s directors or employees who are directly engaged in providing investment advisory or other services to the covered fund may invest in the covered fund; and
- the banking entity clearly and conspicuously makes the following written disclosures to any prospective and actual investor in the covered fund: (a) any losses in the covered fund will be borne solely by the investor and not by the banking entity and its affiliates or subsidiaries; (b) the investor should read the fund offering documents before investing; (c) the ownership interests in the fund are not insured by the FDIC and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case); and (d) the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund.

As a result, a banking entity must carefully review its relationships with any covered funds, including the types of services it offers to such covered funds, organizational documents, etc., in order to determine whether the banking entity must modify certain of its activities in order to fall within the scope of permitted activities.

*Organizing and offering an issuing entity of asset-backed securities*. A banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund that acts as a securitizer, as the term is used in Section 15G of the Securities Exchange Act of 1934, as amended, of the issuing entity so long as the banking entity and its affiliates comply with the conditions listed above.

[3] The final rule does not require the customer relationship to be pre-existing.

*Underwriting and market making in ownership interests of a covered fund*. Banking entities may engage in underwriting and market making in ownership interests of a covered fund, so long as: (i) the activity is otherwise conducted in accordance with the requirements regarding underwriting and market making of the final rule (as discussed under "Permitted Trading Activities" below); (ii) for banking entities acting as sponsor, investment adviser or commodity trading advisor, ownership interests acquired or retained by the banking entity are included in the calculation of ownership interests permitted to be held by the banking entity described below; and (iii) the aggregate value of all ownership interests are included in the calculation of all ownership interests, as described below.

**Permitted Investments in a Covered Fund**

A banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers for the following purposes:

- *Seeding*. Establishing the covered fund and providing it with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to seeding and aggregate fund limitations. A banking entity may make any investment (up to 100%) to establish the covered fund and provide the covered fund with sufficient initial equity for investment to attract unaffiliated investors, provided that the banking entity must actively seek unaffiliated investors to reduce its ownership interest to comply with the per-fund limitation within one year of the establishment of the covered fund (which per-fund conformance period may be extended for up to two additional years upon application to the Federal Reserve). The date of establishment is the date on which the covered fund begins to make investments.

- *De minimis investments*. Making and retaining an investment in the covered fund, subject to per-fund and aggregate limitations.

    - *Per-fund limitation*. A banking entity may make and retain an investment in a single covered fund organized and offered by the banking entity, provided that the investment does not exceed 3% of the total number of the outstanding ownership interests in the covered fund <u>or</u> the fair market value of the covered fund (excluding uncalled capital commitments). A banking entity must calculate the amount and value of its ownership interests in covered funds quarterly.

    - *Aggregate limitation*. The banking entity's aggregate interests in all covered funds that it organizes and offers may not exceed 3% of its Tier 1 capital.

*Multi-tier fund investments*. The final rule clarifies that with respect to master-feeder fund structures, for purposes of the above limitations, a banking entity's permitted investment should be measured only at the master fund level. However, if a banking entity invests in a covered fund-of-funds that invests in another covered fund organized and offered by the banking entity, the banking entity's permitted investment should be measured with respect to each fund.

*Co-investments*. In the preamble to the final rule, the agencies suggested that they are concerned about co-investments as a potential method for evading the per-fund and aggregate limitations described above. In particular, the agencies stated that a banking entity that sponsors a covered fund should not make additional side-by-side co-investments with that covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment. Further, if the banking entity co-invests through a vehicle that is itself a covered fund, then the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund. Finally, if a banking entity makes investments side-by-side in substantially the same positions as the covered fund, then the value of such investments will be included for purposes of determining the value of the banking entity's investment in the covered fund.

**Other Permitted Covered Fund Activities and Investments**

*Risk-mitigating hedging activities*. A banking entity may acquire or retain an ownership interest in a covered fund as a hedge to cover a compensation arrangement with a banking entity employee who directly provides investment advisory or other services to the covered fund. In order to rely on this exemption, a banking entity must adopt an internal compliance program.

*Investments outside the United States*. A foreign banking entity may acquire or retain an ownership interest in or sponsor a covered fund if: (i) the banking entity is not organized or controlled by a banking entity organized under the laws of the United States or one or more states; (ii) the banking entity must conduct its sponsorship or investment activities pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act; (iii) no ownership interest in the covered fund is offered or sold to a resident of the United States[4] and (iv) the activity occurs solely outside of the United States, meaning that (a) the banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State; (b) the banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State; (c) the investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and (d) no financing for the banking entity's

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[4] Defined by reference to Rule 902(k) of SEC Regulation S.

ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

*Covered fund interests held or acquired by a regulated insurance company*. An insurance company may acquire or retain ownership interests in, or sponsor, a covered fund, only if: (i) the insurance company retains the ownership interest solely for its general account or for one or more separate accounts established by the company; (ii) the acquisition and retention complies with other relevant law; and (iii) other regulators have not determined that a particular law or regulation is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

**Limitations on Relationships with a Covered Fund**

The following limitations apply to transactions between a banking entity (or any affiliate thereof) and a covered fund that it organizes and offers or for which it otherwise serves, directly or indirectly, as investment manager, investment adviser, commodity trading advisor or sponsor.

*Prohibited transactions*. The banking entity (or any affiliate thereof) and such covered fund may not enter into a **covered transaction**, as defined in Section 23A of the Federal Reserve Act. "Covered transaction" includes, but is not limited to: (i) a loan or extension of credit to the covered fund; (ii) a purchase of assets from the covered fund; (iii) the acceptance of securities issued by the covered fund as collateral security for a loan or extension of credit to a third party; and (iv) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the covered fund.

*Prime brokerage transactions*. The banking entity and the covered fund may nevertheless enter into any prime brokerage transaction, which is defined as any transaction that would be a covered transaction as defined in Section 23A(b)(7) of the Federal Reserve Act that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support," provided that: (i) the banking entity is otherwise in compliance with this rule; (ii) the CEO (or equivalent officer) certifies in writing annually that it does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or any covered fund in which such covered fund invests; and (iii) the Federal Reserve has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

*Market terms requirement*. Under Section 23B of the Federal Reserve Act, certain transactions between the banking entity and the covered fund must be on terms at least as favorable to the banking entity as the prevailing market terms. In the absence of market terms, the transactions must be on terms that in good faith would be offered to nonaffiliated parties. The market terms requirement applies to: (i) any covered transaction; (ii) any prime brokerage transaction; (iii) the sale of securities or other assets to the covered fund; (iv) the payment of money or the furnishing of services to the covered fund; (v) any transaction in which the covered fund acts as an agent or broker for the banking entity or receives a fee for services to the banking entity or a third party; and (vi) any third-party transaction in which the covered fund is a participant or has an interest in the third party.

**Backstop Limitations on Activities Related to Covered Funds**

All permitted activities under the final rule are subject to the limitation that they must not: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial system of the United States.

## Restrictions on Proprietary Trading

**Scope of the Final Rule**

The final rule prohibits banking entities from engaging in "**proprietary trading**," subject to certain exemptions.

"**Proprietary trading**" is defined as engaging as principal for the "**trading account**" of a banking entity in any purchase or sale of one or more financial instruments. "**Financial instruments**" include securities, derivatives, options on securities or derivatives, and contracts of sale of a commodity for future delivery, but do not include loans, certain commodities, foreign exchange or currency. Since the rule only prohibits acting as principal, a banking entity is allowed to be an agent, broker or custodian for an unaffiliated third party.

A banking entity's trading account is defined to cover accounts used to purchase or sell one or more financial instruments principally for the purpose of "**short-term**" profit on the position, including short-term resale based on price movements or arbitrage opportunities, or hedging such short-term positions. A banking entity's trading account is also defined to include an account used to purchase or sell financial instruments that are market capital risk rule positions if the banking entity or its affiliate is an insured depository institution, a bank holding company or a savings and loan holding company and calculates risk-based capital ratios under the market risk capital rule.

The final rule does not include a bright-line definition of "short-term," but there is a rebuttable presumption that a position held for 60 days or less was made for the banking entity's trading account.

It is not just the speed of the trade that triggers the rule's prohibition, but the trade's intent. For example, a banking entity may take a position which it initially intends to be a permitted long-term hedge to protect against risks to certain of its assets. If quickly changing conditions make the hedge unworkable, the rule does not prohibit the banking entity from selling the position, as long as the intent of the trade was not principally for short-term profit.

*Activities not considered proprietary trading.* Proprietary trading does not include the purchase or sale of financial instruments that more closely resemble short-term secured loans, such as repurchase agreements and securities lending agreements, or are for the purpose of liquidity management, pursuant to a documented liquidity management plan. The final rule added a number of exceptions, including the purchase or sale of financial instruments by a banking entity that is acting solely as agent, broker, or custodian, and the purchase or sale of financial instruments through certain deferred compensation, stock-bonus, profit-sharing or similar plans.

*Automatic trading account activities.* Certain purchases or sales of financial instruments are considered to be taken for the banking entity's trading account regardless of the trading period or acquisition intent. If a banking entity is also licensed or registered (or is required to be licensed or registered) as dealer, swap dealer or security-based swap dealer, to the extent that entity purchases or sells a financial instrument in connection with the activities that require the banking entity to be licensed or registered as such, then the purchase or sale is deemed to have been taken for the entity's trading account, whatever the timeframe or intent.

**Permitted Trading Activities**

The final rule exempts the following categories of activities from the general proprietary trading prohibition.

*Underwriting exemption.* The final rule explicitly allows banking entities to engage in underwriting activities. The exemption requires that the banking entity act as underwriter for a distribution of securities and that the trading desk's underwriting position be related to the distribution. The banking entity is also required to establish, maintain and enforce an internal compliance program to monitor compliance with the Volcker Rule, including reasonably designed written policies and procedures, internal controls, analysis and independent testing. The underwriter may only take positions that are designed not to exceed the reasonably expected near term demands of counterparties, and must make reasonable efforts to sell or otherwise reduce the underwriting position, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.

*Market making exemption.* There is also an exemption for market making-activities, which are permitted only if the banking entity's trading desk routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure, and if the amounts, types and risks of the financial instruments in inventory are designed not to exceed the reasonably expected near term demands of clients, customers and counterparties. The banking entity also must establish, maintain and enforce an internal compliance program to monitor compliance with the Volcker Rule.

Many commenters objected to the proposed requirement that market making activities be designed to generate revenue primarily from fees or other customer revenues not attributable to appreciation in the value of the financial positions. As a result, this requirement was removed from the final rule.

*Hedging exemption*. The final rule incorporates the statutory exemption for risk-mitigating hedging activities, allowing a banking entity, pursuant to an internal compliance program, to take positions to reduce specific risks associated with its other holdings. The position must demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts or other holdings of the banking entity, and must not give rise at the inception of the hedge to any significant new exposure that is itself not hedged. The banking entity must continuously review the hedging position for compliance with the rule and mitigate any developing exposure. In addition, the banking entity must document, even beyond the previously discussed compliance program, the purpose of each hedging position taken, the specific, identifiable risk it hedges, and the trading desk or other business unit that is establishing and responsible for the hedge. These requirements are designed to prevent the exemption from being used to engage in scenario hedging, general asset-liability management or other prohibited activities, or to conduct prohibited proprietary trading under the guise of hedging.

Each of the underwriting exemption, market making exemption and hedging exemption require that the compensation arrangements of persons performing the related activities not be designed to reward or incentivize prohibited proprietary trading.

*Additional exemptions*. Additional exemptions are provided for trading in government obligations, as well as for trading on behalf of customers in a fiduciary capacity, or as riskless principal offsetting a customer position. In addition, banking entities that are insurance companies are permitted to purchase or sell financial instruments solely for the general account of the insurance company or a separate account established by the insurance company if conducted in compliance with the relevant insurance company investment laws and regulations.

*Proprietary trading outside the United States*. The rule permits certain foreign proprietary trading activities by foreign banking entities conducted outside of the United States. The final rule clarifies this extraterritorial requirement, moving from a transaction-based to a risk-based approach intended to ensure that the risk of the trading activity is kept out of the United States. Accordingly, the rule broadly prohibits proprietary trading by banking entities located or organized in the United States (although foreign banking entities acting outside of the United States are allowed to conduct proprietary trades on U.S. exchanges and clearing facilities).

*Override authority*. All permitted activities under the final rule are subject to the limitation that they must not: (i) result in a material conflict of interest between the banking entity and its counterparties; (ii) result in a material exposure by the banking entity to a high-risk asset or trading strategy; or (iii) pose a threat to the soundness of the banking entity or to the financial stability of the United States.

## New Reporting and Compliance Requirements

The final rule retains the reporting and compliance program requirements in the proposed rule with a number of modifications designed to make them more tailored to the size, complexity and type of activity conducted by each banking entity.

**Reporting Requirements**

In general, a banking entity engaged in permitted proprietary trading will be required to report various metrics if it, together with its affiliates, has trading assets and liabilities the average gross sum of which over the previous four consecutive quarters equals or exceeds $10 billion. The final rule reduced the number of metrics to be reported from 17 to 7, which relate to risk and position limits and usage, risk factor sensitivities, value-at-risk and stress VaR, comprehensive profit and loss attribution, inventory turnover, inventory aging, and customer facing trade ratio.

In response to comments, the final rule raises the threshold for metrics reporting from that contained in the final rule to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in approach based on the size of trading assets and liabilities. The largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) are required to report information beginning on June 30, 2014. Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would also be required to report this information beginning on April 30, 2016, and December 31, 2016, respectively.

**Compliance Programs for Banking Entities Engaged in Restricted Activities**

Similar to the final rule, the final rule provides that banking entities that are engaged in permitted proprietary trading or covered fund activities must establish a compliance program, which must include: (i) written policies and procedures to document, describe, monitor and limit the restricted activities; (ii) internal controls to monitor compliance; (iii) a management framework that clearly delineates responsibility and accountability for compliance; (iv) independent testing and audit of the effectiveness of the compliance program; (v) training of personnel and managers to effectively implement and enforce the compliance program; and (vi) records to be kept for five years to demonstrate compliance.

Unlike the final rule, the final rule provides an accommodation for banking entities with total consolidated assets of $10 billion or less that engage in permitted proprietary trading or covered fund activities. These banking entities may generally satisfy their compliance obligations by including appropriate references to the requirements of the Volcker Rule in their existing compliance policies and procedures with adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

Banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years are required to retain additional records regarding funds and other entities, including documentation of the exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7) of the Investment Company Act relied on by each fund sponsored by the banking entity in determining that such fund is not a covered fund.

The regulating agency of a banking entity may impose additional requirements as it deems appropriate. A banking entity that violates or evades the Volcker Rule regulations may be ordered to restrict or terminate the offending activity and, as relevant, dispose of the offending investment.

**Enhanced Compliance Requirements for Larger Banking Entities**

The final rule applies enhanced compliance obligations to banking entities that have total consolidated assets as of the previous year end of $50 billion or more (or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more) or that are required to comply with the reporting requirements described above. For these larger banking entities, the final rule requires that the compliance program satisfy a variety of additional requirements and minimum standards generally designed to ensure that the banking entity has robust risk management and remediation processes, independent testing and reporting, and other compliance controls to govern its covered trading and covered fund activities. Among the most noteworthy is the requirement that the CEO of a larger banking entity must, annually, attest in writing to the relevant agency that the larger banking entity has in place a compliance program reasonably designed to achieve compliance with the Volcker Rule.

**Banking Entities not Engaged in any Restricted Activities**

Banking entities that are not engaged in restricted proprietary trading or covered fund activities are not required to establish a compliance program prior to becoming engaged in such activities or making such investments.

## Regulatory and Enforcement Issues

The final rule leaves many questions unanswered on the enforcement and regulatory front. For example, as discussed above, certain provisions of the rule provide exceptions to the general prohibition on proprietary trading activities. These provisions, however, will require banking entities to exercise their judgment to distinguish between permitted and prohibited proprietary trades. In addition, even with respect to otherwise permitted proprietary trading activities, banking entities must determine whether the activities (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial system of the United States. These provisions—coupled with arguably nebulous definitions of certain key terms—could potentially become grounds for regulatory inquiries.

The final rule does not clearly identify who will enforce the rule, or how it will be enforced. Each of the five regulatory agencies that approved the rule is tasked with interpreting and enforcing it, but the final rule does not clearly delineate the jurisdictional authority of each agency. The preamble to the final rule explains that a banking entity may, in fact, be subject to jurisdiction by more than one agency. Uncertainty about enforcement responsibilities is likely to endure until the Volcker Rule goes into effect and the five regulatory agencies responsible for policing the rule begin interpreting and enforcing it.

In addition, the final rule does not, on its face, make clear what penalties and sanctions may be imposed on rule violators. The final rule enumerates only two penalties that the enforcing agencies may impose on banking entities that violate it, requiring it to: (i) terminate the activity that violates the rule; and (ii) dispose of any investment. Several commenters raised concerns about this section of the proposed rule. Many suggested the enforcing agencies strengthen the provisions provided for under the rule; others asked for the imposition of automatic and specific penalties on rule violators. The enforcing agencies, however, dismissed these comments, explaining that the agencies may rely on their inherent authority under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law. This suggests that the enforcing agencies may consider violations of the Volcker Rule relevant in investigations into violations of other pre-existing, applicable rules.

## Conformance Period

The statute provides banking entities a period of two years to conform their activities and investments to the requirement of the statute, i.e., until July 21, 2014. However, the Federal Reserve is permitted to extend this conformance period, one year at a time, for a total of no more than three additional years. Pursuant to this authority and in connection with the adoption of the final rule, the Federal Reserve extended the conformance period for an additional year, until July 21, 2015. The Federal Reserve has indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period are in the public interest.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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