
A User's Guide to The Volcker Rule

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Summary

The legislation known as the Volcker Rule was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and codified in Section 13 of the Bank Holding Company Act of 1956, as amended (“BHC Act”).¹ The Volcker Rule generally prohibits, subject to exceptions, a banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in or sponsoring a hedge fund or private equity fund. Certain trading and fund activity is expressly permitted – notably, underwriting activities, market making-related activities, and risk-mitigating hedging activities.

The Volcker Rule legislation covered the area with a broad brush, leaving many significant issues open to regulatory interpretation. In December 2013, five federal financial regulatory agencies (collectively, the “Agencies”),² adopted a final rule (the “Final Rule”) construing the Volcker Rule.³ The Final Rule also sets out a compliance and reporting regime for banking entities engaged in proprietary trading or fund sponsorship or investment. The determinations made by the Agencies in the Final Rule reflect two years of comment and debate following the issuance of a Proposed Rule (the “Proposed Rule”) in November 2011.

Under the Final Rule, larger banks and bank affiliates (based on total assets) that are engaged in proprietary trading permitted by the Final Rule will be subject to a compliance regime to ensure compliance with the Final Rule. In addition, larger banks and bank affiliates (in terms of the amount of their trading assets and liabilities) that are engaged in proprietary trading permitted by the Final Rule will be required to report a highly technical set of quantitative measures. Banking entities with only a “modest” level of trading and fund investment activities will be subject to a much less comprehensive set of compliance requirements. The compliance requirements are discussed in more detail below.

The Final Rule is complex in scope and has already elicited significant commentary and questions from the banking industry and the public at large. The purpose of this guide is to discuss the requirements of the Final Rule at a practical level. While the relevant components of the Final Rule are addressed here, financial institutions should consider all of the Final Rule’s “fine print” – the many detailed definitions and conditions that comprise the Final Rule (as well as the extensive commentary

¹ Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat.1376 (July 21, 2010) (“Dodd-Frank” or the “Act”); Section 13 of the Bank Holding Company Act (“BHC Act”), 12 U.S.C. § 1851.

² The Federal Deposit Insurance Corporation (“FDIC”), the Federal Reserve Board (“FRB”), the Office of the Comptroller of the Currency (“OCC”), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”).

³ The Final Rule may be found

at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf>. The Final Rule was accompanied by a long explanatory commentary (“Attachment B”). Attachment B may be found at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf>.

contained in Attachment B to the Final Rule) – before making any decisions regarding compliance.

The Volcker Rule, as construed by the Final Rule, has special application to foreign banking organizations that have U.S. bank subsidiaries or operate branches, agencies or commercial lending company subsidiaries in the United States (“FBOs”). Please refer to our Client Alert dated December 12, 2013 for a more complete explanation of the impact of the Final Rule on FBOs. The Client Alert may be found at <http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf>.

The Conformance Period

The Final Rule is effective April 1, 2014, but the compliance period during which banking entities must conform their activities to the Volcker Rule has been extended for one year until July 21, 2015. Nonetheless, effective June 30, 2014, the largest banking entities (those with \$50 billion or more in consolidated trading assets and liabilities, as discussed further below) are required to report quantitative measurements to regulators.

The FRB emphasized in its order approving the extension of the conformance period that each banking entity is expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in conformance with the Volcker Rule not later than the end of the conformance period. Moreover, banking entities should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted, and banking entities with stand-alone proprietary trading operations are expected to promptly terminate or divest such operations.

Banking Entities

The Volcker Rule applies to “banking entities.” A “banking entity” includes:

- (i) any insured depository institution;
- (ii) any company that controls an insured depository institution (in other words, any bank holding company or savings and loan holding company);
- (iii) any FBO; and
- (iv) any affiliate of the foregoing. The term “affiliate” is used as defined in the BHC Act and thus includes any company controlled by a banking entity.

Notwithstanding the breadth of the definition of a “banking entity,” there are certain specific exceptions. For example, a “banking entity” does not include a covered fund that is not itself a bank holding company or an FBO. This is an important exception. A bank holding company that serves as the general partner of a fund would be deemed to control that fund. But for this exception, the “covered fund” would itself be a “banking entity” subject to the Volcker Rule.

In addition, a “banking entity” does not include a portfolio company held by a bank holding company or an FBO under the so-called BHC Act’s merchant banking authority,⁴ a company controlled by an insurance company affiliate of a bank holding company,⁵ or any portfolio concern that is controlled by a small business investment company, as defined in Section 103(3) of the Small Business Investment Act of 1958, as long as the portfolio company or portfolio concern is not itself an insured depository institution, a bank holding company or savings and loan holding company, or an FBO.

SUBPART B⁶ – Proprietary Trading

The Volcker Rule prohibits a banking entity from engaging in proprietary trading, subject to certain exceptions discussed below. Proprietary trading is defined as engaging as principal for the trading account of the banking entity in the purchase or sale of a financial instrument. Thus, compliance with the Rule by a banking entity depends on whether the account for which the trade is placed satisfies the definition of “trading account” and whether the trade involves a “financial instrument.”

Definitions

Trading Account. The Final Rule provides a functional definition of “trading account,” which means an account that satisfies any one of three criteria: a “purpose test,” a “market risk capital rule test,” or a “status test.”

The Purpose Test. A trading account includes any account used by a banking entity to buy or sell a financial instrument principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position resulting from any of the foregoing trading activities.

Market Risk Capital Rule Test. If the banking entity or any affiliate is an insured depository institution, bank holding company, or savings and loan holding company and calculates risk-based capital ratios under the U.S. market risk capital rule, a trading account includes accounts used to buy or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions).

Status Test. If the banking entity is licensed or registered (or required to be licensed or registered) to engage in the business of a securities dealer, swap dealer or security-based swap dealer, a trading account includes any account used by a banking entity to purchase or sell financial instruments for any purpose to the extent the financial instruments are purchased or sold in connection with activities that require the banking entity to be so licensed or registered.

⁴ 12 U.S.C. § 1843(k)(4)(H).

⁵ 12 U.S.C. § 1843(k)(4)(I).

⁶ The Volcker Rule is 71 pages long and consists of Subparts A through D and Appendices A and B. Subpart A is titled “Authority and Definitions,” and is not discussed directly here.

Trades are presumed to be for the trading account of a banking entity if the banking entity holds the position for fewer than sixty days, unless the banking entity can demonstrate that it did not make the trade for any of the purposes described in the preceding paragraph.

As the definition of a trading account is broad, the Rule excludes the following types of trading from the definition of proprietary trading:

- Trades pursuant to purchase or reverse repurchase agreements;
- Trades that arise under a transaction in which the banking entity lends or borrows securities temporarily under an agreement pursuant to which the lender retains the economic interest in the securities, and has the right to recall the loaned securities;
- Trades for the purpose of liquidity management in accordance with a documented liquidity management plan that meets specific requirements of the Final Rule;⁷
- Trades by a derivatives clearing organization or clearing agency in connection with clearing or settlement of financial instruments;
- Any “excluded clearing activities”⁸ by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization or a member of a designated financial market utility;
- Trades to satisfy an existing delivery obligation, including to prevent or close out a failure to deliver, in connection with delivery, clearing or settlement activity;
- Trades to satisfy an obligation in connection with a judicial, administrative or self-regulatory organization or arbitration proceeding;
- Trades where the banking entity is acting solely as agent, broker or custodian;
- Trades through a deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity; and
- Trades made in the ordinary course of collecting a debt previously contracted (“DPC”) in good faith, provided that the banking entity divests the financial instrument as soon as practicable.

⁷ The liquidity management plan should:

- (i) specifically contemplate and authorize the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the circumstances in which the securities may be used;
- (ii) require that any transaction in securities under the plan be principally for the purpose of liquidity management and not for short-term price movements, resale, profits or arbitrage;
- (iii) require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses in the short term;
- (iv) limit any securities and other instruments purchased or sold for liquidity management purposes to an amount consistent with the banking entity’s near-term funding needs;
- (v) includes written policies and procedures, internal controls, analysis and independent testing to ensure that transactions in securities other than domestic or foreign government obligations are for the purpose of liquidity management; and
- (vi) be consistent with the relevant Agency’s supervisory requirements regarding liquidity management.

⁸ Final Rule, §____.3(e)(7).

Trades between affiliates are not specifically excluded from the definition of proprietary trading and therefore must rely on a stated exception.

Financial Instrument. A “financial instrument” includes:

- a security (including an option on a security);
- a derivative (including an option on a derivative); and
- a contract of sale of a commodity for future delivery (or an option on the same).

Specifically excluded from the definition of “financial instrument” are:

- loans;
- a commodity that is not (i) an “excluded commodity”⁹ (other than foreign exchange or currency), (ii) a derivative, or (iii) a commodity future; and
- foreign exchange or currency.

Permitted underwriting and market making-related activities

The prohibition against proprietary trading does not apply to permitted underwriting activities and market making-related activities. Significant comment was provided to the Agencies after the publication of the Proposed Rule regarding how best to distinguish these permitted activities from prohibited proprietary trading. The Final Rule enumerates detailed conditions for qualifying as permitted underwriting or market-making. The long commentary published with the Final Rule in Attachment B provides useful insights into the view of the Agencies regarding the distinctive features of these permitted activities. This guide is intended as a summary only.

⁹ An “excluded commodity” is as defined in Section 1a(19) of the Commodity Exchange Act, 7 U.S.C. 1a(19). “The term “excluded commodity” means—

- (i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;
- (ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—
 - (I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or
 - (II) based solely on one or more commodities that have no cash market;
- (iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or
- (iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—
 - (I) beyond the control of the parties to the relevant contract, agreement, or transaction;
 - and
 - (II) associated with a financial, commercial, or economic consequence.”

To engage in either permitted activity, a banking entity must comply with three overall conditions:

- the banking entity must maintain an internal compliance program required by Subpart D (and discussed below) to ensure that the banking entity complies with the conditions permitting the activity;
- the compensation arrangements of people involved in these activities must not be designed to reward or incentivize prohibited proprietary trading; and
- the banking entity must be licensed or registered to engage in the permitted activity.

In addition, the following specific conditions apply.

Underwriting. Underwriting activities are permitted only if the trading desk's¹⁰ underwriting position is related to a "distribution" of securities for which the banking entity is acting as underwriter.¹¹ The amount and type of the securities in the underwriting position cannot exceed the reasonably expected near term demands of clients, customers or counterparties, and the trading desk must make reasonable efforts to reduce the underwriting position within a reasonable period.

The Final Rule defines "distribution" to include offerings of securities made pursuant to a registration statement under the Securities Act of 1933 (the "1933 Act"), as well as offerings whether or not pursuant to the 1933 Act that involve special selling efforts and selling methods.¹²

The Final Rule defines "underwriter" broadly as well, to include a person who has agreed to purchase securities from an issuer or selling security holder for distribution, or engage in or manage a distribution of securities for or on behalf of the issuer or selling security holder, as well as a person who has agreed to participate or is participating in a distribution of securities on behalf of the issuer or selling security holder.

The compliance program described below is a condition for permitted underwriting. The compliance program must include written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

- the products, instruments or exposures each trading desk may trade or manage as part of its underwriting activities;

¹⁰ A "trading desk" is the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity. Final Rule, § __.3(e)(13).

¹¹ Final Rule, § __.4(a).

¹² The definition of "distribution" tracks in some respects the definition provided in Regulation M under the Securities Exchange Act of 1934 (the "Exchange Act"), 17 CFR § 242.100 to 105, but excludes the need to consider the "magnitude" of the offering. Thus, permitted underwriting activities include activities related to 1933 Act registered offerings as well as private placements, Rule 144A offerings, commercial paper offerings, and syndicate and stabilizing activities. Attachment B provides a useful discussion of the types of offerings, as well as the types of syndicate and related stabilizing activities, which are intended to be included.

- limits for each trading desk based on the nature and amount of its underwriting activities, taking into account the amount, types and risk of its underwriting position; the level of exposures to relevant risk factors arising from its underwriting position; and the period of time a security may be held;
- internal controls and ongoing monitoring and analysis of compliance with limits; and
- authorization procedures, including escalation procedures, that require review and approval of any trade exceeding limits, demonstrable analysis of the basis for an increase in a trading desk’s limits and independent review of such analysis and approval.

Market-making. Market making-related activities are permitted only if the relevant trading desk¹³ routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase or sell those types of financial instruments for its own account in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market for the relevant types of financial instruments.¹⁴ In addition, the amount, types and risks of the financial instruments in the trading desk’s market-maker inventory must be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties, based on:

- the liquidity, maturity, and depth of the market for the relevant types of financial instruments; and
- demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades.

The Final Rule establishes a rebuttable presumption that the trading desk of another banking entity with trading assets and liabilities exceeding \$50 billion is not a “client, customer, or counterparty” for the purposes of considering whether trading with that desk is permitted market making. In Attachment B, the Agencies recognize, however, that allowing a trading desk to engage in customer-related interdealer trading is appropriate because it can help a trading desk appropriately manage its inventory and risk levels and can effectively allow clients, customers, or counterparties to access a larger pool of liquidity. However, regulators will scrutinize interdealer trading to ensure it reflects market-making activities and not impermissible proprietary trading.

The compliance program described below is a condition for permitted market making. The compliance program is required to include written policies and procedures, internal controls, analysis and independent testing addressing:

- instruments in which each trading desk will make a market;

¹³ See note 10 *supra*.

¹⁴ Final Rule, § __.4(b).

- actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure;
- limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities;
- internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and
- authorization procedures, including escalation procedures, that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any increase to a trading desk's limits is consistent with the market making exception requirements and independent review of such analysis and approval.

Permitted risk-mitigating hedging activities: The prohibition on proprietary trading does not apply to certain risk-mitigating hedging activities. Section __.5(a) of the Final Rule permits, subject to numerous conditions, hedging activities that are “in connection with and related to individual or aggregated positions, contracts or other holdings” and “designed to reduce the specific risks to the banking entity” that are “related to such positions, contracts or other holdings.”¹⁵ Hedging of general risks that are not related to specific positions, such as risks associated with assets or liabilities of the banking entity generally or risks associated with general market movements or broad economic conditions, is not permitted.

The compliance program described below is a condition for any risk-mitigating hedging activity to be permissible. The compliance program is required to include, among other things:

- written policies and procedures regarding positions, techniques and strategies that may be used for hedging;
- documentation indicating what positions, contracts or other holdings a particular trading desk may use in its hedging activities;
- position and aging limits; and
- internal controls and authorization procedures (including relevant escalation procedures) and analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged, and the correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risks being hedged.

¹⁵ Hedging in conjunction with market making activities is not subject to, and need not satisfy, the requirements for permitted risk-mitigating hedging activities. However, such hedging must still demonstrably reduce or otherwise significantly mitigate one or more specific risks; the trading desk that is engaged in market making must also conduct or direct the hedge (hedges put on by another trading desk are subject to the permitted risk-mitigating hedging activities requirements); and the written policies and procedures addressing permissible hedging techniques and strategies for market making must specify how the trading desk may establish hedges, how such hedges are removed once the risk they are mitigating is unwound and the extent to which the trading desk will engage in anticipatory hedging.

Risk-mitigating hedging activities must not give rise, at the inception of a hedge, to any significant new or additional risk that is not itself hedged contemporaneously, and continuing review, monitoring and management of hedging activity, and ongoing recalibration of the hedging activity, is required. The Final Rule imposes additional documentation requirements with respect to risk-mitigating hedging activities established by a trading desk other than the desk responsible for the underlying positions and with respect to hedges of aggregated positions across trading desks, as well as hedging activities that are effected through financial instruments, exposures, techniques or strategies not specifically identified in applicable policies and procedures.

Anticipatory and dynamic hedging activities are permitted so long as they meet the above requirements.

Other permitted proprietary trading activities

The prohibition on proprietary trading does not apply to the following:

- trading in U.S. government or government agency securities;
- trading in municipal bonds;
- trading by a foreign affiliate of a U.S. banking entity of debt of a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or of any agency or political subdivision of that foreign government, issued by the foreign country in which the foreign affiliate is organized, if the affiliate is a foreign bank or regulated by the foreign sovereign as a securities dealer and the trading is not financed by an affiliate located in the United States or organized under U.S. law;
- trading on behalf of a customer in a fiduciary capacity or as riskless principal; and
- trading by a banking entity that is a regulated insurance company (including a foreign insurance company), whether for the insurance company's general account or for a separate account.

Exemptions for Foreign Banking Entities

The Final Rule establishes an exemption for proprietary trading by certain foreign banking entities to the extent the trading is conducted solely outside the United States. In addition, certain U.S. affiliates of certain foreign banking entities are permitted to engage in proprietary trading of debt of the foreign country (or its agencies or political subdivisions) under which the foreign banking entity is organized. These two exemptions are discussed at greater length in our Client Alert available at <http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf>.

Prudential Backstops

The permitted proprietary trading activities referenced above are not permissible under the Rule if (i) they would involve or result in a material conflict of interest between the

banking entity and its clients, customers or counterparties; (ii) they would result in a material exposure by the banking entity to a high-risk asset¹⁶ or a high-risk trading strategy;¹⁷ or (iii) they pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

A material conflict of interest is deemed to exist if the banking entity engages in transactions that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer or counterparty with respect to such transactions, and prior to engaging in such transactions, the banking entity has not made appropriate disclosures to address the conflict of interest or, in appropriate circumstances, established information barriers memorialized in written policies and procedures, such as physical separation of personnel or functions or other measures designed to prevent such conflict of interest.

Failure to comply with these prudential backstops can take away the availability of what otherwise appears to be a clearly available trading exemption. This is worrisome in that there are no clear guidelines regarding the measures a banking entity is required to take with respect to any given activity to assure compliance. In particular, it will be difficult for banking entities to know what would constitute adequate disclosure to deal with a potential conflict of interest, and what kind of information barriers would be appropriate in particular circumstances. In addition, the incurrence of a substantial financial loss in a permitted trading activity, regardless of the compliance framework in which the activity is conducted, bears the risk, in hindsight, that the activity will be characterized as "high risk," with the consequence of losing the exemption relied on for the activity.

SUBPART C – Covered Funds Activities and Investments

The Volcker Rule prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining an ownership interest in or sponsoring a "covered fund." The prohibition does not extend to the acquisition of ownership interests by a banking entity:

- acting solely as agent, broker or custodian, so long as the activity is conducted for the account of, and on behalf of, a customer, and the banking entity and its affiliates do not retain beneficial ownership in such ownership interest;
- through a deferred compensation, stock bonus, profit-sharing or pension plan if the ownership interest is held or controlled by the banking entity as trustee for the benefit of present or former employees of the banking entity or an affiliate;
- in the ordinary course of collecting a debt previously contracted (subject to certain conditions); or
- on behalf of customers as trustee or in a similar capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, and on

¹⁶ An asset that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Final Rule, § ____.7(c)(1). *See also* note 31 *infra*.

¹⁷ A trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Final Rule, § ____.7(c)(2). *See also* note 31 *infra*.

behalf of, a customer, and the banking entity and its affiliates do not retain beneficial ownership in such ownership interest.

Definition of a covered fund

The Volcker Rule regulates investment by banking entities in, and sponsorship by banking entities, of “covered funds.” There are three prongs to the definition of a “covered fund.”

Funds exempt from the definition of investment company. A covered fund includes an issuer that would be an investment company, but for the exclusions contained in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended (the “1940 Act”). An understanding of this definition depends, in turn, on an understanding of the definition of investment company under the 1940 Act and its exclusions. Although the definition of “investment company” is complex, an investment company is essentially a company that is (or holds itself out as being) engaged primarily in the business of investing, reinvesting or trading in securities. The 1940 Act excludes certain entities from the definition of investment company. The two exclusions critical to the definition of a covered fund are Sections 3(c)(1) and 3(c)(7) of the 1940 Act. Section 3(c)(1) of the 1940 Act excludes from the definition of investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and is not making and does not presently propose to make a public offering of its securities (other than short-term paper). Section 3(c)(7) of the 1940 Act excludes any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition, are “qualified purchasers,”¹⁸ and is not making, and does not presently propose to make, a public offering of its securities.

However, if the investment company in question qualifies for another exclusion or exemption from the definition of an investment company, it is not a covered fund. There are many funds or collective investment vehicles that are excluded from the definition of investment company under sections of the 1940 Act other than Section 3(c)(1) and 3(c)(7); these include entities that rely on exclusions contained in Section 3(c)(5)(C) (*e.g.*, real estate and mortgage funds), Section 3(c)(3) (*e.g.*, insurance companies, banks, and bank common trust funds) and 3(c)(11) (*e.g.*, pension and profit-sharing plans) of the 1940 Act. However, a detailed discussion of these other exclusions is beyond the scope of this guide.

Commodity pools. A covered fund includes those commodity pools that have characteristics that are similar to those of issuers that would be investment companies but for the exclusions contained in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. Thus, “exempt pools” under CFTC Rule 4.7(a)(1)(iii) would fall within the definition of a covered fund, because they have characteristics similar

¹⁸ A qualified purchaser is essentially a natural person (or his or her trusts) with at least \$5 million in investments or a company that makes investments for its own account or for others in an amount of not less than \$25 million. 1940 Act, §2(a)(51A).

to those of hedge funds or private equity funds (that is, they are restricted to investors that meet heightened qualification standards and are not publicly offered). On the other hand, a mutual fund that makes extensive use of commodity interests and whose investment adviser must register as a commodity pool operator (“CPO”) would not be a covered fund. Following the adoption of the Dodd-Frank Act and the resulting changes to the definition of a “commodity pool,” a broader array of vehicles are now characterized as CPOs. For example, mortgage REITs are considered CPOs, although they may be entitled to certain limited relief. As a result of the changes to the definition of “commodity pool,” it will be important to consider whether an entity is a CPO and therefore may be a covered fund.

Foreign covered funds. A covered fund includes certain funds sponsored by a U.S. banking entity¹⁹ or an affiliate thereof, or in which such banking entity or an affiliate holds ownership interests. To qualify as a covered fund, such fund (i) must be, or hold itself out as, an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; (ii) must be organized abroad, and (iii) its ownership interests must be offered and sold solely outside the United States. Notwithstanding the foregoing, such a fund will not be a covered fund if, were the issuer subject to U.S. securities laws, it would not be an investment company by reason of an exclusion or exemption other than Sections 3(c)(1) or 3(c)(7). The purpose of this third prong of the definition of covered fund is to prevent circumvention of the Volcker Rule by U.S. banking entities through the sponsorship of and investment in funds outside the United States.

In the Proposed Rule, this third prong of the covered fund definition had broader scope. It covered any fund organized or offered outside the United States that would be a covered fund under paragraph (i) or (ii)²⁰ of the covered fund definition were it organized or offered under the laws of the United States, or offered to U.S. residents. Such funds have been referred to as “foreign equivalent funds,” in that they were intended to be the foreign “equivalents” to covered funds described in paragraph (i) of the covered fund definition. In the Final Rule, the third prong removes from the covered fund definition all such foreign equivalent funds except those sponsored by U.S. banking entities or in which U.S. banking entities invest. The implication is that foreign equivalent funds are not covered funds under the Final Rule (unless they meet the Final Rule’s narrower definition of a covered fund contained in the third prong). The Agencies acknowledge as much by making the following point with respect to the Final Rule: “A foreign fund may therefore be a covered fund with respect to the U.S. banking entity that

¹⁹ A U.S. banking entity, for these purposes, is a banking entity organized under the laws of the United States or any state of the United States, or any banking entity controlled, directly or indirectly, by such a banking entity. A U.S. branch or agency or U.S. subsidiary of a foreign bank would also qualify as a U.S. banking entity, but the foreign parent bank would not be a U.S. banking entity.

²⁰ We do not address in this User Guide the differences between what commodity pools are covered funds in the Proposed Rule versus in the Final Rule.

sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.”²¹ The treatment of foreign funds, including foreign equivalent funds, needs also to be considered in terms of the exemption for such funds that are sponsored by foreign banking entities, or in which foreign banking entities invest, which we refer to below and discuss in our client alert that may be found at <http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf>.

Entities excluded from the definition of covered fund

The Final Rules enumerates a number of exceptions to the definition of covered fund. These include the following:

Foreign public funds. A covered fund does not include an issuer organized abroad that is authorized to offer and sell ownership interests to retail investors in the issuer’s home jurisdiction and sells ownership interests predominantly through one or more public offerings²² outside the United States. However, this exemption is available to a U.S. banking entity (or a subsidiary of a U.S. banking entity) that sponsors such a fund only if the fund’s ownership interests are sold predominantly to persons other than the sponsoring banking entity, the issuer, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.

Wholly-owned subsidiaries. A covered fund does not include an entity, all of the outstanding ownership interests of which are owned directly or indirectly by a banking entity or its affiliate, except that:

- Up to five percent of the entity’s ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity or its affiliates; and
- Within the five percent ownership interest, up to 0.5 percent of the entity’s outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy or insolvency.

This exemption is likely to be very helpful for financial institutions that establish or rely on special purpose funding programs that utilize trust or other tax pass-through vehicles.

²¹ Attachment B, at 484,485.

²² A foreign fund’s distribution would not be a “public offering” for purposes of this definition if the distribution imposes a required minimum level of net worth or net investments.

Under the Proposed Rule, this exemption was limited to wholly owned subsidiaries engaged in liquidity management. The liquidity management requirement was removed in the Final Rule.

Joint ventures. The Final Rule excludes joint ventures from the definition of covered fund, if the joint venture is:

- between the banking entity (or any of its affiliates) and no more than 10 unaffiliated co-venturers;
- 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;
- is not, and does not hold itself out as being, an entity that raises money from investors primarily for the purpose of investing in securities for resale or trading.

Acquisition vehicles. The Final Rule excludes acquisition vehicles from the definition of covered fund, provided the vehicle is formed solely for the purpose of engaging in a bona fide merger or acquisition transaction and the vehicle exists only for such period as necessary to effectuate the transaction.

Securitization related vehicles. Issuing entities for asset-backed securities that satisfy certain conditions of the Final Rule and invest solely in loans are not covered funds. However, there are strict conditions about what kind of assets such issuing entities can hold and still not be covered funds. Qualifying asset-backed commercial paper conduits and vehicles created to hold assets related to covered bonds are also exempt from the definition of covered funds but only if they meet strict conditions set forth in the Final Rule. In general, the treatment of securitization vehicles under the Volcker Rule is highly complex and evolving, as evidenced by recent publicity about the effect of the Volcker Rule on financial institution holdings of collateralized debt obligations backed by trust preferred securities. We intend to issue a separate client alert in the near future to discuss the effect of the Volcker Rule on securitization related vehicles in more detail than is practical in this guide.

Funds regulated under the 1940 Act. Covered funds do not include registered investment companies (e.g., mutual funds, registered closed-end funds and ETFs) or business development companies (“BDCs”). Also excluded are seeding vehicles for these types of funds that would rely on Section 3(c)(1) or Section 3(c)(7) during the seeding period. To rely on this provision, the banking entity must operate the vehicle pursuant to a written plan that reflects the fact that the vehicle will become a registered investment company or BDC within the time designated by regulation.

Other excluded entities. The Rule also excludes from the definition of covered fund:

- foreign pension or retirement funds;
- insurance company separate accounts;
- bank-owned life insurance company separate accounts;
- Small Business Investment Companies (“SBICs”) and certain permissible public welfare and similar funds; and
- entities used by the FDIC to dispose of assets as receiver or conservator.

The Agencies indicated that they are “working to establish a process” to evaluate requests for other exclusions from the definition of covered fund and will provide further guidance as they gain experience.

Entities not specifically excluded from the definition of covered fund

A number of commenters on the Proposed Rule recommended that certain additional entities be expressly excluded from the definition of covered funds to avoid ambiguity. The Agencies discussed each of these entities in Attachment B²³ and explained the rationale for not providing express exclusions for them. They took the view that some of these entities may be able to rely on the exclusion from the definition of an investment company in sections other than Sections 3(c)(1) and 3(c)(7) of the 1940 Act, or from an express exclusion from the definition of a covered fund in the Final Rule and thus could avoid being a covered fund. Others would likely constitute covered funds. These entities include:

- *Financial market utilities.* Financial market utilities engaged primarily in transferring, clearing or settling payments, securities or other financial transactions among or between financial institutions may be able to rely on the exclusion from the definition of investment company contained in Section 3(b)(1) of the 1940 Act and thus would not be covered funds.
- *Collateral cash pools.* Collateral cash pools may be able to rely on the exemption provided by Section 3(c)(3) of the 1940 Act if structured as a common trust fund maintained exclusively for collective investment by a bank in its capacity as a trustee.
- *Pass-through real estate investment trusts (REITs).* Entities that function as REITs may not be able to rely solely on the exemption provided by Section 3(c)(5)(C) because they hold certain preferred securities and thus may be considered covered funds.
- *Municipal securities tender option bond transactions.* While the Agencies acknowledge that these transactions may involve entities that are not traditional investment pools that rely on the exemptions provided by Section 3(c)(1) and Section 3(c)(7), unless the transactions qualify for other exemptions under the 1940 Act, the Agencies believe they should be treated as covered funds.
- *Venture capital funds.* While they acknowledge that Congress distinguished venture capital funds from other types of private funds in the context of whether

²³ Attachment B, 583-604.

their advisers must register under the Investment Advisers Act, the Agencies believe that venture capital funds are indistinguishable in concept from private funds that rely on Section 3(c)(1) or Section 3(c)(7) and thus should be considered covered funds for purposes of the Final Rule.

- *Credit funds.* Credit funds typically rely on the exemptions provided by Section 3(c)(1) or Section 3(c)(7), in which case (absent another exemption) they would be treated as covered funds. However, some credit funds may qualify from other exclusions from the definition of covered fund, such as the exclusions for joint ventures or loan securitizations.
- *Employee securities companies (“ESCs”).* ESCs may avoid being a covered fund by structuring their activities so as to comply with another exemption under the 1940 Act or applying for and receiving an order pursuant to Section 6(c) of the 1940 Act that is available to ESCs.

Scope of Prohibition

Subject to certain permissible activities described below, a banking entity is not permitted to “sponsor” or acquire an “ownership interest” in a covered fund. These two terms are defined in a detailed manner in the Final Rule.

Sponsorship. To sponsor a fund means (i) to serve as a general partner, managing member, or trustee, or to serve as a commodity pool operator of a commodity pool that is a covered fund; (ii) to select or control the selection of a majority (or to have employees, officers or agents who constitute a majority) of the directors, trustees or management of a covered fund; or (iii) to share with the covered fund the same name, or a variation of the name.

Ownership Interests. An “ownership interest” means any equity, partnership or “other similar interest.” An “other similar interest” includes any interest in or security issued by a covered fund that exhibits certain characteristics on a current, future or contingent basis, including:

- the right to participate in the selection or removal of a general partner, managing member, member of the board of directors, investment manager, investment adviser or commodity trading advisor (not including rights of a creditor to exercise remedies in the event of a default or an acceleration event);
- the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund (regardless of whether the right is pro rata with other owners);
- the right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full (the “residual” in securitizations);
- the right to receive all or a portion of excess spread;
- the amounts payable by the covered fund with respect to the interest could, under the terms of the interest, 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;

- receipt of income on a pass-through basis from the covered fund, or a rate of return that is determined by reference to the performance of the underlying assets of the covered fund (excluding interests that are entitled to received dividend amounts calculated at a fixed or floating rate); and
- any synthetic right to have, receive, or be allocated any of the rights described above (which would not allow banking entities to obtain derivative exposure of these characteristics).

The definition of ownership interest in the Rule may include interests in a covered fund that might not be considered an ownership interest or an equity interest in other contexts. For example, derivative instruments may not be considered ownership in many contexts, but for purposes of the Rule, they may be considered to be ownership interests. Also debt instruments that exhibit specific characteristics of equity (such as participation in profits or losses or the right to select or remove a person with investment discretion) could qualify the instruments as an ownership interest under the Final Rule. Given the breadth of the definition, there may be particular difficulty in determining whether various kinds of structured products would constitute ownership interests.

The Final Rule excludes from the definition of “ownership interest” a “restricted profit interest” held by an entity in a covered fund for which the entity (or an employee of the entity) serves as an investment adviser, investment manager, commodity trading advisor or other service provider so long as:

- The sole purpose and effect of the interest is to allow the entity to share in the profits of the covered fund as performance compensation for advisory services;
- All the profit, once allocated, is distributed to the entity or its employees promptly after being earned, or the covered fund retains it for the purpose of establishing a reserve to satisfy contractual obligations with respect to certain losses;
- Any amounts invested in the covered fund, including any amounts paid by the entity (or its employees) in connection with obtaining the restricted profit interest, are within the Final Rule’s investment limitations;²⁴ and
- The interest is not transferable except to an affiliate, family members or through the intestacy of the employer or former employee, or in connection with the sale of the business that gave

²⁴ These investment limitations are discussed below.

rise to the restricted profit interest to an unaffiliated adviser to the covered fund.

Permitted covered fund sponsorship and investments

Notwithstanding the prohibition on sponsorship and investment in ownership interests in covered funds, the Volcker Rule permits investment and sponsorship of the following covered funds, subject to prescribed limitations and conditions that are summarized below.

Customer funds

A banking entity may acquire ownership interests in or sponsor a covered fund, including acting as a general partner, managing member, trustee, or commodity pool operator of a covered fund as a means of offering investment opportunities to customers. To qualify for this activity, the covered fund activity must be in connection with the banking entity's (or its affiliate's) trust, fiduciary, investment advisory or commodity trading advisory services for its customers (not necessarily pre-existing customers) pursuant to a written plan or other documentation outlining how the banking entity or affiliate intends to provide such services through the organizing and offering of the fund.

Conditions. The sponsorship of or acquisition of ownership interests in a customer fund is subject to the following conditions:

- (i) The banking entity and its affiliates cannot guarantee, assume or otherwise assure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;
- (ii) The covered fund cannot share the same name (or a variety thereof) with the banking entity or an affiliate of the banking entity and cannot use the word "bank" in its name;
- (iii) No director or employee of the banking entity (or an affiliate) can take an ownership interest in the covered fund (except for a director or employee who is directly involved in providing advisory or other services to the fund); and
- (iv) The banking entity must clearly and conspicuously make disclosures specified in the Final Rule in writing to any prospective or actual investor in the covered fund, to the following effect:
 - investors' losses in the covered fund will not be covered by the banking entity;
 - losses incurred by the banking entity will be limited to the losses attributable to their ownership interests in the covered fund and to their carried interest, if any;
 - investors should read fund offering documents before investing; and

- ownership interests in the covered fund are not FDIC insured, and are not deposits, obligations of, or endorsed or guaranteed by the banking entity.

In addition, the disclosure must describe the role of the banking entity and its affiliates and employees in sponsoring or providing services to the covered fund.

Limitations on investments in a single covered fund (“Per-Fund Limitation”). A banking entity’s investment (including investments by affiliates²⁵) in a customer fund may not exceed either:

- three percent of the value of the covered fund, or
- three percent of the number of ownership interests in the covered fund.

The calculations are to be made quarterly. If fair market value cannot be determined, the value shall be the historical cost basis of all investments in and contributions to the covered fund made by the banking entity and its affiliates. Ownership interests held by a director or employee of the banking entity will be attributed to the banking entity if the banking entity finances the acquisition of the ownership interest. The Final Rule addresses how ownership interests in covered funds would be attributed to a banking entity when those interests are held in fund-of-funds or multi-tiered fund structures.

Seeding period. The Final Rule provides a seeding period of one year during which the banking entity may exceed the three percent limit. The Final Rule does not include a quantitative dollar or percentage limitation of the amount that a banking entity may invest or hold to seed a covered fund. However, during the seeding period, the banking entity sponsor must actively seek unaffiliated investors to reduce the aggregate amount of investment in ownership interests to conform to the three percent limit. The regulators may extend the seeding period for an additional two years upon application by the banking entity.

Organizing and offering an issuing entity of asset-backed securities

A banking entity may acquire ownership interests in or sponsor a covered fund that is an issuing entity of asset-backed securities in connection with organizing the covered fund and offering its ownership interests, subject to the same conditions and limitations described above for customer funds. However, a banking entity may hold ownership interests in excess of the three percent per fund limit to the extent a greater retention percentage is required by Section 15G of the Exchange Act and the implementing

²⁵ For these purposes, affiliates do not include registered investment companies, SEC regulated BDCs and foreign public funds as long as the banking entity does not control more than 25% of voting shares of such company or fund and provides investment advisory, commodity trading advisory, administrative and other services to the company or fund. Further, another covered fund will not be deemed an affiliate of the banking entity if held in compliance with the Final Rule.

regulations thereunder.²⁶ In addition, special rules for calculating the per fund investment limit apply.²⁷

Acquisition of ownership interests in covered funds pursuant to permissible underwriting and market making

The prohibition against sponsorship and investment in ownership interests of a covered fund does not apply to a banking entity's acquisition of ownership interests of a covered fund in connection with the banking entity's underwriting of, or making a market in, the covered fund's ownership interests, as long as those underwriting and market making activities conform to the requirements for such permitted activities under the proprietary trading prohibition discussed earlier in this guide. A banking entity must include any ownership interests it acquires in connection with underwriting or making a market in the ownership interests of a customer fund or a covered fund that is an issuing entity of asset-backed securities, as applicable, for purposes of the per fund investment limitation applicable to such fund if the banking entity: (i) with respect to a customer fund, acts as a sponsor, investment adviser, or commodity trading advisor to, or otherwise acquires ownership interests in, the covered fund; (ii) with respect to an issuing entity of asset-backed securities, acquires an ownership interest in the issuing entity as permitted, and either is a "securitizer"²⁸ or is acquiring and retaining an ownership interest in such issuing entity in compliance with Section 15G of the Exchange Act; or (iii) guarantees, assumes or otherwise insures the obligations of the covered fund or of any covered fund in which the covered fund invests.

Aggregate Investment Limits

The aggregate value of all ownership interests of a banking entity and its affiliates²⁹ in customer funds and covered funds that are issuing entities of asset-backed securities, including ownership interests acquired in such funds in connection with permissible underwriting and market making-related activities, may not exceed three percent of the Tier 1 capital of the banking entity. The Final Rule contains guidance as to which entity's capital in a banking group this limitation applies and how the aggregate limit is to be calculated.

Capital deduction for investments in covered funds

A banking entity is required to deduct from Tier 1 capital the greater of (i) the amounts invested in ownership interests of the funds described above, plus any earnings received and (ii) if the banking entity accounts for the profits (losses) of the fund's investments in its financial statements, the fair market value of such ownership interests (together with any amounts paid in obtaining a restricted profit interest).

²⁶ This provision of the Exchange Act, added by Dodd-Frank, deals with the retention by a securitizer of a portion of the credit risk that the securitizer conveys to a third party.

²⁷ Final Rule, § _____.12(b)(3).

²⁸ A defined in the Exchange Act, § 15G(a)(3).

²⁹ See note 22 *supra*.

Limitations on relationships with certain covered funds: “Super 23A”

No banking entity that (i) directly or indirectly serves as investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund, (ii) organizes and offers a customer fund or a covered fund that is an issuing entity of asset-backed securities, or (iii) continues to hold an ownership interest in a covered fund that is an issuing entity of asset-backed securities, and no affiliate of any such banking entity, may engage in any transaction with the applicable covered fund, if the transaction would be a “covered transaction” as defined in Section 23A of the Federal Reserve Act, as if the banking entity (or its affiliate) were a member bank and the applicable covered fund were an affiliate thereof.

A “covered transaction” is defined in Section 23A of the Federal Reserve Act as follows:³⁰

- (i) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;
- (ii) a purchase of or an investment in securities issued by the affiliate;
- (iii) a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
- (iv) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company;
- (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;
- (vi) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate; or
- (vii) a derivative transaction, as defined in paragraph (3) of Section 5200(b) of the Revised Statutes of the United States (12 U.S.C. § 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.

Under Section 23A of the Federal Reserve Act, such “covered transactions” are permitted within limits and subject to conditions. In addition, under Section 23A and Regulation W of the FRB,³¹ certain transactions are exempted. However, subject to the explicit exceptions discussed below, under the Volcker Rule the transactional prohibition is absolute, and the exemptions contained in Section 23A and Regulation W do not apply: hence the reference to this prohibition as “Super 23A.”

³⁰ Federal Reserve Act, Section 23A(c)(b)(7), 12 U.S.C. § 371c(b)(7), as amended by Section 608 of the Dodd-Frank.

³¹ Regulation W, 12 CFR § 223.

In some respects the Super 23A prohibition in the Final Rule is narrower than Section 23A. Section 23A would apply, for example, to an extension of credit by a bank to a customer where the credit is secured by shares of an affiliate of the bank. However, the prohibition in the Final Rule applies only to transactions between a banking entity (or its affiliate) and the applicable covered fund.

Notwithstanding the Super 23A prohibition, acquisitions of ownership interests in applicable covered funds are not proscribed to the extent permitted elsewhere in the Final Rule. In addition, banking entities, subject to certain conditions, may enter into prime brokerage transactions with a covered fund in which an applicable covered that is managed, sponsored or advised by the banking entity or its affiliate has acquired an ownership interest (in other words, a second-tier fund). Under the Final Rule, a prime brokerage transaction is any transaction that would be a “covered transaction,” as defined above,³² that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.³³

The Final Rule also implements the Volcker Rule’s application of the “market terms” requirement in Section 23B of the Federal Reserve Act.³⁴ That section requires that transactions between a bank and its affiliate be on terms that are substantially the same (or at least as favorable to the bank) as those prevailing for comparable transactions with unaffiliated companies. Any banking entity that (i) directly or indirectly serves as investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund, (ii) organizes and offers a customer fund or a covered fund that is an issuing entity of asset-backed securities, or (iii) continues to hold an ownership interest in a covered fund that is an issuing entity of asset-backed securities must make sure that the terms of any transactions with the applicable covered fund are subject to the standards applicable under Section 23B of the Federal Reserve Act as if the banking entity were a bank and the covered fund, its affiliate.

Other permitted covered fund activities

Permitted Risk-Mitigating Hedging Activities.

A banking entity may acquire ownership interests in a covered fund pursuant to an investment that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate that directly provides investment advisory, commodity trading advisory or other services to the covered fund. The availability of this exemption is subject to extensive conditions, including an internal compliance program that is reasonably designed to ensure the banking entity’s compliance with this permitted fund activity.

³² Federal Reserve Act, Section 23A(c)(b)(7), 12 U.S.C. § 371c(b)(7), as amended by Section 608 of Dodd-Frank.

³³ Final Rule, § ____.10(d)(7).

³⁴ Federal Reserve Act, Section 23B(a), 12 U.S.C. § 371c-1(a).

Fund investment and sponsorship by FBOs solely outside the United States

This permitted fund activity is described in detail in our client alert that may be found at <http://www.mofo.com/files/Uploads/Images/131211-Volcker-Rule.pdf>.

Permitted Fund Activities by Regulated Insurance Companies

A regulated insurance company (including a foreign insurance company) that is a banking entity is permitted to sponsor or acquire ownership interests in a covered fund, either for the general account of the insurance company or for one or more separate accounts established by the insurance company, as long as the activity is conducted in compliance with applicable investment laws and regulations (or written regulatory guidance) applicable to the insurance company.

Prudential Backstops

Notwithstanding that sponsorship of, and investment in, covered funds by banking entities is permissible under the specified exceptions discussed above, none of these transactions with covered funds would be permissible if the transactions involve or result in a material conflict of interest between the banking entity and its client, customers or counterparties that is not mitigated by adequate disclosure and/or information barriers in appropriate circumstances, all in the same manner as discussed above at pages 10-11 with respect to the prudential backstops for permitted proprietary trading.

Also, as with permitted proprietary trading, the exemptions for such covered fund investments and activities are not available if they result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy. “High-risk assets” and “high-risk-trading strategy” have the same definitions as used with respect to the prudential backstops for proprietary trading.³⁵

As discussed above with respect to proprietary trading, the prudential backstops could present difficult compliance issues for banking entities. The failure to address conflicts of interest adequately could deprive a banking entity of an exemption for covered fund investment or activity on which the banking entity had relied. Likewise, the incurrence of a substantial financial loss could raise the question of whether the permitted covered fund activity or investment had presented the kind of material risk to a high-risk asset or high-risk trading strategy that would have disintitled a banking entity to the benefit of an exemption it had relied upon.

SUBPART D – Compliance Programs

Much of the emphasis in the Final Rule is on compliance systems and procedures, particularly those designed to ensure that “permissible activities” engaged in by banking entities conform to the Final Rule’s detailed limitations. Compliance program

³⁵ Final Rule, § ____.14(c)(1) and (2). *See also* note 31 *infra*.

establishment, oversight, maintenance and enforcement will be of utmost importance for compliance with the Volcker Rule. The following discussion touches on all aspects of the Final Rule’s compliance program requirements, but to design a compliance program that complies with the Final Rule, a banking entity should rely on the Final Rule itself and supporting materials.

The compliance framework in the Proposed Rule is set forth in Subpart D and Appendices A and B. Section __.20(b) sets forth the basic elements of the six-point program. Section __.20(c) imposes the “enhanced minimum standards for compliance programs” provided in Appendix B on banking entities that:

- (1) engage in permitted proprietary trading and are required to comply with the reporting requirements under Appendix A (that is, have a certain minimum level of trading assets and liabilities, as discussed immediately below);
- (2) as of the previous calendar year-end, had total consolidated assets of \$50 billion or more or, in the case of an FBO, had total U.S. assets of \$50 billion or more; or
- (3) are notified by the relevant Agency that it must satisfy the standards of Appendix B.

Section __.20(d) imposes the reporting requirements described in Appendix A on those banking entities engaged in permitted proprietary trading that have substantial trading assets and liabilities (exceeding \$50 billion until April 30, 2016, at which time the threshold declines to \$25 billion, and then to \$10 billion beginning on December 31, 2016). Simplified compliance programs are imposed by Section __.20(f) on “less active” banking entities, as follows:

- banking entities with no covered activities have no obligation to establish a compliance program until they begin to engage in such activities;
- banking entities with “modest activities,” (those with total assets of \$10 billion or less) need only refer to the requirements of the Volcker Rule in its compliance policies and procedures and make “adjustments as appropriate given the activities, size, scope and complexity of the [banking entity].”

The two appendices provide greater detail about the required compliance program. Appendix B requires enhanced minimum standards for compliance programs with respect to the establishment, oversight, maintenance and enforcement by the largest banking entities of an enhanced compliance program for ensuring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities. Appendix B also addresses responsibility and accountability for the program, independent testing, training and recordkeeping. Appendix A imposes reporting and recordkeeping requirements on banking entities with significant trading assets and liabilities, and identifies the quantitative measurements that must be furnished to the Agencies as part of the required reporting.

The Six-Point Compliance Program

The Volcker Rule requires all except the “less active” banking entities to implement a six-point program set forth in Section __.20(b), which includes the following:

- Written policies and procedures reasonably designed to document, describe, monitor and limit proprietary trading activities, and activities and investments with respect to covered fund activities, to ensure that all activities and investments conducted by the banking entity comply with the Volcker Rule and the Final Rule;
- A system of internal controls reasonably designed to monitor compliance with the Volcker Rule, and to prevent the occurrence of activities or investments that are prohibited by the Rule;
- A management framework that delineates responsibility and accountability for compliance with the Volcker Rule and includes appropriate management review of trading limits, strategies, hedging activities, investments and incentive compensation, among other things;
- Independent testing and audit of the effectiveness of the compliance program. The testing may be conducted by “qualified” personnel of either the banking entity or an outside party;
- Training for trading personnel and managers, as well as other “appropriate” personnel, to appropriately implement and enforce the compliance program; and
- Records sufficient to demonstrate compliance with the Volcker Rule, which records must be provided to the regulator upon request and retained for five years.

APPENDIX A: Reporting and Recordkeeping Requirements for Covered Trading Activities

Appendix A requires a banking entity with significant trading assets and liabilities – those whose average gross sum of trading assets and liabilities over the previous consecutive four quarters, as measured on the last day of each quarter, exceeded \$50 billion between June 30, 2014 and April 29, 2016, \$25 billion between April 30, 2016 and December 30, 2016, and \$10 billion beginning on December 31, 2016 – that are engaged in proprietary trading permitted by the Rule to furnish periodic reports regarding various quantitative measures to the relevant Agency, and to maintain records regarding the preparation and content of those reports. The principal purpose of the reporting and recordkeeping requirements is to assist banking entities and the Agencies in determining whether the banking entities are complying with the Rule.

The seven metrics required by the Rule must be measured daily, and reported for each calendar month within 30 days of the end of the month. However, for banking entities with significant trading (\$50 billion or more in trading assets and liabilities), beginning with information for the month of January 2015, the information must be reported within 10 days of the end of the month. Banking entities must create and maintain records documenting the preparation and content of these reports for five years from the end of the calendar year for which the measurement was taken.

The seven quantitative measurements fall into three categories: Risk-Management Measurements, Source-of-Revenue Measurements and Customer-Facing Activity Measurements. Except as noted below, the period for which each is calculated is one day.

- **Risk management.** The Rule looks at the risks associated with permissible trading in three ways.
 - *Risk and Position Limits and Usage* – this measure looks at the limits that the banking entity permits a trading desk to take at a point in time, and the usage, that is, the portion of that limit that is used by the trading desk’s current trading activity.
 - *Risk Factor Sensitivities* – this measure looks at the changes in a trading desk’s profit and loss that would occur in the event of a change in underlying variables that affect profitability and risk.
 - *Value-at-Risk and Stress Value-at-Risk* – VaR is the commonly-used measure of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time based on current market conditions, and Stress VaR is the percentile measurement based on market conditions of significant financial stress.

- **Source-of-Revenue Measurements**
 - *Comprehensive Profit and Loss Attribution* – this measurement attributes daily fluctuation in the value of a trading desk’s positions to various sources. It combines the daily profit and loss of positions attributable to positions in three categories: (i) existing positions that were held by the trading desk as of the end of the prior day; (ii) new positions that resulted from that day’s activity; and (iii) residual profit and loss other than from existing or new positions. In addition, the profit and loss measurements must calculate the volatility of comprehensive profit and loss (that is, the standard deviation of the trading desk’s one-day profit and loss) for at least a 30, 60 and 90-day lag period.

- **Customer-Facing Activity Measurements**
 - *Inventory Turnover* – this ratio calculates, for 30, 60 and 90-day periods, the ratio of the absolute value of all transactions over the period to the value of the trading desk’s inventory at the beginning of the period.
 - *Inventory Aging* – this separately computes and reports the values of a trading desk’s aggregate assets and aggregate liabilities over all holding periods.
 - *Customer-Facing Trade Ratio – Trade Count Based and Value Based* – this ratio compares the transactions involving counterparties that are customers of the trading desk to the transactions involving counterparties that are not customers of the trading desk. This measurement produces two such ratios – one comparing the numbers of transactions, and one

comparing the values of the transactions. The ratios are required to be determined for 30, 60 and 90-day periods.

APPENDIX B: Enhanced Minimum Standards for Compliance Programs

Appendix B requires the banking entities that come within §__.20(c) (defined at page 24, above) to establish, maintain and enforce an enhanced compliance program. In general, the enhanced compliance program must:

- be reasonably designed to supervise the permitted trading and covered fund activities and investments, identify and monitor the risks of those activities and potential areas of noncompliance, and prevent prohibited activities and investments;
- establish and enforce appropriate limits on the covered activities and investments, including limits on the size, scope, complexity and risks of the individual activities or investments consistent with the requirements of the Volcker Rule and the Final Rule;
- subject the compliance program to periodic independent review and testing, and ensure the entity's internal audit, compliance and internal control functions are effective and independent;
- make senior management and others accountable for the effective implementation of the compliance program, and ensure that the chief executive officer and board of directors review the program; and
- facilitate supervision and examination by the Agencies.

A. Enhanced Compliance Program – Proprietary Trading Activities: Appendix B requires a banking entity to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with its permitted trading activities. The compliance program must include a detailed description of controls to ensure that trading activities are conducted in accordance with the Volcker Rule and Final Rule, and provide for revisions and updates to the program before any expansions or changes in the entity's activities. Further, a banking entity must devote adequate resources and knowledgeable personnel to the supervision of its trading activities.

The following discussion highlights certain of the areas that the written policies and procedures are required to address.

1. Trading desks. The policies and procedures must describe the process for identifying the financial instruments each trading desk may buy or sell, with separate documentation for permissible market-making and hedging activity. In addition, the program should address the trading desks' reporting lines, its mission and strategy, its allocated risks, measurements of risks, the process for setting limits, the types of clients, customers and counterparties with whom the desk can trade, and its compensation arrangements (which may not incentivize prohibited proprietary trading).

2. Descriptions of risks and risk management processes. The program must describe the risk management program for the banking entity's trading activity, including the governance, approval, reporting, escalation and review procedures to ensure that the trading activity complies with the Volcker Rule. The description should include the supervisory and management structures, escalation procedures, and the role of audit, compliance and other units in conducting independent testing.
3. Authorized risks, instruments and products. The banking entity's risk limits for each trading desk should be based on quantitative measures of potential loss. The banking entity should have internal controls that monitor, establish and enforce these limits.
4. Hedging policies and procedures. The banking entity must have written policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that, at a minimum, describe how the trading desk will hedge the risk of its positions, how the banking entity will identify its risks, the level of the organization at which hedging will occur, how hedging will be monitored and by whom, and how permitted hedging will be tested and approved.
5. Analysis and quantitative measurements. The banking entity must perform "robust" analyses and measurements that are reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program, to monitor for prohibited proprietary trading, and to prevent prohibited proprietary trading. The analyses and models must be rigorously tested and reviewed. The banking entity's analyses and quantitative measurements should include the quantitative measurements set out in Appendix A of the Rule (discussed above), plus other measurements to the extent appropriate.
6. Remediation. Importantly, should the quantitative measurements or other information suggest that the trading desk has violated the Rule, the banking entity's procedures should provide for immediate review and investigation of the trading desk's activities, escalation to senior management, and timely notification to the regulator.

In addition, the Rule provides that the compliance program itself must be designed to identify and remedy any potential violations, and to assess the extent to which any activity indicates that modifications need to be made to the program.

B. Enhanced Compliance Program -- Covered Funds Activities or Investments

The Rule also requires banking entities to maintain a compliance program appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made by the banking entity. The compliance program's policies and procedures should address the following areas that are discussed here in summary form:

1. Identification of covered funds. The compliance program must provide a process for identifying and documenting covered funds that each unit in the banking entity sponsors or organizes and offers, and covered funds in which each unit invests.

2. Identification of covered fund activities and investments. The compliance program must identify, document and map each unit within the organization permitted to acquire or hold an interest in any covered fund or sponsor any covered fund.
3. Explanation of compliance. The compliance program must explain how the banking entity monitors for and prohibits conflicts of interest, activities that may threaten the safety and soundness of the banking entity, and potential or actual material exposure to high-risk assets or high-risk trading strategies. The Rule lists a number of assets and strategies that should be taken into account.³⁶
4. Description and documentation of covered fund activities and investments. For each organizational unit engaged in covered fund activities and investments, the compliance program must document the activities and investments that the unit is authorized to conduct, the plan for seeking unaffiliated investors, and how the program complies with the requirements of the Volcker Rule's Subpart C.
5. Internal controls. The banking entity's controls must be reasonably designed to ensure that the covered fund activities and investments comply with the Volcker Rule and to effectively monitor and identify any covered fund activity or investment that may indicate potential violations of the Rule.
6. Remediation of violations. The compliance program must describe procedures for identifying and remedying violations of the Rule.

Responsibility and Accountability for the Compliance Program. The Final Rule requires banking entities to maintain and enforce a governance and management framework with a view to preventing violations of the Volcker Rule. Banking entities must ensure that appropriate personnel are responsible and accountable for the compliance program, that there is a clear reporting line with a chain of responsibility, and that senior management reviews the program periodically. The written compliance program needs to be approved by the board of directors – or an equivalent governance body – and senior management. The Board and senior management also are responsible for establishing an appropriate culture of compliance with the Rule.

³⁶ These high-risk assets or high-risk trading strategies are:

- 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.

Importantly, the CEO of a banking entity that is subject to the enhanced minimum standards for a compliance program must, annually, attest in writing to the appropriate Agency “that the banking entity has in place process to establish, maintain, enforce, review, test and modify the compliance program” to achieve compliance with the Rule. In the case of a U.S. branch or agency of an FBO, the attestation may be provided for the entire U.S. operation of the FBO by the senior management officer of the U.S. operations who is located in the U.S.

The enhanced compliance program also includes requirements regarding **Independent Testing, Training and Recordkeeping.**

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