DechertOnPoint

October 2011 / Issue 13

A legal update from Dechert's Financial Institutions Group

Volcker Rule Regulations Proposed

Section 619 of the Dodd-Frank Act—the Volcker Rule—attempts to limit perceived risks in the financial system created by (i) proprietary trading operations of banks and their affiliated companies through a set of "Trading Restrictions" and (ii) investments by banks and affiliated companies in private equity and hedge funds and relationships with such funds through a set of "Fund Restrictions."

On October 11 and 12, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("FRB"), the Office of Comptroller of the Currency ("OCC") and the Securities and Exchange Commission ("SEC") took steps to implement the Volcker Rule by approving a proposed interagency rule ("Proposed Rule"). It is not clear when the fifth agency required to issue rules implementing the Volcker Rule ("Agency Rules"), the Commodity Futures Trading Commission ("CFTC"), will act.[1]

The Volcker Rule becomes effective on July 21, 2012 ("Effective Date"), regardless of whether implementing Agency Rules are effective on that date. The Proposed Rule has a comment deadline of January 13, 2012. Thus, with a final rule not likely to be issued until just a few months before the Effective Date, impacted institutions may be under pressure to act rapidly to respond to some of the terms of the final rule which become applicable immediately. This consideration will be mitigated to some extent by the general two-year conformance period provided for in the Volcker Rule.

The Proposed Rule recognizes the enormous complexity associated with sharply reducing, but not fully prohibiting, proprietary trading and fund investment and related activities. In that regard, the Agencies have solicited input on nearly 400 questions regarding the implementation of the Volcker Rule. As we have seen with the proposed rule on the Dodd-Frank Act's credit risk retention requirements, informed comments from market participants are critical to ensuring that agency rulemaking action takes a comprehensive view of the issues and operational considerations related to the implementation of the rule.

What Types of Entities Are Subject to the Proposed Rule?

Two Prongs of the Volcker Rule

The application of the Volcker Rule has two distinct prongs.

- Entities that meet the definition of "banking entity" are subject to the Trading Restrictions and the Fund Restrictions.
- Entities that are designated as systemically important financial institutions (each one, a "SIFI") by the Financial Stability Oversight

[1] Together the FRB, SEC, OCC, FDIC and CFTC are referred to as "Agencies." To the extent that a particular reference relates to the Proposed Rule, the term Agencies does not include the CFTC.

Council ("FSOC") are not subject to the Trading Restrictions or Fund Restrictions, but are subject to additional capital requirements and quantitative limitations based on their proprietary trading and relationships with private equity or hedge funds. The Proposed Rule does not address any such requirements for SIFIs at this time, since the FSOC has not yet finalized the criteria for designation of, or designated, any SIFIs.

Banking Entity

Because all banking entities will be subject to Trading Restrictions and Fund Restrictions it is critical to recognize the broad reach of the term "banking entity," which covers:

- Any insured depository institution:
  - Under the Volcker Rule an insured depository institution is any FDIC insured bank or savings institution. The definition in the Proposed Rule also reflects the exclusion in the Volcker Rule for trust or fiduciary institutions that meet certain requirements.
- Any company that controls an insured depository institution:
  - This includes bank holding companies ("BHCs") and savings and loan holding companies. It would also apply to any other company that controls any insured depository institution, such as an industrial bank or credit card bank that is not treated as a bank for purposes of the Bank Holding Company Act ("BHCA").
- Any foreign bank that maintains a branch or agency in a State, and any company that controls such a foreign bank, as well as any commercial lending company organized under State law that is a subsidiary of a foreign bank or its controlling company under section 8 of the International Banking Act of 1978 (Foreign Banking Organization or "FBO"):
  - As discussed below, certain activities of non-U.S. elements of an FBO may be exempt from these restrictions if they meet the off-shore exemption requirements set forth in the Proposed Rule.
- Any affiliate or subsidiary of any of the foregoing:
  - "Affiliate" and "subsidiary" would be defined in accordance with the FRB's Regulation Y governing BHCs.
  - Thus, wherever there is an ultimate controlling parent company of an insured depository institution ("Parent Company"), then all entities that are directly or indirectly controlled by the parent company will be banking entities.

A banking entity would not include either a Covered Fund (as defined below) that is organized, offered and held by a banking entity as a Customer Fund (as defined below) as permitted under the Proposed Rule or an entity that is controlled by such a Customer Fund.

Finally, a mutual fund generally would not be a subsidiary or affiliate of a banking entity if the banking entity only provides advisory or administrative services, has certain limited investments in, or organizes, sponsors and manages the mutual fund in accordance with BHCA rules.

Under the Proposed Rule the individual Agencies will supervise particular banking entities that are under their jurisdiction and such banking entities are referred to as "covered banking entities" and are defined in the individual Agency rules.[2]

[2] Within this update, a reference to a banking entity should be considered a reference to a covered banking entity. For purposes of the FRB, a "covered banking entity" is any banking entity that is: (1) a state member bank; (2) a BHC; (3) a savings and loan holding company; (4) a foreign banking organization; (5) any company that controls an insured depository institution; and (6) any subsidiary of the preceding entities other than a subsidiary for which the OCC, FDIC, CFTC or SEC is the primary financial regulatory agency. As a result of this definition, in a situation where an individual controls a covered banking entity and also separately controls another company, the FRB will not consider the other company to be an affiliate of a covered banking entity and thus the other company and its subsidiaries and affiliates will not be treated as "covered banking entities." For purposes of the OCC, a "covered banking entity" is (1) a national bank; (2) a Federal branch or agency of a foreign bank; (3) a Federal savings association or a Federal savings bank; and (4) any subsidiary of a company described in this paragraph's sections (1) through (3), other than a subsidiary for which the CFTC or SEC is the primary financial regulatory agency. For purposes of FDIC, a "covered banking entity" is an insured depository institution for which the FDIC is the appropriate Federal banking agency under the Federal Deposit Insurance Act. For purposes of the SEC, a "covered banking entity" is an entity for which the SEC is the primary financial regulatory agency, including broker-dealers, investment companies and investment advisers.

Restrictions on Proprietary Trading

The Proposed Rule takes an important step in providing guidance on the critical question of what "proprietary trading" is, but leaves significant uncertainties. It does, however, establish what may be a major compliance burden on banking entities that engage in a significant level of trading activities.

What is Proprietary Trading?

Proprietary trading is defined as:

> [E]ngaging as a principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions. Proprietary trading does not include acting solely as agent, broker, or custodian for an unaffiliated third party.

The Volcker Rule generally defines a "trading account" as an account used for acquiring or taking positions in relevant instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements).

Three Categories of Trading Accounts Under the Proposed Rule

The Proposed Rule provides a far more detailed definition of what will be considered to be a trading account. It creates three categories of activity or status that will cause an account to be treated as a trading account.

Short-Term Intent

An account will be deemed a trading account if it is used by a banking entity to acquire or take covered financial positions for the purpose of:

- Short-term resale;
- Benefitting from actual or expected short-term price movements;[3]
- Realizing short-term arbitrage profits; or
- Hedging one or more of the foregoing positions.

The Proposed Rule establishes a rebuttable presumption that any account used to acquire or take a covered financial position (subject to certain exceptions) that the banking entity holds for sixty days or less will be a trading account unless the banking entity can demonstrate based on all the facts and circumstances that the covered financial position, either individually or as a category was not acquired or taken principally for any of the above described purposes.[4] Notably the Proposed Rule does not establish a rebuttable presumption that an account which holds covered financial positions for sixty-one days or will be presumed not to be a trading account.

Market Risk Capital Rule Covered Positions

An account used to take covered financial positions (other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery) which are market risk capital covered positions will be treated as a trading account if the banking entity or any affiliate that is a BHC calculates risk-based capital ratios under the Market Risk Capital Rules ("MRC Rules"). The Proposed Rule notes that the MRC Rules define an MRC covered position to include all positions in a bank's trading account.[5]

Significantly, neither the MCR Rules, the Call Report, nor relevant accounting standards provide a precise definition of what constitutes a near-term or short-term position for purposes of determining whether a position is of a type held in a trading account or is a trading security. Relevant accounting standards note that "near-term" for purposes of classifying trading activities is

[3] The Proposed Rule notes that this clause of the definition does not require the resale of the position, instead it requires only an intent to engage in any form of transaction on a short-term basis, including a transaction separate from, but related to, the initial acquisition of the position, for the purpose of benefitting from a short-term movement in the price of the underlying position.

[4] The Proposed Rule emphasizes that the sixty-day period is only a presumption. Thus, if a banking entity acquired a covered financial position with a demonstrated intent of holding it for investment or other non-trading purposes but because of unanticipated developments, such as increased customer demand or unexpected liquidity demands, held it less than sixty days, those facts and circumstances would generally suggest that the position was not acquired with short-term trading intent, notwithstanding the presumption.

[5] The Call Report instructions note that trading account positions include any position that is classified as "trading securities." Under GAAP, trading securities are described as being bought and held principally for the purpose of selling them in the near term and used with the objective of generating profits on short-term differences in price.

generally measured in hours and days rather than months or years.

The Proposed Rule provides the following important insight with regard to how the Agencies expect to evaluate what constitutes a trading account under the Proposed Rule:

> The Agencies expect that the precise period of time that may be considered near-term or short-term for purposes of evaluating any particular covered financial position would depend on a variety of factors, including the facts and circumstances of the . . . acquisition, the banking entity's trading and business strategies, and the nature of the relevant markets. In considering the purpose for which a . . . position is taken and evaluating whether such position is acquired or taken for short-term purposes, the Agencies intend to rely on a variety of information, including quantitative measurements of banking entities' covered trading activities . . ., supervisory review of banking entities' compliance practices and internal controls, and supervisory review of individual transactions.

While the Agencies offer more guidance in the Proposed Rule than was contained in the Volcker Rule, they are not currently planning to provide bright line tests.

In some respects, this is similar to how the federal banking agencies have addressed compliance with the anti-money laundering program requirements of the Bank Secrecy Act. The banking agencies provide general guidance as to how a program should operate, but ultimately conduct a relatively subjective evaluation of the strength of a particular program, particularly if significant issues regarding questionable transactions have arisen.

Dealer Activity Trading Accounts

Positions taken by banking entities in connection with certain dealer activities will be treated as trading accounts. The specified dealer statuses and activities are the following:

- A dealer or municipal securities dealer registered with the SEC;
- A government securities dealer that is registered or has filed notice with an appropriate regulatory agency;
- A swap dealer that is registered with the CFTC;
- A security-based swap dealer that is registered with SEC;[6] and
- A banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the U.S.[7]

Certain Accounts Not Deemed to be Trading Accounts

Four types of activity involving covered financial positions would ***not*** cause an account to be deemed a trading account. Those four activity types are:

- Repurchase or reverse repurchase agreement positions pursuant to which the banking entity has agreed in writing to both purchase and sell a stated asset at stated prices and on stated dates, or on demand with the same counterparty.
- Positions that arise under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties.
- Positions taken for bona fide liquidity purposes. This provision will require a banking entity to operate under a documented liquidity management plan that must meet a set of five requirements.[8]
- Positions taken by a banking entity that is a derivative clearing organization registered under the Commodity Exchange Act or a clearing agency

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6 The foregoing provisions only apply to positions taken by a banking entity in connection with one of the specified provisions, not to all of the activities of the banking entity.

7 The final clause is a notable extraterritorial assertion of jurisdiction under the Proposed Rule that, among other things, may raise definitional issues under foreign law.

8 The Agencies are concerned with the potential for abuse of the liquidity management exclusion. They note that the Agencies will review liquidity plans and transactions effected under them to ensure that the applicable criteria are met and that any position taken is fully consistent with such a plan. The Proposed Rule further states that any transactions in which positions characterized as being for liquidity purposes do give rise to appreciable profits or losses as a result of short-term price movements will be subject to significant regulatory scrutiny and, absent compelling explanatory facts and circumstances, would be viewed as prohibited proprietary trading.

registered with the SEC under the Securities Exchange Act of 1934 ("Exchange Act").

What is a Covered Financial Position?

An important limiting factor on the reach of the Trading Restriction is the definition of "covered financial position" since the definition of trading account is limited to covered financial positions. Under the Proposed Rule, a covered financial position means any position, including any long, short, synthetic or other position, in the following:

- A security, including an option on a security;
- A derivative, including an option on a derivative; or
- A contract of sale for a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

A covered financial position does not include any position that itself is (i) a loan,[9] (ii) a commodity, or (iii) foreign exchange or currency.

Activities to Which the Trading Restrictions Do Not Apply

It is essential to recognize that simply because an activity meets the definition of proprietary trading, a banking entity is not necessarily prohibited from engaging in the activity. The Proposed Rule sets forth a range of activities that are exempted from the Trading Restrictions. However, the requirements imposed on these activities in order to qualify for an exemption may result in changes in how such activities have typically been conducted.

Permitted Underwriting Activities

In order to qualify as a permitted underwriting activity a purchase or sale of a covered financial position must meet the following requirements:

- The banking entity must have established an internal compliance program that meets the requirements of the Proposed Rule.
- The covered financial position must be a security.
- The purchase or sale must be effected solely in connection with a distribution of securities for which the banking entity is acting as underwriter.[10]
- The banking entity must meet certain dealer registration requirements.
- The underwriting activities of the banking entity with respect to the position must be designed to not exceed the reasonably expected near-term demands of clients, customers and counterparties.
- The underwriting activities of the banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to (i) appreciation in the value of positions related to such activities, or (ii) the hedging of positions related to such activities.[11]
- The compensation arrangements of persons performing underwriting activities must not be designed to reward proprietary risk-taking.[12]

Permitted Market Making-Related Activities

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9 For purposes of the Proposed Rule a loan is any loan, lease, extension of credit, or secured or unsecured receivable.

10 The Proposed Rule discusses the types of activities that the Agencies will take into consideration in determining whether a banking entity is acting as an underwriter as part of a distribution of securities. The Proposed Rule states that there may be circumstances where an underwriter holds for investment purposes securities it could not sell in the distribution. Assuming that the securities were acquired in a permitted underwriting the banking entity would be permitted to dispose of the securities at a later time.

11 This requirement is intended to ensure that permitted underwriting activities demonstrate patterns of revenue generation and profitability consistent with, and related to, services an underwriter provides to its customers in bringing securities to market, rather than changes in market value of the securities underwritten.

12 This provision is likely to draw significant comment. The Proposed Rule provides further explanation of its intent by stating that it targets an incentive compensation structure that rewards speculation in, and appreciation of, the market value of underwritten securities, rather than success in bringing securities to market for a client. While a banking entity may appropriately take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which its personnel have managed risk, the banking entity should provide compensation incentives that primarily reward client-based revenues and effective client service, not proprietary risk-taking.

The Proposed Rule states that it may be difficult to distinguish principal positions that appropriately support market making-related activities from positions taken for short-term speculative purposes. In order to address this concern the Proposed Rule sets forth a series of requirements in order for the purchase or sale of a covered financial position to qualify as a permitted market making-related activity:

- The banking entity must have established an internal compliance program that meets the requirements of the Proposed Rule;
- The trading desk or other unit that conducts the purchase or sale holds itself out as being willing to buy and sell the covered financial position for its own account on a regular and continuous basis;[13]
- The market making-related activities of the banking entity are designed to not exceed the reasonably expected near-term demands of clients, customers and counterparties;[14]
- The covered entity must meet certain dealer registration requirements;
- The market making-related activities of the banking entity are designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to (i) appreciation in the value of covered financial positions it holds in trading accounts, or (ii) the hedging of positions its holds in trading accounts;
- The market making-related activities of the trading desk or other unit that conducts the purchase or sale must be consistent with guidance provided in the Proposed Rule; and
- The compensation arrangements of persons performing market-making related activities are not designed to reward proprietary risk-taking.[15]

The Proposed Rule further provides that the prohibition on proprietary trading does not apply to certain hedging activities relating to permissible market making-related activities that comply with the Proposed Rule requirements for permitted risk-mitigating hedging activities.

Permitted Risk Mitigating Hedging Activities

The Proposed Rule provides an exemption from the Trading Restrictions for a purchase or sale of a covered financial position made in connection with and related to individual or aggregated positions of the banking entity and is designed to reduce the specific risks to the banking entity related to such positions. The Proposed Rule notes that it can often be difficult in retrospect to determine whether a banking entity engaged in a transaction to mitigate risks arising from related positions or to profit from price movements related to the hedge position itself. In order to address this concern the Proposed Rule establishes a series of requirements in order for a purchase or sale to qualify for this exception:

- The banking entity must have established an internal compliance program that meets the requirements of the Proposed Rule;
- The position must hedge or mitigate one or more specific risks arising from or in connection with and related to individual or aggregated positions;[16]
- The position must be reasonably correlated to the risks it is intended to hedge or mitigate;[17]

13 The Proposed Rule provides a further discussion of the level, and type of, activity that will be expected in order for a banking entity to meet this requirement.

14 The Agencies will closely monitor this requirement. The Proposed Rule notes that a banking entity's expectation regarding near-term customer demand should generally be based on the unique customer base of the banking entity based on particular factors beyond a general expectation of price appreciation. It further notes that to the extent a trading desk or other unit of a banking entity is engaged wholly or principally in trading that is not in response to, or driven by, customer demands, the Agencies would not expect those activities to qualify as permitted market making-related activities.

15 The Proposed Rule provides additional guidance regarding the Agencies' view of permitted market making related activities in a commentary set forth in an Appendix B.

16 These risks may include market, credit, and interest rate risks. The Proposed Rule notes that it permits the hedging of risks on a portfolio basis. It cautions, however, that a banking entity should be prepared to identify the specific position or portfolio of positions that is being hedged and demonstrate that the hedging transaction is risk-reducing in the aggregate.

17 A banking entity will not be expected to show a full correlation, instead only a reasonable correlation will be required.

- It must not give rise at the inception of the hedge to significant exposures that were not already present and that are not hedged contemporaneously;
- The position must be subject to ongoing monitoring and management;[18] and
- The compensation arrangements of persons performing risk-mitigating hedging are not designed to reward proprietary risk-taking.

Permitted Trading in Government and Government-Related Obligations

The Trading Restrictions do not apply to a purchase or sale of (i) an obligation of the U.S. or an agency, (ii) an obligation, participation or other instrument of or issued by Ginne Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or certain Farm Credit System institutions, or (iii) an obligation of a state or a subdivision thereof.

Permitted Trading on Behalf of Customers

The Trading Restrictions do not apply to certain purchases and sales on behalf of a banking entity's customers. This exemption is available in the following situations:

- The banking entity is acting as investment adviser, or in another fiduciary capacity, for the account of the customer, and as to which the customer is the beneficial owner.[19]
- The banking entity is acting as a riskless principal in a transaction in which the banking entity after receiving an order to purchase or sell a covered financial position from or to a customer, purchases or sells the covered financial position for its own account to offset a contemporaneous sale to or purchase from the customer.
- The banking entity is an insurance company that purchases or sells a covered financial position solely for a separate account established by the insurance company for one or more insurance policies issued by the insurance company. All profits and losses arising from the transaction must be allocated to the separate account and inure to the benefit or detriment of the owners of the policies and not the insurance company.[20] The transaction must be conducted in compliance with, and subject to, applicable state insurance law and regulation.

Permitted Trading in the General Account of an Insurance Company

The Trading Restrictions do not apply to the purchase or sale of a covered financial position if a banking entity is an insurance company acting for its general account[21] or an affiliate of an insurance company acting for the insurance company's general account. The insurance company must satisfy the following requirements;

- The insurance company must directly engage in the business of insurance and be subject to regulation by a State insurance regulator or foreign insurance regulator;
- The insurance company or affiliate must purchase or sell solely for the general account of the insurance company;
- The purchase or sale must be conducted in compliance with, and subject to, insurance company investment laws, regulations and written guidance of the applicable State or other jurisdiction of domicile; and
- The appropriate Federal banking agencies, after consultation with the FSOC and the relevant insurance commissioners of the States, must not have jointly determined after notice and comment, that a particular law, regulation, or written guidance is insufficient to protect the safety and

18 A banking entity's internal policies should be designed to ensure that hedges remain effective as correlations or other factors change. A risk-mitigating hedge typically would be unwound as exposure to the underlying risk is reduced or increased as underlying risk is increased. The Proposed Rule notes that selective hedging would be indicative of prohibited proprietary trading.

19 The Proposed Rule notes that where a banking entity acts as an investment adviser to a mutual fund, any trading by the adviser on behalf of the mutual fund would be permitted under this exception as long as all the relevant criteria were met.

20 The Proposed Rule notes that the Agencies would not consider profits from a separate account to inure to the benefit of a banking entity if the banking entity were solely to receive payment, out of separate account profits, of fees unrelated to the investment performance of the separate account.

21 A general account is defined as all of the assets of an insurance company that are not legally segregated and allocated to separate accounts under State law.

soundness of the banking entity or the financial stability of the U.S.[22]

Permitted Off-Shore Trading

The Proposed Rule provides an exemption for trading by a banking entity that occurs outside of the U.S. and meets the following requirements:

- The banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the U.S. or one or more of the States;[23]
- The purchase must be authorized by section (4)(c)(9) or (4)(c)(13) of the BHCA;[24] and
- The purchase or sale must occur wholly outside of the U.S. In order to meet this requirement a transaction must satisfy the following conditions:
  - The banking entity conducting the purchase and sale is not organized under U.S. or State law.
  - No party to the purchase or sale is a resident of the U.S.[25]
  - No personnel of the banking entity who is directly involved in the purchase or sale is physically located in the U.S.[26]
  - The purchase or sale is executed wholly outside of the U.S.

Other Discretionary Exemptions

The Volcker Rule permits the Agencies to grant other exemptions from the Trading Restrictions if they determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the U.S. The Proposed Rule requests comment on whether the Agencies should consider any such exemptions.

Overriding Limitations on Exempted Proprietary Trading Activities

No transaction, class of transactions or activity will be considered permissible under one of the exemptions if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;[27]

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22 The Proposed Rule notes that the Federal banking agencies have not at this point proposed to determine that the laws, regulations and guidance of any particular jurisdiction are insufficient. The Federal banking agencies intend to monitor together with the Federal Insurance Office such laws, regulations and guidance.

23 As a result of this clause, any banking entity that has an ultimate U.S. controlling company may not utilize this exception even if its activities are wholly conducted outside the U.S. The Proposed Rule also provides that a U.S. subsidiary or branch of a foreign banking entity would not qualify for this exception.

24 In order to satisfy this condition, a banking entity that is an FBO must be a qualifying FBO ("QFBO") as defined in 12 C.F.R. § 211.23(a), and must conduct the purchase or sale in compliance with Subpart B of the FRB's Regulation K. For a banking entity that is an FBO but not a QFBO, it must meet at least two of the following three requirements: (i) total assets of the banking entity held outside the U.S. exceed total assets held in the U.S., (ii) total revenues derived from the business of the banking entity outside the U.S. exceed total revenues derived in the U.S., and (iii) total net income derived from the business of the banking entity outside the U.S. exceeds total net income from the business of the banking entity in the U.S.

25 A resident is (i) a natural person resident in the U.S., (ii) a business entity organized under U.S. or State law, (iii) any estate of which any executor or administrator is a U.S. resident, (iv) a trust of which any trustee, beneficiary, or if the trust is revocable, any settlor is a U.S. resident, (v) any agency or branch located in the U.S., (vi) any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the U.S., and (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized under U.S. law, or (if an individual) a resident of the U.S.

26 The Proposed Rule would not treat persons performing purely administrative, clerical or ministerial functions as persons directly involved in the transaction.

27 The Proposed Rule requests comments on the potential relationship between, and interplay of, the Proposed Rule and Section 621 of the Dodd-Frank Act regarding conflicts of interest relating to certain securitizations which contains a prohibition on certain material conflicts of interest.

- Result, directly or indirectly in a material exposure by the banking entity to a high-risk asset[28] or high-risk trading strategy;[29] or

- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the U.S.

The Proposed Rule states that conflicts of interest may arise in a variety of circumstances in connection with permitted trading activities. It notes that a banking entity may acquire information about a particular company through its lending or other activities, which, if improperly transmitted to and used in its trading operations, would permit the banking entity to use such information to its customers', clients' or counterparties' disadvantage. It further notes that a banking entity may conduct a transaction in which it places its own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer in the transaction. Finally, it observes that concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque.

The Proposed Rule provides that a material conflict of interest exists if the banking entity engages in any transaction, class of transactions or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer or counterparty with respect to such transaction, class of transactions, or activities unless the banking entity either (i) makes a timely and effective disclosure that provides the customer, client or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer or counterparty, or (ii) the banking entity has established, maintained and enforced information barriers[30] contained in written policies that are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.

In comments that add some complication to this point, the Proposed Rule observes that while the foregoing conflicts may be material for purposes of the Proposed Rule, the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a "material" conflict of interest with respect to transactions related to bona fide underwriting, market making, risk-mitigating hedging or other permitted activities, assuming these activities are conducted in a manner that its consistent with the Proposed Rule and securities and banking laws and regulations.

Dealings with Private Equity Funds or Hedge Funds

The Volcker Rule prohibits any banking entity from acquiring or retaining an ownership interest in, or sponsoring,[31] a "hedge fund or private equity fund" ("Covered Fund"), as a principal, directly or indirectly, subject to certain exceptions.[32] The Volcker Rule also prohibits a banking entity that serves as an investment manager, investment adviser, or sponsor to a Covered Fund, and any affiliates of the banking entity, from entering into certain "covered transactions" with

28 A high-risk asset is an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.

29 A high-risk trading strategy is 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 fail.

30 A banking entity may not rely on such information barriers if in any specific situation it knows or reasonably should know that, notwithstanding such barriers, the conflict of interest may involve or result in a materially adverse effect on the client, customer or counterparty.

31 A sponsor is an entity that (i) serves as a general partner, member, trustee, or commodity pool operator of a Covered Fund, (ii) in any manner selects or controls a majority of the directors, trustees or management of a Covered Fund; or (iii) shares a name or similar name with a Covered Fund for corporate, marketing, promotional or other purposes.

32 Because the Volcker Rule addresses principal activities, the prohibition on acquiring or retaining ownership interests in Covered Funds would not apply to interests held (i) by a banking entity in good faith in a fiduciary capacity (subject to a limited exception), (ii) by a banking entity in good faith in its fiduciary capacity as a custodian, broker, or agent for an unaffiliated third party, (iii) by a "qualified plan" as that term in defined in section 401 of the Internal Revenue Code of 1956 under certain circumstances, or (iv) by a director or employee of a banking entity who acquires the interest in his or her personal capacity and who is directly engaged in providing advisory or other services to the Covered Fund, unless the banking entity, directly or indirectly, extended credit for the purpose of enabling the director or employee to acquire the ownership interest in the Covered Fund and the credit was used to acquire such ownership interest in the Covered Fund.

Covered Funds, as that term is defined in section 23A of the Federal Reserve Act and imposes restrictions contained in section 23B of the Federal Reserve Act on certain other types of transactions and relationships between a banking entity and a Covered Fund.

Definition of Covered Fund

A "hedge fund" or a "private equity fund" means an issuer that that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("ICA") or similar funds as the Agencies may determine by rule. The definitions of hedge fund and private equity fund have been combined into a single term—a Covered Fund.

The Proposed Rule acknowledges that the statutory definition of private equity fund and hedge fund could potentially include within its scope many entities and corporate structures that would not usually be thought of as private equity funds or hedge funds. It gives as examples: joint ventures, acquisition vehicles, and certain wholly-owned subsidiaries. The Proposed Rule addresses this overreach to some extent through certain exemptions it offers to particular types of entities that might rely on section 3(c)(1) or 3(c)(7) exclusions.

Significantly, the Proposed Rule makes clear that if an issuer, including an issuer of asset-backed securities, may rely on another exclusion or exemption from the definition of investment company, apart from the exclusions in section 3(c)(1) or 3 (c)(7), such as section 3(c)(5), it would not be considered to be a Covered Fund as long as it can satisfy all the requirements for the alternative exclusion.

In addition, the Volcker Rule Agencies have proposed to use their authority to designate "similar funds" to extend the definition of Covered Fund to include:

- A commodity pool, as defined in section 1a(10) of the Commodity Exchange Act; and
- Any issuer, as defined in section 2(a)(22) of the ICA, that is organized and offered outside of the U.S. that would be a Covered Fund were it organized or offered under the laws, or offered to one or more residents, of the U.S. or of one or more States.

The Agencies explained that these additional types of entities were added to the definition of Covered Fund because "they are generally managed and structured similar to a covered fund, except that they are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States."

Definition of Ownership Interest

An ownership interest is defined broadly as any equity, partnership, or other similar interest in a Covered Fund, whether voting or nonvoting, or derivative of such interest. The definition is intended to focus on whether the interest provides a banking entity with exposure to the profits and losses of the Covered Fund rather than the particular form of the interest.[33]

A carried interest that meets certain requirements will not be considered to be an ownership interest. An excluded carried interest means an interest held by a banking entity (or an affiliate, subsidiary, or employee thereof) in a Covered Fund for which the banking entity (or affiliated party) serves as investment manager, investment adviser, or commodity trading advisor, provided that among other things, the sole purpose and effect of the interest is to allow the banking entity (or affiliated party) to share in the profits of the Covered Fund as performance compensation for services provided to the Covered Fund, and further provided that the banking entity (or affiliated party) may be obligated under the terms of such interest to return profits previously received.

Permitted Organizing and Offering of a Covered Fund in Connection with Certain Banking Entity Services

Requirements for Involvement with a Customer Fund

The Volcker Rule's prohibition on organizing and offering a Covered Fund, including serving as a general partner, managing member, or trustee or in any way selecting or controlling a majority of the directors, trustees or management of the Covered Fund does not apply if:

- The banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the Covered Fund.

[33] Accordingly, the Proposed Rule notes that to the extent a debt security exhibits substantially the same characteristics as an equity or other ownership interest, such as the right or ability to share in the Covered Fund's profits or losses, the Agencies would consider such instrument as an "other similar instrument."

- The Covered Fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity, pursuant to a credible plan outlining how the banking entity intends to provide advisory or similar services to it customers through organizing and offering the Covered Fund.[34]

- The banking entity does not acquire or retain an ownership interest in the Covered Fund except as permitted under the Proposed Rule.

- The banking entity complies with the prohibitions and restrictions on transactions and relationships with the Covered Fund imposed under the Proposed Rule.

- The banking entity does not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the Covered Fund or any Covered Fund in which the Covered Fund invests.

- The Covered Fund for corporate, marketing, promotional, or other purposes, does not share the same or similar name with the banking entity or any of its affiliates, and does not use the word "bank" in its name.

- No director or employee of the banking entity takes or retains an ownership interest in the Covered Fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the Covered Fund.

- The banking entity makes specified disclosures to its prospective and actual investors in the Covered Fund.

A Covered Fund that meets the foregoing requirements is referred to as a "Customer Fund."

Permitted Investments in Customer Funds

The general prohibition on holding an ownership interest in a Covered Fund does not apply to a Customer Fund. A banking entity is permitted to make a sufficient initial equity investment to permit the Customer Fund to attract unaffiliated investors as required for a Customer Fund. The banking entity must actively seek unaffiliated investors to reduce its ownership interests to no more than three percent[35] of the total amount or value of outstanding ownership interests of the Customer Fund generally not later than one year after the establishment of the Customer Fund.[36]

The Proposed Rule limits the aggregate value of all ownership interests of the banking entity in all Customer Funds to no more than three percent of the tier 1 capital of the banking entity. A banking entity is required to deduct the aggregate amount of all investments in Customer Funds from the banking entity's tier 1 capital.

Other Permitted Covered Fund Activities Permitted by the Volcker Rule

The Proposed Rule also permits investment in, and sponsorship of, certain Covered Funds that are not Customer Funds as provided in the Volcker Rule. The Proposed Rule permits holding an ownership interest in, and sponsoring, small business investment companies that meet certain requirements. The Proposed Rule also permits investments in a Covered Fund in connection with risk-mitigating hedging activities that meet certain requirements.

Permitted Off-Shore Covered Fund Investments and Activities

The Proposed Rule provides an exemption from the prohibitions on the acquisition or retention of an ownership in, or sponsorship of, a Covered Fund by a banking entity if the following requirements are met:

- The banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the U.S. or one or more of the States;

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34 The customer relationship does not have to be a preexisting one. It may be established in connection with the banking entity's organization and offering of a Covered Fund. The Proposed Rule cautions that a banking entity may not organize and offer a Covered Fund as a means of itself investing in the Covered Fund or in the assets held in the Covered Fund.

35 The Proposed Rule establishes special rules for attributing ownership interests in a Customer Fund to a banking entity and for determining the value of the banking entity's interests in a Customer Fund.

36 Upon application by a banking entity to the FRB, the FRB may extend the period for reaching the reduced level of investment for up to two years taking into account a set of specified factors, and may impose conditions on such extension.

- The purchase must be authorized by section (4)(c)(9) or (4)(c)(13) of the BHCA;[37]
- No ownership interest in the Covered Fund is offered for sale or sold to a resident of the U.S.; and
- The activity must occur solely outside of the U.S. In order to meet this requirement a transaction must satisfy the following conditions:
  - The banking entity conducting the purchase and sale is not organized under U.S. or State law; and
  - No subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the Covered Fund is incorporated in or physically located in the U.S. or one or more States.[38]

Permitted Involvement in Loan Securitizations

A banking entity may acquire or retain an ownership interest, or act as a sponsor to, a Covered Fund that is an issuer of asset-backed securities ("Loan Securitization Exemption"), the assets of which are solely comprised of:

- Loans;
- Contractual rights or assets directly arising from loans supporting the asset-backed securities; and
- Interest rate or foreign exchange derivatives that materially relate to the terms of the loans or contractual rights or assets and that are used for hedging purposes with respect to the securitization structure.

The preamble to the Proposed Rule states that the proposed definition of a banking entity would not include any entity that is a subsidiary or affiliate of a banking entity that is a Covered Fund and any entity controlled by such Covered Fund. However, the proposed regulatory text appears to be more restrictive. It provides an exclusion from the term "banking entity" to:

> A covered fund that is organized, offered and held by a banking entity pursuant to § .11 and in accordance with the provisions of Subpart C, including the provisions governing relationships between a covered fund and a banking entity.

The reference to section .11 on its face is limited to a Customer Fund and thus would not appear to extend to any other type of permitted ownership in, or sponsorship of a Covered Fund. Thus, a Covered Fund that is held and/or sponsored under the Loan Securitization Exemption could be subject to being treated as a banking entity. In this regard, the Proposed Rule requests comments on whether the exclusion for Customer Funds should be modified to exclude any Covered Fund.

In a related matter, the Proposed Rule notes that an issuer of asset-backed securities that is both (i) an affiliate or subsidiary of a banking institution and (ii) does not rely on an exclusion contained in section 3(c)(1) or 3(c)(7) of the ICA (and thus would not be treated as a Covered Fund) would be a banking entity. As a result, such an entity would be subject to the related restrictions and requirements under the Proposed Rule, including (i) the prohibition on proprietary trading, (ii) limitations on investments in, and relationship with Covered Funds, and (iii) compliance program and recordkeeping and reporting requirements. The Proposed Rule notes that given the breadth of the definition of "affiliate," these requirements may apply to a significant portion of the outstanding securitization market, including issuers of asset-backed securities that rely on rule 3a-7 or section 3(c)(5) of the ICA.

Other Permitted Covered Fund Activities Authorized by the Agencies

The Volcker Rule authorizes the Agencies to permit banking entities to engage in Covered Fund activities that the Agencies determine promote and protect the safety and soundness of a banking entity and the financial stability of the U.S. In reliance on that authority, the Proposed Rule would not apply to prohibitions on acquiring or retaining an ownership interest or to acting as a sponsor in the following circumstances:

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37 The same requirements apply to this provision as apply in regard to Permitted Off-shore Trading as described above.

38 The Proposed Rule indicates that an employee or entity with no customer relationship and involved solely in providing administrative services to the Covered Fund, such as clearing and settlement or maintaining and preserving records of the Covered Fund with respect to a transaction where no ownership interest is offered for sale or sold to a resident of the U.S., would not be subject to this requirement.

- Certain bank owned life insurance separate accounts;[39]
- A joint venture between a banking entity or one of its affiliates and any other person, provided that the joint venture is both an operating company and does not engage in any activity or make any investment that is prohibited under the Proposed Rule;
- An acquisition vehicle, provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates;
- A wholly owned subsidiary of a banking entity that is engaged principally in performing bona fide liquidity management activities as provided under the proprietary trading provisions of the Proposed Rule;[40]
- An issuer of an asset-backed security, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a "securitizer" or "originator" in compliance with the minimum requirements of section 15G of the Exchange Act and any implementing regulations thereunder;
- A Covered Fund that is an issuer of asset-backed securities as permitted under the terms of the Loan Securitization Exemption;[41]
- A Covered Fund pursuant to and in compliance with the conformance or extended transition period provided for under the FRB's rules issued under the Volcker Rule; and
- Ownership interests in a Covered Fund acquired or retained in the ordinary course of collecting a debt previously contracted for in good faith.

Limitations on Relationships with Covered Funds

The Volcker Rule prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading adviser, or sponsor to a Covered Fund, and any affiliates of the banking entity, from entering into a transaction with the Covered Fund that would constitute a "covered transaction"[42] under section 23A of the Federal Reserve Act ("section 23A"). Further, the requirements imposed on certain transactions under section 23B of the Federal

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39 This provision would only apply to separate accounts which are used solely for the purpose of allowing a covered banking entity to purchase insurance policies where the banking entity is the beneficiary and the banking entity: (i) does not control the investment decisions with respect to the account; and (ii) complies with applicable agency guidance regarding bank-owned life insurance.

40 The Proposed Rule notes that the exemptions for joint ventures, acquisition vehicles and wholly owned liquidity subsidiaries are directed at entities that may meet the definition of Covered Fund to the extent these entities rely solely on section 3(c)(1) or 3(c)(7) of the ICA. These entities do not, however, engage in the type of and scope of activities to which Congress intended the Volcker Rule to apply. The Agencies expressed concern that without this exemption many entities would be required to alter their corporate structure without achieving any reduction in risk. It seems likely that commenters will focus on whether these three exemptions are sufficient to adequately address this concern.

41 The Proposed Rule explains that this provision is considered to augment the authority in the Loan Securitization Exemption regarding the sale and securitization of loans by permitting a banking entity to engage in the purchase, and not only the sale and securitization, of loans through authorizing the acquisition or retention of an ownership interest in such securitization vehicles that the banking entity does not organize and offer, or for which it does not act as sponsor, provided that the assets or holdings of such vehicles are solely comprised of the referenced instruments or obligations. The Proposed Rule states that permitting banking entities to acquire or retain an ownership interest in such loan securitizations will provide a deeper and richer pool of potential participants and a more liquid market for the sale of securitizations, which should result in increased availability of funds to individuals and small businesses, and provide greater efficiency and diversification of risk.

42 The Proposed Rule summarizes the term "covered transaction" for purposes of section 23A to mean with respect to an affiliate of a member bank: (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 FRB 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.

Reserve Act ("section 23B") will apply to the banking entity or affiliate to the same extent as if the banking entity or affiliate were a member of the Federal Reserve System ("member bank") and the Covered Fund was an affiliate thereof. Together the section 23A prohibitions and the section 23B restrictions are referred to as the "Relationship Restrictions."

It is important to recognize that the Relationship Restrictions apply more broadly than do the ownership and sponsorship provisions of the Volcker Rule. The Relationship Restrictions apply not only to banking entities that sponsor a Covered Fund but also to banking entities that merely act as an investment manager or investment adviser to a Covered Fund.

Since a Customer Fund and any Covered Fund in which it invests would not be a banking entity, the Proposed Rule notes that the Relationship Restrictions do not generally apply to such funds.

It is also important to note that the Relationship Restrictions do not apply to a fund that is not a Covered Fund because it relies on an exclusion other than section 3(c)(1) or 3(c)(7) of the ICA.

Application of Section 23A

The Proposed Rule notes that while one provision of the Volcker Rule prohibits section 23A transactions, other provisions expressly provide for or contemplate such transactions occurring.

In this regard, the Proposed Rule provides that a banking entity may acquire or retain an ownership interest in a Covered Fund as permitted under the terms of the Proposed Rule.[43]

The Proposed Rule also addresses a provision in the Volcker Rule that permits a banking entity to enter into any prime brokerage transaction with a Covered Fund that the banking entity advises, manages, or sponsors, subject to certain restrictions.[44] In order for a banking entity to engage in such a prime brokerage transaction, the banking entity must be in compliance with the requirements of the Proposed Rule with respect to the organization and offering of Customer Funds. In addition:

- The CEO or equivalent officer of the top-tier affiliate of the banking entity certifies in writing annually (with a duty to update this as information materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the Covered Fund or any other Covered Fund in which such Covered Fund invests;
- The FRB has not determined that the prime brokerage transaction would be inconsistent with the safe and sound operation and condition of the banking entity; and
- All prime brokerage transactions with a Covered Fund will be subject to the requirements of section 23B as if the Covered Fund were an affiliate.

Application of Section 23B

The Proposed Rule reflects the Volcker Rule's application of section 23B to banking entities that serve as an investment manager, investment adviser, or sponsor to a Covered Fund to the same extent as if such banking entity were a member bank and the Covered Fund were an affiliate thereof. Section 23B generally requires that certain transactions between member banks and affiliates must be on terms and under circumstances that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies, or in the absence of comparable of transactions, on terms and under circumstances that in good faith would be offered to an unaffiliated party.

Overriding Limitations on Permitted Covered Funds Activities

No transaction, class of transactions or activity will be considered permissible in relation to a Covered Fund if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or

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43 The Proposed Rule expresses the view that there is no evidence that Congress intended the Volcker Rule Relationship Restrictions to override other provisions of the Volcker Rule.

44 The Proposed Rule defines a "prime brokerage transaction" to mean "one or more products or services provided by a banking entity to a Covered Fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support."

- Pose a threat to the safety and soundness of the banking entity or to financial stability of the U.S.

- This provision tracks the definitions and approach to addressing material conflicts of interest that is discussed in detail above in relation to proprietary trading.

Compliance Program Requirements

Depending on the nature of a banking entity's permitted proprietary trading and permitted Covered Funds activities, the banking entity may be subject to substantial compliance program requirements. If a banking entity does not engage in activities that are prohibited or restricted under the Trading Restrictions or the Fund Restrictions, the banking entity will only be required to have compliance policies and procedures that prevent it from becoming engaged in activities or investments that would require it to develop a Volcker Rule compliance program.

Banking entities that do not qualify for the preceding exception must develop a Volcker Rule compliance program that is appropriate for the size, scope and complexity of the activities and business structure of the banking entity.

A compliance program must, at a minimum, include:

- Internal written policies and procedures to document, describe and monitor trading activities and Covered Funds activities to ensure these comply with the Volcker Rule;

- A system of internal controls to monitor and identify potential areas of noncompliance and to prevent prohibited activities and investments;

- A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule;

- Independent testing for the effectiveness of the compliance program conducted by qualified personnel of the banking entity or by a qualified outside party;

- Training for trading personnel, managers, and other appropriate personnel, to effectively implement and enforce the compliance program; and

- Making and keeping records sufficient to demonstrate compliance with the Volcker Rule.

Additional requirements apply to a banking entity if:

- The banking entity engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which, as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion or equals 10 percent or more of its total assets;

- The banking entity has, together with its affiliates and subsidiaries, aggregate investments in one or more Covered Funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or

- The banking entity sponsors or advises, together with its affiliates and subsidiaries, one or more Covered Funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

If a banking entity meets one of these tests, its compliance program must satisfy additional requirements set forth in Appendix C to the Proposed Rule.[45]

Enforcement

The Proposed Rule provides that a banking entity that engages in an activity or makes an investment in violation of the Volcker Rule and the Proposed Rule or in a manner that functions as an evasion of those requirements shall terminate the activity and, as relevant, dispose of the investment. The Proposed Rule further provides after that after due notice and an opportunity for a hearing, if the Agency finds reasonable cause to

[45] Appendix C sets forth the standards for programmatic compliance by banking entities to ensure that they monitor conduct subject to the Volcker Rule's prohibitions and restrictions. Appendix C addresses (i) internal policies and procedures, (ii) internal controls, (iii) responsibility and accountability for the compliance program, (iv) independent testing, (v) training and (vi) recordkeeping. Appendix C incorporates by reference the requirements of Appendix A for a banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which is at least $1 billion as measured on the final day of each of the previous four calendar quarters. For such banking entities, Appendix A requires both (i) the periodic reporting of a variety of quantitative measurements of their covered trading activities, depending on those activities' size and scope, and (ii) the maintenance of records documenting the preparation of those entities' trading reports.

believe any banking entity has engaged in an impermissible activity or investment, the Agency may by order, direct the banking entity to restrict, limit, or terminate the activity, and, as relevant, dispose of the investment.

Conformance Period

As noted above, the Volcker Rule will become effective on July 21, 2012. The Proposed Rule provides that as a general matter, a banking entity must bring its activities and investments into compliance with the requirements of the Volcker Rule no later than July 21, 2014. Under the Volcker Rule, the FRB is given sole authority to issue regulations regarding conformance with the Volcker Rule. The FRB issued a rule implementing this provision in February 2011. The rule is incorporated with certain revisions into the Proposed Rule.

The Proposed Rule indicates that a banking entity will be required to begin complying with the applicable reporting, recordkeeping and compliance program requirements as of July 21, 2012.

It is important to note that the Agencies expect a banking entity to fully conform all of its activities and investments to the requirements of the Proposed Rule as soon as practicable during the conformance period.

The FRB noted that the conformance period does not permit a banking entity to engage in any new activity or make any new investment in a Covered Fund without complying with the Trading Restrictions and Fund Restrictions. Instead the conformance period permits a banking entity to bring its existing non-permissible activities into conformance with the Volcker Rule.

The FRB notes that it expects that each banking entity will identify the trading units of the banking entity that are engaged in prohibited proprietary trading on and after the Effective Date. The banking entity will be expected to bring the prohibited activity of all trading units into compliance as soon as practicable within the conformance period. A trading unit may not expand its activity to including prohibited proprietary trading after the Effective Date. A trading unit that is not identified as engaging in proprietary trading as of the Effective Date may not begin engaging in such activity after the Effective Date.

In case of Covered Fund activities or investments, the Proposed Rule provides that the conformance period[46] generally allows a banking entity to retain an existing investment in a Covered Fund, to make additional capital contributions to a Covered Fund if contractually obligated to do so, or to continue certain existing relationships with a Covered Fund.[47] Under the conformance period or Extended Transition Period, a banking entity may not make a new investment or capital contribution that it is not contractually obligated to make in, or establish a new relationship with, a Covered Fund after the Effective Date.

Cost Benefit Analysis

The Proposed Rule contains an extensive discussion of its economic impact. The Agencies are seeking comments, among other things, on the potential costs and benefits of the aspects of the proposal that involve choices made, or the exercise of discretion by, the Agencies in implementing the Volcker Rule.[48]

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46 The Proposed Rule permits the FRB to extend the two-year conformance period by not more than three separate one-year periods, if the FRB determines that each such extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The FRB may also further permit a single five-year extension for a banking entity to acquire or retain an ownership interest in, or otherwise provide additional capital to, a Covered Fund if (i) the fund meets the requirements to be deemed an illiquid fund; and (ii) the acquisition or retention of such interest, or provision of capital is necessary to fulfill a qualifying contractual obligation that was in effect on May 10, 2010 ("Extended Transition Period").

47 Under the Proposed Rule a banking entity may retain an existing ownership interest in regard to a Covered Fund under the authority of the conformance period or the Extended Transition Period without regard to the individual Covered Fund or aggregate Covered Fund limitations. A banking entity may continue to serve as a sponsor of a Covered Fund under the authority of the conformance period if it acted as sponsor of such Covered Fund as of the Effective Date and the relationship was continuous. A banking entity may serve as a sponsor of an illiquid fund pursuant to an Extended Transition Period to the extent that such service is related to the banking entity's retention of a permitted ownership in the fund.

48 The Proposed Rule does not cite any particular basis for providing a cost benefit analysis. On July 11, 2011, President Obama issued an executive order that called on independent regulatory agencies, to the extent permitted by law, to follow prior executive orders that, among other things, call for a rulemaking proceeding to evaluate whether its benefits justify its costs. The Proposed Rule also includes a discussion by the SEC of competitive con-

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siderations required by provisions of the Exchange Act in regard to certain portions of the Proposed Rule that are being proposed pursuant to the SEC's authority under the Exchange Act with respect to banking entities that are registered broker-dealers and security-based swap dealers.

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