The Volcker Rule: Overview and Compliance Requirements

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Background on the Final Rule

On December 10, 2013, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, "Agencies") released the final rule ("Final Rule") implementing Section 13 of the Bank Holding Company Act ("BHCA"), as added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule. The Volcker Rule was one of the signature reforms of the Dodd-Frank Act and has been the subject of much debate since it was first proposed in Congress. As enacted, the Volcker Rule prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with, hedge funds and private equity funds, subject to several important exemptions. The Agencies issued proposed rules to implement the Volcker Rule in October of 2011, and received more than 18,000 comments, including more than 600 unique comment letters.

The Final Rule significantly limits the trading and investing operations of banking entities, and requires banking entities engaged in permitted trading or permitted covered fund activities to establish and maintain extensive compliance programs and satisfy new reporting requirements. Although the Volcker Rule is often portrayed as directed at the largest, most complex financial institutions, the provisions of the Final Rule apply to *any* banking entity. Accordingly, every banking entity needs to understand the extent to which it must adhere to the compliance and reporting requirements set forth in the Final Rule.

Simultaneous with the issuance of the Final Rule, the Federal Reserve also extended the conformance period to **July 21, 2015**, giving banking entities an additional year to comply. The extension, however, does not apply to the Final Rule's reporting requirements, which will be phased in starting June 30, 2014. The Federal Reserve also indicated that banking entities will be expected to use good faith efforts to bring their activities and investments into compliance during the conformance period. In particular, it stated that banking entities should not expand any activities or make investments with the expectation of receiving another extension in the conformance period.

Update. *On January 14, 2014, in response to a lawsuit over the Final Rule, the Agencies issued an interim final rule to permit the retention of interests or sponsorship of certain collateralized debt obligations backed by trust preferred securities.*

This overview provides a summary of the Final Rule, including its compliance and reporting requirements. Because the Final Rule is more than 70 pages and the accompanying Preamble contains more than 900 pages of guidance, it is advised that banking entities engage counsel for questions about how the Final Rule will apply to specific transactions and activities.

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Overview of the Final Rule

General Applicability

Banking Entity Defined

The Final Rule applies to any "banking entity," which is defined as:

(i) any insured depository institution;

(ii) any company that controls an insured depository institution;

(iii) any company treated as a bank holding company under Section 8 of the International Banking Act of 1978; and

(iv) any affiliate or subsidiary of any of the foregoing entities.

Exclusions

Explicitly excluded from the definition of a banking entity are any "covered fund" (as defined by the Final Rule, see below), any portfolio company held under the merchant banking and insurance company authorities of the BHCA (12 U.S.C. § 1843(k)(4)(H) & (I)), and any portfolio concern controlled by a small business investment company, provided that the covered fund, portfolio company, or portfolio concern is not itself a banking entity under categories (i) – (iii) above.

It is important to note that the Volcker Rule does not apply to non-bank financial companies designated as systemically significant and supervised by the Board of Governors, though such companies that engage in proprietary trading or invest in, or sponsor, covered funds would be subject to additional capital requirements and other limitations under separate rulemakings.

Prohibition on Proprietary Trading

The Final Rule prohibits a banking entity from engaging in "proprietary trading," which is defined as a banking entity engaging as a principal in its "trading account" in any purchase or sale of a financial instrument. A "trading account" is any account used for the purchase or sale of a financial instrument:

(i) for the purpose of short-term trading;[1]

(ii) that is a "covered position" and "trading position" under the Agencies' Market Risk Capital Rules;[2] or

(iii) by a banking entity that is a securities dealer, swap dealer, or securities-based swap dealer in connection with its dealer activities.

There is a rebuttable presumption that a purchase or sale of a financial instrument was for the banking entity's trading account if it was held for less than 60 days.

Financial Instruments Covered

The prohibition on proprietary trading only applies to a purchase or sale of a "financial instrument," which is defined as a security, derivative, contract of sale of a commodity for future delivery, or an option on a security, derivative, or contract of sale for future delivery. The definition of financial instrument excludes any loan, foreign exchange or currency, or commodity (unless such commodity is a derivative, a contract of sale of a commodity for future delivery, an option on such a contract of sale for future delivery, or an excluded commodity ((as defined under Section 1a(19) of the Commodity Exchange Act) (7 U.S.C. § 1a(19)) (other than foreign exchange or currency)).

[1] Specifically, the Final Rule states that such purchase or sale must be for the purpose of "short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions resulting from [the aforementioned purchase or sale]."

[2] This provision applies only to banking entities and their affiliates that are insured depository institutions, bank holding companies, or S&L holding companies and that calculate their capital requirements under the Market Risk Capital Rules.

Excluded Transactions

The Final Rule excludes from the definition of proprietary trading a range of generally operational transactions, including any purchases or sales arising from: (i) a repurchase or reverse repurchase agreement; (ii) a securities lending transaction; (iii) a *bona fide* liquidity management plan;[3] (iv) the clearing of financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency; (v) certain clearing activities by a banking entity that is a member of a clearing agency, derivatives clearing organization, or a designated financial market utility; (vi) an existing delivery obligation; (vii) an obligation of the banking entity in connection with a judicial, administrative, self-regulatory, or arbitration proceeding; (viii) the banking entity acting solely as agent, broker, or custodian; (ix) an employee compensation plan; and (x) the collection of a debt.

Exemptions for Permitted Activities

The Final Rule also provides several important exemptions from the prohibition on proprietary trading, the most important of which are the exemptions for underwriting, market-making, and risk-mitigating hedging activities. Each of these exemptions, however, requires a banking entity to establish and maintain an internal compliance program in accordance with detailed standards set forth in the Final Rule.

- *Underwriting Exemption* – A banking entity may engage in underwriting activities provided that: (i) its trading desk takes positions in a distribution of securities being underwritten by the banking entity; (ii) its trading desk's positions are not designed to "exceed the reasonably expected near term demands" of clients, customers, or counterparties, and "reasonable efforts" are made to sell the position within a reasonable amount of time; (iii) the banking entity establishes and implements an internal compliance program as required by subpart D of the Final Rule (see below); (iv) compensation arrangements for persons performing the underwriting are not designed to reward or incentivize proprietary trading; and (v) the banking entity is licensed or registered to engage in underwriting as required by law. The Final Rule, however, provides that trading desks of other banking entities with $50 billion or more in trading assets and liabilities are not considered clients, customers, or counterparties, unless a trading desk either documents why the other trading desk should be treated as a client, customer, or counterparty, or conducts the trade anonymously on an exchange. "Trading desks" are defined as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of a banking entity or affiliate thereof."

- *Market-Making Exemption* – A banking entity may also engage in market-making provided that: (i) its trading desk "routinely stands ready to purchase or sell one or more types of financial instruments related to its financial exposure" and "is willing to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles;" (ii) its trading desk's inventory is not designed to exceed "the reasonably expected near term demands" of its clients, customers, or counterparties; (iii) the banking entity establishes and implements an internal compliance program as required by subpart D of the Final Rule (see below); (iv) the trading desk remedies any breaches of position limits as promptly as possible; and (v) the banking entity is licensed or registered to engage in market-making activity as required by law.

  It is important to note that the Agencies have indicated that this exemption focuses on a trading desk's aggregate "financial exposure" and "market-maker inventory" rather than on whether each of its transactions is a market–making activity.

- *Permitted Hedging Activities* – A banking entity may engage in risk-mitigating hedging activities related to individual or aggregate positions or other holdings of the banking entity that are "designed to reduce the specific risks" related to such positions or holdings. To engage in permitted hedging activities, however, a banking entity must ensure that the hedging activity is (i) conducted in accordance with its internal controls and procedures; (ii) designed to reduce and "demonstrably reduces" one or more specific, identifiable risks (*e.g.* market risk, counterparty risk, credit risk, interest rate risk) related to positions of the banking entity; (iii) not giving rise at its inception to any new or additional unhedged risk; and (iv) subjected to continual review, monitoring and management by the banking entity. In addition, the banking entity must establish and implement an internal compliance program as required by subpart D of the Final Rule (see below); design the compensation of persons performing the hedging so as not to reward or incentivize proprietary trading; and comply with extensive

[3] The Final Rule provides that such a liquidity management plan must specifically authorize the type, amount, and risks of the securities used, and the liquidity circumstances in which such securities may be used, as well as require any securities purchased or sold to be highly liquid and limited to an amount consistent with the banking entity's near-term funding needs.

documentation requirements for each purchase or sale of financial instruments made to carry out permitted hedging activities

In the Preamble, the Agencies clarified that the hedging exemption does permit the hedging of "aggregate positions of the banking entity" that are "identifiable risks related to specific positions." However, the Agencies further clarified that the exemption does not permit hedging of "generalized risks" based on "non-position-specific modeling or other considerations," including "risks associated with a banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks results from positions lawfully held by the banking entity."

- ***Other Permitted Trading*** – The Final Rule permits banking entities to purchase or sell certain financial instruments, including (i) U.S. government obligations; (ii) obligations of Fannie Mae, Freddie Mac, Federal Home Loan Banks, Farmer Mac, or a Farm Credit System institution; (iii) certain foreign government obligations; and (iv) State and municipal securities (items (i) - (iv) collectively, "Permitted Trading").

- ***Fiduciary, Riskless Principle, Insurance Company, & Foreign Bank Exemptions*** – The prohibition on proprietary trading also does not apply to purchases or sales of a financial instrument by a banking entity that is (i) acting as a trustee, in a fiduciary capacity, for the account of a customer; (ii) acting as a riskless principal; (iii) an insurance company (or an affiliate of an insurance company) purchasing or selling solely for the general account of the insurance company, or a separate account established by the insurance company; or (iv) a foreign banking entity engage in certain trading activities outside the United States.

- ***Limitations on Permitted Trading*** – Any trading activities permitted by the Final Rule must still comply with several important restrictions. Under the Final Rule, permitted trading activity must not (i) result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) involve "high-risk assets" or a "high-risk trading strategy;" or (iii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States. "High-risk assets" and a "high-risk trading strategy" are defined as assets (or group of related assets) or a trading strategy, respectively, that, if held or engaged in by the banking entity, would either significantly increase the likelihood of the banking entity incurring a substantial loss or pose a threat to the financial stability of the United States.

Covered Fund Activities and Investments

General Applicability

The Final Rule prohibits banking entities from acquiring or retaining any ownership interest in, or sponsoring, a covered fund. A "covered fund" is defined as:

(i) any private investment company (an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act (ICA));

(ii) certain private commodity pool operators;[4] or

(iii) with respect to a banking entity that is (or is controlled by a banking entity that is) located in or organized under the laws of the United States or any State, certain foreign funds whose ownership interests are offered and sold outside the United States.[5] (Due to this exemption, certain funds that would be covered funds with respect to a U.S. banking entity will not be covered funds with respect to certain non-U.S. banking entities.)

[4] A commodity pool operator is a covered fund if (i) the commodity pool operator has claimed an exemption under 17 C.F.R. § 4.7; or (ii) the commodity pool operator is registered with the CFTC, substantially all participation units of the commodity pool are owned by qualified eligible persons (defined under 17 C.F.R. § 4.7 (a)(2) and (3)), and the participation units have not been publicly offered to non-qualified eligible persons.

[5] The issuer is a covered fund, with respect to any banking entity organized under or located in the United States or any State (or is controlled by such a banking entity), if the issuer (i) is organized, and its ownership interests are offered and sold, outside of the United States; (ii) raises money, or holds itself out as raising money, primarily to invest in securities for resale or other trading in securities; and (iii) has as its sponsor, or has ownership interests owned by, such banking entity (or one of its affiliates). The Final Rule clarifies that an issuer will not be deemed to be a covered fund with respect to such U.S. banking entity, if the issuer could have relied on an exemption or exclusion from the definition of investment company under the ICA other than those contained in Section 3(c)(1) and (c)(7).

"Sponsoring" a covered fund includes serving as a general partner of a covered fund, selecting or controlling a majority of the directors of a covered fund, or sharing the same name (or a variation of the same name) with a covered fund. "Ownership interest" is defined as "any equity, partnership or other similar interest," including having the right to participate in the selection or removal of a general partner, board member, trustee, investment manager or advisor, or having the right to receive a share of the profits of the covered fund. It was this broad definition of ownership interests that brought TruPS CDOs within the prohibition on investments in covered funds and, consequentially, resulted in a court challenge to the Final Rule by the American Bar Association.

- *Exclusions of Certain Entities* – The Final Rule permits banking entities to invest in or sponsor covered funds and engage in a variety of activities that would otherwise be prohibited (including transactions that would be subject to the Sections 23A and 23B limitations discussed below) by excluding a variety of issuers from the definition of a covered fund, including (i) foreign public funds; (ii) wholly-owned subsidiaries; (iii) joint ventures; (iv) acquisition vehicles; (v) foreign pension or retirement funds; (xi) insurance company separate accounts; (vii) bank owned life insurance separate accounts; (viii) loan securitizations (RMBS, CMBS, car loans and credit card securitizations); (iv) qualifying asset-backed commercial paper conduits; (x) qualifying covered bonds; (xi) small business investment companies; (xii) public welfare investment funds; (xiii) registered investment companies; and (xiv) any other entity the Agencies jointly determine to excluded from the definition.

Permitted Activities

Under the Final Rule, a banking entity may invest in, or sponsor, a covered fund as part of organizing and offering a covered fund. To qualify for this exemption, the following conditions must be satisfied:

(i) the banking entity must either (a) provide *bona fide* trust, fiduciary, investment advisory, or commodity trading services in connection with the organizing and offering of a covered fund to persons that are customers of such services pursuant to a written plan (this is the so-called "customer funds" exception); or (b) act as a securitizer of a covered fund that is an issuer of asset-backed securities or acquire or retain ownership interests in such an issuer as required by the risk retention requirements of the Dodd-Frank Act (12 U.S.C. § 78o-11);[6]

(ii) the banking entity must comply with the Final Rule's limitations on permitted investments (discussed below):

(iii) the banking entity must comply with the Final Rule's limitations on relationships with covered funds (discussed below);

(iv) the banking entity (and its affiliates) cannot guarantee or otherwise insure the obligations or performance of the covered fund or any covered fund in which the covered fund invests;

(v) the banking entity (and its affiliates) and the covered fund cannot share the same name or a variation of the same name, and the covered fund's name may not use the word "bank;"

(vi) none of the banking entity's (or its affiliate's) directors or employees may take or retain an ownership interest in the covered fund (unless the director or employee is directly providing investment advisory or other services to the covered fund at the time the director or employee takes the ownership interest); and

(vii) the banking entity must provide certain disclosures to prospective and actual investors, including stating that losses in the covered fund will be borne solely by its investors and not the banking entity (or its affiliates); that the ownership interest of the covered fund is not guaranteed by the FDIC or any banking entity (unless there is such a guarantee); and the role of the banking entity (and its affiliates) in sponsoring or providing services to the covered fund.

[6] Note that this exemption is for securitizations that do not fall within either the exclusion for loan securitizations under the definition of "covered fund," or another exemption of the ICA other than Section 3(c)(1) and (c)(7), such as Rule 3a-7.

Limits on Permitted Investments

Any investments in covered funds permitted in connection with organizing and offering a covered fund must be for the purpose of (i) establishing a fund with sufficient equity to attract unaffiliated investors during a seeding period; or (ii) making a *de minimis* investment. In addition, such investments, as well as investments made under the underwriting and market-making exemptions to the prohibition on proprietary trading, are further restricted by per fund and aggregate limits and must be deducted from a banking entity's tier 1 capital.

- ***Per Fund Limit*** – Except for the 1-year seeding period following its establishment of a covered fund, a banking entity (and its affiliates) may not make or hold any investments in any covered fund that exceeds three percent of the total number or value of the outstanding ownership interests of the fund calculated on a fair market value basis (unless the market value cannot be determined, then on a historical cost basis) as of the last day of each calendar quarter. However, a banking entity may hold an investment in excess of three percent of the total fair market value of the ownership interests in an issuer of asset-backed securities if a greater percentage is required under the risk retention requirements of the Dodd-Frank Act (12 U.S.C. § 78o-11). Upon application by a banking entity, the Board of Governors may also extend the one-year seeding period for up to two additional years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest.

- ***Aggregate Limit*** – A banking entity (and its affiliates) may not acquire or retain ownership interests in covered funds that collectively exceed three percent of its tier 1 capital as calculated on a historical cost basis on the last day of each calendar quarter.

  For purposes of calculating the per fund and aggregate limits, neither a registered investment company, a SEC-regulated business development company nor a foreign public fund is considered an affiliate of a banking entity if the banking entity does not own or control 25 percent or more of its voting shares, and provides investment advisory, commodity trading advisory, administrative and other services to the company or fund.

- ***Capital Treatment*** – The Final Rules require that a banking entity deduct from its calculation of its tier 1 capital the greater of (i) the historical cost of the amount it paid or contributed to obtain its ownership interest in a covered fund plus earnings received, and (ii) the fair market value of its ownership interest if it accounts for the covered fund's profits or losses in its financial statements.

Other Permitted Activities and Investments

- ***Hedging Activities*** – A banking entity may also acquire or retain ownership interests in a covered fund to hedge risks to the banking entity in connection with a compensation arrangement for an employee that provides advisory or other services to the covered fund. To engage in such permitted hedging activities, the banking entity must establish and maintain an internal compliance program as set forth in subpart D of the Final Rule.

- ***Activities and Investment Outside the U.S.*** – Under the Final Rule, the ban on investing in, or sponsoring, covered funds does not apply to certain overseas activities. This exemption is available if (i) a banking entity is not organized or controlled by a banking entity organized under the laws of the United States or any State; (ii) the activity or investment is in accordance with Section 4(c)(9) or (13) of the BHCA; (iii) no ownership interests in the covered fund is offered or sold to residents of the United States; and (iv) the activity or investment occurs outside of the United States.

- ***Insurance Company Activities*** – The Final Rule also permits regulated insurance companies to acquire or retain an ownership interest in, or sponsor, covered funds, provided that (i) the ownership interest is acquired and retained solely for the general account of, or separate accounts established by, the insurance company; and (ii) the acquisition and retention of ownership interests is conducted in accordance with applicable state insurance laws and regulations (unless Federal banking agencies have determined that such a law or regulation is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States, in which case the activity or investment is prohibited).

Limitations on Relationships

The Final Rule imposes several broad limitations on a banking entity's relationships with covered funds that apply even to transactions and activities otherwise permitted by the Final Rule.

- ***Prohibited Transactions*** – Except for investments in a covered fund permitted by the Final Rule, a banking entity (and its affiliates) is generally prohibited from entering, directly or indirectly, into any covered transaction (as defined under Section 23A of the Federal Reserve Act) with a covered fund for which it serves as an advisor or sponsor, has organized and offered, or in which it holds an ownership interest.

- ***Covered Transactions*** – Under Section 23A, "covered transactions" include loans and extensions of credit, purchases of securities or assets, acceptance of securities of an affiliate (in this context, of a covered fund) as collateral for a loan or extension of credit, issuance of a guarantee or letter of credit on behalf of an affiliate (*i.e.* a covered fund), and securities lending/borrowing and derivative transactions that create exposure to the affiliate (*i.e.* a covered fund).

- ***Prime Brokerage Transactions*** – Notwithstanding the general prohibition on covered transactions, a banking entity (and its affiliates) may have prime brokerage transactions with a covered fund, provided that:

  (i) the CEO of the banking entity certifies annually in writing that the banking entity does not guarantee or otherwise insure the obligations or performance of the covered fund (a CEO must also update the certification following any material changes in the information provided);

  (ii) the Board of Governors has not determined that the transaction is inconsistent with the safety and soundness of the banking entity; and

  (iii) the banking entity complies with the Final Rule's limitations on investing in, or sponsoring, covered funds.

- ***Section 23B Applicability*** – All transactions between a banking entity and a covered fund (include prime brokerage transactions) are subject to the limitations set forth in Section 23B of the Federal Reserve Act (i.e. transactions must be on same terms as provided to non-affiliates).

- ***Other General Limitations*** – Even if a transaction or activity is otherwise permitted by the Final Rule, a banking entity may not enter into such transaction or activity if it:

  (i) results in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

  (ii) results in a material exposure to high-risk assets or a high-risk trading strategy; or

  (iii) poses a threat to its safety and soundness or to the financial stability of the United States.

Compliance Requirements

Although the Final Rule provides broad exemptions from the prohibitions on proprietary trading and restrictions on investing in, or sponsoring, covered funds, these exemptions are conditioned on the banking entity developing and maintaining a compliance program reasonably designed to ensure compliance with the rule. Subpart D of the Final Rule sets forth the specific compliance and reporting requirements banking entities need to satisfy to engage in permitted trading and permitted covered fund activities. For many banking entities, the most important and costly aspect of the Final Rule will be its compliance requirements.

Compliance Programs

Any entity engaged in proprietary trading or covered fund activities must have a compliance program that is "reasonably designed to ensure and monitor compliance with" the Final Rule. A compliance program must be "appropriate for the type, size, scope, and complexity of the activities and business structure of the banking entity." Thus, a compliance program must be carefully tailored to a banking entity's unique operations. Nevertheless, to facilitate compliance, the Final Rule sets forth minimum compliance standards that are scaled to a banking entity's total size and total trading assets and liabilities.

Entities with No Proprietary Trading or Covered Funds

Banking entities that do not engage in any proprietary trading or covered fund activity (other than Permitted Trading) are not required to satisfy the compliance requirements of the Final Rule until they engage in such trading or activities.

Special Rule for Banking Entities with Assets of Less Than $10 Billion

The Final Rule also seeks to minimize compliance costs for smaller banking entities with proprietary trading or covered fund activities by permitting those with consolidated assets of $10 billion or less (as reported on December 31 of the previous two calendar years) to include in their existing compliance policies and procedures provisions to address the compliance requirements mandated by the Final Rule. They need not establish a new compliance program solely to satisfy the Final Rule. Further, these banking entities are allowed to tailor their compliance programs to reflect their activities, size, scope and complexity.

General Requirements

The Final Rule specifies that any program should, at a minimum, include:

- ***Written policies and procedures*** – A banking entity's policies and procedures must "document, describe, monitor, and limit" both trading activities and covered fund activities to ensure compliance with the Volcker Rule.

- ***Internal Controls*** – A system of internal controls must be designed to monitor compliance and prevent violations of the Final Rule.

- ***Management Accountability*** – A banking entity must establish a management framework that "clearly delineates responsibility and accountability for compliance" and provides for management review of "trading limits, strategies, hedging activities, [and] investment incentive compensation" as well as any other matter requiring management attention under the Final Rule or in management's judgment.

- ***Independent Testing*** – A banking entity must "periodically" have its compliance program subjected to independent testing and auditing either by qualified personnel of the banking entity or an outside party. However, the audit need not be done by a designated auditor.

- ***Training*** – All trading personnel and managers, plus any other appropriate personnel, must be trained to implement and enforce the banking entity's compliance program.

- ***Record Retention*** – A banking entity must retain sufficient records for a period of no less than five years to demonstrate its compliance with the Volcker Rule.

Enhanced Minimum Standards

In addition to satisfying the general requirements for a compliance plan set forth above, a banking entity must also satisfy the enhanced minimum standards set forth in Appendix B of the Final Rule if it either (i) has consolidated assets equal to or greater than $50 billion; or (ii) engages in proprietary trading and is subject to the Final Rule's reporting requirements (see below).

- ***Overview*** – In general, an enhanced compliance program must (i) be reasonably designed to identify, document, monitor, and report the proprietary trading and covered fund activity of the banking entity, as well as associated risks, and to promptly address any risks or areas of noncompliance; (ii) establish and enforce limits on covered activities and investments of the banking entity; (iii) conduct periodic independent reviews and testing of the compliance program; (iv) make senior management accountable for the implementation of the compliance program and ensure that the board of directors and chief executive officer review the effectiveness of the program; and (v) facilitate supervision and examination by the Agencies of the banking entity's permitted trading and covered fund activities.

- ***Specific Requirements*** – Appendix B provides a detailed list of items that a compliance program must contain to satisfy the requirements above. Below is an overview of these requirements. Again, these requirements should be viewed as minimum requirements that need to be tailored to a banking entity's own specific operations.

  (i) Enhanced Compliance – The center of any compliance program will be the written policies and procedures that a banking entity adopts to govern its proprietary trading and/or covered fund activities to ensure compliance with the Final Rule. Appendix B provides a long list of separate requirements for compliance programs covering proprietary trading activities and covered fund activities.

1. *Proprietary Trading* – As set forth in Appendix B, an enhanced compliance program must cover the banking entity's proprietary trading activities by including: (i) written policies and procedures governing *each trading desk* containing detailed descriptions of its mission, activities, risk management requirements, and compensation arrangements; (ii) a comprehensive description of the banking entity's risk management program for its trading activity (including its supervisory structure, model review and validation processes, and process for setting and managing the risk limits for each trading desk); (iii) internal controls that are "reasonably designed" to ensure compliance with the Final Rule and the banking entity's own internal policies and procedures, including enforcing risk limits on each trading desk; (iv) written policies and procedures governing hedging instruments and strategies; (v) written policies and procedures governing the regular analysis and quantitative measurement of trading activities to ensure compliance with the banking entity's compliance program (including back testing and review of activities, limits, strategies and hedging); (vi) a description of how the banking entity monitors and prohibits material exposure to high-risk assets or high-risk trading strategies at each trading desk; and (vii) written policies and procedures to document and remedy any violations, and to notify senior management and the board of directors of material weaknesses or significant deficiencies in the compliance plan.

2. *Covered Funds* – An enhanced compliance program must also cover a banking entity's covered fund activities and investments by: (i) having a process for identifying the covered funds that are sponsored, organized, and invested in by the banking entity; (ii) identifying and documenting each unit of the banking entity permitted to hold interests in, or sponsor, covered funds; (iii) monitoring and prohibiting (a) potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties involving covered fund activities and investments, (b) covered fund activities or transactions that may threaten the safety and soundness of the banking entity or expose the banking entity to high-risk assets or high-risk trading strategies; (iv) documenting for *each organizational unit* engaged in covered fund activities its authority to engage in such activities, its plan for seeking unaffiliated investors, and how it complies with the Final Rule; (v) instituting internal controls that identify for further analysis activities that indicate potential violations of the Volcker Rule (including monitoring and limits on individual and aggregate investments); and (vi) written policies and procedures to document and remedy any violations, and notify senior management and the board of directors of material weaknesses or significant deficiencies in the compliance plan.

(ii) Responsibility and Accountability for the Compliance Program – A banking entity must also have a governance and management framework to prevent violations of the Final Rule.

1. *Corporate Governance/Board of Directors* – The board of directors (or an appropriate committee of the board) and senior management of the banking entity must approve the written compliance program. The board is also responsible for setting and communicating an "appropriate culture of compliance" and ensuring that senior management is "fully capable, qualified, and properly motivated" to oversee compliance. This includes making sure that senior management have "appropriate incentives and adequate resources to support compliance." Senior management should also report to the board at least annually on the effectiveness of the compliance program.

2. *Management Procedures* – The banking entity must establish written procedures that describe the specific responsibilities of managers for each trading desk and organizational unit engaged in covered fund activities, as well as the compensation arrangement for traders. The compensation of traders cannot reward or incentivize proprietary trading or encourage excessive or imprudent risk. Managers responsible for trading desks must also be accountable for the enforcement of the banking entity's compliance program.

3. *Senior Management* – The banking entity's senior management must be responsible for implementing, enforcing, and regularly reviewing the compliance program and for ensuring that any compliance failures are corrected.

4. *CEO Attestation* – The CEO of the banking entity must annually attest in writing that, as required by

the Final Rule, it "has in place processes to establish, maintain, enforce, review, test, and modify the compliance program . . . in a manner reasonably designed to achieve compliance."

(iii) Independent Testing – The banking entity must conduct independent testing of its compliance program that includes a review of the adequacy and effectiveness of its internal controls and an analysis and documentation of any breaches. The testing can be conducted by the banking entity's internal audit department, compliance personnel outside the unit being tested, or other qualified independent parties

(iv) Training – A banking entity must regularly provide adequate training for all personnel and managers who engage in trading and covered fund activities.

(v) Recordkeeping – A banking entity must retain sufficient documentation to demonstrate compliance for no less than five years unless a longer period is required by a financial regulator.

Reporting Requirements for Proprietary Trading

The Final Rule also imposes reporting requirements on banking entities with significant trading operations. The reporting requirements generally apply at the *trading desk level*, rather than the entity level. As a result, banking entities will potentially have to collect and track data from multiple units within their operations.

The reporting requirements become effective on **June 30, 2014** for banking entities with $50 billion or more in trading assets and liabilities; on **April 30, 2016** for banking entities with at least $25 billion, but less than $50 billion, in trading assets and liabilities; and on **December 31, 2016** for banking entities with at least $10 billion, but less than $25 billion, in trading assets and liabilities.

These measures should be viewed as the minimum amount of data that a banking entity should collect as the Final Rule states that banking entities may require other information in order to effectively monitor their compliance. Indeed, the Final Rule indicates that quantitative measures should be designed based on each trading desk's unique activities, including the instruments traded, trading strategies, history, and experience.

Furthermore, banking entities are required to conduct an ongoing review and evaluation of all quantitative measures (mandated and otherwise). In the event that any measurement indicates a "heightened risk of impermissible trading" or "material exposure to high-risk assets or trading strategies," the banking entity is required to escalate the results for review and analysis, provide an explanation to the appropriate regulatory agency, and engage in remediation.

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