

Volcker Rule: An Initial Look at Significant Changes

On December 10, 2013 the US federal banking agencies,¹ along with the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) (collectively, the Agencies), adopted the long-awaited and much-anticipated final regulations (the Final Rule) that implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), commonly referred to as the “Volcker Rule”². The Volcker Rule is a key component of the US financial reform effort under the Dodd-Frank Act, and represents perhaps the most significant changes in US financial regulation in decades.

This *Client Alert* provides an initial look at noteworthy changes made in the Final Rule. Over the coming weeks, Latham & Watkins will be publishing a series of additional *Client Alerts* which will explore key aspects of the Final Rule in detail.

Background

The adoption of the Final Rule comes almost three-and-a-half years after the enactment of the Dodd-Frank Act and more than two years after the proposed regulations implementing the Volcker Rule (the Proposed Rule) were issued. The Final Rule itself is 71 pages, and was accompanied by a “Supplementary Information,” or preamble, of almost 900 pages with nearly 2,900 footnotes.

The structure of the Final Rule is similar to that of the Proposed Rule. However, the Final Rule contains a number of significant changes that affect the scope of the rule in a number of important ways. Many of the most problematic provisions in the Proposed Rule have been addressed in the Final Rule. However, many aspects of the Final Rule appear problematic for financial institutions — including their affiliated broker-dealers, asset managers, swap dealers, and sponsored funds — who are subject to the rule. Among other things, the principles-based approach taken in many areas of the Final Rule will present significant challenges for affected institutions to determine with certainty whether activities are within the parameters of permitted activities under the Final Rule. To satisfy the requirements of the various exemptions to the Final Rule and implement the extensive compliance programs — including detailed recordkeeping and reporting requirements — will require significant resources from affected institutions. Also, given the overlapping jurisdictional authority, the Agencies’ priorities and interpretive approaches may not be consistent or coordinated. Much of the impact of the Final Rule will not become apparent until financial institutions and the Agencies apply and implement the Final Rule over the coming months and years.

The Volcker Rule became effective by statute in July 2012, with a two-year conformance period, ending July 2014. However, the Federal Reserve Board has exercised its powers under the Dodd-Frank Act and extended the statutory conformance period by one year, until July 21, 2015. The Final Rule becomes effective on April 1, 2014, and certain recordkeeping and reporting obligations commence for the largest

banks in June 2014. We note that banking entities are already required to use good-faith efforts to comply with the statutory provision. Non-compliant investments are not grandfathered by the Final Rule.

Who is Covered by the Final Rule?

Like the Proposed Rule, the Final Rule applies to any “banking entity,” which includes:

- Any insured depository institution;
- Any company that controls an insured depository institution;
- Any foreign bank that is, or is treated as, a bank holding company under the International Banking Act of 1978; and
- Any affiliate or subsidiary of any of the above.

As in the Proposed Rule, the definition of banking entity under the Final Rule also specifically excludes any “covered fund” that is not itself a banking entity. The Final Rule also added some new exclusions, including (i) any portfolio company held under the merchant banking or insurance company investment authority of the Bank Holding Company (BHC) Act that is not itself a banking entity, and certain small business investment company portfolio concerns and (ii) the Federal Deposit Insurance Corporation (FDIC) acting in its corporate capacity or as conservator or receiver.

What is Covered by the Final Rule?

The Final Rule generally prohibits any banking entity from: (i) engaging in proprietary trading or (ii) acquiring or retaining an ownership interest in or sponsoring a covered fund, except as permitted by the Final Rule.

Proprietary Trading

Key Definitions and Concepts

Proprietary Trading and the Trading Account

The Final Rule retains the Proposed Rule’s overall approach, which prohibits all forms of “proprietary trading,” unless the trading is a “permitted activity,” as outlined below. The Final Rule defines “proprietary trading” as engaging as a principal for the “trading account” of a banking entity in any purchase or sale of one or more “financial instruments.”

A “trading account” is any account used by a banking entity that meets any of the following tests:

- The trading account is used to take positions for short-term resale of the financial instrument, to benefit from short-term price movements or to realize short-term arbitrage profits;
- The account is that of a US or foreign dealer, swap dealer or security-based swap dealer; or
- The account is used for transactions in financial instruments that receive certain treatment under the banking agencies’ market risk capital rules.

The Final Rule retains the rebuttable presumption that any purchase or sale of a financial instrument that is held for 60 days or less is presumed to be proprietary trading. The Final Rule expands this presumption to also cover a financial instrument if the banking entity “substantially transfers” the risk of the financial instrument within 60 days of the purchase or sale. However, the Agencies declined to adopt the converse of this presumption in the Final Rule. In other words, a purchase or sale of a financial instrument that is held for more than 60 days does not necessarily mean it is not proprietary trading.

The types of instruments covered by the proprietary trading prohibition remain the same under the Final Rule. “Financial instruments” include any security, derivative (including any swap, security-based swap, physical commodity forward, foreign exchange forward, and foreign exchange swap, subject to certain exceptions), commodity future, and option on a security, derivative or futures product. “Financial instrument” does not include a loan, a spot foreign exchange instrument or a spot physical commodity instrument.

Like the Proposed Rule, the Final Rule excludes repo and reverse repo transactions, securities borrowing and lending transactions, certain liquidity management activities, transactions as broker, agent or custodian, and certain clearing activities from the definition of proprietary trading. The Final Rule also adds a number of additional exclusions, including:

- Transactions to satisfy existing delivery obligations of the banking entity or its customers;
- Transactions to satisfy an obligation in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding;
- Transactions through a deferred compensation, stock bonus, profit sharing or pension plan; and
- Transactions in the ordinary course of collecting a debt previously contracted.

Permitted Activities

The Final Rule identifies a number of trading activities that, subject to numerous conditions, are permitted, notwithstanding the general prohibition on proprietary trading. The ability to engage in any of these permitted activities, however, is in most cases subject to extensive compliance obligations that will require significant time and resources to develop and implement. Although not discussed herein, the Final Rule also permits certain trading activities by insurance companies and trading on behalf of customers.

Underwriting Activities

In an approach largely consistent with the Proposed Rule, the Final Rule provides an exemption from the prohibition on proprietary trading for certain activities involved in an underwriting — to the extent such activities are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties. The Final Rule provides for a broader range of permitted securities offerings, but it imposes much more substantial compliance obligations. Some of the important changes to the underwriting exemption include:

- Adoption of an “underwriting position” concept, rather than a transaction-by-transaction approach. The focus is the underwriting position managed by a particular “trading desk,” which is defined as the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate.
- Expansion of the concept of what constitutes a “distribution” to include any offering of securities, whether or not subject to registration, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods. The Final Rule eliminates the magnitude of the offering as a criterion for a distribution.
- Clarification of the definition of “underwriter” to include members of an underwriting syndicate and selling group members.
- Elimination of the requirement that the activities generate revenue from fees, commissions, spreads or other income not attributable to the value of the financial instrument or related hedge.
- Elimination of the requirement that a transaction be effected “solely” in connection with a distribution, allowing for a broader scope of permissible activities, such as stabilization activities, syndicate shorting, aftermarket short covering and holding an unsold allotment under certain conditions.

- Addition of an obligation to make reasonable efforts to sell or otherwise reduce an underwriting position within a “reasonable period,” taking into account the liquidity, maturity and depth of the market for the security.

While the Final Rule sought to broaden the underwriting exemption of the Proposed Rule in several respects, before a banking entity can engage in such underwriting activities, a banking entity must implement a compliance program including: written policies and procedures, internal controls, as well as analysis and independent testing relating to the underwriting activities at the level of each relevant trading desk, appropriately tailored to the individual trading activities and strategies of such desk. In addition, compensation arrangements must not be designed to reward or incentivize prohibited proprietary trading. Hedging the underwriter’s risk exposure is not permitted under the underwriting exemption. A banking entity must separately comply with the hedging exemption for such activity.

Market-making Activities

Like the Proposed Rule, the Final Rule provides for an exemption from the proprietary trading prohibition for transactions in connection with market-making activities. In an approach generally consistent with the Proposed Rule, the Final Rule’s market-making exemption requires that the amount, types, and risks of the financial instruments in the trading desk’s market-maker inventory be designed not to exceed — on an ongoing basis — the reasonably expected near-term demands of clients, customers, or counterparties, based on certain market factors and analysis.

The Final Rule establishes particular criteria for the market-making exemption rather than incorporating the commentary in Appendix B of the Proposed Rule regarding identification of permitted market-making related activities. The Final Rule introduces some new or revised criteria, including the requirement that the trading desk “routinely stands ready” to trade and is “willing and available” to quote or trade “throughout market cycles.” The Agencies also made substantive refinements to this exemption compared to the Proposed Rule in an effort to permit banking entities to continue to provide intermediation and liquidity services across markets and asset classes, subject to backstop provisions (discussed below) and implementation of the Final Rule’s extensive compliance, monitoring, recordkeeping and reporting requirements. Banking entities will incur significant compliance costs in connection with their market-making related activities under the Final Rule.

Some of the important modifications to the market-making exemption in the Final Rule include:

- A focus on the overall “financial exposure” and “market-maker inventory” of the trading desk, rather than a trade-by-trade analysis. “Financial exposure” reflects the aggregate risks of the financial instruments, and associated loans, commodities, foreign exchange or currency held by a banking entity or its affiliate and managed by a particular trading desk. The “market-maker inventory” means all of the positions in the financial instruments for which the trading desk stands ready to make a market.
- An emphasis on the activities of each trading desk, which shifts the focus from the desk’s organizational status to a focus on the desk’s operational functionality. A trading desk’s financial exposure may include positions that are booked in different legal entities.
- Imposition of enhanced compliance obligations on each trading desk, including a documented approval process, and established authorization and escalation procedures for any changes.
- A requirement that banking entities must take into account the liquidity, maturity and depth of the market for a particular financial instrument, as well as an analysis of historical customer demand, current inventory and other market factors.

- Elimination of the requirement that a trading desk's market-making related activities be designed to generate revenue primarily from fees, commissions, spread or other income not attributable to appreciation in the value of a financial instrument or related hedging.
- In addition, the Final Rule does not require market-making related hedging activities to separately comply with the hedging exemption, if conducted by the trading desk engaged in the market-making activity. On the other hand, hedging by a different organizational unit must separately comply with the hedging exemptions, including the related documentation requirements.

Risk-mitigating Hedging Activities

The Final Rule adopts the hedging exemption as contained in the Proposed Rule with a number of modifications, which include that the banking entity's hedging activity must be:

- Designed at inception to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates specific, identifiable risks;
- Designed to determine at the inception of the hedging activity whether the activity or the strategy is risk-reducing or mitigating, including through the use of correlation analysis;
- Subject to continuing review, monitoring and management; and
- Implemented, maintained and enforced by a robust and appropriate internal compliance program, including relevant escalation procedures.

Additionally, the Final Rule requires that hedging activities must not give rise to significant new risks that are left unhedged or involve compensation arrangements designed to reward or incentivize persons performing risk-mitigating hedging activities to engage in prohibited proprietary trading.

The Final Rule retains the language from the Proposed Rule that permits hedging of "aggregated" as well as "individual" risks. Accordingly, some forms of portfolio hedging are permitted. However, in the preamble to the Final Rule, the Agencies outline some categories of portfolio hedging that are not permitted.

The Final Rule, like the Proposed Rule, permits dynamic hedging, subject to compliance with the above listed requirements. The Final Rule also does not prohibit anticipatory hedging, and while the timing of such activity is no longer required to be "slightly" before the risk is assumed, such hedging is subject to recalibration if the rationale or reason for the hedge is altered.

Trading in US Government, Agency and Municipal Obligations

The Final Rule is generally consistent with the Proposed Rule with respect to trading in US government obligations. The Final Rule confirms that an obligation guaranteed by the US or an agency thereof is an obligation of such entity. Accordingly, the prohibition on proprietary trading does not apply to obligations issued *or guaranteed by* the US government, US government agencies, or individual states and their political subdivisions, including municipalities. The Final Rule additionally exempts obligations of the FDIC or any entity formed by the FDIC to dispose of assets held by the FDIC in its corporate capacity or as conservator or receiver. Like the Proposed Rule, trading in derivatives on US government obligations is not covered by the exemption for US government obligations.

Trading in Foreign Government Obligations

The Proposed Rule did not contain an exemption for trading in obligations of foreign sovereign entities. However, the Final Rule allows this in two circumstances. First, the US operations of any foreign banking entity that is not controlled by a US banking entity are permitted to engage in proprietary trading in the US in the sovereign debt of the banking entity's home country (and any multinational central bank of which the home country is a member), so long as the trade is not made by a US insured depository institution.

The Final Rule also permits a non-US bank or non-US broker-dealer regulated as a securities dealer and controlled by a US banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized, including obligations of an agency or political subdivision of that foreign sovereign.

The Final Rule does not permit proprietary trading in derivatives on foreign government obligations.

Non-US Trading Activities by Foreign Banking Entities

The Proposed Rule permitted non-US banking entities to engage in trading activities conducted “solely outside the United States” (the SOTUS Exemption). In the Proposed Rule, the Agencies took a mechanical, transaction-based approach to the SOTUS Exemption, requiring, among other things, that (i) no party to the transaction be a resident of the United States, and (ii) the transaction be “executed wholly outside of the United States.” This approach appeared to only provide non-US banking entities with a very narrow exemption under which they could conduct non-US trading activities, and the exemption appeared to preclude the use of any US financial markets, exchanges, market intermediaries or market utilities.

Recognizing the potential adverse impacts and unintended consequences of the Proposed Rule’s transaction-based approach, the Agencies have taken more of a risk-based approach to the exemption for non-US trading by foreign banking entities in the Final Rule. Rather than a mechanical test, the Final Rule focuses more on such factors as where the risks are being taken by the foreign banking entity and where decisions are being made regarding the trading activities. Under the Final Rule, a foreign banking entity that (i) is not controlled by a US banking entity and (ii) meets the requirements for a qualified foreign banking organization (QFBO) under the Federal Reserve’s Regulation K, may engage in proprietary trading activities subject to satisfaction all of the following conditions:

- The entity engaging in the transaction (including any personnel of the entity or its affiliate that arrange, negotiate or execute the transaction) is not organized or located in the US;
- The decision to engage in the transaction is made outside of the US;
- The transaction (including any related hedges) is not booked in any US branch or affiliate of the foreign banking entity; and
- No financing for the transaction is provided for by any US branch or affiliate of the foreign banking entity.

Also, in a significant change from the Proposed Rule SOTUS Exemption’s requirement that no party to a transaction be a resident of the United States, the Final Rule permits a foreign banking entity to engage in proprietary trading transactions with or through a US entity if (i) the transaction is with the foreign operations of a US entity and (ii) no personnel of the US entity located in the US are involved in arranging, negotiating or executing the transaction. The Final Rule also permits a foreign banking entity to conduct trades with an unaffiliated US market intermediary (*i.e.*, US broker-dealer, swap dealer, security-based swap dealer or futures commission merchant) in the following circumstances:

- Any trade with the unaffiliated US intermediary acting as principal, if the trade is promptly cleared and settled; and
- Any trade with the unaffiliated US intermediary acting as agent, if the trade is conducted anonymously on an exchange and promptly cleared and settled.

Backstop Provisions

The Final Rule retains, substantially as proposed, the Proposed Rule’s provisions implementing the statutory “backstops” that prohibit otherwise permitted proprietary trading that would involve a material

conflict of interest, pose a threat to the safety and soundness of the banking entity, or pose a threat to the financial stability of the United States.

Covered Funds

The Final Rule retains the overall structure of the Proposed Rule by generally prohibiting banking entities from investing in, sponsoring and, in certain cases, having certain relationships with, “covered funds,” subject to a number of exclusions and permitted activities.

What is a “Covered Fund”?

The Final Rule clarifies and somewhat narrows the definition of “covered fund” that was included in the Proposed Rule. The Final Rule defines a “covered fund” to include the following:

- Any issuer that would be an investment company under the Investment Company Act of 1940 but for Section 3(c)(1) or Section 3(c)(7);
- Any “commodity pool” as defined under the Commodity Exchange Act for which the commodity pool operator has an exemption under CFTC Rule 4.7 or a commodity pool that meets certain other specified requirements; and
- Any foreign fund offered and sold solely outside the US, but only to the extent that a banking entity that is, or is directly or indirectly controlled by a US entity which has sponsored or invested in that fund, and then only with respect to the US banking entity sponsoring or making the investment (and its affiliates).

The Proposed Rule had included in the definition of “covered fund” any foreign funds that, if subject to US securities laws, would have been required to rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. The Final Rule eliminates that prong. Accordingly, with respect to sponsorship or investments by foreign banking entities, foreign funds that are not offered in the US and, therefore, are not required to rely on Section 3(c)(1) or 3(c)(7), are no longer “covered funds” under the Final Rule.

Exclusions From the Definition of “Covered Fund”

Where the Proposed Rule provided exemptions that would have allowed banking entities to engage in a narrow range of otherwise prohibited activities with certain types of covered funds, while leaving in place other prohibitions with respect to those funds, the Final Rule provides complete exclusions from the definition for a number of types of entities, including the following (each subject to certain conditions):

- Foreign public funds;
- Wholly owned subsidiaries;
- Joint ventures;
- Acquisition vehicles;
- Foreign pension or retirement funds;
- Insurance company separate accounts;
- Bank owned life insurance;
- Loan securitizations;
- Qualifying asset-backed commercial paper conduits;
- Qualifying covered bonds;
- Registered investment companies;
- Entities that can rely on an exclusion or exemption from the definition of “investment company” other than Section 3(c)(1) or Section 3(c)(7);
- Entities that have elected to be regulated as business development companies;
- Small business investment companies and public welfare investment funds; and
- Issuers formed for the purpose of FDIC receivership/conservatorship.

The list of exclusions is not exhaustive, and the Agencies have discretionary authority to add or remove an exclusion. The Agencies declined in the Final Rule to provide requested exclusions for certain types of vehicles, such as venture capital funds and tender option bond structures for municipal securities.

What is an “Ownership Interest”?

In contrast to the Proposed Rule, which specified the types of instruments that would qualify as an ownership interest, the Final Rule identifies characteristics that would cause a particular interest — regardless of the name or legal form of that interest — to be included within the definition of ownership interest. As a result, many securities that have “equity-like” aspects — as defined by the Agencies — but that the market considers to be debt are swept up in the Final Rule.

The Final Rule provides that an “ownership interest” consists of any equity, partnership or other similar interest in a covered fund. “Other similar interest” is further defined to include an interest that:

- Has the right to select or remove a covered fund’s general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (excluding creditors’ rights to exercise remedies in certain circumstances);
- Has the right under the terms of the interest to receive a share of the covered fund’s income or profits;
- Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding creditors’ rights to exercise remedies in certain circumstances);
- Has the right to receive all or a portion of excess spread;
- Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund;
- Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or
- Is the synthetic right to have, receive or be allocated any of the rights above.

As in the Proposed Rule, an ownership interest does not include the carried interests of fund managers or advisors and their personnel. In the Final Rule, the term “carried interest” has been replaced with the term “restricted profit interest,” and there are several restrictions on such interest, including:

- The only purpose and effect of the interest is to allow the manager/advisor or its employees to share in the profits of the covered fund as performance compensation for the advisory services provided to the covered fund by the holder of the interest, provided that the interest may be subject to clawback;
- All such profit, once allocated, is distributed to the holder of the entity promptly after being earned (the profit may be held in a reserve account to cover future losses, but cannot share in subsequent investment gains);
- Any amounts invested in the covered fund in connection with obtaining the restricted profit interest are within the per-fund and aggregate investment limits set forth in the Final Rule; and
- The interest is not transferable by its holder except to affiliates, in connection with a sale of the business that gave rise to the interest, or in other limited circumstances.

The Final Rule clarifies that the restrictions on acquiring or retaining an ownership interest in a covered fund apply only when the banking entity is taking on investment exposure as principal. Thus, a banking entity may acquire or retain an ownership interest in a covered fund where it is acting:

- Solely as agent, broker or custodian on behalf of a customer and where the banking entity does not have a beneficial interest;
- Through a deferred compensation, stock-bonus, profit-sharing or pension plan of such banking entity as trustee for the benefit of the banking entity's employees;
- In the ordinary course of collecting a debt previously contracted in good faith, subject to certain requirements; or
- On behalf of a customer as trustee or in a similar fiduciary capacity for a customer that is not a covered fund and where the banking entity does not have a beneficial interest.

Permitted “Organizing and Offering” and “Sponsoring”

Under the Proposed Rule, a banking entity was permitted to organize and offer a covered fund, including generally acting as a “sponsor” of the fund, provided a number of conditions were met — primarily that such fund was organized and offered in connection with the provision by the banking entity of bona fide trust, fiduciary or investment advisory services to its customers. The Final Rule retains an exemption for organizing and offering funds consistent with the Proposed Rule. Additionally, the Final Rule adopts a substantially similar definition of “sponsor,” with some clarifications and modifications related to trustees without investment discretion. Under the Final Rule, a banking entity will be deemed to “sponsor” a covered fund if the banking entity:

- Serves as a general partner, managing member or trustee of a covered fund, or serves as a commodity pool operator of a covered fund;
- In any manner selects or controls the majority of the directors, trustees or management of a covered fund; or
- Shares the same name or a variation of the same name with the covered fund — whether for corporate, marketing, promotional or other purposes.

As noted above, in general, a banking entity may only invest in the ownership interests of a fund that the banking entity or one of its affiliates has organized and offered, and may only sponsor a covered fund, if the banking entity provides bona fide trust, fiduciary, investment advisory or commodity advisory services and the covered fund is organized and offered only in connection with providing such services to customers of the banking entity. The Agencies have confirmed in the Final Rule that a person can become a customer in connection with investing in the covered fund.

Other requirements and conditions in the Final Rule for organizing and offering (including sponsoring) a covered fund are largely the same as in the Proposed Rule. Among other things, the banking entity and its affiliates cannot directly or indirectly guarantee, assume or otherwise insure the obligations of the covered fund or any covered fund in which the banking entity invests. Also, the covered fund cannot share the name or a variation of the name of the banking entity or an affiliate. Additionally, the banking entity must provide certain specific disclosures to investors in the covered fund.

Organizing and Offering an Issuer of Asset-Backed Securities

The Final Rule provides a new exemption to permit banking entities to organize and offer (including sponsor) issuers of asset-backed securities, subject to most of the conditions and requirements set forth above in connection with permissible organizing and offering covered funds. The exemption for issuers of asset-backed securities excludes the requirement to act as a bona fide trust, fiduciary, investment advisory or commodity trading advisory provider when organizing and offering a covered fund that is an issuing entity of asset-backed securities. The per-fund and aggregate investment limits set forth in the Final Rule (discussed below) are applicable to any ownership interests acquired in connection with organizing and offering a covered fund that is an asset-backed securities issuer. Such limits, however,

have been modified in the Final Rule to permit compliance with risk retention requirements under Section 15G of the Securities Exchange Act of 1934.

Underwriting and Market-Making Activities

The Proposed Rule did not provide an exemption for underwriting or market-making of ownership interests in a covered fund. The Final Rule has been modified to expressly allow underwriting and market-making-related activities with respect to ownership interests in covered funds, provided that such activities are conducted in compliance with the Final Rule's exemptions from the proprietary trading restrictions. In addition, any ownership interests in a covered fund held by a banking entity pursuant to permissible underwriting or market-making activities must be counted towards the aggregate investment limit, and in some cases the per-fund investment limit, discussed below. In addition, such interests are subject to the capital deduction requirement under the Final Rule.

Permitted Ownership of Organized and Offered Funds

As in the Proposed Rule, the Final Rule permits a banking entity to acquire and retain limited ownership interests in covered funds that the banking entity or an affiliate has organized or offered in accordance with the requirements of the Final Rule (described above), subject to two ownership limits. First, the investments of the banking entity and its affiliates in any covered fund generally must comply with a per-fund limit of three percent of the total outstanding ownership interests of any individual fund. Additionally, the aggregate value of all ownership interests of the banking entity and its affiliates in all such covered funds must comply with an aggregate limit of three percent of the banking entity's Tier 1 capital. In addition to these investment limits, the Final Rule also retains the Proposed Rule's requirement that a banking entity deduct the aggregate value of ownership interests in such covered funds from its calculation of regulatory capital.

While retaining the three percent per-fund and aggregate investment limits and the capital deduction requirement, the Final Rule contains some significant modifications related to these requirements. Similar to the Proposed Rule, under the Final Rule a banking entity or its affiliates may provide seed capital to establish a covered fund which the banking entity organizes and offers while the fund seeks unaffiliated investors, and the banking entity may retain a *de minimis* investment in such a fund that may not exceed three percent of the total number or value of the outstanding ownership interests of the fund at any time after one year from the date the fund is established. The Final Rule maintains the one-year seeding period, but clarifies the determination of the date on which the fund is established.

The Final Rule also now permits a banking entity to retain more than three percent in an asset-backed securities vehicle if required to do so under Section 15G of the Exchange Act, which mandates retention of risk by certain securitizers.

Among other important changes, the Final Rule provides for special valuation rules for master-feeder fund structures and fund-of-funds investments. The Final Rule also clarifies and simplifies the requirements for attribution of certain fund investments to a banking entity for purposes of calculating the investment limits. For example, the Final Rule simplifies the calculation of the per-fund investment limit by largely eliminating the Proposed Rule's *pro rata* test for certain noncontrolled investments. In addition, the Final Rule no longer requires attribution of certain parallel investments, while attribution of ownership interests held by directors and employees of a banking entity are attributed to the banking entity for purposes of the investment limitations only if the banking entity financed the purchase of such interests. The Final Rule also clarifies the methods for calculating the aggregate investment limit and the regulatory capital deduction. Calculation methods for foreign banking entities are also clarified in the Final Rule.

Other Permitted Activities

The Final Rule modifies some of the permitted activities that were included in the Proposed Rule. Some of the more significant changes relate to the exemptions for risk-mitigating hedging activities and covered fund activities and investments outside the US. Although not addressed below, the Final Rule retains and modifies the Proposed Rule's exemption for insurance companies' investments in and sponsorship of covered funds, subject to certain conditions.

Risk-Mitigating Hedging Activities

The Final Rule significantly narrows the scope of permissible risk-mitigating hedging activities involving ownership interests in covered funds and does not adopt the proposed exemption for using ownership interests in covered funds to hedge against the economic risks of certain transactions. Risk-mitigating hedging is permitted under the Final Rule only in connection with compensation of an employee who provides advisory or other services to the covered fund. Even with the significantly narrowed scope, additional restrictions apply, including those similar to the conditions for the hedging exemption from the prohibition on proprietary trading.

Covered Fund Activities and Investments Outside the US

The Final Rule retains the Proposed Rule's SOTUS Exemption, which permitted foreign banking entities to invest in and sponsor covered funds "solely outside the United States," subject to certain conditions. The SOTUS Exemption has been modified from the Proposed Rule in a number of ways intended to clarify the scope of the exemption. In particular, the Final Rule adopts a risk-based approach to implementing the exemption (as opposed to the Proposed Rule's transaction-based approach) in order to ensure that the principal risks of covered fund investments and sponsorship by foreign banking entities that is permitted under the SOTUS Exemption only occur and remain outside of the US.

One of the key requirements of the SOTUS Exemption under the Proposed Rule provided that a covered fund — in which a foreign banking entity sought to invest or sponsor — not be offered for sale to a resident of the United States. The Final Rule retains that key requirement but clarifies that such requirement is satisfied if ownership interests in the covered fund are or have been sold pursuant to an investment that does not *target* residents of the United States. Also, the Final Rule aligns the definition of "resident of the United States" with the definition of "US person" under the SEC's Regulation S.

The Final Rule also clarifies that to qualify for the SOTUS Exemption, the foreign banking entity (including relevant personnel) that makes the decision to sponsor or invest in the covered fund must not be located in the US. However, the Final Rule permits US personnel of a foreign banking entity to (i) engage in "back office" activities with respect to a covered fund and (ii) act as investment adviser to a covered fund in certain circumstances. Other requirements under the revised SOTUS Exemption include:

- The investment in or sponsorship of the covered fund (including any related risk-mitigating hedging transaction) cannot be accounted for as principal directly or indirectly on a consolidated basis by any US branch or affiliate of the banking entity; and
- No financing for the banking entity's investment or sponsorship is provided by any US branch or affiliate of the banking entity.

Notwithstanding that the scope of the SOTUS Exemption has been clarified in the Final Rule, the Agencies have noted that both the modification to the foreign funds prong of the covered fund definition and the exclusion of foreign public funds and foreign pension or retirement funds from such definition will have the likely effect of limiting the Rule's extraterritorial application. The exclusion of certain non-US funds from the definition of "covered fund" for foreign banking entities appears to significantly diminish the need for the SOTUS Exemption for foreign banking entities.

Super 23A

The Final Rule retains the Proposed Rule's so-called "Super 23A" provision, which prohibits a banking entity that acts as investment adviser or sponsor to a covered fund from entering into any transaction with such fund that would be a "covered transaction" for purposes of Section 23A of the Federal Reserve Act (which includes, among other things, loans and extensions of credit to the covered fund and purchases of assets from the covered fund). However, the new exclusions from the definition of "covered fund" under the Final Rule (discussed above) have served to reduce the scope of the Super 23A provision.

Backstop Provisions

As with the proprietary trading backstop provisions, the Final Rule also retains the Proposed Rule's provisions implementing the statutory "backstops" that prohibit otherwise permitted sponsoring or investing in covered funds that would involve a material conflict of interest, pose a threat to the safety and soundness of the banking entity or pose a threat to the financial stability of the United States.

Compliance Requirements

Compliance Program

The Final Rule retains the compliance program requirement initially described in the Proposed Rule, but with a number of modifications designed to tailor the requirements to the size, complexity and type of activity conducted by each banking entity. Banking entities that do not engage in any of the proprietary trading or fund-related activities covered by the Final Rule (other than trading in US government obligations) are not required to establish any formal Volcker Rule compliance program. Banking entities with total assets of \$10 billion or less that engage in some covered activities can fold compliance measures related to the Final Rule into their existing compliance programs. Banking entities with total consolidated assets greater than \$10 billion but less than \$50 billion are generally required to establish a compliance program which includes the six elements outlined in the Final Rule (which are substantially similar to the requirements under the Proposed Rule).

Enhanced Minimum Standards for Compliance Programs

Any US banking entity with *total assets* of \$50 billion or more (or a foreign banking entity with *total US assets* of \$50 billion or more) or any banking entity that is required to report proprietary trading metrics (as discussed below) will be subject to enhanced compliance requirements outlined in Appendix B of the Final Rule in addition to the basic compliance program requirements. Also, any banking entity that is so notified by its primary federal supervisory agency must satisfy the enhanced compliance requirements.

CEO Attestation

The Final Rule additionally requires the CEO of a banking entity that is subject to the enhanced compliance requirements in Appendix B to annually attest in writing that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the banking entity's compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule, as implemented by the Final Rule. For US branches or agencies of foreign banking entities, the senior US management officer may provide the attestation for the entity's entire US operations.

Reporting Requirements

Beginning on June 30, 2014, any US banking entity with trading assets and liabilities of \$50 billion or more or any foreign banking entity with trading assets and liabilities of its combined US operations of \$50 billion or more (in both cases, excluding certain US government obligations) that is engaged in proprietary trading activity must also satisfy a number of reporting requirements involving seven specified metrics

related to its trading activities. The number of required metrics has been reduced from 17 under the Proposed Rule. The threshold for the reporting requirements is reduced to \$25 billion beginning on April 30, 2016, and to \$10 billion on December 31, 2016.

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¹ The Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC).

² Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (the BHC Act) (codified at 12 U.S.C. 1851).