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Volcker Rule Alert

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The Volcker Rule Handbook: A Detailed Look at the Final Rule Implementing Section 619 of the Dodd-Frank Act

Three and a half years after passage of the Dodd-Frank Act,[1] the much anticipated final Volcker Rule has been issued. On December 10, 2013, the federal banking regulators, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies") issued a final rule ("Final Rule")[2] to implement Section 13 of the Bank Holding Company Act of 1956 ("BHCA"), which was added by Section 619 of the Dodd-Frank Act.[3] Section 13 of the BHCA generally prohibits any "banking entity" from engaging in "proprietary trading" or from acquiring or retaining an "ownership interest" in or "sponsoring" a hedge fund or private equity fund. The Final Rule largely follows the structure of the rule the Agencies initially proposed,[4] but also contains several important modifications.

The Final Rule will be effective on April 1, 2014. However, in a separate order, the Board extended until July 21, 2015 the period banking entities will have to conform their activities to the new requirements,[5] although certain new reporting requirements will begin for the largest banking entities as early as July 2014. This memorandum discusses the Final Rule and how it has changed from the Proposal, and also identifies numerous interpretive issues the Final Rule raises for banking entities and other market participants. As banking entities continue to analyze the Final Rule, we expect additional interpretive issues to emerge.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013). The Final Rule is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf. The Board, OCC, FDIC and SEC issued a joint release to accompany the Final Rule, which is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf. All page numbers in this memorandum refer to the joint release ("Release"). The CFTC issued a separate largely identical release ("CFTC Release") which is available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121013.pdf.
[3] The federal banking agencies are the Federal Reserve Board ("Board"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Insurance Deposit Corporation ("FDIC").
[4] Proposed Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011) ("Proposed Rule" or "Proposal").
[5] Federal Reserve System, Order Approving Extension of Conformance Period (Dec. 10, 2013) ("Order Extending Conformance Period"), available at http://federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

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I. Executive Summary

Notwithstanding the Board's extension of the conformance period for compliance with the Volcker Rule until July 21, 2015, there is significant uncertainty as to what actions banking entities and other market participants with whom they transact might have to take in the near term to ready themselves for compliance. Although the Final Rule does not contain a mechanism for seeking Agency guidance, we nevertheless expect that as banking entities continue to grapple with the complexity of the Final Rule, new interpretive issues and identification of potentially unintended consequences will emerge that may prompt the Agencies to take further action, in the form of guidance, additional time extensions, or other action.

A. Highlights

The Final Rule modifies the Proposal's general prohibition that compensation in connection with exempted activities not be designed to reward "proprietary risk taking." Instead, in response to comments, the Final Rule requires that compensation not be designed to reward or incentivize prohibited proprietary trading.

In response to comments, the Agencies carved out several critical traditional investment structures used by banking entities from the definition of "covered fund," and thus from the scope of the covered fund prohibitions altogether. The Proposal had created exemptions for many of these structures, *e.g.*, loan securitizations and certain joint ventures, but those definitions were more narrowly drawn and also left these structures subject to certain of the Volcker Rule's restrictions, such as the prohibitions on material conflicts of interest and high-risk assets and trading strategies and the restrictions under Sections 23A and 23B of the Federal Reserve Act.

However, the Final Rule does not contain an exclusion for venture capital funds because the Agencies determined that they share many of the same defining characteristics as private equity funds.

The Agencies had taken the view in the Proposal that the Volcker Rule's statutory exemptions, for example, for market making, underwriting, risk-mitigating hedging, and insurance activities, applied only to the proprietary trading prohibition and not to the covered fund prohibition. Responding to numerous comments to the effect that the statute clearly intended for these exemptions to apply to both types of prohibitions, the Final Rule extends these exemptions to sponsoring or holding ownership interests in covered funds.

The Final Rule more appropriately "accommodate[s] the business of insurance," as directed by the statute, by extending the exemption from the proprietary trading prohibition from a regulated insurance company's activities in its general account to include activities in separate accounts as well.

As for activities "solely outside of the United States," the Final Rule construes this exemption narrowly. We continue to analyze the potential effects of these cross-border provisions.

B. Market-Making Exemption

The Agencies' overall approach to the final market-making exemption was to allow for the "full scope" of market-making activities, while at the same time prohibiting impermissible proprietary trading that poses "significant risk" to the financial system. In contrast to the Proposed Rule, the Final Rule attempts to balance these two goals by eschewing a transaction-based analysis and providing greater flexibility for market-making activities generally, but then limiting these activities through the application of more onerous compliance requirements and risk controls. Thus banking entities will now be permitted to determine the appropriate nature and scope of market-making activities based on the "liquidity, maturity, and depth" of the respective markets, while analyzing their activities more holistically in terms of the overall "financial exposure" and "market-maker inventory" held by any given trading desk. The Final Rule also eliminates the proposed requirement that a banking entity design its activities so that the primary source of revenue would come from "fees, commissions, underwriting spreads, or other income."

C. Underwriting Exemption

The Final Rule provides banking entities with greater flexibility to tailor their underwriting activities to the characteristics of the securities involved and expands permitted underwriting to include the full range of registered offerings and certain private offerings. The Final Rule also aligns the definition of "underwriter" more closely with that of the broader "distribution participant" and expands the range of permitted underwriting-related activities, such as stabilization activities and syndicate shorting.

D. Risk-Mitigating Hedging Exemption

The Release addresses a number of commenter questions and generally affirms that hedging in connection with and related to individual or aggregated positions, including "dynamic hedging" and "anticipatory hedging," is permitted, subject to enhanced documentation and compliance requirements. Unlike the Proposed Rule, the Final Rule does not require that an anticipatory hedge be established "slightly" before a banking entity becomes exposed to the underlying risk. Instead, the Agencies indicate that the various parts of the Final Rule are intended to ensure that all hedging, including anticipatory hedging, are designed to be risk reducing. Notably, while the Final Rule does not use the term "portfolio hedging," the Agencies have attempted to strike a balance between permitted and prohibited aggregate hedging activity.

E. Compliance

The Final Rule establishes a tiered approach to compliance. Banking entities that do not engage in proprietary trading or covered fund activities do not need to establish a Volcker Rule compliance program at all. In addition, small banking entities with less than $10 billion in total assets need not establish a new compliance program but need only include Volcker Rule requirements in their current compliance programs as is appropriate for their size, complexity, and activities. Banking entities with total assets between $10 billion and $50 billion must establish a compliance program under the Final Rule, which must include, among other things, independent testing and a management framework with a clear delineation of responsibility and accountability. Larger banking entities (generally larger than $50 billion in assets) will be subject to an enhanced compliance program with extensive new requirements, including an annual CEO certification requirement.

II. General Definitions

Banking Entity. The Volcker Rule's prohibitions apply to "banking entities," which are broadly defined to include: (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any foreign entity that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, because it has a U.S. branch or agency); and (iv) any affiliate or subsidiary of any such entity. Under the Final Rule, a "banking entity" excludes any covered fund, portfolio company held under a bank holding company's merchant banking authority, or portfolio concern controlled by a small business investment company, if the covered fund, portfolio company, or concern is not itself a banking entity. Also excluded is the FDIC acting in its corporate capacity or as conservator or receiver.

Affiliate and Subsidiary. The definition of "affiliate" did not change from that in the Proposed Rule; an affiliate is any company that controls, is controlled by, or is under common control with another company. A "subsidiary" is (i) any company 25 percent or more of the voting stock of which is owned, directly or indirectly, by the bank holding company; (ii) any company the election of a majority of directors of which is controlled by the bank holding company; or (iii) any company as to the management of which the bank holding company has the power to exert a controlling influence.

"Controlling influence" is generally deemed by the Board to mean a significant influence over a banking organization, but requires less than absolute control over the management and policies of a banking organization, recognizing that the primary definition of control in the BHCA is based on ownership of 25 percent or more of the voting shares. For example, the Board generally considers non-participating board observer rights, or a single board representative, not to constitute a controlling influence. However, having more than two board representatives, or having board representation that exceeds 25 percent of the voting members of the board, or serving as chairman of the board or chairman of a committee of the

board, might be deemed to constitute a controlling influence. Also, ownership of less than 33 percent of the total equity of an organization would generally not constitute a controlling influence, unless that were to include ownership of 15 percent or more of any class of voting securities of the organization.

III. Prohibition on Proprietary Trading – Subpart B

The Final Rule prohibits a banking entity from engaging in "proprietary trading." Proprietary trading is defined in Section __.3(a) as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments." Thus, to be proprietary trading, a *financial instrument* must be purchased or sold by a banking entity *acting as principal* for its *trading account*.

Even if a banking entity's activities fall within the definition of proprietary trading, they may still be permitted if they qualify for one of the following permitted activity exemptions under the Final Rule:

- Underwriting;
- Market-making related activities;
- Risk-mitigating hedging activities;
- Trading in domestic government obligations;
- Trading in foreign government obligations;
- Trading on behalf of customers;
- Trading by a regulated insurance company; and
- Trading activities of foreign banking organizations.

Finally, even if otherwise permitted, proprietary trading activities by a banking entity are subject to the so-called backstop provisions of the Volcker Rule. They will not be permitted if they: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result in a material exposure by the banking entity to a high-risk asset or trading strategy; or (iii) pose a threat to the banking entity's safety and soundness or to the financial stability of the United States.

A. Relevant Definitions

Financial instrument. Financial instruments are defined to include securities, derivatives, and commodity futures, as well as options on any of these instruments.[6] A "derivative" is defined to include swaps, security-based swaps, purchases and sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled, foreign exchange swaps and forwards, retail commodity transactions, and standardized contracts for certain commodities under Section 19 of the Commodity Exchange Act. The definition of "financial instrument" in the Final Rule excludes loans, defined broadly to include any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative; spot foreign exchange; and spot physical commodities.

Exclusions from "proprietary trading." Because the Agencies have determined that these transactions do not involve short-term trading intent, the Final Rule retains from the Proposal certain exclusions from the definition of "proprietary trading." While the Proposal had carved these exclusions out of the definition of "trading account," the Final Rule more neatly excludes them from the definition of "proprietary trading." The Final Rule retains the exclusion for certain repurchase and reverse repurchase agreements and securities lending arrangements, as well as an exception from the definition for short-term liquidity management pursuant to a documented liquidity management plan that satisfies a number of conditions. However, the Final Rule limits the excepted liquidity management plan to purchases and sales only of

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[6] Final Rule, Section __.3(c). The Final Rule has replaced the term "covered financial position" with the term "financial instrument."

highly liquid securities, and not other types of financial instruments, a position that is consistent with the recent proposal by the federal banking agencies on liquidity management requirements.[7] In addition, the liquidity management plan must specifically contemplate and authorize the particular securities to be used for liquidity management, and describe the amount, types, and risks of securities that are consistent with the banking entity's liquidity management. Additional policies, procedures, and internal controls, including a requirement for independent testing, are also now required.

Although the Agencies acknowledged that overly narrow exclusions for these activities might potentially increase the cost of core banking services, they did not expand the proposed exclusion to cover traditional asset-liability management activities, as requested by numerous commenters.

Also excluded from "proprietary trading," and consistent with the Proposal, are purchases and sales by a derivatives clearing organization or a clearing agency in connection with clearing financial instruments. In addition, the Final Rule excludes certain core clearing-related activities by clearing members, an exclusion that had not been proposed.

The Final Rule adds several new exclusions from "proprietary trading." Purchases and sales are excluded if (i) they satisfy an existing delivery obligation of the banking entity or its customers, or an obligation of the banking entity in connection with a judicial, administrative, self-regulatory, or arbitration proceeding; (ii) the banking entity is acting as agent, broker, or custodian; (iii) they are made through certain pension, stock-bonus, or profit-sharing plans; or (iv) they are in the course of collecting a debt previously contracted in good faith.

Trading account. The Final Rule largely retains the definition of "trading account" as proposed, which contains three prongs for determining whether an account is a trading account: a "purpose" prong, a "market risk capital" prong," and a "status" prong. An account is a trading account if it meets one or more of the prongs. Thus, a trading account is any account used by a banking entity to purchase or sell one or more financial instruments (i) principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position resulting from any of these activities; (ii) that are both market risk capital rule-covered positions and trading positions if the banking entity is an insured depository institution or bank or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule;[8] or (iii) if the banking entity acts as a dealer, swap dealer, or security-based swap dealer, whether or not it is so registered.

The purpose prong generally follows the statute's instruction that a trading account include accounts used for taking positions "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").[9]

According to the Agencies, the market risk capital prong is designed to capture trading positions that are covered positions for purposes of the federal banking agencies' market risk capital rules and hedges of those positions. Covered positions under those rules are those held by the banking entity "'for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or to lock-in arbitrage profits'."[10] Instead of using a position's treatment under the market risk capital rules as a factor that would indicate trading purpose, as had been suggested by commenters, the Agencies determined to include this largely duplicative prong because, in their view, the prongs are not only mutually reinforcing, but the market risk capital prong reduces the compliance burden on the largest banking entities by establishing a clear, bright-line rule for determining that a trade is in the trading account.

The third category of account presumes that positions taken in connection with dealer activity generally involve short-term trading because, according to the Agencies, these positions are typically held for sale to customers or otherwise support the firm's trading activities (*e.g.*, by hedging its dealing positions), both

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[7] Proposed Rule, Liquidity Coverage Ratio, Liquidity Risk Measurement, Standards and Monitoring, 78 Fed. Reg. 71818 (Nov. 29, 2013).
[8] The market risk capital rule is contained in Subpart F of 12 C.F.R. 3, 12 C.F.R. 208 and 225, and 12 C.F.R. 324.
[9] BHCA Section 13(h)(6).
[10] Release at 40, quoting 12 C.F.R. 225, Appendix E.

of which are indicative of short-term intent. Thus, despite commenters' concerns that the addition of this prong would make the trading account determination unnecessarily complex, an account of a banking entity that regularly engages in the business of dealing, whether in or outside of the United States, will be deemed a trading account under the Final Rule to the extent financial instruments are purchased or sold in connection with activities that would require the banking entity to be licensed or registered as a dealer, whether or not the banking entity is in fact so licensed or registered.

The Release notes, however, that if, for example, an insured depository institution is registered as a swap dealer, it is only the dealing activities requiring registration that would fall within the dealer trading account prong. If the insured depository institution buys or sells a financial instrument in connection with activities that do not trigger a registration requirement, the financial instrument would be included in a trading account only if it meets one of the other two prongs.

The Agencies rejected commenters' suggestions to use GAAP as the standard for determining whether a position is a trading position.

Rebuttable presumption for short-term trading account. The Final Rule retains the controversial rebuttable presumption of the Proposal that an account will be presumed to be a short-term trading account if it holds a financial instrument for 60 days or less, and extends the presumption to include basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument, or otherwise transfers the instrument's risk within 60 days. The banking entity can rebut the presumption if it can demonstrate, based on all the relevant facts and circumstances, that it did not buy or sell the financial instrument principally for a short-term purpose.

Commenters had argued, among other things, that the rebuttable presumption had no statutory basis, that it would chill permitted market making and underwriting activity, that it would be costly to rebut, and that it was not at all clear whether the Agencies would interpret rebuttals of the presumption consistently. The Agencies rejected these arguments, contending that a clear presumption will ensure consistency in interpretation and simplify the process of evaluating whether individual positions are in a trading account.

However, stating that some proprietary trading could occur outside of the 60-day period, the Agencies declined to provide a safe harbor or a reverse presumption that positions that are held for longer than 60 days are outside of the trading account.

Finally, in response to commenters' concerns about the meaning of "account," the Agencies noted that "the term 'trading account' is a statutory concept and does not necessarily refer to an actual account. Trading account is simply nomenclature for the set of transactions that are subject to the final rule's restrictions on proprietary trading."[11] The Agencies also clarified that the presumption only applies to a particular financial instrument held for 60 days or less and not to the entire account.

B. Permitted Market-Making Related Activities – Section __.4(b)

Section 13(d)(1)(B) exempts from the prohibition on proprietary trading "the purchase, sale, acquisition, or disposition" of financial instruments "in connection with market-making related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."

The Proposed Rule would have implemented this exemption by requiring that a banking entity's market-making related activity comply with seven standards, which were intended to ensure that any banking entity relying on the exemption was both engaged in "bona fide market making," and not taking speculative, proprietary positions. The Agencies received significant comments regarding the proposed market-making exemption relating, among other things, to the scope of the exemption, the appropriate level within a banking entity for applying the exemption, the difficulty of analyzing the availability of the exemption on a transaction-by-transaction basis, the need for a flexible framework to recognize the role of market maker for different asset classes, and the negative impact on liquidity that would result from an overly-restrictive and onerous exemption.

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[11] Release at 38, note 124.

The Final Rule made a number of modifications to address these concerns. The overall approach to the final market-making exemption is intended to enable banking entities to have the flexibility to tailor their market-making activities to the market realities of different asset classes. In addition, the framework adopted in the Final Rule eschews a transaction-by-transaction analysis of the application of the exemption in favor of an analysis of the overall "financial exposure" and "market-maker inventory" held by any given trading desk. While the Final Rule does not provide a purely guidance-based approach to the exemption, the Agencies purposely avoided a "bright-line" approach because of the view that it would reduce flexibility while at the same time lending itself to potential gaming and avoidance.

In explaining the modifications to the Final Rule, the Agencies acknowledged the important role that banking entities' market-making activities play in providing liquidity, and noted that an objective of the Final Rule is to accomplish the twin goals of prohibiting banking entities from engaging in proprietary trading, while not impeding them from engaging in the full scope of market-making activities critical to the provision of intermediation and liquidity services. At the same time, however, the Agencies acknowledged that the burdens and costs embedded in the market-making exemption may cause a banking entity to reconsider whether to conduct market-making related activities.

1. Criteria for Relying on the Market-Making Exemption

Under the Final Rule, a banking entity is allowed to engage in market-making related activities with respect to a particular "trading desk" if the trading desk satisfies six tests:

(i) It "routinely stands ready" and is "willing and available" to trade certain instruments;

(ii) It has a "market-maker inventory" that is designed not to exceed the reasonably expected near term demand of customers, clients, and counterparties;

(iii) The banking entity maintains an appropriate internal compliance program, including "risk limits" on the trading desk's "market-maker inventory" and "financial exposure";

(iv) If a risk limit is exceeded, the trading desk promptly takes action to resume adherence to the limits;

(v) The banking entity has compensation requirements for its traders that are not designed to reward or incentivize prohibited proprietary trading; and

(vi) The banking entity is appropriately licensed or registered to engage in the market-making activity.

A "trading desk" is defined as "the smallest discrete unit of the organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof" (Section __.3(b)(13)). The Proposed Rule had referred to the unit of the banking entity to which the market-making exemption would apply as "a trading desk or other organizational unit." The phrase "or other organizational unit" was removed in the Final Rule to ensure that the management of the risks associated with the market-making activities is centered where the trading actually occurs. Accordingly, the Agencies expect a trading desk will be managed and operated as an individual unit and reflect the level at which the profit and loss of market-making traders is attributed.

Defined by Operational Functionality vs. Corporate Formalities. The determination of what constitutes the "trading desk" is based on "operational functionality" and not "corporate formality." For example, the delineation of the trading desk is not constrained by geographic location or legal entity definition. Similarly, a single trading desk can include employees working on behalf of or booking trades in multiple affiliated legal entities. This is permitted by the language in the exemption, which provides that the trading desk may trade instruments pursuant to the exemption for the trading account of a banking entity or an affiliate thereof. A trading desk that books positions in different affiliated legal entities, however, must have records that identify all positions included in the desk's financial exposure and where such positions are held.

2. Test One: The trading desk "routinely stands ready" and is "willing and available" to trade certain instruments

The first criterion for meeting the market-making exemption is in Section __.4(b)(2)(i). It requires that the trading desk that establishes and manages the financial exposure:

- Routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure; and

- Is willing and available to quote, purchase 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 on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.

Definition of "routinely stands ready" and "willing and available." The Final Rule recognizes that different standards for satisfying the market-making exemption should apply to different asset classes and financial instruments. The Proposed Rule would have required a banking entity to hold itself out as willing to buy or sell "on a regular or continuous basis." Commenters raised concerns that the "on a regular or continuous basis" standard was impractical for market makers in certain markets, especially illiquid ones. In response to these comments, the Final Rule uses the term "routinely," which allows for flexibility based on the characteristics of the individual markets for the different instruments. To comply with the market-making exemption, the trading desk must, given the liquidity and other unique characteristics of the relevant market(s), "routinely" make itself available to trade, in various market conditions. The Agencies provided several examples of how "routinely" may differ across various markets and financial instruments, including:

- *Very liquid equity markets.* A desk should engage in "regular and continuous" quoting and trading on both sides;

- *Less liquid equity markets.* A desk should engage in "regular" quoting, though it may be less frequent – and in some "specialized situations," quotations may only be given upon request;

- *Swaps markets.* A desk should stand ready at the request of a customer "more frequently than occasionally";[12]

- *Customized or bespoke products.* A desk may respond to a request to trade even if it does not normally quote in that product;

- *Very illiquid markets.* A desk may trade "intermittently" or at the request of particular customers (i.e., referred to as "trading by appointment");

- *Block trades.* A desk should trade "from time to time"; and

- *Corporate bond market.* A desk may provide quotes for a subset of the instruments for which it makes a market, though it stands ready to trade the other instruments and provides quotes for these instruments upon request. In this case, the desk's aggregate activity for a particular type of instrument would indicate if it routinely stands ready to make a market in that instrument.

In all cases, however, a trading desk using the market-making exemption—regardless of the liquidity, maturity and depth of the market—must demonstrate a "pattern" of providing quotes and trading on either side of the market. The Agencies stated that even with relatively illiquid derivatives or structured instruments, it is not sufficient if a trading desk only provides a quote or creates a product, at the

[12] This definition is consistent with the definition provided in "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant," 77 Fed. Reg. 30596, 30609 (May 23, 2012). Release at 208. The Agencies also noted that, in the derivatives context, a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or on one side of the market coupled with offsetting positions. Release at 208.

customer's request, "on occasion." In addition, a trading desk's "routine presence" in the market for a particular type of financial instrument would not, on its own, be sufficient grounds for relying on the market-making exemption. Instead, the trading desk would need to demonstrate a pattern of taking these actions in response to demand from multiple customers as to both long and short risk exposures in identified types of instruments.

Commercially Reasonable Amounts Throughout Market Cycles. A trading desk must act as a market maker "throughout market cycles"—*i.e.,* not only when it is profitable or favorable to do so. For example, algorithmic trading strategies that generally only trade when the market factors are favorable to the trading strategy's objectives, and normally exit the market when they are not, would not meet this requirement. Similarly, a trading desk that provides "wide quotations," and does not engage in other activity that demonstrates a willingness to provide intermediation services, would not be seen as "routinely" standing ready to purchase and sell instruments throughout market cycles.

"Financial Exposure" and "Market-Maker Inventory." To provide greater flexibility for appropriate market making, Section __.4(b) requires that banking entities demonstrate the appropriateness of the market-making exemption to their "overall financial exposure" and "market-maker inventory,'" instead of on a transaction-by-transaction basis.

- *Financial Exposure*. "Financial exposure" is broader in scope than "market-maker inventory" and defined as the aggregate[13] risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk act as a market maker, but in which the trading desk does not itself make a market; as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker. Thus, financial exposure is comprised of the risks of: (i) the financial instruments and (derivatives) positions in the market-maker inventory; (ii) financial instruments (and derivatives) used to manage the risks of the financial instruments and derivatives in the inventory; and (iii) associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker.

- *Market-Maker Inventory.* "Market-maker inventory" means "all of the positions, in the financial instruments for which the trading desk stands ready to make a market … that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions."[14]

- *Financial Exposure vs. Market-Maker Inventory*. The instruments comprising the "market-maker inventory" are a subset of the instruments that create the "financial exposure" for the trading desk. The size of both the "market-maker inventory" and "financial exposure" are limited by the requirement that they not exceed "near term customer demand"; the permissible size of the market-maker inventory is explicitly constrained by such demand,

[13] The Agencies noted that the term aggregate does not mean that banking entities can simply net long and short exposures in "similar or related instruments" to determine overall exposure (*i.e.,* combine the long exposure and short exposure in similar instruments to net to zero exposure), rather while such a combination could reduce risk exposure, a banking entity would still have to consider attendant risks such as basis risk or the creation of a new risk exposure. Id.

[14] Inventory refers to both the financial instruments (*i.e.*, securities) as well as the positions acquired as a result of derivatives trading. Release at 197. Whether an instrument or exposure arising from a derivative is consider market-maker inventory is only based on whether the desk makes a market in the instrument; this determination is not based on the type of counterparty, or purpose of the transaction. Release at 201.

while the permissible size of financial exposure is indirectly constrained by such demand since it must be consistent with market-maker inventory.[15]

While a trading desk's financial exposure does not have to be composed exclusively of instruments for which it is a market maker, such instruments should make up a "significant portion" of its financial exposure. For example, it would not be appropriate for a banking entity to apply the market-making exemption to a trading desk that exclusively holds positions in, or is exposed to, financial instruments for which it does not make a market.[16]

Frequency of Monitoring. The frequency of monitoring "market-maker inventory" and "financial exposure" should be based on the nature of the trading desk's trading strategies and instruments traded. Such monitoring and analysis must be in accordance with the trading desk's compliance program, as described below. For instance, if a trading desk acquired and terminated significant financial exposures throughout the day, but generally ended the day with little to no exposures, assessing exposures only at the end of the day would be inappropriate—intraday exposure would need to be assessed.

3. Test Two: Near Term Customer Demand

The second test for complying with the market-making exemption is in Section __.4(b)(2)(ii). Under this test, the "amount, types, and risks" of the instruments in the desk's "market-maker inventory" must be designed not to exceed "reasonably expected near term customer demand" (on an ongoing basis). There are two factors for assessing whether the instruments in the market-maker inventory (including block trades) are appropriate under this standard:

- Liquidity, maturity, and depth of the market; and
- A "demonstrable analysis" of indicators of near term customer demand that includes (i) historical levels of customer demand, (ii) expectations based on market factors, and (iii) current demand.[17]

Standard for determining "near term customer demand" differs across markets. The requirement to conduct a "demonstrable analysis" based on the "liquidity, maturity, and depth" of the market is meant to account for differences in market making across different markets and asset classes. For instance, in highly liquid markets, there would likely be greater turnover and less aged inventory than less liquid markets, where the trading desk is likely to hold the securities longer because of intermittent demand. In less mature markets, because of the lack of historical customer demand information, it may be more difficult to predict near term customer demand and inventory may not closely track customer order flow. In these cases, the Agencies recommended that banking entities use historical data from similar products, reasonable expected future demand which are determined based on customer relationships, or other relevant factors to calculate near term customer demand.

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[15] Therefore, any instruments or positions accounted for in "financial exposure," must be either associated with instruments in the inventory or have been entered into to reduce the risks attendant to those instruments and/or positions. Release at 198-9. The Agencies also noted that, while a banking entity's positions in loans, spot commodities, and spot foreign exchange are not subject to the proprietary trading restrictions at all (and therefore transactions in these instruments are not subject to the market-making exemption or any other exemption), a banking entity "may" include its exposure to these products in its financial exposure analysis if they are related to the trading desk's market-making activities. Release at 197, note 717. However, while note 717 suggests that banking entities have a choice as to whether to include these instruments in their "financial exposure"; the Final Rule defines "financial exposure" as "the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities" suggesting that inclusion of these products, to the extent they are related to the market-making exemption is not discretionary. Section __.4(b)(4).

[16] The Agencies noted, however, that, under limited circumstances—such as the period in which a desk (a) is unwinding a hedging position after the marketing position has already been unwound, or (b) has acquired an anticipatory hedge position prior to acquiring a market-making position—the trading desk's financial exposure would not relate to the financial instruments in which it makes a market. The Agencies note, however, that they expect such occurrences to be "minimal." Release at 211, note 738.

[17] The Agencies noted that, for instance, a trading desk creating a structured product, not based on any customer demand, and then soliciting customers to trade the instrument during or after its creation, would not meet this standard. Release at 241, note 892.

"Demonstrable analysis." As noted above, one of the means to assess whether the market-maker inventory meets near term customer demand is through a "demonstrable analysis" of indicators of near term customer demand. "Demonstrable analysis" means that the analysis must be based on factors, such as trading records and market information, that can be demonstrated in a way that makes the analysis "reviewable." This analysis should be based on (i) current demand, (ii) historical demand, (ii) estimates of future demand based on events that are reasonably expected to occur in the near term, and (iv) indications from customers of future demand.

- *Historical demand.* The appropriate weight given to historical trends by the trading desk should be based on the relevant market and instrument. For instance, historical data may be less relevant when a trading desk expects a change in the pattern of customer needs (*e.g.,* requests for block trades), changes in its business model, or changes in market conditions. Also, in less mature markets, or for a market maker that is a new entrant into an existing market, historical customer data may not be available. The Agencies noted that an analysis that does not provide for *any* consideration of historical trends, however, could carry a greater risk of evasion. As such, absent current or anticipated events, the composition of the market-maker inventory should be "relatively consistent" with the historical profile of the inventory.

- *Anticipatory trading and structured products.* In the Proposed Rules, the Agencies stated that banking entities could engage in anticipatory buying or selling activity if it was reasonable and related to clear and demonstrable trading interest on the part of clients. Partly in response to comments that this would have a negative impact on market makers' "inventory management activity," the Agencies clarified that, under the market-making exemption, banking entities are allowed to engage in anticipatory buying and selling in reasonable expectation of customer near term demand.[18] The Agencies, cautioned, however, that for complex structured products, "demonstrable analysis" would mean that the trading desk would have to have "prior express interest" from customers in the "specific risk exposures" of the instrument.[19]

- *Use of metrics.* Banking entities will not be required to use metrics to demonstrate compliance with the Final Rule. Rather, metrics should be used to monitor the trading desk's activity in order to discern if there was cause for further review.

Definition of "Customer." For purposes of interpreting "near term customer demand," the terms "customer, client or counterparty" (collectively, "customers") mean "market participants that make use of the banking entity's market-making related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services." The Release provides several examples, of how the "customer" definition, in regard to near term customer demand, varies in different contexts, including the following:

- *Exchange trades*. In the context of executions on an exchange (or other organized trading facility), a "customer" would be defined as any person who executes an order against a quote that the market maker posts on the exchange.

- *OTC trades*. In the context of bilateral, off-exchange trades, a "customer," would be a person that makes use of the market maker's intermediation services, by either requesting the services or entering into a "continual relationship" to receive such services.

- *Trades with another trading desk*. The "customer" definition does not encompass another trading desk (or other organizational unit) of another entity if that entity has $50 billion or more in total trading assets and liabilities, unless: (i) the desk documents the "how and why"

[18] The Agencies noted that other factors that could affect near term customer demand are: (i) recent trading volumes and customer trends; (ii) trading patterns of specific customers or other observable customer demand patterns; (iii) analysis of the banking entity's business plan and ability to win new customer business; (iv) evaluation of expected demand under current market conditions compared to prior similar periods; (v) schedule of maturities in customers' existing portfolios; and (vi) expected market events, such as an index rebalancing, and announcements. Release at 258.

[19] Trading desks would also be required to hedge or otherwise mitigate the risks of these exposures, consistent with its hedging policies and procedures and risk limits. Release at 259.

the other trading desk (or other organizational unit) should be treated as a "customer";[20] or (ii) the transactions between the desk are conducted anonymously on an exchange or similar trading facility, provided that such facility permits trading on behalf of a broad range of market participants.

- *Arbitrage trading*. A trading desk that is "wholly" or "principally" involved in arbitrage trading (or a similar practice) would not qualify for the market-making exemption, since it is unresponsive to "customer" demands.[21]

- *ETF activity*. In the exchange-traded fund ("ETF") context, for a banking entity acting as an "Authorized Participant": (i) the market participants, as well as the ETF, would be considered its "customers"; and (ii) the inventory of ETF shares or underlying instruments held by the AP may be included in the market-maker inventory, if they relate to reasonably accepted near term customer demand, under the market-making exemption.[22]

Application of "near term customer demand" to exchange trading. In the anonymous exchange context, a trading desk that submits resting orders (or, on a trading facility where resting orders are not provided, regularly responds to request for quotes) as part of a market-neutral strategy is acting in accordance with the "near term customer demand" requirement. The Agencies note, however, that trading desks may place other types of orders and still meet the "near term customer demand" standard, including market or marketable limit orders.

Application of "near term customer demand" to interdealer trading. A trading desk may use interdealer trading if it is related to facilitating permissible trading with the desk's customers. The Agencies note, however, that interdealer trading will be subject to "some scrutiny" and should be monitored by banking entities, to monitor and detect impermissible proprietary trading.

Accuracy of assessment. Prediction of near term customer demand is subject to some uncertainty and at times there can be differences between predicted demand and actual demand. That said, the Agencies expect such predictions to be generally accurate and if there is a pattern—in the aggregate or over longer periods of time—of the market maker maintaining a significantly larger inventory than what is actually needed for near term customer demand, it may lead to the conclusion that the banking entity's assessments of near term demand are not reasonable.

4. Test Three: Internal Compliance Program

The third test for satisfying the market-making exemption is in Section __.4(b)(2)(iii). It requires that the banking entity "has established and implements, maintains, and enforces an internal compliance program required by Subpart D (discussed in Section VI below) that is reasonably designed" to ensure the banking entity's compliance with the requirements for relying on the market-making exemption. This compliance program must include reasonably designed written policies and procedures, internal controls, analysis, and independent testing that identifies and addresses the following areas:

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[20] The Final Rule provides little guidance on what should be included in this documentation of "how and why"; however, the Agencies note that in describing a similar provision in the proposed rule, the trading unit was "required to describe how it identifies its customers … including documentation explaining when, how, and why a broker-dealer, swap dealer, security-based swap dealer, or any other entity engaged in market making-related activities, or any affiliate thereof, is considered to be a customer of the trading unit." Release at 245, note 900.

[21] A trading desk may however, act as a market maker to a customer engaged in a statistical arbitrage trading strategy. Release at 251.

[22] The criteria can also be applied to other AP activities such as building inventory to "seed" a new ETF or engaging in ETF-loan related transactions. Release at 249. The market-making exemption may also be extended to firms that may or may not be APs for a given ETF, but "actively" engage in buying and selling shares of an ETF and its underlying instruments to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another—such activity may also fall under the market-making exemption if the other characteristics apply because customers take positions in ETFs with the expectation that the price relationship will be maintained. The Agencies note that banking entities engage in a "substantial amount" of AP creation and redemption activity in the ETF market, providing valuable liquidity. Release at 250.

- *Section __.4(b)(2)(iii)(A).* The financial instruments each trading desk stands ready to purchase and sell in accordance with the requirements of the market-making exemption;

- *Section __.4(b)(2)(iii)(B).* The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits established pursuant to the next bullet (*i.e.,* Section __.4(b)(2)(iii)(C)); the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market-making related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

- *Section __.4(b)(2)(iii)(C).* Limits on the following, for each trading desk, based on the nature and amount of the trading desk's market-making related activities, that address the factors prescribed in "Test Two" (*i.e.,* near term customer demand):

    - The amount, types, and risks of its market-maker inventory;

    - The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;

    - The level of exposures to relevant risk factors arising from its financial exposure;

    - The period of time a financial instrument may be held;

- *Section __.4(b)(2)(iii)(D).* Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

- *Section __.4(b)(2)(iii)(E).* Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements for relying on the market-making exemption, and independent review of such demonstrable analysis and approval.

Key aspects of the required compliance program are discussed below.

Risk Limits. Both the trading desk's market-maker inventory and financial exposure must be subject to separate sets of risk limits The types of risk factors that should be considered in determining limits for both should not be limited solely to market risk factors, but all risks (at a granular level) to which the instruments are vulnerable, including, for instance, counterparty risk for derivatives products. The types of limits that the trading desk applies need to be similarly granular, *e.g.*, position limits, sector limits, and geographic limits. The Agencies acknowledged that trading desk limits will differ across asset classes. The Agencies noted, however, that just because an exposure is hedged and within the risk limits, does not mean that it can be considered part of the market-maker inventory, if it is not responsive to customer demand.

Risk Mitigation. The Agencies noted that, as part of the compliance program, a banking entity must be able to demonstrate the relationship between (i) the instruments in which it acts as a market maker, and (ii) the instruments used to manage the risks associated with such instruments; and an explanation of why the latter appropriately and effectively manages the risks of the former. The Agencies further noted that it is not a requirement that a desk hedge or mitigate all of the risks arising from its market-making activities, but desks would be required to (i) contain and limit risk exposures; (ii) follow reasonable procedures to monitor exposures; and (iii) and hedge risks to maintain within its risk limits.

Overhedging. Written policies should be designed to prevent overhedging, *i.e.*, banking entities hedging risks that have already been fully mitigated, thereby establishing a new risk position.

No Need to Comply with the Hedging Exemption. Unlike the Proposed Rule, the Final Rule does not require that market-making related hedging activity comply with both the market-making exemption and the hedging exemption. When market-making trading desks direct the hedging of their own instruments (see below), those instruments only have to meet the requirement of the market-making exemption.

Hedging by Other Organizational Units. The Agencies acknowledged that banking entities may be organized such that other organizational units, aside from the trading desk, establish risk-mitigating positions for one or more trading desks. Whether or not such risk-mitigating positions would be subject to the market-making exemption or the hedging exemption depends on a number of factors. Such positions would be subject to the market-making exemption if the following are true:

- The other organizational unit does so at the direction of the trading desk;
- The other organizational unit undertakes the transaction in accordance with the trading desk's risk management policies;
- The risk-mitigating position is included in the trading desk's daily profit and loss calculation; and
- The risk-mitigating position is attributed to the trading desk's financial exposure (not the other organizational unit's financial exposure).

If any of these criteria are not met, the other organizational unit would not be eligible for the market-making exemption for these positions, but would rather have to comply with the hedging exemption.[23] The Agencies concluded that the "net effect" of these provisions is that the trading desks are able to effectively handle their own hedging and risk mitigation activities on a "holistic basis." Any hedging done on the trading desk's behalf by the direction of other organizational units must be subject to the hedging exemption.[24]

"Source of Revenue" Analysis. The Proposed Rule would have required that a trading desk design its market-making related activity to generate revenue mainly from fees, commissions, and bid-ask spreads, as well as other revenue that was not derived from any increase in the value of a financial instrument (or hedging). In the Final Rule, the Agencies decided to remove this requirement. However, the Agencies determined that, because an analysis of revenue generation and profitability may be valuable in assessing the degree to which the desk's activities are consistent with intermediation and liquidity (versus speculation), they would instead institute a reporting requirement that requires metrics data for profits and losses. This "Comprehensive Profit and Loss Attribution" report addresses similar factors as the "revenue requirement," but is modified so that the focus is not on particular revenue sources (*e.g.,* fees,

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[23] If "a trading desk engages in a risk-mitigating transaction with a second trading desk of the banking entity or an affiliate that is also engaged in permissible market making-related activities, then the risk-mitigating position would be included in the first trading desk's financial exposure and the contra-risk would be included in the second trading desk's market-maker inventory and financial exposure." Release at 204.

[24] The Agencies provide an example of how "a trading desk's market-maker inventory and financial exposure will be analyzed under the market-making exemption":

> [A]ssume a trading desk makes a market in a variety of U.S. corporate bonds and hedges its aggregated positions with a combination of exposures to corporate bond indexes and specific name CDS in which the desk does not make a market. To qualify for the market-making exemption, the trading desk would have to demonstrate, among other things, that: (i) the desk routinely stands ready to purchase and sell the U.S. corporate bonds, consistent with the requirement of § __.4(b)(2)(i) of the final rule, and these instruments (or category of instruments) are identified in the trading desk's compliance program; (ii) the trading desk's market-maker inventory in U.S. corporate bonds is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, consistent with the analysis and limits established by the banking entity for the trading desk; (iii) the trading desk's exposures to corporate bond indexes and single name CDS are designed to mitigate the risk of its financial exposure, are consistent with the products, instruments, or exposures and the techniques and strategies that the trading desk may use to manage its risk effectively (and such use continues to be effective), and do not exceed the trading desk's limits on the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; and (iv) the aggregate risks of the trading desk's exposures to U.S. corporate bonds, corporate bond indexes, and single name CDS do not exceed the trading desk's limits on the level of exposures to relevant risk factors arising from its financial exposure. Release at 205-6.

commissions, bid-ask spreads, and price appreciation) but rather on revenues generated from the desk's positions. The Agencies stated that while there is no requirement that revenue come from certain sources, results from this report may suggest that further review of the desk's activities are warranted.

5. Test Four: "Prompt" Action to Address Risk Limit Breaks

The fourth test for complying with the market-making exemption is in Section __.4(b)(2)(iv), which requires the trading desk to take action to bring the trading desk into compliance with the limits described above "as promptly as possible" after any limit is surpassed. These limits are specified in Section __.4(b)(2)(iii)(C).

The Agencies further noted that banking entities may not exceed the limits established for the trading desk solely because there is customer demand. Before exceeding such limits, the trading desk must follow escalation procedures, which may require additional approval, and provide demonstrable analysis that the increase is appropriate to near term customer demand.[25]

6. Test Five: Compensation Restrictions

The fifth test for complying with the market-making exemption is in Section __.4(b)(2)(v), which states that the compensation arrangements of persons performing the activities permitted by the market-making exemption must be designed not to reward or incentivize prohibited proprietary trading.

The Agencies acknowledged that this prohibition does not mean that an employee of a market-making desk cannot be compensated for successful market making, which includes some element of risk taking. In fact, banking entities may consider, in a trader's compensation determination, profits generated from price movements in principal positions if such profits reflect the extent he trader's effectiveness in managing retained principal risk. That said, compensation incentives must mainly reward effective customer service and customer revenues, and not reward prohibited proprietary trading.

7. Test Six: Licensing and Registration

The final test for meeting the market-making exemption is in Section __.4(b)(2)(vi), which requires that the banking entity be licensed or registered to engage in market-making activity, in accordance with applicable law. Of all the tests, this test is clearly the most straightforward and should be the easiest one to satisfy.[26]

C. Permitted Underwriting Activities – Section __.4(a)

A. Background and Purpose

Section 13(d)(1)(B) of the BHCA exempts from the prohibition on proprietary trading "the purchase, sale, acquisition, or disposition of securities and certain other instruments in connection with underwriting activities, to the extent such activities are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties."

The Proposed Rule would have mandated seven requirements for relying on the exemption for underwriting activities (the "underwriting exemption"): (i) the banking entity must have a compliance program; (ii) the covered financial position is a security; (iii) the purchase or sale is effected *solely* in connection with a distribution of securities for which the banking entity is acting as underwriter; (iv) the banking entity meets applicable dealer registration requirements; (v) the underwriting activities are

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[25] Release at 199-200.

[26] As examples of appropriate registration, the Agencies stated that a banking entity (unless exempt or excluded from the applicable registration): (i) should be an SEC-registered dealer if it intends to rely on the market-making exemption to trade in securities; (ii) should be a CFTC-registered swap dealer or SEC-registered security-based swap dealer if it intends to rely on the market-making exemption for trading in swaps or security-based swaps, respectively; or (iii) may have to be a registered or licensed municipal securities dealer or government securities dealer if relying on the market-making exemption to trade in municipal securities or government securities, respectively. Release at 293-4; at 294, note 1046. The Agencies noted, however, that a banking entity does not have to register as a market maker on an exchange to be eligible for the market-making exemption. Release at 260, note 940.

designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; (vi) the underwriting activities are designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions; and (vii) the compensation arrangements of persons performing underwriting activities are designed not to reward speculative proprietary trading.

While the Agencies adopted many of the provisions substantially as proposed, in response to comments the Final Rule did make certain important changes, added clarifying guidance, and reduced the number of "tests" that banking entities must satisfy from seven to five. The Agencies' overall approach in the Final Rule is two-pronged. First, the Final Rule provides banking entities with greater flexibility to tailor their underwriting activities based on the liquidity, maturity and depth of the individual securities. Second, the Final Rule requires additional risk controls to prevent speculation and improper proprietary trading.

The Agencies broadened the types of (i) offerings that banking entities may provide in reliance on the underwriting exemption (*e.g.*, providing a blanket exemption for registered offerings and expanding the definition of "distribution"), (ii) entities defined as "underwriters," and (iii) activities that underwriters may conduct under the exemption (*e.g.*, clarifying that stabilization activities and syndicate shorting are permissible). Importantly, the Agencies declined certain commenters' requests to impose blanket prohibitions or strict limitations on the underwriting of certain types of securities based on illiquidity or noncompliance with accounting standards.

D. Criteria for Relying on the Underwriting Exemption

Generally, a banking entity must meet five tests to use the underwriting exemption:

(i) The banking entity must act as an underwriter for a distribution of securities and the trading desk's underwriting position must be related to that distribution;

(ii) The composition of securities in the underwriting position must be designed not to exceed the reasonably expected near term customer demand, and reasonable efforts must be undertaken to sell or reduce the position in a reasonable time (taking into consideration the liquidity, maturity, and depth of the market for the relevant type of security);

(iii) The banking entity must establish, implement, maintain, and enforce an internal compliance program that identifies and addresses position limits, internal controls, escalation procedures, and independent testing (among other things);

(iv) The compensation arrangements for employees on the trading desk must not incentivize impermissible proprietary trading; and

(v) The banking entity must be appropriately licensed or registered to engage in underwriting activity.

These tests are discussed in more detail below.

1. Test One: The trading desk's position must be based on a distribution, for which the banking entity acts as underwriter.

The first test for meeting the underwriting exemption is in Section __.4(a)(2)(i). Under this test, the banking entity must be "acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution." An analysis of three terms is essential to determining whether a banking entity satisfies this test: underwriter; distribution; and underwriting position (the term "trading desk" has the same definition as for the market-making exemption). The definitions of these terms, as set forth in the Final Rule and discussed in the Release, are as follows.

a) Definition of "underwriter"

In Section __.4(a)(4), the Agencies establish *alternative* criteria for meeting the definition of "underwriter." Specifically, an "underwriter" is:

(i) A person who has agreed with an issuer or selling security holder to:

- Purchase securities from the issuer or selling security holder for distribution;
- Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or
- Manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or a selling security holder.

The Agencies adopted prong (ii) in response to comments that the Proposed Rule could be read to disallow selling group members, who do not have agreements with underwriters or selling security holders, from taking advantage of the underwriting exemption.

The Agencies have provided examples in the Release of activities that may indicate that a banking entity is acting as an underwriter:

- Assisting an issuer in raising capital;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement (or other offering document);
- Purchasing securities from an issuer, underwriter, or selling security holder, for resale to the public;
- Participating in, or organizing, a syndicate of investment banks;
- Marketing the securities;
- Trading to provide a post-issuance secondary market and to promote price discovery;[27] and
- A primary dealer acting as an underwriter for a sovereign government's issuance of its debt should generally fall under the underwriting exemption.

The Agencies also noted in the Release that the precise activities performed by an underwriter would vary, depending on the liquidity of the securities being underwritten and the type of distribution being conducted. As such, a banking entity would not be required to engage in each of the above-noted activities in order to be considered an "underwriter" for purposes of the exemption. Instead, each trading desk would need to determine what would be appropriate underwriting activity based on the liquidity of the underlying securities, and the type of distribution.[28]

The Release provides examples of activities that may be conducted in connection with an underwriting and, if so, may fall under the underwriting exemption. For example, the following activities may be permissible under the underwriting exemption:

- Stabilization activities;

[27] The Agencies noted that any post-issuance secondary activity must be conducted pursuant to the market-making exemption.

[28] The Agencies noted that a banking entity that does not meet the requirements of the underwriter exemption may meet the requirement of the market-making exemption. Release at 110. For offerings of ETFs, the Agencies noted that an Authorized Participant may meet the requirements of the underwriting exemption, depending on the particular facts and circumstances, including whether it meets the definition of "underwriter" and whether the offered ETF shares meet the definition of "distribution." The Agencies further noted, however, that Authorized Participant activities (such as conducting general creations and redemptions of shares) would more likely fall under the market-making exemption.

- Syndicate shorting and aftermarket short covering;
- Holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so; and
- Helping the issuer mitigate its risk exposure arising from the distribution of its securities (e.g*.,* entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).

To qualify for the underwriting exemption, these activities must be undertaken (i) with the intention to engage in the distribution process, and (ii) in accordance with applicable laws, regulations and/or self-regulatory organizations' rules relating to such activity. Also, any position resulting from these activities must be included in the trading desk's underwriting position (and the restrictions thereupon apply, including the requirements that the trading desk make reasonable efforts to sell or reduce the position, and that the trading desk apply limits on how long a security may be held). Thus, for instance, a trading desk would not be allowed, under the underwriting exemption, to acquire a position as a result of stabilization activities and hold onto the position for an extended period of time.

By contrast, the Release provides examples of activities that a trading desk may engage in as part of its underwriting activity, but that are *not* covered by the underwriting exemption (but may be covered by the hedging or market-making exemption):

- Purchasing a financial instrument on behalf of a customer to enable the customer's purchase of securities in the distribution (this may fall under market-making exemption);
- Purchasing another financial instrument in order to determine the appropriate price for the securities in the distribution (this may fall under the market-making exemption);
- Hedging the underwriters' risk exposure (this may fall under the hedging exemption);
- Selling a security to an intermediary in connection with a structured finance product; and
- Accumulating securities (or other assets) in anticipation of a securitization or re-securitization. The Agencies explained that banking entities are able to accumulate loans in anticipation of a securitization because, under the Final Rule, loans are not defined as financial instruments.

b) Definition of "distribution"

In the Final Rule, the Agencies adopted a broader definition of "distribution" than appeared in the Proposed Rule. Specifically, Section __.4(a)(3) defines the term "distribution" as either:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933 (emphasis added) (Section __.4(a)(3)).

This definition is broader than the Proposed Rule, and Regulation M under the Exchange Act, because it does not include, as a condition, that the offering must be "distinguished from ordinary trading transactions by the magnitude of the offering" (Section __.4(a)(3)). According to the Release, the Agencies removed this clause in response to commenters' concerns that it raised uncertainty as to whether banking entities could intermediate small offerings. In explaining the rationale for the removal, the Agencies noted that the "special selling efforts and selling methods" clause was sufficient to effectively prevent impermissible proprietary trading, thus the "magnitude" clause was not necessary. The Agencies also noted that they would rely on the same factors considered in Regulation M to determine if "special selling efforts and selling methods" were present, which may include (among other things) delivering an offering document (*e.g.*, a prospectus), conducting road shows, and receiving compensation

that is consistent with underwriting compensation. The Agencies noted that all of these factors need not be present at the same time, however, for purposes of the underwriting exemption.

An offering may qualify as a distribution regardless of how it is initiated (*e.g.,* issuer-driven, selling security holder-driven, or arising out of a reverse inquiry)[29] or how it is conducted (*e.g.*, direct communication, exchange transactions, or automated execution system). In the Release, the Agencies also specifically affirmed that the following types of offerings may meet the definition of "distribution": (i) offerings made pursuant to a shelf registration statement (whether on a continuous or delayed basis); (ii) bought deals; (iii) "at the market" offerings; (iv) debt offerings; (v) asset-backed security offerings; and (vi) initial public offerings. In addition, offerings made in reliance on the SEC's Rule 144A (or other exemptions), and commercial paper offerings (provided that the commercial paper is a security), may meet the definition of "distribution" if special selling efforts are present.

With respect to securities acquired as a result of bridge loan activity (*i.e.*, the acquisition and resale of securities issued in order to refinance (or in lieu of) bridge loan facilities), the availability of the underwriting exemption would depend on the particular facts and circumstances, since bridge financing arrangements can be structured in a variety of ways. Based on the structuring, bridge loan activity may: (i) qualify for the underwriting exemption; (ii) qualify for the hedging exemption; or (iii) not qualify for either exemption, and therefore be prohibited.

(iii) Definition of "underwriting position"

An underwriting position is defined in Section __.4(a)(6) of the Final Rule as "the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter." An important aspect of this definition is that one underwriting position is based on one distribution, *i.e.*, the exemption's requirements apply on a "distribution-by-distribution basis." In response to comments, the Agencies clarified that they did not intend to define "distribution" more narrowly, *i.e.*, on a transaction-by-transaction basis.

2. Test Two: The underwriting position must be designed not to exceed customer demand, and reasonable selling efforts must be employed.

The second test for meeting the underwriting exemption is in Section __.4(a)(2)(ii), which requires that:

- The amount and type of the securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and

- Reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.

"Reasonably expected near term demands of clients, customers, or counterparties." Section __.4(a)(7) broadly defines the terms "client," "customer," and "counterparty" as "market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter." According to the Release, the following factors may be used to form a reasonable expectation of "near term customer demands": (i) current market conditions; (ii) experience with similar offerings; and (iii) marketing efforts such as book-building (though marketing efforts are not required to be eligible for the exemption).

In further discussing "near term customer demands," the Agencies explained that, for instance, a banking entity cannot structure a complex instrument upon its own initiative (*i.e.,* not based on anticipated customer demand) and rely upon the underwriting exemption. Also, in response to a comment that underwriting should require demand from both the clients that want to market the security and those that

[29] The Agencies noted that a "reverse inquiry" is when "an investor may be allowed to purchase securities from the issuer through an underwriter that is not designated in the prospectus as the issuer's agent by having such underwriter approach the issuer with an interest from the investor." Release at 106, note 390.

want to purchase it, the Agencies affirmed that, while an issuer or selling security holder could be considered a "customer" under the Final Rule, a banking entity cannot satisfy the reasonable expectation of customer demand requirement based *solely* on the issuer's or selling security holder's desire to sell the securities.

On the other hand, the Agencies noted that the trading desk does not have to believe that the securities will be sold *immediately* to meet this expectation, either; the appropriate distribution period varies by "liquidity, maturity, and depth of market." In accordance with this, the Agencies affirmed, in response to a comment suggesting a particular treatment for securitizations,[30] that, as supported by the statutory text and legislative history, the near term customer demand requirement is not meant to discriminate against certain types of securities; therefore, the requirement does not preclude certain types of securities from being distributed, nor apply a different standard solely based on the type of security.

Unsold allotments. The Agencies received a number of comments regarding unsold allotments. While some commenters advocated a strict interpretation of the "near term customer demand" requirement, other commenters advocated greater flexibility, claiming that otherwise, the provision could lead to "fire sales, higher fees for underwriting services, or reluctance to act as an underwriter for certain types of distributions that present a greater risk of unsold allotments."[31] The Agencies concluded that the most appropriate means to address both concerns was to (a) allow underwriters to maintain unsold allotments, since underwriters may legitimately overestimate customer demand and would need to hold securities until they were able to be sold, but (b) require banking entities to "make reasonable efforts to sell or otherwise reduce the underwriting position."

The Agencies stated, however, that if a trading desk engages in "systematic retention" of a position, without making efforts to sell the securities or determining whether a sale is possible (at commercially reasonable prices), such retention would be indicative of an intent to engage in proprietary trading. At the same time, the Agencies acknowledged that a "reasonable period" may differ depending on liquidity, maturity and depth of market (*e.g.*, since the fixed income market is generally less deep than the equity market, an underwriter is more likely to retain unsold allotments in a bond offering).

The Release provides three examples that demonstrate the operation of the "make reasonable efforts to sell or reduce the position" requirement and the Agencies' expectations:

- If there is sufficient investor demand to purchase all of the securities at the offering price, the requirement would prohibit the underwriter from retaining a portion of the allotment;

- If there is insufficient investor demand at the offering price, the requirement would allow the underwriter to retain a portion of the allotment, but make reasonable efforts to sell the unsold allotment; and

- If the underwriter oversells the securities (in excess of its allotted number of securities), resulting in a syndicate short position, the requirement would oblige the underwriter to make reasonable efforts to reduce the syndicate short position by exercising an overallotment option or purchasing shares in the secondary market.

[30] One commenter had suggested that for securitizations, an underwriting should be defined as the "distribution of all, or nearly all, of the securities related to a securitization (excluding the amount required for credit risk retention purposes) along a time line designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." Release at 121, note 445. The Agencies also noted that the credit risk retention requirement (Section 15G of the Exchange Act) would not affect the security's eligibility for the underwriting exemption. Release at 121, note 445.

[31] Release at 122, note 446. The Agencies specifically noted that this clarification should relieve concerns expressed by commenters regarding the treatment of securities that remain in the underwriters' inventory that are acquired as a result of outstanding bridge loans. Release at 116, note 423. Also, in regard to bridge loans, the Agencies noted that a commenter's suggestion that the banking entity be required to assess near term customer demand at the initial extension of the bridge commitment (and not at the period in which the loan is required to be funded or the securities issued when investor demand may have waned) was reasonable. Release at 116, note 423.

3. Test Three: The banking entity establishes an internal compliance program.

The third test for relying on the underwriting exemption is in Section __.4(a)(2)(iii). It requires that the banking entity has established and implements, maintains, and enforces an internal compliance program required by Subpart D[32] that is reasonably designed to ensure the banking entity's compliance with the requirements for relying on the underwriting exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

- The products, instruments, or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;
- Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:
    - Amount, types, and risk of its underwriting position; and
    - Level of exposures to relevant risk factors arising from its underwriting position;
    - Period of time a security may be held;
- Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and
- Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval …

The Agencies noted that the internal compliance program for the underwriting exemption is "substantially similar" to that for the market-making exemption, except that the latter requires more detailed risk management procedures. The Release discusses the following elements of the underwriting compliance program in more detail.

Product Identification. As noted above, banking entities must identify the products, instruments, and exposures of the trading desk. The Agencies stated that this provision should both: (i) prevent an individual trader from establishing positions that are unrelated to any distribution; and (ii) form the basis for the position and risk limits.

Limits. As noted above, banking entities must place limits on: (i) the amount, types, and risk of the securities in its underwriting position; (ii) levels of exposures to risks arising from its position; and (iii) the period in which the security can be held. The Agencies stated that these limits must account for the nature and amount of the trading desk's activities (including near term customer demand), and may differ based on the underlying market in amount of inventory, risk exposure, holding period limits, and other criteria.

Internal Controls and Monitoring. Banking entities must establish internal controls, monitoring, and analysis of the trading desk's compliance with the above-noted limits, including the frequency, nature, extent to which the trading desk exceeds the limits, and a process for modification of the limits. Compliance with this provision may include the use of management and exception reports.

Escalation Procedures. Banking entities must: (i) establish escalation procedures for when a trade would exceed the limits; (ii) engage in demonstrable analysis that exceeding the limits is consistent with near term customer demand; and (iii) provide for independent review of the demonstrable analysis and the approval. Banking entities must maintain records of compliance with this provision under Section __.20(b)(6).

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[32] See discussion of Subpart D of the Final Rule at Section VI below.

4. Test Four: The compensation arrangements do not reward or incentivize prohibited proprietary trading.

The fourth test, which is in Section __.4(a)(iv), provides that the compensation arrangements of persons performing the activities described in the underwriting exemption must be "designed not to reward or incentivize prohibited proprietary trading." An example of an inappropriate compensation approach, cited by the Agencies, is to compensate traders based solely on profit and loss, with no consideration of inventory control or risk undertaken to achieve the profits.

Importantly, the Agencies noted that this prohibition does not prohibit banking entities from:

- Rewarding an employee for successful underwriting, which involves some risk-taking;
- Taking into account, for an employee's compensation, movement in the price of securities that it underwrites to the extent that the revenues reflect the effectiveness with which the employee managed the underwriting risk (as long as the banking entity rewards the employee for client revenues and effective client services, not proprietary trading);
- Compensating an employee from profits arising from unsold allotments; and
- Providing compensation to an employee that is not vested for a period of time.

The Agencies further stated that they did not believe a prohibition on these practices was necessary, given the provisions in the Final Rule that establish sufficient controls on risk-taking activity.

Notably, the Final Rule also rejected the "source of revenue" requirement, which appeared in the Proposed Rule and would have required that the underwriting activities be designed to generate revenues from "fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions." In eliminating this provision, the Agencies noted their belief that other provisions of the Final Rule were sufficient to provide the necessary controls. The Agencies declined to adopt provisions that would have: (i) prevented an underwriter from generating revenue from price appreciation, since such a provision might prohibit the retention of unsold allotments; (ii) prevented a banking entity from acting as an underwriter for a distribution in opaque or illiquid the securities; and (iii) established a revenue requirement for securitization activities.

5. Test Five: The banking entity is registered or licensed as required by law.

The fifth and final test, in Section __.4(a)(v), is that the banking entity is licensed or registered to engage in the underwriting activity, in accordance with applicable law.

Importantly, this provision would not require a banking entity that is not required to register to do so to qualify for the exemption. Similarly, a banking entity that is engaged in business outside of the United States for which no U.S. registration is required would not need to be subject to "substantive regulation" to rely on the exemption, as was proposed.

E. Permitted Risk-Mitigating Hedging Activities – Section __.5

1. Overview

Section __.5 of the Final Rule implements the statutory exemption in Section 13(d)(1)(C) of the BHCA for risk-mitigating hedging activity. The structure of the Final Rule is similar to that of the Proposed Rule in that it requires (i) the establishment of an internal compliance program to ensure compliance with the requirements of the hedging exemption; (ii) hedging of specific risks of a banking entity; and (iii) enhanced documentation requirements as to certain types of hedging transactions. However, a number of modifications were made to the Final Rule to ensure that the exemption is limited to hedging that is risk-mitigating and related to identifiable financial positions of a banking entity. Among other modifications, these changes include:

- Requiring that written policies and procedures be developed and implemented at an appropriate level of the banking entity (expanding on the Proposal's requirement that senior management be accountable for implementation of a compliance program);

- Requiring that a banking entity's policies and procedures specify not only the positions, contracts, or other holdings a trading desk may use in its risk-mitigating hedging transactions, but also position and aging limits for such positions, contracts, and other holdings;

- Expanding the enhanced documentation requirements to apply where hedging is established using an instrument, technique, or strategy not identified in a trading desk's written policies and procedures, and when hedges are established to hedge aggregated positions across two or more trading desks; and

- Modifying the correlation requirement related to hedging under the exemption.

In addition, the Final Rule clarifies that the requirement that the compensation of persons performing risk-mitigating hedging must be designed not to reward prohibited proprietary trading, rather than "proprietary risk-taking," as had been proposed.

The Release also addresses many questions raised by commenters on the Proposed Rule. Specifically, the Release affirms that: (i) the Final Rule permits hedging in connection with and related to individual or aggregated positions; (ii) hedging related to market-making activities is subject to the requirements of the market-making exemption rather than to Section __.5; (iii) subject to enhanced documentation requirements, hedging may occur across affiliates under the exemption; (iv) aggregate hedging, dynamic hedging, and anticipatory hedging meeting the correlation standards and designed to be risk reducing are permissible; and (v) by contrast, the Final Rule does not permit hedging of more generalized risks that a trading desk or combination of desks or the banking entity as a whole believes exists based on non-position-specific modeling or other considerations.

The following sections discuss the hedging exemption in more detail.

2. Permitted Risk-Mitigating Hedging Activities

Section __.5 of the Final Rule provides that the prohibition on proprietary trading "does not apply to risk-mitigating hedging activities of a banking entity in connection with individual or aggregated positions, contracts or other holdings of the banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts or other holdings." To distinguish between risk-reducing activity and prohibited proprietary trading, the Final Rule adopts a "multifaceted approach" to implementing the hedging exemption that includes a required internal compliance program, provisions on conducting risk-mitigating hedging activities, compensation limits, and enhanced documentation requirements for certain hedging activities.

a) General Requirements

Internal Compliance Program. Banking entities relying on the hedging exemption are required to establish an internal compliance program in accordance with Subpart D of the Final Rule that is reasonably designed to ensure a banking entity limits its hedging activities to hedging that is risk-mitigating.[33] The Final Rule retains the proposed requirement that the scope and detail of an internal compliance program reflect the size and activities of the banking entity, but includes additional detail on internal compliance programs. Specifically, to ensure senior management involvement in establishing hedging policies, the written policies and procedures required under the Final Rule must be developed and implemented at "the appropriate level of organization" and address the banking entity's escalation procedures, supervision, and guidance for hedging activities. The Final Rule also adds to the requirement of the Proposal that written policies and procedures document the positions, techniques, and strategies that may be used for hedging with the new requirement that such policies specifically include position and aging limits with respect to hedging positions, contracts, or other holdings. A banking entity's policies and

[33] See discussion of Subpart D of the Final Rule at Section VI below.

procedures also must contain internal controls, ongoing monitoring, and independent testing requirements.

The Final Rule also modifies the requirement in the Proposal that a hedge maintain a correlation to the underlying positions. The Final Rule requires banking entities to analyze correlation before engaging in hedging activity and hedges should be negatively correlated to the risk being hedged. If correlation cannot be demonstrated, a banking entity's analysis must explain why this is the case, how the proposed hedge is designed to reduce or significantly mitigate risk, and how that reduction or mitigation can be demonstrated without correlation.

Finally, the Release notes that hedging may occur across affiliates under the hedging exemption. As discussed below, such hedging is subject to enhanced documentation requirements under the Final Rule to help identify and prevent prohibited proprietary trading.

Conducting Risk-Mitigating Hedging Activity. The Final Rule requires that risk-mitigating hedging activity be conducted in accordance with a banking entity's written policies, procedures, and internal controls. Such activity must, at inception (and at any later adjustments) be designed to reduce or otherwise significantly mitigate, and *demonstrably* reduce or otherwise significantly mitigate, one or more specific, identifiable risks arising in connection with and related to identified individual or aggregated positions, contracts, or other holdings of the banking entity. Moreover, while acknowledging that legitimate hedging transactions may result in new risks, the Final Rule provides that risk reducing hedging activity may not give rise to significant new or additional risk that is not also contemporaneously hedged. Whether hedging activity demonstrably reduces or otherwise significantly mitigates risks that may develop over time will be based on the facts and circumstances of the underlying and hedging positions, contracts, and other holdings of the banking entity and the risks and liquidity thereof.

While the Final Rule does not use the term "portfolio hedging," the Release nevertheless makes clear that the statutory hedging exemption permits a banking entity to engage in risk-mitigating hedging in connection with aggregated positions of the banking entity. Hedging of aggregated positions must be related to identifiable risks related to specific positions, contracts, or other holdings of the banking entity. Banking entities seeking to hedge the risk of an aggregation of positions must be able specifically to identify the risk factors arising from the aggregate position, and to identify the positions being hedged with enough specificity that the specific financial instruments held by the banking entity that comprise the set of positions being hedged can be clearly identified. The Agencies emphasize that the hedging activity cannot be designed to reduce risk associated with the banking entity's general management of its assets and liabilities, general market movements or broad economic conditions, or profit in the case of a general economic downturn, or to counterbalance revenue declines generally or otherwise arbitrage market imbalances.

The Final Rule, like the Proposal, allows "dynamic hedging" and "anticipatory hedging." Dynamic hedging must be designed to reduce or otherwise significantly mitigate, and demonstrably reduce or otherwise significantly mitigate, material changes in risk that develop over time from positions intended to be hedged. "Anticipatory hedging" involves engaging in hedging activity before a banking entity becomes exposed to the underlying risk. Unlike the Proposed Rule, the Final Rule does not require that an anticipatory hedge be established "slightly" before a banking entity becomes exposed to the underlying risk to fall within the exemption. Instead, the Release indicates that the various parts of the Final Rule are designed to ensure that all hedging, including anticipatory hedging, are designed to be risk reducing. In addition, the Final Rule requires ongoing recalibration of hedging activity to ensure that hedging is not proprietary trading and notes that if an anticipated hedge does not materialize within a limited time period, a banking entity is required to extinguish the anticipatory hedge or demonstrably reduce the risk associated with the position as soon as practicable.

By contrast, the hedging exemption is not intended to encompass the hedging of general risks that one or more trading desks or a banking entity as a whole believe exist based on non-position specific considerations.[34] Hedging to reduce risks associated with a banking entity's assets and/or liabilities generally, general market movements or broad economic conditions that are unrelated to the risks

[34] Release at 346.

resulting from positions lawfully held by a banking entity are outside the statutory exemption and the Final Rule.

Compensation Limitations. The Final Rule retains the requirement of the Proposal that the compensation of persons performing risk-mitigating hedging activities be designed not to reward proprietary trading.

(ii) Documentation Requirements

Subsection __.5(c) of the Final Rule requires enhanced documentation for certain hedging transactions. As proposed, banking entities are required to retain enhanced documentation for hedging activity conducted under the exemption if the hedging is not conducted by the specific trading desk establishing or responsible for the underlying positions being hedged. However, the Final Rule has expanded the requirements of the Proposal by requiring enhanced documentation if a hedge is established using a financial instrument, technique, or strategy that is not specifically identified in a trading desk's written policies and procedures as a product, instrument, technique, or strategy that may be used for hedging. Similarly, and unlike the Proposal, the Final Rule requires enhanced documentation for hedges established to hedge aggregated positions across two or more desks. The Release notes that enhanced documentation is necessary in these instances because the further removed hedging activities are from the specific positions, contracts, or other holdings intended to be hedged, the greater the danger that such activity is not limited to hedging specific risks of individual or aggregated positions, contracts, or other holdings of the banking entity. The enhanced documentation must be made contemporaneously with the hedging transaction and must document the: (i) specific and identifiable risks of the identified positions, contracts, or other holdings of the banking entity that the hedge is designed to reduce; (ii) specific risk-mitigating strategy that the hedge is designed to fulfill: and (iii) trading desk or business unit establishing and responsible for the hedge. Banking entities are required to retain the enhanced documentation for at least five years, or such longer period as required by law.

F. Other Permitted Proprietary Trading Activities – Section ___.6

1. Permitted Trading in Domestic Government Obligations – Section __.6(a)

The Final Rule provides an exemption from the prohibition on proprietary trading by a banking entity for trading in domestic government obligations, including:

- Obligations issued or guaranteed by the United States;
- Obligations, participations, or other instruments issued or guaranteed by agencies of the United States or a government sponsored enterprise, such as the Federal National Mortgage Association;
- Obligations of states or political subdivisions or their agencies, including municipal securities; and
- Obligations of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC as conservator or receiver.

In response to numerous commenters' concerns, the Final Rule expands the government securities exemption to include, among other modifications, obligations *guaranteed* by the United States or an agency thereof*, all* municipal securities and not just those issued by states or political subdivisions of states, and FDIC obligations.

However, the Final Rule does not include an exemption for trading in derivatives on U.S. government obligations. However, such trading, including in connection with primary dealer activities, may qualify for the market-making related activities or risk-mitigating hedging exemptions.

2. Permitted Trading in Foreign Government Obligations – Section __.6(b)

While containing an exemption for trading in U.S. government obligations, the Proposed Rule did not exempt proprietary trading in financial instruments issued or guaranteed by a foreign sovereign, though

such trading may have been able to qualify for one or more other exemptions. The Final Rule, however, contains a narrow categorical exemption for trading in foreign government obligations. Section __.6(b) of the Final Rule permits a U.S. affiliate of a foreign bank to engage in proprietary trading in financial instruments issued or guaranteed by a foreign sovereign or any agency or political subdivision thereof (including a multinational central bank of which the foreign sovereign is a part), if:

- The U.S. affiliate is controlled by a banking entity organized under the laws of a foreign sovereign, and is not controlled by a top-tier U.S. banking entity;

- The government obligations are issued or guaranteed by the foreign bank's home country government or any agency or political subdivision thereof (or a multinational central bank of which the foreign sovereign is a member); and

- The purchase or sale as principal is not made by a U.S. insured depository institution.

The Final Rule also permits foreign banks that are foreign affiliates of U.S. banking entities to engage in proprietary trading in obligations issued or guaranteed by the government where the foreign affiliate is organized, *i.e.*, the host country, or by agencies or political subdivisions of the host country (or a multinational central bank of which the host country is a member). A foreign affiliate also may engage in proprietary trading in these obligations if it is regulated as a securities dealer in the host country. To avail itself of this exemption the foreign affiliate must own the financial instrument and the trade cannot be financed by a U.S. affiliate.

3. Permitted Trading on Behalf of Customers – Section __.6(c)

As with the Proposed Rule, the Final Rule also permits trading on behalf of customers. A banking entity acting as trustee or in a similar fiduciary capacity, for example in the context of providing advisory, trust, or other fiduciary services to customers, may conduct proprietary trading activities if the transaction is for the account or on behalf of the customer and the banking entity does not have or retain beneficial ownership of the financial instruments. Banking entities are also allowed to engage in riskless principal transactions. Any transaction conducted pursuant to the riskless principal exemption must be customer-driven and may not expose the banking entity to gains or losses as principal on the value of the traded instruments. The banking entity may not buy or sell a financial instrument without first having a customer order for that financial instrument that it contemporaneously offsets.

4. Permitted Insurance Company Activities – Section __.6(d)

In response to the statutory requirement that the Agencies appropriately accommodate the business of insurance,[35] the Final Rule contains an exemption for trading for both the general and separate accounts of regulated insurance companies. Although the Proposed Rule had permitted trading activity by an insurance company for a separate account as part of its trading on behalf of customers exemption, the Final Rule combines this exemption with an exemption for trading activity in an insurance company's general account, which had also been proposed. To ensure there are no gaps in the scope of the exemption, the Final Rule defines the general account of an insurance company to be all of the assets of the insurance company other than separate account assets.

Thus, Section __.6(d) of the Final Rule permits proprietary trading by a banking entity that is an insurance company or an affiliate of an insurance company for the general and separate accounts of the insurance company if the trading is conducted in compliance with and subject to relevant insurance investment laws, regulations, or guidance, and if the federal banking agencies, after consultation with the Financial Stability Oversight Council and relevant insurance regulators, do not jointly determine (after notice and comment) that any particular insurance law, regulation, or guidance is insufficient to protect the banking entity's safety and soundness or U.S. financial stability. The federal banking agencies have not determined, as part of the final rule, that any state's or jurisdiction's applicable insurance laws, regulations, or guidance are insufficient.

[35] *See* 18 U.S.C. Section 1851(d)(1)(F).

5. Proprietary Trading by Foreign Banking Entities – Section __.6(e)

To implement the statutory limitation on the extraterritorial reach of the Volcker Rule, the Proposed Rule provided an exemption from the restriction on proprietary trading for trading "solely outside the United States." In determining what constitutes activity conducted "solely outside the United States," the Proposed Rule took a transaction-based approach and required, among other things, that no counterparty to a trade could be a U.S. resident, and each proprietary trade was required to be conducted "wholly outside" the United States. The Final Rule, however, focuses not on the location of the trading activity but rather on the location of the parties and their personnel. The Final Rule exempts from the prohibition on proprietary trading the purchase or sale of financial instruments by foreign banks subject to the following requirements:

- The foreign bank may not be directly or indirectly controlled by a U.S. banking entity;
- The foreign bank must be a Qualified Foreign Banking Organization ("FBO")[36] under Regulation K. Any non-U.S. banking entity that controls a U.S. thrift or FDIC-insured industrial bank must meet a modified Qualified FBO test;
- Neither the banking entity engaging as principal in the transaction, nor any personnel of the banking entity or its affiliate that arrange, negotiate or execute the purchase or sale may be located in or organized under the laws of the United States;
- The banking entity (including relevant personnel) that makes the decision to engage in the transaction as principal may not be located in or organized under the laws of the United States;
- The transaction, including any related risk-mitigating hedging transaction, may not be accounted for as principal directly or on a consolidated basis by any branch or affiliate located in or organized under the laws of the United States;
- No financing for the transaction may be provided, directly or indirectly, by any branch or affiliate is located in or organized under the laws of the United States; and
- The purchase or sale may not be conducted with or through any U.S. entity.

However, a foreign bank may effect a transaction with the foreign operations of a U.S. entity if no personnel of the U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of the transaction. A foreign bank may also effect a transaction with an unaffiliated market intermediary acting as principal, provided the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty. Finally, a foreign bank also may effect a transaction through an unaffiliated market intermediary acting as agent, if the transaction is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty. "Unaffiliated market intermediary" is defined for this purpose as an unaffiliated U.S. broker, dealer, or futures commission merchant.

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[36] An FBO is defined in relation to the Board's Regulation K, *i.e.*, as (i) a company organized under the laws of a foreign country that engages in the business of banking, and any non-U.S. subsidiary or affiliate, that: (a) operates a branch, agency, or commercial lending company subsidiary in the United States; (b) controls a bank in the United States; or (c) controls certain Edge corporations; and (ii) any company of which that foreign bank is a subsidiary. An FBO does not include any foreign bank organized under the laws of the Puerto Rico, Guam, American Samoa, the U.S. Virgin Islands, or the Northern Mariana Islands. A Qualified FBO is an FBO that satisfies certain standards under the Final Rule.

IV. Covered Fund Activities and Investments (Subpart C)

A. General Prohibition – Section __.10(a)

Section 13(a) of the BHCA prohibits a banking entity from acquiring and retaining any ownership interest in, or acting as sponsor to, a "covered fund," except as otherwise permitted. The Final Rule applies this statutory prohibition to a banking entity engaging in covered activities, directly or indirectly, as principal (the "Covered Fund Prohibition"). As with the proprietary trading prohibition, the statute contains a number of exclusions, each of which is implemented in the Final Rule.

The Final Rule makes the scope of acting "as principal" clear and more consistent with the proprietary trading restrictions. Accordingly, the Final Rule excludes from the scope of the Covered Fund Prohibition acquiring or retaining an ownership interest in a covered fund in connection with acting on behalf of customers as an agent, broker, custodian, or trustee or similar fiduciary capacity, through a deferred compensation or similar plan, or in the ordinary course of collecting a debt previously contracted. The Agencies determined that these types of interests do not involve a banking entity engaging in an activity intended or designed to take an ownership interest in a covered fund as principal and therefore are not the types of activities the Volker Rule was intended to address. The Release emphasizes that these exclusions do not permit a banking entity to engage in establishing, organization, and offering, or acting as sponsor to a covered fund in a manner other than as permitted elsewhere in the Final Rule.

In addition, as with the proprietary trading prohibition, even if otherwise permitted, covered fund activities remain subject to the Volcker Rule's backstop provisions, discussed below in Section V.

B. Definitions

1. Covered Fund

Section 13(h)(2) of the BHCA defines hedge fund and private equity fund as "any issuer that would be an investment company, as defined in the Investment Company Act of 1940 ['ICA'] . . ., but for [S]ection 3(c)(1) or 3(c)(7) of that Act," or any similar fund that the Agencies determine to include. Like the Proposed Rule, the Final Rule tracks the language of the statute by tying the definition of covered fund to Sections 3(c)(1) and 3(c)(7).

However, unlike the Proposed Rule, which included all commodity pools and any foreign equivalent of a hedge fund, private equity fund, or commodity pool in the definition of covered fund, the Final Rule includes a more limited group of commodity pools and foreign funds.

Commodity Pools. The Agencies had proposed to include within the definition of a covered fund a "commodity pool" as defined in the Commodity Exchange Act. Many commenters objected to this inclusion because under the CFTC's interpretation of the term "commodity pool" a fund that engages in only a single futures or swap transaction may be a commodity pool and hence would be a covered fund under the proposal. In the Final Rule, the Agencies narrowed the coverage of commodity pools so that a covered fund would include only those pools that "are similar to issuers that would be investment companies as defined in the [ICA] but for [S]ection 3(c)(1) or 3(c)(7) of that Act."

Specifically, a commodity pool will be a covered fund if the operator of the pool is registered as a commodity pool operator and the operator has claimed an exemption under Section 4.7 of the CFTC's regulations for funds that are offered only to qualified eligible persons. Similarly, if the operator of a pool has not claimed an exemption under Section 4.7, but substantially all of the pool's participation units are owned by qualified eligible persons under Section 4.7(a)(2) and 4.7(a)(3) of the CFTC's regulations, and the pool has not been publicly offered to persons that are not such qualified eligible persons, the commodity pool would be a covered fund. The latter condition is intended to ensure that funds that are eligible for the Section 4.7 exemption cannot avoid becoming a covered fund by not claiming that exemption. Commodity pools for which the pool operator is either excluded or exempted from the definition of commodity pool operator by CFTC regulation or no-action relief would not be within the definition of covered fund. A commodity pool that is included within the CFTC definition of commodity pool through either of these criteria nonetheless will not be a covered fund if the pool also qualifies for an exclusion from the covered fund definition, including the exclusion for registered investment companies.

Foreign Funds. A foreign fund will be deemed a covered fund only as to any U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as a sponsor to the fund or has an ownership interest in the fund. Under the Final Rule, a foreign fund is a covered fund if it: (i) is organized or established outside the United States; and (ii) holds itself out as being an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and (iii) has as its sponsor the banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by the banking entity (or an affiliate thereof). If a foreign fund could rely on an exclusion from the definition of investment company under the ICA *other than* Sections 3(c)(1) or 3(c)(7), it will not be a covered fund.

2. Exclusions From the Definition of Covered Fund

The Agencies received significant commentary on what types of entities should be excluded from the definition of covered fund. Unlike the Proposal, the Final Rule deems certain types of entities to be *excluded* from the covered fund definition rather than included, but *permitted.* Although the Final Rule includes 13 specific exclusions discussed in detail below, the Agencies did not exclude venture capital funds, credit funds, cash management vehicles, or cash collateral pools, despite the suggestions of commenters. Most notably, the Agencies did not include an exclusion for venture capital funds because they determined that venture capital funds share many of the same defining characteristics as private equity funds. They also stated that the language of the statute does not support providing such an exclusion, even though the statute explicitly refers to hedge funds and private equity funds and not venture capital funds.

The following are excluded from the definition of covered fund:

Foreign Public Funds. Foreign public fund generally means any issuer organized or established outside of the United States in which the ownership interests are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through public offerings outside of the United States However, as to a foreign public fund sponsored by a U.S. banking entity, the exclusion is available only if the ownership interests are sold predominantly to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.

Wholly-Owned Subsidiaries. The Final Rule removes the requirement that wholly-owned subsidiaries be engaged in *bona fide* liquidity management activities. This means that any wholly-owned subsidiary is excluded from the definition of covered fund. The definition of wholly-owned subsidiary requires that all of the outstanding "ownership interests" must be owned directly or indirectly by the banking entity or an affiliate thereof, except that up to five percent of the outstanding ownership interests may be held by employees or directors of the banking entity or such affiliate. In addition, up to one-half of one percent may be held by a third party, if acquired or retained for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

Joint Ventures. A joint venture will be excluded from the definition of covered fund if it is comprised of no more than 10 unaffiliated co-venturers; is in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities. Unlike the Proposed Rule, the Final Rule does not require that such entities be operating companies.

Acquisition Vehicles. The Final Rule more clearly delineates the limited activities in which an excluded acquisition vehicle may engage. However, as in the Proposed Rule, the acquisition vehicle must be formed solely for the purpose of engaging in *bona fide* merger or acquisition transaction and exist only for such time as necessary to effect the transaction.

Foreign Pension or Retirement Funds. The Final Rule excludes any plan, fund, or program providing pension, retirement, or similar benefits that is (i) organized and administered outside of the United States; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and (iii) established for the benefit of citizens or residents of one or more foreign sovereign

or any political subdivision thereof. This exclusion effectively treats such entities like their U.S. pension fund counterparts, which typically rely on an exclusion from the definition of investment company in Section 3(c)(11) of the ICA.

Insurance Company Separate Accounts. To accommodate the business of insurance in a regulated insurance company, the Final Rule excludes an insurance company separate account if no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.

Bank Owned Life Insurance. Like the Proposed Rule, the Final Rule recognizes that investments by banking entities in life insurance policies that cover key employees do not typically involve speculative risks and help banking entities reduce their employee benefit costs. Accordingly, the Final Rule excludes a separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which such banking entity(ies) is a beneficiary if the banking entity that purchases the policy does not control the investment decisions regarding the underlying assets or holdings of the separate account, and does not participate in the profits and losses of the separate account except in compliance with applicable supervisory guidance regarding bank owned life insurance.

Loan Securitizations. In keeping with Section 13(g)(2) of the BHCA, which provides that nothing in the Volcker Rule "shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law," the Final Rule also excludes loan securitizations from the definition of covered fund. Recognizing that, to administer a loan securitization transaction, loan securitizations must hold assets other than the loans underlying the securitization, the Final Rule excludes all loan securitizations, the assets of which are comprised solely of (i) loans; (ii) contractual rights or assets relating to servicing or distribution of proceeds or related or incidental to acquiring or holding the loans; (iii) servicing-related cash-equivalent securities; (iv) securities received in lieu of debts previously contracted as to the loans; (v) interest rate or foreign exchange derivatives that related directly to the loans or servicing rights or assets; and (vi) certain intermediate asset-backed securities that are created solely for the purpose of facilitating a loan securitization, and once created, are issued directly into the securitization vehicle (referred to as "units of beneficial interest and collateral certificates"). The Final Rule does not grandfather existing loan securitizations that do not meet these conditions. Stating that the rule of construction applies only to the securitization of "loans," the Agencies declined to include other types of instruments in excluded loan securitizations and also declined to exclude other types of securitization vehicles from the covered fund definition, other than qualifying asset-backed commercial paper conduits and qualifying covered bonds, described below.

As banking entities analyze the Final Rule, a potential interpretive issue has emerged as to whether banking entities that purchase certain debt securities in loan securitizations that are not excluded from the "covered fund" definition could be deemed sponsors or owners merely by virtue of certain contingent rights that attach to those securities.

Qualifying Asset-Backed Commercial Paper Conduits. Because of their similarity to loan securitizations, the Final Rule also excludes certain qualifying asset-backed commercial paper conduits. Such conduits may hold only (i) loans or other assets that would be permissible in a loan securitization and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities. In addition, the conduit may issue only asset-backed securities, comprised of a residual interest and securities with a legal maturity of 397 days or less. Finally, a "regulated liquidity provider,"[37] as defined in the Final Rule, must have a legally binding commitment to provide full and unconditional liquidity coverage for all the outstanding short term asset-backed securities issued by the qualifying asset-backed commercial paper conduits.

[37] A regulated liquidity provider is defined as (i) a depository institution as defined in Section 3 of the Federal Deposit Insurance Act; (ii) a bank holding company or a subsidiary thereof; (iii) a savings and loan holding company, provided all or substantially all of the holding company's activities are permissible for a financial holding company, or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in Section 211.21 of the Federal Reserve Board's Regulation has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or (v) a sovereign nation.

Qualifying Covered Bonds. The Final Rule excludes entities that own a dynamic or fixed pool of assets covering the payment obligations of covered bonds. The assets or holdings in the cover pool must meet the conditions of loan securitization exclusion, except that the securities they issue need not be asset-backed securities.

SBICs and Public Welfare Investment Funds. The statute and the Final Rule, like the Proposed Rule, excludes Small Business Investment Companies and similar funds from the definition of covered fund, subject to the requirements in Section __.10(c)(11).

Registered Investment Companies and Excluded Entities. Although the Proposed Rule did not include registered investment companies and business development companies in the definition of covered fund, the Agencies revised the definition of covered fund expressly to exclude such funds to address concerns that such entities could be treated as covered funds under certain circumstances. Section __.10(c)(12) excludes registered investment companies and issuers that have been elected to be treated as business development companies under Section 54(a) of the ICA. Further, the exclusion also applies to any entity that is formed and operated under a written plan to become a registered investment company or business development company. The Final Rule also excludes any entity that relies on an exclusion from the definition of investment company, other than Sections 3(c)(1) or 3(c)(7) of the ICA. This means that an entity that relies on another exclusion, but also qualifies for exclusion by means of Section 3(c)(1) or Section 3(c)(7), is not a covered fund. For example, a fund that invests primarily in mortgages and other real estate related assets and comes within Section 3(c)(5)(C) of the ICA would not be a covered fund. Similarly, any company that is primarily engaged in a business other than investing in securities, directly or through wholly-owned subsidiaries, and therefore is excluded by Section 3(b)(1) of the ICA, would not be a covered fund.

Issuers in Conjunction with FDIC Receivership or Conservatorship Operations. The Final Rule excludes from the definition of covered fund any issuer that is an entity formed by or on behalf of the FDIC to facilitate the disposal of assets acquired in the FDIC's capacity as a conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

The various exclusions from the definition of covered fund set forth in the Final Rule are quite helpful. Nevertheless, it is very likely that there will remain many interpretive questions about the various types of entities that would be an investment company, but for Section 3(c)(1) or Section 3(c)(7). In particular, these sections are used to avoid investment company status by a wide range of entities that are not commonly thought of as private funds, but that own interests that may be deemed to be securities under some circumstances. If those interests amount to more than 40% of an issuer's assets, the issuer may come within the definition of investment company in Section 3(a)(1)(C) of the ICA, and therefore be what is known as an inadvertent investment company, even though it in no way resembles a private equity fund or a hedge fund.

3. Covered Fund-Related Definitions

Ownership Interest. As with the proposed definition, the Final Rule defines ownership interest to mean "any equity, partnership, or other similar interest" in a covered fund. However, the Final Rule expands significantly the definition of "ownership interest" from that initially proposed, by including a broad definition of "other similar interest." This change was made in response to requests by commenters for additional clarity regarding the types of interests that would be within the scope of the definition. The Final Rule contains six characteristics that would cause an interest to be an "other similar interest" rather than including or excluding specific instruments that might have equity features. The characteristics defining an "other similar interest" are:

- The right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

- The right under the terms of the interest to receive a share of the income, gains, or profits of the covered fund;

- The right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

- The right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

- The terms of the interest provide that the amounts payable by the covered fund could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

- The right to receive income on a pass-through basis from the covered fund, or a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

- Any synthetic right to have, receive, or be allocated any of the rights described above.

As in the Proposed Rule, in adopting the Final Rule, the Agencies recognized that banking entities often serve in a capacity of investment manager, investment adviser, commodity trading advisor, or other service provider to covered funds and are compensated through receipt of a profit interest (referred to as carried interest in the Proposed Rule). Accordingly, the Final Rule excludes a "restricted profit interest" from the definition of ownership interest, if the restrictions in Section __.10(d)(6)(ii) are met. The restrictions are intended to ensure that a restricted profit interest functions as compensation for providing certain services to a covered fund and does not permit the banking entity to evade the investment limits in the Final Rule.

Sponsor. A banking entity would act as a "sponsor" to a covered fund if it exercises some control over the fund. Thus, a banking entity that serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund, or that selects or controls a majority of the fund's directors, trustees, or management, or that shares a name or a similar name with the fund, will be deemed to sponsor the fund. However, a trustee that does not exercise investment discretion, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee, pursuant to section 403(a)(1) of the Employee Retirement Income Security Act, would not be deemed to be a sponsor.

C. Permitted Covered Fund Activities – Sections __.11, __.12, and __.13

1. Organizing and Offering; General Exemption – Section __.11

Section 13(d)(1)(G) of the BHCA provides that a banking entity may invest in and sponsor covered funds within certain limits in connection with the organizing and offering of a covered fund. The Final Rule sets forth those limits and conditions necessary to qualify for this exemption.

The Final Rule was revised by the Agencies in response to commenters' concerns that the Proposed Rule could be read to prohibit a banking entity from engaging in activities that are part of organizing and offering a covered fund but that are not prohibited under the Covered Fund Prohibition, such as serving as investment adviser. Activities which are not covered by the Covered Fund Prohibition, such as serving as investment adviser, need no statutory exemption to be permissible.[38] Accordingly, the Final Rule provides that "a banking entity is not prohibited from *acquiring or retaining an ownership interest in, or acting as a sponsor to, a covered fund in connection with* directly or indirectly organizing and offering a covered fund, including serving as general partner, managing member, trustee, or commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing" if the conditions set forth in Sections __.11(a)(1) through (a)(8) of the Final Rule are met.

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[38] The Agencies noted that "[t]o the extent that an activity is not prohibited by section 13(a), no exemption to that statutory prohibition is need to conduct that activity." Release at 640.

The conditions in the Final Rule were adopted largely as proposed and mirror the language of the statute. To qualify under the exemption, the banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and the covered fund must be organized and offered only in connection with those services and only to the banking entity's customers of those services. As in the Proposed Rule, the Final Rule does not explicitly require a pre-existing customer relationship. Rather, the Agencies emphasized that a banking entity may not organize and offer a covered fund as a means of investing in the fund or its assets for itself. The banking entity must also comply with ownership and other restrictions and limits described in Sections IV.C.2 and IV.E below and must offer the covered fund pursuant to a written plan outlining how the banking entity (or affiliate) intends to provide such services to its customers through the organizing and offering of such fund.

The Final Rule also requires compliance with the following conditions to rely on the exemption:

No Guarantees. To prevent a banking entity from "bailing out" a covered fund in which it has an interest, the Final Rule prohibits a banking entity from, directly or indirectly, guaranteeing, assuming, or otherwise insuring the obligations or performance of a covered fund or of any covered fund in which that fund invests.

No Sharing of Names. A banking entity that organizes and offers a fund (and its affiliates) may not share a name or a variation of the same name with a covered fund for any purpose. The fund also may not use the word "bank" in its name. The Agencies received many comments on the name requirement. Despite commenters' concerns that such restriction would "impose significant business and branding burdens on the industry without providing incremental benefit to the public," the Agencies kept this prohibition as proposed.

Limits on Director or Employee Activities. The banking entity's directors and employees may not take or retain an ownership interest in a covered fund unless they are engaged directly in providing investment advisory or other services to the fund. The Agencies refused to modify this condition despite commenters' suggestions that investments in a sponsored fund by a broader group of banking entity employees should be permitted, regardless of whether they provided such services. The Final Rule provides that a former director or employee may retain such an interest in a covered fund if he or she acquired it while serving as director or employee and providing investment advisory or other services to the fund.

Disclosures. The Final Rule also requires banking entities engaging in covered fund activities to disclose "clearly and conspicuously" to any prospective or actual investor in a covered fund, among other things, that the fund's losses will be borne solely by investors and that the fund is not insured by the FDIC. The disclosure requirements may be met by including them in a fund's offering documents.[39]

a) Organizing and Offering an Issuing Entity of Asset-Backed Securities – Section __.11(b)

The Final Rule adds an additional subsection to Section __.11 to address the unique circumstances and ownership structures presented by securitizations and the new Section 15G of the Exchange Act added by Section 941 of the Dodd-Frank Act, which imposes minimum risk retention requirements in certain asset-backed securities offerings. The Final Rule allows a banking entity to organize and offer a covered fund that is an issuing entity of asset-backed securities, if the requirements in Sections __.11(a)(3) through (a)(8) are met. The Final Rule does not require compliance with Section __.11(a)(1) (requiring that the banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services) and Section __.11(a)(2) (requiring that the fund be organized and offering only in connection with the provision of such services to customers of the banking entity), because banking entities typically do not act in a fiduciary capacity when organizing a covered fund that is a securitization vehicle.

For the purposes of covered funds that are issuers of asset-backed securities, a banking entity will be considered to be "organizing and offering" such an issuer if the banking entity is acting as a "securitizer" of the issuing entity as such term is defined under the Exchange Act or acquiring an ownership interest as

[39] The Final Rule sets forth specific disclosure requirements including verbatim disclosure language that must be set forth in writing to prospective and actual investors. *See also* Release at 658.

required by the Exchange Act. Under the Exchange Act, a securitizer of asset-backed securities must retain an economic interest in not less than 5% of the credit risk of the assets collateralizing such asset-backed security (the "risk retention requirement"). The Agencies determined that where the risk retention requirement applies, that limit governs and supersedes the "per-fund" limits imposed by Section __.12(a)(2), as discussed in Section IV.C.2 below.

b) Permitted Underwriting and Market Making in a Covered Fund – Section __.11(c)

The Proposed Rule construed the underwriting and market-making exemptions in Section 13(d)(1)(B) of the BHCA narrowly and did not apply them to underwriting of, or market making in, interests in covered funds. This limited application drew significant commentary because many perceived there was a strong argument that the statutory language explicitly exempted such activities from both the proprietary trading prohibition and the Covered Funds Prohibition. In response to these comments, the Agencies noted in the Release that underwriting and market making are statutorily permitted activities and exempt from the prohibitions of Section 13(a), "whether on proprietary trading or on covered fund activities."[40] Accordingly, the Final Rule adds Section __.11(c) to provide a covered fund-specific exemption for underwriting and market-making related activities.

Section __.11(c) provides that the Covered Fund Prohibition does not apply to a banking entity's underwriting or market-making related activities involving a covered fund if the activities are conducted in accordance with the market-making and underwriting exemptions in Sections __.4(a) or (b), as applicable (discussed in Sections II.B. and II.C. above), and the ownership interests are included in the calculations of the per-fund and aggregate funds limits and tier 1 capital discussed below.

2. Permitted Investment in Covered Fund – Section __.12

A banking entity may acquire or retain a limited investment interest in a covered fund that it or an affiliate organizes and offers for the purposes of (i) establishing the fund and providing the fund with sufficient equity to allow the fund to attract unaffiliated investors and (ii) making and retaining an investment in the covered fund, in both cases subject to the "per-fund" and "aggregate funds" investment limits described in the Section __.12(a)(2).

If a banking entity acquires an ownership interest in a covered fund for the purposes of establishing such fund, then the banking entity may acquire all of the ownership interests of such fund if the banking entity actively seeks unaffiliated investors to reduce its own seed investment. Additionally, the banking entity must conform its ownership interest to the per-fund limits described in Section IV.C.2(a) below no later than one year from the date of establishment. While the Proposed Rule did not define "date of establishment," the Final Rule has been modified to define such term as the date on which the investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund. For an issuer of asset-backed securities, the date of establishment is the date on which the assets are initially transferred into the issuer.

The one-year limit may be extended for up to two years by application by the banking entity to the Board, if the Board finds that such extension would be consistent with safety and soundness and in the public interest. Section __.12(e)(2) describes the factors to be considered by the Board in making this determination. Among other things, the factors to be considered include whether the investment would result in a material exposure by the banking entity to high-risk assets or trading strategies, the cost to the banking entity of divesting or disposing of the investment within the applicable period, and market conditions.

c) Investment Limits

Per-fund limits. An investment by a banking entity or any of its affiliates in a covered fund must not exceed either three percent of the total number of ownership interests or value of the outstanding ownership interests in the fund. In determining the amount of ownership interests held in a particular covered fund, the banking entity must include all ownership interests permitted under Sections__.4 and

[40] Release at 687.

__.11 of the Final Rule.[41] In calculating the value of its ownership interests, the banking entity should use fair market value of the interest or contribution, or, if fair market value is unavailable, the historical cost basis of all investments and capital contributions. The calculations do not include committed-yet-uncalled funds towards the per-fund limit. Such commitments are only counted for the purposes of the limit when they are actually invested.

For the purposes of banking entities offering or organizing issuers of asset-backed securities pursuant to Section __.11(b) that are subject to the risk retention requirements of Section 15G of the Exchange Act, the banking entity must comply with the Section 15G requirement rather than the three percent limit. In such a case, the investment in a covered fund may not exceed the amount required under the applicable risk retention requirement.[42]

Aggregate fund limits. The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained may not exceed three percent of the banking entity's tier 1 capital as calculated as of the last day of each calendar quarter. The value of the ownership interest for these purposes is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in each covered fund, calculated based on the historical cost basis of such interests. The purpose of using historical cost basis is to prevent a banking entity from increasing "its exposure in the event that any particular investment declines in value as a result of the fund's investment activities."[43]

d) Attribution Rules for Calculating Ownership Interests

The Final Rule sets forth several specific provisions on how to calculate ownership interests for the purposes of the per-fund and aggregate funds limits.[44] Only investments made by the banking entity or another entity controlled by the banking entity must be included for the purposes of both the per-fund and aggregate funds limits. The banking entity need not include any *pro rata* share of any ownership interest held by any entity that is <u>not</u> controlled by the banking entity.[45] The banking entity also must take into account all director or employee investments in covered funds whenever the banking entity provides such person funding for the purposes of acquiring the ownership interest. Covered funds are not considered affiliates of the banking entity for the purposes of these calculations. This means that interests owned by the covered fund will not be attributed to the banking entity if it does not control such fund.

The Final Rule also provides additional clarification on how to apply the per-fund and aggregate funds limits for multi-tier fund structures. For master-feeder structures, if a feeder fund's investment strategy is to invest substantially all of its assets in a master fund, then for the purposes of the per-fund limit, the banking entity's investment is measured only at the master fund level.[46] Similarly, if the banking entity invests in a fund-of-funds structure, and the fund of funds invests in another covered fund that the banking entity organizes and offers, the banking entity must include both its direct investment in the other covered fund as well as its *pro rata* share of the ownership interest of the other fund as held through the fund of funds.

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[41] In addition, when determining the aggregate value of all fund ownership interests for purposes of the aggregate fund limits, the banking entity must include all ownership interests of the banking entity and its affiliates in all covered funds permitted under Sections __.4 and __.11 of the Final Rule. Banking entities that do not have any ownership interest under Section __.12 but act as a market maker or underwriter in accordance with Section __.11(c) of the Final Rule do not need to calculate and comply with these limits.

[42] The risk retention rules were recently reproposed by the agencies charged with implementing Section 15G. *See* Credit Risk Retention, 78 Fed. Reg. 57928 (Sep. 20, 2013).

[43] Release at 693.

[44] The Final Rule does not include the prohibition on parallel investments as originally included in the Proposed Rule. This prohibition would have required banking entities to include any investments made in parallel with a covered fund that it organized and offered for the purposes of the per-fund limit. Release at 710-11.

[45] The Final Rule does not include registered investment companies, business development companies, and foreign public funds as affiliates of the banking entity for the purposes of the per-fund and aggregate fund limits if the banking entity does not own or control 25% of the voting shares of such entity and provides investment advisory, commodity trading advisory, administrative, or other services to such entity in compliance with applicable law.

[46] If the banking entity makes investments directly into the master fund in addition to its investment in the feeder fund, then those investments also must be included in the calculation. Release at 706.

e) Capital Treatment for a Permitted Investment in a Covered Fund

Section 13(d)(4)(B)(iii) of the BHCA provides that, for the purposes of determining compliance with the capital standards under Section 13(d)(3), the aggregate amount of outstanding investments by a banking entity, including retained earnings, be deducted from assets and tangible equity.[47]

Accordingly, for the purposes of calculating compliance with the applicable regulatory capital requirements, a banking entity must make dollar-for-dollar reductions to its tier 1 capital based on the greater of (i) the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest on a historical cost basis, plus any earnings received and (ii) the fair market value of the banking entity's ownership interest in the covered fund if the banking entity accounts for the profits (or losses) of the fund investment in its financials. This deduction must be made each time the banking entity calculates its tier 1 capital.

D. Other Permitted Covered Fund Activities and Investments – Section __.13

Section __.13 of the Final Rule sets forth certain additional covered fund activities and investments that banking entities are permitted to engage in.

1. Permitted Hedging Activities

Under the permitted hedging exclusion, a banking entity may acquire or retain an ownership interest in a covered fund if it is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory, or other services to the covered fund and meets other criteria in the Final Rule. The criteria in Section __.13(a)(2) are largely based on the requirements for the risk-mitigating hedging exemption for trading activities under Section __.5 (discussed in Section III.D. above).

2. Foreign Banking Entities and Permitted Activities Outside of the United States

As with the exemption from the proprietary trading prohibition, certain foreign banking entities whose covered fund activities occur solely outside of the United States will be exempt from the covered fund activities prohibition if (i) it is conducted by a foreign banking entity; (ii) the activities are conducted under Sections 4(c)(9) or 4(c)(13) of the BHCA; (iii) no ownership interest in the fund may be offered or sold to a U.S. resident;[48] and (iv) the activity or investment occurs solely outside of the United States

Unlike the Proposed Rule which adopted a transaction-based approach to determining whether a transaction occurred solely outside of the United States, the Final Rule adopts a risk-based approach requiring that four conditions be met:

- The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or established under the laws of the United States or of any State;

- The banking entity, including relevant personnel, that makes the decision to acquire or retain the ownership interest are not located in the United States or organized under the laws of the United States or of any State;

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[47] The requirement under Section 13(d)(4)(B)(iii) of the BHCA "is independent of the minimum regulatory capital requirements in the final capital rule published by the Federal Banking agencies in 2013." Release at 696.
[48] The Release explains that "the sponsor of a foreign fund would not be viewed as targeting U.S. residents for purposes of the foreign fund exemption if it conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States." Release at 743. The definition of "resident of the United States" has been defined to have the same meaning as "U.S. person" in Regulation S under the Securities Act.

- The investment, including any transaction arising from risk-mitigating hedging, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under U.S. law; and

- No financing for the banking entity's ownership is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under U.S. law.

3. Permitted Activities of Regulated Insurance Companies

To accommodate the business of insurance within an insurance company, the Final Rule does not apply the Covered Fund Prohibition to an insurance company or its affiliate if three conditions are met. First, the insurance company or its affiliate must acquire and retain the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company. Second, the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, all applicable insurance company investment laws and regulations. Third, the appropriate federal banking agencies must not have jointly determined that a particular law, regulation, or written guidance applicable to the insurance company is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

E. Limitations on Relationships with a Covered Fund (Sections 23A/23B) – Section __.14

The Final Rule provides that a banking entity (or an affiliate) that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund, or that continues to hold an ownership interest in a covered fund under the risk retention rules, may not enter into a "covered transaction" with the covered fund, or with any other covered fund that is controlled by such covered fund. This was the so-called "Super 23A" provision of the Proposed Rule, and it survives in the Final Rule. Transactions between banking entities that sponsor or retain risk in a covered fund and that covered fund are also subject to the requirements of Section 23B of the Federal Reserve Act, which requires that all such transactions be at arm's length.

However, despite the blanket prohibition on "covered transactions," the Final Rule provides explicit exclusions for activities that are otherwise permissible under Sections __.11, __.12, or __.13, as well as for certain prime brokerage transactions, if the banking entity complies with all applicable requirements of Section __.11 and the CEO of the banking entity certifies in writing annually that the banking entity does not guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which the covered fund invests. In addition, the Board must not have determined that the transaction is inconsistent with the safe and sound operation and condition of the banking entity. Permissible prime brokerage transactions are also subject to the requirements of Section 23B.

V. Backstop Prohibitions – Sections __.7 and __.15

Even if otherwise permitted under the Final Rule, *e.g.*, through the market-making, risk-mitigating hedging, or organizing and offering exemptions, proprietary trading and covered fund activities by a banking entity remain subject to the backstop provisions of the Volcker Rule. Thus, otherwise permitted activities will be prohibited if they: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result in a material exposure by the banking entity to a high-risk asset or trading strategy; or (iii) pose a threat to the banking entity's safety and soundness or to the financial stability of the United States.

A. Material Conflict of Interest

The Final Rule provides that a banking entity that engages in any transaction, class of transactions, or activity that would involve or result in its interests being materially adverse to the interests of its client, customer, or counterparty with respect to the transaction, class of transactions, or activity, must mitigate the conflict of interest, where possible, through either timely and effective disclosure or information barriers. Effective mitigation will protect the activity from violating Section __.7 or Section __.15, as applicable.

The Release posits that conflicts of interest may arise in a variety of circumstances related to permitted activities. For example, a banking entity could acquire nonpublic information about the financial condition of a particular company through its lending, underwriting, or investment advisory activities, enabling its trading operations to use the information to the disadvantage of its customers, clients, or counterparties. Although the Release observes that the mere fact that a buyer and seller are on opposite sides of a transaction and have differing economic interests would not be deemed a "material" conflict of interest, it emphasizes that the existence of a material conflict of interest depends on the specific facts and circumstances.

If the banking entity elects to address a conflict of interest through disclosure, the disclosure must permit a reasonable client, customer, or counterparty to understand the conflict in a meaningful way and substantially mitigate or negate any materially adverse effect created by the conflict. The implication is that disclosure must be provided sufficiently close in time to the other party's decision to allow for meaningful understanding and mitigation action.

If the banking entity elects to address the conflict through information barriers, it must establish, maintain, and enforce barriers reasonably designed to avoid a conflict's materially adverse effect, through written policies and procedures, physical separation, functional separation, and limitations on types of activity. Although the information barrier components described in the Release are typical of information barriers required by other statutes and regulations, the information barrier permitted by the Final Rule is subject to a significant limitation. The Final Rule provides that notwithstanding a banking entity's establishment of information barriers, the banking entity may not rely on these information barriers if it knows or *should reasonably know* that a material conflict of interest *may* involve or result in a materially adverse effect on a client, customer, or counterparty. In such situations, which neither the Release nor the Final Rule defines, the banking entity must address the conflict through timely and effective disclosure.

B. Material Exposure to a High-Risk Asset or High-Risk Trading Strategy

The Final Rule also prohibits a banking entity from engaging in an exempt activity if the activity would result, directly or indirectly, in a material exposure to a high-risk asset or a high-risk trading strategy. The Final Rule defines a high-risk asset or trading strategy as an asset or trading strategy that would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

Whether an asset or trading strategy is "high-risk" depends on the facts and circumstances. No asset or trading strategy has been identified by the Agencies as *per se* high-risk. Moreover, an asset or trading strategy may be high-risk to one banking entity but not another or may be high-risk to a banking entity under some market conditions but not others. Relevant facts and circumstances include the amount of capital at risk, whether the transaction is hedged, the amount of leverage, and the general financial condition of the banking entity. Banking entities engaged in an exempt activity must have a reasonably designed compliance program to monitor and understand whether they are exposed to high-risk assets or trading strategies.

VI. Compliance Program, Reporting, and Violations (Subpart D and Appendices A and B)

A. Compliance Program Mandate – Section __.20

Section __.20(a) implements Section 13(e)(1) of the BHCA and requires that each banking entity implement a compliance program that is reasonably designed to ensure compliance with the Volcker Rule's prohibitions and restrictions on proprietary trading and covered fund activities. Like the Proposed Rule, the Final Rule adopts a tiered approach to compliance program requirements.

1. Standard Compliance Program Requirements

Subject to the two exceptions described below, the compliance program, at a minimum, must include:

- Written policies and procedures reasonably designed to document, describe, monitor, and limit restricted trading activities and covered fund activities to ensure that all activities comply with the Volcker Rule;

- A system of internal controls reasonably designed to monitor compliance with the Volcker Rule and to prevent the occurrence of prohibited activities;

- A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters identified in the Final Rule or by management as requiring attention;

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

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

- Records sufficient to demonstrate compliance with the Volcker Rule, which a banking entity must promptly provide to the relevant supervisory Agency upon request and retain for a period of no less than 5 years.

In addition, the compliance program of a banking entity with more than $10 billion in total assets must provide for documentation and recordkeeping of: (i) determinations that certain sponsored funds are not covered funds; (ii) the plans for marketing any permitted fund seeding vehicle to investors and converting it into a registered investment company or SEC-regulated business development company; and (iii) for U.S. banking entities, documentation of the value of ownership interests in foreign public funds and the jurisdictions of such funds' organization if the total amount of the interests exceeds $50 million.

There are two exceptions to these requirements for banking entities not engaged in restricted activities and for smaller banking entities. A banking entity that is not engaged in proprietary trading or covered fund activities (other than covered transactions in obligations of or guaranteed by the United States or an agency of the United States and municipal securities) is not required to establish a compliance program. Also, a banking entity engaged in proprietary trading or covered fund activities that had less than $10 billion in total assets at the end of the previous two calendar years instead must only include in its existing compliance policies and procedures references to the Volcker Rule requirements as are appropriate given its activities, size, scope, and complexity.

2. Enhanced Compliance Program Requirements

A banking entity must implement an enhanced compliance program if the banking entity:

- Has covered trading activities sufficient to trigger the Final Rule's requirement that it report the quantitative trading metrics described below (*i.e.*, initially those banking entities with trading assets and liabilities greater than $50 billion, but later those with trading assets and liabilities greater than $10 billion);

- Has total assets as of the previous calendar year end greater than $50 billion (or, with respect to a foreign banking entity, has total U.S. assets greater than $50 billion); or

- Is notified by its primary federal supervisory Agency in writing that it must satisfy these enhanced compliance program requirements.

These thresholds are higher than those contemplated by the Proposed Rule, which would have required enhanced compliance program requirements for banking entities that: (i) had average trading assets and liabilities greater than $1 billion or greater than 10% of its total assets; (ii) owned an average of $1 billion in covered fund interests; or (iii) sponsored covered funds with assets of $1 billion or more. However, as described below, the Final Rule includes a new requirement that the banking entity's CEO must annually attest in writing that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the enhanced compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule.

In addition to the elements required by the standard compliance program, the enhanced compliance program must:

- Be reasonably designed to identify, document, monitor, and report the covered trading and covered fund activities of the banking entity; identify, monitor, and promptly address the risks of these covered activities and potential areas of noncompliance; and prevent activities prohibited by, or that do not comply with, the Volcker Rule;

- Establish and enforce appropriate limits on the covered activities of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of the Volcker Rule;

- Subject the effectiveness of the compliance program to periodic independent review and testing and ensure that the banking entity's internal audit, corporate compliance, and internal control functions involved in review and testing are effective and independent;

- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program; and

- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

In addition to these requirements, Section II of Appendix B to the Final Rule lists specific enhanced compliance program requirements separately applicable to covered trading activities and covered fund activities. If a banking entity is engaged in covered trading activities, the enhanced compliance program must:

- Have written policies and procedures governing each trading desk that include a description of certain information specific to each trading desk that will delineate its processes, mission and strategy, risks, limits, types of clients, customers and counterparties, and its compensation arrangements;

- Include a comprehensive description of the risk management program for the trading activity of the banking entity, as well as a description of the governance, approval, reporting, escalation, review, and other processes that the banking entity will use to reasonably ensure that trading activity is conducted in compliance with the Volcker Rule;

- Implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with the Volcker Rule and with the banking entity's policies and procedures, and establish and enforce risk limits appropriate for the activity of each trading desk; and

- For any permitted risk-mitigating hedging activities, establish, maintain, and enforce policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that describe the positions, techniques, and strategies that each trading desk may use, the manner in which the banking entity will determine that the risks generated by each trading desk have been properly and effectively hedged, the level of the organization at which hedging activity and management will occur, the manner in which such hedging strategies will be monitored and the personnel responsible for such monitoring, the risk management processes used to control unhedged or residual risks, and a description of the process for developing, documenting, testing, approving, and reviewing all hedging positions, techniques, and strategies permitted for each trading desk and for the banking entity.

If the banking entity is engaged in covered fund activities, the enhanced compliance program must:

- Provide a process for identifying all covered funds that the banking entity sponsors or organizes and offers, and covered funds in which the banking entity invests;

- Include a method for identifying all funds and pools that the banking entity sponsors or has an interest in and the type of exemption from the ICA or Commodity Exchange Act relied on by each fund or pool, and the amount of ownership interest the banking entity has in those funds or pools;

- Identify, document, and map where any covered fund activities are permitted to be conducted within the banking entity;

- Include an explanation of how the banking entity complies with the Final Rule, including the restrictions on transactions presenting material conflicts of interest or high-risks to the banking entity;

- Describe sponsorship activities related to covered funds;

- Establish, maintain, and enforce internal controls that are reasonably designed to ensure that the banking entity's covered fund activities comply with the requirements of the Volcker Rule;

- Monitor the banking entity's investments in and transactions with any covered funds; and

- Include procedures for identifying and remediating violations of the Volcker Rule.

In addition to these enhanced compliance program requirements, Section III of Appendix B to the Final Rule requires a banking entity to establish, maintain, and enforce both a governance and management framework to manage its business and employees with a view to preventing violations of the Volcker Rule. This includes a requirement that the banking entity's CEO annually attest in writing to the appropriate Agency that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the enhanced compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule.

3. Reporting and Recordkeeping Requirements for Covered Trading Activities

Each banking entity with significant covered trading activities must report to its primary federal supervisory Agency the quantitative trading metrics set forth in Appendix A to the Final Rule and keep certain records relating to these reports. A banking entity's primary federal supervisory Agency may also designate in writing that the banking entity must report these metrics and keep these records notwithstanding the size of its covered trading activities. These reporting requirements are intended to address some of the difficulties associated with (i) identifying permitted market-making related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. As described above, becoming subject to these reporting and recordkeeping requirements also triggers the enhanced compliance program requirements even if the banking entity has less than $50 billion in total assets.

The Final Rule contemplates a phase-in of the reporting requirements. A U.S. banking entity that, with its affiliates and subsidiaries, has trading assets and liabilities (excluding U.S. government obligations) greater than $50 billion must begin reporting the quantitative trading metrics starting in July 2014, while a U.S. banking entity with trading assets and liabilities greater than $25 billion (but less than $50 billion) must begin reporting in May 2016, and one with trading assets and liabilities greater than $10 billion (but less than $25 billion) must begin reporting in January 2017. For foreign banking entities, the amount of trading assets and liabilities is determined with respect to their U.S. operations. The triggers for the reporting requirements are significantly higher than those contemplated by the Proposed Rule.

Each banking entity subject to these reporting requirements will be required to report for each trading desk the following seven metrics (compared to 17 metrics under the Proposed Rule) on a monthly or quarterly basis (but calculated daily), depending on the amount of the banking entity's trading assets and liabilities:

- Risk and position limits and usage;

- Risk factor sensitivities;
- VaR and stress VaR;
- Comprehensive P&L attribution;
- Inventory turnover;
- Inventory aging; and
- Customer facing trade ratio.

The metrics must be calculated daily and reported to the primary federal supervisory Agency monthly, except that banking entities with less than $50 billion in trading assets and liabilities may report the metrics quarterly. These metrics must be reported by each trading desk. The Agencies believe that applying quantitative measurements to a level that aggregates a variety of distinct trading activities may obscure or "smooth" differences between distinct lines of business, asset categories and risk management processes in a way that renders the measurement relatively uninformative.

For each metric reported to its primary federal supervisory Agency, the banking entity also must create and maintain records documenting the preparation and content of these reports as well as the information necessary to permit the verification of the accuracy of the reports. These records must be kept for five years from the end of the calendar year for which the measurement was taken.

VII. Penalties for Violations and Evasion

Section 21(a) of the Final Rule provides that any banking entity that violates the Volcker Rule (or acts in a manner designed to evade it), "shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment." Section 21(b) was modified from the Proposed Rule to make clear that the Agencies retain their inherent authorities under other relevant provisions of law to enforce compliance with the Volcker Rule. Thus, Section 21(b) provides that whenever the applicable Agency has reasonable cause to believe a violation or evasion has occurred, that Agency may take any action permitted by law to enforce compliance, which includes, for example, seeking civil penalties or referring matters for criminal prosecution, forcing the banking entity or individuals to limit or terminate certain activities, and issuing cease and desist orders.

VIII. Conformance Period, Compliance Dates, and Extensions

Section 13 of the BHCA was effective on July 21, 2012. Section 13(c) of the BHCA provides for an initial two-year conformance period for banking entities to come into compliance with the Volcker Rule's requirements. The initial conformance period is thus scheduled to end on July 21, 2014. The statute permits the Board by rule or order to extend the conformance period for up to three one-year periods if it determines that the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. At its open meeting approving the Final Rule, the Board issued an order granting a one-year extension of the conformance period, until July 21, 2015. This leaves two possible additional one-year extensions.

During this extended time, a banking entity is expected to "engage in good faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments" to the Volcker Rule requirements by no later than July 21, 2015.[49] The order states that good faith efforts include evaluating the extent to which the banking entity is engaged in covered investments or activities as well as developing an "appropriately specific" plan for conformance. Banking entities must promptly terminate or divest any stand-alone proprietary trading operations and may not expand their activities during the conformance period with the expectation that an additional extension will be issued.

[49] Order Extending Conformance Period, p. 3.

The Board will monitor developments to determine whether additional extensions of the conformance period are appropriate.

A. Application for Additional Extensions

Pursuant to an earlier Volcker Rule rulemaking by the Board under Section 13(b)(2)(A) of the BHCA, the Board adopted procedures for banking entities to apply for additional one-year extensions. As noted above, since the Board has issued the first such extension, the conformance period may only be extended for a total of two more years after July 2015. Any banking entity may seek an extension by submitting a detailed request at least 180 days before the end of the applicable conformance period. Rule 225.181(c) of the Board's Regulation Y sets out several factors that will govern the Board's decision, including, for example, the nature and extent of the activity or investment and the banking entity's exposure and risk, the cost to the banking entity of divesting, whether the activity or investment involves or results in material conflicts of interest or a material exposure to high-risk assets or trading strategies, relevant market conditions, relevant contractual terms, and the efforts the banking entity has made to divest.[50] The Board will consult with any other primary financial regulator of the applicant banking entity and "seek to act" within 90 days of receipt of a complete record. Any extension issued by the Board may contain additional conditions.

1. Extensions for Illiquid Funds

In addition to applications for extension by any covered banking entity, banking entities that "acquire or retain" an equity, partnership, or other ownership interest in or otherwise provide additional capital to an "illiquid fund" may use the same procedures to apply for a one-time further extension of up to five years. While the Board will consider the same factors in making its decision, whether or not a covered fund is an "illiquid fund" is determined by reference to definitions in Rule 225.180, pursuant to which an "illiquid fund" means a covered fund that, as of May 1, 2010, was principally (*i.e.,* at least 75%) invested in illiquid assets or was invested in, *and* contractually committed to invest in, illiquid assets. In addition, the covered fund must make all investments pursuant to and consistent with an investment strategy to principally invest in illiquid assets.[51] Thus, the Board will only consider an application for extension if the fund is an illiquid fund *and* if the acquisition or retention by the banking entity of the interest is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010. Any extension granted by the Board will terminate automatically on the day the banking entity is no longer bound by the contractual obligation.

2. Additional Basis for Extension – Seeding a New Fund

As discussed above in Section IV.C(b), Section __.12(a)(1)(i) of the Final Rule permits a banking entity to establish ad provide initial funding to a new fund if the banking entity divests its interest up to the *de minimis* ownership threshold within a year of setting up the fund. In response to numerous comments, the Final Rule contains procedures for requesting up to two additional years to make this divestment. Banking entities must submit a detailed request, which must include their plan for reducing their investment, at least 90 days before the end of the first year of the new fund. The Board will consider largely the same factors and follow the same procedures as in connection with requests for extensions of the conformance period.

IX. Conclusion

Notwithstanding the Board's extension of the conformance period for compliance with the Volcker Rule until July 21, 2015, there is significant uncertainty as to what actions banking entities and other market participants with whom they transact might have to take in the near term to ready themselves for compliance. Although the Final Rule does not contain a mechanism for seeking Agency guidance, we nevertheless expect that as banking entities continue to grapple with the complexity of the Final Rule, new issues will emerge that may prompt the Agencies to take further action, whether in the form of interpretive guidance, additional time extensions, or other action.

[50] Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. at 8277 (Feb. 14, 2011).
[51] Regulation Y, Rule 225.180(f).

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