Client Update
The Volcker Rule: An Overview

NEW YORK
Paul L. Lee
pllee@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

Lee A. Schneider
lschneider@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Samuel E. Proctor
seproctor@debevoise.com

WASHINGTON, D.C.
Satish M. Kini
smkini@debevoise.com

Robert T. Dura
rdura@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

More than two years after they were originally proposed, on December 10, 2013, the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission adopted final regulations (the "Final Rule") to implement Section 13 of the Bank Holding Company Act (commonly known as the "Volcker Rule"). The Final Rule — which is the culmination of a well-reported and extraordinary regulatory process — is approximately 70 pages long and accompanied by a 900-page preamble that seeks to provide interpretive guidance, respond to the extensive comments received on the proposed rules and clarify the intent of the agencies.

Institutions within the ambit of the Volcker Rule must now begin the process of finalizing strategic decisions and implementing a significant compliance program to accommodate the Final Rule's intricate limits on trading and investment activities. In taking these steps, institutions also must consider, in addition to the Volcker Rule, certain other rules, such as the capital rules (including a new Basel fund investment framework published today)[1] and the liquidity coverage ratio.

This Client Update represents our initial analysis of this highly complex new regulation. For the benefit of clients and friends seeking a way to understand the new regulatory framework and its principal features, we present in bullet-point format a top-level review of the major components of the Final Rule. We anticipate providing a more in-depth analysis of the regulation and its implications for affected institutions in the coming weeks.

[1] Basel Committee, *Capital Requirements for Banks' Equity Investments in Funds* (revised December 2013), *available at* http://www.bis.org/publ/bcbs266.htm.

SCOPE AND COVERAGE

The Volcker Rule restricts the ability of banking entities to engage in proprietary trading and to invest in, sponsor and engage in certain types of transactions with certain private funds. Like the agencies' original proposal, the Final Rule defines "banking entity" to mean (i) an insured depository institution; (ii) a company that controls an insured depository institution; (iii) a company that is treated as a bank holding company under the International Banking Act of 1978; and (iv) any affiliate or subsidiary of the above.

The agencies did not adopt any exceptions to this definition (other than exceptions made for technical reasons) although they provide for some lesser compliance burdens for small banking entities, as described below. The agencies also did not address how or whether any Volcker Rule restrictions may be applied to nonbank systemically important financial institutions not affiliated with an insured depository institution. (These firms are not subject to the full scope of the Volcker Rule, but their proprietary trading and private fund activities may be subjected to certain capital requirements and quantitative limits.)

COMPLIANCE DEADLINE

- **Extended Compliance Period.** In a regulatory release accompanying the Final Rule, the Federal Reserve exercised its statutory authority under the Volcker Rule to extend by one year – to July 21, 2015 – the date by which banking entities must come into full conformance with the Volcker Rule's restrictions. As described below, certain reporting requirements will apply before this deadline. The Federal Reserve retains the statutory authority to grant additional extensions, and it previously adopted regulations detailing how requests for extensions would need to be made and how they would be processed. See 12 C.F.R. § 225.181.
- **Expectations of "Good Faith" Compliance Efforts**. In extending the compliance period, the Federal Reserve made clear that it expects banking entities to make "good faith" efforts to come into conformance with the Volcker Rule's requirements by the July 21, 2015 deadline. In particular, the Federal Reserve suggested banking entities commence developing and implementing compliance plans and warned banking entities not to expand activities during the conformance period with an expectation that they will be granted additional time to conform those activities. The Federal Reserve's General Counsel emphasized these points in his presentation to the Federal Reserve Board on December 10.

PROPRIETARY TRADING

- **Prohibition on Proprietary Trading**. The Final Rule prohibits a banking entity from trading any "financial instruments" as "principal" for its "trading account."

- **Trading Account**. The Final Rule defines the term "trading account" substantially as proposed to include an account used by a banking entity for: (i) short-term trading; (ii) trading in market-risk capital rule covered positions and trading positions; and (iii) trading as a dealer, swap dealer or security-based swap dealer. The Final Rule maintains, with certain revisions, a rebuttable presumption that a financial position is presumed to be a short-term position if the position is held less than 60 days. The agencies declined to adopt a "reverse presumption" for positions held for more than 60 days.

- **Exclusions from Proprietary Trading**. The definition of "proprietary trading" excludes transactions related to repos, reverse repos, securities lending, liquidity management, derivatives clearing, covering short sales and similar obligations, acting solely as agent, broker, or custodian (including on behalf of affiliates), satisfying judicial and similar proceedings, debts previously contracted and deferred compensation and similar plans.

- **Asset-Liability Management**. Despite requests from commenters, the Final Rule does not include a general exemption for asset-liability management activities (although, as stated above, it does exempt liquidity management).

- **FX Swaps and Forwards**. Consistent with the proposed rule, FX swaps and forwards are included in the Final Rule's definition of "financial instrument." Thus, proprietary trading in these instruments is subject to the Volcker Rule's prohibition.

- **Market-Making**. The agencies attempted to clarify that the Final Rule does not require a "trade-by-trade" analysis of whether a particular position is a market-making position. Instead, the Final Rule permits market makers to maintain and monitor overall "financial exposure" and "market-maker inventory" held by ***each trading desk***, which desks may operate across legal entities. The agencies removed lengthy guidance from the proposed rule that discussed indicia of market making. The Final Rule, however, includes detailed compliance program requirements that require ex ante limits on how ***each market-maker trading desk*** trades and hedges its risk. The Final Rule appears to suggest that a market-making desk is required to hedge a significant amount of the risk arising from its financial exposures and appears to acknowledge that market-making will have varying characteristics based on the particular asset class.

- **Key Market-Making Criteria**. The exemption includes a number of new or revised criteria, including that the trading desk "***routinely stand ready***" to trade, is "***willing and available***" to quote and otherwise enter into trades "***throughout market cycles***," and that market-maker inventory not be designed to exceed near-term demands based on, among other things, "***demonstrable analysis***" of historical customer demand.

- **Market-Making Related Hedging Exemption**. Market-making related hedging is not required to comply separately with the risk-mitigating hedging exemption.

- **Risk-Mitigating Hedging**. The Final Rule requires that hedging activity at its inception demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks. Hedging activity cannot give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously. Hedging is permitted across affiliates, and dynamic and anticipatory hedging is permitted. The Final Rule includes detailed compliance program requirements that require *ex ante* limits on hedging techniques and strategies, position and aging limits, correlation analysis and ongoing monitoring. Additional documentation standards apply to hedges that are established at a different trading desk than the desk that established the underlying position, across trading desks and for hedges that exceed pre-determined limits.

- **Portfolio Hedging**. The Final Rule's hedging exemption retains the statutory language that provides flexibility for banking entities to hedge "individual or ***aggregated positions***," but the preamble discusses certain categories of so-called "portfolio hedging" that are not permitted.

- **Underwriting Exemption**. The Final Rule adopts the underwriting exemption substantially as proposed but also includes a broader range of permissible activities and offerings, including, for example, distributions of smaller-sized offerings, inclusion of selling-group members and the ability to engage in stabilization and retain unsold allotments. The underwriting exemption includes detailed compliance program requirements that require *ex ante* trading desk limits.

- **Treasury Derivatives**. Trading in U.S. government obligations is exempt from the proprietary trading prohibition. Like the proposed rule, the Final Rule does not permit a banking entity to engage in proprietary trading of derivatives on U.S. government and agency obligations; however, the preamble provides guidance on how Treasury derivatives may be used for permitted market-making and hedging.

- **Municipal Obligations**. The Final Rule permits trading in obligations of any State or political subdivision. The Final Rule expands this exemption to cover agencies and instrumentalities of States and their political subdivisions (by using a definition based on the Securities Act definition of "municipal securities"). Trading in derivatives on municipal securities, however, is generally not permitted.

- **FDIC Obligations**. The Final Rule includes a new exemption for trading in obligations of the FDIC or any entity formed by or on behalf of the FDIC for the purposes of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity as a conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

- **Trading "Solely Outside the United States"**. The agencies appear to have intended to move away from the "transaction-based" approach of the proposed SOTUS exemption. The Final Rule exempts proprietary trading by a foreign banking entity (i.e., a banking entity that is not organized, or controlled by a banking entity that is organized, under U.S. law and that meets certain other requirements) if: (i) the entity (and its personnel that arrange, negotiate or execute a transaction) are not located or organized in the United States; (ii) the trading decision is made outside of the United States; (iii) the trade and any related hedges are not accounted for by any U.S. branch or affiliate; and (iv) financing is not provided by a U.S. branch or affiliate. In addition, the foreign banking entity can trade only with or through a U.S. entity if (i) the trade is with the foreign operations of an unaffiliated U.S. entity and (ii) no personnel of the U.S. entity that are located in the United States are involved in arranging, negotiating, or executing the trade. In addition, the exemption covers trades with a U.S. entity that is an unaffiliated market intermediary if the trade is cleared or is anonymously conducted on an exchange and is cleared.

- **Trading of Foreign Government Obligations by Foreign Banks**. The Final Rule permits U.S. operations of foreign banking entities to engage in proprietary trading in the United States in "home country" obligations and obligations of any multinational central bank of which the home country is a member, so long as the purchase or sale is not made by an insured depository institution. The permitted trading activity in the United States by eligible U.S. operations of a foreign banking entity extends to obligations of political subdivisions of the foreign banking entity's home country. Derivatives on foreign government obligations are not included in the exemption.

- **Trading of Foreign Government Obligations by U.S. Bank Affiliates**. A foreign bank or broker-dealer controlled by a U.S. banking entity is permitted to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized, including obligations of an agency or political subdivision of that foreign sovereign. This exception does not apply to branches and does not allow a U.S. affiliate to finance the transaction. The Final Rule generally does not permit proprietary trading in foreign sovereign obligations by U.S. banking entities. Derivatives on foreign sovereign obligations are not included in the exemption.

- **Trading on Behalf of Customers**. The Final Rule includes exemptions for trading in a fiduciary capacity and riskless principal trading, with certain revisions from the proposed rule.

- **Insurance Companies**. The final rule exempts the purchase or sale of financial instruments by an insurance company or an affiliate solely for the general account or separate accounts of the insurance company, provided such activity is conducted in compliance with and subject to insurance law and regulation. The agencies have also revised the definitions of "general account" and "separate account" to remove any gaps in the definitions, thereby ensuring that all insurance company assets will be covered by the exemption.

- **Metrics**. Banking entities that meet the trading asset and liability thresholds set out below are required to record and report seven quantitative metrics, a reduced number compared to the proposed rule: (i) risk and position limits and usage; (ii) risk factor sensitivities; (iii) value-at-risk and stressed value-at-risk; (iv) comprehensive profit and loss attribution; (v) inventory turnover; (vi) inventory aging; and (vii) customer-facing trade ratio.

- **Metrics Reporting Timeline**.

  - **Reporting begins June 30, 2014**: Banking entities that have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States).

  - **Reporting begins April 30, 2016**: Banking entities with $25 billion or more in world-wide consolidated trading assets and liabilities.

  - **Reporting begins December 31, 2016**: Banking entities with $10 billion or more in world-wide consolidated trading assets and liabilities.

- **Statutory "Backstops"**. The Final Rule includes, with certain revisions from the proposed rule, statutory backstops that prohibit proprietary trading that would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, pose a threat to the safety and soundness of the banking entity, or pose a threat to the financial stability of the United States. Under certain circumstances, banking entities may use disclosure or information barriers to mitigate potential conflicts.

SPONSORING AND INVESTING IN FUNDS

- **Covered Fund Prohibition**. Under the Volcker Rule, a banking entity is prohibited from sponsoring or acquiring or retaining, as principal, directly or indirectly, any ownership interest in a "covered fund." The Final Rule clarifies that this prohibition does not apply to a range of scenarios where a banking entity is not acting as principal including, among other situations, (i) where the banking entity is acting solely as agent, broker, custodian, trustee or in a similar fiduciary capacity and the activity is on behalf of a customer and (ii) where the interest is acquired through a deferred compensation, stock-bonus, profit-sharing or pension plan of a banking entity (or affiliate thereof).

- **Covered Funds**. Generally, the Final Rule defines a "covered fund" as (i) an issuer that would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act; (ii) certain commodity pools; and (iii) with respect to U.S. banking entities only, certain non-U.S. funds that would be required to rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act if offered in the United States. Compared to the proposed rule, the agencies have significantly scaled back the scope of commodity pools and non-U.S. funds that are included in the definition of "covered fund." In particular, with respect to investments or sponsorship by foreign banking entities, non-U.S. funds that are not offered into the United States and, therefore, are not required to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act are no longer "covered funds."

- **Exclusions from Covered Funds**. In addition to the scaled back definition, the Final Rule completely excludes from the definition of "covered fund," among others, (i) certain wholly-owned subsidiaries, joint ventures and acquisition vehicles; (ii) U.S. registered investment companies (e.g., mutual funds), business development companies and issuers that rely on exclusions other than Section 3(c)(1) and 3(c)(7) of the Investment Company Act; (iii) foreign public funds and foreign pension funds; (iv) small business investment companies and public welfare funds; (v) certain insurance company separate accounts and separate accounts for bank-owned life insurance; and (vi) certain loan securitization vehicles, asset-backed commercial paper conduits and asset pools that cover the payment obligations of covered bonds. The Final Rules does not, however, exclude all types of entities for which industry groups and other commenters requested exemptions; the agencies expressly rejected exclusions from the covered fund definition for cash collateral pools, pass-through REITs, tender option bond vehicles, venture capital funds and credit funds.

- **Insurance Companies**. The Final Rule expressly provides that the covered fund prohibition does not apply to the acquisition or retention by an insurance company or an affiliate therefore of any ownership interest in, or sponsorship of, a covered fund if the insurance company or affiliate acquires and retains the ownership interest solely for the general account or one or more separate accounts of the insurance company in compliance with and subject to insurance law and regulation.

- **Bank Customer Funds**. Under the Final Rule, a banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund in connection with organizing and offering a covered fund for customers of the banking entity's bona fide trust, fiduciary, investment advisory or commodity trading advisory services (so-called customer funds). The restrictions related to customer funds remain substantially the same as in the proposal. In particular, there remains no requirement that there be a pre-existing relationship with the customer; however, the restrictions on name sharing between the banking entity and the covered fund remain. Banking entities also must adhere to a 3% limit on investments in each customer fund, and total investment across all customer funds is capped at 3% of a bank's Tier 1 capital.

- **SOTUS Funds**. Under the Final Rule, there remains an exemption from the covered fund prohibition for foreign banking entities with respect to certain covered funds that are "solely outside the United States" (so-called SOTUS funds). The importance of this SOTUS fund exemption appears to be diminished because of the exclusion of most non-U.S. funds from the definition of covered funds for most foreign banking entities (as discussed above). The requirements of the SOTUS exemption include that (i) the banking entity and the relevant personnel making sponsorship or investment decisions are not located in the United States, (ii) the sponsorship or investment is not accounted for on a consolidated basis by any branch or affiliate of the foreign bank in the United States, (iii) no financing for the foreign bank's sponsorship of or investment in the fund is provided by any branch or affiliate located in the US or organized under U.S. law and (iv) no ownership interest of the covered fund is offered (or has been offered) to U.S. residents.

- **Super 23A**. The final rule retains the "Super 23A" provision banning a banking entity that serves as an investment adviser or sponsor to a covered fund from entering into any transaction with that fund if the transaction would be a "covered transaction" under Section 23A of the Federal Reserve Act, subject to limited exceptions. The scope of Super 23A, however, has been reduced by the exclusions from the definition of covered fund (discussed above), including exclusions for wholly-owned subsidiaries and registered investment companies.

COMPLIANCE PROGRAMS

- **No program required** if the banking entity does not engage in covered trading activities or covered fund activities and investments.
- **Existing compliance policies and procedures** can be updated to reference the Final Rule for banking entities with total consolidated assets of $10 billion or less that engage in covered trading activities or covered fund activities and investments.
- **New compliance programs are required** for banking entities with total consolidated assets greater than $10 billion and less than $50 billion.
- **Enhanced compliance programs are required** for banking entities with $50 billion or more in total consolidated assets (or a foreign banking entity that has total U.S. assets of $50 billion or more) or that is required to report metrics under the final rule.

CEO ATTESTATION

The Final Rule imposes a CEO attestation requirement on banking entities subject to the enhanced compliance program. The attestation requirement, which was the subject of significant controversy and media attention, requires the CEO of the banking entity to attest annually to the relevant agency in writing that it has processes to establish, maintain, enforce, review, test and modify its compliance program to achieve compliance with the Volcker Rule. For U.S. branches or agencies of foreign banking entities, the senior U.S. management officer may provide the attestation for the entire U.S. operations of that entity.

CONCLUSION

The Final Rule is the beginning of a long process to implement the Volcker Rule and for banking entities to conform their activities with the new standards. Undoubtedly, a broad range of interpretive issues will arise as the industry continues to develop a complete understanding of the consequences and practical implications of the Final Rule and, unfortunately, it is not yet clear how the agencies will coordinate or react in response to the inevitable need for guidance and relief.

* * *

Please do not hesitate to contact us with any questions.