

Client Update

New Volcker Rule FAQs Provide Guidance on Market Making in Covered Funds and CEO Certification for Prime Brokerage Transactions

NEW YORK

David L. Portilla
dlportilla@debevoise.com

WASHINGTON, D.C.

Satish M. Kini
smkini@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

On September 25, 2015, the Federal Reserve and other agencies charged with implementing the Volcker Rule issued two new Frequently Asked Questions (“FAQs”), numbered 17 and 18 in the list that the agencies have published, to clarify certain aspects of the final Volcker Rule regulations (the “Final Rule”). One of the FAQs provides guidance on the agencies’ expectations for market making in covered fund interests. The second specifies the appropriate timing for the annual CEO certification required for use of the prime brokerage exception to the Final Rule’s so-called Super 23A prohibition.

FAQ 17: COMPLIANCE FOR MARKET MAKING AND THE IDENTIFICATION OF COVERED FUNDS

The Final Rule prohibits a banking entity from engaging in proprietary trading, with limited exceptions, including one for market making-related activities. To qualify for the market making exemption, a banking entity must maintain a compliance program reasonably designed to ensure compliance with the Final Rule. FAQ 17 gives guidance on the agencies’ expectations for market making in covered fund interests.

In particular, the FAQ provides that a banking entity may rely on “objective factors” to determine whether a security is issued by a covered fund. The need to identify covered fund interests is important because, although a banking entity may engage in market making in covered fund interests, the Final Rule includes per-fund and aggregate quantitative limits on the amount of covered fund interests a banking entity may hold, including as part of market making activities. The FAQ describes “objective factors” as factual criteria that can be used to reliably identify whether an issuer or a particular type of issuer is a covered fund. The FAQ also endorses use of a shared utility or service provider

that uses objective factors to identify covered funds, which is helpful given industry-wide efforts to develop such a solution.

The FAQ, however, notes limits on its guidance. For example, a banking entity may not rely solely on the name of the issuer or the title of the issuer's security to make a covered fund determination. In addition, reliance on objective factors, or on a shared utility or third party service provider that uses objective factors to make a covered fund determination must be subject to the Final Rule's independent testing and audit requirements. If the objective factors used by the banking entity, shared utility or third party service provider are not effective in identifying whether a security is issued by a covered fund, the banking entity must promptly update its compliance program to address the issue. This latter point seems to suggest the agencies believe a "living" (as opposed to a single, point-in-time) Volcker Rule analysis is important.

FAQ 18: CEO CERTIFICATION FOR PRIME BROKERAGE EXCEPTION TO SUPER 23A PROHIBITION

The Final Rule's so-called "Super 23A" provisions prohibit a banking entity and its affiliates from entering into a covered transaction as defined by Section 23A of the Federal Reserve Act with a covered fund (or a covered fund controlled by such fund) if the banking entity serves as the investment manager (or similar role) for the covered fund, or organizes and offers the fund under the Final Rule's "customer fund" exemption.

Certain prime brokerage transactions, however, are permitted, notwithstanding the Super 23A prohibition, provided certain conditions are met. One of the conditions is that the banking entity's CEO annually certify as to compliance with the prime brokerage exception.

FAQ 18 clarifies that the first CEO certification for the prime brokerage exception is due no later than March 31 following the end of the relevant conformance period. For example, for funds subject to the conformance period that ended on July 21, 2015, the first CEO certification would be due no later than March 31, 2016. For "legacy funds" subject to the conformance period that currently ends on July 31, 2016, the first CEO certification would be due no later than March 31 following the end of this latter conformance date (the Federal Reserve has indicated that this date will be extended to July 21, 2017). This distinction would matter only if a banking entity engages in transactions subject to the prime brokerage exception with legacy funds, and not with other covered funds, such that a CEO certification is not required by March 31, 2016.

After the initial submission, the CEO certification must be provided annually within one year of the prior certification.

* * *

Please do not hesitate to contact us with any questions.