On December 10, 2013, the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission and the Commodity Futures Trading Commission (CFTC), and collectively, the Agencies issued the final rule (Final Rule) implementing the “Volcker Rule” requirements of section 13 (section 13) of the Bank Holding Company Act (BHC Act), which were added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Final Rule will, as anticipated, significantly affect the trading and private fund investment activities of banks and their affiliates, and will also significantly impact their customers, including private funds, insurers, and energy and commodity traders. Shortly after the Final Rule’s release, the American Bankers Association (ABA) on December 24, 2013, brought an action against the FRB, the OCC and the FDIC that sought to void one of the Final Rule’s provisions and, in a related development, Rep. Jeb Hensarling is reportedly planning to introduce a bill that would amend the Volcker Rule (see Section II.B. below). The Final Rule is effective April 1, 2014, and banking entities generally have until July 21, 2015, to conform their activities and investments to the Final Rule. Banking entities with $50 billion or more in trading assets and liabilities must, however, begin reporting quantitative metrics on June 30, 2014.

The main parts of the Final Rule are as follows:

- **Proprietary Trading Restriction:** The Final Rule imposes (i) limitations on short-term proprietary trading (Proprietary Trading Restriction) of financial instruments by any banking entity, and (ii) reporting obligations on banking entities with significant trading operations designed to assist the Agencies in identifying prohibited proprietary trading. Subject to limited exceptions, “Banking entity” means (i) an insured depository institution, (ii) any foreign bank operating a branch or agency in the U.S., and (iii) any affiliate of (i) or (ii). An affiliate is defined as any company that controls, is controlled by, or is under common control with another company and includes non-bank affiliates such as insurers and finance companies.

- **Ownership Restriction and Relationship Restrictions:** The Final Rule limits or prohibits a banking entity from sponsoring or having an ownership interest (Ownership Restriction) in, or certain relationships (Relationship Restrictions) with, private funds meeting the definition of “covered fund.”

- **Regulatory Capital:** The Final Rule requires a banking entity to deduct the greater of 1) historical cost, plus earnings, and 2) fair market value of all qualifying de minimis covered fund investments made by the entity from the entity’s tier 1 capital.

- **Compliance Program:** Banking entities are required to establish an internal compliance program designed to help ensure and monitor compliance with the prohibitions and restrictions of section 13 and the Final Rule. The CEO of a banking entity subject to enhanced compliance program requirements must annually attest in writing to the relevant agency that the entity has in place a compliance program reasonably designed to achieve compliance with section 13 and the Final Rule.

**Key Takeaways:**

Banking entities with significant trading activities will be subject to granular reporting and enhanced compliance policies, procedures and controls, and those responsible for implementing the internal framework will have heightened responsibilities.
The Final Rule provides an opportunity for prudential supervisors to challenge trading decisions with the benefit of hindsight. Banks with significant trading activities may need to walk a fine line of implementing policies and procedures that aim to protect the bank from regulatory skirmishes without inhibiting a trading desk from conducting bona fide market making or hedging activities.

Since banking entities generally may not own covered funds and the definition of covered funds includes an “ownership interest” in a variety of non-loan securitizations, many banks will need to determine, based on a security-by-security review of underlying documentation, whether they may have an “ownership interest” in covered funds; where they own such covered funds, banks entity investors are required either to restructure the investment or divest.

Private fund managers may for some fixed income and alternative strategies consider using a closed-end fund registered under the Investment Company Act of 1940 (1940 Act) if it is important for them to attract seed money or significant investments by U.S. financial holding companies or other banks.

Instead of investing via a covered fund subject to the Final Rule’s restrictions, some banking entity sponsors of covered funds may in some cases look to use registered funds as collective investment vehicles; the use of business development companies (BDCs) is one example.

Instead of investing via a covered fund subject to the Final Rule’s restrictions, banking entity sponsors are incentivized to make direct investments in portfolio companies where they are permitted under the BHC Act’s merchant banking authority. It is expected that further regulatory guidance will be sought from the Agencies on the question of permissible parallel investments.

Banking entities are permitted to enter into qualifying joint ventures with 10 or fewer unaffiliated co-venturers.²

The broad definition of covered funds may negatively affect the liquidity of a variety of pre-Volcker securitizations, which could result in investment opportunities for real-money buyers such as insurers.³

Collateralized Loan Obligations (CLOs), consumer asset-backed securities (ABS) and loan-based securitization structures will continue to be the focus of U.S. banking entities’ securitization activities.

The Final Rule may result in further standardization of securitization issuances, since wherever possible bank underwriters will prefer to distribute ABS that are not covered funds and hence qualify for investment by banking entities.

Part I of this memo will focus on the Final Rule’s Proprietary Trading Restriction; Part II on the Ownership Restriction, including a description of the ABA lawsuit; Part III on the Relationship Restrictions and Other Restrictions; and Part IV on the reporting and compliance program requirements.

I. Proprietary Trading Restriction

Subject to the exemptions and permitted activities described below, a banking entity may not engage as principal for the trading account in any purchase or sale of “financial instruments,” meaning

1) a security,
2) a commodity futures contract, or
3) derivatives, including swaps, security-based swaps, foreign exchange swaps and forwards, and physically settled commodity forwards; and 4) any option on 1), 2) or 3).

A. Trading Account Activity

Any purchase or sale of a financial instrument is “trading account” activity covered by the Proprietary Trading Restriction if it meets a “short-term purpose test,” i.e., is principally for the purpose of short-term (i) resale, (ii) price movements, (iii) arbitrage profits, or hedging positions resulting from these activities.

The purchase or sale of a financial instrument by a banking entity is presumed to be for the trading account if the banking entity holds the position for 60 days or less, unless the entity can demonstrate that the purchase or sale does not meet the short-term purpose test. The Agencies declined to provide a reverse presumption, in recognition that some proprietary trading could occur outside of the 60-day period.

Trading activity is deemed to be “trading account” activity covered by the Proprietary Trading Restriction in two cases:

- if a banking entity purchases or sells one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of such market risk capital rule positions), or
- if a banking entity is a dealer, a swap dealer or a security-based swap dealer and purchases or sells a financial instrument in connection with its swap dealer business (dealer activities), whether inside or outside the U.S. Underlying the Agencies’ treatment of dealer activities is the assumption that financial instruments bought or sold by dealers are generally held with short-term intent.

B. Excluded Trading Activity

Spot foreign exchange and spot physical commodities transactions are excluded from the Proprietary Trading Restriction. In addition, other trading activity is not subject to the Proprietary Trading Restriction, namely, the purchase or sale of a financial instrument:

- solely as broker, agent, or custodian,
- under certain repurchase or reverse repurchase and securities lending agreements,
- for bona fide liquidity management purposes,
- by certain derivatives clearing organizations (DCOs) or clearing agencies in connection with clearing activities,
- by a member of a clearing agency, DCO, or designated financial market utility engaged in excluded clearing activities,
- to satisfy existing delivery obligations,
- to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding,
through a deferred compensation or similar plan or
to satisfy a debt previously contracted.\(^9\)

C. Exempt Activities

The Final Rule exempts certain underwriting, market making, risk-mitigating hedging activities, and certain other proprietary trading activities.

1. Underwriting and Market Making Activities

The Final Rule exempts:

* the purchase or sale of securities and certain other instruments in connection with "underwriting activities,"\(^{10}\) to the extent that such activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties; and

* "market making activities"\(^{11}\) meeting the following requirements:

  − the trading desk that manages a financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure for its own account, in commercially reasonable amounts and throughout market cycles;

  − the amount, types, and risks of the financial instruments in the trading desk’s market-maker inventory are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties, and for this purpose other large dealers may be considered customers only in limited circumstances; and

  − to the extent that any identified limit is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.

If the "reasonably expected near-term demands of clients or counterparties" do not materialize, the desk may be exposed to heightened regulatory scrutiny in the event of an unusual gain or loss.

The Final Rule makes clear that a trading desk will not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading.\(^{12}\)

The exemptions for underwriting and market making activities are, moreover, available only if:

* the banking entity maintains and enforces an internal compliance program that is reasonably designed to ensure its compliance with the underwriting or market-making exemption, as the case may be;

* the compensation arrangements of persons performing underwriting- or market-making-related activities, as the case may be, are designed not to reward or incentivize prohibited proprietary trading; and

* the banking entity is licensed or registered to engage in underwriting- or market-making-related activities in accordance with applicable law.\(^{13}\)

2. Risk Mitigating Hedging Activities\(^{14}\)
Risk mitigating hedging activities designed to reduce the specific risks to a banking entity related to positions or holdings are permitted if:

- the banking entity implements and enforces an internal compliance program reasonably designed to ensure compliance with the Final Rule’s requirements, including a correlation analysis demonstrating that the hedging activity demonstrably reduces or otherwise significantly mitigates the identifiable risks being hedged;

- the activity is conducted in accordance with the written policies and procedures, is designed to reduce or otherwise significantly mitigate, and demonstrably reduces or significantly mitigates one or more identifiable risks related to identified positions, and does not give rise to any significant new risk that is not itself hedged contemporaneously; and

- the compensation arrangements of persons performing risk mitigating hedging activities are designed not to reward or incentivize proprietary trading.

In addition, there is a specific documentation requirement with respect to certain risk mitigating hedging activities, including those not established by the specific trading desk responsible for the underlying positions.

### 3. Other Permitted Proprietary Trading

The Final Rule permits a banking entity to engage in trading in certain government obligations, trading on behalf of customers, trading by insurance companies, and trading outside of the U.S. by certain foreign banking entities. However, a banking entity is prohibited from relying on any exemption to the Proprietary Trading Restriction if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to U.S. financial stability.

### II. Ownership Restriction

Subject to certain exceptions, a banking entity generally may not sponsor, or as principal acquire or retain any ownership interest in, covered funds. Non-qualifying ABS—i.e., ABS that are “covered funds”—may include certain

- CLOs and collateralized debt obligations (CDOs),

- pass-through real estate investment trusts (REITs),

- interests in cash collateral pools,

- tender option bonds,

- venture capital funds,

- credit funds or

- securities of certain legacy special purpose entities.

### A. Key Definitions: Ownership Interest and Covered Fund

An “ownership interest” means an “equity, partnership, or other similar interest.” For this purpose,
“other similar interest” is defined more broadly in the Final Rule than it was in the notice of proposed rulemaking\textsuperscript{19} (NPR) and includes, in addition to interests typically associated with a holder of equity, any interest that:

* has the right to participate in the selection or removal of a general partner, managing member, member of the board, investment manager, investment adviser, or commodity trading advisor of the covered fund; or

* has the right to receive a share of the income of the covered fund; or

* provides that the amounts payable by the covered fund with respect to such interest could be reduced based on losses arising from the underlying assets.

A “

covered fund”\textsuperscript{20} generally includes:

* an issuer that would be an investment company under the Investment Company Act of 1940 but for exemptions under sections 3(c)(1) or 3(c)(7) of that Act (hereinafter referred to as a “section 3(c)(1) or (7) issuer”). These exemptions are generally available to privately offered companies whose securities are beneficially owned by 100 or fewer persons or owned exclusively by qualified purchasers;

* a commodity pool

  − that is an “exempt pool” under CFTC Rule 4.7, i.e., a pool whose participation units are sold in certain unregistered offerings and whose units are offered only to qualified eligible persons (investors meeting certain heightened qualification standards); or

  − whose operator is registered with the CFTC as a commodity pool operator, if qualified eligible persons own substantially all of the pool’s participation units and such units have not been publicly offered to persons who are not qualified eligible persons under 17 CFR §§ 4.7(a)(2) and (3); and

* a foreign fund,\textsuperscript{21} which is a term that applies only to a U.S. banking entity (including the U.S. branch, agency, or subsidiary of a foreign banking organization) and means any fund that

  (A) is offered and sold outside the U.S.,

  (B) is not a foreign public fund,

  (C) raises money primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and

  (D) is sponsored or owned by such banking entity.

**B. ABA Lawsuit and House Bill**

The broad definitions of “ownership interest” and “covered fund” result in debt-like interests in certain non-loan securitizations being covered by the Final Rule’s Ownership Restriction. This is problematic for some small banks that are apparently significant buyers of Collateralized Debt Obligations backed by Trust Preferred Securities (TruPS CDOs), a securitization of trust-preferred securities that some of these banks have classified as hold-to-maturity and carry at amortized cost, which now exceeds their fair value. The potential consequence of the Ownership Restriction is the realization of an accounting loss that would hit both earnings and regulatory capital.

This potential consequence was first reported on December 16, 2013, when Zions Bancorp disclosed that it would have to sell TruPS CDOs and take a $387 million charge to write down the value of the securities. After reclassifying the CDOs from hold-to-maturity to available-for-sale, Zions
estimated that its tier 1 common equity ratio would fall from 10.47% to 9.74%.\(^{22}\)

In response to inquiries from members of Congress regarding potentially similarly situated community banks, the FRB responded with a FAQ on December 19 reminding banks that an issuer than can rely on a 1940 Act exemption other than sections 3(c)(1) or 3(c)(7) would not be a covered fund and indicating that

- a banking entity should evaluate if a security issued by a TruPS CDO is an ownership interest as defined under the Final Rule,
- if the CDO issuer is not a covered fund at the end of the conformance period, the banking entity would not need to divest its CDO holdings, and
- to the extent that a banking entity initiates actions to conform its interests in the CDO to the Final Rule, the banking agencies would expect the entity to develop a conformance plan that is appropriately specific.

Unassuaged by the FRB’s FAQ, and apparently concerned by the prospect that some small banks could potentially suffer significant capital hits as a result of their TruPS CDO holdings, the ABA and four banks on December 24, 2013, brought an action against the FRB, the OCC and the FDIC, requesting a temporary restraining order and an injunction that would void the definition of the term “other similar interest.” In response, the Agencies (excluding the CFTC) issued a joint statement on December 27, 2013, indicating that they were evaluating if it was “appropriate not to cover pooling vehicles that invest in TruPS in order to eliminate restrictions that might otherwise have consequences that are inconsistent with the relief Congress intended to provide community banking organizations under section 171(b)(4)(C) of the Dodd-Frank Act.”\(^{24}\) The ABA then reportedly dropped its request for a temporary restraining order, but did not withdraw its lawsuit.\(^{25}\)

On January 2, 2014, the Loan Syndications and Trading Association reportedly asked federal regulators to confirm by January 15, 2014, that the right to remove a manager in breach of obligations would not result in an “ownership interest” in CLOs.\(^{26}\)

House Financial Services Committee Chairman Jeb Hensarling is reportedly planning to introduce a bill that would remove any obstacle to banking entities’ owning TruPS CDOs. The amendment of the Volcker Rule may reportedly also create a loophole that would allow banking entities to own a wide variety of ABS, so long as the ABS pool includes at least one qualifying TruPS CDO security, instead of the limited range of qualifying ABS described in Section II.E.2. below.\(^{27}\)

**Lesson Learned From the ABA Lawsuit**

Because the key terms “ownership interest” and “covered fund” are broadly defined, and covered funds include a variety of non-loan securitizations, a bank may need to determine, based on a security-by-security review of underlying documentation, if it has an “ownership interest” in covered funds; if so, the bank would need to initiate actions to conform its interest to the Final Rule.

**C. Qualifying De Minimis Investments**

A banking entity may sponsor a covered fund and (together with affiliates) retain an ownership interest, subject to a single fund limit of 3% (3% fund limit) of the ownership interests of the fund (or such greater amount – typically 5% – as is required by the credit risk retention rules implementing section 15G of the Securities Exchange Act of 1934), so long as

- the banking entity organizes and offers the covered fund in connection with the provision of bona fide trust, fiduciary, investment advisory or commodity trading advisory services, or the
banking entity organizes and offers a covered fund that is an ABS issuer,

* the total amount of the covered fund investments held by such entity and its affiliates is not greater than 3% of the entity’s tier 1 capital, and

* the banking entity complies with Super 23A and other applicable requirements.\(^{28}\)

The Final Rule requires a banking entity to deduct the greater of 1) historical cost, plus earnings, and 2) fair market value of all qualifying de minimis covered fund investments made by the entity from the entity’s tier 1 capital. The banking agencies recognize that the final Basel III rules impose risk weights and deductions that do not correspond to the deduction for covered fund investments imposed by the Final Rule. The banking agencies intend to review the interaction between the requirements of the Final Rule and the Basel III\(^{29}\) rules, and expect to propose “steps to reconcile the two rules.”\(^{30}\)

### D. Qualifying Joint Ventures

A U.S. banking entity may enter into a joint venture with 10 or fewer unaffiliated co-venturers, provided that the venture:

* engages in activities that are permissible for the entity, other than investing in securities for resale or other disposition; and

* is not, and does not hold itself out as being, an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

The exemption for joint venture interests in the proposed Volcker rule had been limited to interests in “operating companies”;\(^{31}\) the above exemption is not so limited. For example, it would appear that under the Final Rule a banking entity may participate in a Qualifying Joint Venture regarding commodity interests so long as the venture’s activities are permissible for the banking entity.

### E. Certain Permissible Bank Investments

#### 1. Registered Investment Companies, Including BDCs.

To originate ABS that qualify for investment by U.S. banking entities, a bank may structure a transaction in which the issuer:

* relies on a 1940 Act exemption other than section 3(c)(1) or section 3(c)(7), e.g., section 3(c)(5) (for securitizations of accounts receivable, mortgages, and certain other asset types), or

* registers under the 1940 Act (registered company).

The Final Rule does not:

* restrict a banking entity’s ability to invest in and sponsor registered companies, including BDCs; or

* apply to the holdings of BDCs or other registered companies in which a banking entity invests, so long as the relevant registered company is not itself an “affiliate” of the banking entity.
Accordingly, so long as the bank holding company does not directly or indirectly control the registered company under the BHC Act, a bank holding company may generally invest in a BDC or other registered company without being subject to the Ownership Restriction or the Relationship Restrictions or, with respect to portfolio companies, the Proprietary Trading Restriction.\textsuperscript{32}

Also, a seeding vehicle that will become a BDC or other registered investment company would not itself be viewed as violating the requirements of the Final Rule during the seeding period so long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan, developed in accordance with the banking entity’s compliance program, that reflects the banking entity’s determination that the vehicle will become a BDC or other registered investment company within the time period provided for seeding a covered fund under the Final Rule.

Because of these provisions of the Final Rule,

- additional financial holding companies with asset management businesses may organize BDCs as vehicles for making debt and equity investments in BDC-eligible portfolio companies, and
- private fund managers may for some fixed income and alternative strategies use a closed-end fund registered under the 1940 Act if it is important for them to attract seed money or significant investments by financial holding companies or other banks.

2. Qualifying ABS.

A banking entity may own a defined range of ABS, whose issuers are not “covered funds” even if issued or guaranteed by section 3(c)(1) or (7) issuers, such as:

- qualifying loan securitizations,
- qualifying Asset-Backed Commercial Paper (\textit{ABCP}) issuances,
- qualifying covered bonds, and
- separate account bank-owned life insurance (\textit{BOLI}).

The Final Rule may result in further standardization of securitization issuances, since a bank will prefer to distribute ABS that qualify for investment by banks without being subject to the Final Rule’s Ownership or Relationship Restrictions. Issuers of non-qualifying ABS will presumably need to pay a premium to compensate for the less liquid nature of such securities vis-a-vis qualifying ABS.

a. Qualifying Loan Securitizations. The only \textit{permissible securitization assets} that may be held by a qualifying loan securitization are:

- loans, including residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases and equipment leases,
- servicing or certain other rights incidental to holding the loans,
- cash equivalents, including certain high quality, highly liquid short-term securities,
• qualifying rate or currency derivatives, and

• certain special units of beneficial interest or collateral certificates. 33

The Agencies also indicated that “esoteric asset classes supported by loans may also be able to rely on the loan securitization exclusion, such as time share loans, container leases, and servicer advances.” 34

b. Qualifying ABCP. Qualifying ABCP are securities that comprise only a residual interest and ABCP having a maximum term of 397 days, whose cash flows are supported:

• by no assets other than permissible securitization assets and certain asset-backed securities supported by loans that were issued or initially sold to such issuer, and

• by a liquidity facility that provides 100% liquidity coverage from a regulated liquidity provider.

c. Qualifying Covered Bonds. Qualifying covered bonds are certain securities, whose cover pool comprises only permissible securitization assets. Because many cover pools contain residential mortgage-backed securities or other assets that are not permissible securitization assets, the Agencies acknowledged that the exclusion from the definition of covered fund that the Final Rule provides for covered bonds may not be available to many of the existing cover pools that support outstanding covered bonds.

d. Separate Account BOLI. A banking entity may invest in separate account BOLI, provided that no banking entity that purchases the policy controls the investment decisions regarding the underlying separate account assets or participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance.

F. Exemptions for Banking Entities that Are Insurance Companies

If a banking entity is a regulated insurer, the Final Rule provides an exemption35 for proprietary trading activity in the general account or in a separate account36 of the insurer, provided:

• the insurer (or an affiliate) purchases or sells financial instruments solely for the insurer’s general account or a separate account established by the insurer,

• the purchase and sale is conducted in compliance with, and subject to, the insurance company investment laws and regulations of the State or jurisdiction in which such insurance company is domiciled (collectively, “insurance regulation”); and

• the appropriate Federal banking agencies (after consultation with the Financial Stability Oversight Council (FSOC) and relevant State insurance commissioners) have not jointly determined that a particular insurance regulation is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

In addition, if a banking entity is a regulated insurer, the Final Rule37 provides an exemption38 permitting such insurer (or affiliate) to sponsor, or to acquire and retain an ownership interest in, covered funds, provided:

• the insurer (or affiliate) acquires and retains the ownership interest solely for the insurer’s general account or one or more of its separate accounts,

• the acquisition and retention of the ownership interest is conducted in compliance with, and
subject to, insurance regulation, and

- the appropriate Federal banking agencies (after consultation with the FSOC and relevant State insurance commissioners) have not jointly determined that a particular insurance regulation is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

The exemptions that a regulated insurer enjoys from the Final Rule’s restrictions are subject to general limitations that prohibit a permitted activity if it would result in a material conflict of interest between the insurer and its clients or counterparties or in a material exposure to high-risk assets or high-risk trading strategies.  

The Final Rule also provides exemptions that allow insurers that are banking entities to sponsor, and banking entities to invest in, BOLI and corporate owned life insurance (COLI) separate accounts (e.g., separate accounts that rely on a section 3(c)(1) or section 3(c)(7) exemption from the 1940 Act in private placements of life insurance). Specifically, the Final Rule provides that generally a “covered fund” does not include separate accounts so long as either:

- no banking entity other than the insurance company that establishes the separate account participates in the account’s profits and losses or
- the separate account is used solely for the purpose of allowing one or more banking entities to purchase qualifying BOLI.

The Agencies “expect [banking entities that are] insurance companies to have appropriate compliance programs in place for any activities subject to section 13.”

If a regulated insurer is a banking entity with significant trading activities, and the insurer’s activities are limited to permitted activities, then the banking entity may, but is not required to, meet the reporting requirement with respect to trading metrics.

Under section 13, nonbank financial companies designated by the FSOC as systemically important financial institutions (SIFIs) that engage in proprietary trading activities or make investments in covered funds may be subject to additional capital requirements and quantitative limits by the appropriate Agency or Agencies. The Agencies noted that two of the three companies currently designated by FSOC for supervision by the FRB are affiliated with insured depository institutions (American International Group, Inc. and General Electric Capital Corporation, Inc.) and are therefore currently banking entities for purposes of section 13. Interestingly, the FRB staff indicated that it “is exploring whether the third entity i.e., Prudential Financial, Inc. (PFI) engages in any activity that would be subject to section 13 of the BHC Act, and will propose action consistent with that section if appropriate and applicable.” The fact that the Agencies refrained, at least preliminarily, from applying to PFI capital requirements with respect to its proprietary trading and investments in covered funds suggests that, for purposes of the Volcker Rule’s capital requirements, the Agencies are considering treating SIFIs that are not banking entities differently from SIFIs that are banking entities.

**G. Private Funds: Parallel Investments, Master/Feeder Funds, and Fund of Funds**

If a banking entity sponsor’s investment in a hedge fund or private equity fund currently is greater than the 3% fund limit, the entity will seek to bring its investment into compliance with the 3% fund limit by the end of the conformance period. To do so, the banking entity may seek to restructure its investment.

If a banking entity makes a parallel direct investment (for example under its merchant banking authority) in one or more companies in which a fund organized and offered by the banking entity also invests, the direct investment would not, in some circumstances, count against the 3% fund limit.
the Final Rule, the banking agencies did not draw a clear line between the direct investments that will, and those that will not, count against the 3% fund limit, but did set out some limits with respect to co-investment.

Where, for example, a banking entity sponsors a covered fund and a covered fund’s investment manager determines that the covered fund does not have sufficient capital, or it would not be suitable for the covered fund, to make the entire investment in a portfolio company, the banking entity should not itself make any side by side privately negotiated co-investment with the covered fund, unless the value of such co-investment is less than 3% of the value of the total amount co-invested by others in such investment. And if a banking entity sponsor makes investments side by side in substantially the same positions as a covered fund, then the value of such investments should be included for purposes of determining the value of the banking entity’s investment in the covered fund.

The Final Rule also clarifies how a banking entity is to apply the 3% fund limit in the case of master-feeder and fund-of-funds structures that a banking entity organizes and offers.

In the case of master-feeder structures, the 3% fund limit will apply not to the feeder but only to the master fund; and the investment in the master fund will include:

- any direct investment in the master fund, and
- a pro-rata share of any ownership interest in the master fund that is held indirectly through the feeder fund.

Likewise, for fund-of-funds investments, the banking entity’s permitted investment in the underlying fund will include:

- any direct investment in such fund, and
- a pro-rata share of any ownership interest in such fund that is held indirectly through the fund of funds.

A banking entity’s ownership interest in a covered fund excludes the entity’s “restricted profit interest” in the fund.44

III. Relationship Restrictions and Other Restrictions

A. Super 23A Restrictions.

The Final Rule generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organizes and offers a covered fund, or that retains an ownership interest in certain covered funds, as well as any affiliate of such banking entity, from entering into a transaction with the covered fund, or with any other covered fund that is controlled by such covered fund, that would be a “covered transaction” as defined in section 23A of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate thereof (Super 23A Restrictions).46 Covered transactions include certain loans and extensions of credit to a covered fund, guarantees of a covered fund’s obligations, or a credit exposure to a covered fund arising from a derivatives transaction.

The Final Rule provides an exception from the Super 23A Restrictions for any prime brokerage transaction with a second-tier covered fund (i.e., a covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or affiliate) has taken
an ownership interest) so long as certain conditions are met, including that the CEO (or equivalent officer) of the banking entity certifies in writing that the banking entity does not, directly or indirectly, guarantee or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests.47

B. Other Limitations on Permitted Covered Fund Activities

No transaction or activity may be deemed permissible under the Final Rule’s provisions concerning organizing, offering, owning, and performing certain other activities with respect to covered funds if the transaction or activity would: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.48 Material conflicts of interest may be addressed via timely and effective disclosure or information barriers.49

IV. Reporting and Compliance Program Requirements

A. Reporting Requirements for Banking Entities with Significant Trading Activities

Banking entities with significant trading activities and any other banking entity notified by the relevant Agency must report to its primary supervisory Agency seven quantitative metrics designed to help firms and regulators monitor and identify prohibited proprietary trading and high-risk trading strategies:

• risk and position limits and usage;
• risk factor sensitivities;
• Value-at-Risk and stress VaR;
• comprehensive profit and loss attribution;
• inventory turnover;
• inventory aging; and
• customer facing trade ratio.50

Banking entities with significant trading activities are:

• any banking entity that together with its affiliates and subsidiaries has trading assets and liabilities (excluding assets or liabilities involving U.S. Treasuries and Agencies) the average gross sum of which over the previous four calendar quarters is at least equal to:

  − $50 billion beginning on June 30, 2014 (Category 1),
  − $25 billion beginning on April 30, 2016 (Category 2) and
  − $10 billion beginning on December 31, 2016, (Category 3).51

Banking entities with significant trading activities will be required to begin to report the required
quantitative metrics as follows:

- June 30, 2014, for Category 1 banking entities, which are required to report on a monthly basis;

- April 30, 2016, for Category 2 banking entities, which are required to report on a quarterly basis; and

- December 31, 2016, for Category 3 banking entities, which are required to report on a quarterly basis.

B. Compliance Program

Banking entities are required to establish an internal compliance program designed to help ensure and monitor compliance with the prohibitions and restrictions of section 13 and the Final Rule. However, a banking entity that does not engage in proprietary trading activities or make covered fund investments (other than permitted trading activities in domestic government obligations) may satisfy the compliance program requirements prior to commencing such trading or investing activities. A banking entity must establish a compliance program as soon as practicable and in no event later than the end of the conformance period.

1. Banking Entities with $10 Billion or Less in Total Assets

A banking entity with $10 billion or less in total consolidated assets may satisfy the compliance program requirements by including in its existing compliance policies and procedures appropriate references to section 13 and the Final Rule, and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

2. Minimum Requirements for Banking Entities with More Than $10 Billion and Less than $50 Billion in Total Assets

For banking entities with more than $10 billion and less than $50 billion in total consolidated assets, the Final Rule specifies six elements that each compliance program must, at a minimum, include. Those elements are:

- written policies and procedures that establish trading and exposure limits for the activities conducted by the banking entity,

- internal controls,

- a management framework that delineates responsibility and accountability for compliance with the Final Rule,

- independent testing and audit,

- training, and

- recordkeeping.

3. Enhanced Requirements for Banking Entities with Significant Trading Activities or with Total Assets of $50 Billion or More

Banking entities with significant trading activities, any banking entity with total consolidated assets of
$50 billion or more or, in the case of a foreign banking entity, any entity whose U.S. operations have assets of $50 billion or more, and any other banking entity notified by the relevant Agency must also implement an enhanced compliance program, which must:

- be reasonably designed to identify, document, monitor, and report the covered activities and investments of the banking entity; identify, monitor, and promptly address the risks of covered activities and investments and potential areas of non-compliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 and the Final Rule;

- establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments;

- subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the 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; the CEO must in this connection annually attest in writing to the relevant agency that the entity has in place a compliance program reasonably designed to achieve compliance with section 13 and the Final Rule; and

- facilitate supervision and examination by the Agencies of the banking entity’s covered trading and covered fund activities and investments.\(^5\)

The deadline for meeting the enhanced compliance program requirements is July 21, 2015, for Category 1 banking entities; April 30, 2016, for Category 2 banking entities; and December 31, 2016, for Category 3 banking entities.

4. Additional Documentation Regarding Funds

For banking entities with more than $10 billion in total consolidated assets, the compliance program requires additional documentation regarding funds.\(^6\)

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1 Final Rule § 212(c).
2 See Section II.D.
3 According to a December 31, 2013, Bloomberg News report, Community Bank System Inc. sold collateralized debt obligations (CDOs) and other securities at a loss of about $6.9 million to comply with the Volcker Rule.
4 The Agencies rejected arguments that physically settled commodity forwards were not subject to section 13’s prohibition of proprietary trading.
5 Supplementary Information, p. 47.
6 Final Rule § 213(b)(ii).
7 Final Rule § 213(b)(iii).
8 See Supplementary Information, p. 41.
9 Final Rule § 213(d).
10 Final Rule § 214(a).
11 Final Rule § 214(b).
12 Supplementary Information, p. 251.
13 Final Rule § 214(a) and (b).
14 Final Rule § 215.
15 Final Rule § 216.
16 Final Rule § 217.
17 Final Rule § 210 and § 211.
18 Final Rule § 210(d)(6)(i).
19 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With Hedge
20 Final Rule § __.10(b).
21 Final Rule § __.10(b); § __.10(c)(1).
22 Financial Times, December 17, 2013, p. 13; see also footnote 3 above.
23 FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule (Dec. 19, 2013).
24 Statement regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Rules implementing section 619 of the Dodd-Frank Act, p. 2. Under section 171, depository institution holding companies must phase out the inclusion of TruPS in their calculation of tier 1 capital, but section 171(b)(4)(C) permanently grandfathered TruPS issued before May 19, 2010, by certain companies with total assets of less than $15 billion.
28 Final Rule § __.11.
30 Supplementary Information, p. 698.
32 Final Rule § __.12(b) A U.S. financial holding company may, without being deemed to control a registered company for the purpose of the BHC Act, both serve as an investment adviser to a registered investment company and hold less than 25% of such company’s voting shares.
33 See BHC Act § 13(g)(2).
34 Supplementary Information, p. 570.
35 Final Rule § __.6(d).
36 “Separate Account” means an account established and maintained to hold assets that are legally segregated from the insurer’s other assets, under which income, gains, and losses from assets allocated to such account, are credited to or charged against such account without regard to other income, gains, or losses of the insurer. Final Rule § __.2(bb).
37 Final Rule § __.13(c).
38 Final Rule § __.13(c).
39 Final Rule § __.7 and § __.15.
40 Final Rule § __.10(c)(6) and § __.10(c)(7).
41 Supplementary Information, p. 408.
42 See Section IV.A, below.
43 Staff Memo to FRB regarding the draft Final Rule (Dec. 9, 2013), footnote 3.
44 Final Rule § __.10(d)(6)(ii).
45 I.e., ownership interests in ABS of issuers organized and offered under Final Rule § __.11(b).
46 Final Rule § __.14(a).
47 § __.14(a)(2)(i)(B).
48 § __.15(a).
49 § __.15(b).
50 Final Rule § __.20(d) and Appendix A.
51 In the case of a foreign banking entity, the trading asset and liability thresholds apply to the combined U.S. operations of such entity. Final Rule § __.20(d)(1).
52 Final Rule § __.20(d).
53 Final Rule § __.20(f)(1).
54 Final Rule § __.20(f)(2).
55 Final Rule § __.20(c) and Appendix B.
56 Final Rule § __.20(e).

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Sutherland attorney with whom you regularly work.