



CLEARY  
GOTTLIEB

**THE VOLCKER RULE PROPOSAL  
CHALLENGES, OPEN ISSUES AND UNINTENDED CONSEQUENCES**  
NOVEMBER 29, 2011



# THE VOLCKER RULE PROPOSAL: CHALLENGES, OPEN ISSUES AND UNINTENDED CONSEQUENCES

From its inception, the Volcker Rule has been one of the most controversial elements of U.S. financial reform. While its advocates view it as a critical step in reinstating limits on risky behavior that puts banks and taxpayer money at risk, the industry generally views it as a misguided response that will add to overwhelming regulatory burdens without addressing the actual causes of the financial crisis. To date, no other country has proposed similar prohibitions on proprietary trading or private equity and hedge fund activities.

It took the regulatory agencies fifteen months to produce a proposed rule, which was released just one week before the statutory deadline for a final rule. While the proposal provides the agencies' preliminary views on some aspects of the statutory framework, it is clear that there is much more work to be done. Dozens of implementation issues raised in comment letters preceding the proposal were not addressed. Many provisions require further refinement to achieve their stated objective and avoid unintended consequences. The proposal itself requests comment on hundreds of issues, ranging from questions about basic approaches to granular questions about implications for specific market activities. Some questions were undoubtedly included in order to build an administrative record with an eye to future court challenges, but in our view some reveal uncertainty and a lack of consensus among the agencies regarding key issues.

*The clear takeaway from the proposal is that many elements of the implementing rules are still in play.* The proposal will require extensive, detailed comments from industry participants and trade associations to obtain the clarity required to proceed with permissible business activities, achieve a workable implementation timetable, and avoid unnecessary limitations on traditional banking practices that the proponents of the Volcker Rule intended to preserve. Clear, constructive input is especially important in light of the serious burdens on the agencies' staffs and the time pressures to finalize the rule.

*One of the central challenges in both the proprietary trading and private funds sections of the proposal is how to preclude specified prohibited activity and prevent evasion, while permitting activity that is recognized as beneficial and which the statute specifically sought to protect.* The proprietary trading provisions, for example, reflect the difficulty of creating a regulatory regime that distinguishes between speculative proprietary trading, which the Volcker Rule seeks to push out of banking organizations into other sectors of the financial markets, and the essential market making, liquidity supporting and other financial intermediation functions that the Volcker Rule seeks to permit for banking organizations. On the

funds side, as just one example, the proposal struggles to reconcile the restrictions on sponsoring and investing in broadly defined “covered funds” with the statutory mandate not to restrict the securitization of loans—a particular challenge given that securitization structures do not map neatly to Volcker Rule definitions and are subject to separate and in some respects directly conflicting requirements under Dodd-Frank.

*A second challenge is determining the appropriate application of the rule to activities outside the United States, balancing the need to limit the unwarranted extraterritorial application of U.S. law with concerns about U.S. institutions’ ability to compete with foreign banks. On this issue, the proposal takes an expansive view of the extraterritorial reach of the Volcker Rule and a very restrictive approach to the exemptions for proprietary trading and funds activity that foreign banking organizations conduct outside the United States.* The proposed limitations on the exemptions—for example, the requirement that trades could not involve a U.S. counterparty or be executed in the United States—would have significant implications for foreign banks’ overseas activity and for U.S. markets. Foreign banks (and perhaps their supervisors) will argue that the exemptions are inconsistent with longstanding banking and securities law precedents regarding the extraterritorial application of U.S. law. U.S. banks, on the other hand, may consider taking up the agencies’ invitation to argue that U.S. banks should be permitted to engage in the same activities outside the United States that are permitted to their foreign competitors.

With respect to *compliance risks*, the proposal helpfully clarifies that if the agencies detect activities that they believe are impermissible, they will instruct the banking entity to stop those activities going forward. This suggests a constructive approach that will facilitate compliance and appropriate continuation of permissible activities. Nevertheless, many institutions remain understandably concerned that the agencies may over time diverge in their approaches, and some may take a more enforcement-oriented approach. If they do, this could cause some institutions to manage their activities in an overly cautious manner and perhaps cease what otherwise should be permissible market making, intermediation and risk-management activities, to the detriment of U.S. financial markets and institutions’ safety and soundness.

Given all of the open issues and complexities of the proposal, and that rules are unlikely to be finalized until late spring in the best-case scenario (and well after the July 2012 effective date in foreseeable scenarios), *timing for implementation has emerged as a significant issue*. This is particularly true on the proprietary trading side in light of the proposal’s requirement to establish recordkeeping, reporting and compliance systems by the effective date, as well as the reference in the preamble to bringing proprietary trading into compliance “as soon as practicable” within the conformance period. The agencies have asked about the viability of banking organizations putting such systems in place by July, and the conformance timetable more broadly. Particularly if the agencies were to resolve their significant questions in ways that would require issuing a second proposed rule, that could lead to a delay in the ultimate compliance deadline of July 2014. In view of the extensive proposed compliance obligations, and the potentially disruptive effects

on U.S. markets and market participants, we expect the industry will press hard for extensions of compliance deadlines and perhaps even the effective date.

One theme emerging from discussions in Washington has been that while there may be unanticipated negative consequences of certain aspects of the rule, the agencies believe that their hands are tied by the statute. *This suggestion should be resisted.* The agencies have ample discretion to interpret the ambiguities, contradictions and gaps in the Volcker Rule in ways that avoid or minimize these negative consequences. Indeed, the proposal evidences the agencies' willingness and ability to use their interpretive authority either to widen or to narrow the scope of the statute's restrictions—for example, by interpreting "solely outside of the United States" to preclude the execution of trades in the United States, or concluding that the so-called "Super 23A" prohibition on covered transactions should not prohibit investments in sponsored funds. Congress also gave the agencies exemptive authority under Section 13(d)(1)(J) of the BHCA to permit activity that the agencies determine would promote the safety and soundness of a banking entity and U.S. financial stability. The agencies should be urged to exercise their interpretive and exemptive authority to promote those goals and appropriate implementation of the statute.

## PROPRIETARY TRADING: KEY TAKEAWAYS AND SPECIFIC HIGHLIGHTS OF THE PROPOSAL

The agencies' proposal on proprietary trading reflects a hybrid of two regulatory approaches, as it shares features of both a rigid, rules-based approach and a flexible, principles-based approach. On its face, the proposal imposes extensive specific requirements. Interwoven with those requirements are numerous critical matters where judgment and discretion must be exercised—in the first instance by a banking organization and in the second instance by examiners. In some cases, key determinations would be made based upon an assessment of the intent of a transaction (e.g., to determine if a trade was "proprietary trading" conducted with the intent to profit from short-term price movements, or to judge whether a transaction was intended to hedge a particular risk). Significantly, although certain instruments and discrete activities have been defined as outside the scope of the proposed rule, no safe harbors for permissible activities have yet been proposed.

*Banking entities that are active participants in the financial markets can expect to face burdensome compliance obligations.* In an effort to detect and prevent potential evasion and disguised proprietary trading, the agencies have indicated that they expect to rely on robust internal compliance regimes (including mandates down to the level of individual traders), massive data collection, and horizontal peer reviews across institutions and trading desks. This basic approach was laid out in the Financial Stability Oversight Council's study on the Volcker Rule, but the proposal more clearly highlights some of the implications of this approach.

A proactive approach to building such a program could prove vital. The tone of the proposal reflects significant concerns about the possibility of evasion, and by establishing credibility through a proactive compliance program, an institution is more likely to be able to establish that particular activities reflected good faith

judgments about the distinctions in the Volcker Rule when the inevitable disagreements with examiners arise.

*One key challenge will be how to calibrate trading compliance systems, and how to handle the agencies' planned use of horizontal reviews across peer firms.* For example, institutions will need to determine at a basic level how much customer-facing activity is too little, how much inventory turnover is enough, etc. At a more detailed level, institutions will need to set parameters for the multitude of P&L-based metrics and ratios called for under the proposal for specific types of activities and products. Unless the agencies contemplate providing this guidance during the implementation process, the criteria and metrics used by individual firms will not map exactly to those used by their peer firms. This could be problematic where the agencies are using horizontal reviews to assess the appropriateness of a firm's standards, and could contribute to disagreements between banking organizations and their examiners over calibration issues.

Although the proposal recognizes throughout that different markets and products will have different characteristics, the baseline approaches to trading, hedging, and market making, including the baseline factors and metrics used to define proprietary trading, appear to be derived mainly from the features of the relatively better understood exchange-traded equity marketplace. The challenge of applying this model to other, less liquid markets, to bespoke products or in adverse market conditions should not be underestimated.

A detailed analysis of the proposal's proprietary trading provisions is provided in Part I of the attached outline. *At a high level, the key new developments in the proposal with respect to proprietary trading restrictions include the following:*

- Proprietary trading activities conducted as of the effective date may continue into the conformance period, although the proposal refers to winding down prohibited trading as "soon as practicable" during the conformance period.
- The proposal provides helpful (but limited) exclusions for repurchase and reverse repurchase agreements, securities borrowing and lending transactions and positions taken for bona fide liquidity management purposes.
- The proposed rule interprets the exceptions for underwriting and market-making-related activities narrowly and would require a burdensome recordkeeping and compliance regime.
- Portfolio and dynamic hedging are permitted, but hedging activities would also be subjected to documentation and compliance requirements.
- The reporting requirements for institutions engaged in "significant trading activities" are more onerous than expected.
- The proposal narrowly interprets the exception for foreign banking organizations to conduct proprietary trading outside the United States. The exception would prohibit trading with U.S. counterparties and require transactions to be executed wholly outside the United States.

## RESTRICTIONS ON SPONSORING AND INVESTING IN PRIVATE FUNDS: KEY TAKEAWAYS AND SPECIFIC HIGHLIGHTS OF THE PROPOSAL

*On the funds side, the Volcker Rule framework presents significant challenges due to the many inconsistencies and ambiguities in the statute.* The proposal takes some steps towards addressing interpretive questions and unintended consequences, but also gives the impression that the agencies themselves are still grappling with the complexity of the rule and the implications of various approaches. Many significant interpretive issues are either unaddressed or only partially resolved by the proposal. Other issues that the agencies have addressed have in turn created new questions and issues. Given the complexity and short time frame, a significant effort will be required by both the industry and the agencies to parse all the implications of the proposal and to identify approaches that could achieve the statute's aim while minimizing unnecessary and unintended negative consequences.

*The most significant interpretive challenge is a fundamental scope question:* how the agencies should define what is a hedge fund or private equity fund subject to the rule's prohibitions. Everyone agrees that the statutory definition sweeps too broadly. But the proposal's efforts to remedy this overbreadth by creating a series of narrow exemptions makes clear that it will be very difficult to come up with exemptions to cover every form of entity that is caught up by the statutory definition but in fact does not resemble a private equity or hedge fund. The agencies ask in the preamble whether they should take a different approach and focus the definition of covered funds on the characteristics of a private equity or hedge fund (e.g., compensation structure, investor composition, investment strategy), but such an approach presents its own challenges.

*One practical implication of this difficulty* is that the agencies should in any final rule provide for a process and criteria to evaluate individual cases upon request, perhaps modeled on SEC no-action letters. Even if the agencies appropriately expand the scope of various exemptions they have proposed, there inevitably will be a significant number of entities caught up by the statutory definition that Congress did not intend to restrict.

Part II of the attached outline analyzes the funds provisions of the proposal and its implications. *At a high level, the key new developments in the proposal with respect to private equity and hedge funds include the following:*

- Although the proposal provides several exemptions aimed at addressing the overly broad scope of "covered funds" in the statute, the exemptions are too narrow to include many common corporate structures and do not cover venture capital funds.
- Although exemptions permit banking entities to sponsor or invest in certain entities that fall under the "covered funds" definition (such as certain loan securitization vehicles, corporate structures, or foreign funds, among others), the "Super 23A" prohibition against banking entities entering into lending or other covered transactions with such entities that it sponsors or advises would still apply.

- The proposal expands the scope of covered funds to include commodity pools and foreign equivalents of covered funds; the inclusion of commodity pools creates overbreadth issues that will need to be addressed.
- The proposal expands the scope of an “ownership interest” beyond its plain meaning to include interests that create economic exposure to a covered fund, including fund-linked derivatives.
- If a banking entity finances employee investments in sponsored funds, those investments would count towards the banking entity’s 3% investment limit under the so-called “de minimis exception”. Proprietary investments that a banking entity makes alongside a sponsored fund may also count towards its 3% limit.
- Under the foreign funds exception, no U.S. employees or U.S. entities may be involved in the offer or sale of fund interests. It appears that U.S. portfolio management activities may be permissible.
- The hedging exception for fund interests permits only limited hedging of certain customer-driven transactions and employee compensation arrangements.
- The proposal provides no additional guidance regarding conformance requirements for pre-effective date activities that implicate the name-sharing prohibition, the prohibition on covered transactions, limitations on employee investments, or the U.S. marketing restriction for foreign funds.

## KEY ISSUES FOR SECURITIZATION

*Although the Volcker Rule is not aimed at regulating securitization, it could have a significant impact on issuers of asset-backed securities.* The agencies included two carve-outs in the proposal for certain loan securitization vehicles and for acquisition of securitization interests pursuant to Dodd-Frank’s risk retention requirements, but both will require revisions to achieve their intended effect. Dozens of questions related to the impact of various provisions on securitization vehicles are spread through the proposal, and it is evident that the agencies are in the early stages of determining how to apply—or avoid applying—the rule’s prohibitions to securitization vehicles. Our analysis of how the proposal could affect securitization activity is provided in Part III of the attached outline.

## ORGANIZATION OF THE MEMORANDUM

The purpose of this memorandum and the attached outline is to discuss the key implications of the proposal for market participants and to highlight specific analytical issues and interpretive questions throughout the proposal that should be addressed in comments and considered as businesses prepare for the July 2012 effective date. The outline addresses proprietary trading, funds activities (including implications for employee compensation arrangements), the impact on securitization activities, and timing and practical challenges related to required compliance programs.



We have attempted to limit our summary of the proposal to what is required in presenting our analysis, as many excellent summaries have already been published. *To facilitate review by readers already familiar with the proposal, we have highlighted in red italics the areas in our outline where we focus on key implications and observations.*

# TABLE OF CONTENTS

<b>I. PROPRIETARY TRADING</b>	<b>1</b>
A. Scope of Covered “Banking Entities” Subject to the Volcker Rule	1
B. Trading Activities Subject to the Proposed Rule	2
C. Permitted Trading Activities	6
D. Limitations on Permitted Trading Activities	20
E. Reporting and Recordkeeping Requirements	21
F. Application of the Conformance Period to Proprietary Trading Activities	23
<b>II. SPONSORING AND INVESTING IN COVERED FUNDS</b>	<b>24</b>
A. Scope of Covered “Banking Entities” Subject to the Volcker Rule	24
B. Main Issues of Scope: Covered Funds; Restricted Sponsorship; and Restricted Ownership Interests	24
C. Permissible Investments: Acquiring Fund Interests Held as Collateral	33
D. The De Minimis Exception: Permitted Sponsorship and Investment in Connection with Asset Management Services	33
E. Foreign Funds Exception	38
F. Permitted Risk-Mitigating Hedging Activities	40
G. No Insurance Company Exception for Investments in Covered Funds	41
H. “Super 23A” Restrictions on Transactions with Covered Funds	41
I. Conflict of Interest, Risk, and Safety and Soundness Restrictions Applicable to All Fund Activities	43
J. Implications of Funds Provisions for Employee Investments and Employee Compensation Structures	44
<b>III. IMPLICATIONS FOR SECURITIZATIONS</b>	<b>47</b>
A. Overview and Main Takeaways	47
B. Treatment of Loan Securitizations	48
C. Treatment of Other Asset-Backed Securitizations	49
D. Implications for ABS Issuers Deemed to Be Covered Funds	50
E. Implications for ABS Issuers Deemed to Be Banking Entities	54
<b>IV. REQUIRED COMPLIANCE PROGRAMS</b>	<b>57</b>
A. Scope of Compliance Requirements	57
B. Core Components of Compliance Programs	57
C. No CEO Attestation	58
D. Additional Requirements for Entities with Significant Covered Activities	58
E. Application to Foreign Banking Entities	60

# I. PROPRIETARY TRADING

## A. Scope of Covered “Banking Entities” Subject to the Volcker Rule<sup>1</sup>

1. The Volcker Rule generally applies to all U.S. insured depository institutions (other than certain limited purpose trust institutions) (“IDIs”); companies that control an IDI; foreign banking organizations with branches or agencies or bank subsidiaries in the United States (“FBOs”); and the affiliates and subsidiaries of all such entities (“banking entities”).<sup>2</sup> Throughout this memorandum, references to a banking entity generally include its subsidiaries and affiliates.

*There is no U.S. territorial limitation to the scope of covered banking entities, so the Volcker Rule potentially applies to a banking entity’s global operations. Exemptions are available for certain proprietary trading and funds activity conducted “solely outside of the United States”, but under the proposal these exemptions are subject to significant limitations and are not available to U.S. banking entities.*

### 2. Exclusion of Certain Controlled Funds

The proposal acknowledges that it would be inconsistent with the purpose and intent of the statute to apply the prohibitions of the Volcker Rule to a private equity or hedge fund controlled by a banking entity. As a result, the proposed rule excludes certain funds from the banking entity definition. Under the proposal, not all controlled private equity or hedge funds would be excluded; instead only covered funds organized, offered and held pursuant to the so-called “de minimis exception”, as well as any other entity controlled by such a covered fund, would be excluded.<sup>3</sup>

*This carve-out appears to be too narrow to accomplish its intended result, as it does not address (i) covered funds that may be controlled under the BHCA, but are not organized and offered pursuant to the de minimis exception (e.g., funds sponsored pursuant to other exemptions, such as those for certain securitization vehicles or foreign funds), or (ii) investment vehicles controlled by the banking entity that are not “covered funds” (e.g., some securitization vehicles and possibly registered investment companies).<sup>4</sup> For example, it appears that if an FBO sponsored a hedge*

<sup>1</sup> The Volcker Rule was enacted as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or “Dodd-Frank”) and is codified as Section 13 of the Bank Holding Company Act of 1956, as amended (the “BHCA”) (12 U.S.C. § 1851).

The proposed rule was issued by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Federal Deposit Insurance Corporation (the “FDIC”), the Office of the Comptroller of the Currency (the “OCC”) and the Securities and Exchange Commission (the “SEC” and, together with the Federal Reserve, the OCC and the FDIC, the “Agencies”). 76 Fed. Reg. 68,846 (Nov. 7, 2011). The Commodity Futures Trading Commission (the “CFTC”) is also required to issue a rule to implement the Volcker Rule. While the CFTC has apparently chosen not to join the other Agencies in this proposal, we do not believe that this necessarily reflects any substantial divergence as to the scope or approach of the proposal. Comments on the proposal are due on or before January 13, 2012.

<sup>2</sup> The proposed rule provides that “affiliate” and “subsidiary” will have the same meanings as in Section 2 of the BHCA. These definitions incorporate the broad definition of “control” in the BHCA, as interpreted by the Federal Reserve, which includes (i) owning, controlling or having the power to vote 25% or more of a class of voting securities of a company; (ii) controlling in any manner the election of a majority of the directors or trustees of the company; or (iii) exercising a controlling influence over the management or policies of the company. A banking entity acting as general partner or managing member of a fund would be deemed to control that fund under the BHCA (and thus, the Volcker Rule). See 12 U.S.C. §§ 1841(a)(2), (d) and (k); 12 C.F.R. § 225.2(e).

The Volcker Rule also provides for nonbank financial companies that have been designated for supervision by the Federal Reserve and that engage in proprietary trading and covered funds activities to be subjected to additional capital requirements, quantitative limits, or other restrictions. The Financial Stability Oversight Council (“FSOC”) has not yet designated any such companies, and the Agencies have not proposed any such additional requirements.

<sup>3</sup> The de minimis exception is described in Sections \_\_.11 and \_\_.12 of the proposed rule, and described below in Part II.D.

<sup>4</sup> Bank holding companies often limit their relationship to a mutual fund so as to avoid the mutual fund becoming an affiliate under the BHCA, and thus it is possible that failing to exclude registered investment companies from the definition of banking entity would not have a significant practical effect. As noted in the preamble, a mutual fund would generally not be an affiliate of a banking entity if the banking entity only provides advisory or administrative services to, has limited investments in, or organizes, sponsors and manages a mutual fund in accordance with BHCA rules. See, e.g., 12 U.S.C. §§ 1483(c)(6), (c)(8), and (k); 12 C.F.R. §§ 225.28(b)(6), 225.86(b)(3), 225.125. To the extent institutions do control mutual funds or other registered investment companies for purposes of the BHCA, they should highlight this fact in comment letters.

*fund outside the United States, with no U.S. investors, and held a 5% interest in that fund, the hedge fund would need to comply with the Volcker Rule's proprietary trading restrictions.<sup>5</sup>*

## **B. Trading Activities Subject to the Proposed Rule**

1. The Volcker Rule generally prohibits banking entities from engaging in “proprietary trading”, subject to certain exceptions. Following the structure of the statute, the proposed rule defines proprietary trading as engaging in the purchase or sale of one or more covered financial positions as principal for the trading account of the banking entity. Each of these key terms is described broadly, apparently to capture a broad range of activities within the statutory scheme. Any activity that falls within the proprietary trading definition would be required to comply with one of the specific exceptions for permitted activities.

*This approach—casting the “proprietary trading” net broadly—has the effect of putting additional pressure on the viability of the Agencies’ implementation of the exceptions for permissible activities, such as underwriting, market making and hedging. This is because banking entities will need to rely on those exceptions, as opposed to a narrower definition of proprietary trading, to continue appropriate activities.*

### **2. Purchase and Sale**

- (a) The proposal defines “purchase and sale” to encompass a wide range of transactions that could create, eliminate, increase or reduce exposure to a covered financial position. In the case of derivatives, for example, the proposal would cover the execution, early termination, assignment, exchange or conveyance of, or extinguishing of rights or obligations under, a derivative.
- (b) *Banking entities should be able to modify the terms of their swaps and other derivatives without creating a “purchase or sale” as defined in the proposal.*

### **3. Covered Financial Position**

- (a) “Covered financial position” is defined very broadly to include any position, whether long, short, synthetic or other, in a security, derivative, or contract for sale of a commodity for future delivery, or in an option on such securities, derivatives or contracts.
- (b) *Certain implicit exclusions in the statutory text have been made explicit in the proposal, as discussed in Part I.C. below.*

### **4. Trading Account**

- (a) A key to the definition of proprietary trading is the definition of “trading account”, which the proposal seeks to define based on the intent of a banking entity to earn short-term profits. The proposal contains three overlapping definitions: a purpose test, a market risk capital rule test and a dealer registration test.

<sup>5</sup> The Agencies appear to recognize that the exclusion is insufficiently broad in these respects, as it includes questions about whether all covered funds, as well as registered investment companies and issuers of asset-backed securities (“ABS”) should be excluded from the definition of banking entity.

(b) Purpose test

- (i) Trading account would include any account used by a banking entity to acquire or take one or more covered financial positions principally for the purpose of reselling in the short term; benefitting from actual or expected short-term price movements; realizing short-term arbitrage profits; or hedging one or more positions described above.

- (ii) *The intent behind a particular transaction or class or series of transactions may be difficult to ascertain, sometimes hinging on the intentions of individual traders. In some cases, it could be challenging for banking entities to establish that particular transactions or classes of transactions should not be considered proprietary trading. If a banking entity wishes to establish that certain activities should not need to comply with the enumerated exceptions described below, it may need to create and maintain contemporaneous records demonstrating, on a transaction or class basis, the intent of the activities.*

*On the other hand, many financial institutions already make these judgments on a regular basis, for example when classifying assets as trading securities under GAAP or when determining which positions should be treated as covered positions under the market risk capital rules (as described below).*

- (iii) *The preamble's explanation of the four prongs of the purpose test demonstrates a desire to reach beyond simple purchase and sale transactions to any transaction or series of transactions that can generate short-term profits from price movements or price differences. Thus it suggests that transactions designed to offset or close out a portion of the risks of a position could be included in the trading account even if the banking entity continues to hold the original position, as could arbitrage strategies (such as relative value convergence arbitrage) that can generate profits from price differences without any actual movements in price.*
- (iv) *The proposal suggests that the intent-based definition of trading account would include a derivative, "regardless of the term of that position", that is subject to the exchange of short-term variation margin "through which the banking entity intends to benefit from short-term price movements." The proposal also refers to the exchange of variation margin as a "potential indicator" of short-term trading. Because proposed rules under Title VII of Dodd-Frank would require the exchange of variation margin for nearly every swap contract (including, for example, long-term credit default swaps and interest rate swaps linked to bank loans), it will be important to clarify that this reference would apply only if the exchange of variation margin were itself designed as a concealed proprietary trading strategy, and not to ordinary course exchange of variation margin, especially if required by regulation.*

(c) Market risk capital rule test

- (i) Trading account would also include any account used by a banking entity to acquire or take one or more covered financial positions that are "covered positions" under the market risk capital rule as implemented in the United States.<sup>6</sup>

<sup>6</sup> See 12 C.F.R. pt. 3, Appendix B; 12 C.F.R. pt. 208, Appendix E; 12 C.F.R. pt. 225, Appendix E; 12 C.F.R. pt. 325, Appendix C. The market risk capital rules define "covered position" by reference to the assets and liabilities reported as trading assets and trading liabilities held in an institution's "trading account" on an institution's call report for an insured depository institution or FR Y-9 (for a bank holding company).

- (ii) This definition would apply only if the banking entity or a bank holding company affiliate of the banking entity is subject to a risk-based capital requirement under the market risk capital rule. It specifically excludes positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery (which are always treated as market risk capital rule covered positions, irrespective of any short-term or long-term trading intent), which would still be captured in the definition of trading account by the purpose test if they were entered into with a short-term trading intent.
  - (iii) *The Agencies clarify in the preamble that they intend to base this second test on the market risk capital rule as it is proposed to be amended. Assuming the market risk capital rule is amended as described in the notice of proposed rulemaking issued in January 2011, the definition of "trading position" for that purpose would be substantively identical to the purpose test. These proposed amendments, which drew few industry comments, are expected to be finalized by year end.*
  - (iv) *Most FBOs will not be required to apply the market risk capital rule test because the market risk capital rule is defined in the proposal to include only the U.S. rules implementing the Basel 2.5 revisions to the market risk framework. The proposal is somewhat ambiguous regarding the extent to which the market risk capital rule test would apply to an FBO's U.S. bank holding company subsidiary that is or becomes subject to the market risk capital rule (or its affiliates).<sup>7</sup>*
- (d) Activities requiring registration test
- (i) Lastly, trading account would include any account used by a banking entity to acquire or take one or more covered financial positions for any purpose, if the banking entity is a registered securities dealer, municipal securities dealer, government securities dealer,<sup>8</sup> swap dealer, or security-based swap dealer. In each case, however, the definition applies only to the extent a position is acquired or taken in connection with the activities of the dealer that require it to be registered, or to file notice.
- The inclusion of this prong is somewhat curious, because activities that require registration as a dealer generally involve activities that could be broadly characterized as customer intermediation services and the provision of liquidity (those activities generally meant to be permissible under the proposed rule), and normally would not include the activities of persons engaging in the markets purely as a proprietary trader. The most likely explanation is that the Agencies wished to assure that dealers implement the compliance programs required of those who take advantage of the market-making exemption.*
- (ii) The definition also includes entities engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States to the extent a position is acquired or taken in connection with the activities of such business.

<sup>7</sup> A U.S. banking organization is subject to the market risk capital rule if it has trading assets and liabilities in excess of 10% of its total assets or greater than \$1 billion. Many intermediate U.S. bank holding companies of FBOs are not currently subject to the Federal Reserve's capital adequacy guidelines for bank holding companies, including the market risk capital rule, under the Federal Reserve's supervisory guidance in SR Letter 01-01. However, the so-called Collins Amendment, Section 171 of the Dodd-Frank Act, eliminates this exemption for intermediate U.S. bank holding companies on July 21, 2015.

<sup>8</sup> Including entities that are exempted from registration but must file notice with the appropriate regulatory agency under the Securities Exchange Act of 1934 (the "Exchange Act").

- (e) *The apparent purpose of using three overlapping definitions for trading account is to prevent evasion and regulatory arbitrage, and perhaps to simplify the process of identifying trading accounts for entities subject to the market risk capital rule and/or registration as a dealer in one or more financial instruments. The second and third definitions, as proposed, would appear to be more or less swallowed by the purpose test. Each focuses on positions taken (i) for the purpose of selling in the near term or otherwise profiting from short-term price movements, (ii) to accommodate customers and other trading activities, or (iii) as part of underwriting or dealing activities. The practical effect of using all three definitions is unclear, but the approach would appear to add complexity to the industry's efforts to comply.*
- (f) *The proposal does not directly adopt GAAP definitions, so there is no direct one-for-one correlation between GAAP accounting and classification of accounts for purposes of the Volcker Rule. GAAP "trading securities", which are defined as securities "bought and held principally for the purpose of selling in the near-term" and are reported as part of the trading account in call reports (and therefore are covered positions under the market risk capital rule) will generally be included in the definition of trading account. However, firms are permitted to classify assets as trading securities under GAAP even when there is no intent to sell in the near term, raising questions about the appropriate treatment of these positions under the Volcker Rule. Investments that are classified under GAAP as held to maturity (where the holder has the positive intent and ability to hold the securities to maturity) and available for sale (for securities that are neither trading securities nor held-to-maturity) would appear generally to be outside the definition of trading account and would not be subject to the Volcker Rule. But the treatment of available-for-sale securities could be subject to some uncertainty, as the GAAP definition is stated in the negative (i.e., neither held with the intent to resell in the near term nor with the intent to hold until maturity, but rather with the intent to hold for an indefinite period). Similar questions arise under the IFRS classifications "fair value through profit or loss", "available for sale" and "held to maturity".*
- (g) Rebuttable presumption for positions held less than sixty days
- (i) The proposed rule establishes a rebuttable presumption that any account used to acquire or take a covered financial position that the banking entity holds for a period of sixty days or less is a trading account. The presumption would not apply if the banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for short-term resale; benefitting from actual or expected short-term price movements; realizing short-term arbitrage profits; or hedging one or more positions described above.
- (ii) *The proposal indicates that the rebuttable presumption is intended to assist institutions not currently subject to the market risk capital rules or dealer registration requirements, which presumably have less expertise in evaluating short term trading intent.*
- (iii) *The proposal suggests that banking entities could at times be required to rebut this presumption for individual positions, although it leaves room for rebutting categories of positions. It is not clear whether rebuttals would come after the fact, or whether a banking entity could rebut the presumption in advance of a series of trades. In either case, banking entities would need to develop recordkeeping systems sufficient to document and demonstrate the purpose of the banking entity's positions.*



- (iv) *Given the likely practical difficulties and burden involved in rebutting the presumption, firms may decide simply to treat most or all positions held less than 60 days as part of the trading account and rely on other exceptions.*
- (v) *The Agencies have asked whether they should include a presumption in the other direction—i.e., a presumption that covered positions held beyond a certain time are not in a trading account position.*
- (h) Arbitrage and other complex trading strategies
  - (i) The proposal emphasizes that a position would not need to be purchased and then sold in order to give rise to short-term profits and be included in the trading account of a banking entity. Arbitrage transactions, transactions intended to offset or close out certain risks of another position, and other nonsales activities could all fall into the trading account definition. The proposal specifically asks whether all arbitrage positions should be included in the trading account unless the banking entity that establishes the position has a long-term intent.
  - (ii) *Because correlated or offsetting transactions could be deemed a covered financial position in a banking entity's trading account, the proposal raises significant issues with respect to how such positions will be identified.*
- (i) Interaffiliate Transactions

*One area that is not addressed in the proposal is the treatment of interaffiliate transactions. From a common sense perspective, such transactions, typically entered into as a way to manage enterprise-wide risk, liquidity and capital (although other purposes are also possible), would seem to be outside the scope of the definition of proprietary trading. However, the proposal's approach to defining trading account, as well as the application of the sixty day rebuttable presumption, raises a question whether some interaffiliate trades, swaps and other positions could fall into the definition of proprietary trading. Were this to occur, it is not clear that the permitted trading activities described below would be sufficient to exempt all such transactions, and the burden of documenting such transactions in order to rely on these exemptions would create inefficiencies. To address these issues, the Agencies could consider adding an express presumption that interaffiliate transactions are not part of the trading account, or an exemption for interaffiliate transactions under the Agencies' BHCA Section 13(d)(1)(I) authority on the grounds of safety and soundness.*

### **C. Permitted Trading Activities**

1. The proposal contains several exclusions for instruments or activities that would be outside the scope of the Volcker Rule's ban on proprietary trading, in which banking entities can transact without complying with Volcker Rule restrictions or subjecting the trading activity to the more burdensome aspects of the proposed rule's compliance, recordkeeping and reporting requirements. It also would specifically permit certain types of trading by banking entities as principal subject to specific conditions described as designed to prevent banking entities from conducting proprietary trading under the guise of a permitted activity.



## 2. Excluded Instruments

- (a) Loans, commodities and foreign exchange and currency are specifically excluded from the scope of the proposal, but futures, forwards, swaps and other derivatives are not.
- (i) *Trading operations in foreign exchange and commodities would currently need to be limited to spot transactions in order to put them outside the scope of the proposal, but the proposal does not provide guidance on what settlement timeframe is necessary for a transaction to qualify. One approach that the Agencies could adopt is the Commodity Exchange Act's retail foreign currency and commodity provisions.<sup>9</sup> Under those provisions, foreign currency transactions are excluded if they result in actual delivery within 2 days, and commodity transactions are excluded if they result in actual delivery within 28 days. That standard could prove problematic, however, for transactions in emerging market currencies and other transactions with atypical settlement cycles.*
- (ii) *The Agencies specifically ask for comments on whether physically-settled foreign exchange forwards and swaps, physically-settled commodities forwards, certain retail foreign exchange and commodities derivatives and certain leveraged precious metals contracts, which are currently included in the proposed rule's definition of derivative, should be excluded from the scope of the Volcker Rule.<sup>10</sup> This approach raises the question whether the burdens associated with requiring institutions to segregate their foreign exchange activities into spot and derivatives segments for Volcker Rule compliance purposes could adversely affect the availability or pricing of such activities for counterparties and/or affect market liquidity.*
- (iii) *The loan exclusion, which the Agencies characterize as "expansive", would permit the purchase and sale of loans, leases, extensions of credit and secured and unsecured receivables to continue unhindered, but specifically does not include asset-backed securities backed by loans, creating another regulatory context where the distinction between loans and debt securities will be relevant.*
- (b) Identified banking products, such as deposit accounts, savings accounts, certificates of deposit, or other deposit instruments issued by a bank; banker's acceptances; letters of credit issued or loans made by a bank; debit accounts at a bank arising from a credit card or similar arrangement; and participations in certain loans, are also excluded by virtue of their exclusion from the definition of derivative.
- (i) *This exclusion should cover all manner of deposit products provided by banks to their customers, including, for example, equity and other market-linked deposit products.*

## 3. Agency, Brokerage and Custodial Transactions

Transactions where a banking entity is not taking a position as principal are outside the scope of the proprietary trading definition. To this end, the proposal specifically clarifies that acting solely as agent, broker, or custodian for an unaffiliated third party are not within the scope of the proprietary trading definition. These types of transactions would not need to comply with one of the enumerated exceptions for permitted trading activities described below.

<sup>9</sup> The proposed rule separately covers transactions subject to those provisions within its definition of "derivatives" subject to the Volcker Rule's proprietary trading prohibition.

<sup>10</sup> See 76 Fed. Reg. at 68,866.

#### 4. Other Excluded Transactions

(a) The proposal excludes four specific activities from the definition of proprietary trading: repurchase or reverse repurchase arrangements and securities lending transactions subject to written agreements; positions taken for bona fide liquidity management purposes subject to a documented liquidity management plan; and positions held by a registered derivatives clearing organization or clearing agency acting as a central counterparty. Banking entities would be permitted to engage in these activities without the need to comply with one of the enumerated exceptions described below.

- (i) *The repurchase and reverse repurchase exclusion is limited to simultaneous agreements to purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty. The preamble asks whether “open dated repurchase agreements” or other types of agreements should be included. The exclusion would appear to apply to at least some forms of structured or term repurchase agreements, although the treatment of embedded derivatives, common in the structured repurchase markets, is unclear.*
- (ii) *The exemption for registered derivatives clearing organizations and clearing agencies would permit such entities that are affiliated with banking entities (and therefore deemed to be banking entities themselves) to continue acting as central counterparties without interference from the Volcker Rule. The exemption would not appear to cover foreign clearing organizations that are not registered in the United States, even though banking entities regularly invest in such entities.*

(b) Under the liquidity management exclusion, a banking entity’s documented liquidity plan would be required to meet the following conditions:

- (i) Specifically contemplate and authorize each instrument used for liquidity management;
- (ii) Require that any transaction authorized under the plan be principally for the purpose of liquidity management, and not short-term profits;
- (iii) Limit such instruments to “highly liquid” instruments which are not expected to lead to appreciable profits or losses as a result of short-term price movements;
- (iv) Limit positions taken for liquidity management purposes to an amount consistent with the banking entity’s near-term funding needs; and
- (v) Be consistent with its regulatory agency’s supervisory requirements, guidance and expectations.

(c) *The concept of a liquidity plan exclusion could be an important exception to the proposed rule’s restrictions on short-term trading. In a mandated study, FSOC discussed how banking entities often use their investment portfolios as liquidity buffers in their asset-liability management operations, and observed that such activities serve important safety and soundness objectives, which created some hope that such activities would be broadly exempted.<sup>11</sup>*

*The exclusion in the proposed rule, however, is drawn narrowly. The conditions it places on liquidity management plans are likely to significantly restrict a banking entity’s flexibility to conduct asset-liability and liquidity management in the most efficient manner. Indeed, the*

<sup>11</sup> FSOC, Study and Recommendations on Prohibitions on Proprietary Trading and Relationships with Hedge Funds and Private Equity Funds (Jan. 2011) (the “FSOC Study”) at 47.

*Agencies appear prepared to take a very narrow view of this exclusion, as evidenced by the preamble's statement that any appreciable profits or losses that do arise from short-term price movements in connection with liquidity management could be presumptively viewed as prohibited proprietary trading absent "compelling explanatory facts and circumstances"—this despite the fact that even U.S. Treasuries exhibit significant short-term volatility.*

#### 5. Permitted Underwriting and Market-making-related Activities

- (a) Section \_\_.4 of the proposal would permit banking entities to engage in proprietary trading that constitutes underwriting and market-making-related activities, subject to specific criteria designed to ensure prohibited proprietary trading is not disguised as a permitted activity. In each case, a banking entity would be permitted to rely on the exception only if:
- (i) The banking entity has established a comprehensive internal compliance program, as discussed below;
  - (ii) The banking entity is registered as a dealer with the appropriate regulator, or otherwise is exempt from registration or excluded from regulation as a dealer, if registration is generally required to deal in the covered financial position at issue.<sup>12</sup> Banking entities located outside the United States would be required to be engaged in the business of a dealer outside the United States and be subject to substantive regulation of such business in that jurisdiction; and
  - (iii) The activity is designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties.
- (A) *This requirement may prove very significant in the context of market making. The proposal makes clear that expectations should be based on a banking entity's unique customer base and the near-term demands of those customers assessed based on particular factors beyond a general expectation of price appreciation. Notably, however, the proposed rule does not define client, customer, and counterparty, and asks for comment on how market makers typically anticipate customer demand.*
- (B) *In the context of market making in securities executed on an organized trading facility or exchange, the proposal suggests that a market-making activity would be generally consistent with reasonably expected near-term demand if the activity involves passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy.*
- (C) *Arbitrage trading primarily with non-customers would not be viewed as satisfying this condition, although the proposal asks whether certain arbitrage trading strategies that promote liquidity and price transparency should be deemed market-making-related activities even if they are not customer-facing.*
- (D) *Effective market making often involves pricing based on expectations of short-term market direction or convergence of correlated instruments, making a distinction between market making and directional or arbitrage strategies more difficult than the proposal suggests.*

<sup>12</sup> E.g., to rely on the exception for market making or underwriting with respect to securities, the banking entity must be registered as a dealer with the SEC, or exempt from registration; to rely on the exception for market making in swaps, the banking entity must be registered as a swap dealer with the CFTC, or exempt from registration; etc.

- (iv) The activity is designed to generate revenues primarily from fees, commissions, underwriting or bid-ask spreads or other income not attributable to appreciation in the value of covered financial positions the banking entity holds related to such activities or the hedging of such covered financial positions.

*The proposal's reference to revenues "primarily" from fees, commission, etc. suggests that the Agencies do not expect that revenues would be exclusively derived from such sources. Instead, a trading unit engaged in underwriting or market making should be able to conduct their business in a way designed to generate some portion of the trading unit's revenues from appreciation of positions held as principal consistent with this standard. The emphasis on "design" also suggests that short-term trading profits could permissibly make up a substantial part of revenue in certain periods (e.g., as a natural result of the market's behavior at a point in time), so long as the business is designed primarily to generate revenues from other sources.*

- (v) The banking entity's compensation arrangements are designed to primarily reward client revenues and effective client services, not to encourage proprietary risk-taking.

(A) *There is surprisingly little discussion or guidance concerning what specific forms or structures of compensation would be appropriate. The proposed rule requires that compensation be "designed not to reward proprietary risk-taking", but the preamble clarifies that compensation must "primarily" be based on client revenues and services, and acknowledges revenues resulting from price increases can be taken into account in compensation to reflect effective management of retained principal risk.*

(B) *The restrictions on revenue and compensation may not be appropriate for all markets and product types in which a banking entity engages as underwriter or market maker. The proposal asks if limits on revenue sources could discourage beneficial underwriting and market-making activities, and more generally asks for comment on the types of revenue and compensation that would be consistent (or inconsistent) with permitted underwriting and market-making-related activities.*

- (b) In addition, the permitted underwriting and market-making-related activities each would be subject to two unique conditions:

(i) Underwriting activities

(A) Permitted underwriting activities are further limited to (i) purchases and sales of securities that are (ii) effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter.

(B) The proposal's definitions of distribution and underwriter mirror the definitions in the SEC's Regulation M, and the Agencies indicate that they intend to interpret the terms in a manner consistent with interpretations under Regulation M.

(C) Distribution. In order to qualify, transactions under the underwriting exception would need to be distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

*The preamble explains that the magnitude element is not intended to require a large scale distribution, but merely to distinguish a distribution from ordinary trading. Many (although not necessarily all) private placements could qualify under this element, and*

*the preamble specifically asks whether private placements have been appropriately accommodated. Factors relevant to the magnitude element include the number of shares to be registered for sale by the issuer and the percentage of the outstanding shares, public float, and trading volume that those shares represent.*

*Special selling efforts and methods could include greater than normal sales compensation arrangements, delivering a sales document, such as a prospectus or market letters, and conducting road shows.*

*Based on precedents under Regulation M, transactions that could potentially be deemed distributions under the underwriting exception include registered public offerings, private placements, Rule 144A transactions, major sales campaigns by a broker-dealer, and sales made pursuant to a shelf registration statement.*

- (D) Underwriter. The proposal defines an underwriter as a person who has agreed with an issuer of securities or selling security holder (i) to purchase securities for distribution; (ii) to engage in a distribution of securities for or on behalf of such issuer or selling security holder; or (iii) to manage a distribution of securities for or on behalf of such issuer or selling security holder.

Underwriter would also include any person who has an agreement with another person described under (i), (ii), or (iii) above to engage in a distribution of such securities for or on behalf of the issuer or selling security holder, an addition apparently designed to ensure that underwriting syndication would remain permissible.

*The proposal indicates that factors relevant to determining whether a banking entity is acting as an underwriter include (i) assisting an issuer in capital raising; (ii) performing due diligence; (iii) advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering documents; (iv) purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public; (v) participating in or organizing a syndicate of investment banks; (vi) marketing securities; and (vii) transacting to provide a post-issuance secondary market and to facilitate price discovery.*

*The proposal helpfully acknowledges that not all factors will be present in every underwriting, and can vary depending on the type of distribution and liquidity of the securities.*

*The proposal would allow a banking entity acting as underwriter (i) to trade in securities after a distribution to stabilize the secondary market and (ii) to hold securities it could not place in the distribution for investment purposes and sell them at a later time. However, the Agencies are seeking comment on whether they should place any requirements on retained securities from an underwriting (e.g., should there be specific disclosure or documentation requirements).*

(ii) Market-making-related activities

- (A) Market-making-related activities are further limited to “trading desk[s] or other organizational unit[s]” that (i) are engaged in “bona fide” market making in the covered financial position (where the “organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular

or continuous basis”) and (ii) conduct their activities in a manner consistent with the commentary set forth in Appendix B to the proposal, discussed below, which sets forth how the Agencies propose to distinguish market making from proprietary trading.

- (B) The proposal identifies indicia of bona fide market making the Agencies would look for to determine whether a banking entity’s activities are legitimately market-making related, but acknowledges that variations in liquidity, trade size, infrastructure, trading volume and frequency, and even geographic location will influence a market maker’s activities.
- (C) *It appears that the proposal would limit trading under the market-making-related exception to only those desks or other organizational units actually engaged in market making. Under this proposed approach, it may not be possible for other organizational units to make occasional trades pursuant to the authority of a market-making trading unit.*
- (D) *The extent to which the market-making-related activity exception will permit or limit less liquid markets and trading practices, such as distressed debt and structured products trading, remains subject to considerable uncertainty.*
- (E) Liquid markets. In relatively liquid markets such as exchange-traded equity securities, the proposal indicates a trading unit engaged in market-making-related activities should generally be:
- Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
  - Engaged in a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;
  - Making continuous quotations that are at or near the market on both sides; and
  - Providing widely accessible and broadly disseminated quotes.
- (F) Illiquid markets. In less liquid markets, such as OTC securities and derivatives markets, the proposal acknowledges that the indicia for identifying a market maker may vary, but should still generally include:
- Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;
  - With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and
  - Maintaining transaction volumes and risk proportionate to historical customer liquidity and investments needs.

*It is not clear whether a banking entity would be permitted to rely on the market-making-related exception to engage in one-off bespoke trades for a client, and as discussed below, the separate exception for trading on behalf of customers appears to have been interpreted in the proposal too narrowly to permit such transactions.*



(G) Derivatives markets. The proposal also references the CFTC and SEC's discussion of the characteristics of swap dealers and securities-based swap dealers in a recent rule proposal to understand the role of market makers in derivatives markets, noting that dealers:

- Tend to accommodate demand for swaps and security-based swaps from other parties;
- Are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;
- Tend not to request that other parties propose the terms of swaps or security-based swaps, but instead tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest; and
- Tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative.<sup>13</sup>

(H) Block Positioning and Anticipatory Positions. The proposal would permit banking entities to engage in block positioning for the purpose of intermediating customer trading, referring to the definition of qualified block positioner in the SEC's Rule 3b-8(c) for guidance on when block positioning could be deemed market-making related. The proposal would also permit banking entities to take positions in anticipation of customer demand, so long as the positions are "reasonable" and "related to clear, demonstrable trading interest" of customers or counterparties.

*Despite the detail provided in the proposal, the extent to which block positioning, dealer inventory, anticipatory and residual positions will be permitted as market-making-related activities in practice, and what documentation a banking entity will be required to provide in order to support such a characterization, remains unclear.*

(c) Distinguishing market making from proprietary trading

- (i) In order to assist banking entities and the Agencies in distinguishing proprietary trading from market-making-related activities, Appendix B to the proposal sets forth guidance on the characteristics of market making and proprietary trading and identifies key factors that distinguish the two.
- (ii) The proposal describes market making as passively providing liquidity (for securities traded on an exchange) or otherwise providing an intermediation service to its customers by acting as a counterparty ready to buy or sell (for less liquid, OTC contexts). According to Appendix B, a market maker generally limits its exposure to movements in price, through hedging or otherwise; relies on revenues that take the form of fees and spreads; generates significant revenue relative to the risk it retains; limits its engagement with "non-customers" to transactions that facilitate or support customer transactions (e.g.,

<sup>13</sup> The CFTC/SEC release cited by the proposal also characterizes as swap dealing the creation of financial products that include swaps. See 75 Fed. Reg. 80,174 (Dec. 21, 2010).

hedging, acquiring inventory, disposing of positions from customers);<sup>14</sup> generally engages in more transactions where it earns fees, rather than pays fees; and does not provide compensation that rewards proprietary risk taking. On the other hand, proprietary trading involves capitalizing on risks; non-customer-facing transactions; the payment of fees, commissions and spreads; and compensation focused on rewarding proprietary risk taking.

(iii) Based on this discussion, Appendix B identifies six factors that would lead the Agencies to find a banking entity to be engaging in proprietary trading, absent explanatory circumstances. In order to assess these factors, the Agencies intend to rely on a range of metrics and statistical analysis using both traditional and novel ratios and measurements, much of which will be informed by the reporting and review of the quantitative metrics described in Part I.E, below. The six factors are:

(A) Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;

*The Agencies propose to use measurements such as VaR and stress VaR, VaR exceedance, and risk factor sensitivities to examine the level of risk required to conduct market making and significant changes in risk over time and across similarly-situated trading units and firms.*

(B) Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;

*The Agencies propose to use measurements such as comprehensive profit and loss ("P&L"), portfolio P&L, fee income and expense, and spread P&L to evaluate revenues derived from price movements versus fees.*

(C) Trading activity in which a trading unit: (i) generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility;

*The Agencies propose to use a variety of P&L measurements and ratios, such as volatility of P&L, P&L to volatility ratios, attribution of P&L, and unprofitable trading days based on P&L to assess the connection between risk and revenues and the consistency of profitability.*

(D) Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near term customer demands;

*The Agencies propose to use a customer-facing trade ratio, among other factors, to assess the extent to which a trading unit engages in customer transactions.*

<sup>14</sup> Although there is a significant focus on the distinction between customer and non-customer in the market-making context, the proposed rule does not define customer for purposes of the proprietary trading prohibition, except that, in measuring the customer-facing trade ratio, a "counterparty is considered to be a customer of the trading unit if the counterparty is neither a counterparty to a transaction executed on a designated contract market registered under the Commodity Exchange Act or national securities exchange registered under the Exchange Act, nor a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof." Dealers and other market makers could be considered customers if a banking entity "treats that entity as a customer and has documented how and why the entity is treated as such."



- (E) Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads; and

*The Agencies propose to use a pay-to-receive spread ratio among other factors to assess a trading unit's payment and receipt of fees.*

- (F) The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.

*(iv) In all cases, the Agencies propose to make comparisons both to a trading unit or firm's historical performance and to other similarly situated firms and trading units. This level of horizontal review could create de facto industry standards set by the Agencies, and there is likely to be little transparency as to the underlying data.*

*(v) The proposed rule provides examples of factors that could explain divergences from the expectations of the Agencies, which would include sudden market disruptions, changes to market practices, changes in the firm's business or focus, attempt to expand or contract market share, and even general price trends.*

#### 6. Permitted Risk-mitigating Hedging

- (a) Section \_\_.5 of the proposal would permit risk-mitigating hedging, including portfolio and dynamic hedging. Hedging activities would be permitted subject to the following criteria:

- (i) Banking entities seeking to rely on the risk-mitigating hedging exception must establish a comprehensive internal compliance program;

- (ii) Compensation arrangements related to hedging activities are designed not to reward proprietary risk-taking;

- (iii) Hedging activities must be conducted in accordance with written policies, procedures and internal controls;

- (iv) Hedging activities must hedge or otherwise mitigate one or more specific risks related to individual or aggregated positions;

- (v) Hedging activities must be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate;

- (vi) Hedging activities must not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction; and

- (vii) Hedging activities must be subject to continuing review, monitoring and management after the hedge position is established.

*Perfect one-to-one matches are not required. The proposal helpfully acknowledges that not all positions can be fully hedged and would only require "reasonable" correlation between a hedge and its underlying risk.*

*To limit evasion (e.g., through the use of over-hedging, correlation trading, or pairs trading), the proposal would require that permissible hedging not give rise to significant new exposures. Hedges designed to limit one risk could not simultaneously give rise to significant other unhedged risks, although the proposal acknowledges that new risks could arise after a hedge is put in place.*

*Portfolio and dynamic hedging would be permitted, indicating that the Agencies have overcome concerns expressed in the FSOC Study and the proposal that such hedging activities are difficult to distinguish from proprietary trading. Anticipatory hedging of risks slightly in advance of an expected or highly likely exposure (for example, when contractually obligated) would also be permitted. The practical issues institutions will face in implementation, however, will include the documentation and internal compliance program requirements necessary to support certain types of portfolio and dynamic hedging strategies. In light of the important risk management function that hedging serves, it will be critical that practical compliance burden not undermine the utility of this exception.*

*The proposal invites comment on whether these restrictions on hedging activities might discourage banking entities from engaging in other permitted activities or activities outside the scope of the Volcker Rule (e.g., lending) because of the additional difficulty of hedging risks associated with those activities.*

(b) Contemporaneous documentation requirement

- (i) Banking entities would need to contemporaneously document hedges which are established at a level of the organization that is different from the level of the organization establishing the positions meant to be hedged. At a minimum, the banking entity would need to identify the risk-mitigating purpose of the transaction, the risks to be reduced, and the level of the organization that is establishing the hedge.
- (ii) *This requirement could seriously impair hedging strategies that focus on enterprise-wide risk. More generally, it will be important to make sure that this expressed expectation of significant foresight in banking entities' hedging decisions—to be able to identify risks, effectively hedge the risks without significant other exposures, and continually review such hedges—not create compliance traps for banks that fail to hedge adequately.*

(c) Market-making-related hedging

- (i) The proposal provides that a transaction could be deemed to be part of a banking entity's market-making-related activities if it is entered into to reduce specific risks from the positions acquired pursuant to market-making-related activities and it satisfies all the requirements of the hedging exception.
- (ii) *The significance of this particular provision is somewhat unclear; it would seem that the general hedging exception could just as easily permit such transactions. It likely reflects heightened concern among the Agencies that hedging presents a risk of evasion when linked to market-making operations. The preamble notes that, for purposes of the contemporaneous documentation requirement, individual trading desks are generally responsible for establishing risks that must be hedged. If those risks are hedged at a different organizational level, the banking entity would be required to contemporaneously document the purpose and risks to be hedged.*
- (d) *The challenge of distinguishing permissible customer driven or hedging activities from speculative trading is not new. In the context of defining bank-permissible derivatives activities, the OCC has established principles to implement both of those standards and relied on prudential supervision to enforce them.<sup>15</sup> The OCC has never determined that*

<sup>15</sup> See generally Robert L. Tortoriello, Guide to Bank Underwriting, Dealing and Brokerage Activities pt. II.E (Thompson West, 16th ed. 2011) (the "Guide to Bank Underwriting").

*patterns of activity required complex, metrics-based recordkeeping and reporting approaches to detect and prevent evasion, drawing into question the need for the burdensome approaches reflected in the proposal.*

7. Permitted Trading by Foreign Banking Entities Outside the United States

- (a) Section \_\_.6 of the proposal would permit banking entities that are organized under foreign law and controlled only by entities organized under foreign law to engage in proprietary trading outside of the United States.
- (b) *The U.S. subsidiaries, branches and agencies of foreign banking entities are not eligible for this exception, nor are foreign subsidiaries of foreign banking entities if controlled by a U.S. intermediate company.*
- (c) *The proposal asks whether the Agencies should use their exemptive authority to promote safety and soundness under the Volcker Rule to permit domestic banking entities to engage in proprietary trading overseas, perhaps creating the possibility that the Agencies could give both foreign and domestic banking entities more flexibility in their overseas operations.*
- (d) Trading pursuant to Sections 4(c)(9) and 4(c)(13) of the BHCA
  - (i) For banking entities that are FBOs under the Federal Reserve's Regulation K, the banking entity would be required to be a qualifying foreign banking organization ("QFBO").<sup>16</sup>
  - (ii) Banking entities that are not FBOs and therefore not generally subject to the BHCA (e.g., because they own a U.S. savings association or industrial loan company) would be required to satisfy a test that largely mirrors the QFBO test.
- (e) Solely outside of the United States

Transactions under this exception must take place "solely outside of the United States." The proposal takes a narrow interpretation of the statutory text, and would deem a transaction to have taken place solely outside of the United States only where:

- (i) No party to the transaction is a resident of the United States;

*The proposal's definition of U.S. resident is somewhat similar to the SEC's definition of "U.S. person" under Regulation S, but it is broader in several significant ways.<sup>17</sup> For example, it appears to define U.S. resident to include the foreign branches of U.S. residents (e.g., foreign branches of U.S. banks and insurance companies), which are specifically excluded under Regulation S. Such branches, which otherwise operate as residents of their host country and under the substantive regulation of their host country, would apparently be impermissible counterparties under the proposed definition. This difference could be problematic from the perspective of U.S. banking entities conducting permissible trading activities (e.g., market making, hedging, etc.) through their overseas branches, which would not be eligible counterparties of an FBO unless the FBO were relying on a different exception from the Volcker Rule.*

*The proposal would also include as a U.S. resident any U.S. dealer or fiduciary, regardless of whether the dealer or fiduciary is acting on behalf of a foreign client. If adopted, this would constrain the activities of U.S. managers.*

<sup>16</sup> E.g., more than half of the FBO's worldwide business is banking, disregarding its U.S. banking operations, and more than half of the organization's banking business is outside of the United States. See 12 C.F.R. § 211.23(a).

<sup>17</sup> See 17 C.F.R. § 230.902(k).

*In other ways, we expect that the U.S. resident limitation in the foreign trading exception would function in a manner parallel to existing U.S. securities laws. For example, subject to compliance with other terms of the foreign trading exception, it should generally permit foreign banking entities to trade with all natural persons (including U.S. citizens) residing outside the United States and with the foreign subsidiaries of U.S. companies, provided that, to prevent evasion, the foreign subsidiary was not established principally for the purpose of taking advantage of the relevant exception for activities conducted outside the U.S. It should also permit a foreign banking entity to trade on a foreign exchange, so long as the foreign exchange does not permit direct participation by U.S. residents and trading by foreign members of the exchange on behalf of U.S. residents does not take place on a disclosed basis.*

- (ii) No personnel of the banking entity who is directly involved in the transaction is physically located in the United States; and

*Personnel performing purely administrative, clerical or ministerial functions would not be subject to this restriction.*

- (iii) The transaction is executed wholly outside the United States.

*The preamble specifically notes the Agencies' intent to exclude U.S. execution facilities.*

- (f) *This interpretation of the foreign trading exception could severely curtail foreign banking entities' ability to invest in the United States, and is likely to result in the movement of jobs and transactions overseas. It may be possible for a foreign banking entity to trade in U.S. assets through another foreign financial institution acting as intermediary (e.g., riskless principal transactions, etc.). Otherwise, alternate trading platforms established and maintained outside the United States may be the only option for foreign banking entities seeking to trade in U.S. securities.*
- (g) *This narrow interpretation is not required by the plain language of the statutory test, which focuses on the location of the activity that a banking entity engages in as principal and exposes it to risk (the statute required only that "trading occurs solely outside of the United States"). This interpretation is also inconsistent with longstanding banking and securities law precedents that determine the location of trading activity based on the location of the risk and the ultimate mind and management of the activity. The justification cited by the Agencies in considering factors unrelated to the location of risk and management were concerns over competitive parity.*
- (h) *The narrow manner in which the proposal would define a permissible "foreign" transaction, and its departure from the ways that U.S. banking regulators have analyzed cross-border transactions in loans and securities for more than 20 years,<sup>18</sup> is likely to raise significant concerns at the level of EU, European national and Asian national banking regulators regarding what is perceived as a broadly extraterritorial approach to the application of the Volcker Rule. The legislative history of the Dodd-Frank Act specifically directed U.S. regulators to take an approach to cross-border application of the Volcker Rule in a manner consistent with prior Federal Reserve precedent under Regulation K.*

<sup>18</sup> See, e.g., *Guide to Bank Underwriting* pt. XI.E.1.

## 8. Permitted Trading in Government Securities

Section \_\_.6 of the proposal would allow banking entities to trade in (i) the obligations of the United States or any agency thereof, (ii) the obligations of any state or political subdivision thereof, and (iii) the obligations, participations and other instruments of the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution.

*Although trading in government securities markets includes options and forwards on government securities, this exception does not appear to permit trading in options or derivatives. It also does not permit trading of foreign government securities. The proposal requests comment on whether such trading should be permitted under the Agencies' exemptive power under the Volcker Rule. Substantial liquidity in non-U.S. government securities markets could be lost if this exception is not expanded before the proposed rule is finalized. U.S.-headquartered banking entities make up a significant portion of the markets for the securities of some sovereigns.*

*The exclusion of Canadian government securities would appear to violate U.S. obligations under the U.S.-Canada Free Trade Agreement ("CFTA") and the North American Free Trade Agreement ("NAFTA") that require the United States to permit domestic and foreign banks, bank holding companies and their affiliates to deal in, underwrite, and purchase debt obligations backed by Canada or its political subdivisions to the same extent as such banks and bank holding companies and their affiliates are permitted to deal in, underwrite and purchase U.S. government securities.<sup>19</sup>*

## 9. Permitted Trading on Behalf of Customers

(a) Section \_\_.6 of the proposal interprets the statutory exception for trading "on behalf of customers" very narrowly, limiting such permitted trading to three specific exceptions. It would permit:

- (i) Trading conducted by a banking entity as principal (i.e., in street name) acting as investment adviser, trustee, or in a similar fiduciary capacity for a customer and for the account of that customer.

*The banking entity's customer, and not the banking entity or any subsidiary or affiliate of the banking entity, would need to be the beneficial owner of the covered financial position. The banking entity could not have long or short exposure under the position.*

- (ii) Riskless principal transactions initiated by the order of a customer of the banking entity.

*Riskless principal transactions would be limited to situations where, upon receiving an order from a customer, the banking entity conducts a purchase or sale for its own account to offset a contemporaneous sale to or purchase from the customer. The proposal specifically asks for comment on whether other limitations (e.g., on spreads, timeframe, etc.) should be applied to riskless principal transactions.*

<sup>19</sup> See, e.g., CFTA, § 1702(1) (Jan. 2, 1988); NAFTA, annex 1401.4 (Dec. 17, 1992) (incorporating by reference Section 1702(1) of the CFTA). See also 12 U.S.C. § 24(Seventh) (permitting national banks to deal in, underwrite and purchase Canadian government securities to the same extent as U.S. government securities).

(iii) Trading by an insurance company for the separate accounts of insurance policyholders.

*The separate account exception would apply to both domestic and foreign regulated insurance companies. To satisfy the exception, all profits and losses must be allocated to the separate account and inure to its beneficial owners, not the banking entity.*

(b) *Each of these exceptions provides a helpful clarification for specific transactions whose status might otherwise have been in some doubt, but the statutory text does not mandate such a narrow approach to defining trading on behalf of customers. The statutory language would support expanding this exception to include many other types of transactions that a banking entity could undertake to accommodate a customer. For example, the exception would not appear to permit the structuring and execution of one-off bespoke trades for a client in which a banking entity acts as principal. A more expansive view of the exception would permit a banking entity to enter into any transaction as principal to effect a customer's valid and independent business purpose.*

#### 10. Permitted Trading by an Insurance Company for its General Account

Section \_\_.6 of the proposal would also permit regulated domestic and foreign insurance companies to engage in proprietary trading solely for the general account of the insurance company, subject to the laws, regulations and written guidance governing insurance company investments in the State or jurisdiction in which such insurance company is domiciled. Such trading could be prohibited, however, if the OCC, Federal Reserve and FDIC, after consultation with the FSOC and the relevant insurance commissioners of the States, jointly determine that a particular law, regulation, or written guidance is insufficient to protect the safety and soundness of the banking entity or of the financial stability of the United States.

*The proposal helpfully clarifies that the statutory insurance company exception applies to both domestic and foreign companies. The proposal does not explain how the "general account" requirement should be applied to foreign insurance companies.*

#### **D. Limitations on Permitted Trading Activities**

1. No trading activities otherwise permitted under Sections \_\_.4, \_\_.5 and \_\_.6 of the proposal would be permitted if they:

(a) Involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties;

*The proposal would find a conflict of interest wherever a transaction, class of transactions or activity would result in the banking entity's interests being materially adverse to those of its client, customer or counterparty with respect to such transaction, class of transactions or activity. Unlike the SEC's recently proposed Rule 127B prohibiting certain material conflicts of interest involving securitizations, which limited possible conflict scenarios to several very specific situations,<sup>20</sup> the proposal's definition of material conflict of interest would cover a broad range of possible scenarios. Material conflicts could include, among other things, substantial nonpublic information, disparate treatment of customers, or transactions placing banking entities interests ahead of their customers or counterparties. The mere fact that a banking entity was on the opposite side of a transaction with a customer or counterparty, however, would not be deemed a material conflict.*

<sup>20</sup> See 76 Fed. Reg. 60,320 (Sept. 28, 2011).



*Helpfully, the proposal would permit banking entities to address potential material conflicts through (i) specific, timely and effective disclosure and (ii) information barriers. Thus, for example, if the public trading side of a banking entity makes a market in securities and the banking entity's investment banking arm learned substantial nonpublic information about the company, effective information barriers and disclosure of the potential for such conflicts to arise should be sufficient to mitigate the conflict. If these tools could not mitigate a material conflict, the transaction would be prohibited.*

- (b) Result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy; or

*The proposal's definition of high-risk assets and trading strategies—as assets or strategies that substantially increase likelihood that banking entity would suffer substantial loss or fail—does not provide practical guidance as to the effect of this provision. More likely than not, it would serve as an additional tool for the Agencies use at their discretion to curtail activities they view as overly risky.*

- (c) Pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.

*The proposal does not address the possibility raised in the statute that the Agencies would apply additional capital requirements and quantitative limits for permitted trading activities.*

## **E. Reporting and Recordkeeping Requirements**

1. Any banking entity engaged in trading activities restricted by the proprietary trading prohibition and associated exceptions would be required to comply with certain recordkeeping requirements pursuant to the proposal's required compliance programs, described in Part IV below. In addition, any such banking entity which, counting all affiliates on a worldwide basis, has trading assets and liabilities equal to \$1 billion or more, as measured on the last day of each calendar quarter for the last four quarters, would be required to comply with the specific quantitative reporting and recordkeeping requirements set forth in Appendix A of the proposal. Banking entities with over \$5 billion in trading assets and liabilities would report on a larger cross-section of data than entities between \$1 and 5 billion.
2. These requirements would apply to each "trading unit", which is defined to include multiple layers of an organization, including individual trading desks, each organizational unit used to structure and control the risk-taking of such subordinate units, and the banking entity's entire trading operations taken as a whole.
3. *The scope of data and the specificity of reporting (down to the level of individual trading desks) required are beyond anything financial institutions currently collect for their own purposes. Financial institutions subject to these requirements, especially those engaged in significant market-making-related activities, would need to make significant investments in infrastructure, technology and dedicated compliance personnel in order to meet their reporting and recordkeeping obligations under the proposed rule.*

4. The quantitative metrics are designed to address several aspects of trading activity the Agencies believe will help them to identify prohibited proprietary trading in trading units that also conduct permitted trading activities. These measures include:
  - (a) Risk-Management Measurements (e.g., measurements of VaR and stress VaR, VaR exceedance, risk factor sensitivities, risk and position limits);
  - (b) Source-of-Revenue Measurements (e.g., portfolio and comprehensive P&L, spread P&L, fee income and expense, and comprehensive P&L attribution);
  - (c) Revenue-Relative-to-Risk Measurements (e.g., volatility of comprehensive and portfolio P&L, P&L to volatility ratios, attribution of P&L, unprofitable trading days based on P&L, skewness and kurtosis of portfolio P&L);
  - (d) Customer-Facing Activity Measurements (e.g., inventory turnover and aging, and customer-facing trade ratio); and
  - (e) Payments of Fees, Commissions and Spreads Measurements (e.g., the pay-to-receive spread ratio).
5. Trading units engaged in market making would report on a much larger set of measurements than trading units engaged in underwriting, hedging or activities permitted under Section \_\_.6. Many of the measurements are calculated on a daily basis, while others are calculated on 30, 60 and 90 day periods. In all cases, reporting will be required on a monthly basis.
6. *The Agencies appear to expect reporting and recordkeeping requirements to be in place by the effective date, so that they may be further developed and tailored throughout the conformance period, although there also appears to be a general expectation that reporting will be ramped up over time. Among other topics, the Agencies are exploring and seeking comment on the possibility of using the conformance period to establish specific numerical thresholds for certain metrics, which, if exceeded, would require some kind of internal or external review. Nevertheless, quantitative metrics are not intended to dispositively identify proprietary trading.*
7. *The proposal clearly signals the intent to engage in robust horizontal review across trading units and firms. One open question is how well the Agencies, in reviewing data, will be able to take into account the differences between firms and trading units, based on their position in the market, instruments, trading strategies, activities, experience, or other factors. Firms may find themselves having to justify any variances from what the Agencies perceive to be peer group norms. Competition and innovation between firms could be hindered if firms adjust their practices to avoid becoming a persistent outlier based on a new or innovative strategy or methodology.*
8. *Foreign banking entities seeking to engage in market making, underwriting and other forms of permitted trading in the United States may be required to implement these reporting measures outside the United States, including in their home offices with respect to such activities. It is not clear from the proposal the extent to which foreign banking entities could limit their compliance with these reporting requirements to only a subset of the organization, or to only their U.S. facing activities.*



## **F. Application of the Conformance Period to Proprietary Trading Activities**

1. The preamble states that prohibited proprietary trading activities that began before the effective date would be permitted to continue into the conformance period, which ends on July 21, 2014, unless extended.<sup>21</sup> Each banking entity would be required to identify those trading units of the banking entity that are engaged in prohibited proprietary trading as of or after the effective date of the Volcker Rule (July 21, 2012), and the type of proprietary trading in which they are engaged.
2. The preamble indicates that a trading unit would not be permitted to expand its activity to include prohibited proprietary trading after the effective date, and that a trading unit that is not identified as engaging in proprietary trading as of the effective date could not begin engaging in such activity after the effective date.

*The manner in which a banking entity identifies which of its trading units are engaged in prohibited proprietary trading and the types of proprietary trading in which they are engaged will be important to establish the baseline for activities that can continue into the conformance period.*

3. The preamble states that banking entities will be expected to bring their prohibited proprietary trading activities into compliance with the requirements of the proposed rule “as soon as practicable” within the conformance period.

*The actual expectations of the Agencies as to the speed and timeframe within which they expect banking entities to come into compliance remain unclear. The phrasing used in the preamble, “as soon as practicable”, indicates some cause for hope that the Agencies will recognize the practical difficulties banking entities will face in fully implementing the proposed rule, and the potentially adverse economic results that would result from moving too fast.*

4. *The proposal appears to require banking entities to have implemented the compliance program, reporting and recordkeeping requirements of the proposal by the effective date specified in the statute, July 21, 2012. At the same time, the Agencies pose questions inviting the industry to explain why there would be insufficient time to implement these requirements, and other parts of the preamble imply an expectation that not all quantitative reporting measures will be in place by July 2012. It appears the Agencies understand that banking entities will not be able to fully comply with the recordkeeping, reporting and compliance requirements by the effective date.*

<sup>21</sup> Prohibited proprietary trading is trading that is not excluded from the definition of proprietary trading or excepted from the prohibition on proprietary trading pursuant to Sections \_\_.4, \_\_.5 and \_\_.6 of the proposed rule.

## II. SPONSORING AND INVESTING IN COVERED FUNDS

### A. Scope of Covered “Banking Entities” Subject to the Volcker Rule

1. As discussed above, the Volcker Rule generally applies to “banking entities”, which are defined to include U.S. IDIs; companies that control an IDI; FBOs; and the affiliates and subsidiaries of all such entities.
2. Exclusion of Certain Controlled Funds

The proposal acknowledges that it would be inconsistent with the purpose and intent of the statute to apply the prohibitions of the Volcker Rule to a private equity or hedge fund controlled by a banking entity. As a result, the proposed rule excludes from the banking entity definition covered funds organized, offered and held pursuant to the so-called “de minimis exception”, as well as any other entity controlled by such a covered fund. (As noted above, the proposed rule does not exclude covered funds controlled pursuant to other exceptions or other controlled investment vehicles from the banking entity definition.)

*This carve-out appears to be too narrow to accomplish its intended result, as it does not address (i) covered funds that are controlled by a banking entity, but are not organized and offered pursuant to the de minimis exception, or (ii) investment vehicles controlled by the banking entity that are not “covered funds”.*

### B. Main Issues of Scope: Covered Funds; Restricted Sponsorship; and Restricted Ownership Interests

*Like the proprietary trading portion of the Volcker Rule, the funds portion raises threshold questions of what types of funds and activities are potentially subject to the general prohibition on sponsoring or investing in hedge funds and private equity funds. There are then separate issues associated with the various exemptions in the Volcker Rule, including the “de minimis” exception, which is designed to preserve traditional asset management activities that banking entities have engaged in for decades, and exceptions aimed at limiting the application of the proposed rule to common corporate structures and other entities not intended to be covered by the Volcker Rule. In this Part II.B, we discuss issues relating to the threshold questions of what types of funds, sponsorship and investments would be subject to the Volcker Rule under the proposal.*

#### 1. “Covered Funds” Subject to Volcker Rule Limitations

- (a) The proposal attempts to address the widely acknowledged overbreadth of the Volcker Rule’s statutory definition of “hedge funds and private equity funds”, which is based on exemptions in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the “40 Act”).<sup>22</sup>

<sup>22</sup> The statute defines a “hedge fund” and a “private equity fund” each to be “an issuer that would be an investment company, as defined in the Investment Company Act of 1940 . . . but for section (3)(c)(1) or 3(c)(7) of that Act, or such similar funds” as the regulators determine by rule to include. Sections 3(c)(1) and 3(c)(7) of the ‘40 Act exclude from the definition of investment company, respectively, (1) any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper), and (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time proposes to make a public offering of such securities. See 15 U.S.C. §§ 80a-3(c)(1) and (c)(7).

The FSOC Study acknowledged the overbreadth of the Volcker Rule’s definition of hedge fund and private equity fund and indicated that Congress may not have intended the definition to capture certain types of funds within its scope.

- (b) The proposal addresses this issue by providing carve-outs permitting banking entities to sponsor and invest in certain types of covered funds, each of which we discuss below. Importantly, the proposed rule does not narrow the definition of a covered fund, but instead provides exemptions that permit a banking entity to sponsor or invest in certain issuers that fall under the definition of covered funds.
- (c) *The way in which the Agencies have approached the overbreadth of the Volcker Rule definition of hedge funds and private equity funds raises a number of important issues.*
- (i) *First, the approach puts significant pressure on the adequacy of the proposed carve-outs. The carve-outs in the proposal, as discussed below, include only a subset of the carve-outs suggested by the industry in previous comment letters. In addition, the wording of several of the carve-outs creates questions about whether they will achieve their intended purpose.*
- The Agencies could have taken a different approach to this issue, which would involve defining the characteristics of a hedge fund or private equity fund that should be treated as a covered fund subject to the Volcker Rule. Indeed, the Agencies have asked in the preamble whether the definition of covered funds should focus on the characteristics of the entity rather than whether it would be an investment company but for Section 3(c)(1) or 3(c)(7) of the '40 Act. A subsequent question suggests a list of characteristics (e.g., compensation structure, trading/investment strategy, use of leverage, investor composition) that might inform whether an entity should be treated as a covered fund. An approach focused on characteristics rather than reliance on Section 3(c)(1) or 3(c)(7) would likely result in a definition that more accurately reflects the result intended by Congress.*
- (ii) *Second, by broadly including all 3(c)(1) and 3(c)(7) exempt issuers as covered funds and creating carve-outs that allow banks to sponsor and invest in certain categories of funds (but not taking those categories of funds outside of the Volcker Rule entirely), the proposal suggests that other Volcker Rule limitations, such as the "Super 23A" prohibition on lending to such funds, would still apply. In other words, even if a banking entity is permitted to invest in or sponsor such a covered fund without restrictions, the "Super 23A" restrictions prohibiting lending and other covered transactions with the covered fund would still apply, as would applicable Volcker Rule limits on conflicts of interest and high-risk assets or trading strategies (see Parts II.H and II.I below). As discussed below, this would create anomalous results in several specific contexts and appears to extend beyond what Congress intended.*
- (iii) *The preamble confirms that an issuer that may have been designed to rely on Section 3(c)(1) or 3(c)(7) of the '40 Act at the time of its formation would not be a covered fund under the Volcker Rule if it could qualify for another exemption under the '40 Act—i.e., if it would not be an investment company "but for" Section 3(c)(1) or 3(c)(7). As discussed in Part III below, many private securitization vehicles that relied on Section 3(c)(1) or 3(c)(7) may be eligible for other exemptions from the '40 Act, such as Section 3(c)(5)(C) (issuers holding mortgages and other interests in real estate) and SEC Rule 3a-7 (issuers of ABS).*
- (d) The proposal also exercises the Agencies' authority under the Volcker Rule to define commodity pools and certain foreign funds as "similar funds" subject to the Volcker Rule's restrictions.

(e) Scope expanded to include commodity pools as “similar funds”

- (i) As suggested by the FSOC Study, the proposal expands the scope of covered funds to include “commodity pools”. The proposal defines the term “commodity pool” by reference to the definition in the Commodity Exchange Act (“CEA”).<sup>23</sup>
- (ii) *The inclusion of commodity pools as defined in the CEA would appear to create a variety of unintended consequences. The “commodity pool” definition is substantially broader than the preamble suggests.<sup>24</sup> Nearly every fund that makes even incidental investments in futures, options on futures, commodity options, swaps and certain other instruments subject to CFTC regulation, even for hedging purposes, is a “commodity pool” as defined in the CEA—regardless of the nature of its investors.<sup>25</sup> Feeder funds that invest more than 5% of their assets in a commodity pool may also be regarded as commodity pools.<sup>26</sup>*
- (iii) *As a result, the proposed inclusion of commodity pools could prohibit banking entity investments in many “public” funds such as mutual funds and exchange-traded funds.*
- (iv) *In addition, the proposal’s related expansion of the term “sponsor” to include CPOs could significantly broaden the scope of activities deemed to be prohibited sponsorship, since some entities may serve as manager and CPO of a fund that they would not otherwise “sponsor” under the statutory definition (See Part II.B.2 below).*
- (v) *A potentially more viable approach to including those commodity pools that are commonly understood as “hedge funds” would look instead to the registration exemptions for CPOs. For example, CFTC Rule 4.13(a)(4) exempts certain CPOs from registration that operate commodity pools whose participants are limited to “qualified eligible person[s]”.<sup>27</sup> This definition would more closely parallel the scope of Section 3(c)(7) of the ‘40 Act. On the other hand, this approach would still suffer from the same problems of overbreadth as reliance on ‘40 Act exemptions. Again, an approach based on the characteristics of the fund would be a more workable way to achieve the statute’s intent.*

(f) Scope expanded to cover foreign equivalent funds as “similar funds”

- (i) The proposed rule would also expand the scope of covered funds to include any foreign fund that would be a covered fund if it were organized or offered under U.S. law or to U.S. residents.
- (ii) *The main practical (and likely unintended) significance of this expansion for FBOs is that Super 23A, discussed in Part II.H below, would apparently apply to foreign covered funds with no U.S. investors or other U.S. nexus. Otherwise, this expansion may not have a significant effect on fund investment and sponsorship by FBOs, as most foreign private*

<sup>23</sup> See CEA § 1a(10) (7 U.S.C. § 1a(10)).

<sup>24</sup> The term “commodity pool” means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in “commodity interests,” which, following Dodd-Frank, includes swaps and certain other instruments in addition to futures. *Id.* See also Edward F. Greene et al., *U.S. Regulation of the International Securities and Derivatives Market*, §§ 12.13 – 12.16 (2009) (“*International Securities and Derivatives Market*”) (discussing definition of commodity pool and commodity pool operator (“CPO”) and certain exemptions from regulation for CPOs).

<sup>25</sup> Similar to the ‘40 Act’s definition of investment company, the CEA defines commodity pool very broadly and relies on exemptions to limit its impact. However, in the case of commodity pools, exemptions are generally granted to the operator of the pool, *i.e.*, the person or entity with the authority to control the day-to-day operations of the pool. Exemptions are rarely granted to the pools themselves. The CFTC and its staff have issued “not a pool” interpretations only in the limited cases of certain ERISA plans and funds held solely by employees, family members and other close associates of a fund’s manager.

<sup>26</sup> See CFTC Interpretive Letter No. 86-22, *Comm. Fut. L. Rep.* (CCH) ¶ 23,280 (Sept. 19, 1986).

<sup>27</sup> See 17 C.F.R. § 4.13(a)(4). The CFTC does not have an exemption from the definition of CPO that parallels Section 3(c)(1) of the ‘40 Act. In addition, the CFTC has proposed rescinding the Rule 4.13(a)(4) exemption. See 76 Fed. Reg. 7976 (Feb. 11, 2011).

*equity or hedge funds that offer interests in the United States likely rely on Sections 3(c)(1) and/or 3(c)(7) and thus would already be covered funds, and many covered funds that do not offer any interests in the United States would comply with the requirements of the foreign fund exemption (discussed in Part II.E below).*

- (iii) *However, for U.S. banking entities, which under the proposal are ineligible for the foreign funds exception, expanding the definition of covered funds to cover non-U.S. funds that do not rely on Sections 3(c)(1) and/or 3(c)(7) would have a significant practical impact. A foreign subsidiary of a U.S. banking entity that under the statutory text would have been free to invest in a non-U.S. fund that was not sold into the United States and therefore did not rely on Section 3(c)(1) or 3(c)(7) would no longer be able to invest in that fund under the proposed rule, except pursuant to the terms of the de minimis or other exceptions available to U.S. banking entities. If the Agencies were to extend the foreign funds exemption to U.S. banking entities (see Part II.E below), this effect would be mitigated.*

(g) No explicit exemption for regulated foreign investment companies

- (i) While U.S. mutual funds and other registered investment companies generally fall outside the scope of the Volcker Rule,<sup>28</sup> comparable regulated foreign investment companies that engage in public offerings outside the United States may be covered as a result of relying on Sections 3(c)(1) and/or 3(c)(7) for limited (or inadvertent) sales in the United States.
- (ii) The proposal did not adopt the industry suggestion that such regulated foreign investment companies and mutual funds (such as SICAVs and UCITS)—especially those publicly sold or traded on exchanges—should be exempt.
- (iii) *It seems unlikely that Congress intended to permit banking entities freely to sponsor and invest in a U.S. mutual fund while prohibiting banking entities from sponsoring and investing in a comparable fund outside the United States. We expect the industry will renew its suggestion on this issue in comments on the proposal.*

(h) No proposed procedure for case-by-case exemptions

*Given the inherent limitations of the Agencies' approach to defining covered funds, it is unlikely that a final rule, even with the benefit of industry comment, will be able to refine this approach in a manner that draws appropriate distinctions in all cases. As a practical matter, it will be critical that banking entities be able to obtain timely guidance from the relevant Agency (whether formal or informal, legal opinions or no-action letters, or case-by-case exemptions). The proposal does not contain a procedure for this type of guidance or relief, but we expect that one will need to be developed.*

(i) Carve-outs permitting banking entities to sponsor and invest in certain 3(c)(1) or 3(c)(7) issuers

The proposed rule would permit banking entities to sponsor or invest without limitation in the following entities, despite their status as covered funds:<sup>29</sup>

- (i) Certain small business investment companies ("SBICs") and public interest investments;

*The SBIC exemption could create renewed interest in the use of SBICs as an investment fund format. Several bank holding companies formed SBICs to make venture capital*

<sup>28</sup> The proposal's inclusion of commodity pools adds a complication to this general understanding, as discussed below.

<sup>29</sup> Parts II.D and II.E below discuss in detail the de minimis and foreign fund exceptions, which permit investment in and sponsorship of covered funds subject to significant limitations.

*investments before the Gramm-Leach-Bliley Act expanded the merchant banking authority of financial holding companies in 1999. SBICs can be especially useful in the venture capital context because the criteria for what qualifies as a “small business” investment apply at the time of investment, not necessarily throughout the life of the investment.*

*Similarly, the exclusion for certain types of public interest investments would support a relatively broad range of real estate, community development and other other types of investment funds, including funds that already exist in the marketplace.*

- (ii) A separate account used to allow a banking entity to purchase an insurance policy (so-called “COLI” or “BOLI” policies), provided that the banking entity does not have investment discretion with respect to the account’s underlying assets or holdings;
- (iii) A joint venture between the banking entity and any other person, provided that the joint venture is an operating company and does not engage in the ownership, sponsorship and proprietary trading activities prohibited by the proposed rule;

*Although a helpful concept, this and other exemptions for certain corporate structures appear to be overly narrow. For example, the requirement that a joint venture be an operating company is unclear and probably unnecessary to prevent evasion of prohibitions on fund activities through joint venture arrangements. At a minimum, the Agencies should clarify that the exception would permit joint ventures in the form of holding companies that control one or more operating companies.*

- (iv) Consolidated, wholly owned subsidiaries engaged principally in liquidity management activities;<sup>30</sup>

*Similarly, it is unclear why a company engaged in bona fide liquidity management for a banking entity must be consolidated or wholly owned, or more generally why wholly owned subsidiaries are not categorically exempt from restrictions on fund activities.*

- (v) An acquisition vehicle, provided that its sole purpose and effect is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or an affiliate;

*It is unclear what this carve-out is intended to permit. It could be read to reach only temporary special-purpose corporate entities formed to facilitate a merger or acquisition, such as a merger subsidiary in a triangular merger. If so, it would be far too narrow to address industry concerns communicated to the Agencies with respect to acquisition vehicles. The industry had suggested, and strong policy rationales support, excluding from the Volcker Rule acquisition vehicles formed for a banking entity (and other investors) to invest in a single company, and therefore this may be the better reading.*

- (vi) Loan securitization vehicles, the assets of which are comprised solely of (A) loans, (B) contractual rights or assets directly arising from those loans supporting the ABS, and (C) interest rate or foreign exchange derivatives that materially relate to the terms of such loans, contractual rights or assets and are used for hedging purposes with respect to the securitization structure; and

<sup>30</sup> Liquidity management activities are those described in Section \_\_.3(b)(2)(iii)(C) of the proposed rule.



*The scope of the loan securitization exemption as proposed appears to be too narrow to achieve its intended purpose. Especially because many loan securitization vehicles have traditionally relied on Section 3(c)(1) or 3(c)(7) and thus would be covered funds under the proposal, the scope of this carve-out raises a number of important issues. See Part III below for a discussion of this and other issues related to securitization activities.*

- (vii) Securitization vehicles generally, but only with respect to interests retained by a banking entity that is a “securitizer” or “originator” and is retaining interests “in compliance with the minimum requirements” of Dodd-Frank’s risk retention rules.<sup>31</sup>

*See Part III below for an in-depth discussion of this issue.*

- (viii) *The carve-outs in the proposal would address only a fraction of the wide range of entities that do not resemble private equity or hedge funds but are swept up by the definition of “covered fund”. Most of the categories of such entities highlighted by industry groups in comment letters were not addressed in the proposal. Even where certain types of entities are addressed, in some cases the exemption is crafted too narrowly to achieve what appears to be the intended result.*
- (ix) *The proposal does not contain an express carve-out for venture capital funds. Despite explicit congressional support for excluding such entities from the Volcker Rule and numerous industry comments supporting an exemption, the Agencies have not proposed to exclude them.<sup>32</sup> The preamble poses one question regarding the possibility, and asks if the definition used by the SEC in its recent rulemaking under the Investment Advisers Act of 1940 (the “Advisers Act”) would be an appropriate definition.<sup>33</sup> While a potentially helpful starting point, the SEC’s definition of venture capital fund under the Advisers Act would presumably need to be expanded in the Volcker Rule context, since unlike a registration framework for advisers (where the consequences of a relatively narrow definition of venture capital funds may not be as problematic), the prohibitions of the Volcker Rule have potentially dramatic consequences for the availability of capital for start-up ventures, small businesses and innovation in U.S. markets.*

## 2. Generally Prohibited Sponsorship: “Sponsor” Focuses on Ability to Control

- (a) Under the proposed rule, a banking entity is deemed the “sponsor” of a fund if it serves as general partner, managing member, trustee or CPO; in any manner selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a fund; or shares with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

*This definition is consistent with the statute, except that it adds CPO to the list of roles that constitute sponsorship. This change may be a logical outgrowth of the decision to cover commodity pools in the definition of covered fund, but it raises additional—and presumably*

<sup>31</sup> See Section 941 of the Dodd-Frank Act.

<sup>32</sup> See, e.g., 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (Colloquy between Sen. Boxer and Sen. Dodd).

<sup>33</sup> See Advisers Act Rule 203(l)-1, 76 Fed. Reg. 39,646 (July 6, 2011) (to be codified at 17 C.F.R. § 275.203(l)-1) (exempting certain investment advisors to venture capital funds from registration requirements under the Advisers Act).

*unintended—complications in contexts where a CPO manages a covered fund but does not serve as general partner or the equivalent.*<sup>34</sup>

- (b) The preamble indicates that the definition of sponsor is meant to focus on “the ability to control the decision-making and operational functions of the fund.” This raises questions about the type and level of control that could cause a banking entity to be deemed to be the sponsor of a covered fund.

*The definition of sponsor is generally consistent with BHCA definitions and interpretations of what constitutes control in the context of investment funds. For example, serving as a general partner or managing member generally creates control, whereas providing investment advisory services to a fund with an independent board or general partner generally does not (absent other control factors).*<sup>35</sup> *It appears that Congress and the Agencies deliberately followed a similar approach in the definition of sponsor by not including investment advisor in the list of roles that create sponsorship, but the preamble language cited above could raise questions about whether banking entities serving as a manager or advisor could be viewed as sponsoring a covered fund under certain circumstances.*

- (c) The proposed rule provides that a banking entity would not be deemed a sponsor of a covered fund if it selects or controls, or has employees, officers or agents who serve as, a trustee that does not have investment discretion (including a directed trustee under ERISA). A banking entity would be a sponsor if it “directs” such a trustee.

*This confirms, for example, that a bank would be permitted to provide trustee services for its clients’ 401k plans and other pension plans where, as directed trustee, the banking entity has no investment discretion but simply takes instructions from the participants, the employer or a plan fiduciary.*

### 3. Generally Prohibited “Ownership Interests” Are Broadly Defined

- (a) The proposal expands the definition of an “ownership interest” in a fund beyond the statutory “equity, partnership or other ownership interest” to include derivatives of such interests, and indicates that the definition is intended to capture interests that have “substantially the same characteristics as an equity or other ownership interest” and to focus on “whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form.”

*The addition of certain derivatives is an expansion of the plain meaning of the statutory text, apparently meant to prevent banking entities from evading de minimis ownership limits in sponsored funds through total return swaps or other derivatives that replicate the economic terms of a fund ownership interest. Because the definition focuses on derivatives as interests “in” a fund, the treatment of derivatives as ownership interests may be different depending on whether the banking entity is party to a derivative contract with the fund (or its sponsor) as opposed to a derivative with a third party that references a fund interest.*

<sup>34</sup> The CFTC has interpreted a CPO to be the person or entity with day-to-day authority over the operation of the pool, including authority to retain or change the pool’s advisor or broker, similar to the general partner or managing member of a fund. In some cases, however, investment managers or other entities related to a fund may be designated as CPOs. While the CFTC has indicated that a registered investment company’s underwriters, investment advisors, depositors or sponsors, who might be regarded as within the literal scope of the CPO definition, are generally not CPOs, in another context the CFTC staff has taken the position that the entity engaged in arranging, promoting and underwriting a corporate fund, and not the fund’s directors, should be regarded as the fund’s CPO.

<sup>35</sup> See generally *Guide to Bank Underwriting* pt. VIII.C.1.b.ii.C (discussing control issues relating to bank advisory and administrative services provided to mutual funds). See also *Janus Capital Group, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296 (2011) (holding that the advisor to a mutual fund could not be held liable under SEC Rule 10b-5 and Section 10(b) of the Exchange Act for statements “made” by a mutual fund it advised, but did not control).



- (b) Examples of other “ownership interests” in the preamble include debt securities and other interests that provide the right to vote or synthetic interests that earn a return based on the performance of the fund’s underlying holdings or investments.

*This broad definition could place significant limits on a banking entity’s investments in fund-linked derivative products and on employee compensation structures involving notional interests in a banking entity’s sponsored funds (see discussion in Part II.J below regarding implications for employee compensation structures). However, the proposal presumably was not intended to treat bona fide lending arrangements with legitimate and customary protective covenants as “ownership interests”, even if, for example, the interest rate on the loan is based on the performance or revenue of the fund.*

- (c) The proposed rule also suggests that if a banking entity invests in parallel with a covered fund, the banking entity’s investment may be treated as an ownership interest in the fund itself for purposes of its 3% ownership limit under the de minimis exception (see Part II.D below).

- (i) In the context of sponsored funds where a banking entity’s investment is limited to 3% of the fund’s capital, the proposed rule would count towards that 3% limit investments made pursuant to contractual obligations to invest in one or more investments with a fund. The proposed rule would require that any investments made through “knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments” with a sponsored fund would be deemed investments in the fund.<sup>36</sup>

- (ii) The preamble states that the inclusion of such parallel investments will prevent a banking entity from “evading the [de minimis] limitations . . . through committed co-investments.”

- (iii) *The discussion of parallel investments in the proposal is focused on investments alongside sponsored funds. It does not address the separate contexts in which (a) a banking entity may invest alongside a third-party fund, or (b) the banking entity may allow asset management clients to invest alongside the banking entity’s own permissible proprietary investments. However, the approach of the proposal confirms that such investments need to be evaluated carefully to confirm they are consistent with the Volcker Rule’s fund ownership limitation.*

- (iv) *The proposal’s approach on this point should eliminate any doubt over a banking entity’s ability to invest more than 3% in a single feeder fund in a master-feeder structure if, on an aggregate basis, the banking entity’s investment in the entire master-feeder structure represents less than 3%.*

- (d) Carried interest not an ownership interest, subject to certain conditions

- (i) The proposed rule clarifies that carried interest is not treated as an ownership interest, subject to certain conditions. The exclusion is intended to permit profit sharing as performance compensation for services to the covered fund and requires, among other things, that:

- (A) the banking entity (or an affiliate, subsidiary or employee thereof) serves as investment manager, investment adviser or commodity trading adviser to the covered fund,
- (B) the “sole purpose and effect of the interest” is to share in the profits of the covered fund as performance compensation for services provided to the covered fund,

<sup>36</sup> Proposed rule Section \_\_.12(b)(2)(ii).

- (C) the person or entity receiving the interest does not provide funds to the covered fund in connection with the interest,
- (D) the interest is not transferred other than to an affiliate or subsidiary of the banking entity, and
- (E) profits, once allocated and if not promptly distributed, do not share in the subsequent profits and losses of the covered fund.

- (ii) *Private equity and hedge fund structures typically include a small capital commitment by the general partner to the fund. In order for the carried interest clarification to have meaning, this capital commitment should not be viewed as funds provided in connection with the carried interest.*
- (iii) *The condition that allocated profits not promptly distributed cannot share in subsequent profits and losses should not impair typical carried interest clawback structures.*
- (iv) *In many common U.S. fund structures, a “reserve” portion of the carried interest that has already been formally allocated for tax reasons is invested in or alongside the fund. It is unclear whether this mechanism could result in the reserve portion being treated as an “ownership interest”. The common European structure in which allocated carried interest shares in the subsequent losses, but not profits, of the fund should presumably not result in the carried interest being treated as an ownership interest.*

#### 4. Prohibition Applies Only to Interests Held “as Principal”

- (a) Under the proposed rule, the Volcker Rule’s prohibitions apply only to investments made “as principal, directly or indirectly”. These words do not appear in the statute in relation to funds, but the concept is consistent with expectations about how it would be implemented.
- (b) According to the preamble, because the prohibition would apply only to investments as principal, it generally would not apply to the acquisition by a banking entity of interests (including a general partner or membership interest): (i) in a fiduciary capacity; (ii) as custodian, broker, agent for unaffiliated third party; (iii) by qualified employee pension and benefits plans under ERISA; or (iv) by a director or employee acting in his or her personal capacity and who is directly engaged in providing advisory or other services to the covered fund, unless the banking entity, directly or indirectly, extended credit for the purpose of enabling the director or employee to acquire the interest.<sup>37</sup>
- (c) *The clarification regarding treatment of employee pension and benefit plans helpfully addresses concerns raised by several commenters that some such plans could be viewed as banking entities and therefore prohibited from investing in third-party private equity and hedge funds.*
- (d) *The clarification regarding the treatment of investments by directors and employees does not address such investments in third-party funds. The attribution of leveraged employee investments to a banking entity appears designed to address only the issue of which investments in a banking entity’s sponsored funds would count toward its de minimis limits. It does not appear that the Agencies intended to extend this attribution principle to employee and director investments in their personal capacity in third-party funds.*

<sup>37</sup> A subsequent discussion in the preamble regarding limits on employee investments in sponsored funds expands this formulation slightly, suggesting that such employee or director investments would be attributed to a banking entity if it “either extends credit for the purpose of allowing the director or employee to acquire such ownership interest, guarantees the director or employee’s purchase, or guarantees the director or employee against loss on the investment.” See discussion of employee investments in Part II.J below.

### **C. Permissible Investments: Acquiring Fund Interests Held as Collateral**

1. As expected, the proposal would permit a banking entity to acquire and hold for a limited time fund interests acquired in the ordinary course of collecting a “debt previously contracted”. This authority is comparable to other “DPC” authority that permits a bank to acquire certain otherwise impermissible interests in connection with extensions of credit.<sup>38</sup>
2. *The proposal does not provide a time period for divestiture; the applicable periods presumably will derive from the applicable regulatory regime for the banking entity in question.*<sup>39</sup>

### **D. The De Minimis Exception: Permitted Sponsorship and Investment in Connection with Asset Management Services**

1. This exception permits a banking entity to “organize and offer”, including to serve as sponsor of, a covered fund and to make limited investments in such a fund, subject to certain limitations.<sup>40</sup>
2. Criteria. To qualify for this exception:

- (a) A banking entity must provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services (“asset management services”), and the covered fund must be organized and offered in connection with such services.

*The proposal does not define qualifying asset management services, but their scope is acknowledged to be very broad.*<sup>41</sup>

- (b) The covered fund must be offered only to customers of the banking entity’s asset management services.

*The proposal does not require a pre-existing relationship with customers that invest in the covered funds. The customer relationship may generally be established through or in connection with the organization and offering of the fund.*

*Although the proposed rule has no definition for customer in this context, the preamble asks whether a definition should be adopted, and specifically mentions the concept of a “pre-existing, substantive relationship” used in the context of private offerings under the SEC’s Regulation D.*

- (c) The organization and marketing of the covered fund must be conducted pursuant to a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund.
- (d) Investments by the banking entity under the de minimis exception will be subject to two distinct quantitative limits—an individual fund limit of 3% of each fund’s interests, and an aggregate investment limit of 3% of tier 1 capital—as described in more detail below.

<sup>38</sup> See BHCA § 4(c)(2) (12 U.S.C. § 1843(c)(2)) and 12 C.F.R. § 225.22(d)(1), which permit bank holding companies to acquire nonbanking shares in satisfaction of a debt previously contracted, provided that such shares are disposed of within two years, with the possibility of three one-year extensions from the Federal Reserve and, in more limited circumstances, an additional five years (for a maximum holding period of 10 years).

<sup>39</sup> E.g., for national banks, 12 C.F.R. § 1.7; for bank holding companies, 12 C.F.R. § 225.22(d)(1).

<sup>40</sup> In the proposed rule, “organize and offer” includes, but is not limited to, serving as a 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.

<sup>41</sup> See, e.g., 12 C.F.R. pt. 9 (fiduciary activities of national banks).

*Investments made in connection with other exceptions, such as a banking entity's permissible hedging activities, sponsoring and investing in SBICs or public interest entities, or in the case of a non-U.S. banking entity, investments in a foreign covered fund, are not subject to these quantitative limits.*

- (e) The banking entity must comply with the Super 23A restrictions on transactions with the covered fund, as discussed in Part II.H below.
- (f) The banking entity may not guarantee or otherwise insure or assume the obligations or performance of the covered fund or of any covered fund in which such covered fund invests.
- (g) The proposal prohibits the covered fund from sharing the same name or a variation of the same name with the banking entity that organizes or serves as a sponsor to that fund (or an affiliate or subsidiary of such banking entity), and prohibits the covered fund from using "bank" in its name.

*If applied literally, the proposal would prohibit a covered fund under this exception from sharing a name with any affiliate in the banking group (other than certain other covered funds). It would seem more practical—and consistent with the purpose of the restriction—to limit the prohibition to names used by the fund sponsor, its parent and major "brand name" affiliates. The preamble raises questions regarding the appropriate scope of the name restriction.*

*The proposal contains no suggestion that existing funds (many of which were formed long before the Volcker Rule was adopted) that share a name with a banking entity would be required to change their names by the July 2014 conformance date, and it is not clear that there would be any benefits to imposing such a requirement.*

- (h) No director or employee of the banking entity may take or retain an ownership interest in the fund unless he or she is directly engaged in providing investment advisory or "other services" to the covered fund.

*The scope and implications of this prohibition, which should presumably permit investments by many employees providing services other than asset management (e.g., legal, compliance, sales, etc.) are discussed in Part II.J below.*

- (i) The banking entity must make specific disclosures to investors, in the fund's offering documents or elsewhere, including the statement that neither the banking entity nor its affiliates will be responsible for losses on any covered fund.

*There is no suggestion that banking entities would need to provide additional disclosure for existing funds.*

### 3. Individual Fund Ownership Limit

- (a) Banking entities are permitted to acquire and hold ownership interests in covered funds they organize and offer in order to (i) make investments of seed capital necessary to establish the fund and attract outside investors, or (ii) make and retain a de minimis investment in the covered fund. Any such investments must be reduced, by no later than one year after a fund is established (subject to the possibility of an extension of up to two years upon application to the Federal Reserve), to comply with the following requirements:

- (i) The value of a banking entity's total investments and/or capital contributions made in a single covered fund cannot exceed 3% of the value of the total investments or capital contributions in the covered fund (and the banking entity may not absorb more than 3% of the covered fund's potential losses).

*The inclusion of a value test in the proposed rule is an expansion of the statutory text, which refers only to a banking entity's share of a fund's "total ownership interests".*

*Committed but undrawn funds are excluded from the calculation of the banking entity's investments.*

- (ii) The total number of ownership interests held by the banking entity cannot exceed 3% of the total number of ownership interests held by all persons in a single covered fund.

*A banking entity must calculate the amount and value of its ownership interests in the same manner that the covered fund determines the aggregate value and amount of its assets and ownership interests.*

*The proposal does not address how to count and compare different classes of ownership interests, potentially with different economic and control rights, in a single fund. It also does not address when a covered fund would be considered to be established for purposes of the one-year grace period for seed capital beyond 3%. Because a fund may have multiple "closings," and there may be a lag between a fund's closing and its first investment, it would appear simplest to measure the one-year period from the date of the fund's first investment.*

(b) Attribution of indirect interests

- (i) 100% of the ownership interests in a covered fund held by any entity that is controlled by a banking entity will be attributed to the banking entity for purposes of determining the banking entity's total ownership stake in the covered fund.
- (ii) If a banking entity controls or has the power to vote more than 5% of an entity's voting shares but does not control the entity, that entity's interest in any covered fund will be attributed to the banking entity on a pro rata basis in proportion to the banking entity's interest in such entity.

*This requirement, which represents another expansion beyond the requirements of the statutory text, is inconsistent with traditional BHCA doctrines of control and attribution, where only interests of controlled affiliates and subsidiaries are attributed to their parent.<sup>42</sup> Adopting the proposed approach would present immense practical difficulties, as banking entities would be forced to monitor the investments of companies over which they have no practical (or even BHCA) control.*

- (iii) Parallel Investments. As discussed above, under the proposal, parallel investments by a banking entity may be included in the per-fund ownership limitation if the banking entity is contractually obligated to directly invest in, or is found to be knowingly acting in concert through a joint or parallel investment in, one or more investments with a covered fund that is organized and offered by the banking entity.

<sup>42</sup> See BHCA § 2(g)(1) (12 U.S.C. § 1841(g)(1)).

- (c) The individual fund ownership limit must be calculated as often as redemptions are allowed or the valuation is calculated (e.g., daily for certain hedge funds), but no less frequently than quarterly.

*Frequent, particularly daily, calculations of ownership limits raise the question of how a banking entity will manage its own interests to remain under the 3% limit in a fund with fluctuating ownership interests. The preamble raises the possibility of “tag-along” redemption rights, giving the banking entity the right to reduce its interest whenever any other investors choose to do the same.*

#### 4. Aggregate Fund Ownership Limit

- (a) The aggregate of a banking entity’s ownership interests in all covered funds held under the de minimis exception would be limited to 3% of the banking entity’s tier 1 capital. This aggregate calculation must be made on a quarterly basis.
- (i) *The proposal suggests that the aggregate limit would apply to the “sum of the value of each investment in a covered fund” held under the de minimis exception “as determined in accordance with applicable accounting standards.” It is unclear how this method would work in practice—i.e., whether the value would be based on GAAP (or IFRS) consolidation at the level of the parent or whether it would also include direct and indirect ownership interests applying BHCA control rules. However, the proposal does not suggest that the attribution rules established for the per-fund limit (e.g., pro rata calculations for certain noncontrolled investments) would apply to the aggregate calculation.*
- (ii) *As noted above, investments made in connection with other exceptions, such as a banking entity’s hedging activities, sponsoring and investing in SBICs or public interest entities or, in the case of a non-U.S. banking entity, investments in a foreign covered fund, are not counted towards the aggregate fund ownership limit. Foreign banking organizations’ investments in exempt foreign covered funds therefore should not limit their U.S. investment capacity under the de minimis exception.*
- (iii) *The proposal does not contain a procedure to request extensions for banking entities that exceed the aggregate ownership limit, other than the general procedure for applying for extensions of the conformance period. The preamble notes that the statute does not expressly provide for extensions of time for the aggregate ownership limit, but asks whether a grace period should be provided.*
- (iv) *The preamble also asks whether a grace period or conformance period should be provided for banking entities that breach the 3% aggregate limit for a reason unrelated to additional investments, such as declining capital levels. Such a grace or conformance period, or even a full exemption from any unwind requirement, would be consistent with current bank regulatory approaches (e.g., those related to lending limits and transactions with affiliates).<sup>43</sup>*
- (b) The proposal acknowledges that some banking entities are not required to calculate or report their tier 1 capital under federal regulatory guidelines. Accordingly, the proposal provides a methodology for how different entities should determine tier 1 capital for purposes of calculating the aggregate fund limit.

<sup>43</sup> See, e.g., 12 C.F.R. § 32.6 (requiring only reasonable efforts to bring loans that exceed loans to one borrower limits and exempting efforts that would be inconsistent with safety and soundness); 12 C.F.R. § 223.11 (only prohibiting new loans that would exceed quantitative affiliate lending limits).



- (c) If a banking entity is required to calculate and report its tier 1 capital, it would use the amount of tier 1 capital that the investing entity reported to its appropriate U.S. financial regulatory agency.<sup>44</sup>
- (d) If a banking entity is not required to calculate and report its tier 1 capital, then its tier 1 capital for purposes of the aggregate ownership limit will be deemed equal to:
  - (i) The tier 1 capital of its parent depository institution, if the entity is a subsidiary of a depository institution;
  - (ii) The tier 1 capital of the top-tier affiliate of the banking entity that reports tier 1 capital, if the entity is a subsidiary of a bank holding company and is not controlled by a depository institution; or
  - (iii) The total amount of shareholders' equity of the top-tier affiliate, if the entity is not a subsidiary of a bank holding company or a company treated as a bank holding company.
  - (iv) *The preamble indicates that the final scenario is intended to apply to entities such as holding companies for thrifts or industrial loan companies. However, most SLHCs (possibly excluding unitary SLHCs) are expected to begin reporting tier 1 capital under forthcoming Federal Reserve capital rules, so this requirement will presumably be updated to require SLHCs and their subsidiaries to rely on tier 1 capital as opposed to total shareholders' equity to the extent the SLHC reports tier 1 capital. To the extent unitary SLHCs are required to establish intermediate holding companies subject to capital requirements, the intermediate holding company would likely be treated as the top-tier capital reporting affiliate, not its ultimate parent.*
- (e) Treatment of foreign banking organizations
  - (i) Neither the proposed rule nor the preamble specifically addresses how a foreign banking organization should calculate its tier 1 capital for purposes of the aggregate ownership limit.
  - (ii) *Traditionally, FBOs would calculate their tier 1 capital for U.S. regulatory purposes at the level of the top-tier foreign bank based on its home country regulator's capital definitions. It appears the treatment of FBOs was not considered in the context of the de minimis exception, and this issue will need to be addressed in the final rule.*
  - (iii) *For example, there is a potential question regarding the treatment of intermediate U.S. bank holding companies with foreign bank parents, especially after passage of the Collins Amendment,<sup>45</sup> which will require intermediate U.S. bank holding companies relying on Federal Reserve letter SR 01-01 to maintain minimum capital ratios as set forth in the Federal Reserve's capital adequacy guidelines for bank holding companies only after a five-year phase in. While the proposed rule could be read to require such companies and their subsidiaries to use the intermediate company's tier 1 capital, and not the tier 1 capital of their foreign parent, the more likely intended approach would look to the top-tier parent bank's tier 1 capital based on its home country capital definitions, an approach that would be consistent with past practice and precedents.*

<sup>44</sup> In general, covered banking entities that report tier 1 capital include national and state depository institutions and bank holding companies. Savings and loan holding companies ("SLHCs") are expected to begin reporting tier 1 capital under the Federal Reserve's forthcoming capital rules.

<sup>45</sup> Section 171 of the Dodd-Frank Act.



- (f) If a depository institution does not exhaust its 3% tier 1 capital limit, it may transfer its excess capacity to an affiliated banking entity to support the affiliate's investments in covered funds, so long as the affiliate is not itself (i) a depository institution that holds and reports tier 1 capital or (ii) a direct or indirect subsidiary of such a depository institution.
5. Required Deductions from Tier 1 Capital
- (a) The proposed rule requires that banking entities deduct from tier 1 capital the aggregate value of all permitted investments made pursuant to the de minimis exception.
  - (b) Deductions would not be required for investments in covered funds permitted under other provisions of the proposed rule (e.g., in connection with permitted risk-mitigating hedging activities or ownership interests acquired in the course of collecting a debt previously contracted).
  - (c) *Although the statute suggests that capital charges should increase as the leverage of an underlying covered fund increases, the proposed rule does not provide a mechanism for doing so. Instead, it asks for comments on whether and how the required deduction should account for the leverage of a covered fund.*
  - (d) *The proposal does not address FBOs in the context of the tier 1 capital deduction. However, previous practice, including in the context of the Gramm-Leach-Bliley Act, would suggest that the capital deduction would not be applied to FBOs, which calculate their tier 1 capital under home country capital standards.*

## E. Foreign Funds Exception

1. The Volcker Rule permits banking entities to sponsor and invest in covered funds outside the United States, subject to certain limitations (the "foreign funds exception").<sup>46</sup> The proposed rule's interpretations of several of those limitations will be highly significant for FBOs engaged in covered funds activities outside the United States.
2. Limited to Non-U.S. Banking Entities
  - (a) The proposed rule requires that the banking entity not be controlled by a U.S. banking entity.
  - (b) *The preamble discussion regarding the exception for proprietary trading conducted outside the United States asks whether the Agencies should use their exemptive authority in BHCA Section 13(d)(1)(I) to permit U.S. banking entities to engage in proprietary trading outside the United States. The preamble does not include a similar question with respect to permitting U.S. banking entities to engage in covered funds activities outside the United States, but similar policy considerations would support such an exemption.*
3. Activities Conducted Pursuant to BHCA Sections 4(c)(9) and 4(c)(13)
  - (a) For an FBO, the proposed rule requires that the banking entity be a QFBO and conduct the activity in compliance with subpart B of the Federal Reserve's Regulation K.<sup>47</sup> A foreign banking entity that is not currently subject to the BHCA (e.g., a company that owns a U.S. thrift), must meet requirements similar to the QFBO test.

<sup>46</sup> See 12 U.S.C. § 1851(d)(1)(I).

<sup>47</sup> 12 C.F.R. pt. 211, Subpart B.

- (b) *The preamble discussion of what it means to conduct an activity pursuant to BHCA Section 4(c)(9) focuses solely on the QFBO requirement for banking organizations and the comparable standard that would be applied to other foreign companies. This appears to suggest that if a banking entity meets the QFBO test, the activity fulfills the “pursuant to 4(c)(9)” requirement.*

#### 4. No Offers or Sales to U.S. Residents

- (a) The proposed rule repeats the statutory limitation that “[n]o ownership interest in such covered fund is offered for sale or sold to a resident of the United States,” without providing any clarification on its scope.
- (b) *This leaves open several interpretive questions that will have a significant impact on the scope of the foreign funds exception. For example, the proposal does not confirm whether the limitation would apply only to marketing and sales by the banking entity, and not to sales into the United States by a third party (e.g., by a third-party fund sponsor or in secondary market sales, in each case without any direct or indirect involvement by the banking entity). Applying the limitation to the activities of the banking entity itself would appear to be consistent with the underlying competitive equality considerations.*
- (c) *The proposal also did not explicitly address the timing of the U.S. marketing prohibition—i.e., whether a covered fund could qualify under the foreign fund exception going forward as long as any U.S. marketing and sales to U.S. residents occurred prior to the July 2014 conformance date (or, at the earliest, the July 2012 effective date). In light of the proposal’s emphasis on ceasing prohibited activities as of the effective date and bringing activities and investments into compliance by the July 2014 conformance date, it would appear that as long as any U.S. marketing is completed by July 2012, and possibly by July 2014, a covered fund should be eligible for the exemption. It would be helpful for the Agencies to confirm this view in light of ongoing offerings that have relied on this understanding.*
- (d) *The proposal’s definition of U.S. resident is similar to the SEC’s definition of U.S. person under Regulation S, which should assist banking entities with experience making offers under Regulation S in complying with the marketing restrictions, but it is broader in several respects.<sup>48</sup> For individuals, the definition generally looks to the location of the person’s residence. The definition should generally permit FBOs to sell non-U.S. covered fund interests to all natural persons (including U.S. citizens) residing outside the United States and to the foreign subsidiaries of U.S. companies, provided that the foreign subsidiary was not established for purposes of evading these geographic restrictions and the other terms of the exception are met. On the other hand, the proposal would define U.S. resident to include the foreign branches of U.S. residents (e.g., foreign branches of U.S. banks and insurance companies), which are specifically excluded under Regulation S, and would also include as a U.S. resident any U.S. dealer or fiduciary, regardless of whether the dealer or fiduciary is acting on behalf of a foreign client.*

#### 5. Activities Conducted “Solely Outside of the United States”

- (a) The proposal takes a relatively narrow approach to defining the statutory requirement that activity occur “solely outside of the United States”. Under the proposed rule, an activity will be deemed to have taken place solely outside of the United States only where:
- (i) The transaction is conducted by a banking entity that is not organized under U.S. law;

<sup>48</sup> See Part I.C.7(e) above.

- (ii) No U.S. employee or affiliate of the banking entity is involved in the offer or sale of ownership interests in the covered fund; and
- (iii) No ownership interest in the covered fund is offered for sale or sold to a U.S. resident.
- (b) *This interpretation is more restrictive than the statutory language, which requires that the sponsorship or investment take place “solely outside of the United States”, but does not prohibit any related transactions or activities from taking place in the United States.*
- (c) *The preamble notes that the Agencies chose not to adopt an approach focusing on whether the risk of a transaction or activity and decisionmaking occurs solely outside of the United States, which would have been consistent with relevant banking and securities law precedents. Instead, the proposal aims to prevent FBOs from engaging in any transactions within U.S. markets that are prohibited for U.S. banking entities. As a result, the proposal “focuses on the extent to which material elements of the transaction occur within, or are effected by personnel within, the United States.”*
- (d) *The proposal expressly precludes involvement by U.S. personnel and entities in sales or offers of the fund. Consequently, while not free from doubt, it would appear consistent with the “solely outside of the United States” criteria for a foreign fund to use a U.S. advisor or sub-advisor or to rely on U.S. personnel in organizing the fund. The preamble also notes that U.S. personnel would be permitted to provide administrative and back-office services. Since advisory personnel typically play some role in marketing a fund, consideration would have to be given to the scope of their permissible activities, possibly drawing on the restrictions on participation in offers and sales of securities under Rule 3a4-1 of the Exchange Act.<sup>49</sup>*

#### 6. Compliance with Other Volcker Rule Limitations

*Because the proposal does not exempt foreign covered funds that meet the criteria above from the definition of “covered fund”, the Volcker Rule’s restrictions and requirements other than the prohibition on sponsoring or investing in such funds would appear to apply. For example, absent clarification from the Agencies, it appears that a foreign fund would still be subject to Super 23A and the prohibitions on material conflicts of interest and high-risk assets or trading strategies in connection with non-U.S. funds activities, even where such activities have no nexus with the United States. This result would appear inconsistent with congressional intent and the presumption against extraterritorial application of U.S. law, and the Agencies have discretion to interpret the statute as not extending to activities conducted solely outside of the United States.<sup>50</sup>*

#### F. Permitted Risk-Mitigating Hedging Activities

1. A banking entity may acquire covered fund interests to hedge risks that arise from providing:
  - (a) customers (other than banking entities) exposure to covered funds (e.g., total return swaps or hedge-fund-linked notes); or
  - (b) employees with incentive compensation linked to the performance of a covered fund, provided the employee directly provides advisory or “other services” to the covered fund.

<sup>49</sup> Rule 3a4-1 exempts associated persons of issuers (which would include an advisor) from the definition of broker, subject to certain conditions, including restricted participation in transactions involving the offer and sale of securities. See 17 C.F.R. § 240.3a4-1.

<sup>50</sup> The Supreme Court recently reaffirmed the presumption against extraterritorial application of U.S. law in Morrison v. National Australia Bank, 130 S. Ct. 2869 (2010).

2. A permitted hedge (a) may only offset exposure to a covered fund through an offsetting interest in the same covered fund and in the same amount, and (b) may not give rise to significant exposures that were not already present and that are not hedged contemporaneously.
3. The compensation arrangements being hedged must be designed not to reward proprietary risk-taking.
4. The banking entity must, at the time the transaction is conducted, document the risk-mitigating purpose and identify risks that the hedge is designed to reduce.
5. Fund ownership interests acquired pursuant to the hedging exception do not count towards a banking entity's 3% ownership limitations in connection with the de minimis exemption.
6. *While inclusion of this hedging exception provides helpful flexibility, the scope of the hedging exception as applied to fund interests is narrower than expected. The statutory text would have supported a much broader approach.*

#### **G. No Insurance Company Exception for Investments in Covered Funds**

Although the statutory text and policy behind the insurance company exception would have supported an exemption for the purchase and sale of covered fund interests by a regulated insurance company, just as it permits proprietary trading by a regulated insurance company, the Agencies apparently chose not to include such an exemption. This could have significant negative impacts on insurance companies with depository institution affiliates, restricting a class of investment they would otherwise use to manage their general account subject to state or foreign insurance law. The exemption for insurance company proprietary trading is discussed in Part I.C.10 above.

#### **H. "Super 23A" Restrictions on Transactions with Covered Funds**

1. The proposed rule generally would not permit a banking entity to extend credit to or enter into "covered transactions" (as defined in Section 23A of the Federal Reserve Act)<sup>51</sup> with any covered fund that the banking entity sponsors, organizes and offers pursuant to the de minimis exception, manages or advises, or with any other covered fund that is controlled by such fund. This prohibition is commonly referred to as "Super 23A".
2. *The proposal does not discuss questions raised in comments about how Super 23A would be applied to transactions between a non-U.S. banking entity and a non-U.S. fund (e.g., lending by an FBO head office to a non-U.S. sponsored fund). As discussed above, Super 23A appears to apply under the proposal to all covered funds, even funds that a banking entity may freely sponsor or invest in pursuant to an exception (e.g., acquisition structures, joint ventures, SBICs, foreign funds (for FBOs), etc.).*

<sup>51</sup> 12 U.S.C. § 371c. "Covered transactions" under Section 23A, as amended by Dodd-Frank, include (i) a loan or extension of credit to the covered fund (including a repurchase agreement); (ii) purchase of or an investment in securities of the covered fund; (iii) purchase of assets from the covered fund, except certain exempted purchases of real and personal property; (iv) the acceptance of securities or other debt obligations issued by the covered fund as collateral for a loan to any other person; (v) the issuance of a guarantee, acceptance or letter of credit on behalf of the covered fund; (vi) a securities lending transaction that causes the bank to have credit exposure to the covered fund; and (vii) a derivative transaction that causes the bank to have credit exposure to the covered fund.

3. *If this overbroad application of Super 23A is not corrected in the final rule, it could have significant negative unintended consequences on a wide variety of foreign and domestic transactions and structures that were not intended to be covered under the Volcker Rule.*
  - (a) *In the foreign funds context, the proposed rule could be read to prohibit loans and other extensions of credit from the head office of an FBO to a privately offered investment fund that it operates and advises wholly outside of the United States and that has no U.S. investors or other U.S. nexus.*
  - (b) *In the context of corporate structures, the proposed rule could be read to prohibit loans, guarantees, reverse repos and securities borrowing, derivative transactions and other covered transactions from a U.S. bank holding company or a foreign affiliate of an FBO to its wholly owned acquisition vehicle or liquidity management vehicle, or to any of a number of other corporate structures and SPVs that technically rely on Section 3(c)(1) or 3(c)(7) of the '40 Act.*
  - (c) *Although the Agencies state in the preamble that they believe they have no authority to create exemptions from Super 23A, these examples are clearly inconsistent with congressional intent and the policies behind the Volcker Rule. In the case of foreign funds, they are also inconsistent with traditional limits on the extraterritorial application of U.S. law and deference to home country prudential supervision. Although the Agencies may (or may not) be constrained in their authority to adopt exemptions from Super 23A, they have ample discretion to interpret Super 23A in accordance with its intended meaning. Indeed, the Agencies used their interpretive discretion to conclude that Super 23A does not prohibit a banking entity from investing in a sponsored fund, even though such an investment is a "covered transaction" as defined in Section 23A of the Federal Reserve Act. While this could be viewed as an "exemption" from Super 23A in a practical sense, it was a necessary interpretation to make sense of the statutory language. Similar interpretations could clarify the intended scope of Super 23A to address the issues outlined above.*

#### 4. Permissible Prime Brokerage for Underlying Covered Funds

- (a) Under the statute, banking entities are specifically authorized to enter into prime brokerage transactions with a covered fund in which a covered fund managed, sponsored, or advised by the banking entity invests, provided that certain conditions are met.<sup>52</sup> Thus, for example, a bank could not extend credit to a bank-sponsored fund-of-funds as part of a prime brokerage relationship, but could provide such services to underlying funds in which that fund-of-funds invests.
- (b) To enter into such prime brokerage transactions, the CEO of the top-tier affiliate of the banking entity would be required to certify in writing annually that the covered banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund (*i.e.*, the sponsored or advised fund) or of any covered fund in which that covered fund invests, with a duty to update based on any material changes.

*The proposal does not address how the CEO certification requirement should be adapted for foreign banking organizations.*

<sup>52</sup> The scope of the prime brokerage authorization is broader than the scope of the Super 23A prohibition itself, since Super 23A applies only to transactions with a controlled underlying fund, whereas the exception refers to prime brokerage with an underlying fund in which a sponsored/advised fund "has taken an ownership interest". This mismatch appears in the statute as well. Presumably, the express authorization for prime brokerage arrangements should not be understood to impose additional requirements on prime brokerage transactions that are not subject to Super 23A in the first place (*i.e.*, those with non-controlled underlying funds).

- (c) All such prime brokerage transactions would be required to comply with Section 23B of the Federal Reserve Act (“Section 23B”).<sup>53</sup> In effect, this requires the prime brokerage transaction to be on arm’s-length, market terms.
- 5. Super 23A also requires that all of a banking entity’s transactions with a covered fund that the banking entity sponsors, organizes and offers pursuant to the de minimis exception, manages or advises, must comply with Section 23B. Thus, “covered transactions” with sponsored or advised funds (such as lending) are prohibited, and all other transactions must be on market terms.

**I. Conflict of Interest, Risk, and Safety and Soundness Restrictions Applicable to All Fund Activities**

- 1. All transactions and activities subject to the Volcker Rule’s general prohibitions on proprietary trading and sponsoring and investing in covered funds must comply with certain over-riding limits on permitted activities. That is, otherwise permissible transactions and activities are impermissible if they would:
  - (a) involve a material conflict of interest,
  - (b) directly or indirectly expose the banking entity to a high-risk asset or a high-risk trading strategy,
  - (c) pose a threat to the safety and soundness of the banking entity, or
  - (d) pose a threat to the financial stability of the United States.<sup>54</sup>
- 2. *Because fund investors generally make a single investment decision (to invest in the fund) long before many or all of the investments the fund will make are known or anticipated, there is no clear analogy to the more tailored, transaction-specific disclosure discussed in the context of the proprietary trading prohibition of material conflicts of interest. It is possible that current standard disclosure practices in private fund offering documents would be sufficient to mitigate most conflicts of interest in the offer and sale of covered funds under the proposed rule.*
- 3. *Although the prohibitions on high-risk trading strategies and high-risk assets could be read effectively to bar investments in covered funds that engage in transactions that would be impermissible under the comparable proprietary trading restrictions, it would seem appropriate to take into account how the 3% limit on a banking entity’s ownership interest in any covered fund limits the banking entity’s potential exposure to such strategies and assets.*
- 4. *The Agencies will likely rely heavily on the quantitative reporting required of a banking entity engaged in significant trading activities to identify high-risk assets and trading strategies (see Part I.E above). The activities of covered funds are not subject to such reporting requirements, and the proposed rule does not provide an alternative means for identifying high-risk assets and trading strategies in the funds activity context.*

<sup>53</sup> 12 U.S.C. § 371c-1.

<sup>54</sup> See Part I.D above.



## **J. Implications of Funds Provisions for Employee Investments and Employee Compensation Structures**

*The application of the Volcker Rule's funds provisions to employee compensation structures is one of the most complex aspects of the rule and one where additional industry input will be vital in the rulemaking process to avoid unintended consequences.*

### **1. Restriction on Employee Investments in Sponsored Funds**

- (a) Pursuant to the statutory terms of the de minimis exception, employees and directors of banking entities are permitted to invest in a sponsored fund only if they are "directly engaged in providing investment advisory or other services to the covered fund" (the "Employee Investment Restriction").
- (b) The proposal does not address questions raised in comments about the meaning of "directly engaged" or the scope of "other services," other than to ask whether the Agencies should provide additional guidance on the latter.
- (c) The preamble notes that the rationale for permitting certain limited employee investments was to align a manager's or advisor's incentives with those of its customers, who often request that managers or advisors have "skin in the game".
- (d) *The fact that the statutory language includes references to "other services" supports the position that Congress did not intend to limit employee investments only to those professionals providing investment advisory or management services and that, in the absence of contrary guidance from the Agencies, "other services" could be broadly interpreted. A broad interpretation might include administrative, legal, compliance, risk management, investor relations and accounting services, among others. On the other hand, it seems unlikely that the exception will be so broadly construed as to permit investments by all persons in senior management based on their position rather than any involvement with covered fund-related activities.*
- (e) *The proposed rule's definition of "ownership interest" to include derivatives raises the question whether employee compensation structures involving notional employee investments (where an employee's return is tied to a sponsored fund's performance) might be subject to the Employee Investment Restriction.*
- (f) *Even if such notional programs are not directly restricted, because the proposed hedging exemption permits an acquisition of covered fund interests to hedge compensation arrangements only with employees who directly provide services to the covered fund, a broad-based notional compensation plan may prove impractical.*
- (g) *Whether an employee investment vehicle that is organized to be independent of a banking entity should be treated as "sponsored" by the banking entity and thus subject to the Employee Investment Restriction will depend on an analysis of specific facts and circumstances.*

### **2. Attribution of Leveraged Employee Investments in a Sponsored Fund**

- (a) The proposed rule itself does not provide for any attribution of employee investments to a banking entity, but the preamble indicates that employee and director investments in sponsored covered funds will be attributed to the banking entity for purposes of its 3% individual fund limit and 3% aggregate limit only if the banking entity, directly or indirectly, extends credit for



the purpose of enabling the director or employee to acquire the ownership interest, guarantees the director or employee's purchase, or guarantees the director or employee against loss on the investment.

(b) As a result, leveraged employee investments in funds sponsored pursuant to the de minimis exception will generally count towards a banking entity's 3% individual fund limit and its 3% of tier 1 capital limit on aggregate fund investments.<sup>55</sup>

(c) *Where an employee compensation arrangement involves a master-feeder structure with a sponsored employee feeder fund that is limited to investing in a sponsored master fund, it would appear consistent with the approach of the proposal to aggregate the feeder with the master fund for purposes of calculating compliance with the 3% limit.*

### 3. Employee Investments in Third-Party Funds

(a) *Employees and directors of a banking entity should generally be free to invest in third-party funds in their individual capacity.*

(b) *The proposal does not directly address the permissibility of providing leverage for employee investments in third-party funds. The discussion of attributing leveraged employee investments to the banking entity appears only in the context of employee investments in sponsored funds. There is no suggestion that this attribution principle would apply to investments in third-party funds. If it were applied in that context, leveraged employee investments in third-party covered funds would generally be impermissible (since the banking entity itself may not invest in such funds, absent an exemption).*

(c) *Under the terms of the proposed hedging exemption, a banking entity would generally not be permitted to acquire interests in a third-party covered fund to hedge a notional employee compensation structure (unless the relevant employees are directly engaged in providing services to the fund, e.g., through a sub-advisory arrangement).*

### 4. Pension Plans

(a) The preamble clarifies that banking entity pension plans that are qualified employee benefits plans under ERISA should not be prohibited from investing in covered funds. Their investments do not represent investments of the banking entity "as principal".

(b) Many U.S. and non-U.S. financial institutions have foreign pension plans that are similar to U.S. qualified plans. Although the preamble does not address them, it should be reasonable to take the view that investments by similar foreign plans should also not be restricted.

### 5. Super 23A Implications for Leveraging Employee Investments

*The proposal explicitly contemplates the possibility of a banking entity financing employee investments in covered funds. This appears to confirm that providing leverage to an employee investment vehicle sponsored or advised by the banking entity should be permissible under Super 23A.*

<sup>55</sup> As discussed in Part II.D above, only investments made pursuant to the de minimis exception are subject to the 3% individual fund cap and count towards the 3% aggregate limit.

6. Using Fund Interests as Collateral for Leverage

*As expected, the proposed rule would permit a banking entity to acquire and hold for a limited time covered fund interests that are acquired in the ordinary course of collecting a debt previously contracted. This “DPC” authority addresses concerns about the ability to secure leverage or other loans with covered fund interests.*

7. Conformance of Employee Investments

*The proposal does not discuss how the conformance requirements will be applied to employee investments. It would seem unreasonable to expect that banking entities would be required to force employees to divest from sponsored covered funds in which they held investments prior to the Volcker Rule effective date in order for the banking entity to comply with the Employee Investment Restriction.*

### III. IMPLICATIONS FOR SECURITIZATIONS

#### A. Overview and Main Takeaways

1. *Although the Volcker Rule was never intended to address practices within the securitization market, it could have a profound impact on banking entities' involvement in asset-backed securitizations, another example of the unintended collateral effects of the Volcker Rule's broad scope. Especially given regulatory uncertainties in other areas of the securitization market, the Volcker Rule's implementation will need to be carefully tailored to avoid unnecessary burdens on an important segment of the financial markets.*
2. *The Volcker Rule could affect the securitization market in two primary ways.*
  - (a) *First, defining "covered fund" to include all entities relying on Section 3(c)(1) or 3(c)(7) of the '40 Act would capture a broad range of issuers of privately placed asset-backed securities ("private ABS issuers") unless exempted under the Agencies' implementing rules. Given the ease with which Rule 144A-QIB restricted securities can be limited to "qualified purchasers", it has become common for a variety of private ABS issuers to rely on Section 3(c)(7) rather than more restrictive exemptions under the '40 Act.*
  - (b) *Second, any ABS issuer, private or public, could be deemed a banking entity (and therefore subject to restrictions on proprietary trading) if it is controlled by, or is under common control with, a banking entity. As described in Parts I.A and II.A above, the BHCA's broad definition of control may sweep in several categories of entities not intended to be treated as banking entities.*
3. *The proposal acknowledges these issues, but it is clear that the Agencies are still in the early stages of grappling with them. It is difficult to discern in places whether the Agencies wish to exempt ABS issuers more broadly from the scope of the Volcker Rule, or use the Volcker Rule to further regulate the securitization market. This may reflect differences among the Agencies over appropriate policies and approaches.*
4. *The proposed rule makes some effort to limit its impact on the securitization market. In particular, it provides significant exemptions for loan-based securitizations. It would exempt loan securitizations from the prohibition on banking entity sponsorship and ownership applicable to other covered funds, providing relief for loan-based private ABS issuers that rely on Section 3(c)(1) or 3(c)(7) of the '40 Act. And for ABS issuers that are deemed to be banking entities, the definition of proprietary trading excludes the purchase and sale of loans, which should permit the investment strategies employed by loan securitizations to continue. Although these discrete exemptions are significant, they are strictly limited to securitizations consisting entirely of loans and other extensions of credit, which may still be too narrow to accommodate many predominantly (but not 100%) loan-based securitizations.*
5. *The proposed rule provides only limited relief for ABS issuers that purchase securities (such as CDOs) and synthetic ABS. For these issuers, the proposed rule contains a single targeted exemption that seeks to reconcile the Volcker Rule's ownership and sponsorship restrictions with Dodd-Frank's risk retention requirements. From the questions posed in the preamble, it seems the Agencies may not yet have reached a consensus on how much flexibility they are willing to provide for banks' securitization activities. Part of this uncertainty may stem from concerns about potential evasion if exemptions are granted too broadly, but it may also reflect differences of opinion as to the benefits associated with different securitization products.*

6. *It is worth considering whether a better approach than discrete exemptions would be a categorical exclusion of securitizations, properly defined, from the provisions of the Volcker Rule, along with targeted conditions on the exclusion to prevent evasion of the core prohibition on proprietary trading. Although securitizations share some formal characteristics with traditional hedge funds and private equity funds, there are substantial distinctions between securitizations and the “traditional” private equity and hedge funds the Volcker Rule was intended to target, and there is little policy justification for treating them the same way (even presumptively).*
7. *Many existing ABS issuers and securitization structures may not be significantly affected by the Volcker Rule due to its extended conformance period. Full compliance will not be required until July 2014, and up to three one-year extensions may be granted. ABS structures established before it became clear that securitizations could be affected by the Volcker Rule would seem to have a particularly sympathetic case for extensions. Based on issuance volume and market-standard structures, it appears that many legacy CDOs and CLOs from before the financial crisis will have entered their run-off period long before the Volcker Rule would be applied to them.*

## **B. Treatment of Loan Securitizations**

1. The proposed rule would permit a banking entity to freely sponsor and/or hold an ownership interest in a covered fund that is an ABS issuer whose assets or holdings are comprised solely of loans, contractual rights or assets directly arising from those loans, and interest rate or foreign exchange derivatives that materially relate to those loans.
  - (a) The proposed rule defines “loan” as “any loan, lease, extension of credit, or secured or unsecured receivable.” While the phrase “extension of credit” is quite broad, it appears that the Agencies intended to exclude bonds or other instruments considered to be securities.
  - (b) This exemption implements the statutory provision directing 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.
2. Loan securitizations that rely on this exemption would still be subject to the Super 23A provisions of the Volcker Rule. As discussed in Part II.H above, the various exemptions for investments in and sponsorship of entities that are caught in the covered fund definition would not exempt entities from Super 23A.
3. *The practical impact of the Volcker Rule on loan securitizations qualifying for this exemption would likely be limited to the application of Super 23A, which would prohibit any banking entity that sponsors, advises, manages or organizes and offers an ABS issuer that is a covered fund from entering into a covered transaction with such ABS issuer (see Part II.H for a more detailed discussion of Super 23A).<sup>56</sup> To the extent a banking entity serving in one or more of those roles would typically provide credit support, guarantees, warehouse or other credit facilities to, or otherwise engage in covered transactions with, the ABS issuer, Super 23A could require significant changes to current market arrangements. The case for using the Agencies’ interpretive authority to clarify that such transactions are not prohibited is especially strong in the loan context, given the express statutory direction that nothing in the Volcker Rule should be construed to limit the sale and securitization of loans.*

<sup>56</sup> The proposed rule’s limits on material conflicts of interest, high risk assets and trading strategies, and risks to safety and soundness or financial stability would also apply. See Part II.I above.

4. *Otherwise, ABS issuers qualifying for the loan securitization exemption are largely free of the Volcker Rule's restrictions. Not only would banking entities be free to invest in and sponsor such an ABS issuer, but if the ABS issuer were deemed to be a banking entity due to a controlling position held by another banking entity, the Volcker Rule's proprietary trading restrictions should not prevent the ABS issuer from buying and selling loans or conducting the limited hedging relating directly to those loans that is permitted under the loan securitization exemption.*
5. *Despite the clear attempt to exempt CLOs and other loan securitizations from the main restrictions in the Volcker Rule, the exemption as currently written may not be sufficient to avoid restricting many loan-based securitizations currently in the market. For example, most market-standard CLOs have generally been permitted to hold at least some assets that are not "loans" as defined, including debt in the form of corporate bonds, government bonds or other liquid securities held on a short-term basis and, in some cases, synthetic securities. In addition, lenders to companies that become distressed often receive equity interests, equity securities or other securities in the context of a workout. To fully exempt such structures, it may be necessary to clarify that the benefit of this exemption is not lost if a loan securitization receives non-loan assets in a workout or other similar situation (i.e., treating such non-loan assets as assets arising directly from the loan), and to permit a percentage of non-loan assets in loan securitizations generally (e.g., investments in securities and other instruments that are generally considered cash equivalents for cash management and liquidity purposes).*

### **C. Treatment of Other Asset-Backed Securitizations**

1. ABS issuers that invest in assets other than loans would be unable to qualify for the proposed rule's loan securitization exception. If they fall under the scope of the proposed rule, they would be generally subject to the Volcker Rule's restrictions and limitations, subject to the availability of other exceptions, including the risk retention exception described below.
2. Securitization Issuers that Are "Covered Funds"
  - (a) As discussed above, the proposed rule's definition of "covered fund" may bring a large number of existing private ABS issuers (as well as new transactions) that rely on Section 3(c)(1) or 3(c)(7) of the '40 Act within the scope of the Volcker Rule. It has become common for private ABS issuers to rely on Section 3(c)(7) rather than more restrictive exemptions such as Rule 3a-7 under the '40 Act (for certain static securitizations) and Section 3(c)(5) of the '40 Act (for securitizations of accounts receivable, mortgages and certain other asset types).<sup>57</sup>

*Securitizations that are not structured as static transactions, but rather rely on an investment manager to make investment decisions after the initial issuance of the ABS, generally have no viable alternatives to 3(c)(1) and 3(c)(7).*

*Issuers of securities publicly offered in the United States are not permitted to rely on Section 3(c)(1) or 3(c)(7), and would likely not be captured by the core definition of covered fund. Such issuers are either registered under the '40 Act or rely on a different exemption. Private ABS issuers can also avoid the covered fund designation to the extent they could rely on another exemption from the '40 Act. The proposal validated the "but for" test in the statute, indicating that issuers could escape the definition of covered fund even if they are documented to rely on Section 3(c)(1) or 3(c)(7), so long as they could qualify for another exemption from the '40 Act.*

<sup>57</sup> Moreover, the SEC is considering amending Rule 3a-7 and Section 3(c)(5), which may further limit the availability of those exemptions for asset-backed issuers.

- (b) The inclusion of “foreign-equivalent” funds in the covered fund definition could make foreign private ABS issuers that do not offer their securities to U.S. persons subject to the proposed rule.

*Foreign public ABS issuers could also be caught by the covered fund definition. To the extent they permit U.S. investors, such issuers would typically be deemed to rely on Section 3(c)(1) or 3(c)(7) of the ‘40 Act under the SEC’s Touche Remnant doctrine and SEC rules adopted pursuant to Dodd-Frank.<sup>58</sup>*

- (c) *As discussed in Part II.B, the addition of commodity pools to the covered funds definition could bring a wide range of otherwise exempt entities into the scope of the Volcker Rule, including public ABS issuers and private ABS issuers relying on other ‘40 Act exemptions (such as Section 3(c)(5) or Rule 3a-7).*

#### **D. Implications for ABS Issuers Deemed to Be Covered Funds**

1. As described above in Part II, banking entities are generally prohibited from (i) having an ownership interest in a covered fund, (ii) sponsoring a covered fund, or (iii) engaging in certain covered transactions with a sponsored or advised covered fund, subject to certain exceptions.

2. Definition of “Ownership Interest” in the Context of Securitizations

- (a) An “ownership interest” is “any equity, partnership, or other similar interest . . . whether voting or nonvoting.”

*This could cover those securities of a securitization that comprise the “equity” tranche, usually the most subordinate class of securities, although the proposal’s treatment of such hybrid securities with debt and equity characteristics in the context of typical securitization structures is especially unclear.*

- (b) The preamble states that the “ownership interest” definition “focuses on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form,” and notes that the Agencies could consider debt securities that exhibit “substantially the same characteristics as an equity or other ownership interest” as an ownership interest. Some of the characteristics that the preamble states are indicative of an ownership interest include providing the holder with “voting rights, the right or ability to share in the covered fund’s profits or losses, or the ability . . . to earn a return based on the performance of the fund’s underlying holdings or investments.”

- (c) *The language of the preamble raises questions as to which classes of debt securities would be considered “ownership interests”, and in particular whether securities that have certain types of control rights (such as rights to remove or select the investment manager) or that potentially share in losses of the issuer under some circumstances might be considered “ownership interests” regardless of their treatment as debt for other purposes. Application of these concepts of ownership to ABS transactions, where BHCA control and economic exposure are often separate, raises difficult questions of legal form and the ultimate policy goals of the Agencies.*

<sup>58</sup> See, e.g., International Securities and Derivatives Market § 12.06 (2009) (discussing the SEC’s approach to foreign investment funds engaged in private sales to U.S. investors).

- (d) *For example, the Agencies ask whether the proposed rule should “exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest.” This question implies that the Agencies may focus on the most junior class of securitizations (which has first loss exposure and typically also the potential for significant upside if a deal performs well) rather than other classes of the capital structure that may have certain voting rights or other control rights.*<sup>59</sup>

### 3. Definition of Sponsorship in the Context of Securitizations

- (a) Section \_\_.10(b)(5) of the proposed rule defines “sponsor” to include serving “as a general partner, managing member, trustee, or commodity pool operator of a covered fund; [or i]n any manner . . . select[ing] or . . . control[ing] . . . a majority of the directors, trustees or management of a covered fund.”<sup>60</sup> Notably, sponsor should not generally include acting solely as investment advisor, investment manager or commodity trading advisor to a covered fund.

*In many ways, this mimics the definition of control under the BHCA in the context of investment funds, where a company would be deemed to control a fund if it served as the general partner or managing member of the fund (and therefore had the authority to take control of the operations of the fund by, for example, firing the investment manager), but would not control the fund if it served solely as investment manager or investment advisor.*

- (b) Applying the concepts of sponsor and control in the context of securitization is complicated by the fact that ABS issuers often do not have the same corporate structures as those typically used by hedge funds and private equity funds.
- (i) *For example, ABS issuers will often have an independent trustee or board serving in what would be the putative BHCA control position, but without any direct authority over the operations of the issuer.*
- (ii) *The investment advisor or collateral manager to an actively managed ABS issuer, which is typically the entity with the most discretionary authority over the issuer’s operations, would apparently not be captured by the definition of sponsor, and under applicable BHCA control doctrines serving as investment manager should not generally constitute control. Nevertheless, the advisor or manager of an ABS issuer could be deemed to control the “management of the covered fund,” depending on the facts and circumstances.*
- (iii) *BHCA control doctrines are not well developed in the context of securitization, and it is likely that institutions have come to a range of views as to the factors that would lead to an ABS issuer being deemed a controlled affiliate of a banking group. Institutions may even have developed different views depending upon context (e.g., reporting of BHCA controlled affiliates to the Federal Reserve on Form FR Y-10).*

<sup>59</sup> It would also be helpful to clarify that the residual interest would relate to classes that have potential upside and not only a greater risk of loss than more senior classes in the capital structure.

<sup>60</sup> The inclusion of “trustee” in the definition of sponsor only includes trustees that may exercise investment discretion, and thus should not reach typical indenture trustees.



- (iv) *Section 23A, prior to being amended by Section 608 of Dodd-Frank, deemed any investment fund or other company that was “sponsored and advised” by a bank to be that bank’s affiliate (i.e., even if it was not “controlled” by the bank’s holding company).<sup>61</sup> The Federal Reserve’s adopting release for Regulation W notes that the legislative history of Section 23A suggests that “sponsored and advised” companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.<sup>62</sup> Notably, the Federal Reserve declined to address the treatment of securitization vehicles in that release, citing the complexity of the issues involved.*
- (v) *In the context of the Volcker Rule, which imposes strict limits on relationships that constitute sponsorship of a covered fund, these doctrines will need to be developed, so that banking entities can understand which actions beyond mere investment advice would constitute sponsorship of an ABS issuer that is a covered fund.*

#### 4. Exceptions Permitting a Banking Entity to Sponsor or Invest in a Covered Fund

- (a) Beyond the special exemption for loan securitizations, the proposal contains three exceptions which could permit a banking entity to sponsor or acquire or hold an ownership interest in a “non-loan” ABS issuer that is a covered fund.
- (b) De Minimis Exception
  - (i) As discussed in Part II.D above, a banking entity is permitted to invest in any covered fund it has organized and offered to (i) provide the fund with seed capital or (ii) make or retain a de minimis investment in the fund, in each case not to exceed 3% of the total value or outstanding ownership interests in the fund after one year from when the fund was established.
  - (ii) *This exemption should be available for investments in securitization issuers that are covered funds to the same extent as any other covered fund; however, unlike hedge funds or private equity funds, the “equity” tranche of a securitization typically comprises only a fraction of the overall capital structure. It is not clear how the Agencies might adapt the 3% ownership limitation to fit typical securitization structures.*
- (c) Foreign Funds Exemption
  - (i) *To the extent a foreign ABS issuer satisfies the requirements of the foreign funds exemption described in Part II.E above, it would be exempt from Volcker Rule restrictions. Most importantly, the ABS issuer could not offer or sell any securities into the United States, and no U.S. personnel of the banking entity offering or selling the securities could be located in the United States.*

<sup>61</sup> Under Regulation W, 12 C.F.R. pt. 223, which implements Sections 23A and 23B, a bank’s affiliates include not just companies under common control with the bank, but also (i) registered investment companies advised by the bank and (ii) unregistered investment funds advised by the bank if the bank holds 5% or more of the equity capital or any class of voting shares of the fund. Dodd-Frank amends Section 23A to make any investment fund advised by a bank an affiliate of that bank, whether or not the fund is registered or the bank holds an equity or other stake in the fund, and removing the “sponsored and advised” prong.

<sup>62</sup> See 67 Fed. Reg. 76,560 (Dec. 12, 2002).

(d) Risk Retention Exception

- (i) The proposed rule would also permit a banking entity to “acquire or retain an ownership interest in or act as sponsor to,” an ABS issuer to the extent that the banking entity, as “securitizer” or “originator”, is required by Section 15G of the Exchange Act<sup>63</sup> to retain an economic interest in a portion of the credit risk of the securitization.
- (ii) This exception applies “only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a ‘securitizer’ or ‘originator’ in compliance with the minimum requirements of section 15G of the Exchange Act.” (emphasis added)<sup>64</sup>
- (iii) *Banking entities should be free to sponsor and invest in ABS issuers so long as any investment in the issuer complies with both this restriction and Section 15G of the Exchange Act.*
- (iv) *Section 15G of the Exchange Act permits the securitizer or originator to satisfy the risk retention requirement for a securitization in several ways, and not all approaches require that the securitizer or originator hold the same amount of equity. Presumably a banking entity would not be required to choose the risk retention option that requires the purchase of the smallest ownership interest, and any of the available risk retention options should qualify for this exception.*<sup>65</sup>

5. Limitations on Transactions with ABS Issuers that Are Covered Funds

- (a) As discussed in Part II.H above, the Volcker Rule’s Super 23A provisions prohibit a covered banking entity that serves as “investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund, or that organizes and offers a covered fund,” or any affiliate of the entity, from entering into certain “covered transactions” with the fund.
  - (i) *This broad prohibition could impact a number of agreements and transactions between banks and ABS issuers sponsored, organized or advised by banking entities, potentially including pre-closing warehouse lines of credit, interest rate or foreign exchange hedge agreements and synthetic securitizations.*
  - (ii) *As noted in Part II.H.3(c) above, the Agencies appear to have taken the position that they do not have any authority to create exemptions from Super 23A. Given the number of clearly unintended consequences from the overbroad application of Super 23A as set forth in the proposed rule, it will be important for the Agencies to use their interpretive authority to clarify that Super 23A would not prevent these standard market arrangements.*
- (b) The proposed rule’s limitations on material conflicts of interest, high risk assets and trading strategies, and risks to safety and soundness and financial stability would also apply to any relationships between a banking entity and covered ABS issuer.

<sup>63</sup> 15 U.S.C § 78o-11.

<sup>64</sup> Section 15G of the Exchange Act was added by Section 941 of the Dodd-Frank Act and requires “securitizers” (and in some cases “originators”) to retain at least 5% of the credit risk of their transactions. The federal agencies charged with promulgating rules to implement this requirement have issued proposed rules for comment but have not finalized them. See 76 Fed. Reg. 24,090 (Apr. 29, 2011).

<sup>65</sup> For example, the risk retention proposed rules would allow retaining a 5% “vertical slice” of the capital structure or retaining an amount of the “first loss” securities in an amount equal to 5% of the overall securitization

- (i) *The proposal's conflict of interest provisions appear to be broader than the SEC's proposed rulemaking implementing Section 621 of the Dodd-Frank Act, which prohibits certain conflicts of interest between securitizers and investors.*

#### **E. Implications for ABS Issuers Deemed to Be Banking Entities**

1. An ABS issuer may be deemed a banking entity if it controls, is controlled by, or is under common control with, a banking entity. As described above, the BHCA's broad definition of control may sweep in several categories of entities not intended to be treated as banking entities.
2. If an ABS issuer were deemed to be a banking entity, it could become subject to all the provisions of the Volcker Rule applicable to the banking entities generally, including the prohibitions on proprietary trading and holding an ownership interest in covered funds, and related compliance and reporting responsibilities discussed above.
3. The definition of banking entity specifically carves out any "covered fund" organized pursuant to the de minimis exception. Not all ABS issuers will be covered funds, however. Public ABS issuers and private ABS issuers that can rely on other, non-3(c)(1)/3(c)(7) exemptions from the '40 Act, could be deemed banking entities if they are controlled by or under common control with a banking entity. In addition, as formulated in the proposal, this carve-out would not include covered funds that qualify for exemptions other than the de minimis exception, such as the loan securitization exception.
4. *As discussed above, BHCA control doctrines are not well developed in the area of securitization. Now that the Volcker Rule has raised the stakes involved in determining affiliation and control, the Agencies and the industry will need to seriously consider what relationships between a banking entity and an ABS issuer constitute control of the ABS issuer.*
5. *Banking entities may be associated with a securitization issuer in a number of ways, including as sponsor, as depositor in a trust structure, as investment manager or as servicer. Some of these roles—even roles which traditionally have not been equated with control—may potentially implicate BHCA control under the totality of the facts and circumstances. Without clear guidance from the Agencies, ABS issuers will be subject to considerable uncertainty as to whether their arrangements constitute affiliation with a banking entity, and institutions may develop diverging views, leading to a lack of market consistency.*
6. *Although bank holding companies and FBOs report their U.S. BHCA "subsidiaries" to the Federal Reserve, those determinations should not be taken as definitive determinations of control and affiliation. Such structure data may be overinclusive, since some institutions may choose voluntarily to report such entities even where BHCA control is not clear. Firms involved in securitization (and other activities) will need to reexamine their prior determinations to ensure these entities are properly categorized.*
7. Application of Proprietary Trading Limitations to ABS Issuers that Are Banking Entities
  - (a) The impact of applying the prohibition on proprietary trading, discussed in Part I, to an ABS issuer would depend on the type of securitization at issue.
    - (i) For static deals where the assets are not actively managed, and most assets are sold only when they are in default or have stopped performing, the ABS issuer's accounts should not be treated as "trading accounts" subject to the proprietary trading restrictions.

- (ii) Securitization issuers that have actively managed portfolios, however, may be affected by the proprietary trading prohibition.
  - (b) The principal questions will be whether assets owned by the issuer are “covered financial positions” and whether the purchases and sales amount to “short-term” purchases and sales such that the issuer’s account would be considered to be a “trading account” of the banking entity.<sup>66</sup>
  - (c) *The assets that comprise a significant segment of the asset-backed market—residential and commercial mortgage loans, credit card and various types of other receivables, student loans and corporate loans, for example—are not securities, derivatives or contracts of sale of a commodity for future delivery. The types of assets making up these securitizations seem to fall outside of the proprietary trading restriction.*
  - (d) *With respect to the short-term trading test, even securitizations that are not static (ranging from actively managed securitizations to securitizations of revolving receivables accounts) impose significant contractual limitations on the circumstances under which an ABS issuer may buy and sell assets. It is unclear whether this flexibility would need to be further restricted to avoid a conflict with the proprietary trading prohibition.*
  - (e) *An issuer relying on the exemption from registration as an investment company provided by Rule 3a-7 under the ‘40 Act is already subject to a restriction that it not acquire or dispose of its assets for the primary purpose of recognizing gains or decreasing losses resulting from market value changes. It would appear that any transactions satisfying this condition should not be deemed to be transactions for a Volcker Rule “trading account”, and therefore such transactions should be outside the scope of the Volcker Rule’s prohibition against proprietary trading.*
8. Application of Prohibition on Acquiring Ownership Interests in Covered Funds to ABS Issuers that Are Banking Entities
- Certain ABS issuers purchase the securities of other securitizations (most commonly seen in so-called “CDO-squared” transactions, but also to a limited extent in CLOs and potentially residential mortgage-backed securities transactions classified for tax purposes as Re-REMICs). An ABS issuer that is deemed to be a banking entity would apparently not be permitted to purchase any such securities that would be considered “ownership interests”, subject to the exceptions discussed above. To the extent such issuers are purchasing the debt securities of other issuers that do not constitute “equity-like” ownership interests, this prohibition should not apply.*
9. Application of Compliance and Reporting Obligations to ABS Issuers that Are Banking Entities
- (a) A literal reading of the proposed rule suggests that the compliance and reporting obligations discussed in Parts I.E and IV could apply to an ABS issuer that was determined to be a banking entity.

<sup>66</sup> See Part I for further discussion of these key terms.

- (b) *These obligations would be problematic for current securitizations, as the operating structure of most ABS issuers is not compatible with the demands imposed by the rule: there is no operational capacity outside of the third parties that conduct the issuer's limited business. Moreover, reporting of information about the issuer is prescribed by the agreements governing the securities issuance, which would need to be amended to comply with these new requirements. Such amendment processes, which would likely require consent of the issuer's investors, would be costly and time consuming.*
- (c) *The Agencies ask questions regarding the impact of imposing compliance obligations on ABS issuers, and this is an area worthy of further consideration. It may be inappropriate to impose these requirements on ABS issuers.*

## IV. REQUIRED COMPLIANCE PROGRAMS

### A. Scope of Compliance Requirements

1. All banking entities engaged in activities that are restricted under the proposal would be required to establish a compliance program reasonably designed to ensure and monitor compliance. Such a program should be “suitable for the size, scope, and complexity of activities and business structure of the banking entity,” and banking entities with substantial trading or fund activities would be required to satisfy certain minimum standards. According to the proposal, the compliance and recordkeeping requirements would become effective in July 2012.
  - (a) *The specific requirements for a compliance program, along with the associated reporting and recordkeeping requirements, are not a feature of the statutory scheme, although they are consistent with the recommendations of the FSOC Study.*
  - (b) *Given the likely timing of the final rulemaking, it will be difficult for institutions with significant trading or fund activities to implement the required compliance and recordkeeping programs by July 2012. On an ongoing basis, institutions will be challenged to structure flexible compliance programs that can respond to rapidly changing market conditions, and frequent and rapid reviews and updates of these programs will likely be required to respond to those changes, adding to already significant burdens of the proposed rule’s compliance requirements.*
2. Covered banking entities that engage in no prohibited or restricted activities would not need a compliance program, but would need to have compliance policies and procedures that include measures designed to prevent the covered banking entity from becoming engaged in such activities or making such investments.
  - (a) *In general, it is unclear whether a banking entity that engages only in activities permitted under the various exemptions in the proposed rule (e.g., trading in U.S. government obligations or engaging in activities that are “solely outside of the United States”) can take advantage of this exemption from the broader compliance program requirements.*
3. *Although the compliance, reporting and recordkeeping requirements in the proposal were clearly designed with traditional banks and broker-dealers in mind, they will also apply to other banking entities with large trading operations, such as an insurance company with an affiliated bank or thrift.*

### B. Core Components of Compliance Programs

1. Internal written policies and procedures reasonably designed to document, describe and monitor activities and investments with respect to covered funds and/or proprietary trading;
2. System of internal controls reasonably designed to monitor and identify potential areas of noncompliance and to prevent the occurrence of prohibited activities or investments;
3. Management framework that clearly delineates responsibility and accountability for compliance;
4. Independent testing for the effectiveness of the compliance program conducted by qualified banking entity personnel or outside party;

5. Training for appropriate personnel; and
6. Making and keeping records sufficient to demonstrate compliance, promptly providing the records to the appropriate Agency upon request, and retaining the records for at least 5 years.

#### **C. No CEO Attestation**

*The proposal did not include a requirement for a Sarbanes-Oxley style attestation regarding compliance procedures, as had been recommended by the FSOC Study and some commenters. However, the Agencies asked a question in the preamble about whether such an attestation requirement would be appropriate, and whether the Agencies should prescribe any other particular corporate governance practices for the review and approval of compliance plans. The prospect of a CEO attestation requirement has been controversial, and if the Agencies were to adopt such a requirement, it would likely be met with industry opposition.*

#### **D. Additional Requirements for Entities with Significant Covered Activities**

1. The compliance programs for banking entities that engage in significant levels of covered trading and funds activities will be required to satisfy detailed minimum standards set forth in Appendix C of the proposed rule. A banking entity may also be subjected to these standards if the relevant Agency deems it appropriate.
2. Quantitative thresholds for application of minimum standards
  - (a) Proprietary trading activities
    - (i) The banking entity engages in proprietary trading and (together with affiliates and subsidiaries) has “trading assets and liabilities” the average gross sum of which (on a worldwide basis) is at least \$1 billion or is at least 10% of its total assets.
    - (ii) *“Trading assets and liabilities”, which are meant to be calculated on a worldwide basis, are not defined in the proposal. It is unclear whether this calculation is meant to include the assets and liabilities from trading activities that are not proprietary trading (i.e., trading other than as principal) or that are permissible foreign activities under the proposed rule.*
  - (b) Covered fund activities
    - (i) The banking entity engages in covered fund activities and (together with affiliates and subsidiaries) has aggregate investments in covered funds of \$1 billion or more or that sponsors or advises covered funds that have \$1 billion or more in total assets under management.
    - (ii) *Because many foreign funds fall within the definition of “covered fund”, it appears that the proposal as written would count investments in and transactions with these funds that are permissible under the exemption for activities outside the United States toward these thresholds.*



3. The minimum standards set forth in Appendix C are focused on four of the six identified core components of a compliance program. They establish detailed requirements for a banking entity's internal policies and procedures, internal controls, management framework, and independent testing. For example:
  - (a) Written policies and procedures must identify each asset management unit or trading unit and its place within the organization structure, and provide detailed descriptions of the mission, strategy and compliance of each such unit.
  - (b) The management framework of a banking entity must establish a clear chain of responsibility and accountability from individual trader mandates and line managers up through the CEO and board of directors, who are responsible for approving the compliance program and establishing a strong culture of compliance.
  - (c) Compliance programs must be independently tested for effectiveness at least once every 12 months.
4. Certain standards are tailored specifically to either trading or fund activity.
  - (a) With respect to covered fund activities, a compliance program would be required to, among other things, provide a comprehensive description of the mission and strategy of each asset management unit relating to its covered fund activities or investments. The policies and procedures would also have to specify how the covered banking entity identifies covered funds that it sponsors, organizes, or invests in.
  - (a) With respect to proprietary trading, a compliance program would be required to, among other things, establish, maintain, document and enforce trader mandates, and provide a comprehensive description of risk management for each trading unit. Further, the covered banking entity would be required to perform quantitative assessments of covered trading activities and have specific policies and procedures with respect to hedging, including provisions articulating how risks generated by each trading unit are hedged.

*Individual trader mandates will be a new and burdensome requirement for most institutions, inconsistent with current industry practice; today mandates are generally set at the "desk" level. Similarly, the requirement that the intent or purpose of certain transactions be documented contemporaneously with the transaction is inconsistent with the typical risk-management and compliance programs applicable to trading desks and traders.*
5. Banking entities would be permitted, but not required, to establish their compliance programs on an enterprise-wide basis.
  - (a) The program would be required to be clearly applicable to all affiliates and subsidiaries and to address the consolidated organization's business structure, size, complexity, as well as the particular activities, risks and applicable legal requirements of each subsidiary and affiliate.

#### **E. Application to Foreign Banking Entities**

1. *There is no categorical exception for banking entities organized outside the United States, and the proposal does not explain how the compliance program requirements should be tailored to FBOs, especially in relation to their non-U.S. activities.*
2. *As proposed, the extraterritorial reach of the proposal implies that foreign banking entities seeking to engage in trading or fund investment or sponsorship that would be restricted under the Volcker Rule would be required to implement these compliance measures outside the United States, including in their head offices. Although compliance programs are intended to be flexible and tailored to the structure and risks of an organization, it is not clear from the proposal whether foreign banking entities could limit their compliance with these requirements to only a subset of the organization.*

\* \* \*

If you have any questions, please feel free to contact any of the individuals listed on the attached contacts list or your regular contacts at the firm.

CLEARY GOTTlieb STEEN & HAMILTON LLP

# CONTACTS

## Financial Institutions

Kenneth L. Bachman, Jr. Partner	(202) 974-1520	kbachman@cgsh.com
Derek M. Bush Partner	(202) 974-1526	dbush@cgsh.com
Timothy J. Byrne Senior Attorney	(212) 225-2879	tbyrne@cgsh.com
Katherine M. Carroll Associate	(202) 974-1584	kcarroll@cgsh.com
Hugh C. Conroy, Jr. Counsel	(212) 225-2828	hconroy@cgsh.com
Patrick Fuller Associate	(202) 974-1534	pfuller@cgsh.com
Linda J. Soldo Partner	(202) 974-1640	lsoldo@cgsh.com
Robert L. Tortoriello Partner	(212) 225-2390	rtortoriello@cgsh.com

## Broker-Dealer and Derivatives

David Aman Partner	(212) 225-2262	daman@cgsh.com
Colin D. Lloyd Associate	(202) 974-1908	clloyd@cgsh.com
Giovanni P. Prezioso Partner	(202) 974-1650	gprezioso@cgsh.com
Edward J. Rosen Partner	(212) 225-2820	erosen@cgsh.com

## Securitization

Raymond B. Check Partner	(212) 225-2122	rcheck@cgsh.com
Michael A. Mazzuchi Partner	(202) 974-1572	mmazzuchi@cgsh.com
Joyce E. McCarty Counsel	(202) 974-1574	jmccarty@cgsh.com
Paul R. St. Lawrence Associate	(202) 974-1782	pstlawrence@cgsh.com
David L. Sugerman Partner	(212) 225-2890	dsugerman@cgsh.com

## Private Equity and Hedge Funds

Michael A. Gerstenzang Partner	(212) 225-2096	mgerstenzang@cgsh.com
Robert J. Raymond Partner	(212) 225-2994	rraymond@cgsh.com

## '40 Act and Advisers Act

Robin M. Bergen Partner	(202) 974-1514	rbergen@cgsh.com
Richard S. Lincer Partner	(212) 225-2560	rlincer@cgsh.com





NEW YORK  
WASHINGTON  
PARIS  
BRUSSELS  
LONDON  
MOSCOW  
FRANKFURT  
COLOGNE  
ROME  
MILAN  
HONG KONG  
BEIJING  
BUENOS AIRES  
SÃO PAULO

CLEARY GOTTlieb STEEN & HAMILTON LLP