Morgan Lewis

white paper

A Review of, and Insights into, the Volcker Rule Regulations

January 2014

Executive Summary

- The final regulations (Regulations) adopted by the five federal financial regulatory agencies (Agencies) on December 10, 2013 to implement the proprietary trading and private fund prohibitions of the Volcker Rule have made a number of material changes to the proposed rules (Proposed Rules) published by the Agencies in late 2011, while preserving the basic prohibitions and major exclusions and exceptions of the Volcker Rule.
- In many respects, the changes to the Regulations, with the exception of their treatment of hedging activities (discussed below), are reasonably accommodating to banking industry concerns with the impact and burdens associated with the Proposed Rules.
- The Regulations will become effective on April 1, 2014, but affected banking organizations generally will have until July 21, 2015 to bring their proprietary trading and private fund activities into conformance with the Volcker Rule and the Regulations. Banking organizations are expected to engage in "good faith efforts" to bring all of their covered activities into compliance by the July 2015 conformance date.

Prohibition on Proprietary Trading

- The key statutory exemptions for underwriting, market making, risk-mitigating hedging activities, liquidity management, trading in government obligations, trading on behalf of customers, insurance company general account transactions, and trading by foreign banking entities that occurs "solely outside of the U.S." are incorporated in the Regulations.
- The final definition of "proprietary trading" in the Regulations conditionally excludes a number of discrete transactions and activities of banking entities, including repo and securities lending activities, liquidity management activities, transactions as agent for customers, certain clearing transactions, employee benefit plan transactions, and transactions in a DPC capacity.
- *Underwriting.* The Agencies adopted the statutory underwriting exemption substantially as proposed, but with several changes and clarifications relating to the contours of the exemption to better align the exemption with the benefits that underwriting activities provide to clients, counterparties and the financial markets, and with key concepts embodied in the federal securities laws.
- *Market Making.* The Regulations' implementation of the statutory exemption for market making activities makes several changes and clarifications relative to the exemption contained in the Proposed Rules, including a more flexible consideration of the liquidity, maturity and depth of the market for a given financial instrument in applying the exemption, and the removal of the previously proposed Appendix B.
- *Risk-Mitigating Hedging.* The Regulations exempt a banking entity's risk-mitigating hedging activities in connection with and related to positions, contracts or other holdings that are designed to reduce the specific risks associated with such positions, contracts or holdings. Banking entities, however, may only hedge risks that are specific and identifiable under this exemption, and may not engage in hedging to reduce general risks, such as general market movements and broad economic conditions.
- The Regulations implement the statutory exemption for proprietary trading that is done for the purposes of liquidity management through an exclusion from the definition of "proprietary trading." Permitted trading under this exclusion must be effected under a liquidity management plan, and does not extend to broad asset-liability management, earnings management or scenario hedging.
- The Regulations implement the statutory exemption for trading by a regulated insurance company in the general account, and also permit trading in qualifying insurance company separate accounts.
- The Regulations permit foreign banking entities located outside of the United States that are not directly or indirectly controlled by a bank organized under U.S. laws or the laws of any state to engage in proprietary trading, provided that certain conditions are met. In addition, foreign banking organizations may execute and clear transactions generally through established U.S. exchange, trading and clearing facilities.

 © 2014 Morgan, Lewis & Bockius LLP

Prohibition and Restrictions on Ownership Interests in, and Certain Relationships with, Covered Funds

- The statutory Volcker Rule generally covers any entity that is exempt under Investment Company Act section 3(c)(1) or 3(c)(7), or such similar funds as the Agencies may, by rule, determine. The Regulations extend the definition of "covered fund" to certain exempt commodity pools and foreign private funds that are sponsored or owned by a U.S. banking entity.
- The Regulations contain a number of important exclusions from the definition of a "covered fund," which means that these excluded activities not only are not subject to the private fund prohibition, but also will not be subject to the strict prohibition on certain transactions between banking entities and covered funds, and the conflicts of interest and high-risk transactions limitations. Exempt activities include joint ventures, acquisition vehicles, foreign pension funds, qualifying asset-backed commercial paper conduits, covered bonds, registered investment companies, and SBIC and public welfare investments.
- *Securitizations.* Qualifying loan securitizations are excluded from the coverage of the Volcker Rule, but non-loan securitization transactions, as well as loan "resecuritizations," will be subject to the covered funds restrictions if they satisfy the "covered fund" definition.
- *Funds "Organized and Offered."* The Regulations implement the key covered funds statutory exemption that permits a banking entity to acquire and retain an ownership interest in a covered fund in connection with the bona fide "organizing and offering" of a covered fund to its fiduciary and asset management clients so long as certain requirements are met. Banking entities are not required to have a preexisting relationship with these customers in order to rely on this exemption.
- *Investments in Funds*. The Regulations permit a banking entity to acquire ownership interests in a covered fund under the "organized and offered" exemption so long as (i) its investment in the fund does not, after one year from the date the fund is established, exceed 3% of the total outstanding ownership interests in, or value of, the fund (the "per-fund limitation"), and (ii) the aggregate value of all investments in all covered funds does not exceed 3% of its tier 1 capital (the "aggregate funds limitation"). In addition, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations only if the investment is made by the banking entity or another entity controlled by the banking entity.
- The Regulations allow a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge, but only with respect to an ownership interest that is designed to "demonstrably reduce" or "significantly mitigate the specific, identifiable risks" to the banking entity in connection with a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to the fund.
- The Regulations conditionally exempt the acquisition or retention by an insurance company, or an affiliate thereof, of any ownership interest in, or the sponsorship of, a covered fund for its general account or for one or more separate accounts.
- The Regulations create a conditional exclusion for the sponsorship of, and acquisition of ownership interests in, "foreign public funds" that are widely sold outside of the United States.
- The Regulations liberalize the conditions contained in the Proposed Rules under which a foreign banking organization may acquire or retain an ownership interest in, or act as sponsor to, covered funds that are organized and sold "solely outside of the U.S."

Other Volcker Rule Requirements

- The Regulations implement without major changes from the Proposed Rules the statutory Volcker Rule prohibition on activities and investments that pose a threat to the safety and soundness of a banking entity or to the financial stability of the United States, or an activity or investment that involves a "material conflict of interest between a banking entity and its clients, customers, or counterparties" or "high-risk assets or trading strategies."

 © 2014 Morgan, Lewis & Bockius LLP

Compliance and Reporting Requirements

- The Regulations require banking entities engaged in proprietary trading or covered fund activities and investments to develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule and the Regulations.
- In general, the Regulations reduce the amount of information and data that banking entities must collect and report, but preserve the core elements of a required compliance program.
- In addition, the Regulations seek to reduce compliance burdens on community banks and banks that do not engage in covered trading and private fund activities.

Introduction

The Regulations[1] adopted by the Agencies[2] on December 10, 2013 under section 619 of the Dodd-Frank Wall Street Accountability and Consumer Protection Act (Dodd-Frank Act)—known as the Volcker Rule—are the culmination of a controversial and sometimes contentious multi-agency effort to implement what, in turn, is one of the most controversial provisions of the Dodd-Frank Act. Even with the publication of the Regulations, the controversy over the Volcker Rule and the Agencies' actions to implement it apparently will continue at least for the short term, compliments of the current dustup over the impact of the Regulations on the value of collateralized debt obligations (CDOs) backed by trust preferred securities (TruPS) held by approximately 250 community banks (see discussion at the end of this analysis), and the legal actions just filed by the banking industry against the three federal banking agencies to challenge this impact. The TruPS CDO controversy notwithstanding, however, at long last the Agencies have released the final Regulations, and the financial services industry now can concretely assess the Volcker Rule's and the Regulations' impact on its activities.

Generally, the Volcker Rule prohibits, subject to important exceptions, (i) proprietary trading in securities and other financial instruments by "banking entities," and (ii) banking entities from sponsoring or acquiring an ownership interest in private equity and hedge funds (collectively, "covered activities"). In addition, the Volcker Rule prohibits a banking entity from engaging in a covered activity or making an investment if the activity or investment would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States, or if the activity or investment involves a "material conflict of interest between a banking entity and its clients, customers, or counterparties" or "high-risk assets or trading strategies." In turn, the statutory Volcker Rule charged the Agencies with the challenging task of implementing its requirements through regulation.

The Agencies responded to the statutory direction first by publishing the Proposed Rules in October 2011.[3] These highly complex and question-laden proposals drew more than 18,000 comments (albeit a large number of them essentially were form comments), many of them critical of the Proposed Rules' possible negative impact on legitimate and long-established bank activities, the costs and burdens associated with complying with the regulations, and the possible adverse competitive impact on the U.S. financial services industry. Notably, the Proposed Rules generated highly detailed and substantive comments from a large number of trade groups and criticisms from several foreign financial regulators that questioned the Proposed Rules' potential extraterritorial impact.

The ensuing two-year regulatory process of moving the Proposed Rules from proposed to final form was, in a word, tortuous. The Agencies were confronted with an avalanche of comments, both substantive and non-substantive, that they needed to address. Complicating the task were intervening events in the financial sector, including certain trading and other misadventures occurring in the wholesale banking sector, that materially increased the political pressure on the Agencies to come out with a "tough" set of final rules. In addition,

1. View the Regulations at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf.

2. The Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

3. View the Proposed Rules at http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf.

 © 2014 Morgan, Lewis & Bockius LLP

widespread reports of substantive disagreements among the Agencies over the nature and content of the final rules were further indications of the depth of the Agencies' difficulties in creating final rules.

The Regulations, however, have now been published, and banking organizations now have at least the benefit of knowing what the final requirements are, if not how they will be construed and applied by multiple regulatory agencies over the coming months and years. The Regulations, amounting to over 70 pages of actual rules and almost 900 pages of commentary, are anything but the soul of wit, but the Regulations do create the outline of a concrete regulatory framework that banking organizations can address.

We now turn to the Regulations to review their requirements and assess their consequences.

The Final Regulations: An Overview

While the Regulations preserve the basic prohibitions and major exclusions and exceptions of the Volcker Rule, the Regulations, with the exception of their treatment of hedging activities (discussed below), made changes to the proposed regulations that for the most part sought to be reasonably accommodating to banking industry concerns.

The Regulations prohibit "banking entities," which are generally defined as insured depository institutions and companies affiliated with insured depository institutions, from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments for their own account.[4] The Regulations also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds, certain commodity pools, and certain foreign private funds (defined as "covered funds").[5]

The Regulations implement the principal Volcker Rule statutory exemptions for:

- underwriting and market making activities
- risk-mitigation hedging activities
- liquidity management activities
- trading in government obligations
- trading for the accounts of customers
- insurance company general account activities
- trading by foreign banking organizations that occurs "solely outside the U.S."
- organizing and offering hedge funds or private equity funds to fiduciary and asset management clients
- small business and public welfare investment fund activities
- foreign banking organizations' investments in and sponsorship of private funds that occur "solely outside the U.S."

In addition, however, the Regulations conditionally exclude from the Volcker Rule trading and fund prohibitions on other important activities, including:

- qualifying insurance company separate account activities
- lending and qualifying loan securitization activities
- trading in certain foreign sovereign obligations

4. *See* final rule § __.2(c).

5. *See id.* § __.10.

© 2014 Morgan, Lewis & Bockius LLP

- underwriting and market making in covered funds
- investment and sponsorship activities relating to registered investment companies and certain foreign public funds
- bank-owned life insurance transactions

Unlike the Proposed Rules, however, the Regulations narrow the types of permissible hedging activities, effectively prohibiting portfolio-level hedging that is not tied to specific financial instruments being hedged. This change in the scope of the hedging exemption was in response to criticisms of the Proposed Rules' hedging exemption conditions, which many public and political commentators said were too broad.

Like the Proposed Rules, the Regulations will require affected banking organizations to adopt and implement compliance and reporting plans and programs, the scope and complexity of which will vary according to the size of the banking organization and the nature and scope of its proprietary trading and private fund activities. The Regulations, however, have been modified from the Proposed Rules in an effort to reduce the compliance burdens on smaller banking organizations.

Effective Date and Conformance Period

The Regulations will become effective on April 1, 2014, but affected banking organizations generally will have until July 21, 2015 to bring their proprietary trading and private fund activities into conformance with the Volcker Rule and the Regulations; this new conformance date is an administrative extension of the original statutory conformance date of July 21, 2014.

To this end, the Federal Reserve Board has published an order extending the Volcker Rule conformance period to July 2015 and discussing the responsibilities of banking organizations with respect to their covered activities during the conformance period.[6] As was the case with the Federal Reserve Board's prior conformance period policy statement,[7] banking organizations are expected to engage in "good faith efforts" to bring all of their covered activities into compliance by the July 2015 conformance date. In an indirect response to ongoing banking industry questions about the nature and extent of permitted covered activities during the conformance period, the Federal Reserve Board has cautioned that "banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted."

Prohibition on Proprietary Trading[8]

The Regulations prohibit a banking entity from engaging as principal in transactions in securities and other financial instruments (collectively, "financial instruments") for the trading account of the banking entity, except for the specific exemptions set forth in the Regulations. The Regulations maintain the rebuttable presumption in the Proposed Rules that if a banking entity holds financial instruments for less than 60 days, it will be presumed to be for the trading account of the banking entity.

As noted above, the key statutory exemptions for underwriting, market making, risk-mitigating hedging activities, liquidity management, trading in government obligations, trading on behalf of customers, insurance company general account transactions, and trading by foreign banking entities that occurs "solely outside of the U.S." are incorporated in the Regulations, with some important modifications from the statute and the Proposed Rules, discussed below.

6. View the order at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.
7. View the statement of policy at http://www.gpo.gov/fdsys/pkg/FR-2012-06-08/pdf/2012-13937.pdf.
8. *See generally id.* § __.3.

 © 2014 Morgan, Lewis & Bockius LLP

A. Key Coverage Terms

The Regulations incorporate and define the key statutory coverage terms of the Volcker Rule, with few material changes from the Proposed Rules.

1. "Banking Entity"[9]

A banking entity includes (i) any insured depository institution; (ii) any company that controls an insured depository institution (including a bank holding company and savings and loan holding company, or any other company that controls an insured depository institution but that is not a bank holding company or savings and loan holding company (e.g., the parent company of an industrial loan company)); (iii) any foreign bank that is treated as a bank holding company for purposes of section 8(a) of the International Banking Act of 1978 (in general, any foreign bank operating a branch, agency or commercial lending company in the United States); and (iv) any affiliate or subsidiary of any of the foregoing.

2. "Proprietary Trading"[10]

The Regulations define "proprietary trading" as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments. This definition in effect restates the statutory definition. In adopting this definition in the Regulations, the Agencies declined to create any bright-line definitions or narrow the scope of the basic definition, as a number of commenters had requested.

3. "Trading Account"[11]

The final definition of "trading account" is substantively consistent with the definition set forth in the Proposed Rules. A trading account is defined as any account that is used to purchase or sell financial instruments principally for the purpose of short-term resale, benefitting from short-term price movements, locking in short-term arbitrage profits, or hedging another trading account position. In the case of a securities dealer or swaps dealer, however, a trading account includes any account of such a firm, and includes dealers acting as such outside of the United States as well as within the United States. As was the case with the Proposed Rules, under the Regulations a financial instrument that is held for 60 days or less is subject to a rebuttable presumption that the financial instrument is held in the trading account of the banking entity; importantly, however, there is no corresponding safe harbor or "reverse presumption" (i.e., a presumption of non-trading account treatment) for traded positions held for longer than 60 days. Further, the Agencies expressly declined to refer to applicable accounting standards in determining whether an account is a trading account.

4. "Financial Instrument"[12]

The final definition of "financial instrument," which becomes an instrument that is subject to the Volcker Rule proprietary trading prohibition, is substantively consistent with the definition set forth in the Proposed Rules, albeit the definition is recast in terms of a financial instrument rather than a "covered financial position" as defined in the Proposed Rules. A financial instrument includes any security, commodity forward, or derivative, but does *not* include loans, spot commodities or spot foreign exchange or currency. Derivatives include a wide variety of derivative transactions and instruments, including foreign exchange swaps and forwards. In turn, the definitions of "securities" and "swaps" reference existing definitions under the federal securities and commodities laws.

---

9. *See id.* § __.2(c).

10. *See id.* § __.3(a).

11. *See id.* § __.3(b).

12. *See id.* § __.3(c).

 © 2014 Morgan, Lewis & Bockius LLP

5. "Proprietary Trading" Definitional Exclusions[13]

The final definition of "proprietary trading" in the Regulations conditionally excludes a number of discrete transactions and activities of banking entities. Consequently, these excluded activities not only are not subject to the proprietary trading prohibition, but will not be subject to the Volcker Rule's and the Regulations' general conflicts of interest and high-risk transactions limitations. Excluded transactions and activities include:

- Qualifying repurchase and reverse repurchase agreement transactions;
- Purchases or sales of securities in connection with qualifying securities lending and borrowing transactions;
- Purchases and sales of securities for liquidity management purposes (discussed in more detail below);
- Purchases or sales of financial instruments by a derivatives clearing organization (DCO) or a clearing agency in connection with clearing financial instruments;
- Excluded clearing activities by members of a clearing agency, DCO, or designated financial market utility;
- Purchases and sales of financial instruments to satisfy existing delivery obligations of the banking entity or its customers, or to satisfy an obligation in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding;
- Purchases and sales of financial instruments by a banking entity that is acting solely as agent, broker, or custodian;
- Purchases and sales of financial instruments through a qualifying domestic or foreign deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity for the benefit of plan participants; or
- Qualifying debt-previously-contracted (DPC) purchases or sales of financial instruments.

B. Underwriting Exemption[14]

Consistent with the statute, the Regulations exempt from the prohibition of proprietary trading qualifying underwriting activities. The Agencies decided to adopt the underwriting exemption substantially as proposed, but with several changes and clarifications relating to the contours of the exemption to better align the exemption with the benefits that underwriting activities provide to clients, counterparties and the financial markets. In general, the underwriting exemption framework is intended to recognize the differences in underwriting activities across markets and asset classes by establishing criteria, based on the liquidity, maturity, and depth of the market for the particular type of security that, according to the Agencies, will be applied "flexibly." To satisfy the underwriting exemption, a banking entity must demonstrate compliance with five core elements or standards:

- The banking entity must act as an "underwriter" for a "distribution" of "securities" (as those terms are generally defined and applied under the federal securities laws) and the trading desk's underwriting position must be "related to" such a distribution;
- The amount and types of securities in the trading desk's underwriting position must be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties, and reasonable efforts must be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security;
- The banking entity must establish, implement, maintain, and enforce an internal compliance program (including "reasonably designed" written policies and procedures, internal controls, analysis and independent testing), the required details of which are set forth in the Regulations, that is reasonably designed to ensure the banking entity's compliance with the requirements of the underwriting exemption;

---

13. *See id.* § __.3(d).

14. *See id.* § __.4(a).

 © 2014 Morgan, Lewis & Bockius LLP

- The compensation arrangements of persons performing the banking entity's underwriting activities may not be designed not to "reward or incentivize" prohibited proprietary trading; and
- The banking entity must be licensed or registered to engage in covered underwriting activities in accordance with applicable law.

Under the final underwriting exemption:

- The Agencies have limited the availability of the exemption to distributions of "securities."
- The underwriting exemption will generally be applied at the trading desk level. A trading desk may engage in activities that are customarily related to an underwriting (e.g., stabilization activities), but a trading desk may only engage in activities that are related to a particular distribution of securities for which the banking entity is acting as an underwriter.
- The Agencies have clarified that the exemption would apply on a distribution-by-distribution basis, rather than a transaction-by-transaction basis, as was proposed in the Proposed Rules, but a banking entity may not aggregate positions from multiple distributions for which it is acting as an underwriter.
- The Regulations modify the definition of "distribution" to (i) an offering of securities that is distinguished from ordinary trading by presence of special selling efforts and methods, *or* (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.
- The Regulations have modified the definition of "underwriter" to better align the definition with that of "distribution participant" in SEC Regulation M. The modified "underwriter" definition therefore includes both the members of the underwriter syndicate and selling group members, regardless of contractual privity.
- The Agencies clarified that the activities of authorized participants in the distribution of exchange-traded funds (ETFs) should be analyzed in the context of the market making exemption because it is driven by the demands of other market participants rather than by the issuer itself. Unlike the market making exemption, hedging underwriter risk exposure is not permitted under the underwriter exemption, and therefore banking entities must conduct any hedging activities in accordance with the risk-mitigating hedging exemption.
- The Regulations clarify that a banking entity must make reasonable efforts to sell or otherwise reduce unsold allotments held by the trading desk, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.
- The Regulations do not include a requirement in the Proposed Rules that the underwriting activities of a banking entity be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions.

C. **Market Making Exemption**[15]

The Regulations' implementation of the statutory exemption for market making activities makes several changes and clarifications relative to the exemption contained in the Proposed Rules. The essential elements of the final market making exemption include the following:

- The banking entity must stand ready to purchase and sell one or more types of financial instruments related to its financial exposure and must be willing and available to quote, buy and sell or otherwise enter into long and short positions in the instruments in commercially reasonable amounts throughout market cycles on a basis that is appropriate for the liquidity, maturity and depth of the market for the financial instrument. In addition, an entity with $50 billion or more in trading assets and liabilities cannot qualify as a client, customer or counterparty unless the banking entity documents how and why the relevant trading unit of such entity should be treated as a client, customer or counterparty, or the trade is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

15. *See id.* § __.4(b).

© 2014 Morgan, Lewis & Bockius LLP

- The amounts, types and risks of the instruments in the trading desk's inventory must not be designed to exceed on an ongoing basis the reasonably expected near-term demands of clients, customers or counterparties. The Regulations will require banking entities to engage in a demonstrable analysis of historical customer demand, and the current inventory of financial instruments as well as market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments in which the desk makes a market. At the same time, banking entities will be permitted to take positions, and maintain market making inventories, in reasonable expectation of customer demand in the near term, provided that they engage in a demonstrable analysis that the amount, types and risks of instruments are designed not to exceed expected near-term demands, taking into account characteristics of the markets for the particular financial instrument.
- The banking entity must maintain an internal compliance program that includes:
  - the financial instruments that each trading desk stands ready to purchase and sell as a market maker;
  - the actions the trading desk will take to reduce or mitigate promptly the risks of financial exposure;
  - limits on the amounts, types and risks of market-maker inventory, products, instruments, exposures, the level of exposures to relevant risk factors arising from its financial exposures and the period of time that an instrument can be held;
  - internal controls and ongoing monitoring and analysis of the trading desk's compliance with such limits; and
  - authorization and escalation procedures for when such limits are exceeded.
- If a limit is exceeded, the trading desk must take action to come into compliance as promptly as possible after the limit is exceeded.
- The banking entity's compensation scheme for traders may not be designed to reward or incentivize prohibited proprietary trading.
- The banking entity must be licensed or registered to engage in market making–related activities in accordance with applicable law, to the extent such registration is required.

The Regulations differ from the Proposed Rules in several material ways:

- The Regulations allow banking entities to engage in a variety of established dealer activities, including primary dealer activities, acting as an authorized participant for ETFs, and facilitating block trades, to the extent otherwise permitted under applicable law and in accordance with the framework governing market making–related or underwriting activities contained in the Regulations.
- The Agencies will not evaluate whether a banking entity is in compliance with the market making exemption by using a trade-by-trade analysis; rather, the application of the exemption will take into consideration the liquidity, maturity and depth of the market for a given financial instrument.
- Unlike the Proposed Rules, the Regulations do not require that market making–related activities be designed to generate revenues primarily from fees or other customer revenues, but banking entities with significant trading activities will have to report data regarding patterns of revenue generation by market making trading desks involved in market making activities. In turn, this data may trigger further supervisory review of the desk's activities and may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation.
- The Regulations no longer include Appendix B from the Proposed Rules. This is a significant accommodation to industry concerns over the requirements and impact of the proposed Appendix B. While Appendix B purported to clarify what types of activities would be considered permissible market making–related activities, it contained a number of troublesome presumptions of activities that would be considered impermissible proprietary trading unless the banking entity could convince its regulators otherwise. Many of those presumptions seemed to incorporate market making concepts from the very liquid equities markets and looked as though they could be interpreted narrowly in ways that would not take into account how banking entities make markets in less liquid asset classes, such as some credit, commodities and derivatives markets. In contrast, the Regulations and much of the language in the preamble now clarify that a banking entity may

 © 2014 Morgan, Lewis & Bockius LLP

engage in market making in different types of asset classes, and that market making–related activity may vary based on the liquidity, maturity, and depth of the market for the particular financial instrument.

- The Regulations add a requirement that the trading desk conduct an analysis of customer demand for purposes of not engaging in market making activities that can be reasonably expected to exceed near-term client demands. Again, this requirement seems geared toward identifying and taking into account the different trading characteristics of particular markets or financial products in which banking entities make markets.
- The Regulations changed the Proposed Rules' requirement that a banking entity be willing to buy and sell on a regular or continuous basis to a requirement that a banking entity "routinely" stand ready to trade one or more types of financial instruments on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.
- Unlike the Proposed Rules, the Regulations do not require that market making–related hedging comply with the risk-mitigating hedging exemption, provided that the hedging is conducted or directed by the same trading desk that is conducting the market making activity.
- As alluded to above, the Regulations do not require a foreign banking entity to be subject to substantial regulation in the foreign jurisdiction in which it operates; foreign banking entities instead are required to be registered in a foreign jurisdiction only to the extent required by the foreign jurisdiction.

D. **Risk-Mitigating Hedging Exemption**[16]

The Regulations exempt a banking entity's risk-mitigating hedging activities in connection with and related to positions, contracts or other holdings that are designed to reduce the *specific* risks associated with such positions, contracts or holdings. Importantly, the Regulations clarify that a banking entity may only hedge risks that are specific and identifiable in order to avail itself of this exemption. Thus, a banking entity must be able to identify the specific financial instrument or components of the financial instrument positions that are being hedged.

- The statutory portfolio exemption allows banking entities to hedge "in connection with and related to individual or aggregated positions, contracts or other holdings of the banking entity." In the Regulations, however, the Agencies stated that a banking entity may hedge across more than one position, contract or holding, but that hedging across multiple positions must be in connection with aggregated positions of the banking entity and must be related to identifiable risks. The Regulations do not permit hedging to reduce general risks, such as general market movements and broad economic conditions.
- The Proposed Rules also required that the hedging position be "correlated" to the position being hedged. The Regulations eliminate the correlation requirement, but require that the banking entity conduct a correlation analysis that, ideally, would demonstrate how the hedging position is correlated with the position being hedged. However, the Agencies recognized that, in certain circumstances, a hedge may not correlate with the position being hedged. In such a case, a banking entity should be able to explain the reasons for the lack of correlation.
- Banking entities are required to conduct analysis and independent testing to ensure that the hedging positions, techniques and strategies used are reasonably designed to mitigate the risk being hedged. The banking entity is required to determine whether the strategy is risk reducing at the inception of the hedge.
- A banking entity must have a compliance program for risk-mitigating hedging activities. The Agencies left the internal compliance programs largely intact from the Proposed Rules, but provided more detail regarding the required elements of the compliance program. Banking entities must develop and implement written policies and procedures that include the positions, techniques and strategies that may be used for hedging. The policies and procedures must include documentation regarding what positions, contracts and other holdings may be used in the banking entity's risk-mitigating hedging activities. It must also include position limits and aging limits.

16. *See generally id.* § __.5.

© 2014 Morgan, Lewis & Bockius LLP

E. Liquidity Management Exclusion[17]

The Regulations implement the statutory exemption for proprietary trading that is done for the purposes of liquidity management through an exclusion from the definition of "proprietary trading." To rely on this exclusion, a banking entity must satisfy certain conditions:

- The banking entity may only trade securities under this exclusion.
- The securities must be highly liquid instruments that are not reasonably expected to give rise to appreciable profits and losses due to short-term price movement.
- Trading activities that expose the banking entity to substantial risk as a result of shifts in market values that are unrelated to near-term funding needs are not permitted, regardless of the stated exemption.
- The banking entity must create a plan that specifically authorizes the particular securities to be used. The plan must describe the amounts, types and risks of such securities. It must also include the circumstances in which the securities may be used and circumstances in which the securities must be used. The banking entity may only use the securities in an amount consistent with its near-term funding needs.
- As with the risk-mitigating hedging exemption, the banking entity is required to develop a compliance program. The compliance program must include internal controls, analysis and independent testing.
- The Agencies determined not to expand the liquidity management exclusion to allow broad asset-liability management, earnings management or scenario hedging.

F. Insurance Company Exemption[18]

The Regulations implement the statutory exemption for trading by a regulated insurance company in the general account. In addition, however, the Regulations also will allow trading by an insurance company in a separate account where the separate account's assets and returns are legally segregated from the insurance company's other assets, and not dependent on the insurance company's returns.

For both general and separate account activities, the exemption is available only if the trading is conducted by a domestic or foreign insurance company that is "primarily and predominantly engaged" in writing insurance or reinsuring insurance risks, and is regulated by a state or foreign insurance regulator.

G. Trading on Behalf of Customers

The Regulations permit a banking entity to trade in financial instruments on behalf of customers (i) as trustee or in a similar fiduciary capacity for a customer and so long as the transaction is conducted for the account of, or on behalf of, the customer; and (ii) if the banking entity does not have or retain a beneficial ownership of the financial instruments. In addition, qualifying riskless principal transactions in financial instruments on behalf of customers—but not including underwriting or market making transactions, which are separately and conditionally exempted—also are exempt from the Volcker Rule trading prohibition under this particular exemption. Note that banking entity transactions solely in an agency, brokerage or custodial capacity separately are exempted from the definition of "proprietary trading" (discussed in section A.5 above).

H. Foreign Bank Trading Exemption[19]

The Regulations permit foreign banking entities located outside of the United States that are not directly or indirectly controlled by a bank organized under U.S. laws or the laws of any state to engage in proprietary trading, provided that the following conditions are met:

---

17. *See id.* § __.3(d)(3).

18. *See id.* § __.6(d).

19. *See id.* § __.6(e).

© 2014 Morgan, Lewis & Bockius LLP

- The foreign banking entity, including its personnel, that makes the decision to purchase or sell a position as principal is not located in the United States or organized under U.S. or state law.
- The purchase or sale (including any related risk-mitigating hedging transaction) is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under U.S. or state law.
- No finance for the purchase or sale is directly or indirectly provided by any branch or affiliate located in the United States or organized under U.S. or state law.
- The purchase or sale is not conducted with or through any U.S. entity other than:
  - a purchase or sale with the foreign operations of a U.S. entity if no personnel of such entity located in the United States are involved in the arrangement, negotiation or execution;
  - a purchase or sale with an unaffiliated market intermediary acting as principal, provided that it is cleared and settled through a clearing agency or DCO that is acting as central counterparty; or
  - a purchase or sale through an unaffiliated market intermediary, provided it is conducted anonymously on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or DCO acting as central counterparty.

The approach taken in the Regulations, which the Agencies have described as "risk-based," is a material—and many will say welcome—departure from the approach taken in the Proposed Rules. The Proposed Rules might have precluded a foreign banking entity from engaging in proprietary trading through any transaction that had any U.S. connection, which arguably would have prohibited foreign banking entities effecting proprietary transactions on U.S. exchanges or through U.S. trading or clearing facilities. The Proposed Rules also included a transaction-by-transaction approach to evaluating whether a trade was a prohibited proprietary trade.

In response to extensive comments on this provision, the Agencies have revised the Regulations to permit foreign bank purchases and sales with an unaffiliated market intermediary acting as principal, provided that the transaction is cleared through a clearing agency or DCO acting as a central counterparty. The Regulations also permit foreign banking entities to engage in purchases and sales through an unaffiliated market intermediary that is conducted anonymously on an exchange or similar trading facility and cleared and settled through a clearing agency or DCO acting as a central counterparty.

I. Trading in Government Obligations

1. U.S. Government Obligations

Consistent with the statute and the Proposed Rules, the Regulations permit proprietary trading in U.S. government and agency obligations. The Agencies, however, decided not to exempt trading in derivatives on such obligations from the Volcker Rule proprietary trading prohibitions.

2. Foreign Government Obligations

Unlike the Proposed Rules, the Regulations exempt certain trading activities in foreign government obligations. Specifically, U.S. operations of foreign banking entities (excluding insured U.S. depository institutions) may engage in proprietary trading in the United States in the sovereign debt of the home country under whose laws the banking entity—or the banking entity that controls it—is organized, as well as political subdivisions of the home sovereign. In addition, foreign banking entities may purchase and sell in the United States the obligations of any multinational central bank of which the foreign sovereign is a member, so long as the purchase or sale as principal is not made by an insured depository institution. Again, the Agencies have not exempted trading in derivatives on qualifying foreign obligations from the Volcker Rule proprietary trading prohibitions.

With one exception, the Regulations do not allow U.S. banking entities to rely on this exemption to trade in foreign or multilateral development bank obligations. That exception allows a foreign bank or regulated foreign broker-dealer that is controlled by a U.S. banking entity to trade in the obligations of the foreign sovereign under whose laws the foreign entity is organized.

© 2014 Morgan, Lewis & Bockius LLP

3. Municipal Obligations

In addition to implementing the statutory exemption for trading in the obligations of any state or political subdivision of a state, the Regulations expand the exemption to include trading in obligations issued by state and municipal agencies and instrumentalities. Trading in derivatives on such obligations, however, is not covered under this exemption.

Prohibition and Restrictions on Ownership Interests in, and Certain Relationships with, Covered Funds[20]

The Regulations prohibit any banking entity from acquiring *or retaining an ownership interest in*, or *sponsoring*, a hedge fund or private equity fund (covered fund), subject to certain exemptions, including investment and sponsorship activities in connection with "organizing and offering" a covered fund, small business and public welfare fund activities, and covered fund activities of foreign banking entities occurring "solely outside of the U.S." In this regard, the prohibition on covered fund activities and investments applies to the consolidated, worldwide operations of U.S. banking entities.

The Regulations contain a number of important and helpful modifications to the Proposed Rules, in particular excluding altogether—and not just exempting—a number of private fund structures and activities from the applicability of the Volcker Rule. The new exclusions from the Volcker Rule for these fund activities, in contrast to an exemption, will ensure that these excluded activities, in addition to not being subject to the basic private fund prohibition, will not be subject to other collateral requirements of the Volcker Rule (discussed below). By the same token, the Regulations are not altogether hospitable in their treatment of certain structured finance activities of affected banking entities (CDOs are one such example), which will create coverage and compliance issues for banking organizations that are active in these areas.

A. Key Coverage Terms

1. Definition of "covered fund"[21]

The statutory Volcker Rule covers any entity that would be an investment company under the Investment Company Act of 1940 but for the exclusions under sections 3(c)(1) and 3(c)(7) of that act, or such similar funds as the Agencies may, by rule, determine. The Proposed Rules adopted this definition with little interpretation and extended its coverage to all commodity pools and certain foreign funds.

The Regulations, however, make a number of important changes to the definition of a "covered fund." First, the revised definition has narrowed the coverage for commodity pools contained in the Proposed Rules by now including only those commodity pools for which the commodity pool operator has claimed an exemption under CFTC rules for commodity pools offered solely to qualified eligible investors, or any commodity pool where (i) the commodity pool operator is registered with the CFTC as a commodity pool operator in connection with the operation of the commodity pool, (ii) substantially all participation units of the commodity pool are owned by qualified eligible persons, and (iii) participation units have not been publicly offered to persons who are not qualified eligible persons.

The Regulations further revised the Proposed Rules' treatment of foreign funds that might be subject to the Volcker Rule. Thus, a foreign fund is only a covered fund where it is sponsored by, or has issued an ownership interest to, a banking entity that is, or is controlled by a banking entity that is, located in or organized under the laws of the United States or any state.

20. *See generally id.* § __.10.

21. *See id.* § __.10(b).

© 2014 Morgan, Lewis & Bockius LLP

The Regulations also contain a number of important exclusions from the definition of a "covered fund," which means that these excluded activities not only are not subject to the private fund prohibition, but also will not be subject to the strict prohibition on certain transactions between banking entities and covered funds, and the conflicts of interest and high-risk transactions limitations. Funds that are excluded from the definition of a "covered fund" under the Regulations include conditional exclusions for:[22]

- foreign public funds (see discussion in subsection E below);
- wholly owned subsidiaries of banking entities: up to 5% of these entities may be owned by directors and employees of the banking entity;
- joint ventures that do not engage in investing money for others, and are limited to not more than 10 investors other than the banking entity;
- acquisition vehicles;
- foreign pension or retirement funds;
- insurance company separate accounts, provided that no banking entity other than the insurance company participates in the account's profits and losses;
- separate accounts used to purchase qualifying bank-owned life insurance;
- certain loan securitization vehicles (see discussion in subsection 2 below);
- qualifying asset-backed commercial paper conduits;
- qualifying covered bonds issued under the laws of a non-U.S. jurisdiction;
- SBICs and qualifying public welfare investment funds;
- registered investment companies; and
- any issuer excluded by joint action of the Agencies where the Agencies determine that the exclusion is consistent with the purposes of the Volcker Rule.

2. Treatment of Loan Securitizations[23]

In a departure from the approach used in the Proposed Rule, which proposed a combination of exclusions and exemptions for qualifying loan securitizations, the Regulations create a single exclusion from the covered fund definition (as opposed to an exemption from the Volcker Rule) for loan securitizations that are composed *only* of:

- loans;
- servicing assets in the nature of contractual rights or assets that support the servicing of the fund's assets or related or incidental to the purpose of loan assets;
- risk-reducing interest rate and foreign exchange derivatives that relate to qualifying loans and assets held by the securitization vehicle; and
- special units of beneficial interests (such as those issued in automobile lease securitizations) or collateral certificates.

Other types of securitizations, including securitizations of securities (or resecuritizations), such as CDO securitizations and municipal tender option bonds, or securitizations of assets other than loan assets (e.g., real estate or intellectual property), are potentially subject to treatment as covered funds under the Regulations. In this regard, the Agencies were not inclined, notwithstanding commenter requests, to expand the scope of the statutory loan/loan securitization exclusions under the Volcker Rule beyond what the Agencies believed was intended

22. *See id.* § __.10(c).

23. *See id.* § __.10(c)(8).

© 2014 Morgan, Lewis & Bockius LLP

under the Volcker Rule. If a non-loan securitization vehicle can rely on an Investment Company Act exemption other than section 3(c)(1) or 3(c)(7), however, it would be excluded from the definition of a "covered fund."

3. Funds Not Excluded

The Regulations do *not* exempt other types of funds that fall within the technical definition of a covered fund, notwithstanding the requests of many commenters that other fund structures and activities be excluded or exempted. Among the exclusions that the Agencies considered but did not adopt are exclusions or exemptions for:

- financial market utilities established under Title VIII of the Dodd-Frank Act;
- cash collateral pools created in connection with securities lending and borrowing activities;
- pass-through real estate investment trusts (REITs);
- municipal tender option bond transactions;
- venture capital funds;
- funds formed with third-party investors that make investments in loans (credit funds); or
- employee securities companies.

In general, the Agencies declined to create additional exclusions because they believed that (i) certain fund activities could rely on an Investment Company Act exemption other than section 3(c)(1) or 3(c)(7) (e.g., financial market utilities) or be conformed to an existing exclusion or exemption at little cost (e.g., employee securities companies), (ii) the Volcker Rule statutory language did not support creating a separate exemption (e.g., venture capital funds), or (iii) excluding or exempting a particular fund would give rise to the possibility of evasion of the Volcker Rule (e.g., credit funds).

In addition, the Agencies declined to "grandfather" existing covered funds, noting that the Volcker Rule conformance period was designed to allow banking entities to bring their activities and investments into compliance with the Volcker Rule.

4. Definition of "Ownership Interest"[24]

The covered fund investment prohibitions apply to the acquisition by a banking entity of any "ownership interest" in a covered fund. In turn, the Regulations define an "ownership interest" as any "equity, partnership, or other similar interest."

The term "other similar interest," however, includes a variety of economic interests in a covered fund that function in the manner of an equity or partnership interest, including an interest that:

- has selection or removal rights with respect to a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading adviser of the fund (excluding creditor rights associated with an event of default or an acceleration event);
- has the right to receive a share of the income, gains or profits of the fund;
- has the right to receive the underlying assets of the fund after all other interests have been redeemed and/or paid in full (excluding creditor rights associated with an event of default or an acceleration event);
- has the right to receive all or a portion of the fund's excess spread;
- may share in losses arising from the underlying assets of the covered fund;

24. *See id.* § __.10(d)(6).

 © 2014 Morgan, Lewis & Bockius LLP

- receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or
- in substance has any synthetic right to any of the foregoing rights.

The final definition of “ownership interest” is broadly consistent with the definition that was contained in the Proposed Rules, albeit more precise with respect to the types of “similar interests” (e.g., derivatives of ownership interests) that are treated as ownership interests. Importantly, and consistent with the Proposed Rules, an ownership interest does not include a carried interest, referred to in the Regulations as a “restricted profit interest.” A “restricted profit interest” is an interest held by an investment manager or other service provider to a covered fund that serves as performance compensation for such services and that is subject to certain restrictions, including that (i) its share of fund profits must either be distributed or retained as a reserve against “clawbacks” of fund distributions and may not be shared in subsequent fund gains, (ii) any amounts may not exceed the *de minimis* limits for banking entities in covered funds that they organize and offer (discussed below), and (iii) it may not be transferred (except for transfers to an affiliate or immediate family members, or in connection with the sale of the business giving rise to the interest).

5. Definition of “Sponsor”[25]

The statutory Volcker Rule defines a “sponsor” to mean (i) serving as a general partner, managing member, or trustee of a covered fund; (ii) in any manner selecting or controlling (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) sharing with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. The Proposed Rules’ “sponsor” definition essentially tracked the statutory definition, and the definition of “sponsor” in the Regulations is largely unchanged from the Proposed Rules. Some changes were made to clarify that directed trustees (trustees that do not exercise investment discretion over a fund’s investments), including trustees that are subject to the direction of an unaffiliated, non-trustee ERISA fiduciary or similar foreign fiduciary, are not treated as “sponsors” under the Regulations. In general, those directed trustees excluded from the definition of “sponsor” generally lack any ability to exercise control over a fund on an ongoing basis. The Agencies, however, have declined to create a separate “sponsor” definition for issuers of covered funds that issue asset-backed securities, noting that qualifying loan securitizations have been excluded from the definition of “covered fund.”

6. Definition of “U.S. Resident”[26]

One of the key jurisdictional limits of the Volcker Rule private fund prohibitions is that it does not apply to foreign funds that, among other things, are not offered to “residents of the U.S.” This term, which is not defined in the statute, was defined in the Proposed Rules in a manner that was similar, but not identical, to SEC Regulation S (offshore sales of unregistered securities). The Agencies have decided to conform the definition of “resident of the U.S.” in the Regulations to the definition of a “U.S. person” in Regulation S on the theory that the markets generally understand and rely on the body of law that has developed under Regulation S. This definitional decision, in turn, has consequences for the scope of the “solely outside the U.S.” exemption (discussed below) for foreign private fund sponsorship and ownership activities.

B. “Organized and Offered” Exemption[27]

The Regulations implement the key covered funds statutory exemption that permits a banking entity to acquire and retain an ownership interest in a covered fund in connection with “organizing and offering” a covered fund to its fiduciary and asset management clients so long as certain requirements are met. In order to qualify for this exemption, and subject to a number of investment limits discussed in more detail below, a banking entity:

25. *See id.* § __.10(d)(9).

26. *See id.* § __.10(d)(8).

27. *See generally id.* § __.11.

© 2014 Morgan, Lewis & Bockius LLP

- must provide "bona fide trust, fiduciary, or advisory services" and may only offer ownership interests in the covered fund to customers of these trust, fiduciary or advisory services;
- may establish the customer relationship for these services through or in connection with the organization and offering of the covered fund;
- must develop a written plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through the fund;
- may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the fund or any covered fund in which such fund invests;
- must make specified written disclosures to investors; and
- may not share the same name or a variation of the same name with the fund for corporate, marketing, promotional, or other purposes or use the word "bank" in the fund's name.

The Regulations do not materially depart from the language of the statute or the Proposed Rules. Importantly, the Regulations do not require a pre-existing customer relationship in order for a banking entity to satisfy the "bona fide trust, fiduciary, or advisory services" requirement. However, the Regulations do require a banking entity that relies on this exemption to organize and offer a covered fund pursuant to a written plan outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund. The Regulations require that the plan be credible and indicate that the banking entity has conducted "reasonable analysis" to show that the fund is organized and offered for the purpose of providing bona fide services to customers of the banking entity and not to evade the Volcker Rule.

Other key aspects of the Regulations' coverage of the "organized and offered" exemption include:

- The Regulations permit a banking entity to own an interest in a securitization vehicle that the banking entity organizes and offers so long as the banking entity complies with the restrictions noted above with two exceptions: (i) the banking entity is not required to offer ownership interests only to customers of trust, fiduciary, or investment advisory services; and (ii) the banking entity's ownership of a covered fund is limited to no more than 3% of the covered fund's ownership interests (discussed below); however, any banking entity that organizes and offers a securitization vehicle that is a covered fund, i.e., acts as a "securitizer" of that vehicle, may retain a risk interest in the securitization in excess of 3% as may be necessary to satisfy the risk retention requirements of the Dodd-Frank Act's securitization provisions.
- The Regulations expressly permit underwriting and market making–related activities for a covered fund that relies on the "organizing and offering" exemption, a point that was not addressed in the Proposed Rules. Like the general exemption for such activities conducted under the proprietary trading exemption, permitted underwriting and market making activities must be designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties.

C. Permitted Investments in a Covered Fund[28]

1. "*De Minimis*" Exemption for "Organized and Offered" Funds[29]

Consistent with the statutory Volcker Rule and the Proposed Rules, the Regulations permit a banking entity to acquire ownership interests in a covered fund so long as its investment in the fund does not, after one year from the date the fund is established, exceed 3% of the total outstanding ownership interests in the fund (the "per-fund limitation"). This investment authority, however, is limited to covered funds that a banking entity organizes and offers under the statutory exemption for such activities.

28. *See generally id.* § __.12.

29. *See id.* § __.12(a)(2).

 © 2014 Morgan, Lewis & Bockius LLP

The Regulations, as was the case with the Proposed Rules, require that a banking entity calculate its 3% per-fund limitation that are not issuing entities of asset-backed securities based on *both* the fair market value of its actual investments and capital contributions in and to each covered fund, *and* the total number of ownership interests it has actually acquired in each covered fund. In the case of master-feeder fund investments, the banking entity's investment shall be measured only at the master fund level, but its pro rata share of any ownership interest of the master fund that is held through the feeder fund must also be included. As noted above, any banking entity that organizes and offers a securitization vehicle that is a covered fund by acting as a "securitizer" of that vehicle may retain a risk interest in the securitization entity in excess of 3% as may be necessary to satisfy the risk retention requirements of the Dodd-Frank Act's securitization provisions (codified at section 15G of the Securities Exchange Act of 1934).

A banking entity that sponsors, has an advisory relationship with, or provides a guarantee to a covered fund must include any ownership interest it holds under the underwriting or market making exemptions in calculating compliance with the 3% per fund, aggregate total and capital deduction limitations governing ownership of covered funds. This would have the effect of limiting the aggregate amount of ownership interests of a covered fund that a banking entity may underwrite or make a market in to 3% of the ownership interests of the covered fund if the banking entity is simultaneously an investment adviser or sponsor of the covered fund. However, the Regulations provide an exclusion from the definition of "ownership interest" for certain types of incentive arrangements, subject to certain requirements.

A banking entity's aggregate investments in all covered funds may not exceed 3% of the banking entity's total applicable tier 1 capital calculated as of the last day of the most recent calendar quarter as reported to the banking entity's relevant federal banking agency. The aggregate value of covered fund investments is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in each covered fund, *including* any amounts paid by the entity (or employee thereof) in connection with obtaining a carried interest (or restricted profit interest), measured on a historical cost basis.

In the case of a foreign banking organization, the aggregate funds limitation is based on the consolidated tier 1 capital of the foreign banking organization, as calculated under applicable home country standards. A U.S. bank or savings and loan holding company that is controlled by a foreign banking entity must separately meet the investment limitations based on the U.S. tier 1 capital of the company.

In addition, all director or employee investments in a covered fund must be attributed to the banking entity under the per-fund and aggregate funds limitations whenever the banking entity provides the employee or director funding to acquire the ownership interest. Restricted profit interests acquired by such persons, however, must be attributed to the banking entity regardless of the presence or absence of such funding.

A banking entity's permissible covered fund investments must be deducted dollar-for-dollar from its tier 1 regulatory capital. In this regard, the Regulations require in general that the banking entity must deduct the greater of historical cost or fair market value of all its covered fund investments from its tier 1 capital. In the case of foreign banking organizations, they are not required to make this capital deduction under their home-country standards for direct, branch or agency covered fund investments, but their U.S. bank or bank holding company subsidiaries that make such investments must deduct their investments from their U.S. regulatory capital.

2. Seeding Activities

The Volcker Rule allows a one-year period for covered fund "seeding" activities where a banking entity's ownership interest in a covered fund may exceed the 3% cap. The Regulations provide that the seeding period begins with the date a fund is "established," meaning the date on which the fund's investment adviser party begins to make investments that execute an investment or trading strategy for the covered fund. In the case of a covered fund that is an asset-backed securities issuer, the issuer is "established" on the date on which the assets are initially transferred to the issuer. In addition, the Regulations require a covered fund to develop and document a plan for offering shares to non-affiliated other investors and conforming the sponsoring banking entity's investments to the *de minimis* limits.

 © 2014 Morgan, Lewis & Bockius LLP

3. Attribution of Ownership Interests[30]

In a change from the Proposed Rules, the Regulations provide that a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations *only* if the investment is made by the banking entity or another entity controlled by the banking entity.

In another departure from the Proposed Rules, the Regulations do not treat parallel (or side-by-side) investments made by a banking entity in a company alongside an "organized and offered" fund as being directly subject to the covered fund ownership prohibitions, nor do they consider such investments for purposes of calculating the banking entity's compliance with the per-fund or aggregate funds limitations, subject to certain limitations suggested by the Agencies in the accompanying discussion that are designed to prevent evasion of the general Volcker Rule fund investment prohibitions.

4. Extensions of Permitted Investment Periods

The Regulations provide that written banking entity requests for extensions of the conformance period provided for the per-fund limitation must be submitted to the Federal Reserve Board at least 90 days prior to the expiration of the applicable time period, and include the reasons why the banking entity believes the extension should be granted, including a discussion of relevant statutory factors that the Federal Reserve Board must consider in order to rule on the extension. The request, which may be granted, denied or conditioned at the Federal Reserve Board's discretion, also must explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods to the limits imposed by the final rule.

5. Hedging Activities[31]

The Regulations allow a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge, but only with respect to an ownership interest that is designed to "demonstrably reduce" or "significantly mitigate the specific, identifiable risks" to the banking entity in connection with a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to the fund. Banking entities relying on this exemption must create and implement a compliance program to ensure compliance with the conditions of this exemption.

This limited availability of the hedging exemption for covered funds is narrower than that proposed in the Proposed Rules, which also would have allowed the acquisition of covered fund ownership interests when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund. The Agencies not only generally rejected multiple commenter requests for an expansion of the hedging exemption, but also concluded that allowing a banking entity to hedge customer exposures was a high-risk activity that was inconsistent with the purposes of the Volcker Rule.

D. Insurance Company Activities

In an expansion of the Proposed Rules' exemption for insurance company activities, the Regulations exempt the acquisition or retention by a domestic or foreign insurance company, or an affiliate thereof, of any ownership interest in, or the sponsorship of, a covered fund, subject to three conditions:

- The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company;

30. *See id.* § __.12(b)(1).

31. *See generally id.* § __.13(a).

 © 2014 Morgan, Lewis & Bockius LLP

- The acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which such insurance company is domiciled;
- The federal banking agencies, after consultation with the Financial Stability Oversight Council or the relevant state or foreign insurance commissioners, have not jointly determined, after notice and comment, that a particular insurance law, regulation, or written guidance is "insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States."

Although the exemption for insurance company general account activities is contained in the statutory Volcker Rule, the Agencies have extended the Regulations' exemption to qualifying foreign insurance company activities, as well as separate account activities. Note, however, that the Regulations appear in separate sections to both exclude from the "covered fund" definition, and exempt, certain insurance company separate accounts, so it is not altogether clear how the additional provisions of the Volcker Rule relating to transactions between a banking entity and a covered fund (see subsection F below), and the restrictions on high-risk transactions and activities (see discussion below), will apply to these separate accounts.

E. Treatment of Foreign Funds

1. Foreign Public Funds[32]

The Regulations create a conditional exclusion for "foreign public funds" that are sold outside of the United States. This exclusion applies to covered funds (i) that are organized or established outside of the United States, (ii) the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction, (iii) that are sold predominantly through one or more public offerings outside of the United States (namely, 85% or more of the fund's interests are sold to non-U.S. residents), and (iv) that are sold predominantly (again, 85% or more of the fund's interests) to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of these entities.

2. Covered Funds Offered "Solely Outside of the U.S."[33]

Consistent with the statutory exemption, the Proposed Rules would have allowed a foreign banking entity (but not a U.S. banking entity) to acquire or retain an ownership interest in, or act as sponsor to, a covered fund if (i) the activity or investment is conducted by a banking entity pursuant to Bank Holding Company Act subsection 4(c)(9) or 4(c)(13); (ii) the activity occurs "solely outside of the U.S."; (iii) no ownership interest in such fund is offered for sale or sold to a "resident of the United States"; and (iv) the banking entity is not directly or indirectly controlled by a U.S. banking entity.

In general, this exemption is available only to qualified foreign banking organizations within the meaning of Federal Reserve Board Regulation K, or to those foreign banking organizations (such as savings and loan holding companies) that can demonstrate their compliance with the U.S./worldwide banking assets, income or revenue requirements of Regulation K that are applicable to qualified foreign banking organizations.

The Regulations carry this forward from the Proposed Rules, albeit with some significant changes—the principal change being a transition to a "risk-based approach" consisting of the following elements:

- The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the United States;
- The investment or sponsorship, including any related hedging transactions, is not accounted for as principal in the United States;

---

32. *See id.* § __.10(c)(1).

33. *See id.* § __.13(b).

 © 2014 Morgan, Lewis & Bockius LLP

- Ownership interests in the covered fund are not targeted to residents of the United States; and
- No financing for the banking entity's ownership or sponsorship is provided by a U.S. affiliate of the foreign banking entity.

As noted previously, the definition of a "resident of the United States" has been aligned with the definition of a "U.S. person" under SEC Regulation S. As a result, a foreign covered fund offering that is "targeted" at non-U.S. persons within the meaning of Regulation S would generally satisfy the non-U.S. resident element of the Regulations. At the same time, the acquisition of a foreign private fund's ownership interest by any U.S. resident will raise questions as to the fund's compliance with the "solely outside of the U.S." exemption.

In addition, the Regulations allow a foreign private fund to effect portfolio transactions on or through public third-party U.S. exchanges, marketplace facilities or clearinghouse facilities. The exemption also will permit U.S. personnel to perform certain investment advisory activities and back-office administrative functions that are not related to the sponsorship or acquisition of ownership interests in a covered fund.

F. Limitations on Transactions and Relationships with a Covered Fund[34]

The Volcker Rule generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund, or that "organizes and offers" a covered fund (discussed below), from entering into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act (FRA)(bank transactions with affiliates). Under the Regulations, this prohibition does not prohibit permitted *de minimis* investments made under the "organized and offered" exemption discussed above.

The statute provides for one relatively narrow conditional exemption for prime brokerage transactions between a banking entity and a covered fund in which a covered fund managed, sponsored, or advised by that banking entity has taken an ownership interest. In addition, the statutory Volcker Rule subjects any otherwise exempt covered fund transaction between the banking entity and covered fund to the affiliate transaction restrictions of section 23B of the FRA, including the market terms (or arm's-length) requirements thereof, meaning that such transactions or relationships must be on terms and under circumstances that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving other unaffiliated companies, or that in good faith would be offered or would apply to unaffiliated companies.

The Regulations do not materially modify this so-called "super 23A" prohibition, nor do they materially depart from the Proposed Rules. In this regard, the Regulations generally apply the super 23A prohibition and section 23B restrictions substantially as written, and do not incorporate section 23A's statutory exemptions. In a mildly helpful clarification, the Agencies stated that only banking entity transactions *with* a covered fund are subject to the Volcker Rule prohibitions, stating that transactions between a banking entity and a third party that is not a covered fund is not subject to these prohibitions and restrictions (using securities margin lending transactions secured by covered shares as an example of this point). Even so, the clarification does not indicate whether banking entity transactions with third parties that are subject to the section 23A "attribution rule" (where the proceeds of a third-party transaction are transferred to or used for the benefit of an affiliate) would be excluded under this reading.

With respect to the conditional exemption for prime brokerage transactions, the Regulations make no material changes from the Proposed Rules, but do incorporate within the definition of "prime brokerage" transaction a reference to the definition of "covered transactions" under section 23A. In this manner, the Regulations avoid any ambiguity as to whether prime brokerage activities that do not constitute "covered transactions" might be subject to the Volcker Rule restrictions.

34. *See generally id.* § __.14.

 © 2014 Morgan, Lewis & Bockius LLP

High-Risk Trading and Covered Fund Activities[35]

The statutory Volcker Rule prohibits a banking entity from engaging in an otherwise exempt trading or fund activity or making an exempt investment if the activity or investment would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States, or if the activity or investment involves a "material conflict of interest between a banking entity and its clients, customers, or counterparties" or "high-risk assets or trading strategies." These restrictions apply to trading and private fund–related activities that are exempt from the general Volcker Rule prohibitions; they do not apply to trading and fund activities (in particular the latter) that are *excluded* by statute or regulation from the coverage of the Volcker Rule.

The Proposed Rules created a framework for the disclosure of conflicts of interest and the requirements for managing such conflicts, and generally restated the statutory prohibitions against transactions and activities that posed safety and soundness or financial stability risks. The Regulations do not materially depart from the Proposed Rules with regard to these conflicts and prudential matters.

Under the Regulations, a banking entity would be prohibited from engaging in exempted trading activities if the transaction would involve or result in a "material conflict of interest" between the banking entity and its client, customers or counterparties. In turn, a "material conflict of interest" exists if the banking entity's interests in any covered transaction or activity are materially adverse to the interests of its client, customer, or counterparty in a transaction or activity, unless the banking entity:

- makes prior timely disclosure to the client, customer or counterparty of clear and meaningful information regarding the conflict; or
- creates and enforces information barriers, such as physical separation of personnel or functions, that address the conflict.

Under this construct, a client, customer or counterparty would have the opportunity to "substantially mitigate" the conflict or adverse effect. The Agencies determined not to require a total mitigation of the conflict, but also declined to accept commenter requests that a party's waiver of, or consent to, the conflict be sufficient to comply with the relevant Volcker Rule prohibitions.

The Volcker Rule, as implemented by the Regulations, also prohibits any transaction or activity that would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies, each of which are defined as transactions or strategies that would "significantly increase the likelihood" that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. The Agencies, however, provided little gloss on the meaning of these terms, other than to reserve for themselves the authority to address these issues through later regulatory or supervisory action.

Compliance and Reporting Requirements[36]

The Regulations require banking entities engaged in proprietary trading or covered fund activities and investments to develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule and the Regulations, based on a tiered approach calibrated to the size, complexity and activities of a banking organization. In addition, the Regulations specify a variety of data collection and reporting requirements that are applicable primarily to banking entities that are engaged in proprietary trading activities.

35. *See generally id.* §§ __.7, __.15.

36. *See generally id.* § __.20.

© 2014 Morgan, Lewis & Bockius LLP

These compliance program and reporting requirements generally were included in the Proposed Rules, but attracted a significant amount of negative comments raising concerns about the costs and burdens of these requirements, and their suitability for smaller, less complex banking organizations. While the substance of the compliance program and reporting requirements in the Regulations carries forward the basic tiered framework and substance of the requirements set forth in the Proposed Rules, the Agencies have made several adjustments to these requirements in an effort to more closely align their elements with the size, complexity and activities of the banking entity.

A. Compliance Requirements[37]

The Agencies have implemented these requirements in the Regulations as follows:

- All banking entities with $10 billion or more in total assets must create and implement a compliance program that contains six elements:
  - Written policies and procedures reasonably designed to document, describe, monitor and limit impermissible and exempt trading activities, including setting, monitoring and managing (i) required trading limits required under the Regulations, and (ii) covered fund activities subject to the Regulations to ensure that all activities and investments conducted by the banking entity that are subject to the Volcker Rule comply with the Volcker Rule and the Regulations;
  - A system of internal controls reasonably designed to monitor compliance with the Volcker Rule and the Regulations, and prevent the occurrence of prohibited activities or investments;
  - A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and the Regulations and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention;
  - Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;
  - Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
  - Records sufficient to demonstrate compliance with the Volcker Rule and the Regulations, which a banking entity must promptly provide to its principal supervisory agency upon request and retain for a period of no less than five years.
- Banking entities that (i) have total consolidated assets of $50 billion or more (or $50 billion or more in total U.S. assets for foreign banking entities), (ii) engage in significant permitted proprietary trading, or (iii) have been notified in writing by their principal supervisory agencies will be required to create and implement an enhanced compliance program. The major elements of this enhanced program are:
  - identification, monitoring and reporting of permitted trading and fund activities and investments, and their risks, and prevention of activities or investments that do not comply with the Volcker Rule;
  - “appropriate limits” on covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments;
  - periodic independent review and testing, and ensuring the effectiveness and independence of participating internal audit, corporate compliance and internal control functions;
  - senior management accountability for the effective implementation of the compliance program, and board of directors and chief executive officer review of the effectiveness of the compliance program; and
  - facilitating agency supervision and examination of permitted trading and covered fund activities and investments.
- For smaller banking entities, the Agencies have modified the compliance program requirements set forth in the Proposed Rules. Specifically:
  - A banking entity that does not engage in permitted covered activities or investments, other than trading activities in domestic federal or state obligations, must only establish the required compliance program prior to becoming engaged in such activities or making such investments.

37. *See id.* § __.20(a)-(c).

 © 2014 Morgan, Lewis & Bockius LLP

– A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in permitted covered activities or investments, other than trading activities in domestic federal or state obligations, may include in its existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule and the Regulations, and adjustments "as appropriate given the activities, size, scope and complexity of the banking entity."

B. Reporting Requirements[38]

Banking entities that have significant trading assets and liabilities are subject to additional proprietary trading reporting requirements. In general, these requirements will require banking entities to report regularly on their trading activities for each trading desk and include data on seven quantitative measures (risk and position limits and usage, risk factor sensitivities, value-at-risk (VaR) and stress VaR, comprehensive profit and loss attribution, inventory turnover, inventory aging, and customer-facing trade ratio). These reporting requirements must be incorporated into the banking entity's required compliance program. The primary purpose of this reporting framework will generally be to allow banking entities, and the Agencies, to better understand the nature, scope, profile and risks of their trading activities, monitor those trading activities, promote compliance with the Volcker Rule's permitted trading activity exemptions and other requirements, and enable the Agencies to plan their examination activities with respect to such activities. The Regulations stress that the quantitative measurements to be furnished to the Agencies "are not intended to serve as a dispositive tool for the identification of permissible or impermissible activities." The Agencies have delayed all reporting until July 2014 and phased in the requirements, noting that by September 2015 they expect to evaluate the data for its usefulness in detecting impermissible trading activity or excessive risk-taking, and its costs.

The level of trading assets and liabilities that triggers these additional reporting requirements is established as a threshold amount that declines over the first two years of the Regulations' implementation. Thus, the trading assets/liabilities threshold for reporting under these additional requirements is initially fixed at $50 billion beginning on June 30, 2014, and declines to $25 billion beginning on April 30, 2016, and $10 billion beginning on December 31, 2016. In the case of a foreign banking entity, these thresholds are applied to its combined U.S. operations, including all subsidiaries, affiliates, branches and agencies operating, located or organized in the United States. These thresholds all are measured by reference to the average gross sum of trading assets and liabilities over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, excluding trading assets and liabilities involving obligations issued or guaranteed by the United States or a U.S. agency.

In addition, the Agencies have reserved the right in the Regulations to impose these additional reporting requirements by prior written notice to other specific banking entities.

Authority to Address Violations, or Terminate Activities or Investments[39]

The Regulations include a separate provision broadly allowing the Agencies to require the termination of impermissible trading and covered fund activities, and impose penalties for violations of the Volcker Rule and the Regulations. The final requirements track those contained in the Proposed Rules, albeit with the following clarifications:

- The Agencies declined commenter requests to allocate among the Agencies, or require coordination of, examination and enforcement activities, stating that each Agency has the authority to require banking entities under its jurisdiction to terminate activities or investments that violate or act as an evasion of the Volcker Rule and the Regulations.

38. *See id.* § __.20(d).

39. *See id.* § __.21.

 © 2014 Morgan, Lewis & Bockius LLP

- The Agencies clarified that the enforcement authority provided in the Regulations is not exclusive of other enforcement and compliance authorities that the Agencies otherwise may have.

Some Observations on the Volcker Rule and the Regulations

A. The Regulations' Impact on Banking Organization Constituencies

In the last few months leading up to the adoption of the Regulations, there was substantial concern in sectors of the financial industry that the final Volcker Rule regulations could be very stringent. Among other developments, there was a widespread expectation that the Agencies would materially limit the scope of the risk mitigating hedging exemption by excluding general portfolio hedging from its coverage, in response to the perception—accurate or not—that the "London Whale" and LIBOR developments that emerged in 2012 demonstrated the need for strong limits on bank proprietary trading. In addition, media reports of disagreements among the Agencies that were fueled in part by reports of certain Agency officials pressing for more stringent limits on trading activities again suggested that the Volcker Rule regulatory implementation process could well lead to "tougher" regulations than even those proposed in the Proposed Rules. By the same token, early expectations—or hopes—arising in the period after the publication of the Proposed Rules that the Agencies might demonstrate flexibility, if not forbearance, in the rule-writing process had become quite muted by the fall of 2013.

When viewed against this backdrop, the case can be made that the final Regulations were not as stringent as they might have been (although as discussed below, community banks that hold TruPS CDOs may not agree with this assessment). Here is a brief look at the major constituencies affected by the Volcker Rule (some of which are overlapping), and how they fared under the final Regulations.

1. Large Banking Organizations

The large banking organizations are the banks that are most affected by the Volcker Rule, of course—the large (if not vast) majority of proprietary trading activities affected by the Volcker Rule resides in this constituency, and these banking organizations also are more likely to be active in private fund sponsorship and investment activities that fall under the Volcker Rule. The major adverse (from the banking industry's standpoint) change that was made to the Regulations as adopted was the exclusion of general hedging activities from the scope of the risk-mitigating hedging exemption, but by mid-2013, this change was entirely expected. The general trading prohibitions otherwise were left intact without major modifications—again, this result was generally expected—but some modifications to the required elements of the underwriting and market making exemptions might make reliance on these particular exemptions somewhat less cumbersome for affected banking organizations.

For example, the Agencies have made a generally good effort to address industry comments on many of the shortcomings in the market making exemption from the Proposed Rules. As highlighted above, presumptions of proprietary trading in Appendix B and a liquid equities focus have been replaced by Regulations and preamble discussions that acknowledge differences in trading characteristics among different asset classes and particular financial products. There has also been a marked shift from a potential trade-by-trade analysis, or perhaps even a game of "spot the prop trade," to a seemingly more reasonable approach that takes into account the very real differences in what it means to make markets in different financial products. In addition, the number of quantitative measurements that must be reported has been significantly reduced, and those that remain seem to have been chosen for their predictive value in making distinctions between permissible and impermissible activities, but that is subject to some debate. The Agencies have also made it clear that they intend to use the reported quantitative measurements to learn about the trading characteristics of particular markets and that they will evaluate their value and may make changes to the requirements, and one hopes this will lead to productive dialogues between banking entities and their regulators. While these are positive developments, it should also be noted that the definition of "trading desk" is still quite strict (it is the "smallest discrete unit of organization") and it remains to be seen how the Agencies will attempt to make comparisons or perform horizontal reviews across banking entities, and whether organizational differences among competitors will adversely affect the value of any of the reported quantitative measurements.

 © 2014 Morgan, Lewis & Bockius LLP

A number of changes were made to the scope and impact of the private funds prohibitions, in particular the Agencies' decision to exclude a number of private fund–like structures from the definition of a "covered fund," thus excluding them altogether from the coverage of the Volcker Rule, including its "super 23A" prohibition and high-risk transaction restrictions. These changes may prove helpful for the large bank community, including for activities such as qualifying loan securitizations, joint venture and acquisition activities, regulated general and separate account activities (for insurance companies), and bank-owned life insurance transactions. In addition, the "organized and offered" exemption was adopted in substantially unchanged form from the Proposed Rules, albeit with a helpful clarification that the availability of this particular exemption does not depend on the existence of a preexisting relationship with trust, fiduciary and asset management customers. Less helpful, however, was the Agencies' unwillingness to exclude or exempt other fund structures (e.g., loan "resecuritization" and pass-through REIT structures) from the applicability of the Volcker Rule; in this regard, the Agencies either seemed reluctant to depart from what they believed were the plain terms of the statute itself or believed that additional exclusions for these other activities could create the risk of evasive activities.

2. Community and Smaller Regional Banks

Most community banks are not actively engaged in "pure" proprietary trading activities of the sort subject to the Volcker Rule, with the possible exception of trading in U.S. government, agency and municipal obligations, which are exempt trading activities. Community banks can be involved, however, in liquidity management, risk-reducing hedging activities, and customer-facing activities, and, as a result, they will need to pay attention to the framework and conditions for relying on these exemptions. In addition, most community banks are not actively involved in the sponsorship of covered private funds, but they may invest in third-party private funds structures, including asset securitization vehicles (and TruPS CDOs), for a variety of legitimate reasons. In turn, these activities will now be subject to the limits and conditions of the Volcker Rule and the Regulations, including the compliance program and management requirements. In this regard, the Agencies did make efforts in the Regulations to accommodate community banks and smaller regional banks by reducing the compliance management obligations on banks that are not actively engaged in covered trading and fund activities. It remains to be seen, however, whether these promised burden reductions actually will materialize because even those banking organizations that engage in no regulated trading or fund activities still will need to ensure that they are not, even inadvertently, engaging in covered trading and private funds activities.

3. Foreign Banking Organizations

Foreign banking organizations obtained important and sensible relief from the Agencies' exclusion of foreign public funds from the definition of a covered fund, and the decision to recast the "solely outside of the U.S." exemption in risk-based rather than transactional terms. These changes alleviated some of the problematic extraterritorial consequences of the Proposed Rules and afford foreign banking organizations continued access to public U.S. trading and clearing facilities without being in violation of the Volcker Rule. Further, the Agencies' decision to allow trading in foreign sovereign obligations will help address some concerns that the Volcker Rule, as applied by the Agencies in the Proposed Rules, would have an unnecessary adverse impact on the global markets for sovereign obligations. At the same time, foreign banking organizations otherwise will face the same questions and challenges in the applicability of the Volcker Rule and the Regulations to their U.S. activities as is the case with their U.S. counterparts.

B. The Compliance Challenges

In some instances, the Regulations expressly require that banking organizations proposing to rely on one or more of the key trading and covered fund exemptions, such as underwriting, market making, liquidity management, and private funds offerings to fiduciary and asset management clients, do so in accordance with a written plan or compliance program that specifies the nature, scope and risks associated with those activities, and how those activities will comply with the Volcker Rule and the Regulations. Even for those activities where a plan or program is not expressly required as part of the activity in question, it is unwise for banking organizations to take an ad hoc approach to conducting covered activities, even those that are permissible. Instead, banking organizations will need to develop and document in advance written programs, policies and procedures that will define the activities in question and demonstrate how those activities, and the manner in which they are conducted and overseen, will

 © 2014 Morgan, Lewis & Bockius LLP

be consistent with the Volcker Rule and the Regulations. Banking organizations also may safely assume that their primary regulatory agencies will be closely scrutinizing these plans and programs, and will criticize those that do not, in their view, provide reasonable assurances of Volcker Rule compliance.

Notwithstanding some of the accommodations that the Agencies made in the Regulations with respect to the Volcker Rule compliance programs and accompanying reporting data that are required, banking organizations that are active in the trading and private funds environments will still face the substantial and time-consuming task of developing the necessary systems to implement and enforce the required programs, and collecting and reporting the required data. What may complicate this task, however, are two factors. First, at this time the Agencies themselves probably do not fully know what they want to see in an acceptable activity plan or compliance program. As a consequence, the framework and particulars of a satisfactory plan or program may well be a regulatory work in progress where banking organizations will have to adjust and adapt to the inevitable changes in Agency thinking on the subject. Second, there is the risk that the Agencies may diverge in their interpretation and enforcement of the Volcker Rule and the Regulations, which would create formidable compliance challenges for banking organizations in general, but in particular for those conducted in multiple affiliates and business units that are subject to the jurisdiction of more than one regulatory agency. In adopting the Regulations, the Agencies declined to commit to any formal requirement for the coordination of supervisory or enforcement action, although they stated that such coordination was, in effect, standard operating procedure. While by all accounts it would be counterproductive regulatory and public policy for the Agencies not to apply uniform standards of compliance and supervision to their Volcker Rule regulatory and supervisory activities, banking organizations cannot automatically assume that this will be the case, and they will need to engage each of their primary regulatory agencies with regard to the regulatory and supervisory priorities and expectations of the latter.

C. The Problem of TruPS CDOs

That the Regulations already are being challenged in court, albeit on narrow legal grounds, may be a fitting coda to the regulatory headaches surrounding the Agencies' efforts to implement a complex and controversial statute. The legal problem created by the TruPS CDO controversy, however, is one that the banking Agencies, at least, could and should have readily been able to avoid. Instead of simply excluding these particular instruments—which were helpful several years back in allowing community banks to raise regulatory capital—from the definition of a covered fund, the banking Agencies issued an interpretive release on TruPS CDOs that not only provided no relief of any kind, but also had the effect—intended or otherwise—of telling the community banks that they would need to dispose of their TruPS CDO holdings by the end of the Volcker Rule conformance period. At this point, generally accepted accounting principles (GAAP) have taken over by requiring banks holding these instruments to determine if they are "impaired" for GAAP purposes, and then having to mark down the value of their TruPS CDOs if they were determined to be impaired. With the close of a periodic—and for many banks, annual—accounting period approaching, the banking industry has felt compelled to challenge the Agencies' intended application of the Volcker Rule to TruPS CDOs in federal district court and the U.S. Court of Appeals.

There are at least three lessons that emerge from this situation. One obvious lesson is that the Agencies will need to be cautious, going forward, as to how they further formulate the boundaries of the Volcker Rule through regulations, interpretation, or supervision and enforcement. Second, the banking industry will need to pay close attention to how the Agencies actually implement and enforce the Volcker Rule and the Regulations through the supervision and enforcement processes. While the TruPS CDO matter is a visible example of how Agency regulatory and supervisory actions may unexpectedly affect the contours and the impact of the Volcker Rule, how the Volcker Rule regulatory framework will be influenced by regulatory actions over the medium to long term may not always be as obvious. Finally, it is inevitable, given the complexity of the Volcker Rule framework, that the Agencies will make mistakes in the regulatory implementation process; indeed, in the case of the TruPS CDOs, they have made one—if only because it is difficult at best to justify the treatment of TruPS CDOs as covered funds as necessary to promote the core purposes of the Volcker Rule—and the optimal solution for all concerned would be for the banking Agencies to step up to the plate and make the necessary adjustments. Indeed, the

© 2014 Morgan, Lewis & Bockius LLP

Agencies announced on December 27[40] that in response to community bank concerns, they were reviewing the treatment of TruPS CDOs under the Volcker Rule, an action that hopefully will lead in the short term to a revised and more logical outcome.

Final Thoughts

One very likely outcome of the Volcker Rule—as has been true for much of the Dodd-Frank Act—is that it and the Regulations will lead to a number of unintended consequences in the financial markets. This is not because the Volcker Rule and the Regulations will have consequences that are intended or known, but instead it is the connections that may exist between its intended, known and unintended consequences that may lead to more problematic outcomes for the financial services industry.

At its core, the Volcker Rule is supposed to limit banking organizations' involvement in high-risk proprietary trading and private fund sponsorship and investment activities, and we have seen a number of the banking organizations that have been active in the trading and fund sponsorship businesses already terminate or reduce their involvement in those activities. That is an intended consequence with an expected outcome. Similarly, the Agencies' decision *not* to exclude various fund structures from the Volcker Rule's coverage was done with the full knowledge, and presumably intent, that affected market participants—primarily the banks sponsoring or owning these funds, as well as the funds themselves and their managers—would have to either cease or reconfigure their activities in order to comply with the Regulations. But these decisions will lead to other unknown consequences, some of which (unlike the TruPS CDO matter) may not be readily apparent for some period of time.

Contacts

If you have any questions or would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis lawyers:

Washington, D.C.

Charles M. Horn	202.739.5951	chorn@morganlewis.com
Julie A. Marcacci	202.739.5160	jmarcacci@morganlewis.com

New York

William Iwaschuk	212.309.6680	wiwaschuk@morganlewis.com
Kaitlyn L. Piper	212.309.6275	kpiper@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 25 offices across the United States, Europe, Asia, and the Middle East, Morgan Lewis provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labor and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. Our international team of lawyers, patent agents, benefits advisers, regulatory scientists, and other specialists—more than 1,600 legal professionals total—serves clients from locations in Almaty, Beijing, Boston, Brussels, Chicago, Dallas, Dubai,* Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Moscow, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

*In association with Mohammed Buhashem Advocates & Legal Consultants

This White Paper is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2014 Morgan, Lewis & Bockius LLP. All Rights Reserved.

40. View the announcement at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131227a1.pdf.