SHEARMAN & STERLING LLP

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY, INVESTMENT FUNDS

CLIENT PUBLICATION

January 2, 2014

Volcker Unbound

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling lawyer or any of the following:

Contacts

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Donald N. Lamson
Washington, DC
+1.202.508.8130
donald.lamson@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Bjorn Bjerke
New York
+1.212.848.4607
bjorn.bjerke@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Geoffrey B. Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

The regulation that will implement the Volcker Rule was finally issued on December 10, 2013. Major financial institutions around the world will have to review a host of activities and investments in order to comply with the new regime. We discuss below in detail the Rule's prohibition on proprietary trading, its prohibition on sponsoring and investing in private funds, and the impact of these prohibitions on those banking institutions that are headquartered outside the United States. Compliance with the full regulation will be required by July 21, 2015.

Immediately below is a brief summary of the Volcker Rule and the proceedings leading to the final action. Following the summary are separate sections that explain and discuss the significant aspects of the regulation: proprietary trading, private funds, and the impact on banks headquartered outside of the United States. A brief discussion of international ramifications of the Volcker Rule follows.

Shearman & Sterling has prepared the Volcker Assistant©, which may be of use to institutions as they demonstrate required good faith compliance with the rule.[1]

Background

The Statute

The Volcker Rule was enacted in 2010 by the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank").[2] In general, it prohibits banking institutions operating in the United States from engaging in proprietary trading activities and from

[1] For further information about the Volcker Assistant©, you may wish to visit our micro-site, *available at* http://www.volckerassistant.com/.

[2] The Volcker Rule is in Section 619 of Dodd Frank, Pub. L. No. 111 203, 124 Stat. 1376 (2010), adding new Section 13 to the Bank Holding Company Act of 1956, as amended ("BHCA"), and codified at 12 USC § 1851. Hereinafter, the statute will be referred to as the "Volcker Rule" or the "Statute".

Contacts (cont.)

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Jesse P. Kanach
Washington, DC
+1.202.508.8026
jesse.kanach@shearman.com

Christina Broch
Washington, DC
+1.202.508.8028
christina.broch@shearman.com

Sylvia Favretto
Washington, DC
+1.202.508.8176
sylvia.favretto@shearman.com

Christian Gloger
New York
+1.212.848.8241
christian.gloger@shearman.com

Mak Judge
London
+44.20.7655.5182
mak.judge@shearman.com

Laura Schnaidt
New York
+1.212.848.5115
laura.schnaidt@shearman.com

sponsoring or investing in private funds. A variety of exceptions permit some amount of trading as principal, both for the purpose of satisfying client demands and of hedging the institution's risks, the sponsorship of private funds for purposes of satisfying fiduciary client demands, and some amount of activity outside the United States that would otherwise be impermissible.

While most of the discussion of the impact of the Volcker Rule has focused on risk reduction in commercial banking organizations, the main impetus is cultural, according to former Federal Reserve Chairman Volcker, whose proposal in early 2010 led to its enactment. He explained in a speech:

> The justification for official support and protection of commercial banks is to assure maintenance of a flow of credit to business and individuals and to provide a stable, efficient payment system. Those are both matters entailed in continuing customer relations and necessarily imply an element of fiduciary responsibility. Imposing on those essential banking functions a system of highly rewarded—*very* highly rewarded—impersonal trading dismissive of client relationships presents cultural conflicts that are hard—I think really impossible—to successfully reconcile within a single institution.[3]

Despite this justification, almost all of the discussion surrounding the detailed requirements that would enforce the Volcker Rule has focused on the riskiness, or lack thereof, of various activities and investments. Partly this is due to the difficulties that regulatory agencies, especially lawyers, meet when attempting to establish a culture, and in part due to the political process that shaped the Volcker Rule in its final form, where the desire to prohibit future "bail-outs" of global financial institutions came to the forefront. The result is that the resulting requirements focus on the dangers to banking institutions of various activities rather than former Chairman Volcker's concern about highly rewarded impersonal trading polluting client-based business. The two concepts overlap, of course, but client-based activities can nevertheless give rise to significant risks. This leaves a genuine concern that the implementation of the Volcker Rule has gone beyond the concept that underlies it.

The Volcker Rule's prohibition of proprietary trading—for the institution's own account and profit—in financial instruments while allowing customer-serving activities in those same types of financial instruments is at the heart of the difficulty of fashioning a set of detailed requirements intended to implement the prohibition. Similarly, the prohibition on sponsoring or investing in private funds while allowing the sponsorship of such funds in connection with fiduciary activities, again for the purpose of serving customers, entails

3 Paul Volcker, William Taylor Memorial Lecture (Sept. 23, 2011) (emphasis in original).

difficult compromises. The application of the prohibitions and the exceptions is significantly exacerbated when the cross-border activities of institutions are taken into account.

The Regulation

Five Federal regulatory agencies are responsible for interpreting and enforcing the Volcker Rule: the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), and Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies"). Each one is responsible for certain types of financial institutions with an overlap in certain cases.[4]

The Agencies issued a notice of proposed rulemaking in October 2011 (the "2011 Proposal").[5] After more than two years, the Agencies issued a final regulation, uniform among all of them (the "Final Regulation"), in order to provide detail on how banking institutions are to comply.[6] In addition, the Final Regulation imposes a compliance and reporting regime intended to enforce the limits on permissible activities in order to avoid evasions of the main prohibitions.

Effective Date and Period to Conform

The Statute provided that it would become effective two years after enactment, or on July 21, 2012, and that banking entities subject to its requirements would have two more years, until July 21, 2014, to bring existing activities and investment into conformity with final regulations, with authority granted to the Federal Reserve to extend the conformance period, one year at a time, for a total of no more than three additional years.[7] The Federal Reserve in 2012 issued a statement that banking entities should "engage in good-faith planning efforts" in order to be prepared to

[4] For example, the SEC is the primary Federal supervisor of registered broker-dealers, while the Federal Reserve has general "umbrella" supervisory authority over all non-bank subsidiaries of bank holding companies, a category that applies to almost all of the major financial organizations in the United States and a large number of organizations headquartered outside of the United States.

[5] 76 Fed. Reg. 68,846 (Nov. 7, 2011). If you wish to obtain further information on the 2011 Proposal, you may wish to review our client memorandum issued at that time, "In the Eye of the Beholder: The Volcker Rule Proposal and What It Means" (Oct. 27, 2011), *available at* http://www.shearman.com/~/media/Files/NewsInsights/Publications/2011/10/In%20the%20Eye%20of%20the%20Beholder%20The%20Volcker%20Rule%20Prop__/Files/View%20full%20memo%20In%20the%20Eye%20of%20the%20Beholder%20%20The%20V__/FileAttachment/IntheEyeoftheBeholderTheVolckerRuleProposalandWh__.pdf.

[6] The text of the Final Regulation and the supplemental information explaining the decisions made by the agencies (called the "Preamble") can be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf and http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf, respectively. The 2011 Proposal took 127 pages in the Federal Register and posed 383 substantive numbered questions on which comment was requested. The Final Regulation has not yet appeared in the Federal Register, but the version currently available sets out the Final Regulation in 71 pages and the Preamble in 882 pages.

[7] 12 USC § 1851(c). The provision set the effective date as the earlier of 12 months after the issuance of final rules or two years after the date of enactment. Because the Final Regulation has been issued so much later than contemplated, the July 2014 conformance date is the important one.

implement final rules when issued.[8] Because the Final Regulation has been issued only six months before the July 2014 conformance date, the Federal Reserve issued an order granting a one-year extension to all banking entities until July 21, 2015, noting that it would monitor developments to see if a further extension would be appropriate.[9]

Litigation was commenced on December 23 by the American Bankers Association and several US banks requesting a stay of one portion of the Final Regulation pertaining to impermissible investments in certain collateralized debt obligations ("CDOs") that may be covered funds.[10] The substantive issue is discussed below. The petition requests a stay of enforcement of at least the relevant portion. Further proceedings in the litigation have been delayed until mid-January 2014.

Proprietary Trading

Introduction and Executive Summary

The headline hallmark of the Volcker Rule is the prohibition on proprietary trading by "banking entities."

The Volcker Rule prohibits trading as principal for the trading account of a banking entity in specified financial instruments. Equally important, it provides for multiple exemptions permitting principal trading including underwriting, market-making, hedging, and activities solely outside the United States. Each of these terms is freighted with meaning. In addition, each of the exemptions is itself a complex mix of detailed criteria and interpretation.

The Basic Prohibition: Trading as Principal by a Banking Entity in Specified Financial Instruments

Simply enough, the Volcker Rule prohibits banking entities from engaging in proprietary trading. However, the complexity begins there: proprietary trading is generally defined as "engaging as principal for the trading account of the banking entity in any transaction to purchase, sell, or otherwise acquire or dispose of" specified "financial instruments."

Definitions

"Financial Instrument"

"Financial instrument" includes securities, derivatives, and futures contracts, as well as other instruments that the Agencies are authorized to identify by rule. The term excludes loans, spot commodities and spot foreign exchange.[11]

[8] Federal Reserve System, "Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," 77 Fed. Reg. 33949 (June 8, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-06-08/pdf/2012-13937.pdf.

[9] Federal Reserve System, "Order Approving Extension of Conformance Period" (issued December 10, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf and Preamble, page 9. Certain reporting requirements imposed on the largest banking entities become effective at dates in 2014, as discussed below.

[10] Petition for Review, United States Court of Appeals for the District of Columbia Circuit, American Bankers Association et al. v. Board of Governors et al. (13-1310, filed December 23, 2013).

[11] Section __.3(c) of the Final Regulation. A "loan" is defined as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative." Section __.2(s) of the Final Regulation. This definition is applicable both to proprietary trading and covered funds. Preamble at pages 530-31.

"Banking Entity"

"Banking entity" includes an insured depository institution, its holding company, a bank headquartered outside the United States that is treated as a bank holding company under the International Banking Act of 1978, as amended ("IBA"), and any subsidiary or affiliate of any of these entities.[12]

"Trading Account"

A "trading account" is an account used to hold a financial instrument "principally for the purpose of selling in the near-term (or otherwise with an intent to resell in order to profit from short-term price movements)." The Final Regulation identifies two other types of accounts that also qualify as a trading account: (i) an account of an insured depository institution or its holding company that holds financial instruments that are both covered positions and trading positions under the market risk capital rules, and (ii) accounts of a registered securities dealer, swap dealer or security-based swap dealer in the United States or an entity that engages in such business outside of the United States.[13]

The Final Regulation adopts a presumption that a position held for less than 60 days is held in a trading account.[14] This means that short-term principal trading by a banking entity that does not fall neatly within one of the enumerated exemptions will be presumed to be prohibited proprietary trading for purposes of the Rule. While market participants can avoid trading strategies that clearly may offend the 60-day standard, the Agencies declined to identify a bright-line or safe harbor term beyond which trading will be presumed to be held for a reason other than proprietary trading.

"Trading Desk"

A "trading desk" is the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account. As further discussed below, each trading desk should have its own measure of profit and loss, and records reflecting the trading desk's financial exposure and where such positions are held in order to measure compliance with the Final Regulation.[15]

Exemptions: An Overview of the List of Permitted Principal Trading

With respect to compliance with the general prohibition, the Volcker Rule exempts several types of financial instruments and activities from the general prohibition.[16] It also authorizes the Agencies to exempt by rule additional activities that promote and protect the safety and soundness of banking entities and the financial stability of the United States.[17] The Agencies exercised this authority in several instances, as described below.

[12] 12 USC 1851(h); Section __.2(c) of the Final Regulation. The treatment of any affiliate of a banking entity as a banking entity means, for example, that market-participant securities broker-dealers are, like their parent banks (or bank holding companies), prohibited from proprietary trading unless authorized by an exception. The IBA is at 12 USC §§ 3101 et seq., 92 Stat. 707, Pub. L. No. 95-369 (Sept. 17, 1978). The Volcker Rule applies to any bank headquartered outside the United States that has a branch or agency in the United States or certain other types of US subsidiaries, but does not apply to such a bank that has only a US representative office.

[13] Section __.3(b)(1)(ii), (iii) of the Final Regulation.

[14] 12 USC § 1851(h)(6) and Section __.3(b)(2) of the Final Regulation.

[15] Section __.3(e)(13) of the Final Regulation.

[16] 12 USC § 1851(d).

[17] 12 USC § 1851(d)(1)(J).

US Government and Agency Securities, and Municipal Securities

The Volcker Rule provides an explicit exemption for trading in (i) US Federal government and agency obligations, (ii) securities, participations and other instruments issued by certain specified entities, and (iii) obligations issued by US States and their political subdivisions.[18] Thus, such securities are free of the proprietary trading prohibition, though they are covered by certain of the recordkeeping and monitoring requirements described below. However, derivatives on which such obligations are the underlying instrument are not exempt.[19]

The Statute did not provide an exemption for sovereign debt of other nations. However, as described below, the Agencies have chosen to create limited exceptions for certain sovereign debt for certain types of banking entities.

Underwriting

The Final Regulation exempts securities underwriting activities, so long as that activity is "client-facing" and does not exceed the reasonably expected near-term demands of clients. The Final Regulation:

- Limits the underwriting exemption to distributions of securities by an underwriter,[20] and limits the trading position to that which is related to the distribution;[21]

[18] 12 USC § 1851(d)(1)(A). The specified Federal entities are the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under the Farm Credit Act of 1971. Obligations of other issuers guaranteed by the United States or its agencies are similarly exempt. Preamble, page 368. The definition of municipal securities is broad and includes so-called "conduit" obligations. Preamble, pages 385-88 and n.1407.

[19] Preamble, pages 365-68.

[20] The term "underwriter" is defined in the Final Regulation to mean either (i) a person who has agreed with an issuer or selling security holder to (A) purchase securities from the issuer or selling security holder for distribution, (B) engage in a distribution of securities for or on behalf of the issuer or selling security holder, or (C) manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder. Section __.4(a)(4) of the Final Regulation. Selling group members may qualify as underwriters, but will be required to comply with the Final Regulation's requirements for underwriters generally. Preamble, pages 107-09.

[21] The term "distribution" is defined in the Final Regulation as either (i) an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods, or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act. Section __.4(a)(3) of the Final Regulation. While the first part of the definition above draws heavily on the Securities Act and Securities Exchange Act definitions, the Agencies note that: "The policy goals of this rule differ from those of the SEC's Regulation M, which is an anti-manipulation rule. The focus on magnitude [found in the Exchange Act definition of "distribution"] is appropriate for that regulation because it helps identify offerings that can give rise to an incentive to condition the market for the offered security. To the contrary, this rule is intended to allow banking entities to continue to provide client-oriented financial services, including underwriting services. The SEC emphasizes that this rule does not have any impact on Regulation M." Preamble, page 104, n.379 and 380. The second part of the definition covers any registered securities offerings, including so-called "at-the-market" offerings, regardless of magnitude.

- Requires a compliance program that is reasonably designed to achieve compliance with the rule and the underwriting exception; and,
- Requires the disposal of underwriting positions within a reasonable period.[22]

While the Agencies did not provide detailed guidance for determining how an underwriter could make decisions regarding inventory, the Preamble provides some guidance as to the breadth of the underwriting exception. Examples of activities that can be undertaken in connection with the underwriting exemption include:

- stabilization activities,
- establishment of syndicate short positions and aftermarket short covering,
- holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution (and selling such position when it is reasonable to do so), and
- helping the issuer mitigate its risk exposure arising from the distribution of its securities (for example, entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).[23]

The Agencies note, however, that such activities should be intended to effectuate the distribution process and provide benefits to issuers, selling security holders, or purchasers in the distribution.

Market-making

As noted above, the Volcker Rule exempts "market-making" from the general prohibition on proprietary trading. In adopting the Final Regulation, the Agencies added conditions to the market-making exemption in order to ensure that such activity is (i) "client-facing" and (ii) does not exceed the reasonably expected near-term demands of clients. Both of these conditions are based on the terms of the Statute.

The core philosophy underscoring the market-making exemption is that market-making must be related to the intermediation of trading. As a result, the Final Regulation relies on three principles: (i) a market maker stands ready to purchase and sell to the market, (ii) the precise nature of what constitutes market-making will vary based on the context of the market and asset class, and (iii) a banking entity must develop and implement policies and procedures that are reasonably designed to limit the financial exposure and inventory of the market-making trading desk.[24]

To rely on the exemption, a market-maker must:

- Stand ready to purchase and sell financial instruments for its own account in "commercially reasonable amounts" "throughout market cycles" on a "routine" basis;

[22] Section __ 4(a)(2)(ii) of the Final Regulation.

[23] Preamble, page 112 and n.402 through 405.

[24] Preamble, page 156 n.582. The Final Regulation is intended to provide a framework to assess whether trading activities are consistent with the Statute and to give flexibility to banking entities to design systems applicable to a variety of markets and instruments. Preamble, pages 161-68. Individual trades will not be reviewed in isolation but rather as part of the entity's trading operations generally. Preamble, page 168 n.616.

- Ensure that its inventory of financial instruments does not exceed the reasonably expected near-term demands of clients;[25]
- Adopt certain written policies and procedures for individual trading desks, including:
  - A description of the financial instruments the trading desk makes a market in;
  - Actions the trading desk will take to hedge its financial risks;
  - Limits on inventory, financial exposures, and hedging;
  - Procedures for authorizing increased trading activity in excess of established limits; and
  - Internal controls monitoring the market-making activity;
- Compensate employees in a manner that avoids rewarding or encouraging prohibited trading; and
- Be registered as a dealer in accordance with applicable securities or commodities laws.[26]

The Final Regulation does not require that market-making activities be limited to generate revenues primarily from fees, nor does it prescribe standardized regulatory limits on the amount of inventory or principal risk that a market-maker may retain. Large banking entities relying on the exemption must collect and report data regarding trading desk revenue and other metrics as discussed below.

Hedging

The Final Regulation exempts from the prohibition certain hedging activity, but, like other exemptions, carefully circumscribes its parameters. Permitted hedging:

- Must be risk-mitigating, and related to identifiable financial positions;
- Must reduce one or more specific identifiable risks related to the entity's positions;
- May not give rise to significant new or additional risks; and
- Must be reviewed and recalibrated on an ongoing basis.[27]

Consistent with other exemptions, hedging must be conducted in accordance with a compliance program that includes internal controls, monitoring and authorization procedures. Also consistent with other exemptions, the banking entity may not compensate employees engaged in this exemption so as to reward prohibited trading.

[25] The Final Regulation defines clients to exclude large bank institutions in many circumstances, which may limit so-called "inter-dealer" trading activity.

[26] Section __ .4(b)(2) of the Final Regulation. The market-making exemption also contemplates that a trading desk may engage in hedging of its market-making operations. This type of hedging is not subject to the limitations of the separate exemption allowing hedging generally that is discussed below, but must be conducted by the particular desk and subject to exposure limits set out in the banking entity's compliance program. Preamble, pages 198-204, 270, 284. A "trading desk" may cross legal entities, even if offshore. Preamble, page 192 n.706, page 193.

[27] Section __.5(b) of the Final Regulation.

Although hedging can relate to multiple identifiable positions, the exemption does not allow portfolio hedging, which includes scenario hedging, revenue hedging, and general asset-liability management. It does permit dynamic hedging (which in some cases may be required in order to recalibrate the hedge) and anticipatory hedging.[28]

A banking entity may conduct hedging across units, but it must document hedging activity that is conducted by a unit of the banking entity other than the trading desk responsible for the position being hedged.[29]

SOTUS Activities

The Final Regulation exempts proprietary trading by banking organizations headquartered outside the United States "solely outside of the United States," using a risk-based approach. The exemption is available in connection with a purchase or sale where:

- The banking entity headquartered outside the United States acts as principal outside the United States;
- The entity and relevant personnel that make the trading decision are located outside the United States;
- Trading is not accounted for as principal in the United States;
- A US affiliate does not provide financing for the trading; and
- The trading is not conducted with or through any US entity, other than on an anonymous basis on a US exchange or through a US central counterparty, or in a transaction with the non-US operations of a US entity.[30]

The Agencies justified the expansion of the exemption to transactions on US exchanges and clearing facilities by recognizing that driving such activity offshore could result in reductions in the competitiveness of those facilities and indirectly damage US market participants more generally.[31] The Agencies also note that they considered allowing non-US offices and subsidiaries of US banking entities to engage in a broader range of activities pursuant to their exemptive authority but determined not to do so "at this time," implying that they might do so at some time in the future.[32]

Liquidity Management

The Final Regulation permits trading to implement liquidity management programs to permit banking entities to meet their obligations as they come due. This exemption was not in the Statute, but rather was adopted by the Agencies pursuant to their exemptive authority mentioned above.

To prevent abuse of the exemption, the Final Regulation requires that:

- Liquidity management be conducted in accordance with a plan specifying the securities to be used;
- The securities be purchased and sold for liquidity management and not for short-term price movements;
- The securities be liquid;

[28] Portfolio hedging generally is discussed at length in the Preamble, pages 334-56, and specific examples are given on page 346.

[29] Section __.5(c)(1) of the Final Regulation.

[30] Section __.6(e)(3) of the Final Regulation.

[31] Preamble, pages 416-23.

[32] Preamble, page 425.

- The amounts held are consistent with the near-term funding needs of the banking entity;
- There be independent testing, internal controls, and analysis; and
- The liquidity management plan and activities be consistent with the requirements of the entity's supervisor.[33]

This exemption appears obvious and essential for banking entities, yet the concern of the Agencies that the exemption may lead to abuse probably accounts for the insertion of the extensive conditions listed above.

Non-US Sovereign Obligations

The Agencies also used their exemptive authority to provide two separate exemptions for non-US sovereign debt. One allows trading by banks headquartered outside the United States in sovereign debt of their home countries. The other allows trading by non-US subsidiaries of US banks of the sovereign debt of the country where the subsidiary is located. In an extraordinary display, many non-US governments and agencies protested the lack of such an exemption and the absence of an explicit exemption in the 2011 Proposal.[34]

The US offices and subsidiaries, other than an insured depository institution, of a banking entity headquartered outside the United States may engage in trading in obligations of the home country.[35] Absent the exemption, a number of banks headquartered outside the United States with trading operations in New York would have been unable to support the market for their sovereigns' debt. The Agencies justified this exemption as promoting safety and soundness and financial stability by allowing the US operations of banking entities headquartered outside the United States to facilitate the depth and liquidity of debt of the non-US sovereign that charters the banking entity. This corresponds to the exemption for trading in US obligations.

The Final Regulation also permits a non-US bank or securities broker-dealer subsidiary of a US banking entity to trade in obligations of the sovereign that charters the subsidiary.[36] This exemption was similarly justified as promoting safety and soundness and financial stability by allowing US banking entities to own and operate banks and securities broker-dealers overseas to facilitate liquidity in the sovereign debt of the host country. Just as a majority of the primary dealers in US government debt are headquartered outside the United States, non-US sovereigns similarly have come to rely on US banking entities to participate in the local markets for host sovereign debt.[37] The exemption is not available to the non-US *branch* of a US banking entity, however. It also means that a US banking entity's subsidiary may not engage in proprietary trading in sovereign debt of any other country. For example, the London subsidiary of a US banking entity may engage in proprietary trading of UK Government securities but not in German or French sovereign debt. Such activity would be subject to the other exemptions, such as market-making and underwriting, and their respective restrictions.

33 Section __.3(d)(3) of the Final Regulation. The Preamble notes that, "To ensure sufficient flexibility to respond to liquidity needs arising from changing economic times, a banking entity should envision and address a range of liquidity circumstances in its liquidity management plan, and provide a mechanism for periodically reviewing and revising the" plan. Page 64, n.240.

34 The issue was raised in the 2011 Proposal in a numbered question but without discussion. Question 122, 76 Fed. Reg. at 68,878.

35 Section __.6(b)(1) of the Final Regulation.

36 Section __.6(b)(2) of the Final Regulation.

37 The list of primary dealers with the Federal Reserve Bank of New York currently shows 21 primary dealers, of which 14 are controlled by banks headquartered outside the United States. The list is available at http://www.newyorkfed.org/markets/pridealers_current.html.

FDIC Obligations

The Final Regulation also provides an exemption for trading in obligations of the FDIC to facilitate the disposal of assets acquired in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of Dodd-Frank. This exemption will facilitate the FDIC's access to funding for resolutions and its conducting of receiverships and conservatorships.[38]

Securities Financing Transactions

The Final Regulation excludes repurchase, reverse repurchase and securities lending and borrowing transactions in securities from the proprietary trading restrictions, in recognition of the fact that banking entities play a significant role in such transactions and such transactions are typically a form of financing, rather than ones intended to take advantage of changes in the value of the underlying securities.[39]

Cleared Transactions

The Final Regulation provides an exemption from the proprietary trading restriction for various activities by banking entities that are clearing members of derivatives clearing houses. These include purchases and sales of financial instruments in connection with the management of a default or threatened default of a customer or clearing member.[40]

Restrictions on Permitted Activities

As a fail-safe condition, the Statute prohibits a banking entity from engaging in proprietary trading that, while ostensibly permissible, still would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States, or involve a material conflict of interest with customers or "high-risk assets or trading strategies." The Statute specifies that a banking entity would have a "material conflict of interest" if its interests are materially adverse to those of its client in a transaction or activity, unless the banking entity makes adequate disclosure to the client regarding the conflict, or uses information barriers to manage the conflict.[41]

This appears to serve as a catchall to allow the Agencies to address large problems arising from "plain vanilla" activities. The Final Regulation does not identify particular types of trading that would violate this standard, so banking entities will discover the breadth of offending activities only as the Agencies engage in the supervisory process.[42]

[38] Section __.6(a)(4) of the Final Regulation.

[39] Section __.3(d)(1) of the Final Regulation.

[40] Section __.3(d)(2) of the Final Regulation.

[41] Similar rules prevent securities dealers from trading for their own proprietary account, or for a discretionary account, ahead of a customer's account. See Rule 5270 of the Financial Industry Regulatory Authority.

[42] 12 USC §1851(d)(2) and Section __.7(b) and (c) of the Final Regulation.

Compliance Programs Based on Institution Size

The Continuum of Required Compliance Programs

Banking entities engaged in proprietary trading must develop a program to demonstrate compliance with the Volcker Rule. In response to public comments, the Agencies scaled those requirements to the size and complexity of the banking entity:

- A banking entity that does not engage in covered trading activities (other than trading in US government and related obligations) is not required to establish a compliance program.[43]
- A banking entity with assets of $10 billion or less that engages in trading activities may satisfy the compliance program requirement by including in its existing compliance policies and procedures references to the requirements of the Volcker Rule.[44]
- A banking entity with $10 billion or more in total assets engaged in trading activities covered by the regulation must establish policies and procedures that are fully compliant with the Final Regulation.[45]
- A banking entity with total assets of $50 billion or more, or banking entity headquartered outside the United States with $50 billion or more in US assets (including all US offices and affiliates), must engage in specified risk management, independent testing, and certification by the Chief Executive Officer ("CEO") of the program.[46]

Required Compliance Programs for Large Entities

For banking entities with $10 billion or more in total assets, the Final Regulation specifies six elements that a compliance program must include:

- Policies and procedures that establish trading and exposure limits;
- Internal controls;
- Management responsibility for compliance;
- Independent testing and audit;
- Training; and
- Recordkeeping.[47]

A banking entity with total assets of $50 billion or more, or a banking entity headquartered outside the United States with US (not global) assets of $50 billion or more, must adopt a compliance program that satisfies additional requirements related to risk management and remediation processes, independent testing, and reporting. The CEO of the banking

[43] Section __.20(f)(1) of the Final Regulation.

[44] Section __.20(f)(2) of the Final Regulation.

[45] Section __.20(b) of the Final Regulation.

[46] Section __.20(c) and Appendix B, Section III, of the Final Regulation.

[47] Section __.20(b) of the Final Regulation.

entity must annually attest in writing to its supervisor that the entity has instituted a compliance program to achieve compliance with the Volcker Rule.[48]

Metrics

The Final Regulation requires banking entities with significant trading operations to prepare metrics to help regulators identify prohibited trading and high risk trading strategies. Banking entities with worldwide trading assets and liabilities (excluding obligations of the US government or its agencies) of $50 billion or more must report metrics beginning in July 2014.[49] With respect to a banking entity headquartered outside the United States, the same threshold is applied to the trading assets and liabilities of the US operations of the banking entity. Beginning on April 30, 2016, this threshold drops to $25 billion and then to $10 billion beginning on December 31, 2016.

The Final Regulation requires the measurement and reporting of seven metrics:

- Risk and position limits and usage;
- Risk factor sensitivities;
- Value-at-risk and stress VaR;
- Comprehensive profit and loss attribution;
- Inventory turnover;
- Inventory aging; and
- Customer facing trade ratio—trade count based and value based.[50]

The Final Regulation does not specify those thresholds that will prompt regulatory review, and in fact states that quantitative metrics will not be used as a "dispositive tool" to differentiate permissible and impermissible trading activities in recognition of differences in measurements across markets and asset classes.[51] The Agencies admit that banking entities may not currently calculate all of the required metrics and may have to create and implement new processes and incur increased compliance costs as a result.

A Note on SIFIs

The Financial Stability Oversight Council has designated three non-bank financial companies as "systemically important."[52] This designation renders them banking entities for purposes of the Volcker Rule. Although a designated entity is not subject to the prohibition on proprietary trading, its Federal regulatory agency may require an entity that

[48] Section __.20(c) of the Final Regulation.

[49] Permissible investment in non-US government obligations are not excluded for purposes of calculating this reporting threshold.

[50] Appendix A to the Final Regulation. The 2011 Proposal set out 17 metrics; the Agencies pared the number of metrics apparently to reduce the burden on reporting institutions. Preamble, pages 815-29.

[51] Preamble, page 317.

[52] American International Group, Inc.; General Electric Capital Corporation, Inc.; and Prudential Financial, Inc., *available at* http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

engages in proprietary trading activities (or makes investments in hedge funds) to be subject to additional capital requirements or quantitative limits.[53] At this time, no such action has been taken.

Private Funds

Often lost from the Volcker Rule headlines, which focused on rolling back proprietary trading by banks, has been the significant impact on the relationship between banks and investment funds. This Section focuses on that aspect of the Volcker Rule.

The highlights of the private-fund part of the Final Regulation are:

- <u>New compliance date</u>: As outlined earlier in this memorandum, the July 21, 2015 compliance date represents a one-year push-back from the originally expected July 2014 date. Various extensions also may be available, in the discretion of the Agencies as described above.
- <u>New definition of covered funds</u>: The definition of "covered funds," which is at the heart of this aspect of the rule, received the most attention as the Agencies transformed the terms of the 2011 Proposal into the Final Regulation. A number of significant new carve-outs from the definition were added, including one for so-called "foreign public funds" (non-US analogs to retail US registered funds).
- <u>Substantially the same "sponsorship ban" and fiduciary exception to that ban</u>: The ban on sponsorship by banking entities of covered funds carried through into the Final Regulation largely intact, as did the ban's most significant exception. It continues to be the case that—even after the Volcker Rule takes effect—a banking entity will be able to sponsor a private funds business, so long as that business is in furtherance of the bank's delivery of investment management, trust and similar services to bank customers. A bank customer for this purpose need not have connections to the bank beyond the relevant investment management or trust service.
- <u>Substantially the same ban on investments in third-party funds and limits on investments in affiliated funds</u>: The ban on investments in private funds except for investments under the so-called "twin 3% tests" likewise carried through into the Final Regulation largely intact. Under the twin 3% tests, a banking entity subject to the Volcker Rule generally may invest, as principal, only in the bank's or its affiliates' sponsored funds (i.e., no investments in third-party covered funds) and only up to, *first*, 3% of the value of the interests issued by each covered fund and, *second*, when taking all covered fund investments in the aggregate, only up to 3% of the bank's tier 1 capital. Complex instructions surround the calculations underlying these tests.
- <u>Expanded SOTUS exception for non-US banking entities</u>: The broad solely-outside-the-United States ("<u>SOTUS</u>") exception carried through into the Final Regulation and has been expanded at the margins. Helpfully, the definition of non-US persons that will be applied is that under Regulation S, which is widely used in practice, and not the originally proposed definition. The 2011 Proposal contemplated something of a hybrid to Regulation S and would have been more complicated to implement.
- <u>Substantially the same catch-all "exception from the exceptions"</u>: Regardless of whether an investment or activity is otherwise permitted, a banking entity may not engage in the investment or activity if (i) there would be a material conflict of interest between the banking entity and its clients, customers or counterparties, (ii) there would be material

[53] 12 USC § 1851(a)(2) and (f)(4).

exposure, directly or indirectly, to high risk assets or a high risk trading strategy, or (iii) the investment or activity poses a safety and soundness risk to the banking entity or a risk to the financial stability of the United States.

- Implications for securitization transactions: Although the Final Regulation provides some exemptions, banking entity involvement with securitization and similar structures, including CDO transactions, may be restricted under the Final Regulation. In particular, as discussed below, there continues to be uncertainty as to how the Final Regulation applies to various aspects of such transactions, and market participants have already noted certain (possibly unintended) consequences for banking entities holding interests in such transactions.

So Much Meaning in a Single Sentence

The Final Regulation implements the Statute's general prohibition on investments in certain types of funds and activities related to those funds and does so initially in a brief (22-word) clause, which is subject to certain exceptions:

- "...a banking entity
- may not, as principal, directly or indirectly,
- acquire or retain any ownership interest in
- or sponsor
- a covered fund."[54]

Understanding the specific meanings given to each of these terms—and especially what is carved out from them—is the key to understanding the operation of the rule as a whole.

Definitions

"Banking Entity"

As discussed above in connection with proprietary trading, a "banking entity" includes an insured depository institution, its holding company, a bank headquartered outside the United States that is treated as a bank holding company under the IBA, and any subsidiary or affiliate of the foregoing. A banking entity includes, for example, any US or non-US based asset management company controlled by a banking entity.

The definition of banking entity excludes a "covered fund" unless such fund is itself an insured depository institution, a holding company of such an institution, or a non-US bank that is treated as a bank holding company.[55] This carve-out was included in the 2011 Proposal in order to avoid causing a covered fund to be an "affiliate" of a banking entity, and thereby itself become subject to the prohibitions on proprietary trading and fund investment.[56] It appears to recognize the permissibility of a permissible covered fund being a "fund-of-funds" or similar structure.

"Covered Fund"

The Statute does not use the term "covered fund." It instead speaks to limiting the relationships between banks and "hedge funds" and "private equity funds" and then collectively defines a hedge fund or private equity fund as (i) an issuer

[54] Section __.10(a)(1) of the Final Regulation.

[55] Section __.2(c)(2)(i) of the Final Regulation.

[56] 2011 Proposal at 68,855-56.

that would be an investment company, as defined in the Investment Company Act of 1940, but for the exclusion provided by Section 3(c)(1) or 3(c)(7) thereof ("3(c)(1) and 3(c)(7) Entities"), or (ii) such similar funds as the Agencies may determine by rule.[57] The Agencies' rulemaking merged these concepts into a single defined term, the "covered fund."[58]

As to scope of coverage, the reference to the Section 3(c)(1) and 3(c)(7) exclusions captures nearly all hedge funds and private equity funds that are either organized as US entities or offered to US person investors. But the reference also risks being over-inclusive and capturing many entities that, while they technically may be 3(c)(1) and 3(c)(7) Entities, do not resemble hedge funds or private equity funds. The Agencies recognized the risk of over-inclusion and provided more than a dozen specific exemptions, listed below. Implementing the Congressional direction to cover "similar funds" to hedge funds and private equity, the Agencies also added certain entities to the definition of a covered fund.

Additions to the definition of a covered fund are as follows:

- Certain commodity pools: These are (i) commodity pools whose commodity pool operators ("CPOs") are exempt from regulation in connection with the pools under CFTC Rule 4.7 ("Rule 4.7 Pools") and (ii) certain commodity pools structurally similar to Rule 4.7 Pools in that the commodity pool operator is registered with the CFTC as a CPO, substantially all of the pool's units are owned by "qualified eligible persons" under CFTC Rule 4.7(a)(2) and 4.7(a)(3) and the pool's units have not been publicly offered to persons who are not qualified eligible persons.[59]
- Certain non-US funds that would have been 3(c)(1) and 3(c)(7) Entities had they been US funds: This addition to the covered pool definition explicitly affects only US banking entities. In particular, a banking entity located in or organized under US laws (or any banking entity that is controlled by such an entity) will treat as a covered fund an entity, other than a foreign public fund as described below, that (i) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States and (ii) is or holds itself out as being an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities. United States branches, agencies and subsidiaries of a bank headquartered outside the United States are deemed to be located in the United States for purpose of this exemption, while the bank that operates or controls the branch, agency or subsidiary is not.[60]

Exemptions from the definition of a covered fund are as follows:[61]

- Otherwise exempt entities under the Investment Company Act: These are entities, whether organized under US or non-US law, that can or could rely on an exception or exemption from the definition of "investment company" under the Investment Company Act other than Section 3(c)(1) or 3(c)(7). This provision has the practical effect that, for example, many real estate funds and some types of finance companies and securitization vehicles will be exempt. One

57 12 USC § 1851(h)(2).

58 Section __.10(b) of the Final Regulation.

59 Section __.10(b)(1)(ii) of the Final Regulation. Public commodity pools would not be treated as covered funds, however, consistent with the treatment of registered investment companies.

60 Section __.10(b)(1)(iii) of the Final Regulation.

61 Except as otherwise indicated, all of the following exemptions are listed in Section __.10(c) of the Final Regulation.

such example is a real estate fund or finance company that relies instead on exemptions under Section 3(c)(5) of the Investment Company Act or a securitization vehicle that relies on Rule 3a-7 under that Act.[62]

- "Foreign public funds": These generally are non-US funds that are authorized in their home jurisdiction to make public offerings to non-US retail investors. The fact that US investors may buy interests in a foreign public fund in the course of secondary trading outside the United States generally will not disqualify the fund from the exemption. There also are special rules for a foreign public fund sponsored by US banking entities or their affiliates, which generally limit the participation in the foreign public fund by the US banking entity and certain related persons to 15% of the fund's ownership interests.
- Wholly owned subsidiaries: The requirement that a subsidiary be "wholly owned" is subject to limited leeway for ownership by banking entity employees or directors and for third-party ownership when necessary to establish the subsidiary's "separateness" or to address bankruptcy, insolvency or similar concerns.
- Joint ventures: An exempt joint venture may not be in the business of investing in securities for resale or trading in securities and may have no more than 10 unaffiliated co-venturers.
- Acquisition vehicles solely for the purpose to effectuate a merger or acquisition.
- Certain non-US pension or retirement funds.
- Insurance company separate accounts: No banking entity other than an insurance company may participate in such an account's profits and losses.
- Certain bank-owned life insurance (called "BOLI") accounts.
- Certain loan securitization vehicles: This exemption is subject to detailed asset composition rules for the vehicle that specifically prohibit inclusion of almost all securities (other than cash equivalents) and derivatives (other than interest rate and currency derivatives).[63] Certain CLO and similar structures that are predominantly but not entirely loan-based may not fall within the exemption.
- Certain asset-backed commercial paper conduits: Again, this exemption is subject to detailed asset composition rules and to a requirement that the conduit be supported by a regulated liquidity provider.
- Qualifying covered bonds.
- Small business investment companies and public welfare funds.
- SEC-registered investment companies and SEC-regulated business development companies: This exemption also covers related seed accounts, subject to rules formalizing the seeding process under a written plan and applying investment company leverage rules to the seed account.
- FDIC receivership or conservatorship entities.
- Other exemptions. Other entities may be found to be exempt by the Agencies, acting jointly and by public notice.

[62] Section __.10(b)(2) of the Final Regulation.

[63] Preamble, pages 539-42.

Whether a banking entity may invest in instruments issued by an entity exempt under these various carve-outs from the definition of covered funds will turn also on whether doing so otherwise violates the Volcker Rule's limitations on proprietary trading by the banking entity.

"As Principal"

The Final Regulation states that a covered banking entity may not "as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor" a covered fund. The rule does not specify a definition for the phrase "as principal, directly or indirectly," but a series of exemptions suggests its meaning.

In particular, there are four exemptions from the prohibition on acquiring or retaining an ownership interest in a covered fund by a banking entity:

- When the banking entity is acting solely as an agent, broker or custodian subject to certain conditions, so long as the activity is for the account of or on behalf of a customer and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;
- When the banking entity holds the interest through a deferred compensation, stock-bonus, profit-sharing or pension plan (whether under US or non-US law) and the banking entity acts as trustee for the benefit of current or former employees of the banking entity or its affiliates;
- When the banking entity retains an ownership interest in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the interest as soon as practicable; or
- When the banking entity acts on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is for the account of or on behalf of the customer and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest.[64]

There is nothing to suggest that these four exemptions are intended to be the exclusive inventory of what it means to not act as principal. Individual banking entities may, over time, develop their own views on additional circumstances that appear to be similarly innocuous. The phrase "engaging as principal" is similarly key to the Volcker Rule's prohibition on proprietary trading by banks, so that it is also possible that learning on the phrase will be imported back and forth across these different spheres.

"Ownership Interest"

An "ownership interest" consists of any equity, partnership, or other similar interest in a covered fund. "Other similar interest" is a catch-all phrase to be understood by reference to a laundry list of potentially defining characteristics, including:

- Rights to participate in the selection or removal of a covered fund's governing entity or body (but excluding rights of a creditor arising upon an event of default or acceleration event);
- Rights to receive a share of a covered fund's income, profits or gains;

[64] Section __.10(a)(2) of the Final Regulation.

- Rights to a covered fund's residual underlying assets (again excluding rights of a creditor arising upon an event of default or acceleration event);
- Rights to receive a spread between interest earned by a covered pool and interest paid out by the pool;
- Rights to payments that are reduced by loss offsets;
- Rights to payments based on the performance of underlying assets of the covered pool; and
- Synthetic rights analogous to any of these.[65]

The sole exception is for a so-called "restricted profit interest" received by an entity (or an employee or former employee thereof) as compensation for providing investment management, investment advisory, commodity trading advisory or other services to a covered fund by the banking entity (or the employee or former employee). Such a restricted profit interest will not be considered an "ownership interest" in the covered fund subject to several conditions, including requirements that:

- The interest be subject to transfer restrictions, and
- The interest, once allocated, be distributed to the banking entity (the employee or former employee) promptly after being earned, or may be retained by the fund unless the sole purpose of retaining the interest is to create a reserve to satisfy the fund's losses and the retained interest does not share in subsequent investment gains of the covered fund. This prohibition to share in subsequent investment gains means that a number of performance fee arrangements that are common under current business practices may not be carved out from the definition of ownership interest.[66]

For vehicles that issue multiple classes of interests, including debt interests, there may be uncertainty as to which interests are ownership interests. As noted above, litigation has commenced to stay enforcement of the Final Regulation in the case of holdings by banking entities of interests in collateralized debt obligations backed by trust preferred securities, known as "TruPS CDOs." Banks that hold TruPS CDOs had expressed concern that they would be required to divest such interests when the effective date arrives and accordingly that they may no longer hold them until maturity; for accounting purposes, not being able to hold them in that capacity might require the banks to recognize losses. The Federal Reserve, FDIC and OCC issued a statement indicating that bank holders should consider whether the interest might not be an "ownership interest" under the Final Regulation, whether the CDO might qualify for an exemption other than under Section 3(c)(1) or 3(c)(7) of the Investment Company Act, or whether a CDO might be restructured in order to avoid treatment as a covered fund.[67] Arguably, if any of these were true, a bank would not have to recognize any losses at this

65 Section __.10(d)(6) of the Final Regulation. Credit transactions that do not have equity-like features would generally not constitute ownership interests, even if the terms include a "step-up" in interest-rate margin if the fund breaches a negotiated covenant. Preamble, page 611.

66 Section __.10(d)(6)(ii) of the Final Regulation.

67 "FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule" (Dec. 19, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131219d1.pdf.

time. The OCC, Federal Reserve, FDIC and SEC issued a statement on December 27 that they would evaluate whether it would be appropriate not to cover pooling vehicles that invest in TruPS no later than January 15, 2014.[68]

"Sponsor"

The Final Regulation adopts, substantially unchanged, the Statute's definition of a covered fund's "sponsor" as an entity that:

- Serves as a general partner, managing member, or trustee of the covered fund, or as commodity pool operator to the covered fund (the term "trustee" generally does not encompass trustees that do not exercise investment discretion with respect to a covered fund);
- In any manner selects or controls a majority of the directors, trustees, or management of the covered fund; or
- Shares with the covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.[69]

The Exemptions

The Final Regulation contains a number of exemptions to both the general prohibition on banking entities sponsoring covered funds and the related ban on their acquiring and retaining ownership interest in such funds generally, subject to specified conditions and limitations.

Bona Fide Services

The Statute provides an exclusion from the sponsorship prohibition for "bona fide trust, fiduciary, investment advisory, or commodity trading advisory services" to persons who are customers of these services. This exemption is intended to recognize that banking entities and their affiliates should continue to be able to engage in traditional asset management and advisory activities for their customers.

A number of conditions accompany the exemption:

- There should be a "written plan" or similar documentation outlining how the banking entity or its affiliate intends to provide advisory or similar services to its customers through organizing and offering the fund. The Preamble suggests reasons why one might choose to deliver advisory services through funds, such as efficiency, expanded access to the services for smaller customers, and performance consistency across accounts.
- Certain mandated disclosures must be made to investors that, among other things, emphasize the separateness of the fund from the bank and discourage expectations that the bank or a banking insurance scheme will stand behind the fund's losses.
- Holdings in the covered fund by the banking entity's officers and directors are restricted to those individuals who are directly engaged in providing the fund with services at the time when the employee takes the interest (this close

[68] "Statement regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Rules implementing Section 619 of the Dodd-Frank Act" (Dec. 27, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131227a1.pdf.

[69] 12 USC § 1851(h)(5) and Section __.10(d)(9) of the Final Regulation. Control may cease to exist if, after formation and appointment of initial directors by the sponsor, a shareholder vote or other action takes place that could replace the original appointees. Preamble at pages 631-32.

ring-fencing of who may invest in the funds is contrary to practice in which, for example, participation in a fund historically has been attractive for a broad set of bank executives). Holdings by employees and directors also may be attributed to the banking entity itself should the bank or an affiliate extend credit or guarantee against loss in connection with the holdings.

- The fund may not have the same name as the covered banking entity or a variation of the bank's name (and may not use the word "bank" in the name at all).[70]
- There can be no guarantee of the fund's performance by the sponsoring banking entity.[71]

The Final Regulation does not require that a pre-existing relationship exist with the customers to whom the banking entity offers interests in the sponsored fund. This relationship is permitted to arise through the offering of the fund. In addition, the only relationship between a banking customer and the banking entity can be the provision of advisory services to the customer through the customer's investment in a covered fund.

De Minimis Investments in Sponsored Fund (the "Twin 3% Tests")

In connection with the exclusion above for sponsoring (or otherwise "organizing and offering") a private fund, a banking entity and its affiliates also may make limited investments in such a fund. This includes investments that "seed" the fund with potentially all of its initial capital. Investments are generally subject to three principal limitations:

- No third-party funds: The banking entity may invest only in covered funds that it, an affiliate or a subsidiary has organized and offered. Thus, wholly third-party covered funds are made off limits under this exemption.
- 3% per-fund limit: The investment may not represent more than 3% of the total amount of value of the outstanding ownership interests of each fund—with this limitation applying only after the expiration of a one-year seeding period that generally begins when the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund. An extension request may be granted if additional time is needed in order to establish a track record. In addition, the 3% limitation is raised to 5% when necessary to accommodate the "skin in the game" requirements under section 15G of the Securities Exchange Act of 1934.
- 3% aggregate limit: The banking entity and its affiliates may invest in the aggregate no more than 3% of its tier 1 capital in covered funds (for banks headquartered outside the United States, tier 1 capital as calculated under applicable home country standards). Compliance with this limit is measured quarterly.

Capital commitments to a covered fund that have not yet been called are not counted towards the various thresholds.[72]

Also, in calculating investments against these limits, special attribution rules apply. First, the banking entity must include the amount and value of its permitted investment in a single covered fund, whether held directly by it or any affiliate. Second, SEC-registered investment companies, SEC-registered business development companies, and foreign public

70 The Final Regulation prohibits the use of the name of an affiliate, even if that name is different from the name of the affiliated bank, in the name of the covered fund. Section __.11(a)(6)(i) of the Final Regulation. However, the banking entity providing the advisory services may have a name similar to that of the bank so long as the name is not part of the fund's name.

71 Section __.11(a) of the Final Regulation.

72 Section __.12(b)(2)(ii) of the Final Regulation.

funds will not be considered affiliates of the banking entity, and therefore their investments will not be attributed to the banking entity, so long as the banking entity does not own, control or hold the power to vote 25% or more of the voting shares and provides investment advisory, commodity trading advisory, administrative and other services to the company or fund under applicable regulatory authority. The attribution requirement in the 2011 Proposal would have looked through ownership of entities in which the banking entity had as little as a 5% ownership interest, but this is not included in the Final Regulation.[73]

Finally, detailed rules apply to attribution under fund-of-funds and master-feeder fund structures.[74] There is also guidance that applies to "co-investments," in which an investment may not be made in a fund itself but instead is made alongside the fund directly in the fund's underlying assets, stating that any such investments by a banking entity generally should be aggregated with the entity's investment in the fund for purposes of calculating compliance with the 3% limit.[75]

SOTUS

For a banking entity headquartered outside the United States, covered funds generally do not include a non-US fund that is not offered in the United States or otherwise does not rely on Section 3(c)(1) or 3(c)(7). In addition, similar to an analogous provision for proprietary trading, non US banking entities may rely on an exception to the prohibition on acquiring or retaining an ownership interest in or sponsoring a covered fund. Any such activity generally must meet the following criteria:

- The banking entity involved must not be organized by or directly or indirectly controlled by a US entity;
- The banking entity or investment must satisfy certain Federal Reserve requirements intended to assure the "foreignness" of the entity;
- No ownership interest in the relevant fund may be offered for sale or sold to a resident of the United States (applying the US person definition under Regulation S and subject to guidance that addresses when an offering is or is not targeted to US persons, including a provision that generally disregards US person participation that arises through secondary market transactions in a fund's interests); and
- The activity or investment occurs solely outside of the United States.[76]

Activity will be considered to have occurred solely outside of the United States only if, in addition to the criteria set forth above:

- The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located or organized in the United States;
- The investment or sponsorship, including any transaction arising from risk-mitigating hedging, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate located or organized in the United States; and

[73] Section __.12(b)(1) of the Final Regulation.

[74] Section __.12(b)(4) of the Final Regulation.

[75] Preamble at pages 711-12.

[76] Section __.13(b) of the Final Regulation. The rationale for this exemption is discussed at pages 722-23 of the Preamble.

- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located or organized in the United States.

Nonetheless, back office and administrative operations relevant to the fund may be conducted in the United States.

Other Exemptions

A number of other, more specialized exemptions also may be available, including:

- Risk-mitigation hedge purposes: This relatively narrow exemption permits investments in covered funds intended to reduce specific risks arising in connection with either the banking entity acting as intermediary on behalf of a customer or the banking entity covering a compensation arrangement with an employee with respect to the performance of a particular covered fund.[77]

- Insurance: Activities undertaken in general or special accounts of an insurance company affiliate of a banking entity generally are permitted so long as they are engaged in under the supervision of applicable insurance regulatory authorities.[78]

- Underwriting and market-making: Underwriting and market-making involving interests in covered funds generally are permitted subject to the applicable restrictions on those activities under the proprietary trading sections of the Volcker Rule. However, ownership interests that a banking entity acquires or retains as a result of these activities will be attributed to the banking entity for the purposes of the 3% per-fund and aggregate limits.[79]

Restrictions on Transactions with Covered Funds (so-called "Super 23A")

Restrictions on Transactions with Covered Funds Generally

The Statute broadly prohibits a banking entity (and its affiliates) that serves, directly or indirectly, as an investment manager, investment adviser, commodity trading adviser or sponsor to a covered fund, that organizes and offers a covered fund, or that continues to hold an ownership interest, from entering into a transaction with the covered fund, or any covered fund controlled by such fund, that would be a covered transaction under Section 23A of the Federal Reserve Act as if the banking entity or its affiliate were a member bank and the covered fund were an affiliate of the banking entity.[80]

This provision, known as "Super 23A," is more restrictive than the general application of Section 23A, which permits covered transactions within statutory quantitative and qualitative limits. Banking entities are also subject to certain restrictions under Section 23B of the Federal Reserve Act.

Restrictions of Super 23A

The Final Regulation states that any transaction with a fund that would be a "covered transaction" as defined in Section 23A is prohibited between a covered fund and a banking entity (and any affiliate) that is acting as investment manager, investment sponsor, commodity trading adviser, or sponsor to a covered fund. While there is no explicit listing

[77] Section __.13(a) of the Final Regulation.

[78] Section __.13(c) of the Final Regulation.

[79] Section __.11(c) of the Final Regulation. An exemption may also apply where the entity is required to retain an ownership interest under the separate Dodd-Frank retention rules in Section 15G of the Securities Exchange Act of 1934.

[80] 12 USC § 1851(f).

of prohibited transactions, it seems clear that the following transactions, based on the literal language of Section 23A, would be prohibited:

- An extension of credit to a related covered fund;
- A purchase of or investment in securities issued by a related covered fund;
- A purchase of assets from the related covered fund, including an asset subject to recourse or an agreement to repurchase;
- Issuing a guarantee, acceptance or letter of credit on behalf of the related covered fund, a confirmation of a letter of credit issued by the affiliated covered fund and a cross-affiliate netting arrangement;
- The borrowing or lending of securities to the extent that such transaction causes a banking entity to have credit exposure to the related covered fund; and
- Certain derivative transactions that cause a banking entity to have credit exposure to the related covered fund.[81]

The imposition of "Super 23A" on permissible covered funds may create significant burdens on banking entities in that they will be more restricted in their ability to provide services for their related funds.

Exceptions to the Super 23A Restrictions

One exception in the Statute allows a banking entity to serve as a prime broker, subject to Section 23B of the Federal Reserve Act, not for a banking entity's sponsored fund, but rather for funds in which such a fund invests that are sponsored by others. However, the banking entity must be in compliance with the limitations imposed in connection with organizing and offering a covered fund, the CEO of the banking entity must make an annual written certification that the banking entity does not guarantee, assume or insure the obligations or performance of the covered fund or of any covered fund in which the covered fund invests, and the transaction must not be inconsistent with the safe and sound operation and condition of the banking entity.

The Super 23A restriction also does not prohibit a banking entity from extending credit to a customer secured by shares of a covered fund (as well as, perhaps, other securities). However, the Agencies indicated that they will use their supervisory authority to monitor that banking entities will not attempt to evade the restrictions imposed on transactions with covered

[81] Section __.14(a)(1) of the Final Regulation. For the list of "covered transactions" in Section 23A, *see* Section 23A(b)(7) of the Federal Reserve Act, 12 USC § 371c, as amended by Section 608(a)(1) of Dodd-Frank. Section 23A is implemented by the Federal Reserve's Regulation W, 12 CFR Part 223. The Preamble makes clear that the exceptions from the restrictions of Section 23A in the statute itself and in Regulation W are not applicable to "Super 23A." Preamble, pages 753-56. In addition, it should be noted that Regulation W has not been amended to incorporate the last two items on the list above of covered transactions despite the fact that they were added to the statute effective in July 2012. If you wish to learn more about the Dodd-Frank amendments to Section 23A, you may wish to review our client memorandum, "Dodd-Frank Act: Derivatives as Credit Extensions of Banks" (Aug. 16, 2010), *available at* http://www.shearman.com/~/media/Files/NewsInsights/Publications/2010/08/DoddFrank%20Act%20%20Derivatives%20as%20Credit%20Extensions%20__/Files/View%20full%20memo%20DoddFrank%20Act%20%20Derivatives%20as%20Cre__/FileAttachment/FIA081710DerivativesasCreditExtensionsofBanks.pdf.

funds. It should be noted that, in certain circumstances, an extension of credit to a borrower secured by shares of a fund advised by the lending bank would be a covered transaction under Section 23A itself.[82]

Exceptions to the Exceptions

Under the Final Regulation, regardless of whether an investment or activity is otherwise permitted, a banking entity may not engage in the investment or activity if it would involve or result in (i) a material conflict of interest between the banking entity and its clients, customers or counterparties, (ii) material exposure, directly or indirectly, by the banking entity, to high risk assets or a high risk trading strategy, or (iii) a safety and soundness threat to the banking entity or a risk to the financial stability of the United States. These are effectively the same limitations on a banking entity's involvement in permissible trading under the Volcker Rule's proprietary trading provisions and are subject to the same conditions.

The Final Regulation permits the use of disclosures and information barriers as a means to address conflicts of interest that otherwise might be disqualifying under these "exceptions to the exceptions" terms. Banking entities that will continue to sponsor funds going forward should adhere closely to these requirements and the generally applicable compliance requirements discussed below.

Compliance Requirements

Like proprietary trading, engagement in permissible funds activities requires that a banking entity have a written compliance program designed to ensure and monitor compliance with the requirements of the Volcker Rule and the Final Regulation.[83] The statistical monitoring and reporting that the large institutions engaged in permissible trading will have to perform is not required in the funds business.

Any banking entity that is not engaged in any activity involving covered funds is required to incorporate measures designed to prevent engagement in sponsoring or investing in covered funds and to require establishment of a compliance program if in the future it commences a permissible private funds activity. This is the same standard as for proprietary trading.

To the extent that a banking entity engages in fund-related activities or investments that are prohibited or restricted by the Final Regulation, each such entity must develop and provide for the ongoing administration of a compliance program that is reasonably designed to ensure and monitor compliance with the provisions of the Final Regulation. The required compliance program must, at a minimum, contain each of the following elements:

- Written policies and procedures reasonably designed to document, describe and monitor and limit activities and investments with respect to covered funds including setting, monitoring and managing required limits to ensure that such activities and investments comply with the Final Regulation;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Final Regulation and to prevent the occurrence of activities or investments that are prohibited thereby;

[82] Section 23A(b)(7)(D) of Section 23A, also in Regulation W at 12 CFR § 223.3(h)(4). The definition of an advised fund as an "affiliate" for purposes of Section 23A is at Section 23A(b)(1)(D).

[83] Section __.20(a) of the Final Regulation.

- A management framework that clearly delineates responsibility and accountability for compliance with the Final Regulation and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters;
- Independent testing and auditing for the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;
- Training for 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 Final Regulation for a period of no less than five years or such longer period as required.[84]

There are additional documentation requirements for covered funds:

- Any banking entity with more than $10 billion in assets as of the previous two years must maintain records to show documentation of any exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7) of the Investment Company Act that were relied on by each fund sponsored by a banking entity (or its subsidiaries or affiliates) in determining the fund was not a covered fund.
- Banking entities must also show supporting documentation for each sponsored fund for which a banking entity relies on an exclusion from the covered fund definition.
- For each seeding vehicle that will become a registered investment company or SEC-regulated business development company, banking entities must have certain written procedures documenting the future marketing and operational plans for the seeding vehicle.
- For those banking entities controlled directly or indirectly by a US-located or US-organized banking entity, if the aggregate amount of ownership interests in foreign public funds owned by the banking entity (or affiliates controlled by a US banking entity) exceeds $50 million, the banking entity must document the value of its ownership interests.[85]

The Final Regulation contains the requirement for a banking entity's CEO annually to attest in writing to the appropriate Agency that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program of a firm. In case of a bank headquartered outside the United States with a US branch or agency, the attestation may be provided by the senior management officer of its US operations who is located in the United States.[86]

Banks Headquartered Outside the United States

General Application

The Volcker Rule generally applies to all US offices and subsidiaries of a banking institution headquartered outside the United States that is engaged in banking in the United States through a US bank subsidiary, certain other types of banking

84 Section __.20(b) of the Final Regulation. The list includes only those requirements that apply to covered funds and not those applicable to trading activities.

85 Section __.20(e) of the Final Regulation.

86 Appendix B, Section III of the Final Regulation and Preamble, pages 803-04.

subsidiaries, or a branch or agency. While most of the Volcker Rule's requirements apply to the US operations in the same way as they do to US institutions, several exemptions give limited relief to those headquartered outside the United States, and some cross-border implications deserve special mention.[87]

The headline changes in the Final Regulation from the 2011 Proposal for banks headquartered outside the United States are the following:

- Broader scope of permissible activities outside the United States, especially with regard to transactions with US-related entities outside the United States and with unaffiliated US entities.
- Exemption for debt issued by home-country sovereign governments generally matching the statutory exemption for US government debt.
- Exemption from coverage of non-US funds not offered to US investors and permissible investments in funds that are publicly distributed outside the United States.
- Recognition of the use of US-based personnel to provide advice and administrative services.

US Operations

The same general limitations applicable to trading and investment activities of US banks apply to the US operations of banks headquartered outside the United States. In addition, the requirements on implementing a program to enforce compliance with the Final Regulation are generally the same as for US banks, but with some differences.

No US Trading or Funds Activities

A bank headquartered outside the United States that engages through its US offices and subsidiaries in no activities subject to the prohibition on proprietary trading, other than trading in US government securities, or sponsoring or investing in private funds, need only establish the policies and procedures discussed below at such time as it begins to engage in them.[88]

Trading in Home Country Sovereign Debt

While US Federal and local government debt is exempt from the prohibition on proprietary trading, sovereign debt of other countries is not mentioned in the language of the statute. The Agencies responded to criticism of this limitation by creating an exception that allows US subsidiaries (other than US bank subsidiaries) of banks headquartered outside the United States to trade the sovereign debt of their home countries.[89] However, if a bank headquartered outside the United

[87] The Volcker Rule applies to any bank headquartered outside the United States that has a branch or agency in the United States or a US bank or Edge Act subsidiary, but not to one that has only a US representative office.

[88] Section __.20(f)(1) of the Final Regulation. A separate section imposes a requirement to implement a truncated compliance program on banking institutions with $10 billion or less in total consolidated assets. Section __.20(f)(2) of the Final Regulation. While banks headquartered outside the United States are not mentioned, it appears unlikely that a bank of that small size would have US operations. The intent was to provide relief to US community banks. See Preamble, page 773.

[89] Section __.6(b)(1) of the Final Regulation. The exemption covers any financial instrument that is an obligation of, or is issued or guaranteed by, a foreign sovereign or its agencies or political subdivisions, and of a multinational central bank of which the country is a member.

States is controlled by another such bank with a different home country, the first (subsidiary) bank's US offices and subsidiaries may trade only in that bank's home country debt and not in the debt of the higher-tier bank.[90]

Any holdings of such debt are subject to reporting requirements, discussed below, that are not applicable to holdings of US government securities.

Investment in Foreign Public Funds

A non-US fund that is publicly distributed outside of the United States is exempt from treatment as a "covered fund" for any US or non-US banking institution that invests in it.[91] The rationale is that US registered funds are not private funds subject to the Volcker Rule, and commenters argued that non-US funds that are similarly distributed for investment by the public should be exempt.[92] In general, a foreign public fund is one that is publicly distributed predominantly to retail investors outside the United States with no net worth requirement for investors and that is authorized in its home jurisdiction to make such a public offering of its securities.[93]

Requirements for All US Trading and Funds Activities

A bank headquartered outside the United States that conducts trading activity in the United States must have the same policies and procedures described above.[94] Similarly, recordkeeping requirements for activities involving private funds are as described above.[95] The CEO attestation requirement noted above may be satisfied by the senior management officer of US operations for a bank headquartered outside the United States with a US branch or agency.[96]

Non-US Operations

The operations outside the United States of a bank headquartered outside the United States are subject to constraints only insofar as US residents and entities are involved. An exception for activities "solely outside of the United States" (known as "SOTUS"), discussed above, allows for a great deal of activity outside US borders involving proprietary trading and fund activities so long as the activities truly are outside the United States. Several issues concerning the scope of the SOTUS exception were clarified in the Final Regulation.

Sponsoring and Investing in Non-US Funds

Funds organized under non-US law are exempt from treatment as "covered funds" subject to the regulations so long as (i) no US residents, as defined under Regulation S of the SEC, are solicited to invest in the fund or are sold interests in the

[90] Preamble, page 375, n.1366.

[91] Section __.10(c)(1) of the Final Regulation. Both US banks and banks headquartered outside the United States may invest in such funds.

[92] Section __.6(b)(2) of the Final Regulation.

[93] Section __.10(c)(1)(i)(C), (1)(iii) of the Final Regulation. The Preamble states that an offering is "made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States." Preamble, page 506. Additional restrictions apply to any foreign public fund of which a US bank is the sponsor. Section __.10(c)(1)(ii) of the Final Regulation.

[94] Section __.20(b) of the Final Regulation. The enhanced requirements applicable to banking entities with $50 billion or more in assets apply only to those banks headquartered outside the United States with total US assets, including branches, agencies and subsidiaries.

[95] Section __.20(e) of the Final Regulation.

[96] Appendix B, Section III, "CEO attestation," of the Final Regulation.

fund, (ii) any bank headquartered outside the United States makes an investment in the fund pursuant to the authority of Section 4(c)(9) of the BHCA, and (iii) the activity or investment occurs solely outside of the United States.[97]

The definition of "US resident" incorporates the SEC's definition, which will make compliance easier since that definition is widely understood. The Preamble indicates that secondary market sales by non-US resident investors to US investors, and even registration of fund interests on a non-US stock exchange, would not violate the Final Regulation.[98] In addition, the reference to Section 4(c)(9) does not require compliance with all provisions of the regulation that implements it but rather generally requires that the bank headquartered outside the United States comply with the regulation's definitional provisions.[99] It means that the decision to invest or sponsor is made by a non-US entity and non-US personnel, the investment or sponsorship is not accounted for by a US entity, and no financing for the ownership or sponsorship is provided by a US entity.[100] US personnel may advise the bank headquartered outside the United States concerning investments of a non-US fund sponsored by the bank and conduct administrative and back-office operations.[101]

If a US banking organization through a non-US subsidiary invests in the fund, the fund is a "covered fund" as to the US organization, but the fund's exemption from coverage for a bank investor headquartered outside the United States is not affected.[102]

Trading Through the Use of US Personnel or Facilities

In general, the SOTUS exception requires that a bank headquartered outside the United States conduct its trading activities with very little US involvement.

Thus, trading covered by the SOTUS exception is required to (i) be engaged in as principal by a non-US entity, and no US personnel may arrange, negotiate or execute the transaction, (ii) the banking entity that makes the final decision to buy or sell is outside the United States and not organized under US law, (iii) the transaction must not be accounted for as principal by any US entity, (iv) financing is not provided by any US entity, and (v) the transaction is not conducted through any US entity except for a non-US arm of a US entity or is conducted with an unaffiliated market intermediary so long as the transaction is promptly cleared and settled through a central counterparty.[103]

The prohibition on the use of financing by a US affiliate of the bank headquartered outside the United States under the SOTUS exception presents an issue when using US dollars inasmuch as those dollars are likely obtained through the routine activities of the US branch or other office or subsidiary. The Preamble states that this is not intended to preclude the use of "collected" funds in an account at a US branch.[104]

97 Section __.13(b)(1) of the Final Regulation.

98 Preamble, pages 743-44.

99 Preamble, page 731, n.2410.

100 Section __.13(b)(4) of the Final Regulation.

101 Preamble, pages 737-38.

102 Preamble, pages 485-86 and 642.

103 Section __.6(e)(1), (2) and (3) of the Final Regulation. The bank headquartered outside the United States need not confirm that a US bank's non-US arm is acting in compliance with the Final Regulation when engaging in the transaction. Preamble, page 428.

104 Preamble, page 422, n.1522.

Compliance and Reporting

Unlike the text of the Final Regulation, which generally makes clear which provisions apply to US banks and which ones apply to banks headquartered outside the United States, the Appendices setting out the compliance and reporting requirements noted above do not clearly state that they do not apply to non-US operations of banks headquartered outside the United States. However, the reference in the Appendices to imposing reporting requirements, and enhanced compliance policies and procedures, only on banks headquartered outside the United States with a certain amount of US trading assets and liabilities provides a strong inference that the compliance and reporting requirements apply only to US operations. The Preamble confirms this conclusion.[105]

International Ramifications

The Volcker Rule does not exist in a global vacuum. The United Kingdom, France, Germany and European Union, as well as other countries, are giving serious consideration to regulatory reforms that might address what are perceived as possible causes of, or at least contributions to, the financial crisis and resulting rescue operations required for several internationally active institutions.

The United Kingdom has adopted legislation, The Financial Services (Banking Reform) Act 2013 (the "UK Act"), based on the recommendations of the 2011 Vickers Report.[106] The UK Act includes a prohibition on UK deposit-taking banks from dealing in investments as principal, subject to certain exceptions which are still to be finalized in secondary legislation.[107] These exceptions are likely to follow those recommended in the 2011 Vickers Report, namely, an exception for banks with less than £25 billion in retail deposits, and exceptions for underwriting, market-making, payment services, commercial lending, simple derivatives trading, debt equity swaps, securitization of own assets, and certain ancillary activities.[108] Unlike the Volcker Rule, the UK Act does not prohibit proprietary trading; it only requires such activities to be carried on outside the deposit-taking banking entity.

The prohibition applies to all deposit-taking banks incorporated in the United Kingdom, irrespective of where their deposit-taking activities are located. This means that any UK-incorporated bank which is also a "banking entity" under the Volcker Rule would be subject to both the Final Regulation and the UK Act and would need to rely on one of the exceptions in the Final Regulation (such as the "SOTUS" exception discussed earlier) with respect to its UK business in order to engage in proprietary trading within the same group. It is worth noting in addition that the UK Treasury has the power to prohibit ring-fenced bodies from establishing or maintaining a branch in a specific country or territory.

105 Preamble, page 728, n.2401.

106 The UK Act, which received Royal Asset on December 18, 2013, is *available at* http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf.

107 The draft secondary legislation, which has since been subject to consultation, is *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf

108 If you wish to obtain more information on this action, you may review our client memorandum, "Vickers Recommendations on Bank Ring-fencing Made Law in the UK" (19 Dec. 2013), *available at* http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/12/VickersRecommendationsonBankRingfencingMadeLawintheUKFIAFR121913.pdf.

Branches and establishments of non-UK banks operating within the UK are not within the scope of the UK ring-fencing regime.

The French regime on the separation and regulation of banking activities, published on July 26, 2013, requires the ring-fencing of proprietary trading and other activities deemed to be high risk from traditional deposit-taking and commercial lending activities.[109] Such ring-fencing must be in effect by July 1, 2015 but banks are required to identify which proprietary trading activities are to be transferred by July 1, 2014. In Germany, new legislation, approved on June 7, 2013, similarly requires banks and banking groups to separate their proprietary trading and certain other high-risk activities from their deposit-taking business.[110] The prohibition will enter into force on July 1, 2015. Both regimes provide for certain exceptions, with the ring-fencing and separation rules only applying once certain thresholds are exceeded.

The European Commission is expected to present its own pan-European proposals on bank structure in January 2014. These proposals are expected to be based on the high-level recommendations of the 2012 Liikanen Report.[111] The Report also proposed the ring-fencing of deposit-taking banks from proprietary trading activities carried on by other entities in the same banking group, subject to similar exceptions as set out above, such as lending, trade finance, private wealth and asset management, plain vanilla securitization, simple derivative transactions, underwriting and restricted hedging service to non-bank clients. It appears likely that the European proposals will be higher level than the UK, French or German proposals, thereby enabling local, more detailed separation approaches to be tried out in the first instance (*i.e.* at the member state level), with a view to mandating any stricter approach at a later stage once the effects of the differing approaches to bank structure can be better ascertained. The pending European proposals are therefore not expected to require any significant changes to the UK, French or German regimes.

The UK, French, German and EU reforms do not go as far as the Volcker Rule. However, the topic is under ongoing review. For instance, in the United Kingdom the UK Act requires regulators to review, within 12 months of the ring-fencing requirement taking effect, proprietary trading activities engaged in by all regulated financial institutions in the UK (and not just deposit-taking banks). Regulators are also required to review the ring-fencing rules themselves within five years.

Therefore the interplay between the different international regimes cannot yet be fully determined. In addition to the European proposals emerging shortly and any changes of tack entailed as a result of that process, there could well, over time, be further convergence with the Volcker Rule. Nevertheless, in the short to medium term at least, the world is likely to have somewhat conflicting and overlapping approaches taken at a national level to structural safeguards imposed on deposit-taking institutions. How internationally-active banking institutions will deal with the different regimes will be one of many challenges for the future structuring of banking businesses.

[109] The Law of 26 July 2013 on the Separation and Regulation of Banking Activities (Law no. 2013-672) is *available at* http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000027754539.

[110] The Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups is *available at* http://www.bundesrat.de/cln_330/SharedDocs/Drucksachen/2013/0301-400/378-13,templateId=raw,property=publicationFile.pdf/378-13.pdf

[111] The final report of the High-level Expert Group on reforming the structure of the EU banking sector chaired by Erkki Liikanen dated 2 October 2012 is *available at* http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

* * * *

The Final Regulation will lead to significant changes in the ways that banking institutions conduct their market-related activities and serve their customer bases. We will continue to monitor developments and provide updates as appropriate.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069