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OCC's Interim Volcker Rule Examination Procedures Provide Much-Needed Guidance to Banks Seeking to Comply

On June 12, 2014, the Office of the Comptroller of the Currency (OCC) issued interim procedures for examiners to assess banks' progress in developing a framework to comply with the requirements of what is commonly known as the "Volcker Rule."¹ The interim procedures would apply to examinations of national banks (other than certain limited-purpose trust banks), federal savings associations, and federal branches and agencies of foreign banks (collectively, "Banks").² Although the OCC's interim procedures are addressed to examiners rather than banks, they shed some (long awaited) light on the OCC's focus and priorities with regard to the implementation of the Volcker Rule.³

The Volcker Rule prohibits banking entities from engaging in short-term proprietary trading of financial instruments ("Proprietary Trading") and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds ("Covered Funds"). Unless the Board of Governors of the Federal Reserve System ("Federal Reserve") extends the conformance period again, Banks must conform their activities and investments to the regulations' requirements by July 2015. However, as stated in the OCC's interim procedures, Banks that do not have ownership interest in, sponsor, or have certain relationships with Covered Funds ("Cover Fund Activities") and limit their Proprietary Trading to domestic government obligations are not required to adopt compliance programs or report metrics, and OCC examiners are not required to conduct additional procedures.

The interim procedures are divided into four categories: General Procedures, Proprietary Trading, Covered Funds, and Conclusions. Below we summarize the key objectives of each category; however, for banks seeking to comply, we recommend a review of the entire set of interim examination procedures.

GENERAL PROCEDURES

The General Procedures direct examiners to assess a Bank's progress toward identifying its activities that are subject to the regulations. In particular, an examiner shall assess a Bank's progress in identifying (i) its banking entities that are engaged in Proprietary Trading and Covered Fund Activities, and then (ii) the respective Proprietary Trading and Covered Fund Activities. Among other requirements that the examiners must assess, the interim procedures indicate that a Bank must identify:

- Purchases and sales of financial instruments for specified short term purposes;
- Trading desks responsible for short-term trading, and exemptions on which each desk intends to rely for such activities; and

¹ The Volcker Rule is section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, together with implementing regulations.

² The OCC's press release accompanying the interim procedures is available [here](#).

³ The OCC cautions that the interim procedures present a simplified version of the regulations and directs examiners to consult 12 C.F.R. Part 44 for more details.

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- Ownership interests in covered funds, covered funds that the Bank sponsors or advises, and entities that the Bank expects to be exempt from the definition of Covered Funds.

The General Procedures also require examiners to assess a Bank's:

1. Progress toward establishing a compliance program.

Among other requirements, the procedures indicate that Banks are required to determine what kind of compliance program is required (e.g., None, Simplified, Standard, Enhanced), and to document why each fund that the Bank sponsors will be exempt from the definition of Covered Fund.

2. Plan for avoiding material conflicts of interest and material exposures to high-risk assets and high-risk trading strategies.

The interim procedures indicate that, among other requirements, a Bank must develop criteria for identifying material conflicts of interest, high-risk assets, and high-risk trading strategies, and take into account exposure to seven types of assets (set forth in Appendix B.II.A, Other Compliance Matters).

PROPRIETARY TRADING

With regard to a Bank's Proprietary Trading, an examiner is expected to assess the following:

1. A Bank's progress toward computing and reporting metrics as and when required.

A Bank must determine whether it is subject to metrics reporting and, if so, when reporting begins. The interim procedures provide a convenient reminder that the largest banks – those with trading assets and liabilities of at least \$50 billion, need to start collecting metrics on July 1, 2014, and reporting them monthly starting on September 2. The procedures require examiners to assess the bank's progress toward identifying the trading desks that will compute and report metrics, strongly suggesting that banks are required to do so. As part of identifying the trading desks that will compute and report metrics, banks must determine how many trading desks will report metrics (and whether the number of trading desks is reasonable). Relevant factors for identifying trading desks include "whether the trading desk is managed and operated as an individual unit and whether the profit and loss of employees engaged in a particular activity is attributed at that level."

The interim procedures indicate at least one potentially evasive practice that examiners should look out for: if a Bank combines previously delineated trading desks into a single trading desk, whether it is acceptable depends on whether the desks have similar strategies, the combination has a legitimate business purpose, and the combination allows the bank to more accurately reflect the positions and fluctuations of its proprietary trading. Multiple units with disparate trading strategies being combined into a single desk "could suggest a Bank's attempt to dilute the ability of the metrics to monitor" Proprietary Trading.

2. A Bank's ability to calculate the required metrics.

For the **customer-facing trade ratio**, the procedures expect a Bank to "tag" each trade as customer-facing or not, in order to enable a Bank to determine how it will identify whether a counterparty is a client, customer, or counterparty.

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For the **inventory turnover ratio** and **inventory aging**, the Bank's systems must compute delta-adjusted notional value and 10-year bond equivalent values. For options, value means delta-adjusted notional value; for other interest rate derivatives, value means 10-year bond equivalent value.

For **comprehensive profit and loss (P&L) attribution**, the procedures expect that a Bank's systems are able to segregate P&L into three categories:

- P&L associated with the trading desk's existing positions (i.e., those held at the end of the prior day) and reflecting changes in value on the day. P&L must be further attributed as applicable to changes in market risk factors and any other applicable elements—such as cash flows, carry, changes in reserves, or trade amendments, cancellation, or exercise.
- P&L associated with new positions (i.e., executed during the day) including commissions, fee income and expenses, and market gains or losses. P&L from new positions may be reported in aggregate and does not need to be further attributed.
- Residual P&L that cannot be explained by existing and new positions.

Banks must compute **value-at risk (VAR)** and **stress VAR** metrics for each trading desk. The procedures expect risk sensitivities to be reported on a sufficiently granular basis to account for a preponderance of the expected price variation in the trading desk's holdings. In addition, the procedures require metrics reported across all trading desks to capture all of the Bank's trading risk from underwriting, market making-related activities, risk-mitigating hedging, and trading in domestic government obligations or foreign government obligations.

3. A Bank's progress toward using the metrics to monitor for impermissible Proprietary Trading.

The interim procedures indicate that the Bank must ensure that its metrics reports are meaningful, and that it has established a policy and practice for reviewing, and escalating to its governing body and the OCC, for further review, measurement results that indicate a heightened risk of impermissible Proprietary Trading, along with analysis and explanation.

4. A Bank's progress toward identifying its market making-related activities, market-maker inventory, and reasonably expected near-term demand.

The interim procedures expect Banks to develop systems to separately measure and manage each desk's market-maker inventory and overall financial exposure. Banks must also document, for each market-making desk, the securities, derivatives, and futures in which the desk makes a market, in addition to ownership interests in covered funds in which the desk makes a market, if relevant.

In addition to other requirements, the procedures indicate that Banks must be capable of separately identifying, monitoring, and managing each market-making desk's (1) market-maker inventory; (2) financial exposure; (3) reasonably expected near-term demand; and (4) financial instruments that contribute to its financial exposure, but are not included in the market-maker inventory.

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5. A Bank's progress toward establishing a compliance program for its permitted market making-related activities.

According to the exam procedures, the compliance program specific to market-making activities should have detailed desk mandates and limits for each desk's inventory and financial exposure, based on risk appetite and reasonably expected near-term demand. The procedures discuss policies and procedures, internal controls, analysis, independent testing, and other features of an internal compliance program reasonably designed to ensure compliance with the requirements of the regulations governing market-making activities.

6. A Bank's progress toward establishing a compliance program for its underwriting activity.

The compliance program specific to underwriting requires detailed desk mandates and limits for each desk's underwriting position, based on the nature and amount of the desk's underwriting activities and reasonably expected near-term demand. The procedures discuss policies and procedures, internal controls, analysis, independent testing, and other features of an internal compliance program reasonably designed to ensure compliance with the requirements of the regulations governing underwriting activities.

7. A Bank's progress toward establishing a compliance program for its risk-mitigating hedging activity and satisfying the regulations' documentation requirements.

The interim procedures discuss the requirements for complying with the regulation's compliance program for risk-mitigating hedging activity, including documentation requirements under certain circumstances. The interim procedures clarify that not all hedges rely on the risk-mitigating hedging permitted activity; for example, hedging that occurs as part of market making-related activity is covered by that activity. The procedures indicate that trades that rely on the risk-mitigating hedging permitted activity are likely to be short-term derivatives that involve multiple trading desks or legal entities.

COVERED FUNDS

An examiner's assessment with regard to Covered Fund Activities will focus on a Bank's plan for conforming asset management and sponsorship activities.

Subject to conditions, a Bank may acquire or retain an ownership interest in, sponsor, or organize and offer a Covered Fund as part of its trust, fiduciary, or investment advisory business. The interim procedures expect a Bank to identify, and create a written plan outlining how it intends to offer, Covered Funds that the Bank organizes and offers to investors as part of such business. A Bank must also identify and plan to change the names of such Covered Funds that share the same name or a variation of the same name with the Bank or an affiliate, or have "bank" included in the name of such funds.

Among other conditions, a Bank that serves as the investment manager, investment adviser, or sponsor to a Covered Fund, or that organizes and offers a covered fund, generally may not enter into a covered transaction (as defined in section 23A of the Federal Reserve Act) with the fund. A Bank must also engage in all transactions with a Covered Fund on market terms in accordance with section 23B of the Federal Reserve Act. The procedures briefly discuss such restrictions and note that, in certain cases, a Bank may enter into prime brokerage transactions with a Covered Fund that the Bank indirectly owns through a Covered Fund that the Bank manages, sponsors, or advises.

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The interim procedures address other requirements relating to such asset management and sponsorship activities, including written disclosures to investors.

The interim procedures further require that an examination should assess a Bank's plans for:

1. Conforming *securitization activities* involving a securitization vehicle that is a Covered Fund.

Banks may organize and offer securitizations on the same terms as they may permissibly offer Covered Funds to their trust, fiduciary, and investment advisory clients, except that securitizations need not be part of the Bank's trust, fiduciary, or investment advisory services. The procedures indicate that a Bank must identify securitizations in which the securitization vehicle is a Covered Fund and (i) for which the bank was the securitizer under the risk retention rule (when it is finalized) or (ii) in which the bank acquired or retained an ownership interest as the risk retention rule requires. A Bank must also identify and plan to change the names of such securitizations that share the same name or a variation of the same name with the Bank or an affiliate, or have "bank" included in their names.

The interim procedures address other requirements relating to such securitization activities, including written disclosures to investors.

2. Conforming *underwriting and market-making activities* in Covered Funds.

A Bank may hold an ownership interest in a Covered Fund as part of its underwriting activities or market making-related activities. Among other requirements, the procedures expect Banks to identify the underwriting and market making-related activities involving Covered Funds, and develop a plan to ensure compliance with the requirements of the regulations.

3. Conforming *hedging activities* using Covered Funds.

Covered Funds used for hedging is only permitted for hedging compensation obligations toward an employee who provides investment advisory or other services to a Covered Fund. The procedures indicate that, subject to conditions, a bank may invest in a covered fund as a hedge for compensation obligations to the fund manager based on the value of the fund. The procedures address the documentation, policies, procedures, internal controls, and ongoing monitoring that the regulations require for hedging using Covered Funds.

4. Divesting *nonconforming investments* in Covered Funds.

Unless the Federal Reserve extends the conformance period, banks must conform their investments in covered funds by July 2015. Among other requirements, the procedures indicate that a Bank must identify any illiquid investments for which it plans to seek a special five-year conformance period extension, and to plan for conforming investments in Covered Funds. The procedures also indicate that a Bank may need to engage its accountants to advise on the accounting consequences of different divestiture options.

Examiners looking at the Covered Fund Activities of Banks also must assess the Bank's progress in ensuring compliance with the *de minimis* ownership limits on investments in Covered Funds relevant to permitted asset management, securitization, underwriting, and market-making activities. The interim procedures indicate that

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Banks must test for compliance with the three percent limits quarterly, and maintain records that are sufficient to test for compliance.

CONCLUSIONS

An examiner will have to assess a Bank's overall progress in taking the necessary actions to meet the requirements of the regulations within the conformance period.

The interim procedures require examiners to identify potentially significant gaps in the Bank's efforts to conform its activities and investments to the regulations. If there are any gaps, examiners must take appropriate remedial action, considering the significance of the gap, the remaining conformance period, the Bank's efforts, and other relevant factors.

The interim procedures also contain a glossary which sets forth definitions of key terms in the regulations. While the glossary may be helpful, the OCC recommends that examiners consult the regulations for additional detail, and we recommend that banks do the same; a close review of the regulations, including the commentary in its adopting release, is crucial to ensure compliance with the Volcker Rule during the conformance period and thereafter. Here is one example: the glossary's definition of "Covered Fund" with respect to "funds not offered or sold in the United States" omits the regulation's qualification that such funds are Covered Funds only if they are controlled directly or indirectly by a banking entity located in or organized under the laws of the United States.⁴

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⁴ 12 C.F.R. 44.10(b)(1)(iii). See also 79 Fed. Reg. 5672 ("A foreign fund therefore may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.").