C A D W A L A D E R

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Clients&FriendsMemo

The Volcker Rule's Impact on Foreign Banking Organizations

December 20, 2013

On Tuesday, December 10, 2013, the three federal banking agencies – the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation – as well as the Securities & Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission, approved a final regulation implementing Section 619 of the Dodd-Frank Act, a statutory provision more generally known as the "Volcker Rule." The 72-page final regulations[1] with the accompanying 892-page explanatory "Preamble"[2] were issued nearly three and a half years after the enactment of the Dodd-Frank Act, and more than two years following the proposed regulations issued in October 2011. In conjunction with the adoption of the final regulations, the Federal Reserve issued an order delaying the conformance date for Volcker for an additional year, until July 21, 2015.[3]

The Volcker Rule and last week's implementing regulations are significant in a number of respects. The Volcker Rule and its regulations reflect a shift in U.S. regulatory policy towards foreign banks. While historically U.S. banking regulation sought to regulate only those activities of foreign banks that are conducted within offices or affiliates located in the U.S., the Volcker Rule regulates a foreign bank's activities conducted outside the U.S. that have certain contacts with the U.S. Second, the Volcker Rule represents the first major rollback in bank and bank holding company powers in recent times, following a three-decade period of expansionary authority. The rollback in powers is particularly noteworthy because few other countries have sought to impose similar limitations on their home country banks, and as recognized by Federal Reserve Staff when the final regulations were approved, few countries are expected to adopt Volcker-like limitations in the near future. Thus, foreign banks that become subject to the Volcker Rule will find that U.S. law is more restrictive than home country law. Finally, while the regulations are highly complex, they are also highly dependent on interpretations and positions fleshed out in the supervisory process, and thus the true impact of the Volcker Rule and its regulations will not be understood for some time.

---

1 For the text of the Final Regulations see http://www.federalreserve.gov/aboutthefed/boardmeetings/final-common-rules-20131210.pdf.

2 For the text of the Preamble, see http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf

3 For the text of the Conformance Period Order, see http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf

Overview of the Volcker Rule

The Volcker Rule applies to "banking entities" – defined by statute to include FDIC-insured depository institutions, bank holding companies, savings and loan holding companies, other entities that control an FDIC-insured depository institution, and foreign banks conducting banking activities in the U.S. (referred to generally as a "**foreign banking organization**"), as well as any entity affiliated with any of the foregoing.

The Volcker Rule's statutory language – Section 619 of the Dodd-Frank Act – has three basic elements:

- A general prohibition on "proprietary trading," subject to a few exceptions, including market-making, dealing, and – only with respect to foreign banking organizations, trading activities conducted "solely outside of the United States";
- A prohibition on acquiring or retaining an ownership interest in, or sponsoring, a private equity or hedge fund (referred to in the final regulations as a "**covered fund**"), subject only to a handful of exceptions, including sponsoring, or owning de minimis interests in funds, "organized and offered" by the banking entity for certain asset management purposes and – with respect to foreign banking organizations, covered fund activities conducted "solely outside of the United States"; and
- Restrictions on certain transactions with a private equity or hedge fund if the banking entity or any of its affiliates serves as the fund's sponsor, investment adviser, or investment manager, or if the banking entity "organized and offered" the fund (these restrictions are referred to commonly as "**Super 23A & B**").

The final regulations issued this week provide further clarity on the application of the Volcker Rule to foreign banking organizations in each of these three areas, and address some (but certainly not all) of the concerns voiced in the comment letter process. Adherence to the Volcker Rule and its final regulations will impose a significant burden on foreign banking organizations and will require substantial effort to ensure full conformance by the July 21, 2015 conformance date.

We have attached a summary of the final Volcker Rule regulations, with a particular emphasis on those provisions applicable to foreign banking organizations. However, for most foreign banking organizations, the most important aspects of the final regulations are as follows:

Broad Scope: Despite requests from commenters to limit the broad geographic scope of the Volcker Rule, the final regulations reiterate the extra-territorial scope of the Volcker Rule that appeared in both the statutory language and in the proposed regulations. Under the final regulations, the Volcker Rule applies banking organizations including "any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act," as well as any affiliate or subsidiary of the foregoing (entities subject to the Volcker Rule are collectively referred to as "**banking entities**"). With respect to non-U.S. organizations, a foreign bank that maintains a branch or agency office in the U.S., as well as any foreign bank or foreign company that controls a foreign bank that has a branch or agency in the U.S., is deemed such a "bank holding company." Also covered by the Volcker Rule is any foreign company that controls an FDIC-insured bank or thrift. Finally, any affiliates of these entities are covered as well. ***In sum, a non-U.S. bank that has a branch or agency in the U.S., any company or bank that controls such a non-U.S. bank, any non-U.S. company that controls an FDIC-insured bank or thrift, and any of their respective affiliates,[4] wherever located in the world, are all considered "banking entities" and each and every such entity is subject to the Volcker Rule.***

As a result of this sweeping scope, the Volcker Rule covers nearly 150 top-tier foreign banking organizations headquartered in more than 50 countries outside the U.S., and every one of their affiliates, wherever located.

Proprietary Trading - Exemption for Trading in Foreign Government Obligations: The Volcker Rule prohibits a banking entity from engaging in "proprietary trading" in "financial instruments" (generally, swaps and securities) subject to various exemptions (including exemptions for market-making, underwriting, risk-mitigating hedging, and trading outside the United States). The proposed regulation contained an exemption for trading in U.S. government obligations (including certain state and municipal obligations), but was silent with respect to whether an exemption was available for foreign banks or U.S. banks with respect to non-U.S. government obligations. This issue attracted criticisms during the public comment process, including comment letters from non-U.S. banking regulators.

The final regulations permit a foreign banking organization (including the U.S. branches of the foreign bank or any U.S. subsidiary) to trade in securities that are the obligations of, issued by, or guaranteed by its home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank is organized. With respect to a foreign bank that operates in multiple jurisdictions through branches, it is important to note that this exemption allows only trading in the obligations of the home country of the bank – not the host country where the branch is located. The foreign banking organization may, however, trade in sovereign obligations of the host country (or, for that matter, any other instrument), provided the trading activity is structured to comply with the exemption for trading outside of the United States (discussed immediately below).

Proprietary Trading - Exemption for Trading Outside of the United States: The Volcker Rule's statutory language exempts from the proprietary trading ban those trading activities conducted by

---

[4] Affiliate" status is determined using the Bank Holding Company Act control test (i.e., holding 25% or more of a voting class, being a GP, controlling the selection of a majority of the directors, trustees, or managing members, or otherwise having a "controlling influence").

foreign banking organizations that occur "solely outside of the United States," but the statute did not define the phrase. The proposed regulations define that phrase, and in doing so, would have imposed a number of conditions for such activities to be deemed "solely outside of the United States," including the requirements that no counterparty to the trade may be a resident of the United States, and that the trade may not be "executed" using U.S. execution or clearing facilities (which would have effectively prohibited trading in most U.S. issuer securities. These conditions attracted criticisms regarding their impracticality in the comment process.

The final regulations soften these conditions somewhat; the prohibition on use of U.S. execution facilities was dropped entirely, and certain U.S. persons are permitted to be counterparties.

Under the final regulations, a transaction is considered to satisfy the exemption for transactions "solely outside of the United States" if the following conditions are met:

- The specific banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arranges, negotiates or executes such purchase or sale) is not located in the U.S. or organized under the laws of the U.S. or of any State, and such banking entity is not be owned or controlled, directly or indirectly, by any U.S. entity;
- The banking entity (including its relevant personnel) that makes the decision to purchase or sell as principal is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The purchase or sale (including any transaction arising from risk-mitigating hedging related to the financial instruments purchased or sold) is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's purchase or sale is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- The purchase or sale is not conducted "with or through" any U.S. entity.

Notwithstanding this last condition, a purchase or sale may be "with or through" a U.S. entity if conducted "with or through" (i) the foreign operations of a U.S. entity, (ii) a U.S. entity that is an unaffiliated *market intermediary* (i.e., a U.S. registered broker-dealer, swap dealer, securities-based swap dealer, or futures commission merchant) acting as principal and the transaction is promptly cleared, or (iii) a U.S. entity that is an unaffiliated market intermediary acting as agent and the transaction is conducted anonymously on an exchange and promptly cleared and settled.

As set forth in the final regulations, this exemption enables a foreign banking organization to engage in proprietary trading notwithstanding the Volcker Rule, provided that the transaction is arranged, negotiated, executed, booked, and financed by a banking entity located outside the U.S. (i.e., not its

U.S. branch) and not directly or indirectly by a U.S. entity, no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the arranging, negotiation, execution or decision-making of the transaction, and the counterparty is not a U.S. entity other than certain qualifying *market intermediaries* or the foreign operations of a U.S. banking organization.

Covered Funds - Foreign Regulated Funds: The Volcker Rule's statutory language and the proposed regulations define a "covered fund" solely with respect to its status under the U.S. Investment Company Act of 1940, i.e., whether the fund would be an "investment company" under the Investment Company Act of 1940 but for the exceptions set forth in Sections 3(c)(1) or (3(c)(7) (related to funds with fewer than 100 investors or funds with only qualified purchasers). If a fund is a covered fund, then no banking entity is permitted to acquire or retain an ownership interest in, or sponsor, the covered fund unless an exception applies.

Because the covered fund definition is based solely on a fund's status under the Investment Company Act, it was unclear how to treat a fund organized outside of the United States that would not be available to U.S. investors, because such funds are not subject to the Investment Company Act at all. Thus, there was a possibility that funds that were fully regulated abroad and authorized for sale to retail investors – such as a UCITS – could be considered a "covered fund."

The final regulations create an exemption for foreign public funds, i.e., issuers organized or established outside the U.S. and authorized to offer and sell ownership interests on a retail basis in the issuer's home jurisdiction (e.g., a UCITS), and which sells such ownership interests predominantly (85% or more) through one or more public offerings outside the U.S. Funds satisfying this exception are not considered "covered funds" and foreign banking organizations are not barred from acquiring or retaining an ownership interest in, or sponsoring, a foreign public fund.

It should be noted, however, that the final regulations' compliance provisions require foreign banking organizations to maintain records documenting the basis for being able to rely on this exemption (and certain of the other exemptions from the covered fund definition).

Covered Funds - Foreign Equivalent Funds: To prevent evasion of the Volcker Rule, the proposed regulations contained a provision that required banking organizations (including apparently foreign banking organizations) to determine whether any fund that is organized outside of the United States *would be* a covered fund if it were organized and offered under the laws of the United States or its shares were offered to U.S. residents; if such a fund *would be* a covered fund, the fund is then deemed a covered fund for purposes of the Volcker Rule. This provision would have required foreign banking organizations to speculate how a fund purposefully established outside the U.S. and not offering its shares to U.S. residents would be treated if the fund were established in the U.S. or its shares were offered to U.S. residents—a very challenging, hypothetical mental exercise.

The final regulations abandoned this requirement with respect to foreign banking organizations. Foreign banking organizations are free to sponsor, or acquire a retain an ownership interest in, a covered fund that is organized outside the U.S. (provided certain requirements, discussed below, are satisfied), without having to speculate how the fund would be regulated if it were organized in, or issuing into, the U.S. It is important to note that this foreign equivalent funds concept was retained (in somewhat modified form), however, for U.S. banking organizations.

Covered Funds - Activities Outside of the United States: With respect to foreign banking organizations, the Volcker Rule's statutory language permits acquiring or retaining an ownership interest in, or sponsoring, a covered fund if such activities are conducted "solely outside of the United States." In the proposed rule, the regulators imposed a number of conditions for such activities to be deemed "solely outside of the United States."

The final regulations' requirements are very similar to those requirements that were proposed, and not much relief was granted notwithstanding criticisms and concerns voiced in the comment process. In the final regulations, for covered fund activities by a foreign banking organization to be considered "solely outside of the United States," the following conditions must be satisfied:

- The banking entity acting as the sponsor, or engaging as principal in the acquisition or retention of an ownership interest, must be neither located in the U.S. nor organized under the laws of the U.S. or of any State, and such banking entity may not be owned or controlled, directly or indirectly, by any U.S. entity;
- The banking entity (including its relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor must be neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The ownership or sponsorship (including any transaction arising from risk-mitigating hedging related to the ownership interest) must not be accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's ownership or sponsorship may be provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- No ownership interest in the covered fund may be "offered for sale or sold to" a "resident of the United States."[5]

The final regulations define the phrase "offered for sale or sold to," a phrase that first appeared in the proposed regulations but was not defined. The final regulations state that an ownership interest in the covered fund is "offered for sale or sold" to a resident of the U.S. only if it is sold or has been sold pursuant to an offering that "targets" residents of the U.S. While "targets" is not defined in the

---

5 Based on urgings by commenters, the final regulation adopts the same definition of "resident of the United States" as found in the SEC's Regulation S. Thus, foreign issuers will be able to use a single definition of "resident of the United States" when structuring an offering to comply with U.S. securities laws and the Volcker Rule.

final regulations, the accompanying Preamble sets forth guidelines of what may be necessary to ensure that an offering does not "target" U.S. residents, including prominent disclosures in the offering materials and controls that prevent distribution of offering materials to U.S. residents.

The accompanying Preamble makes it clear that reliance on the outside of the United States exemption does not preclude a foreign banking organization from engaging in other activities with respect to the covered fund using U.S. subsidiaries or U.S. personnel, provided that the requirements listed above are met. For example, a foreign banking organization may use its U.S. subsidiary or personnel to serve as the covered fund's investment adviser or to provide administrative services for offshore affiliates that serve as the covered fund's sponsor. The Preamble also states that tiered arrangements, e.g., arrangements in which a foreign banking organization sponsors an offshore fund, which in turn sponsors or invests in a U.S. fund, may be problematic if the offshore fund was organized for the purpose of investing in a U.S. fund.

The final regulations also make it clear that existing covered fund arrangements must be brought into compliance by the end of the conformance period (or, if either or both of the two one-year extensions are granted, by the end of the extension period), and that there is no grandfathering for pre-existing covered fund arrangements. Thus, if a foreign banking organization has existing covered fund arrangements that are inconsistent with this outside of the United States exemption – for example, because a U.S. subsidiary acts as a general partner or because the fund either has U.S. investors or is not closed to U.S. investors – the foreign banking organization may need to take steps to address these issues by the end of the conformance period (or any extended conformance period).

Covered Funds – Super 23A & Super 23B Restrictions on Transactions with Certain Covered Funds: The Volcker Rule establishes special restrictions on transactions between a covered fund and any banking entity that serves as an *investment manager, investment adviser, organizer and offeror,* or *sponsor* with respect to that covered fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has an ownership interest in the fund. These provisions are nicknamed "Super 23A" and "Super 23B" because they incorporate by reference provisions found in Sections 23A and 23B of the Federal Reserve Act.

- The Volcker Rule's 'Super 23A" provision flatly bars any transaction between such covered fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate" (subject to certain exceptions). Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, a covered fund that is advised, managed, sponsored or organized and offered by the banking entity and its affiliates.

- The Volcker Rule "Super 23B" requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate." Generally speaking, this provision requires all transactions between the fund and the banking entity that advised, managed, sponsored, or organized and offered the fund (or the banking entity's affiliate) to be on arms' length terms.

These aspects of the Volcker Rule, which were incorporated into the proposed regulations with little change from the statutory language, posed significant concern for foreign banking organizations because they were not subject to any geographic restriction. A foreign banking organization (and/or its affiliates), wherever located, that serve as an *investment manager, investment adviser, organizer and offeror,* or *sponsor* to a covered fund appear to be subject to the Super 23A and Super 23B restrictions, even if that covered fund is outside the U.S. and has no U.S. investors.

The final regulations do not expressly limit the seemingly global scope of Super 23A and Super 23B. At most, the final regulations contain an express exemption for acquiring an "ownership interest in a covered fund in accordance with … the requirements of … §__.13 of this subpart." Section __.13(b) authorizes covered fund activities that are "outside of the United States" (as explained earlier). Although not explained further in the final regulations or the accompanying Preamble, this exemption appears to enable a foreign banking organization to acquire and retain an ownership interest in a fund that satisfies the outside of the United States exemption, notwithstanding the restrictions of Super 23A. For example, a foreign banking organization could acquire an ownership interest in a covered fund for which an affiliate is the "organizer and offeror," the investment advisor, the investment manager, or sponsor, provided the outside of the United States conditions are met. However, it is not clear that this exemption would permit Super 23A transactions *other than* the acquisition of an ownership interest – such as a loan to the covered fund, a purchase of assets from the fund, or a guarantee issued on behalf of the fund.

However, other language in the Preamble suggests that the Agencies may have intended to treat a fund meeting the conditions of the Outside of the United States exemption as not being a "covered funds" for purposes of the Volcker Rule, including with respect to Super 23A and Super 23B. In connection with the Agencies' explanation of the exemption for "organized and offered" funds, the Preamble states:

> As described in more detail below, a number of commenters expressed concern about applying the requirements of [the organized and offered exemption] and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of [the Volcker Rule] and implementing regulations. The Agencies believe that many of the concerns raised with respect to applying [the organized and offered exemption] and

> the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. ***In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State….*** Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of [the organized and offered exemption], such as the name-sharing restriction or limitations on director and employee investments.[6]

A similar discussion appears later with respect to the scope of the compliance provisions:

> As discussed in greater detail above in Part IV.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in §__.10(b)(1), a foreign fund 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.***[7]

These discussions suggest that any offshore fund that complies with the outside of the United States exemption ***isn't a "covered fund" at all;*** if so, a foreign banking organization and its affiliates are free to engage in transactions with that fund notwithstanding the limitations of Super 23A, even if the foreign banking organization is the "organizer and offeror," the investment advisor, the investment manager, or sponsor of that fund. Yet, despite the favorable language found in the Preamble, there is no language in the final regulations that expressly confirms this.

Trade Metrics Reporting: Although not required by the Volcker Rule itself, the proposed regulations required banking organizations that engage in proprietary trading activity (including proprietary trading activity that meets certain of the exemptions, such as market-making, underwriting, or transactions solely outside the U.S.) to provide the banking agencies with seventeen trading metrics each month, compiled at the trading desk and business unit levels and calculated generally on a daily basis. The proposal contained two tiers of metrics based on the volume of trading activity, with entities having greater trading activity subject to greater reporting. However, because the thresholds were based on global trading activity, the trade metrics reporting

---

6 See Board of Governors of the Federal Reserve System, Prohibition and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) at pp. 641-42 (emphasis added).

7 Id. at p. 765 (emphasis added).

obligation would in theory apply to foreign banking organizations that have large trading operations but little or no trading in or with the U.S.

The final regulations modify this concept in several important regards. First, the final regulations specify that, with respect to a foreign banking organization, the metrics are calculated based solely on the trading assets and liabilities of its "subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States." Thus, trading activities by a foreign banking organization's non-U.S. affiliates are not taken into account when calculating the thresholds.

Second, the final regulations provide that these trade metrics reporting thresholds will be reduced over time, and will require *monthly* reporting of trading metrics for the highest thresholds and *quarterly* reporting of metrics for the lower thresholds. Under this sliding scale concept, foreign banking organizations with trading assets and liabilities of U.S. operations of $50 billion or more must begin trade metrics reporting beginning on June 30, 2014 on a monthly basis, 30 days in arrears (but becoming 10 days in arrears in January 2015); foreign banking organizations with trading assets and liabilities of U.S. operations of $25 billion or more must begin trade metric reporting on April 30, 2016, on a quarterly basis, 30 days in arrears; foreign banking organizations with trading assets and liabilities of U.S. operations of $10 billion or more must begin trade metric reporting on December 31, 2016, on a quarterly basis, 30 days in arrears.

Third, the final regulations reduce the number of metrics from seventeen to seven. If a foreign banking entity is subject to trade metric reporting, it is required to provide these seven trading metrics data on its proprietary trading activities subject to the Volcker Rule under the various exemptions (such as market-making, underwriting, and trading in U.S. or foreign government obligations), and it is permitted – not required – to include information on its trading activities conducted pursuant to the "outside of the United States" exemption.

Compliance: Compliance provisions were not specifically mandated in the statutory language of the Volcker Rule. However, the proposed regulations contained very burdensome compliance requirements. The proposed regulations established a two-tiered approach towards compliance, with organizations having a larger volume of Volcker-related activities (i.e., trading and covered funds) being subject to much more detailed compliance obligations. The thresholds for this two-tiered approach once again were based on global activities.

For foreign banking organizations, the final regulations abandon the concept of global thresholds and instead look only to U.S. operations. Moreover, the thresholds are no longer based on the volume of Volcker-related activities but rather simply on U.S. assets.

Under the final regulations, foreign banking organizations with consolidated assets of U.S. operations of less than $50 billion are permitted to adopt standard compliance procedures addressing six core elements. Foreign banking organizations with consolidated assets of U.S. operations of $50 billion or more are required to adopt detailed, "enhanced" compliance procedures consistent with Appendix B of the final regulations. In addition, any banking organization that is required to report trading metrics (including, in theory, a foreign banking organization) is also required to adopt the "enhanced" compliance procedures. It is important to remember that the trade metrics thresholds reduce over time, such that foreign banking organizations that have U.S. trading assets and liabilities of $10 billion or more will *eventually* be obligated to adopted enhanced compliance procedures, regardless of amount of their consolidated U.S. assets.[8] Banking entities engaged in no activities covered by the Volcker Rule (other than trading in U.S. government obligations) are required to adopt compliance procedures only before engaging in activities covered by the Volcker Rule, but otherwise are not required to adopt Volcker compliance procedures.

The compliance provisions apply to any entity in the foreign banking organization that engages in at least *some* Volcker-related activities. The final regulations state that the "terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity." As discussed earlier, there is language in the Preamble suggesting that funds operating under the outside of the United States exemption are not, insofar as a foreign banking organization is concerned, a "covered fund" and therefore no compliance program would be required with respect to these fund activities.

For any banking entity with consolidated assets of more than $10 billion (including foreign banking organizations), the final regulations' compliance provisions contain a new documentation requirement with respect to funds activities. The $10 billion threshold appears to be based on *global* consolidated assets, not U.S. assets, and thus will apply to many foreign banking organizations. These banking entities are required to retain records documenting the legal basis that any fund it sponsors or acquires or retains an ownership interest is not a covered fund based on either the Investment Company Act exclusions or certain of the exemptions found in the final regulations.

Finally, with respect to banking entities that are subject to the "enhanced" compliance procedures, the final regulations adopt a "CEO attestation" requirement. Under this provision, the CEO of the banking entity must annually attest to the appropriate federal banking agency "that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program ... in a manner reasonably designed to achieve compliance with" the Volcker Rule and the final regulations. The regulations provide that "in the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management of the [U.S.] operations of the foreign banking entity who is located in the [U.S.]" The final regulations are unclear as to whether this provision allows the senior management of the U.S. operations to also provide the attestation for any non-U.S. operations of

[8] Banking entities with *global* (not *U.S.*) consolidated assets of $10 billion or less may adopt Volcker compliance procedures by including appropriate requirements in existing policies and procedures

the foreign banking organization engaged in Volcker Rule activities or even whether such CEO attestation will be required.

Effective Date: Although materials accompanying the final regulations stated that the final regulations' effective date is April 1, 2014, this is somewhat misleading. Due to the Federal Reserve's extension of the conformance period for an additional year, full conformance with the Volcker Rule's provisions is not required until July 21, 2015. Foreign banking organizations are permitted to request up to two one-year extensions; applications for the first extension period must be filed by mid-January 2015.

Although conformance is not required until July 21, 2015, a foreign banking organization is "expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of [the Volcker Rule and the Final Regulations] by no later than the end of the conformance period."[9] In that regard, the banking agencies expect all banking entities – including foreign banking organizations – to develop conformance plans for bringing their activities and investments into conformance with the Volcker Rule and will likely begin reviewing those conformance plans in 2014. During the conformance period, banking entities "should not expand [existing] activities and make investments … with an expectation that additional time to conform those activities or investments will be granted." It seems likely that, beginning no later than April 1, 2014 (i.e., the effective date of the final regulations), the agencies will expect banking entities to begin these good faith efforts and to avoid expanding activities or making investments that cannot be brought into compliance by July 21, 2015.

While the conformance period delays compliance with the Volcker Rule's restrictions until July 2015, it does not suspend the obligation to provide trading metrics. Foreign banking organizations whose U.S. trading assets and liabilities exceed the relevant thresholds must begin reporting on the relevant threshold date, regardless of the existence of the conformance period or any extensions granted.

* * * * *

A number of unresolved questions remain regarding the Volcker Rule and its final regulations. Moreover, many aspects of the Volcker Rule are left to later supervisory interpretation by the banking agencies – such as the precise scope of activities permitted under the market-making and risk-mitigating exemptions, and the scope of the compliance program needed to satisfy the regulations' compliance provisions. Many of the unresolved questions will hopefully be resolved in the coming months as banking entities begin to construct their conformance plans and these plans are reviewed by the agencies. The full impact of the Volcker Rule, however, will not likely be understood for several years, or examination cycles, afterwards.

---

[9] *See* Board of Governors of the Federal Reserve System, *Order Approving Extension of Conformance Period* (Dec. 10, 2013), at p. 3.

Attached is a more detailed explanation of the Volcker Rule. Inasmuch as the Volcker Rule is highly complex, the explanation is by necessity only a high-level summary.

* * * * *

For further information regarding the Volcker Rule and its final regulations, or if you have any questions about this memorandum, please contact any of the Cadwalader attorneys listed below.

Scott A. Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
Steven D. Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Jeffrey Robins	+1 212 504 6554	jeffrey.robins@cwt.com
Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
James Kong	+1 212 504 6275	james.kong@cwt.com
Nihal Patel	+1 212 504 5645	nihal.patel@cwt.com

Attachment

Implications of The Volcker Rule On Non-U.S. Banks and Affiliates

I. Overview

Scope: Applies to any FDIC-insured bank or thrift, any bank holding company (including a "**foreign banking organization**") as well as any affiliate or subsidiary of the foregoing (collectively referred to as "**banking entities**")

- "FBO" is a foreign bank that maintains a branch or agency office in the U.S.; thus the Volcker Rule applies to a non-U.S. bank that has a branch or agency in the U.S., any foreign organization registered as a "bank holding company," and any of their affiliates, wherever located
- "Affiliate" status is determined using the BHCA control test (i.e., holding 25% or more of a voting class, being a GP, controlling the selection of a majority of the directors, trustees, or managing members, or otherwise having a "**controlling influence**")

Effective: July 21, 2015

- Prior to July 21, 2015, banking entities are expected to use "good faith efforts ... appropriate for its activities and investments, that will result in the conformance of all of its activities and investments ... by no later than the end of the conformance period"
- Banking entities are permitted to request up to two one-year extensions that may be granted in the Agencies' discretion; the first extension request must be submitted by mid-January 2015
- There is a separate five-year extension period available for holding certain "illiquid funds"
- ***There is no "grandfather " concept in the Volcker Rule; all pre-existing investments and activities must be brought into compliance (or terminated) prior to the end of the conformance period (unless an extension is granted)***
- ***Notwithstanding the July 21, 2015 conformance date, certain banking organizations will need to begin reporting trading metrics beginning as of <u>June 30, 2014</u>***

Impact: Proprietary trading & funds activities

II. Proprietary Trading

Scope: Prohibits ***proprietary trading***, defined as engaging *as* ***principal*** in a ***trading account*** of the banking entity to buy or sell a ***financial instrument***

- ***As principal*** includes trading on the banking entity's own behalf
  - Does not include brokerage, agent or custodian trades
- ***Trading account*** includes:
  - any account of a banking entity that is licensed or registered as a securities dealer, swap dealer, or securities based swap dealer (regardless whether licensed or registered under U.S. law),
  - any account treated as a "trading account" under the Market Risk Capital Rules *(although this concept appears limited to U.S. banking entities)*; and
  - any account used to purchase or sell a financial instrument for the purposes short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position from any of the foregoing purchases or sales described above
- Purchases or sales in which the banking entity holds the financial instrument for fewer than 60 days are rebuttably ***presumed*** to be for a ***trading account*** (and thus ***proprietary trading***, if conducted ***as principal***)
- ***Financial instrument*** includes securities, derivatives and swaps (including forwards and futures, and options on securities, derivatives or swaps)
  - Does not include loans, spot FX or spot currency, or physical commodities
- Repos, reverse repos, securities lending / borrowing transactions by banking entities are not considered ***proprietary trading***
- Purchases or sales of a security by a banking entity for *liquidity management* purposes are not considered ***proprietary trading***
  - ***Liquidity management*** is subject to a number of conditions, including (i) existence of a written liquidity management plan, (ii) transactions must be limited to those for short-term funding needs, (iii) securities must be highly liquid, (iv) adoption of written policies, internal controls, analysis, and independent testing

- Other exceptions for transactions required by law, in satisfaction of an existing debt, by clearing members / DCOs, or in connection with a pension plan

III. Exemptions from Proprietary Trading

With the exception of a limited exemption for trading foreign government (non-U.S.) obligations and an exemption for transactions outside the U.S., the proprietary trading provisions do not distinguish between U.S. banking entities and non-U.S. banking entities. The exemptions are as follows:

Underwriting:

- Allows trading by an underwriter in connection with the ***distribution*** (i.e., an offering) of ***securities***
- Limited to taking positions that are "designed not to exceed the reasonably expected near term demand of clients, customers or counterparties," and reasonable efforts must be made to reduce the underwriting position within a reasonable period
- If engaged in underwriting, a banking entity's internal compliance procedures (see below) must include written policies and procedures, internal controls, analysis and independent testing
- A banking entity involved in underwriting must adopt trading desk -level product limits; desk limits; internal controls, monitoring and analysis; authorization procedures for exceptions; and "compensation limits on employees designed not to reward or incentivize excessive prohibited proprietary trading"
- ***The underwriting exemption is available only to those individual banking entities that are licensed or registered to engage in underwriting activities***

Market Making:

- Allows trading by a ***market maker*** in ***financial instruments***
    - A trading desk is deemed to be engaged in market making if the trading desk that "establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments"
- The ***market making*** exemption is limited to taking positions that are "designed not to exceed the reasonably expected near term demand of clients, customers or counterparties," evidenced by a

"demonstrable analysis of historical customer demand, current inventory ..., and market and other factors"

- A banking entity involved in ***market making*** must adopt trading desk -level product limits; desk limits; internal controls, monitoring, analysis; authorization procedures for exceptions; and "compensation limits on employees designed not to reward or incentivize excessive prohibited proprietary trading"
- If engaged in *market making*, a banking entity's internal compliance procedures (see below) must include written policies and procedures, internal controls, analysis and independent testing
- ***The market making exemption is available only to those individual banking entities that are licensed or registered to engage in market making activities***

Risk-Mitigating Hedging

- This exemption allows trading in financial instruments for hedging purposes that "[a]t the inception of the hedging activity... [are] designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity"
- ***Risk-mitigating hedging*** may *not* "give rise, at the inception of the hedge, to any significant or new or additional risk that is not itself hedged contemporaneously"
- Hedging must be subject to ongoing recalibration
- The exemption allows both ***individual or aggregate*** (e.g., portfolio) ***hedging,*** but requires that any hedge "demonstrably reduce or otherwise mitigate the specific, ***identifiable risk(s)*** being hedged"
- If engaged in ***risk-mitigating hedging,*** a banking entity's internal compliance procedures (see below) must include written policies and procedures (including documentation regarding what positions, contracts or other holdings a trading desk may use in its hedging activities), internal controls, and independent testing, as well as "the conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to ***demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged,*** and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged"

- A banking entity must have internal controls and ongoing monitoring activity, management and authorization procedures
- Compensation arrangements for employees involved in ***risk-mitigating hedging*** activities must be "designed not to reward or incentivize prohibited proprietary trading"

Trading in U.S. Government Obligations

- This exemption allows trading in obligations issued or guaranteed by the U.S. Government or the government-sponsored enterprises, any the obligation of any U.S. State or any political subdivisions (including municipalities), or the obligations of the FDIC
- The exemption does not apply to ***derivatives***

Trading in Foreign Government Obligations

- Under this exemption, a foreign banking organization (including the U.S. branches of the foreign bank or any U.S. subsidiary) may trade in securities that are the obligations of, issued by, or guaranteed by the home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank is organized
    - ***With respect to a foreign bank that operates in multiple jurisdictions through branches, it is important to note that this exemption allows only trading in the obligations of <u>the home country of the bank</u> – not the host country where the branch is located***
- A foreign bank subsidiary of a U.S. bank holding company, or a foreign affiliate of a U.S. bank holding company that is regulated in that country as a securities dealer, may trade in securities that are the obligations of, issued by, or guaranteed by the home country (including any agency or political subdivision, and any multinational central bank of which that country is a member) under which the foreign bank or securities dealer is organized
- The exemption does not apply to ***derivatives***

Trading on Behalf of Customers

This exemption allows trading as trustee or fiduciary on behalf of a customer if conducted for the account of the customer, as well as riskless principal trading

Trading by Regulated Insurance Companies

- This exemption allows trading in the general account of a regulated insurance company in compliance with the laws of the country in which the insurance company is domiciled

Trading by Foreign Banking Entities

- This exemption is applicable *only* to a banking entity that is not directly or indirectly controlled by an entity that is, and is not itself, organized under U.S. or any State law
    - ***The exemption is therefore unavailable to all affiliates of a top-tier U.S. bank holding company, or to the U.S. subsidiaries of a foreign banking organization (or any banking entity directly or indirectly controlled by a U.S. subsidiary of a foreign banking organization)***
- Allows trading without restriction (i.e., notwithstanding the provisions of the Volcker Rule) by such banking entities, subject to certain conditions:
- The banking entity is a "qualified banking organization" or meets certain predominance tests regarding the nature and source of its global assets and revenues;
- The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale)" is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The banking entity (including its relevant personnel) that makes the decision to purchase or sell as principal is not located in the U.S. or organized under the laws of the U.S. or of any State;
- The purchase or sale (including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold), is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- The purchase or sale is not conducted "with or through" any ***U.S. entity***.
    - Notwithstanding this condition, a purchase or sale may be "with or through" a U.S. entity if conducted with or through (i) the foreign operations of a U.S. entity, (ii) a U.S. entity that is an unaffiliated *market intermediary* (i.e., a U.S. registered broker-dealer, swap dealer, securities-based swap dealer, or futures commission merchant) acting as ***principal*** and the transaction is promptly cleared, or (iii) a U.S.

entity that is an unaffiliated ***market intermediary*** acting as ***agent*** and the transaction is conducted anonymously on an exchange and promptly cleared and settled

- For purposes of the foregoing, a ***U.S. entity*** is any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State.
- For purposes of the foregoing, a U.S. branch of agency of a foreign bank is deemed to be located in the U.S.
- ***This exemption enables a foreign banking organization to engage in proprietary trading notwithstanding the Volcker Rule, provided that the transaction is arranged, negotiated, executed, booked, and financed by a banking entity located outside the U.S. (i.e., not its U.S. branch), no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the arranging, negotiation, execution or decision-making of the transaction, and the counterparty is not a U.S. entity other than certain qualifying*** **market intermediaries** ***or the foreign operations of a U.S. banking organization***

No Material Conflicts of Interests, Material Exposures, or Threats to Safety and Soundness

- None of the above exceptions are available if the transaction involves or will result in a ***material conflict of interest*** with a client, customer or counterparty, will result in a ***material exposure to a high-risk asset or high-risk trading activity***, or will pose a threat to the safety and soundness of the banking entity or to U.S. financial stability
- The prohibition on conflicts of interest may be avoided if the banking entity makes an appropriate disclosure to the client, customer or counterpart, or if the banking entity establishes information barriers to prevent the conflict of interest from resulting in or involving a material adverse effect on the client, customer or counterparty

IV. Covered Fund Activities

Scope: Prohibits a banking entity, *as principal*, from directly or indirectly acquiring or retaining an *ownership interest* in, or *sponsoring,* a *covered fund*

- *As principal* excludes acquiring or retaining an ownership interest (i) as agent, broker, or custodian conducted for the account of or on behalf of a customer, (ii) through certain deferred compensation or similar plans, or (ii) as trustee or a similar fiduciary capacity on behalf of customers

- *Ownership interest* means any equity, partnership, or ***other similar interest***
    - ***Other similar interest*** is broadly defined to include certain contractual rights or clauses, such as the mere right to participate in the selection or removal of the general partner, managing member, member of the board of directors or trustees, investment manager or investment adviser (whether or not such right is exercised or is outcome-determinative); certain profit-sharing rights or equity-kickers (other than certain profit sharing rights held by investment managers, investment advisers, commodity trading advisers or servicers, or their employees), the rights to any residual; the right to excess spreads; a clause resulting in a modification in the amount of interest paid based on losses or the performance of the covered fund; pass-through income; or synthetic right to have, receive or allocated any of the above rights described above
    - ***The broad* other similar *interest definition could cause instruments typically considered to be debt rather than equity to be nonetheless an ownership interest for purposes of the Volcker Rule***
- *Sponsoring* means (i) to serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund; (ii) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) to share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name
- *Covered fund* means an issuer that would be an "investment company" under the Investment Company Act of 1940 but for the exceptions set forth in Sections 3(c)(1) or (3(c)(7) (related to funds with few than 100 investors or funds with only qualified purchasers), and issuers that are certain ***commodity pools*** as defined under the Commodity Exchange Act
- *Covered fund* also includes funds controlled directly or indirectly by a U.S. banking entity but organized outside the United States (and thus not subject to the Investment Company Act) that holds is, itself out as being, an entity or arrangement that raises money from investors primarily for the purposes of investing in securities for resale or other disposition or otherwise trading in securities, for which the banking entity serves as the sponsor or in which the banking entity has an ownership interest (commonly referred to as *foreign equivalent funds*)
    - ***The foreign equivalent fund provisions generally apply only to U.S. banking organizations, not to foreign banking organizations; this is a significant improvement from the proposed regulations, which would have required foreign banking organizations to determine how an offshore fund would be treated if its shares were offered in the U.S.***

- *Covered fund* also does not include an issuer that can rely on Investment Company Act exemption other than Sections 3(c)(1) or 3(c)(7)

V. Exemptions from the *Covered Fund* Definition

Unlike the proposed regulations, the final regulations contain a number of exemptions from the definition of *covered fund*; these exemptions not only enable a banking entity to sponsor or retain an ownership interest in the exempted entity, but also effectively remove the exempted entity from certain transaction restrictions of the Volcker Rule (known as *Super 23A* and *Super 23B,* discussed later). Other than with respect to the *Foreign Public Funds* and *Covered Bond* exemptions, the exemptions generally apply equally to U.S. banking organizations and foreign banking organizations. These exemptions include:

- ***Foreign Public Funds:*** Issuers organized or established outside the U.S. and authorized to offer and sell ownership interests on a retail basis in the issuer's home jurisdiction (e.g., a UCITS), and which sells such ownership interests predominantly (85% or more) through one or more public offerings outside the U.S. (with certain additional limitations applicable to investors in foreign public funds sponsored by a U.S. bank entity)
    - The compliance provisions of the final regulation require U.S. banking organizations with assets of more than $10 billion to maintain information regarding foreign public funds sponsored by such banking entity
- ***Wholly Owned Subsidiaries:*** Issuers wholly owned by a banking entity or its affiliates other than (i) up to 5% held by employees, or (ii) certain de minimis holdings by third parties if necessary to establish corporate separateness or addressing bankruptcy, insolvency, or similar concerns
- ***Joint Ventures:*** Joint ventures with no more than 10 co-venturers, provided that the joint venture is engaged in activities permissible for the banking entity other than investing in securities for resale or other disposition
- ***Acquisition Vehicles:*** Limited lifetime entities created solely for the purpose of engaging in a bona fide merger or acquisition transaction
- ***Foreign Pension or Retirement Accounts:*** Pension funds organized outside the U.S. for the benefit of citizens or residents outside the U.S.
- ***Insurance Company Separate Accounts:*** Separate accounts created by an insurance company, provided that no banking entity other than the insurance company participates in the account's profits and losses

- *Bank Owned Life Insurance:* An separate account created solely for the purpose of enabling the banking entity to acquire BOLI
- *Loan Securitizations:* Issuers of asset-backed securities the assets of which issuer consist entirely of loans, rate or currency swaps related to those loans, and certain other assets related to or incidental such securitization (but generally excluding assets that are securities)
- The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding loan securitizations sponsored by such banking entity
- *Qualifying ABCP Conduits:* Asset-backed commercial paper conduits owning only loans (or certain related assets) and issuing securities with a legal maturity of 397 days or less, and subject to a liquidity coverage provided by a FDIC-insured bank or thrift, bank holding, savings and loan holding company, or foreign bank, or by the U.S. or foreign sovereign
- The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding ABCP conduits sponsored by such banking entity
- *Qualifying Covered Bond Entities:* Issuers created pursuant to covered bonds offerings by foreign banking organizations (provided the assets of which issuers are limited to those permitted for securitizations, see above)
    - The compliance provisions of the final regulation require banking entities with assets of more than $10 billion to maintain information regarding covered bond entities sponsored by such banking entity
- *SBICs and Public Welfare Investment Funds:* Issuers that are registered small business investment companies, or issuers the business of which is to make investments designed to promote public welfare (as authorized under Section 24 of the National Bank Act)
- *Registered Investment Companies or Excluded Entities:* Issuers registered under the Investment Company Act of 1940, issuers that may rely on an exemption or exclusion other than Section 3(c)(1) or 3(c)(7), or a regulated business development company
- *FDIC Receivership Entities:* Entities created by or on behalf of the FDIC in connection with an FDIC receivership or conservatorship (or an Orderly Liquidation Proceeding under Title II of Dodd-Frank)

Exemption from the Prohibition on Sponsorship or Ownership of Covered Funds

The final regulations contain several exemptions from the prohibition on *retaining or acquiring an ownership interest* in, or ***sponsoring***, a ***covered fund***. While these exemptions enable a banking entity to sponsor, or retain an ownership interest in, the ***covered fund***, the entity nonetheless remains a ***covered fund*** and thus the transaction restrictions of the Volcker Rule (known as ***Super 23A*** and ***Super 23B,*** discussed later) may apply. With the exception of the exemption for ***Corporate Funds Activities Outside the U.S.***, these exemptions below apply equally to U.S. banking organizations and foreign banking organization. These exemptions include:

- *Organized and Offered Funds:* This exemption permits a banking entity to sponsor a covered fund, and permits the banking entity to retain (or its affiliates to acquire) an ownership interest in the covered fund, provided that such ownership interests are reduced to de minimis levels within one year. This exemption is subject to a number of conditions:
- The banking entity (or an affiliate thereof) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;
- The covered fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;
- The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under certain thresholds set forth in the Volcker Rule;
- The banking entity and its affiliates comply with the requirements of Super 23A and Super 23B;
- The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;
- The covered fund, for corporate, marketing, promotional, or other purposes:
    - Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and
    - Does not use the word “bank” in its name;
- No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity

or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

- The banking entity:
  - Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):
    - That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";
    - That such investor should read the fund offering documents before investing in the covered fund;
    - That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and
    - The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and
  - Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.
- Banking entities (and their affiliates) are required to reduce their ownership interests in organized-and-offered funds to certain de minimis limits within one year:
  - *Per-fund limit:* 3% of the total number or value of the outstanding ownership interests in the fund (provided, that a banking entity is permitted to retain a larger amount solely if required under the separately proposed risk retention rules)
  - *Aggregate limit:* the aggregate value of all ownership interest of the banking entity and its affiliates in all organized-and-offered covered funds may not exceed 3% of the banking entity's tier 1 capital

- In addition, for purposes of compliance with regulatory capital requirements, a banking entity's ownership interest in all organized-and-offered covered funds must deduct from its Tier 1 capital
- Detailed provisions for the calculation of the de minimis limits (including treatment of ownership interests held by employees or directors) are included in Section __.12 of the regulations
- *Organized and Offered Asset-Backed Securities Funds:* The final regulation specifically authorizes a banking entity to rely on the organized-and-offered fund exception with respect to asset-based securitizations. This exemption therefore permits a banking entity to organize and offer an asset-backed securities fund that does not meet the ***Loan Securitizations*** exemption discussed previously and thus is a covered fund (for example, if the fund contains assets other than loans)
    - ***Organized-and-Offered Asset-Backed Securities Funds*** must meet all of the requirements of the ***Organized-and-Offered Fund*** exemption, other than the requirements that (i) the banking entity provide bona fide trust, fiduciary, investment advisory, or commodity trading services, and (ii) the covered fund is organized and offered only in connection with the provision of such services and only to persons that are customers of such services
    - Covered funds organized and offered under this exemption remain subject to the restrictions of ***Super 23A*** and ***Super 23B*** and thus certain transactions between the banking entity (or any affiliate) and the covered fund are prohibited
    - ***An* ownership interest *acquired or retained under this exemption must be included in the "de minimis" and capital set-off calculations described above.***
- *Market Making and Underwriting.* This exemption allows a banking entity to retain or acquire an ownership interest in a covered fund if in connection with market making or underwriting activities (as described in the Proprietary Trading provisions of the Volcker Rule)
- ***An* ownership interest *acquired or retained under this exemption must be included in the "de minimis" and capital set-off calculations described above.***
- This exemption does not permit a banking entity to ***sponsor*** a covered fund.
- *Risk Mitigating Hedging.* This narrow exemption permits a banking entity to acquire or retain an ownership interest if "designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund"
    - This exemption allows acquiring or retaining an ownership interest if [a]t the inception of the hedging activity... [it is] designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates

one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee that directly provide advisory , commodity trading advisory, or other services to the covered fund"

- Risk-mitigating hedging may not "give rise, at the inception of the hedge, to any significant or new or additional risk that is not itself hedged contemporaneously," and "must be subject to continuing review, monitoring, and management by the banking entity"
- A banking entity must have internal controls and ongoing monitoring activity, management and authorization procedures
- Compensation arrangement being hedged must relate "solely to the covered fund in which the banking entity (or any affiliate) has acquired an ownership interest and such compensation arrangement must provide that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement"
- Ownership interests held under this exemption are not required to be included in the de minimis and capital set-off calculations
- This exemption allows only acquisition or retention of an ownership interest, but not *sponsoring*
- ***This exemption is considerably narrower than the exemption appearing in the proposed regulation, which allowed acquisition or retention of ownership interests if designed to mitigate a risk to an obligation to a customer***

- Covered Funds Activities Outside the U.S.
  - This exemption is applicable only to a banking entity that is not directly or indirectly controlled by an entity that is, and is not itself, organized under U.S. or any State law
    - ***The exemption is therefore unavailable to all affiliates of a top-tier U.S. bank holding company, or to the U.S. subsidiaries of a foreign banking organization (or any banking entity directly or indirectly controlled by a U.S. subsidiary of a foreign banking organization)***
  - This exemption allows acquiring or retaining an ownership interest of, or sponsoring, a covered fund without restriction (i.e., notwithstanding the provisions of the Volcker Rule) by such banking entities, subject to certain conditions:

- The banking entity is a "qualified banking organization" or meets certain predominance tests regarding the nature and source of its global assets and revenues;
- The banking entity acting as the sponsor, or engaging as principal in the acquisition or retention of an ownership interest, is neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The banking entity (including its relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor is neither located in the U.S. nor organized under the laws of the U.S. or of any State;
- The ownership or sponsorship (including any transaction arising from risk-mitigating hedging related to the ownership interest) is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State;
- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and
- No ownership interest in the covered fund is *offered for sale or sold to* a *resident of the U.S.*
  - A *resident of the U.S.* is defined as under the SEC's Regulation S
  - An ownership interest in the covered fund is ***offered for sale*** *or* ***sale*** *to* a resident of the U.S. only if it is sold or has been sold pursuant to an offering that "*targets*" residents of the U.S.
    - The accompanying Preamble states that a sponsor of a foreign fund will not be viewed as *targeting* U.S. residents "if it conducts an offering directed to residents of one or more countries other than the [U.S.]; includes in the offering materials a prominent disclaimer that the securities are not offered in the U.S. or to residents of the [U.S.]; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the [U.S.]"
- Ownership interests held under this exemption are not required to be included in the de minimis and capital set-off calculations
- *This exemption enables a foreign banking organization to sponsor, or retain or acquire an ownership interest in, a covered fund notwithstanding the Volcker Rule, provided that the sponsorship is conducted, and the ownership interest held*

and financed, by a banking entity located outside the U.S. (i.e., not its U.S. branch), no U.S. personnel of the foreign banking organization (including its U.S. branch personnel) is involved in the decision-making, and the ownership interests in the covered fund are sold in an offering not targeting U.S. residents

- This exemption does not preclude a foreign banking organization from engaging onshore in other activities with respect to the covered fund; for example, the foreign banking organization could serve as an investment adviser to the covered fund through a U.S. affiliate, or could use U.S. personnel with respect to administrative or back-office functions with respect to sponsorship or ownership activities.

- **Acquisitions by an Insurance Company.** This exemption allows the acquisition or retention of an ownership interest in a covered fund if held in the general account or in one or more separate accounts of an insurance company, conducted compliance with the laws of the country in which the insurance company is domiciled

No Material Conflicts of Interests, Material Exposures, or Threats to Safety and Soundness

- None of the above exceptions are available if the transaction involves or will result in a *material conflict of interest* with a client, customer or counterparty, will result in a *material exposure to a high-risk asset or high-risk trading activity,* or will pose a threat to the safety and soundness of the banking entity or to U.S. financial stability
    - The prohibition on conflicts of interest may be avoided if the banking entity makes an appropriate disclosure to the client, customer or counterpart, or if the banking entity establishes information barriers to prevent the conflict of interest from resulting in or involving a material adverse effect on the client, customer or counterparty

VI. Super 23A / Super 23B

The Volcker Rule establishes special restrictions on transactions between a *covered fund* and any banking entity that serves as an i*nvestment manager, investment adviser, organizer and offeror,* or *sponsor* with respect to that fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has invested in the fund. These restrictions are fairly onerous:

- No Covered Transactions (Super 23A)
    - The Volcker Rule flatly bars any transaction between such covered fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate."
    - Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, the covered fund.
        - Notwithstanding Super 23A, investments in the fund are permitted to the extent otherwise authorized by the Volcker Rule (e.g., ownership interests held pursuant to the Organized and Offered exception, market making and underwriting activities, and pursuant to the risk retention rule)
- Arms' Length (Super 23B)
    - The Volcker Rule requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a "bank" and the fund treated as if it were a nonbank "affiliate."
    - Generally speaking, this provision requires all transactions between the fund and the banking entity (or its affiliate) to be on arms' length terms.
- *Neither the Volcker Rule nor the final regulations contain a blanket exemption from Super 23A or Super 23B with respect to foreign banking organizations or their activities conducted abroad. Thus, the Super 23A and Super 23B restriction on transactions with covered funds appears to apply to non- U.S. entities operating solely outside the United States, if the non- U.S. entity is merely affiliated with a foreign banking organization. The effect of this is, Super 23A appears to bar certain transactions between a foreign banking organization and a covered fund that is sponsored, organized, advised, or managed by that foreign banking organization (or an affiliate), even if no party to the transaction is located in or otherwise connected to the U.S., and even if the covered fund is not "offered for sale or sold to" U.S. residents.*
- *The final regulations, however, contain an exemption for acquiring an "ownership interest in a covered fund in accordance with … the requirements of … §__.13 of this subpart." Section __.13(b) authorizes covered fund activities that are outside of the U.S., as explained earlier. Although not explained in the final regulations or the accompanying Preamble, this exemption appears to enable a foreign banking organization to acquire and retain an ownership interest that satisfies the Outside the U.S. exemption, notwithstanding*

the restrictions of Super 23A. For example, a foreign banking organization could acquire an ownership interest in a covered fund for which an affiliate is the "organizer and offeror," the investment advisor, the investment manager, or sponsor, provided the Outside the U.S. conditions are met. However, it is not clear that this exemption would permit Super 23A transactions other than acquisition of shares – such as a loan to the covered fund, a purchase of assets from the fund, or a guarantee issued on behalf of the fund.

- *The language in the Preamble suggests that the Agencies may have intended to treat a fund meeting the conditions of the Outside of the United States exemption as not being a "covered funds" for purposes of the Volcker Rule, including with respect to Super 23A and Super 23B. In connection with the Agencies' explanation of the exemption for "organized and offered" funds, the Preamble states:*

> *As described in more detail below, a number of commenters expressed concern about applying the requirements of [the organized and offered exemption] and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of [the Volcker Rule] and implementing regulations. The Agencies believe that many of the concerns raised with respect to applying [the organized and offered exemption] and the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State.… Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of [the organized and offered exemption], such as the name-sharing restriction or limitations on director and employee investments.*

A similar discussion appears later with respect to the scope of the compliance provisions:

> *As discussed in greater detail above in Part IV.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in §__.10(b)(1), a foreign fund 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.*

This language suggests that any offshore fund that complies with the Outside of the United States exemption isn't a "covered fund" at all; if so, a foreign banking organization (and its affiliates) are free to engage in transactions with that fund notwithstanding the limitations of Super 23A, even if the foreign banking organization is the "organizer and offeror," the investment advisor, the investment manager, or sponsor of that fund. Yet, despite the favorable language found in the Preamble, there is no language in the final regulations that expressly confirms this.

VII. Trade Metrics Reporting

Scope:

- The trade metrics reporting obligations only to those banking organizations that have ***trading assets and liabilities*** equaling or exceeding certain thresholds, determined based on the four previous calendar quarters
- ***Trading assets and liabilities*** is not defined in the final regulation, but it appears that the regulators intend to incorporate the term as used in Call Report Instructions and capital regulations
- For purposes of the calculations, trading assets and liabilities involving obligations of or guaranteed by the U.S. or any agency of the U.S. are excluded
- For U.S. banking organizations, the threshold is calculated based on ***global*** considered trading assets (including all affiliates); ***for foreign banking organizations, the threshold is calculated solely based on trading assets and liabilities of its "subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the [U.S.]"***
- The initial threshold of $50 billion and commences as of June 30, 2014, but the threshold will be reduced to $25 billion on April 30, 2016, and to $10 billion on December 31, 2016
- Reporting is required monthly, 30 days in arrears (reduced to 10 days in arrears in January 2015) for banking entities with trading assets and liabilities of $50 billion or more; for other banking organizations, reporting is quarterly, 30 days in arrears
    - ***Thus, foreign banking organizations with historical trading assets and liabilities of U.S. operations of $50 billion or more must begin trade metrics reporting beginning on June 30, 2014 on a monthly basis, 30 days in arrears (but becoming 10 days in arrears in January 2015); foreign banking organizations with trading assets and liabilities of U.S. operations of $25 billion or more must begin trade metric reporting on April 30, 2016, on a quarterly basis, 30 days in arrears; foreign banking organizations with trading assets and liabilities of U.S. operations of $10 billion or more must begin***

trade metric reporting on December 31, 2016, on a quarterly basis, 30 days in arrears

- Trade metrics reporting entail seven metrics:
  - Risk and position limits and usage
  - Risk Factor Sensitivity
  - Value-at-Risk and Stress Value-at-Risk
  - Comprehensive Profit and Loss Attribution
  - Inventory Turnover
  - Inventory Aging; and Customer-Facing Trade Ratio
  - Trading metrics must be gathered and reported at the trading desk level, generally reflecting calculations conducted on a daily basis
  - Details on the calculations are set forth in Appendix A to the final regulation
  - Banking entities are required to reporting trading metrics with respect to market-making, underwriting, risk-mitigating hedging, and U.S. and foreign government obligations. Banking entities may, but are not required to, include trading metrics with respect to other exempted trading activity (such as trading outside of the United States)

VIII. Compliance

Scope: The compliance requirements vary depending on nature of the activities engaged in and the size of the entity (on a consolidated basis)

- Banking entities engaged in no activities covered by the Volcker Rule (other than trading in U.S. government obligations) are required to adopt compliance procedures only before engaging in activities covered by the Volcker Rule, but otherwise are not required to adopt Volcker compliance procedures

- Banking entities with consolidated assets of $10 billion or less may adopt Volcker compliance procedures by including appropriate requirements in existing policies and procedures

- Banking entities with consolidated assets of less than $50 billion (or foreign banking organizations with consolidated assets of U.S. operations of less than $50 billion) are permitted to adopt standard compliance procedures addressing six elements

- Banking entities with consolidated assets of $50 billion or more (or foreign banking organizations with consolidated assets of U.S. operations of $50 billion or more), or any banking entity, regardless of size, that is required to provide trade metrics reporting under Appendix A, are required to adopt "enhanced" compliance procedures consistent with Appendix B
  - ***It is important to recognize that the threshold for reporting trading metrics will decrease from $50 billion to $10 billion by December 31, 2016; this will***

have the effect of <u>increasing</u> the number of banking organizations subject to the enhanced compliance procedures.

- *The final regulations require foreign banking organizations to adopt compliance procedures (either standard or enhanced, depending on their assets); these compliance procedures must be adopted by the foreign banking organization and its affiliates, wherever located, and are not limited to the U.S. subsidiaries and operations of the foreign banking organization*

IX. Six Elements:

- Written policies and procedures "to ensure that all activities and investments conducted by the banking entity that are subject to [the Volcker Rule and the final regulations] comply with the [Volcker Rule and the final regulations]"
- A system of internal controls reasonably designed to monitor compliance with [the Volcker Rule and the final regulations] and to prevent occurrence of prohibited activities and investments
- A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and the final regulations, including management review of trading limits, strategies, hedging activities, investments, incentive compensation, among others
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel (either inside or outside of the banking entity)
- Training for trading personal and managers, and other appropriate personnel
- Retention of records sufficient to demonstrate compliance, to be retained for a period of at least five years.

X. Enhanced Compliance (Appendix B)

- The *enhanced* program requirements impose highly detailed compliance obligations, including desk-level requirements, with respect to each of the six elements. The overall compliance program must be approved by the board of directors or an appropriate committee of the board (or an equivalent body) and senior management, and include governance procedures establishing management accountability.
- In particular, the enhanced compliance procedures requires the CEO of the banking entity to annually attest to the appropriate federal banking agency "that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program ... in a manner reasonably designed to achieve compliance with" the Volcker Rule and the final regulations.

- The regulations provide that "in the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management of the [U.S.] operations of the foreign banking entity who is located in the [U.S.]"
    - ***The final regulations are unclear as to whether this provision allows the senior management of the U.S. operations to also provide the attestation for any <u>non-U.S. affiliate</u> engaged in Volcker Rule activities.***

XI. Fund Documentation

- For any banking entity with consolidated assets of more than $10 billion (including foreign banking organizations), the compliance procedures require retention of records documenting:
    - the exclusions or exemptions other than Section 3(c)(1) or 3(c)(7) under the Investment Company Act for any fund sponsored by the banking entity (i.e., establishing that the fund is able to rely on an exemption other than Sections 3(c)(1) or 3(c)(7));
    - supporting any the determination by the banking entity that any fund is not a ***covered fund*** based on the ***Organized and Offered, Foreign Public Fund, Loan Securitization, Qualifying ABCP Conduit,*** or ***Qualifying Covered Bond*** exemptions in the final regulations
    - Certain information regarding seeding vehicles that will become registered investment companies or business development companies; and
    - With respect to U.S. banking organizations only, information regarding the aggregate amount of investment in foreign public funds (to the extent exceeding $50 million)
- ***Note that, with exception of the last requirement, these documentation requirements apply equally to U.S. banking organizations and foreign banking organizations***