Volcker Rule

A Lexis Practice Advisor® Practice Note by
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INTRODUCTION

This practice note provides an overview of the Volcker Rule, which was enacted in 2010 as Section 619 of the comprehensive Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and codified as the new Section 13 of the Bank Holding Company Act of 1956 (BHC Act), 12 U.S.C. §1851. The final regulations implementing the Volcker Rule, which were proposed by the responsible U.S. federal agencies—the Board of Governors of the Federal Reserve System (Federal Reserve), the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)—were promulgated on December 10, 2013, and became effective on April 1, 2014. 12 C.F.R. Parts 44, 248 and 351; 17 C.F.R. Parts 75 and 255.

This practice note addresses:

- Volcker Rule Background
- Legislative and Regulatory Updates
- Proprietary Trading
- Covered Funds Activities
- Compliance and Penalties

For more information on the Volcker Rule as it relates to collateralized loan obligations, or CLOs, see Collateralized Loan Obligations under the Volcker Rule.

VOLCKER RULE BACKGROUND

The Volcker Rule essentially contains two prohibitions aimed at "banking entities": A banking entity may not (1) engage in "proprietary trading" or (2) as principal, directly or indirectly, acquire or retain any ownership interest in, or sponsor, "covered funds," which essentially are private equity funds and hedge funds. The Rule is named after former Federal Reserve chairman Paul A. Volcker Jr., who proposed these restrictions under the stated belief that certain types of speculative activities—namely, the types intended to be covered under the Rule—had contributed to the onset of the financial crisis of 2007–2010.

The following banking entities are subject to the Volcker Rule:

- Any insured depository institution (i.e., any bank or savings association the deposits of which are insured by the FDIC)

- Any company that controls an insured depository institution
- Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., any foreign banking organization that is a registered bank holding company or has a U.S. branch, agency, or commercial lending company subsidiary, but not merely a representative office)
- Any affiliate or subsidiary of any of the foregoing entities

As the last bullet indicates, the definition of a banking entity encompasses a surprisingly broad range of entities. It may not seem intuitive to include some of these entities within such definition. For instance, suppose your client is a foreign insurance company with no U.S. presence, and the ultimate parent of this insurance company is a foreign holding company that has a local bank subsidiary with a small branch in New York City. That holding company and *each* of its subsidiaries worldwide, including your client insurance company, is a banking entity within the meaning of the Volcker Rule and therefore is subject to the Volcker Rule prohibitions and restrictions described in this practice note.

“Proprietary trading,” the first of the two restricted activities under the Volcker Rule, is defined very broadly to cover purchase or sale, as principal, of “financial instruments” (again, defined rather broadly) by a banking entity for one of its “trading accounts.” Similarly, the second Volcker Rule-mandated restriction—direct or indirect acquisition or retention of any “ownership interest” in, or sponsorship of, a “covered fund” by banking entities—on its face curbs a bewildering array of fund formation / investment management activities. Moreover, each banking entity must have in place a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions under the Volcker Rule. The compliance program must include, among other things, written policies and procedures reasonably designed to document, describe, monitor, and limit the activities in question; a system of internal controls reasonably designed to monitor compliance; independent testing and audit; and a minimum five-year record maintenance requirement. In counseling your banking entity clients regarding the risk of noncompliance, you should also remind them that because the Volcker Rule has been codified as part of the BHC Act, this statute’s civil *and* criminal sanctions regime could apply to contraventions and violations of the Rule.

Recognizing the risk of overregulation, as well as the heightened compliance burden, associated with this vastly complicated rule, Congress and the federal agencies charged with implementing and enforcing the Volcker Rule have attempted to lessen the unintended consequences of the Volcker Rule in two principal ways. First, there are definitional exclusions, both statutory and regulatory, from broadly defined terms such as “financial instrument,” “trading account,” “covered fund,” and “ownership interest.” Second, there is a fairly broad array of exemptions for certain types of activities and investments—presumably those that fall safely outside the speculation-curbing intent behind this regime—that remain within the defined proscriptions and therefore would otherwise be impermissible for banking entities. This practice note provides a general summary of the definitional exclusions and policy-driven exemptions regarding (1) proprietary trading and (2) investment in and sponsorship of covered funds, in that order.

LEGISLATIVE AND REGULATORY UPDATES

In a 2017 development, the U.S. Treasury Department issued in June 2017 a document titled “A Financial System That Creates Economic Opportunities Banks and Credit Unions”. This document was a report in response to President Trump’s Executive Order 13772 of February 3, 2017, which established the policy of his administration to regulate the U.S. financial system in a manner consistent with a set of “Core Principles” set forth therein. The Treasury report identified laws, treaties, regulations, guidance, reporting and record keeping requirements, and other government policies that it said “inhibit Federal regulation of the U.S. financial system.”

The Treasury report contains a detailed list of recommendations to Congress and federal agencies to further this aim. Some of the salient recommendations in the report for "improving the Volcker Rule" include revisions to the following provisions (all of which are discussed below in this practice note):

- Exempt from the Volcker Rule banking entities with $10 billion or less in assets.
- Exempt from the proprietary trading prohibitions of the Volcker Rule banking entities with over $10 billion in assets that are not subject to the market risk capital rules.
- Eliminate the 60-day rebuttable presumption from the definition of proprietary trading.
- Regulators should give banks additional flexibility to adjust their determinations of the reasonable amount of market-making inventory:
    - For illiquid securities, banks should have greater leeway to anticipate changes in markets.
    - For over-the-counter derivatives, regulators should focus more on ensuring that banks appropriately hedge the positions they maintain.
    - Banks that have not yet established a market-making presence in a particular asset class should have more discretion to meet the reasonably expected near-term demands (RENTD) condition.
    - Banking entities should be able to enter into block trades even if they involve a trading volume outside of historical averages.
- Eliminate the requirement to maintain documentation of the specific assets and risks being hedged.
- The existing "enhanced" compliance program under the regulations should apply only to those banking entities with at least $10 billion in trading assets and liabilities on a consolidated basis; the current application is to all banking entities with over $50 billion in total consolidated assets.
- Banks should be given greater ability to tailor their compliance programs to the particular activities engaged in by the bank and the particular risk profile of that activity.
- Regulators should adopt a simple definition of covered funds that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed.
- The exemptions in Section 23A of the Federal Reserve Act should be restored in the Volcker Rule so that they apply to banking entities' transactions with their covered funds.
- The initial "seeding period" exemption from the covered funds investment restriction should be extended to three years, rather than one year, to provide banking entities with additional time to stand up new funds and allow them to establish the track records they need to attract investors.
- Banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor, provided that the separate identity of the funds is clearly disclosed to investors.
- An exemption of the Volcker Rule's definition of banking entity should be provided for foreign funds owned or controlled by a foreign affiliate of a U.S. bank or a foreign bank with U.S. operations.
- Consideration should be given to permitting a banking entity that is sufficiently well-capitalized—such that the risks posed by its proprietary trading are adequately mitigated by its capital—to opt out of the Volcker Rule altogether, if the institution remains subject to trader mandates and ongoing supervision and examination to reduce risks to the safety net.

In preparing the report the Treasury consulted not only with member agencies of the Financial Stability Oversight Council (including the Federal Reserve), but also with a wide range of stakeholders such as trade groups, financial services firms, consumer and other advocacy groups, academics, financial markets utilities, and rating agencies and, as such, the document likely reflects a broader consensus among various interested parties. For these reasons, lawyers who represent financial institutions would be well-advised to monitor in the coming months, if not years, how some of Treasury's recommendations in the report may evolve into legislative and regulatory proposals.

Coordinated Reviews for Qualifying Foreign Excluded Funds. On July 21, 2017, five federal financial regulatory agencies, including the Federal Reserve, announced that they are coordinating their respective reviews of the treatment of certain foreign funds under the Volcker Rule. These "foreign excluded funds" are investment funds organized and offered outside of the United States that are excluded from the definition of "covered fund" and, as such, the restrictions of the Volcker Rule generally would not apply to investments in, or sponsorship of, such funds by a foreign banking entity.

However, complexities in the statute and the implementing regulations may result in certain foreign excluded funds becoming subject to the Volcker Rule and, as such, a number of foreign banking entities, foreign government officials, and other market participants have expressed concern about possible unintended consequences and extraterritorial impact. In particular, they have contended that certain foreign excluded funds may fall within the definition of "banking entity" under the Volcker Rule if they are an affiliate of a foreign banking entity under the BHC Act by virtue of typical corporate governance structures for funds sponsored by a foreign banking entity in a foreign jurisdiction or by virtue of investment by the foreign banking entity in the fund. For instance, where a foreign banking entity owns a large amount of the fund, selects the board of directors of the fund, or acts as general partner or trustee of the fund, the foreign bank may be deemed by law to "control" the foreign fund. A foreign fund thus deemed to be controlled by a foreign banking entity would be an affiliate of the foreign bank under the BHC Act, and the statute by its terms subjects an affiliate of a banking entity to the restrictions on covered fund and proprietary trading activities in the United States.

The July 21, 2017 announcement stated that staffs of the five federal agencies are considering ways in which the implementing regulation may be amended, or other appropriate action may be taken, to address any unintended consequences of the Volcker Rule for foreign excluded funds in foreign jurisdictions. The announcement left open the possibility that Congressional action may be necessary to fully address the issue.

The announcement further noted that, in order to provide additional time, the Federal Reserve, the OCC and the FDIC will not propose to take action during the one-year period ending July 21, 2018, against a foreign banking entity based on attribution of the activities and investments of qualifying foreign excluded funds to the foreign banking entity, or against a qualifying foreign excluded fund as a banking entity, in each case where the foreign banking entity's acquisition or retention of any ownership interest in, or sponsorship of, the qualifying foreign excluded fund would meet the requirements for permitted covered fund activities and investments solely outside the United States, as more fully described below in this practice note.

The Economic Growth Act. On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act) was signed into law. The Economic Growth Act, among other things, benefits community banks— institutions with $10 billion or less in assets—and makes key changes to enhanced prudential standards and supervision requirements and provides that banking organizations with less than $10 billion in aggregate assets will no longer be subject to the Volcker Rule. Section 204 of the Economic Growth Act further amends the Volcker Rule by removing the restriction that generally prohibits hedge funds and private equity funds from having the same name, or a variation of the same name, as a "banking entity" that is an investment adviser to the fund. This amendment, however, keeps in place the prohibition on sharing a name with a bank.

In June 2018, the Federal Reserve, the OCC, and the FDIC each issued a Notice of Proposed Rulemaking (2018 NPR) proposing several changes to the Volcker Rule. The 2018 NPR proposes significant changes to the Volcker Rule's proprietary trading restrictions, a new tiered system of compliance, and a streamlined set of compliance metrics. While the 2018 NPR seeks public comment on covered fund provisions, the 2018 NPR reaffirms existing frequently asked questions and regulatory guidance concerning definitions of "covered fund" and "banking entity" under the Volcker Rule. The comment period for the 2018 NPR expires on October 17, 2018. It is anticipated that, upon receipt of what many observers expect to be a large number of voluminous comments, the Federal Reserve and the other responsible federal agencies will take some time to amend the Volcker Rule partly as proposed in the 2018 NPR or, alternatively, issue another Notice of Proposed Rulemaking incorporating some of such comments. Some of the salient aspects of the 2018 NPR are noted below as annotations to the existing rules.

PROPRIETARY TRADING

Nature of the Proprietary Trading Prohibition

The first part of the Volcker Rule prohibits a banking entity from engaging in proprietary trading. "Proprietary trading" is defined to mean engaging as principal for the "trading account" of the banking entity in any purchase or sale of one or more financial instruments.

"Financial instrument" includes a security, a derivative, and a contract of sale of a commodity for future delivery, or an option on any of the foregoing. The term "security" includes any note, stock, security future, bond, debenture, certificate of interest, or participation in any profit-sharing agreement, any collateral-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security." The term "derivative" includes any swap (as defined in the Commodity Exchange Act), security-based swap (as defined in the Securities Exchange Act of 1934), purchase or sale of a commodity for deferred delivery that is intended to be physically settled, or any foreign exchange forward or foreign exchange swap. Swaps include ISDA master agreements.

In other words, financial instruments cover an extensive array of financial products and contracts. The term financial instrument, however, does not include:

- A loan
- A commodity, unless it is (1) an excluded commodity (other than foreign exchange or currency), (2) a derivative, (3) a contract of sale of a commodity for future delivery, or (4) an option on a contract of sale of a commodity for future delivery
- Foreign exchange or currency

The term trading account is also defined broadly. If an account meets one of the following three tests, then such account is a trading account under the Volcker Rule:

- **Purpose test.** Is the account used to purchase or sell financial instruments principally for the purpose of (1) short-term resale, (2) benefitting from actual or expected short-term price movements, (3) realizing short-term arbitrage profits, or (4) hedging one or more positions resulting from the purchases or sales described in (1) through (3)? The purchase/sale of a financial instrument is presumed to be for the trading account if the banking entity holds the instrument for fewer than 60 days or substantially transfers the risk of the instrument within 60 days of the purchase/sale, unless the banking entity can demonstrate that it did not purchase/sell the instrument principally for any of the aforementioned purposes.

- **Dealer registration test.** If the account is used by a banking entity to purchase/sell financial instruments for any purpose, is the banking entity (1) a U.S. licensed or registered securities dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased/sold in connection with the activities that require the banking entity to be so licensed or registered; or (2) engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased/sold in connection with the activities of such business? If the answer to either of the foregoing questions is yes, then the account in question is a Volcker Rule trading account.
- **Market risk capital rule test.** If the account is used to purchase/sell financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), is the banking entity or any affiliate thereof an FDIC-insured depository institution, bank holding company, or savings and loan holding company that calculates risk-based capital under the market risk capital rule? Again, if the answer to this question is yes, then the account is a trading account.

The 2018 NPR proposes to replace the intent-based purpose test of the proprietary trading definition and the 60-day rebuttable presumption, all described above, with a new accounting prong that captures positions recorded at fair value on a recurring basis, which the responsible federal agencies believe would cover derivatives, trading securities and available-for-sale (AFS) securities. It has been noted, however, the new accounting prong may create a new set of questions regarding its scope and application. The market risk capital test and dealer test would remain as currently in effect.

Exclusions from the "proprietary trading" definition. The following types of transactions are not deemed to constitute proprietary trading and therefore are outside the purview of the Volcker Rule prohibition on the same:

- Repo and reverse repo transactions
- Securities lending transactions
- Purchase/sale pursuant to a liquidity management plan. The liquidity management plan must be documented; specifically contemplate and authorize the particular securities to be so used; and specify the permissible amount, types, and risks of the attendant securities (e.g., must be highly liquid securities). The 2018 NPR would expand the liquidity management exclusion beyond securities to also permit FX forwards, swaps and physically-settled cross-currency swaps, a expanded relief that would likely be welcomed by the industry.
- Purchase/sale by a derivatives clearing organization or a clearing agency in connection with clearing financial instruments
- Excluded clearing activities by a member of a clearing agency, a member of a derivatives clearing agency, or a member of a designated financial market utility
- Purchase/sale in satisfaction of (1) an existing delivery obligation of the banking entity or its customers (e.g., prevention or closeout of a failure to deliver) in connection with delivery, clearing, or settlement activity or (2) an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization (SRO), or arbitration proceeding
- Purchase/sale by a banking entity acting solely as agent, broker, or custodian
- Purchase/sale through a deferred-compensation, stock-bonus, profit-sharing, or pension plan of the banking entity in its capacity as trustee for the benefit of current or former employees
- Purchase/sale in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable

As you can see, the exceptions from the definition of "proprietary trading" are quite numerous. In counseling your banking entity client, it is therefore critical to examine the entire list of exceptions at the outset to determine whether a particular activity may fall under an exception, because once an activity is outside the definition of proprietary trading, you are in the clear as far as that activity is concerned.

Permitted Proprietary Trading Activities

To recap, the Volcker Rule prohibits a banking entity from engaging in proprietary trading, which is defined to mean engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments. As noted above under *Nature of the Proprietary Trading Prohibition*, certain trading activities that would otherwise fall within the definition of proprietary trading are expressly excluded from it. There is an array of proprietary trading activities that would normally fall within the definition but, for a variety of policy reasons, are permitted for banking entities, typically because they do not constitute the type of speculative trading that the Volcker Rule is intended to curb.

These permitted proprietary trading activities include (1) underwriting activities, (2) market making–related activities, (3) risk-mitigating hedging activities, (4) trading in U.S. and non-U.S. government securities, (5) trading on behalf of customers, (6) trading by a regulated insurance company and (7) trading activities of foreign banking entities. Each of these activities is discussed in further detail below.

Underwriting Activities

Underwriting activities are permitted subject to the following criteria, which are designed to limit and detect evasive transactions:

- The banking entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution.
- The amount and types of securities in the underwriting position are designed not to exceed the reasonably expected near-term demands, and reasonable efforts are made to reduce the underwriting position within a reasonable period.
- The banking entity has established the requisite internal compliance program.
- The compensation arrangements are designed not to reward or incentivize prohibited proprietary trading.

Market Making–Related Activities

Market making-related activities are permitted only if:

- The trading desk routinely stands ready to purchase and sell the types of financial instruments related to the financial exposure and is willing and available to quote, purchase, and sell in commercially reasonable amounts
- The amount, types and risks in the trading desk's inventory are designed not to exceed the reasonably expected near-term demands (RENTD), based on (1) the liquidity, maturity, and depth of the market and (2) demonstrable analysis of historical customer demand, current inventory, and market and other factors
- If any established limit for a trading desk is exceeded, the trading desk takes actions to come back into compliance promptly
- The banking entity has established the requisite internal compliance program
- The compensation arrangements are designed not to reward or incentivize prohibited proprietary trading

In the context of this market-making exemption to the proprietary trading prohibition, as well as in the context of recordkeeping and reporting requirements discussed under "Compliance Program Requirements" in Compliance and Penalties and "Proprietary Trading Reporting Requirements" in Compliance and Penalties the concept of a "trading desk" is important because the relevant provisions center around the question of what is, in fact, a trading desk. The term is defined as the smallest discrete organized unit of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof. Federal regulators expect a trading desk to be managed and operated as an individual unit and to reflect the level at which the profit and loss of the traders is attributed. The regulators apparently believe that this approach helps to manage risks of trading activity more effectively by requiring the establishment of limits, management oversight, and accountability at the level where the trading activity occurs. Significantly, this means that a trading desk may span more than one legal entity, employees of a single trading desk may be working on behalf of multiple affiliated legal entities, and trades and positions managed by the desk may be booked in different affiliated entities. If a single trading desk books positions in different affiliated legal entities, it must have records that identify all positions included in the trading desk's financial exposure and the legal entities where such positions are held.

Under the 2018 NPR, compliance with RENTD under the market-making and underwriting exemptions would be presumed if the banking entity maintains and enforces internal risk limits for each trading desk -- another welcome regulatory relief.

Risk-Mitigating Hedging Activities

The prohibition against proprietary trading does not apply to risk-mitigating hedging activities in connection with individual or aggregated positions, contracts, or other holdings designed to reduce the specific risks in connection therewith, if:

- The banking entity has established the requisite internal compliance program
- The hedging activity, at its inception, is designed to reduce or mitigate specific, identifiable risks (e.g., market risk, counterparty risk) arising in connection with identified positions and does not give rise to any significant new or additional risk that is not hedged at the same time
- The compensation arrangements are not designed to reward or incentivize prohibited proprietary trading

The 2018 NPR removes the requirements for correlation analysis and showing that the hedge "demonstrably reduces or otherwise significantly mitigates" an identifiable risk. For organizations with under $10 billion in trading assets and liabilities, requirements of the hedging exemption are further simplified as long as the hedge is "designed" at inception to reduce or otherwise significantly mitigate an identifiable risk and it is subject to ongoing recalibration.

Trading in U.S. and Non-U.S. Government Securities

Proprietary trading in the following financial instruments is permitted:

- U.S. federal, state, and local government obligations: A financial instrument that is an obligation of: (1) the U.S. government, 2) an agency of the United States or a U.S. government–sponsored enterprise (including Ginnie Mae, Fannie Mae, and Freddie Mac), (3) a U.S. state or a political subdivision thereof, including any municipal security or (4) the FDIC (including in its capacity as conservator or receiver)
- A financial instrument that is an obligation of a non-U.S. sovereign (or any agency or political subdivision thereof), so long as: (1) the banking entity making the purchase/sale is organized under (or is controlled by a banking entity organized under) the laws of a foreign sovereign and is not controlled by a top-tier banking entity that is organized under the laws of the United States, (2) the financial instrument is an obligation of the

foreign sovereign under the laws of which the foreign bank entity referred to below is organized (e.g., in the case of a Spanish banking entity, the financial instrument must be a Spanish government obligation) and (3) the purchase/sale is not made by an FDIC-insured depository institution (Note this exemption is only available to affiliates of foreign banking entities in the United States.)

Trading on Behalf of Customers

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments as follows:

- **Fiduciary transactions.** Purchase or sale by a banking entity acting as trustee or in a similar fiduciary capacity, as long as (1) the transaction is conducted for the account of, or on behalf of, a customer; and (2) the banking entity does not have or retain beneficial ownership of the financial instrument.
- **Riskless principal transactions.** Purchase or sale by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving from a customer an order to purchase a financial instrument, purchases the financial instrument for its own account to offset a contemporaneous sale to the customer.

Trading by a Regulated Insurance Company

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity that is an insurance company (or an affiliate thereof) if all of the following conditions are met:

- The insurance company or its affiliate purchases or sells the financial instruments solely for the general account of the insurance company or a separate account established by the insurance company.
- The purchase or sale is conducted in compliance with the insurance company investment laws, regulations, and written guidance of the U.S. state or the jurisdiction of domicile of such insurance company.
- The appropriate U.S. federal banking agencies have not determined that the particular law, regulation, or written guidance referred to above is insufficient to protect the safety and soundness of the covered banking entity or the financial stability of the United States.

For purposes of this exemption, the following defined terms apply:

"Insurance company" means a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsurance risks underwritten by insurance companies, subject to supervision as such by a U.S. state insurance regulator or a foreign insurance regulator.

"General account" means all of the assets of an insurance company except those allocated to one or more separate accounts.

"Separate account" means an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses (whether or not realized) from assets allocated to such account are credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

Trading Activities of Foreign Banking Entities

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments by a foreign banking entity under the following conditions.

1. The banking entity is not organized (or controlled by a banking entity that is organized) under the laws of the United States or any U.S. state.
2. The purchase or sale is made pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act. A foreign banking organization, more than half of whose worldwide business is banking and more than half of whose banking business is outside the United States (a qualifying foreign banking organization, or QFBO), by meeting at least two of the three quantitative tests measuring its consolidated assets, revenues, and net income, is allowed some relief from the extraterritorial reach of the BHC Act.
3. The transaction takes place solely outside the United States (SOTUS). SOTUS means:

    a) The 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 United States or organized under the laws of the United States or any U.S. state

    b) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or any U.S. state

    c) 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 on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or any U.S. state

    d) No financing for the banking entity's purchases or sales is provided by any branch or affiliate that is located in the United States or organized under the laws of the United States or any U.S. state

    e) The purchase or sale is not conducted with or through any "U.S. entity," other than:

        (i) A purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale

        (ii) A purchase or sale with an "unaffiliated market intermediary" acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty

        (iii) A purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty

For purposes of this SOTUS trading exemption set forth in (e), the following definitions apply:

A "U.S. entity" is any entity that is (or 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 any U.S. state.

A "U.S. branch, agency or subsidiary" of a foreign banking entity is considered to be located in the United States. However, the foreign bank that operates or controls that branch, agency, or subsidiary is *not* considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

> An "unaffiliated market intermediary" means an unaffiliated entity, acting as an intermediary, that is an SEC-registered broker-dealer, a CFTC-registered swap dealer, an SEC-registered security-based swap dealer, or a CFTC-registered futures commission merchant.

To say that foreign banks and their affiliates play a major role in the U.S. banking, trading, and investment management spheres is an understatement. As such, if your client is a foreign banking entity, it would be prudent to query at the outset whether a SOTUS exemption may apply with respect to a trading activity (or, as noted below, a fund investment/sponsorship activity) that may otherwise be covered by and restricted under the Volcker Rule.

The 2018 NPR proposes to remove several conditions from the SOTUS trading exemption, including (1) the prohibition against the purchase or sale being conducted with or through a U.S. entity, (2) the prohibition against provision of financing for the transaction by any U.S. branch or entity and (3) the requirement that no U.S. personnel be involved in arranging, negotiating or executing the transaction.

Backstop Prohibition

None of the activities discussed above under "Permitted Proprietary Trading Activities" in Proprietary Trading (including underwriting, market making, risk-mitigating hedging, trading in government securities, and SOTUS trading) is permissible if the transaction or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties
- Result, directly or indirectly, in a material exposure by the banking entity to a "high-risk asset" or a "high-risk trading strategy"
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States

A high-risk asset is an asset that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. A high-risk trading strategy is a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

In order to mitigate potential conflicts of interest, prior to effecting the transactions in question, the banking entity must take one of the following actions:

- The banking entity must make clear, timely, and effective disclosure of the nature of the conflict of interest and other required information; and make such disclosure explicitly and effectively, in a manner that provides the recipient of the disclosed information the opportunity to negate any material adverse effect of the purported conflict.
- The banking entity must establish, maintain, and enforce certain prescribed information barriers (such as physical separation of personnel or functions, or limitations on types of activity) that are memorialized in written policies and procedures.

COVERED FUNDS ACTIVITIES

Nature of the Covered Funds Prohibition

We now turn to the second prohibition under the Volcker Rule, which provides that a banking entity shall not, as principal, directly or indirectly, acquire or retain any "ownership interest" in, or "sponsor," a "covered fund."

A covered fund means either:

- An issuer of securities that is excluded from the definition of "investment company" based solely on Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (individual investments of at least $5 million) of the Investment Company Act of 1940 (1940 Act) –or–
- A commodity pool (1) for which the commodity pool operator has claimed an exemption under 17 CFR 4.7 or (2) for which a CFTC-registered commodity pool operator is the commodity pool operator, substantially all participation units of which are owned by qualified eligible persons (QEPs), and participation units of which have not been publicly offered to non-QEPs.

The apparent legislative intent behind this somewhat convoluted definition of covered fund is to bring within the purview of the Volcker Rule only those funds that are commonly referred to as private equity funds or hedge funds. However, as you can see, the definition can cover many other types of pooled investment vehicles, most of which presumably had, or will have, little to do with banking entities' imprudent involvement with speculative instruments. Be that as it may, the question of whether a particular fund or vehicle is or is not a Volcker Rule "covered fund" has been and likely will continue to be a source of some confusion among practitioners. For instance, the SEC has stated that, "certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association, are exempted from the [1940 Act] under Section 2(b), which exempts, among other things, activities of United States Government instrumentalities and wholly owned corporations of such instrumentalities." See, e.g., Federal National Mortgage Association, SEC No-Action Letter (May 25, 1988). If an issuer may rely on Section 2(b) of the 1940 Act, it would be relying on a 1940 Act exemption other than the exclusions contained in Section 3(c)(1) or 3(c)(7), and thus would be excluded from the definition of "covered fund."

Covered funds also include, for any banking entity that is (or is controlled by a banking entity that is) located in or organized under the laws of the United States or any U.S. state, an entity (1) that is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (2) that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or otherwise trading in securities; and (3) (A) whose sponsor is that banking entity or an affiliate thereof; or (B) that has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

For this purpose, a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States. However, the foreign bank that operates or controls that branch, agency or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. In other words, generally speaking, a banking entity whose ultimate parent is a foreign bank or holding company can, in a way that one whose ultimate parent is a U.S. entity cannot, engage in certain types of covered funds–related activities offshore as long as there is no U.S. entity in the chain of ownership leading from the ultimate foreign parent to the would-be covered fund in question.

The 2018 NPR does not propose any changes to the "covered fund" definition, but requests comment on a number of revisions, including: whether to adopt a characteristics-based definition of covered fund; and whether to revisit the conditions of various exclusions from the covered fund definition, including those for foreign public funds, securitizations, family wealth management vehicles, and joint ventures.

Ownership interests subject to the Volcker Rule include any equity, partnership, or other similar interest in a covered fund, whether voting or nonvoting, or any derivative of such interest. Determinative factors for "other similar interests" include (1) the right to participate in the selection or removal of general partner and the like; (2) the right to receive a share of the income, gains, or profits of the fund; (3) the right to receive the underlying assets of the fund after all other interests have been redeemed or paid in full; (4) the right to receive all or a portion of excess spread; (5) a provision that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund; (6) receipt of income on a pass-through basis from the covered fund, or a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; and (7) any synthetic right to have, receive, or be allocated any of the foregoing.

The term ownership interest, however, does not include "restricted profit interest" (or carried interest), which is an interest held by an entity (or a current or former employee thereof) in a covered fund for which the entity (or the employee) serves as investment manager, investment advisor, commodity trading advisor, or other service provider. Some of the factors that determine the designation of restricted profit interest are:

- The sole purpose and effect of the interest is to allow the entity (or the employee) to share in the profits of the fund as compensation for the services provided, along with certain obligations to return previously received profits
- All such profits, once allocated, are distributed promptly after being earned or are retained for the sole purpose of establishing a reserve amount for subsequent losses
- Investment limits described below in subsection 4 (Investing in a Fund Organized by a Banking Entity) under "Permitted Covered Funds Activities" in Covered Funds Activities
- Transfer restrictions to nonaffiliates.

A banking entity is a "sponsor" of a covered fund if such banking entity:

- Serves as a general partner, managing member, trustee or commodity pool operator of the fund
- In any manner selects or controls a majority of the directors, trustees or management of the fund –or–
- Shares with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name

The following types of funds, vehicles, and products are excluded from the definition of covered funds:

- Foreign public funds
- Wholly owned subsidiaries
- Joint ventures
- Acquisition vehicles
- Foreign pension or retirement funds
- Insurance company separate accounts
- Bank-owned life insurance
- Loan securitizations
- Qualifying asset-backed commercial paper conduits
- Qualifying covered bonds

- SBICs and public welfare investment funds
- Registered investment companies and excluded entities (Note, again, that an issuer of securities that may rely on an exclusion or exemption from the definition of investment company under the 1940 Act other than the exclusions contained in Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (individual investments of at least $5 million) would not be a “covered fund.”)
- Issuers in conjunction with the FDIC’s receivership or conservatorship
- Any issuer that the appropriate federal banking agencies, the SEC, and the CFTC jointly determine should be excluded from the covered fund definition

Permitted Covered Funds Activities

To recap, the Volcker Rule prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining any ownership interest in, or sponsoring, a covered fund. As noted above under “Nature of the Covered Funds Prohibition” in Covered Funds Activities, certain funds and other investment vehicles that would ordinarily fall within the definition of covered funds are expressly excluded from it. There is also an array of covered funds investment and sponsorship activities that would fall within the relevant definitions which, for a variety of policy reasons, are permitted for banking entities. They include the following seven circumstances: (1) acting as an agent, broker, or custodian, (2) permitted organizing and offering, (3) permitted underwriting and market making, (4) investing in a fund organized by a banking entity, (5) risk-mitigating hedging activities, (6) activities and investments outside of the United States, and (7) regulated investment companies. Each of these is discussed in greater detail below.

1. Agent, Broker, or Custodian

   The general prohibition against a banking entity acquiring or retaining any ownership interest in or sponsoring a covered fund does not apply to the following situations:

   - Banking entity acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer and the banking entity does not have or retain beneficial ownership of such interest
   - If the ownership interest is held by the banking entity as trustee for the benefit of its current or former employees through a deferred compensation, pension, or other similar plan
   - In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable and within the period prescribed by the applicable U.S. regulatory agency

2. Permitted Organizing and Offering

   In general, a banking entity may acquire or retain an ownership interest in or sponsor a covered fund in connection with organizing and offering such fund, if all of the following conditions are met:

   (a) The banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services

   (b) The 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 offered by the banking entity

(c) The banking entity and its affiliates do not acquire or retain an ownership interest in the fund except to the extent described below in subsection 4 (Investing in a Fund Organized by a Banking Entity)

(d) The banking entity and its affiliates comply with the so-called Super 23A and 23B requirements to the extent described below in Permitted Covered Funds Activities – Limitations on Covered Fund Relationships

(e) The banking entity does not guarantee, assume, or otherwise insure the obligations or performance of the covered fund (or any other covered fund in which the covered fund invests)

(f) The covered fund, for corporate, marketing, promotional, or other purposes, does not (1) share the same name or a variation of the same name with the banking entity and (2) does not use the word “bank” in its name

(g) No director or employee of the banking entity takes or retains an ownership interest in the covered fund, except for those who are directly engaged in providing relevant services to the fund at the time of taking such ownership interest

(h) The banking entity clearly and conspicuously discloses to any prospective and actual investor in the covered fund:

- That any losses in the fund will be borne solely by the investors and not by the banking entity; therefore, the banking entity’s losses will be limited to losses attributable to the ownership interests in the fund held by the banking entity in its capacity as investor
- That the ownership interests in the fund are not insured by the FDIC, and are not deposits at, obligations of, or endorsed or guaranteed in any way by any banking entity (unless that is the case)
- The role of the banking entity in sponsoring or providing any services to the fund

3. Permitted Underwriting and Market Making

A banking entity may engage in underwriting or market making–related activities involving a covered fund, subject to the following conditions:

(a) Such activities are conducted in accordance with the requirements described above with respect to underwriting and market making-related activities under Proprietary Trading – Permitted Proprietary Trading Activities.

(b) Any ownership interests acquired in connection with underwriting and market making–related activities are included in the calculation of ownership interests permitted to be held under the limitations described immediately below in subsection 4 (Investing in a Fund Organized by a Banking Entity).

(c) The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired under the permitted organizing, offering, underwriting, and market making authorities are included in the same calculation of ownership interests referred to in clause (b) above.

4. Investing in a Fund Organized by a Banking Entity

A banking entity may acquire and retain an ownership interest in a covered fund organized and offered by it, for two distinct purposes:

a) *Provision of initial equity in connection with the establishment of a fund*, in order to attract unaffiliated investors, subject to a seeding period limit as well as an aggregate limit.

- **Seeding period.** The banking entity (1) must actively seek unaffiliated investors to reduce (through redemption, etc.) the aggregate amount of all ownership interests of the banking entity in the fund to the de minimis limits discussed below and (2) must, no later than one year after the date of establishment of the fund (i.e., the date on which the investment adviser begins making investments pursuant to the investment strategy for the fund), conform its ownership interest in the fund to the per-fund limits discussed below. This one-year period can be extended for up to two additional years by the Federal Reserve.

b) *De minimis investment*, subject to per-fund limits and an aggregate limit.

- **Per-fund limits.** A de minimis investment in any covered fund may not exceed 3% of the total number or value of the outstanding ownership interests of the fund.
- **Aggregate limit.** The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under the authority of either (1) providing initial equity in connection with establishment of a fund or (2) de minimis investment may not exceed 3% of the tier 1 capital of the banking entity, as calculated as of the last day of each calendar quarter. For this purpose, the aggregate value of all ownership interests held by a banking entity is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds, on a historical cost basis.

5. Risk-Mitigating Hedging Activities

An ownership interest in a covered fund that is designed to demonstrably reduce or mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee that provides investment advisory services to the covered fund is permitted only if:

(a) The banking entity has established a compliance program that includes (i) reasonably designed policies and procedures and (ii) internal controls and ongoing monitoring, management and authorization procedures

(b) The acquisition of the ownership interest (i) is made in accordance with the policies, procedures and internal controls; (ii) is designed to and does, in fact, reduce or mitigate one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee who directly provides investment advisory, commodity trading, or other services to the covered fund; (iii) does not give rise to any significant new risk that is not hedged contemporaneously; and (iv) is subject to continuing review, monitoring, and management

(c) The compensation arrangement relates solely to the fund in which the banking entity has acquired an ownership interest pursuant to this exception, and such arrangement provides that any losses incurred by the banking entity on such interest will be offset by corresponding decreases in amounts payable under such arrangement

6. Activities and Investments Outside of the United States

Covered fund activities and investments outside of the United States are permitted only if:

(a) The banking entity is not organized (or controlled by a banking entity that is organized) under the laws of the United States or any U.S. state

(b) The activity or investment is made pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act (See QFBO discussion above in "Permitted Proprietary Trading Activities" – Trading Activities of Foreign Banking Entities in connection with SOTUS trading exemption.)

(c) No ownership interest in the covered fund is offered for sale or sold to a "resident of the U.S." In order to meet this requirement, such ownership interest may only be sold pursuant to an offering that does not "target residents of the U.S."

(d) The activity or investment occurs solely outside of the United States (SOTUS)

"Resident of the U.S." has the same meaning as "U.S. person" under Regulation S of the SEC and therefore includes the following:

- Any natural person resident in the United States
- Any partnership or corporation organized or incorporated under the laws of the United States
- Any estate of which any executor or administrator is a U.S. person
- Any trust of which any trustee is a U.S. person
- Any agency or branch of a foreign entity located in the United States
- Any nondiscretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person
- Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States

The following are *not* "residents of the U.S.":

- Any discretionary account or similar account held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or resident in the United States
- An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country
- Any agency or branch of a U.S. person located outside the United States if (1) the agency or branch operates for valid business reasons and (2) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located
- The International Monetary Fund, the International Bank for Reconstruction and Development, the Asian Development Bank, the United Nations, and their agencies, affiliates, and pension plans, and any other similar international organizations, their agencies, affiliates, and pension plans

An ownership interest is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold pursuant to an "offering that targets residents of the U.S." The sponsor of a foreign fund would not be viewed as targeting U.S. residents if it:

- Conducts an offering directed to residents of one or more countries other than the United States
- Includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States
- ncludes other reasonable procedures so that access to offering and subscription materials would be restricted only to persons that are not residents of the United States

If ownership interests that are issued in a foreign offering are listed on a foreign exchange, secondary market transactions could be undertaken by the banking entity outside the United States in accordance with Regulation S. Foreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States. Sponsors of covered funds established outside of the United States must examine the facts and circumstances of their particular offerings and confirm that the offering does not target residents of the United States.

A covered fund activity of investment occurs solely outside the United States only if:

- The banking entity acting as sponsor, or engaging as principal in the acquisition of the ownership interest, is not (and is not controlled by) a banking entity located in the United States or organized under the laws of the United States or any U.S. state
- The banking entity (including relevant personnel) that makes the decision to acquire the ownership interest or act as sponsor to the fund is not located in the United States or organized under the laws of the United States or any U.S. state
- The investment or sponsorship (including any transaction arising from risk-mitigating hedging related to an ownership interest) is not accounted for as principal on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or any U.S. state
- No financing for the banking entity's ownership or sponsorship is provided by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or any U.S. state

7. Regulated Investment Companies

The prohibition against ownership and sponsorship of covered funds does not apply to investments and activities by an insurance company if:

- The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or a separate account established by the insurance company
- The acquisition and retention of the ownership interest is conducted in compliance with the insurance company investment laws, regulations and written guidance of the U.S. state or the jurisdiction of domicile of such insurance company
- The appropriate U.S. federal banking agencies have not determined that a particular law, regulation or written guidance referred to immediately above is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States

Limitations on Covered Fund Relationships

No banking entity that (1) serves as the investment manager or sponsor to a covered fund or (2) organizes and offers a covered fund pursuant to the permitted organization and offering exception discussed above under "Permitted Covered Funds Activities" in Covered Funds Activities, and no affiliate of such entity, may enter into a transaction with the covered fund that would be a "covered transaction" as defined in Section 23A of the Federal Reserve Act, as if such banking entity and the affiliate thereof were a member of the Federal Reserve System and the covered fund were an affiliate thereof. Moreover, a banking entity that (1) serves as the investment manager or sponsor to a covered fund or (2) organizes and offers a covered fund pursuant to the permitted organization and offering exception will be subject to Section 23B of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate thereof.

Under Section 23A of the Federal Reserve Act, a "covered transaction" means with respect to an affiliate of a member bank:

- A loan or extension of credit to the affiliate, including a repo transaction
- A purchase of securities issued by the affiliate
- A purchase of assets from the affiliate, except such purchase of property as may be specifically exempted by the Federal Reserve
- The acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan or extension of credit
- The issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate
- A transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a bank to have credit exposure to the affiliate
- A derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes a bank to have credit exposure to the affiliate

Notwithstanding the general rule with respect to Federal Reserve Act Section 23A described above, a banking entity may:

- Acquire and retain any ownership interest in a covered fund in accordance with the various exemptions discussed above
- Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity has taken an ownership interest, if certain specified requirements are met

Under Section 23B of the Federal Reserve Act, a member bank or its subsidiary:

- May not purchase as fiduciary any securities or other assets from any affiliate, unless such purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction governing the fiduciary relationship
- Whether acting as principal or fiduciary, may not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank

Backstop Prohibition

None of the permitted investments or activities discussed above under *Permitted Covered Funds Activities* (including permitted organizing and offering, underwriting, market making, investments, risk-mitigating hedging, and SOTUS covered fund activities) is permissible if the transaction or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties
- Result, directly or indirectly, in a material exposure by the banking entity to a "high-risk asset" or a "high-risk trading strategy"
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States

The terms high-risk asset and high-risk trading strategy have the same meanings as those used in the Backstop Prohibition section above under "Permitted Proprietary Trading Activities" in Proprietary Trading.

COMPLIANCE AND PENALTIES

Compliance Program Requirements

Each banking entity must develop and administer a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments described above. The compliance program, at a minimum, must include:

- Written policies and procedures reasonably designed to document, describe, monitor, and limit proprietary trading activities (including setting, monitoring, and managing required limits) and covered fund activities and investments conducted by the banking entity to ensure compliance
- A system of internal controls reasonably designed to monitor compliance and to prevent the occurrence of prohibited activities or investments
- A management framework that clearly delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters requiring attention
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or a qualified outside party
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program
- Records sufficient to demonstrate compliance, which the banking entity must promptly provide to the applicable U.S. federal agency (most likely, the Federal Reserve) upon request and retain for at least five years

Proprietary Trading Reporting Requirements

A foreign banking entity engaged in permitted proprietary trading activity must comply with the reporting requirements described in Appendix A of the Federal Reserve's Regulation VV if the average gross sum of the trading assets and liabilities of the combined U.S. operations of such foreign banking entity (including all subsidiaries, affiliates, branches, and agencies of the foreign banking entity operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the following threshold:

- $50 billion beginning on June 30, 2014
- $25 billion beginning on April 30, 2016
- $10 billion beginning on December 31, 2016

A banking entity with $50 billion or more in trading assets and liabilities (as calculated in the manner described above) must report the information required by Appendix A of Regulation VV for each calendar month within 30 days of the end of the relevant calendar month.

Beginning with information for the month of January 2015, such information must be reported within ten days of the end of each calendar month.

Any other banking entity subject to Appendix A must report the information required by Appendix A for each calendar quarter within 30 days of the end of that calendar quarter unless the Federal Reserve notifies the banking entity in writing that it must report on a different basis.

The 2018 NPR proposes to create three categories of banking entities based on the size of gross trading assets and liabilities: $10 billion and above; between $10 billion and $1 billion; and under $1 billion. According to Federal Reserve staff, approximately 40 firms have $1 billion or more in trading assets and liabilities, accounting for 98% of U.S. trading activity, and only 18 are over $10 billion.

Only firms with $10 billion or more in trading assets and liabilities would be required to implement the full "six-pillar" compliance program and metrics reporting regime. Firms between $1 billion and $10 billion under this metric would be required to implement a simplified program by incorporating Volcker Rule compliance into existing policies and procedures. Firms with less than $1 billion would benefit from a "presumption of compliance" with "no obligation to demonstrate compliance on an ongoing basis". However, if the Federal Reserve or another responsible federal agency that supervises the banking entity in question were to determine that such banking entity was engaged in prohibited trading or covered fund activity, it could force the banking entity to remediate the activity and/or implement a compliance program. For foreign banks, the $10 billion threshold is measured by reference to the foreign bank's combined U.S. operations, but the $1 billion threshold would be measured on a global basis.

Additional Documentation for Covered Funds

Any banking entity that has more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years must maintain records that include:

- Documentation of the exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7) of the 1940 Act relied on by each fund sponsored by the banking entity in determining that such fund is not a covered fund
- For each fund sponsored by the banking entity for which the banking entity relies on an exclusion from the definition of covered fund described above, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to such exclusions
- For each seeding vehicle described above that will become a registered investment company, a plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company, the period of time during which the vehicle will operate as a seeding vehicle, and the banking entity's plan to market the vehicle and convert it into a registered investment company within the specified time period
- A foreign banking entity that has total U.S. assets as of the previous calendar year-end of $50 billion or more must establish enhanced minimum standards for compliance

Penalties for Violations

As noted above, the Volcker Rule is embodied in Section 13 of the BHC Act; therefore, any violation of the Rule is subject to the penalty provisions of that Act.

Criminal penalty

- Whoever knowingly violates any provision of the BHC Act or Federal Reserve regulation issued under the BHC Act shall be imprisoned not more than one year, fined not more than $100,000 per day for each day during which the violation continues, or both.
- Whoever, with the intent to deceive, defraud, or profit significantly, knowingly violates any provision of the BHC Act shall be imprisoned not more than five years, fined not more than $1,000,000 per day for each day during which the violation continues, or both.
- Every officer, director, agent, and employee of a bank holding company shall be subject to penalties for false entries in any book, report, or statement of such bank holding company

Civil money penalty

Any company that violates, and any individual who participates in a violation of, any provision of the BHC Act, or any regulation or order issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $25,000 for each day during which such violation continues. The term "violate" includes any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

- **First tier.** Any company that (A) maintains procedures reasonably adapted to avoid any inadvertent error and, unintentionally and as a result of such an error, (i) fails to make such reports within the period of time specified by the Federal Reserve or (ii) submits any false or misleading report; or (B) inadvertently transmits any report that is minimally late, shall be subject to a penalty of not more than $2,000 for each day during which such failure continues or such false or misleading information is not corrected.
- **Second tier.** Any company that (A) fails to make such reports as may be required under the BHC Act within the period of time specified by the Federal Reserve or (B) submits any false or misleading report in a manner not described in the first tier shall be subject to a penalty of not more than $20,000 for each day during which such failure continues or such false or misleading information is not corrected.
- **Third tier.** If any company knowingly or with reckless disregard for the accuracy of any information or report described in the second tier submits any false or misleading report, the Federal Reserve may, in its discretion, assess a penalty of not more than $1,000,000 or 1% of total assets of such company, whichever is less, per day for each day during which such failure continues or such false or misleading information is not corrected.

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