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The Volcker Rule Proposal: An Initial Review

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Ever since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010,[1] banking organizations (and some nonbank financial institutions) have attempted to determine the breadth and impact of the Volcker Rule. This rule, now section 13 of the Bank Holding Company Act,[2] generally prohibits a covered banking entity ("CBE")[3] from proprietary trading and from investing in or controlling private equity or hedge funds. Long-awaited guidance is now at hand. Earlier this week, the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") (collectively, the "Agencies") all approved a proposed regulation (the "Proposed Rule") for publication.[4] The Commodities Futures Trading Commission ("CFTC") is expected to release its own proposal to implement the Volcker Rule in the near future.

The Proposed Rule sweeps more broadly than the Volcker Rule requires but provides some greater specificity on certain provisions of the Act. The Proposed Rule could have a severe impact on trading or fund ownership or control by banking institutions and others. In a very general sense, the Proposed Rule purports to accommodate trading or fund sponsorships for the benefit of, and where the underlying risks are borne by, customers. If any of these activities are not "for" customers—or if a CBE is unable to demonstrate this fact—then the activity is forbidden. Permitted activities are subject to an array of restrictions and compliance requirements.

The Proposed Rule, if finalized in its current form, is likely to have a significant impact in several areas, including:

- Derivatives;
- Debt markets;
- Securitizations;
- Sponsored funds; and
- U.S. operations of foreign banks.

[1] Pub. L. No. 111-203, § 619, 12 Stat. 1376, 1620 (July 21, 2010) ("Dodd-Frank" or the "Act").

[2] 12 U.S.C. § 1851. This provision is Section 619 in Dodd-Frank. We refer herein to section 13 of the Bank Holding Company Act as the "Volcker Rule."

[3] A CBE is an insured depository institution, its holding company, and any affiliate. Nonbank financial institutions also would become subject to the capital and certain other requirements if and when the Financial Stability Oversight Council ("FSOC") designates them as systemically important. The Volcker Rule does not apply the prohibitions on proprietary trading and certain private equity and hedge fund activity to these institutions, however. These designations may be a while in coming; the FSOC has just begun the rulemaking process for designation. The FSOC proposal for the process is available at http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.

[4] The Proposed Rule is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111011a1.pdf.

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The deadline for comments is January 13, 2012. A hard deadline for a final rule would be July 21, 2012—the date on which the Volcker Rule is to take effect, rule or no rule.

This alert does not purport to be a comprehensive or exhaustive analysis of the Volcker Rule proposal. We discuss the major provisions of the Proposed Rule, beginning with proprietary trading. We then turn to private equity and hedge funds, and conclude with a discussion of compliance requirements and other provisions covering both activities. The Preamble specifically seeks comments on scores of issues raised by the Volcker Rule.

I. PROPRIETARY TRADING

The Volcker Rule broadly prohibits "proprietary trading"—referred to as "covered trading activities" in the Proposed Rule—but permits short-term trading in connection with underwriting, market-making, hedging, and other activities. The Proposed Rule imposes several conditions on the conduct of these activities, including adherence to an extensive compliance regime and the maintenance and reporting of detailed trading records.

A. Definitions

The scope of the prohibition on proprietary trading depends on a set of interlocking definitions. The "proprietary trading" covered by the Volcker Rule means certain trading within a "trading account," which is one in which a CBE may take a "covered financial position" ("CFP") for the purpose of short-term profits.

1. Proprietary trading

Proprietary trading by a CBE is defined in section 3(b)(1) of the Proposed Rule as engaging as principal for its own trading account in any transaction to purchase or sell, or otherwise acquire or dispose of, any of several categories of securities or other instruments (known as covered financial positions) is engaged in proprietary trading under the Proposed Rule.

2. Trading account

Section 3(b)(2) of the Proposed Rule identifies three kinds of accounts as trading accounts, the first of which is specified in the Volcker Rule. The other two are creations of the regulators. An account will be regarded as a trading account if the CBE uses the account for one of three purposes:

(i) To acquire or take one or more CFPs principally for the purpose of either short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one of these positions;

(ii) To acquire or take a CFP that is subject to the market risk capital rule, if the CBE (or any affiliate that is a bank holding company) calculates risk-based capital ratios under that rule. Positions that are foreign exchange derivatives, commodity derivatives, or commodity futures are not CFPs for the purpose of this definition; and

(iii) To acquire or take a CFP for any purpose if the CBE undertakes the transaction in its capacity as a SEC-registered dealer or municipal securities dealer, (b) a registered government securities dealer, (c) a CFTC-registered swap dealer, or (d) an SEC-registered security-based swap dealer. If the CBE is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside the U.S., then any CFP taken in connection with that business will be a trading account.

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3. Covered financial position

The term “covered financial position” (“CFP”), as defined in section 3(b)(3) of the Proposed Rule, encompasses any position in any security, derivative, or a commodity futures contract, as well as any options on any of these instruments. The nature of the position on the instrument—long, short, synthetic—does not affect status as a CFP. A loan, a commodity, and foreign exchange or currency does not constitute CFPs.

4. Near term and short term

Even though these terms are critical to the application of the Volcker Rule to a particular account, the Volcker Rule does not define them. The Proposed Rule does not provide a precise definition but sets 60 days as a rough guideline. Under section 3(b)(2)(ii) of the Proposed Rule, a CFP held for less than 60 days is presumed to be held over the near term or in the short term. A CBE may attempt to rebut the presumption. The standards that an agency would apply for rebutting the presumption, or the basis on which an agency would decide that a position held greater than 60 days is either short-term or not, rely primarily on a judgment of the intent behind or purpose of taking the position at the outset. For example, an acquisition made with an intent to hold but terminated prematurely in less than 60 days for reasons outside the control of the acquirer would represent a rebuttable position.

5. Accounts that are not trading accounts

Notwithstanding that an account may possess the features above, section 3(b)(2)(iii) of the Proposed Rule does not treat it as a trading account if it is used to acquire CFPs that:

(i) arise under repos or reverse repos. The Agencies explain that repos and reverse repos operate in economic substance as secured loans and do not attempt to anticipate movements in asset prices;

(ii) arise under written securities lending agreements. These arrangements operate in economic substance, according to the Agencies, as a means to facilitate settlement of securities transactions and are not based on anticipated movements in asset prices;

(iii) are entered into for *bona fide* liquidity management purposes pursuant to a documented liquidity management plan that meets five criteria: the plan (i) specifically contemplates and authorizes the financial instrument to be used, (ii) requires principally liquidity management and not short-term resale or arbitrage transactions, (iii) requires that any such position be highly liquid and not likely to give rise to appreciable profits or losses from short-term price movements, (iv) limits liquidity positions to those that meet the banking entity’s near-term funding needs and (v) meets the relevant agency’s supervisory requirements, guidance, and expectations on liquidity management; or

(iv) are acquired by a covered banking entity that is a registered derivatives clearing organization or clearing agency.

B. Permissible trading

The Proposed Rule permits certain kinds of short-term trading in connection with underwriting, market-making, and hedging activities, among others. The theory is that trading in these contexts does not present the speculative risks present in stand-alone proprietary trading. As a rule of thumb, short-term trading as a part of underwriting and market-

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making programs would be permissible so long as a CBE generates returns on these programs largely through fees and other compensation reflecting the services provided and not through gains on short-term CFPs. As a corollary, the CBE must be able to demonstrate that this is so. A comprehensive compliance program is also a common requirement.

1. Underwriting

This permissible activity is available to a CBE that is registered under the Exchange Act, or exempt from registration or (in the case of non-exempted securities) a dealer outside the U.S. subject to regulation in its jurisdiction.[5] Section 4(a) of the Proposed Rule explains that in order to qualify for permissible underwriting, a CBE must meet several conditions:

(i) The CBE must have established the necessary compliance program;

(ii) The CFP must be a security. The Agencies advise that this and other terms are to be interpreted by reference to definitions of the same terms in the SEC's Regulation M;

(iii) The purchase or sale is effected solely in connection with a distribution of securities for which the CBE is acting as underwriter.[6] The Agencies explain that underwriting is commonly understood to mean an offering of securities that by reason of the magnitude of the offering and the presence of special selling efforts is distinct from routing trading in the securities;

(iv) The underwriting activities are designed not to exceed reasonably expected near-term demands of clients;

(v) The underwriting activities are designed to generate revenues primarily from fees, commissions, spreads or other income not attributable either to appreciation of the related securities or to related hedging arrangements; and

(vi) The compensation arrangements of the underwriter's personnel are designed not to reward proprietary risk taking.

2. Market making

This permissible trading activity is perhaps the most sensitive in the Proposed Rule because of the apparent difficulty in distinguishing market making from proprietary trading. As with underwriting, it is an essential intermediation function in the financial industry and can be critical for otherwise illiquid securities. As part of this function, a CBE may well find itself holding positions it hopes to liquidate in a short period of time. Reflecting the complexity of the issue, the Proposed Rule contains, in addition to the language of the regulation itself, a separate commentary on the nature of permissible market making (Appendix B) and special reporting requirements ostensibly designed to enable the regulators to determine whether a CBE is appropriately making a market in certain securities or impermissibly trading on a proprietary basis.

[5] For particular securities that require specific registrations—e.g., for municipal securities, registration as a municipal securities dealer—the CBE must have satisfied the requirement or claim a valid exemption.

[6] For purposes of this exemption, an "underwriter" is defined as a person who has agreed with an issuer or seller of securities (or a person who has an agreement with such a person to engage in a distribution of such securities) to: (1) purchase securities for distribution; (2) engage in such a distribution on behalf of such issuer or seller or (3) manage such a distribution. The Proposed Rule also identifies several factors that will form its judgment on whether a CBE is an underwriter.

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The regulatory language in section 4(b) of the Proposed Rule is only a starting point for analyzing whether market-making functions will receive regulatory approval. The regulation enumerates several criteria that a CBE must meet in order to trade as a market maker. The prerequisites that are somewhat objective or at least within the control of a CBE are that the CBE (i) has established the necessary compliance program (discussed in detail below); (ii) holds itself out as willing to buy or sell positions for its own account on a regular basis; and (iii) is either registered with the SEC or CFTC as applicable, exempt from such registration, or (in the case of certain securities and swaps) is a dealer outside the U.S. subject to regulation in the appropriate foreign jurisdiction.

In addition, the regulation sets forth more qualitative standards to test the customer orientation of permissible market making against the internal orientation of impermissible trading. These standards overlap with the discussion in Appendix B. The regulatory prerequisites are largely in the affirmative, however, while Appendix B lists several red flags that would disqualify trading from the market-making authority. Under the regulation, a CBE must design its market-making functions in order to meet but not exceed reasonably expected demands of clients; to generate revenues from fees, commissions, and sources other than the appreciation of positions; and to compensate individuals for successful market making but not proprietary risk taking.

Appendix B discusses several tests for or characteristics of proprietary trading rather than market making, any one of which could be disqualifying:

(i) a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;

(ii) the unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;

(iii) the unit generates only very small or very large amounts of revenue per unit of risk taken, does not demonstrate consistent profitability, or demonstrates high earnings volatility;

(iv) the unit does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making desk to provide liquidity services, or retains principal positions and risks in excess of reasonably expected near term customer demands;

(v) the unit routinely pays rather than earns fees, commissions, or spreads; and

(vi) the unit provides compensation incentives to employees that primarily reward proprietary risk taking.

3. Risk-mitigating hedging activities

Under section 5 of the Proposed Rule, a CBE may purchase or sell a CFP without triggering the proprietary trading ban if the transaction is designed to hedge against certain risks for certain types or categories of positions or assets. A transaction permitted as a hedging transaction must be made in connection with and related to "individual or aggregated positions, contracts, or other holdings" and is designed to reduce specific risks related to these items.

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In order for a CBE to trade under the hedging rubric, it must have established the necessary compliance regime discussed below. The regime must include policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing. Additionally, each purchase or sale of a CFP must:

(i) be conducted in accordance with the compliance program;

(ii) hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings;

(iii) be reasonably correlated, based on upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate;

(iv) not give rise, at the inception of the hedge, to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings and that are not hedged contemporaneously; and

(v) be subject to continuing review, monitoring and management that is consistent with the policies and procedures that are part of the compliance program; that maintains a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate.

Finally, the CBE's compensation arrangements must be designed not to reward proprietary risk taking.

An important documentation requirement also applies to certain hedging transactions. If the level of organization that hedges a risk is different from the level that holds the underlying position that gives rise to the risk to be hedged, then the covered banking entity must document: (1) the purpose of the hedge; (2) the risk being hedged against; and (3) the level of the organization that is establishing the hedge. This documentation must occur when the hedge is executed.

4. Trading in government obligations

Section 6(a) of the Proposed Rule allows a CBE to trade, without concern for the prohibition on proprietary trading, various kinds of obligations issued by the U.S., state, or local governments, or their agencies. U.S. obligations include those issued by any U.S. agencies, instruments issued by Ginnie Mae, Fannie Mae, Freddie Mac, one of the Federal Home Loan Banks, Farmer Mac, and any Farm Credit System institution. Both general obligations and limited obligations issued by any of these entities may be traded under this provision.

5. Off-shore trading

A foreign CBE may engage in proprietary trading solely outside the U.S.; an option not available to U.S. CBEs or CBEs controlled by a U.S. banking entity. The specific requirements for such off-shore trading are set forth in section 6(d) of the Proposed Rule as follows:

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- The CBE is not directly or indirectly controlled by a banking entity that is organized under U.S. law or the law of one of the states.
- The purchase or sale is conducted pursuant to section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act. This requirement means that:
  - for any CBE that is a foreign banking organization ("FBO"), it must be a qualifying FBO and must be trading in compliance with subpart B of Regulation K; or
  - all other CBEs (i.e., CBEs that are not FBOs) must meet at least two of the following three requirements: (i) total assets held outside the U.S. exceed those held in the U.S., (ii) total revenues derived outside the U.S. exceed those derived in the U.S. or (iii) total income derived outside the U.S. exceeds that derived in the U.S.
- The purchase or sale occurs solely outside the U.S. This requirement can be met only if the trading satisfies four conditions:
  - The CBE conducting the trade is not organized under the laws of the U.S. or one of the states;
  - No party to the transaction is a resident of the U.S.;
  - No personnel of the CBE who are directly involved in the trade are physically located in the U.S.; and
  - The purchase or sale is executed wholly outside the U.S.

6. Other trading activities

Three other types of trading are exempt from the proprietary trading ban and are not subject to the compliance obligations that come into play for underwriting, market making, or hedging.

- *Permitted trading on behalf of customers.* Trades on behalf of customers are permissible under section 6(b) of the Proposed Rule if the CBE (1) acts as investment adviser, commodity trading advisor, trustee or in another similar capacity, for the account of a customer and the customer is the sole beneficial owner of the related covered financial position; (2) acts as riskless principal; or (3) is a state- or foreign-regulated insurance company trading solely for a separate account of its policyholders and such insurance company does not recognize any profits or losses from any purchase or sale of such covered financial position.
- *Permitted trading by a regulated insurance company.* A state- or foreign-regulated insurance company may, under section 6(c) of the Proposed Rule, engage in proprietary trading solely for its general account.

C. Reporting and recordkeeping

Section 7 of the Proposed Rule, together with Appendices A and B, requires larger CBEs to keep daily records of their permissible covered trading activities and to file corresponding reports with their regulators on a monthly basis. For CBEs subject to these rules, records must be kept at the "trading unit" level, regardless of the size of the book at any particular unit. A trading unit includes (a) each discrete unit engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity; (b) each organizational unit used to structure and control the activities and employees of one or more of the discrete units addressed in (a); and (c) all trading operations, collectively. The relevant regulatory agency may designate additional units.

Reporting and recordkeeping requirements vary significantly depending on whether a trading unit is engaged in market-

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making or in one of the other three broad categories of permissible trading: underwriting, hedging, or trading U.S. government obligations.

Requirements for units engaged in underwriting, hedging or trading in U.S. government securities do not kick in until the average gross sum of trading assets and liabilities at the CBE equals or exceeds $5 billion. The gross sum includes the trading assets and liabilities of any affiliate or subsidiary of the CBE, and the average is calculated with the quarter-end numbers of the four prior calendar quarters. For those units at CBEs below $5 billion, there are no specific recordkeeping or reporting requirements. Each unit at a CBE above the $5 billion level must record five pieces of data: value-at-risk and stress VaR, risk factor sensitivities, risk and position limits, comprehensive profit and loss, and comprehensive profit and loss attribution.

Requirements begin to apply to market-making units at CBEs that pass a $1 billion threshold (calculated in the same manner as the $5 billion mark above). The Proposed Rule apparently requires more extensive reporting for market-making units because of the difficulty in distinguishing market-making for customers from proprietary trading. The reported data is intended to make it possible to draw this distinction. Each trading unit of a CBE over the $1 billion threshold but below the $5 billion level that engages in market-making must calculate eight measurements each trading day. This data includes comprehensive profit and loss, portfolio profit and loss, fee income and expense, spread profit and loss, value-at-risk, comprehensive profit and loss attribution, volatility of comprehensive and portfolio profit and loss, and ratios of the volatility measurements. When a CBE passes the $5 billion mark, the CBE’s trading units that conduct market making must record 17 pieces of data, including more data on risk sensitivities and inventory.

All records must be maintained for at least five years.

II. PRIVATE EQUITY AND HEDGE FUNDS

The Volcker Rule does not allow a CBE to invest in or control a private equity or hedge fund, activities referred to in the Proposed Rule as “covered fund activities or investments.” As we explain below, and consistent with the theory that customer-oriented activities should be allowed to continue, a CBE may sponsor and retain a small ownership interest in a fund for the benefit of its customers. Certain other covered fund activities or investments would be permissible as well, although these activities would be smaller in scope.

A. Definitions

The ban on investment in or control of a private equity or hedge fund depends on the definitions of covered fund and ownership interest. Section 10(b) of the Proposed Rule provides these definitions.

1. Covered fund

The general prohibition on covered fund activities or investments applies to several types of entities, including:

- an issuer that would be an investment company but relies exclusively on the exemptions of section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;
- a commodity pool, as defined in section 1a(10) of the Commodity Exchange Act;
- any similar fund determined by the Agencies, by rule; and
- the foreign equivalent of any entity identified as a covered fund.

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The Agencies recognize that this definition may capture entities and corporate structures that would not usually be seen as a “hedge fund” or “private equity fund.” Accordingly, section 14 of the Proposed Rule explicitly excludes (under certain circumstances) the following entities from the definition of a covered fund: (i) bank owned life insurance; (ii) joint ventures that are operating companies; (iii) acquisition vehicles; (iv) wholly-owned subsidiaries that are principally engaged in bona fide liquidity management activities and are carried on the balance sheet of the banking entity; and (vi) covered fund activities or interest in connection with collecting a debt previously contracted in good faith. The Proposed Rule also adopts the implicit statutory exclusion for special purpose vehicles involved in securitization transactions.

In addition, the Agencies have asked for comment on whether other funds or entities should be exempt from the prohibitions on investment fund activity. Possible exclusions would include venture capital funds, so-called “loan funds,” and non-U.S. funds or entities. The Agencies are also willing to consider comments on other funds that might possess certain characteristics that would warrant exclusion.

2. Ownership interest

The Proposed Rule defines “ownership interest” in section 10(b)(3) as any equity, partnership or similar interest in a covered fund, whether voting or nonvoting, and excludes certain “carried interest” in a covered fund for which the banking entity serves as investment manager, investment adviser or commodity trading adviser. The definition focuses on the characteristics of the interest and whether it provides the banking entity with economic exposure to the profits and losses of the covered fund. For example, debt securities, to the extent that they have the same characteristics as an equity security (e.g., voting rights or the ability to share in the covered fund’s profits or losses) may be considered “other similar interests” and thus ownership interests that could be subject to the private equity or hedge fund prohibitions. on investment in or control or sponsorship of a private equity or hedge fund.

B. Customer-oriented funds

The prohibition on investment in or control or sponsorship of a covered fund encompasses a CBE’s role “as principal, directly or indirectly.” Subject to certain requirements, the Volcker Rule and section 11 of the Proposed Rule do not prohibit investing in or sponsoring a covered fund (i) in good faith in a fiduciary capacity; (ii) in good faith as a custodian, broker, or agent for an unaffiliated third party; (iii) by a qualified employee benefit plan under ERISA; or (iv) by a director or employee of the banking entity in a personal capacity, if he or she is directly engaged in providing advisory or other services to the covered fund and if he or she did not borrow the funds for such investment from the banking entity.

Several restrictions apply to a CBE’s role with these funds, as set forth in section 12 of the Proposed Rule. A CBE may acquire and retain a *de minimis* ownership interest in a covered fund. This interest may at no time exceed 3% of the total outstanding ownership interests in each fund, and the aggregate value of all ownership interest of the CBE in all covered funds may not exceed 3% of the CBE’s tier 1 capital. The capital-based calculation must be made on a quarterly basis.

A CBE may establish a covered fund and provide it with sufficient initial equity to attract unaffiliated investors. In this case, a banking entity may have 100% ownership interest in a covered fund, but it must actively seek unaffiliated investors and reduce its ownership interest in the covered fund below the 3% ceiling within one year after the establishment of the fund. The FRB may grant a CBE an extension of up to two years to meet the 3% limit on an investment in a single covered fund, if it determines that an extension is consistent with safety and soundness and not detrimental to the public interest.

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C. Other permitted investment fund activity

Section 13 of the Proposed Rule permits CBEs to acquire ownership interests in, or act as sponsor to, small business investment corporations and to make public welfare investments and qualified rehabilitation expenditures.

A CBE may also acquire and retain an ownership interest in a covered fund for certain risk-mitigating hedging purposes. Such an interest is permissible only (i) if the CBE acts as an intermediary on behalf of a customer that is not itself a banking entity in order to hedge the customer's exposure to the profits and losses of the covered fund, or (ii) to cover the risk arising from a compensation arrangement with an employee of the CBE that directly provides investment advisory or other services to the covered fund (incentive-based compensation risk). The risk-mitigating hedge must be designed to reduce the specific risk to the CBE in connection with and related to such obligations or liabilities and the risk-mitigating hedging activity must be conducted in accordance with the CBE's internal compliance program. Moreover, the banking entity must document at the time the transaction is conducted (i) the risk-mitigating purpose, (ii) the risk that the hedge is designed to reduce, and (iii) the level of organization that is establishing the hedge.

D. Prohibited transactions in permissible relationships

The Volcker Rule and the Proposed Rule do not forbid all relationships between a CBE and a covered fund. A CBE may, for instance, advise a covered fund. Even these activities are restricted, however. Section 16 of the Proposed Rule implements Volcker Rule (f), which forbids transactions of the type that, when engaged in by an insured depository and an affiliate, would be subject to the requirements of section 23A of the Federal Reserve Act. That is, a CBE that, directly or indirectly, serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund is barred from engaging in any transaction with the covered fund, if the transaction would be a "covered transaction" as defined in Section 23A of the Federal Reserve Act, as if the CBE and any affiliate thereof were a member bank and the covered fund were an affiliate thereof.

The Proposed Rule includes the statutory prohibition and clarifies that the exemptions of Section 23A of the Federal Reserve Act do not apply to the ban on transactions between a CBE and a covered fund. However, CBEs, subject to certain conditions, may enter into any prime brokerage transaction with a covered fund that is managed, sponsored, or advised by the CBE. In addition, Section 16(b) implements the Volcker Rule's application of the "market terms" requirement in section 23B of the Federal Reserve Act. Any transaction between a CBE and a covered fund that is managed, advised, or sponsored by the CBE must be on terms at least as favorable to the CBE as transactions between a covered fund and another entity providing the same service.

E. Off-shore investment fund activity

As with off-shore trading, a foreign CBE may invest in, control, or sponsor a private equity or hedge fund outside the U.S., an alternative that (again, as with off-shore trading) is not available to a U.S. bank holding company or any of its subsidiary CBEs. The precise requirements under section 13(c) of the Proposed Rule are as follows:

- The CBE is not directly or indirectly controlled by a banking entity that is organized under U.S. law or the law of one of the States.
- The purchase or sale is conducted pursuant to section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act. This requirement means that:

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  - for any CBE that is a foreign banking organization ("FBO"), the CBE must be a qualifying FBO and must be investing in, controlling, or sponsoring a covered fund in compliance with subpart B of Regulation K; and
  - all other CBEs (i.e., CBEs that are not FBOs) must meet at least two of the following three requirements: (i) total assets held outside the U.S. exceed those held in the U.S., (ii) total revenues derived outside the U.S. exceed those derived in the U.S. or (iii) total income derived outside the U.S. exceeds that derived in the U.S.

- No ownership interest in the covered fund is offered for sale or sold to a U.S. resident.
- The activity occurs solely outside the U.S. This requirement can be met only if the activity satisfies two conditions:
  - the CBE engaged in the investment, sponsorship, or control is not organized under the laws of the U.S. or one of the states; and
  - no subsidiary, affiliate, or employee of the CBE involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the U.S. or in one or more states.

III. GENERAL PROVISIONS

Section 619 contains three provisions that could restrict otherwise permissible activities, whether in the proprietary trading realm or in the area of private equity and hedge fund activity. Enhanced capital requirements may apply. A covered entity may not engage in any activity that presents a material conflict of interest. A covered entity must prepare an elaborate series of reports on operations subject to the Rule.

A. Capital requirements and quantitative limitations

Subsection (d)(3) of the Volcker Rule authorizes the Agencies to set capital requirements and quantitative limitations, including divestiture requirements, on permissible trading or investment fund activities, if the Agencies determine that such requirements are necessary to protect the safety and soundness of a CBE. The Proposed Rule does not establish any such restrictions, but the Agencies reserve their authority to do so in the future. Section (a)(2) of the Volcker Rule requires (and does not merely authorize) additional capital requirements for and quantitative limits on trading or investment fund activities not available to CBEs by nonbank financial institutions that have been designated as systemically important. The Proposed Rule does not address such requirements.

Section 12(d) of the Proposed Rule requires that a CBE deduct all permissible investments in covered funds from Tier 1 capital.

B. Controls

Sections 4(a)(2), 4(b)(2), 5(b), and 15 of the Proposed Rule require all CBEs to develop a program to monitor compliance with the prohibitions or restrictions on covered trading activities and investment fund activities. The substance of the required compliance program for the largest CBEs is set forth in Appendix C to the Proposed Rule. The requirements identify three tiers of CBEs:

(i) All CBEs must have a program of some kind, even if they engage in no covered trading or investment fund activities. For the CBEs that do not engage in such activities, they must include in their compliance policies and procedures measures designed to prevent the CBE from becoming engaged in activities prohibited or restricted by the Proposed Rule. If a CBE chooses to enter into permissible trading or investment fund activity, it must have a full compliance structure in place beforehand.

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(ii) All CBEs that engage in any covered trading or investment fund activity must have in place (a) policies and procedures, (b) a system of internal controls, (c) a management framework that delineates responsibility and accountability for compliance, (d) independent testing of the effectiveness of the compliance program, (e) suitable training for trading personnel and managers, and (f) maintenance of records to demonstrate compliance to be provided to the appropriate regulator and to be retained for five years.

(iii) A more detailed and rigorous compliance program, described in Appendix C to the Proposed Rule, is necessary for CBEs engaged in significant amounts of covered trading or investment fund activity. Specifically, these more stringent requirements apply if the average gross sum of trading assets and liabilities over the four prior calendar quarters is equal to or more than $1 billion or equal to 10% or more of total assets. For fund activity, the full-blown program is required for any CBE that holds aggregate investments in one or more covered funds where the average value of these investments equals or exceeds $1 billion or sponsors one or more covered funds whose average total assets equal or exceed $1 billion. The investments or sponsorships by all affiliates of the CBE are included in the measurements. The average is calculated from the quarter-end values over the prior four calendar quarters.

Appendix C to the Proposed Rule describes an elaborate compliance program for CBEs in the third tier. Detailed policies and procedures at the trading unit level are necessary for both permissible trading and permissible investment fund activity. A complex set of internal controls, involving officials at many levels of the CBE, as well as directors, is required as well. Independent testing, training, and recordkeeping are also necessary.

C. Prudential backstops

The Proposed Rule also provides two prudential backstops to otherwise permissible covered trading or investment fund activity. Section (d)(2) of the Volcker Rule bars any permissible trading or investment fund activity that would result in a material conflict of interest between the CBE and its clients, customers, or counterparties, that would result in a material exposure by the CBE to high-risk assets or high-risk trading strategies, or that would pose a threat either to the safety and soundness of the CBE or to the financial stability of the United States. Sections 8 and 17 of the Proposed Rule provide greater detail on the first two limitations.

1. Material conflicts of interest

A material conflict of interest exists where, with respect to a transaction, class of transactions, or activity, the CBE's interests are materially adverse to those of its clients, customers, or counterparties. A CBE can cure the conflict for the purpose of the Volcker Rule in one of two ways:

(i) before effecting the transaction or engaging in the activity, the CBE discloses the conflict and other necessary information in sufficient detail to enable a reasonable client to meaningfully understand it and makes the disclosure explicitly and effectively and in a manner that provides a reasonable client, customer, or counterparty the opportunity to negate or mitigate any resulting materially adverse effect; or

(ii) the CBE erects formal information barriers, memorialized in writing, designed to prevent a material

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adverse effect on a client, customer, or counterparty as a result of the conflict. The CBE may not rely on this provision if it knows or should reasonably know that, notwithstanding the barriers, the conflict may result in a materially adverse effect on the client.

2. High-risk asset or high-risk trading strategy

With respect to high-risk exposures, the Proposed Rule defines an asset (or group of assets) or trading strategy as high risk if the asset or strategy would "significantly" increase the likelihood that a CBE would incur a substantial financial loss or would fail.

D. Conformance periods

Conformance periods are discussed primarily in section 31 of the Proposed Rule, a provision in subpart E for which the FRB has sole rulemaking authority. The Proposed Rule does not go much beyond the Volcker Rule provisions.

The starting point is that a CBE has until July 21, 2014, to bring any trading or investment fund activities into compliance. A company that was not a CBE on July 21, 2012, will have a two-year conformance period running from the date it became a CBE. The FRB may extend these two-year periods for three separate one-year periods, if the agency makes findings that an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.

An additional five years beyond any of the one-year extensions generally available may be provided for an investment in an illiquid fund where the investment is based on an obligation entered into before May 1, 2010. An illiquid fund is one that does not hold liquid assets (typically, cash or assets readily traded or bought and sold) and that is subject to statutory or contractual limits on the sale or liquidation of an ownership interest.

The Proposed Rule describes a formal process by which a CBE may request an extension from the FRB. In reviewing a request, the FRB must consider several factors.

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