Proposed Volcker Rule Regulations: A Summary

October 18, 2011

Section 619 of the Dodd-Frank Act,[1] commonly known as the Volcker Rule, has been described by regulators as a key part of the effort to strengthen the financial system and constrain risk taking at banking entities.[2] It unquestionably has far reaching implications for financial institutions and the financial system.

The Volcker Rule is codified as Section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act").[3] Its operative provisions prohibit any "banking entity" (as defined — broadly) from (i) engaging in proprietary trading and (ii) acquiring or retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds or certain other private funds ("covered funds"), subject to certain exemptions.

Implementation of the Volcker Rule requires rulemaking, and the release of proposed regulations has been anxiously awaited by the financial community. On October 11, the federal banking agencies[4] and the Securities and Exchange Commission ("SEC") released for comment a notice of proposed rulemaking (the "Notice") with implementing regulations (the "Proposed Regulations").[5] The Proposed Regulations provide extensive additional detail to the framework of Section 619.

Implementation of the Volcker Rule raises complex and difficult issues, as the regulators evidently recognize. The Proposed Regulations include nearly 400 specific questions on which comment is solicited. The deadline for comments is January 13, 2012. Given the many issues raised and the impact that implementation is expected to have, interested parties should consider commenting on matters that may affect them most directly.

This Summary of the Proposed Regulations is divided into six sections:

- Matters of General Application
- Proprietary Trading
- Covered Fund Activities and Investments
- Applicability of Proposed Regulations to Securitizations
- Exemptions for Activities by Foreign Banking Entities
- Compliance, Internal Controls, Reporting and Recordkeeping

We will follow developments in the rulemaking process and continue to analyze and consider the implications of the Proposed Regulations.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] *See* Financial Stability Oversight Council ("FSOC"), Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (January 18, 2011), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[3] 12 U.S.C. § 1841 *et seq*.

[4] Namely, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Board") and the Federal Deposit Insurance Corporation ("FDIC").

[5] Notice of Proposed Rulemaking, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, *available at* http://sec.gov/rules/proposed/2011/34-65545.pdf.

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Executive Summary

- *The Volcker Rule, Generally*. Section 619 of the Dodd-Frank Act added a new Section 13 to the BHC Act that generally prohibits any banking entity from (i) engaging in proprietary trading or (ii) acquiring or retaining an ownership interest in, sponsoring or having certain relationships with a covered fund, subject to certain exemptions. The Proposed Regulations generally track this statutory framework and provide extensive additional detail.

- *Scope*. The Proposed Regulations are applicable to all "banking entities", which include entities supervised by the federal banking agencies and their affiliates and subsidiaries. Certain of those affiliates and subsidiaries include entities regulated by the SEC and the Commodity Futures Trading Commission (the "CFTC").

- *Rulemaking*. The statutory Volcker Rule requires each of the federal banking agencies, the SEC and the CFTC to issue its own implementing regulations, and requires those regulations to be coordinated, consistent and comparable. The Proposed Regulations currently represent the joint effort of all regulators subject to the statutory mandate, except the CFTC.

- *Prohibition on Proprietary Trading*. A banking entity is prohibited from engaging in proprietary trading, other than certain permitted trading activities. Permitted trading activities include:

    - Underwriting and market making-related activities;
    - Risk-mitigating hedging activity;
    - Trading in certain government obligations;
    - Trading on behalf of customers;
    - Trading by a regulated insurance company; and
    - Foreign trading by non-U.S. banking entities.

  Entities that engage in permitted trading activities are subject to certain limitations, and must comply with various requirements and internal controls, including a comprehensive compliance regime and trader compensation review.

- *Prohibition on Investing in or Sponsoring Covered Funds*. A banking entity may not, as principal, directly or indirectly acquire or retain any ownership interest in or sponsor a covered fund, subject to certain exemptions. These exemptions include:

    - Organizing and offering a covered fund, subject to significant restrictions and limitations (including a requirement that the banking entity provides bona fide trust, fiduciary or advisory services to the covered fund and the fund is organized and offered only in connection with the provision of those services to customers);
    - Certain permitted investments; and
    - Foreign covered fund activities by non-U.S. banking entities.

Entities that engage in any of the foregoing activities are subject to certain limitations, including restrictions on relationships with covered funds. These entities must comply with various compliance requirements and internal controls.

- *Applicability of Proposed Regulations to Securitizations*. The covered fund restrictions of the Proposed Regulations could apply to some securitization structures, although they would apply only to certain specified ownership interests in asset-backed issuers that rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; the restrictions generally would not apply to issuers that rely on any other exemption or exclusion from the definition of "investment company." The Proposed Regulations also contain express exemptions for any credit risk retention in a securitization transaction that is required by the Dodd-Frank Act, and for the acquisition or retention of certain other asset-backed securities. The proprietary trading restrictions of the Proposed Regulations could restrict the ability of a securitization vehicle to buy and sell securities, and the prohibitions on covered transactions with a covered fund could restrict some banking entities from providing liquidity, servicing advances and other customary extensions of credit.

- *Activities by Foreign Banking Entities Outside the United States*. The Proposed Regulations provide additional exemptions from the proprietary trading restrictions and the restrictions on investing in and sponsoring covered funds for certain foreign bank entities.

- *Compliance Program, Internal Controls, Reporting and Recordkeeping Requirements*. The Proposed Regulations require banking entities to implement compliance programs designed to ensure and monitor compliance with the Volcker Rule's prohibitions on proprietary trading and investing in and sponsoring covered funds and restrictions on engaging in such activities under the exemptions of the rules. Banking entities must also comply with certain reporting and recordkeeping requirements.

Matters of General Application

Banking Entity, Defined

The prohibitions of the Volcker Rule apply to banking entities. The Proposed Regulations track Section 619 closely in broadly defining a "banking entity" as any of the following:

- Any insured depository institution (other than certain limited purpose trust institutions);
- Any company that controls an insured depository institution (accordingly a company could be subject to the Volcker Rule solely because it controls a "nonbank" bank such as a savings bank or industrial loan company, even though the company is not a bank holding company);
- Any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (12 U.S.C. § 3106); and
- Any affiliate or subsidiary of any of the foregoing.

Excluded from this definition is any affiliate or subsidiary of a banking entity that is a covered fund that is organized, offered or held by a banking entity as permitted under the Proposed Regulations, or an entity controlled by such a covered fund. This exclusion is intended to permit covered funds permissibly sponsored by a banking entity to avoid the restrictions of the Volcker Rule, such as the restriction on proprietary trading.

We note that the term "covered banking entities" is used in the Proposed Regulations to refer to banking entities subject to Volcker Rule regulation by the relevant regulator. For purposes of this Summary, we use the term "banking entities."

Multiple Regulators and the Proposed Regulations

The Volcker Rule covers all banking entities, which include entities supervised by the federal banking agencies and such entities' affiliates and subsidiaries. Certain of those affiliates and subsidiaries include CFTC or SEC-regulated entities. Section 619 requires each of the CFTC, SEC and federal banking agencies to issue its own implementing regulations, and that those regulations be coordinated, consistent and comparable. The CFTC did not join in issuing the Notice and Proposed Regulations, although it was consulted in their formulation. That regulator has not stated whether it will adopt the Proposed Regulations or issue its own rule proposal.[6]

Under new Section 13 of the BHC Act, rules implementing the Volcker Rule must be issued by: (i) the appropriate federal banking agencies, jointly, with respect to insured depository institutions; (ii) the Board, with respect to any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of Section 8 of the International Banking Act, any nonbank financial company supervised by the Board and any subsidiary of any of the foregoing (other than a subsidiary for which an appropriate federal banking regulator, the SEC or the CFTC is the primary financial regulatory agency (as defined in Section 2 of the Dodd-Frank Act)); (iii) the CFTC, with respect to any entity for which it is the

[6] *See* Christopher Doering, *CFTC takes wait-and-see approach on Volcker Rule*, REUTERS, Oct. 7, 2011, http://www.reuters.com/article/2011/10/07/us-financial-regulation-volcker-cftc-idUSTRE7966D620111007.

primary financial regulatory agency; and (iv) the SEC, with respect to any entity for which it is the primary financial regulatory agency.

In the Proposed Regulations each regulator is proposing the same rules, which would apply only to banking entities for which that regulator has primary jurisdiction.[7] This harmonized approach to implementation is intended to ensure the application of the new prohibitions and restrictions is consistent across different types of entities. It remains to be seen whether the final regulations will retain this uniform approach.

Effective Date and Conformance Period

The effective date for the Volcker Rule and its implementing regulations is July 21, 2012, subject to a conformance period and certain extensions. The Notice states that the attendant compliance programs and reporting and recordkeeping requirements would also be required to be in place by the effective date. The Notice does recognize that banking entities may need time to prepare for effectiveness of the Proposed Regulations and, specifically, to implement the compliance program, internal controls and reporting and recordkeeping requirements. Accordingly, the Notice requests comment on whether a phased in approach to implementation should be used.

The Proposed Regulations include a conformance period extending two years beyond the effective date, with the possibility of three one-year extensions, and an additional period of up to five years for investments in "illiquid funds."[8] In all cases, extensions of the conformance period require Board approval. In the Notice, the regulators state their expectation that banking entities conform their activities to the requirements of the Proposed Regulations "as soon as practicable within the conformance periods."

The conformance period by its terms applies both to proprietary trading and acquiring an ownership interest in, or having certain relationships with, a covered fund. As mentioned above, however, the regulators expect compliance as soon as practicable. It is likely that the conformance period will be more frequently needed for divestiture of ownership interests in, or severing relationships with, covered funds. It is less likely that the conformance period will be needed for proprietary trading given the inherent short term nature of this activity.

The Proposed Regulations also provide that the conformance period for a company that becomes a banking entity after July 21, 2010 will begin on the date it becomes a banking entity. Nonbank financial companies will also have the benefit of a two-year conformance period with the possibility of extension.

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[7] The Board's rules would apply to a company that is subject to the Volcker Rule solely because it controls a "nonbank bank" such as a savings bank or industrial loan company, even if the company is not generally subject to the Board's jurisdiction as a bank holding company.

[8] The conformance period provisions contained in the Proposed Regulations incorporate, with minor technical and confirming edits, the final rule issued by the Board in February 2011. *See* 76 Fed. Reg. 8265 (Feb. 14, 2011).

<u>Nonbank Financial Companies</u>

In addition to the restrictions imposed on banking entities, the Volcker Rule provides for certain nonbank financial companies to be subject to additional capital requirements, quantitative limits or other restrictions. Specifically, the Volcker Rule covers nonbank financial companies and other companies that the FSOC has determined, under Section 113 of the Dodd-Frank Act, shall be subject to supervision by the Board and prudential standards. The FSOC has not yet finalized the criteria for designation of, and has not yet designated any nonbank financial company subject to supervision. The Proposed Regulations do not address the requirements and/or restrictions applicable to them. In the Notice, the regulators indicate their intent to propose regulations at a later date to implement the statutory provisions addressing activities of systemically significant non-financial companies supervised by the Board once the criteria for designating such non-financial companies for supervision are determined by the FSOC.

Proprietary Trading

The Proposed Regulations would implement the statutory provision prohibiting a banking entity from engaging in "proprietary trading" and the statutory exemptions for certain permitted activities. The Notice, the Proposed Regulations and accompanying Appendices A and B attempt to address many of the complexities and practical challenges in differentiating permitted and prohibited trading activities of banking entities. It is evident from these materials that the regulators are struggling in making these distinctions.

General Prohibition and Key Definitions	
General Prohibition	• Proprietary trading by a banking entity is not permissible unless the transaction qualifies for one of the exemptions described below. • Proprietary trading may be further limited by provisions prohibiting conflicts of interest and high-risk trading.
Proprietary Trading	• "Proprietary trading" is defined as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more covered financial positions. • Proprietary trading does not include acting solely as agent, broker or custodian for an unaffiliated third party.
Trading Account	• Principal trading must be conducted in a "trading account" to qualify as proprietary trading. "Trading account" has a three-pronged definition, any one of which is sufficient to bring an account within the definition: o Any account used by a banking entity to acquire or take one or more covered financial positions 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 such positions; o Any account used by a banking entity to acquire or take one or more covered financial positions that are "covered positions" under the federal banking agencies' market risk capital rules ("Market Risk Capital Rules"), if the banking entity, or an affiliate of the banking entity that is a bank holding company, calculates risk-based capital ratios under the Market Risk Capital Rules; or o Any account used by a banking entity to take one or more covered financial positions for any purpose if the banking entity is a registered securities dealer, municipal securities dealer, government securities dealer, swap dealer or security-based swap dealer, as well as covered financial positions taken by a banking entity that is engaged in the business of a dealer, swap dealer or security-based swap dealer outside the United States to the extent the position is taken in connection with the activities of such business. • Rebuttable presumption: The Proposed Regulations include a rebuttable presumption that any account used to acquire or take a covered financial

	position (other than a covered financial position described in the second or third prong of the definition of trading account) that is held for 60 days or less is a trading account, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes. • Certain positions are excluded as not making an account a "trading account": o Positions under certain repurchase and reverse repurchase agreements; o Positions under securities lending transactions; o Positions acquired or taken for bona fide liquidity management purposes in accordance with a documented liquidity management plan; and o Positions acquired or taken by banking entities that are registered derivatives clearing organizations or clearing agencies in connection with clearing derivatives or securities transactions. • Merchant banking investments made by banking entities that are financial holding companies pursuant to Section 4(k)(4)(H) of the BHC Act should not be considered trading account positions because such investments are generally not short-term investments.
Covered Financial Position	• "Covered financial position" is defined as any long, short, synthetic or other position in: o A security, including an option on a security; o A derivative, including an option on a derivative; or o A contract or sale of a commodity for future delivery, or an option on such a contract. • Any position that is a loan, commodity or foreign exchange or currency is not a covered financial position. • "Derivative" for this purpose is defined to include any "swap" (as defined in Section 1a(47) of the Commodity Exchange Act (as amended) (the "CEA")) or any "security-based swap" (as defined in Section 3(a)(68) of the Securities Exchange Act), in each case as further jointly defined by the CFTC and the SEC, in consultation with the Board, pursuant to Section 712(d) of the Dodd-Frank Act. o The definition of "derivative" also includes certain other types of transactions that appear to be, or operate in economic substance, as derivatives. These include: • Purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled; • Foreign exchange forwards and swaps (as defined in Sections 1a(24) and 1a(25) of the CEA, respectively); and • Agreements, contracts or transactions in certain retail foreign currency transactions (as described in Section 2(c)(2)(C)(i) of the CEA). o "Derivatives" do not include (1) consumer, commercial or other agreements, contracts or transactions that the CFTC and SEC have jointly determined are not "swaps" or "security-based swaps" or (2) "identified banking products", such as deposit accounts, savings accounts, certificates of deposits or other instruments issued by a bank.

<table>
<tr><th colspan="2">Permitted Underwriting Activities</th></tr>
<tr><td>Rule</td><td>A banking entity may purchase or sell a covered financial position in connection with the banking entity’s underwriting activities, subject to compliance with the requirements described below.
The Proposed Regulations permit a banking entity to act as an underwriter in distributions, which are defined as offerings of securities, whether or not registered under the Securities Act of 1933. This activity is distinguished from ordinary market making by magnitude of the offering and by special selling efforts and methods. The definition in the Proposed Regulations is consistent with the definition in Regulation M.</td></tr>
<tr><td>Required Criteria for Underwriting Activities</td><td>To rely on this exemption, a banking entity’s underwriting activities must meet each of seven criteria:
The banking entity must establish an internal compliance program as required by the Proposed Regulations that is designed to ensure compliance with the underwriting exemption (see discussion of compliance programs below);
The covered financial position that is being purchased or sold must be a security;
The transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter;
If the transaction involves a security for which an underwriter must generally be a United States-registered securities dealer, municipal securities dealer or government securities dealer, the banking entity must have the appropriate dealer registration or otherwise be exempt from registration or excluded from regulation as a dealer (or, if the banking entity is engaged in the business of a dealer outside the United States in a manner for which no United States registration is required, the banking entity must be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located);
The underwriting activities with respect to the covered financial position must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties;
The underwriting activities must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income rather than from appreciation in the value of covered financial positions the banking entity holds related to such activities or the hedging of such covered financial position; and
The compensation arrangements of persons performing the underwriting activities must be designed not to reward proprietary risk-taking.</td></tr>
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<tr><th colspan="2">Permitted Market Making Activities</th></tr>
<tr><td>Rule</td><td>

A banking entity may purchase or sell a covered financial position in connection with the banking entity's market making-related activities, subject to compliance with the requirements described below.
Appendix B to the Proposed Regulations includes extensive commentary regarding the differences between and similarities of permitted market making activities and prohibited proprietary trading. This commentary is required to be incorporated into the relevant banking entity's compliance program.
In summary, the regulators propose to distinguish prohibited proprietary trading from market making based on the following general propositions:

Proprietary trading generally will exhibit significantly higher, sustained levels of retained risk than market making;
Market making is a customer-facing activity, reasonably expected to meet near term customer demands, while proprietary trading rarely involves customer interaction;
Market making revenue generally is derived from fees, commissions and spreads rather than risk, while proprietary trading revenue is derived primarily from price movements of retained principal positions and risks; and
Compensation to personnel for market making activities generally is based on customer revenue and customer service, not proprietary risk-taking.

The regulators recognize the inherent difficulty in distinguishing between the risks of permissible market making-related activities and the risks of impermissible proprietary trading. Although the regulators have described a number of relevant factors for the purpose of distinguishing the two, they have retained ultimate discretion to decide whether a particular trading activity falls in one category or the other. This lack of a "bright line" creates a significant degree of uncertainty for the financial community that may only be clarified once the regulators have had the opportunity to apply the Proposed Regulations in practice, raising the potential danger of rule interpretation through enforcement.
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<tr><td>Required Criteria for Permitted Market Making Activities</td><td>

To rely on this exemption, a banking entity's market making activities must meet each of the following seven criteria:

Internal Compliance Program. The banking entity must establish an internal compliance program designed to ensure compliance with the market making exemption (see discussion of compliance programs below);
Bona Fide Market Making. The trading desk or other organizational unit that conducts the transaction must hold itself out as being willing to buy and sell (including through entering into long and short positions in) the particular covered financial position for its own account on a regular or continuous basis, i.e., must engage in bona fide market making activities;
Meeting Client Demand. The market making activities must be designed not to exceed the reasonably expected near-term demands of clients,

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	customers and counterparties; o *Registration.* The banking entity must be appropriately registered as a dealer, or exempt from registration or excluded from regulation as a dealer under applicable securities or commodities laws; o *Source of Revenues.* The market making-related activities must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions that the trading desk holds or the hedging of such positions; o *Appendix B Commentary.* The market making-related activities must be consistent with the regulators' commentary provided in Appendix B, which, as explained above, discusses various factors by which the regulators propose to distinguish prohibited proprietary trading from permitted market making-related activities; o *Trader Compensation.* The compensation arrangements of persons performing market making-related activities must be designed not to encourage or reward proprietary risk-taking. • For trading in more liquid markets, the bona fide market making requirement will generally include the desk making continuous two-sided quotes and holding itself out to transact at both sides of the market on a continuous basis (similar to the SEC's criteria for bona fide market making). • For trading in less liquid markets, the bona fide market making requirement will generally include the desk holding itself out to provide liquidity through providing quotes on a regular basis, but not a continuous basis as required for more liquid markets. • A banking entity with significant covered trading activities (as any banking entity taking advantage of the market making exemption would likely be) must report certain quantitative measurements for each of its trading units. As explained in Appendix B, the regulators will consider these quantitative measurements in evaluating whether a banking entity is engaged in market making or proprietary trading.
Market Making-Related Hedging	• The purchase or sale of a covered financial position for purposes of hedging market making positions will qualify for the market making exemption if it meets two requirements: o The purchase or sale must be conducted to reduce the specific risks to the banking entity in connection with and related to individual positions, contracts or other holdings acquired pursuant to the market making exemption; and o The hedging transaction must also meet the criteria specified in the general exemption for risk-mitigating hedging activity (described below).

<table>
<tr><th colspan="2">Permitted Risk-Mitigating Hedging Activities</th></tr>
<tr><td>Rule</td><td>A banking entity may purchase or sell a covered financial position if the transaction (i) is made in connection with or related to its individual or aggregated positions, contracts or other holdings and (ii) is designed to reduce the specific risks to the banking entity in connection with such positions, contracts or other holdings.</td></tr>
<tr><td>Required Criteria for Permitted Risk-Mitigating Hedging Activities</td><td>To rely on this exemption, risk-mitigating hedging activities must meet each of these seven criteria:
The banking entity must establish an internal compliance program as required by the Proposed Regulations that is designed to ensure compliance with the hedging exemption (see discussion of compliance programs below);
The transaction must have been made in accordance with hedging-related written policies, procedures and internal controls established by the banking entity pursuant to the Proposed Regulations' compliance program requirements;
The transaction must hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, basis risk or similar risk, arising in connection with and related to individual or aggregated positions, contracts or other holdings of the banking;
The transaction must be reasonably correlated to the risk(s) the transaction is intended to hedge or otherwise mitigate;
The transaction must not give rise, at the inception of the hedge, to significant exposures not already present in the individual or aggregate positions, contracts or other holdings of the banking entity that are not themselves hedged in a contemporaneous transaction;
The transaction must be subject to continuing review, monitoring and management after the hedge position is established that is consistent with the banking entity's written hedging policies and procedures and maintains a reasonable level of correlation to the risk(s) that the transaction is intended to hedge or otherwise mitigate; and
The compensation of persons performing the risk-mitigating hedging activities must not be designed to reward proprietary risk-taking.
The Proposed Regulations follow the language of Section 619 in permitting hedging related to risks of aggregated positions, which contemplates hedging across trading desks (sometimes referred to as portfolio hedging).
It is anticipated that portfolio hedging will be subject to close scrutiny by regulators who are concerned about potential abuse.
The regulators request comments on whether additional restrictions should be placed on use of the hedging exemption for aggregated positions.</td></tr>
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Documentation Requirement	• The Proposed Regulations impose a documentation requirement on certain types of hedging transactions. • Specifically, for any transaction that involves a hedge established at a level of the organization that is different than the level of the organization establishing the underlying position, the banking entity must maintain certain documentation relating to the hedge.

Permitted Trading in Government Obligations	

Rule	• A banking entity may purchase or sell a covered financial position that is a government obligation.
	• Covered government obligations include:
	  o An obligation of the United States or any regulator thereof;
	  o An obligation, participation or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Mortgage Corporation or a Farm Credit System institution chartered under the Farm Credit Act of 1971; or
	  o An obligation issued by any state or political subdivision thereof.
	• The exemption applies to transactions in both general obligations and limited obligations of such government entities, including revenue bonds.
	• This exemption permits proprietary trading not only in obligations of such government entities, but also participations and other instruments of or issued by such entities, such as pass-through or participation certificates issued by one of the government-sponsored entities in connection with their securitization activities.

Permitted Trading on Behalf of Customers	
Rule	• A banking entity may purchase or sell a covered financial position on behalf of customers.

Three Categories of Transactions Are Permitted	• The Proposed Regulations identify three categories of transactions that the regulators consider to be "on behalf of customers":
	  o The transaction is conducted by a banking entity acting as an investment adviser, commodity trading advisor, trustee or in a similar fiduciary capacity for the account of a customer and involves solely covered financial positions of which the banking entity's customer (and not the banking entity or any of its subsidiaries or affiliates) is beneficial owner;
	  o The banking entity is acting as riskless principal (as determined based on language similar to that used in the Board's Regulation Y, OCC interpretive letters and the SEC's Rule 3a5-1); or
	  o The banking entity is a regulated insurance company directly engaged in

	the business of insurance and conducts the transaction for a separate account established for policyholders, provided that all ensuing profits or losses are allocated to the policyholder's account and the transaction is conducted in accordance with applicable insurance company investment and other laws, regulations and guidelines. • Inclusion of trading for separate accounts in this exemption is helpful for and is provided in response to comments by insurance companies, as the statutory exemption for insurance companies only covers trading for an insurance company's general account (see below). • Only transactions meeting the criteria for one of these three categories will qualify for this exemption.

Permitted Trading by Regulated Insurance Companies	
Rule	• A banking entity may purchase or sell a covered financial position, if the entity is (i) a regulated insurance company directly engaged in the business of insurance acting for its general account or (ii) an affiliate of an insurance company acting solely for the insurance company's general account. o Such trading is only permitted if the company and transaction are in compliance with the applicable insurance regulatory framework and such framework is deemed adequate. o The adequacy of a given jurisdiction's insurance regulatory framework is subject to the discretion of the appropriate federal banking agencies, after consultation with the FSOC and the relevant state insurance commissioners. • The Proposed Regulations define a general account as insurance company assets that are not legally segregated and allocated to separate accounts under applicable state or foreign law.

Permitted Trading Outside of the United States
Certain foreign banking entities controlled by a foreign parent company may engage in proprietary trading that occurs solely outside of the United States. A discussion of this exemption is included below.

Discretionary Exemptions for Proprietary Trading
The statutory Volcker Rule provisions permit the regulators to grant, by rule, other exemptions from the prohibition on proprietary trading if the regulators determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States. The regulators have not proposed any such discretionary exemptions at this time, but request comment about whether additional exemptions should be included the final rule.

Limitations on Permitted Trading Activities — Conflicts of Interest, Material Exposure to High-Risk Assets or Trading Strategies, Threats to Safety and Soundness	
Rule	• No activity may qualify for an exemption from the proprietary trading prohibition if the activity would: o Involve or result in a "material conflict of interest" between the banking entity and its clients, customers or counterparties; o Result, directly or indirectly, in a material exposure by the banking entity to a "high-risk asset" or a "high-risk trading strategy"; or o Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.
Defining a "Material Conflict of Interest"	• A "material conflict of interest" exists where the banking entity engages in any activity that would involve or result in the banking entity's interests being materially adverse to those of its client, customer or counterparty with respect to such activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest through either: (i) timely and effective disclosure to the counterparty or (ii) informational barriers. • Banking entities will likely have to develop complex disclosure, even for arms length transactions with equally sophisticated counterparties. Whether the Proposed Regulations, if adopted, will mitigate systemic risk and protect the interests of the parties sufficiently to justify the likely added expense is important to consider.
Defining "High-Risk Asset" and "High-Risk Trading Strategy"	• A "high-risk asset" is an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. • A "high-risk trading strategy" is a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. • The reporting and recordkeeping requirements in Appendix A and the compliance program requirement in Appendix C to the Proposed Regulations mandate extensive monitoring and measurement of assets and activities that might meet the definitions of "high-risk asset" and/or "high-risk strategy" to determine whether there was prohibited material exposure.

Covered Fund Activities and Investments

The Proposed Regulations would implement the statutory provision prohibiting a banking entity from acquiring or retaining any ownership interest in, or sponsoring, a covered fund, subject to certain exemptions and limitations. The statutory Volcker Rule raised a number of significant issues, particularly for banking entities engaged in the asset management business. The Notice and the Proposed Regulations provide some helpful additional detail and resolve a few of the issues in a positive manner for these banking entities, but many of the provisions remain subject to interpretation.

General Prohibition and Key Definitions	
General Prohibition	• Except as otherwise provided, a banking entity may not, as principal, directly or indirectly acquire or retain any ownership interest in or sponsor a covered fund.
Covered Fund	• A "covered fund" is: o A fund subject to the "private investment company" exceptions contained in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940[9]; o A commodity pool (as defined in Section 1a(10) of the CEA)[10]; o A similar non-United States entity; or o A similar fund as the appropriate federal banking agency, the SEC or the CFTC may determine by rule.
Ownership Interest	• An "ownership interest" includes any equity, partnership or similar interest, whether voting or non-voting, or any derivative of such instrument. • Debt investments will not constitute "ownership interests", but a debt security with equity characteristics could be deemed an ownership interest because it is a "similar instrument" to an equity interest.
Carried Interest Not Ownership Interest	• An ownership interest does not include a typical carried interest or other performance compensation where the banking entity serves as investment manager, investment adviser or commodity trading adviser to a covered fund, provided: o The sole purpose and effect of the interest is to allow the banking entity (or an affiliate, subsidiary or employee thereof) to share in the profits of the covered fund as performance compensation for services provided to the

[9] Section 3(c)(1) excepts from the definition of investment company a fund that meets two requirements: (i) it must be an "issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons" and (ii) one "which is not making and does not presently propose to make a public offering of its securities." Section 3(c)(7) exempts any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers," and which is not making and does not at the time propose to make a public offering of such securities.

[10] "Commodity pool" is defined in the CEA to mean any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests, including any: (i) commodity for future delivery, security futures product or swap; (ii) agreement, contract or transaction described in Section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the CEA; (iii) commodity option authorized under Section 4c of the CEA; or (iv) leverage transaction authorized under Section 23 of the CEA.

	covered fund; o Such profit, once allocated, is distributed promptly after being earned (or, if reinvested, does not share in subsequent profits and losses of the covered fund); o The banking entity (or an affiliate, subsidiary or employee thereof) does not provide funds to the covered fund in connection with acquiring or retaining the interest; and o The interest is not transferable by the banking entity (or an affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary thereof.
Sponsor	• In general, a banking entity is a "sponsor" of a covered fund where the banking entity: o Serves as general partner, managing member, trustee or commodity pool operator of the fund; o In any manner selects or controls a majority of the directors, trustees or management of the fund; or o Shares the same name or a variation of the same name with the fund for corporate, marketing, promotional or other purposes.

Permitted Organizing and Offering of a Covered Fund	
Rule	• The Volcker Rule and the Proposed Regulations do not prohibit a banking entity from, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee or commodity pool operator of a covered fund and in any manner selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund, including any necessary expenses for the foregoing, only if: o The banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisor services; o The covered fund is organized and offered only in connection with the provisions of the foregoing and only to persons that are customers of such services of the banking entity; • Section 619 could have been read to imply that pre-existing customer relationships were required; • The Proposed Regulations make clear that a pre-existing relationship need not be in place, but that offers must be pursuant to a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund; o The banking entity does not acquire or retain an ownership interest in the covered fund except as set forth below; o The banking entity complies with the restrictions set forth below; o The banking entity does not, directly or indirectly, guarantee, assume or

	otherwise insure the obligations or performance of the covered fund or any covered fund in which such covered fund invests (note that this may prevent the banking entity from serving as the general partner of the covered fund); o The covered fund, for corporate, marketing, promotional or other purposes, does not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and does not use the word "bank" in its name; o No director or employee of the banking entity takes or retains an ownership interest in the covered fund, unless the director or employee is directly engaged in providing investment advisory or other services to the covered fund (it is not clear how to determine which employees would be deemed to be directly engaged in providing services); o The banking entity: (i) clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund: (a) that any losses will be borne solely by investors and not the banking entity (or its affiliates or subsidiaries); (b) that the investor should read the offering documents before investing; (c) that ownership interests are not insured by the FDIC and are not deposits, obligations, or endorsed or guaranteed in any way by any banking entity (unless that is not the case); and (d) the role of the banking entity in sponsoring or providing services to the covered fund; and (ii) complies with other rules designed to ensure losses are borne solely by investors (these disclosures can be made in the covered fund's offering documents); and o The banking entity complies with any additional rules of the appropriate federal banking agencies, the SEC or the CFTC that are designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity and its affiliates or subsidiaries.

Permitted Investments in Covered Funds	
Rule	• A banking entity can make an investment in a covered fund for the purpose of (i) establishing the covered fund and providing sufficient initial equity to permit the fund to attract unaffiliated investors or (ii) making and retaining an investment in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund. o The banking entity must actively seek unaffiliated investors to reduce its ownership interest to 3 percent of the total outstanding ownership interests in the fund, and may not exceed 3 percent of the total amount or value of outstanding ownership interests of the fund not later than one year after the date of establishment of the fund. o A banking entity may apply for an extension to meet these requirements for up to two additional years. To grant an extension, the Board must find that the extension would be consistent with safety and soundness and not

detrimental to the public interest.
  - The Board may impose conditions on any extension it determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the Volcker Rule.
- The aggregate value of all ownership interests of a banking entity in all covered funds may not exceed 3 percent of the tier 1 capital of the banking entity determined in accordance with applicable accounting standards (calculated as of the last day of each calendar quarter).
  - If a banking entity is required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be equal to the amount of tier 1 capital calculated by that banking entity as of the last day of the most recent calendar quarter that has ended, as reported to its primary financial regulatory agency.
  - If a banking entity does not itself calculate and report tier 1 capital but is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, the banking entity should measure based on the amount of the tier 1 capital of the controlling depository institution.
  - If the banking entity is not controlled by a depository institution, but is a subsidiary of a bank holding company or company that is treated as a bank holding company, the banking entity should measure based on the amount of tier 1 capital reported by the top-tier affiliate.
  - In all other circumstances, the banking entity should measure based on the amount of shareholders' equity of the top-tier affiliate within its organization.
  - A banking entity must deduct the aggregate value of all permitted investments in covered funds from tier 1 capital when making this measurement.
- Certain other counting provisions for determining the value of ownership interests in a covered fund:
  - The amount and value of an investment in any single covered fund includes: (i) any ownership interest held in covered funds, and (ii) the pro rata share of any ownership interest held in a covered fund by any entity that the banking entity owns, controls or holds with the power to vote more than 5 percent of the voting shares.
  - If a banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity, whether or not pursuant to an express agreement, such investments shall be included in any calculation.
  - A banking entity must calculate its investment in the same manner and according to the same standards used by the covered fund for determining the aggregate value of the fund's assets and ownership interests.

Investments as Hedges	• A banking entity can acquire or retain an ownership interest in a covered fund when hedging a position (i) to facilitate the exposure by a customer to the profits and losses of the covered fund, or (ii) in connection with a compensation arrangement to an employee that provides investment advisory or other services to the covered fund. o The banking entity must establish certain internal compliance programs, and create and maintain documents relating to the purpose of the investment and the risks the investment is hedging. o The compensation arrangements of persons performing the risk-mitigating hedging activities cannot be designed to reward proprietary risk-taking.
Other Permitted Investments	• A banking entity can make investments in: o Small business investment companies ("SBICs") and certain public interest investments; o A covered fund that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure; o A covered fund that is an issuer of certain asset-backed securities; o A separate account that is used solely for the purpose of allowing a banking entity to purchase certain insurance policies; o A joint venture that is an operating company and does not engage in any activity or make any investment prohibited under the Proposed Regulations; o An acquisition vehicle the sole purpose and effect of which is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates; o An issuer of an asset-backed security that is retained by a banking entity in compliance with the minimum requirements of the Exchange Act, or certain other investments in an issuer of certain asset-backed securities; o A wholly-owned subsidiary of the banking entity that is engaged principally in performing bona fide liquidity management activities and carried on the balance sheet of the banking entity; and o A covered fund that is acquired or retained in the ordinary course of collecting a debt previously contracted in good faith, if the banking entity divests the ownership interest within applicable time periods.
Limitations on Transactions between Banking Entities and Related Covered Funds	• The Proposed Regulations would prohibit any banking entity that, directly or indirectly, serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund (or that organizes and offers a covered fund as permitted by the Proposed Regulation) and its affiliates from engaging in any "covered transaction," as defined in Section 23A of the Federal Reserve Act, with the covered fund, or with any fund that is controlled by the covered fund, applied as if the banking entity or affiliate were a member bank and the covered fund were an affiliate. • The restriction applies to Section 23A "covered transactions," which include, for example, loans and other extensions of credit and purchases of securities or other assets. Under the Dodd-Frank Act amendments effective on July 21, 2012

	(the same date as the effective date of the Proposed Regulations), "covered transactions" also will include credit exposure from derivatives transactions, securities lending and borrowing transactions, and repurchase agreement transactions. • This restriction is broader than the Section 23A restriction on covered transactions between banks and their affiliates: o The Proposed Regulations would prohibit covered transactions between banking entities (including their affiliates) and covered funds subject to the restriction, while Section 23A permits covered transactions between banks and their affiliates provided certain quantitative and qualitative requirements are met; and o Section 23A's exemptions for certain types of covered transactions would generally not be applicable (*e.g.*, no exemptions for transactions secured by cash or government securities, intra-day extensions of credit).[11] • Two categories of transactions would be permitted despite the prohibition. o A banking entity would be permitted to acquire or retain an ownership in a covered fund as permitted under the Proposed Regulations. o A banking entity would be permitted to enter into any prime brokerage transaction (including custody, clearance, securities borrowing or lending services, trade execution, or financing and data, operational and portfolio management support) with any covered fund in which a covered fund managed, sponsored or advised by the banking entity (or its affiliate or subsidiary) has taken an ownership interest if: • The banking entity complies with the requirements under the Proposed Regulations on organizing and offering the covered fund; • The CEO (or equivalent officer) of the banking entity annually certifies in writing that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations of the covered fund or of any covered fund in which the covered fund invests; and • The Board has not determined that the transaction is inconsistent with the safe and sound operation and condition of the banking entity. • Application of Section 23B Market-Terms Requirement: o Section 23B of the Federal Reserve Act would be applied to transactions between a banking entity that serves as investment manager, investment adviser, commodity trading adviser or sponsor to a covered fund (or that organizes and offers a covered fund as permitted by the Proposed Regulations) and that covered fund; o As a result, most transactions between the banking entity and such as a covered fund would be subject the market terms requirement of Section 23B; and o Section 23B also would apply to prime brokerage transactions permitted under the exception to the covered transaction restriction described

[11] The only Section 23A exemption that would apply in this context is the exemption for purchases of real and personal property as specifically exempted by the Board.

	above, as if the counterparty were an affiliate of the banking entity. o To comply with this market terms requirement, the transaction must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transaction with or involving nonaffiliates; or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliates.
Other Limitations on Permitted Covered Fund Activities	• No transaction, class of transactions, or activity may be deemed permissible if the transaction, class of transactions, or activity would: o Involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties, unless: • Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict of interest may arise, the banking entity makes clear, timely and effective disclosure to the counterparty of the conflict of interest and makes such disclosure explicitly and effectively; or • The banking entity has established, maintained and enforced information barriers that are memorialized in written policies and procedures that are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty; o Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; • High-risk asset means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail; • High-risk trading strategy means 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 fail; or o Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Fund Activity Outside of the United States
The general prohibition against banking entities acquiring or retaining an ownership interest in, or sponsoring, covered funds does not apply to certain foreign banking entities controlled by a foreign parent company if the activity is conducted solely outside the United States. A discussion of this exemption is included below.

Applicability of Proposed Regulations to Securitizations

The covered fund restrictions of the Proposed Regulations could apply to some securitization structures, though they would apply only to certain specified ownership interests in asset-backed issuers that rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, and would not apply to issuers that rely on any other exemption or exclusion from the definition of "investment company." The Proposed Regulations also contain express exemptions for any credit risk retention in a securitization transaction that is required by the Dodd-Frank Act, and for the acquisition or retention of certain other asset-backed securities. The proprietary trading restrictions of the Proposed Regulations could restrict the ability of a securitization vehicle to buy and sell securities, and the prohibitions on covered transactions with a covered fund could restrict some banking entities from providing liquidity, servicing advances and other customary extensions of credit.

<table>
<tr><th colspan="2">Covered Fund Restrictions Would Apply Only to "Ownership Interests" in 3(c)(1) and 3(c)(7) Funds</th></tr>
<tr><td>3(c)(1) and 3(c)(7) Funds Only</td><td>• As noted above, a "covered fund" includes an issuer that would be an investment company but for Section 3(c)(1) (the so-called "private investment company" exception) or Section 3(c)(7) (the "qualified purchaser" exception) of the Investment Company Act.
o According to the Notice, if an issuer — including an issuer of asset-backed securities — may rely on another exclusion or exemption from the definition of "investment company," it would not be considered a covered fund, so long as it can satisfy all of the conditions of that alternative exclusion or exemption.
o Therefore, an issuer of asset-backed securities would not be a covered fund if it relies on:
• Rule 3a-7, the exemption for certain issuers of asset-backed securities; or
• Section 3(c)(5), which exempts certain issuers primarily engaged in the business of: acquiring obligations representing part or all of the sales price of merchandise, insurance and services; making loans to manufacturers, wholesalers, retailers and prospective purchasers of merchandise, insurance and services; and/or purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.</td></tr>
<tr><td>"Ownership Interests" Only</td><td>• As noted above, an "ownership interest" in a covered fund includes any equity, partnership or similar interest, whether voting or non-voting, or any derivative of such instrument.
o This includes a membership interest or trust interest in a covered fund.
o According to the Notice, the definition focuses on the attributes of the interest and whether it provides economic exposure to the profits and losses of a covered fund, so a debt security that has substantially the same characteristics as an equity interest could constitute an ownership interest.
o The regulators request comment on:
• Whether additional guidance should be provided on the distinction between debt and equity asset-backed securities and how that</td></tr>
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	distinction applies to the definition of "ownership interest"; and • Whether the Proposed Regulations should exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund, other than the residual interest in a securitization.

Exemptions from Covered Fund Restrictions for Asset-Backed Securities	
Exemption for Required Credit Risk Retention	• The Proposed Regulations would permit a banking entity to acquire or retain any ownership interest in asset-backed securities that is required by the credit risk retention rules adopted pursuant to Section 941 of the Dodd-Frank Act, which as proposed generally would require securitizers to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of asset-backed securities, transfers, sells or conveys to a third party, subject to certain exceptions. • This exemption would be limited to the minimum amount required by the final credit risk retention rules.
Exemptions for Issuers of Asset-Backed Securities	• The Proposed Regulations would permit a banking entity to act as a sponsor to, or to acquire and retain an ownership interest in, a covered fund that is an issuer of asset-backed securities, so long as the covered fund's assets consist solely of: o "Loans"; o Contractual rights or assets directly arising from the securitized loans supporting the asset-backed securities; and o Interest rate or foreign exchange derivatives that materially relate to the terms of the securitized loans or related contractual rights or assets, which are used for hedging purposes with respect to the securitization structure. • These exemptions would permit a securitization by a banking entity, as well as the acquisition by a banking entity of asset-backed securities issued by another entity. • "Loans" is proposed to be broadly defined to include any loan, lease, extension of credit, secured receivable or unsecured receivable. o While the proposed definition is expansive, the Notice states that it does not include any asset-backed securities issued in connection with a loan securitization. Therefore, a resecuritization would not be exempt, nor would a commercial paper conduit that acquires asset-backed securities. o It is not clear whether the proposed exemption would permit a securitization vehicle that is a covered fund to acquire permitted investments, either in the ordinary course or during a pre-funding period. • The scope of permitted derivatives would be limited. o Permitted derivatives would include only those derivatives where the notional amount is tied to the outstanding principal balance of the securitized loans, either individually or in the aggregate. o Permitted derivatives would be required to be entered into solely to hedge risks that result from a mismatch between the loans and the related asset-

	backed securities, such as where fixed rate loans support floating rate asset-backed securities. o The types of derivatives that are proposed to be allowed are not intended to include synthetic securitizations or securitizations of derivatives. • The definition of "asset-backed securities" that would apply for purposes of these exemptions is not clear, and the regulators request comment on the appropriate definition. o One suggested possibility is the definition contained in Item 1101(c) of Regulation AB. Among other things, the use of this definition would limit the exemption to asset-backed securities that meet Regulation AB's stringent requirements: • Backed by financial assets that convert to cash by their terms within a finite time period; • No non-performing assets at issuance; • Less than 50 percent delinquent assets (less than 20 percent for shelf offerings); • Less than 65 percent of the pool balance attributable to residual value of vehicle leases; • Less than 50 percent of the pool balance attributable to residual value of non-vehicle leases (less than 20 percent for shelf offerings); • Revolving period limited to three years for fixed assets; and • Pre-funding period limited to one year and no larger than 50 percent of the offering proceeds (for an amortizing trust) or 50 percent of the pool balance (for a master trust). o Another suggested possibility is the definition contained in Section 3(a)(77) of the Securities Exchange Act, as added by the Dodd-Frank Act. • This definition encompasses a broader range of instruments than the definition of "asset-backed securities" under Regulation AB. • This definition also includes collateralized debt obligations, securities issued or guaranteed by a government sponsored entity such as Fannie Mae or Freddie Mac, and municipal asset-backed securities.

Other Concerns Raised by the Proposed Regulations	
Proprietary Trading Restrictions	• The affiliation of a securitization-related special purpose entity with a banking entity would subject that special purpose entity to the proprietary trading restrictions of the Proposed Regulations. This would impose restrictions on the purchase and sale by such a securitization vehicle of assets that are not "loans" and otherwise are within the scope of "covered financial position." • By restricting the ability of a securitization vehicle to purchase and sell securities, these restrictions could impact, among other things, the ability of a securitization vehicle to buy and sell permitted investments, and the viability of resecuritizations and commercial paper conduits that acquire asset-backed securities.

Prohibition on Covered Transactions with a Covered Fund	• As described above, a banking entity that serves as investment manager, investment adviser or sponsor to a covered fund would be prohibited from engaging in any “covered transaction” with the covered fund. • Because loans and other extensions of credit are “covered transactions,” a banking entity that sponsors, manages or provides advisory services to a securitization vehicle that is a covered fund could be limited in its ability to provide liquidity, servicing advances or other customary extensions of credit to the securitization vehicle.

Activities by Foreign Banking Entities Outside the United States

Foreign companies with banking operations in the United States are generally subject to the Volcker Rule. Such foreign companies are treated as "banking entities" in the Proposed Regulations and would be restricted from engaging in proprietary trading activities or covered fund activities except pursuant to an exemption. The Volcker Rule seeks to limit the extraterritorial application of its restrictions on proprietary trading and fund ownership and sponsorship, while preserving national treatment and competitive equality among United States and foreign firms within the United States. It accomplishes that in part by exemptions that permit foreign banking entities to engage in otherwise prohibited proprietary trading and fund activity so long as such activity occurs solely outside the United States. The exemptions are not available to United States banking entities.

In General	
Generally	• A "banking entity" for purposes of the Volcker Rule includes foreign companies with banking operations in the United States, either because the foreign company controls an insured depository institution in the United States or the foreign company is or controls a foreign bank that is treated as a bank holding company for purposes of Section 8 of the International Banking Act. • This means that the Volcker Rule applies to any foreign company that is or controls a foreign bank that has a branch or agency in the United States, controls a commercial lending company in the United States, controls a United States bank or bank holding company, or controls any other type of insured depository institution in the United States (*e.g.*, a savings bank or industrial loan company). • The Volcker Rule also applies to the subsidiaries and affiliates of such foreign companies. • Foreign banking entities may conduct proprietary trading activities or covered fund activities in reliance on any of the exemptions described above or on the exemptions for foreign banking entities, which are described below.

Permitted Proprietary Trading Outside of the United States	
Rule	• Certain foreign banking entities may engage in proprietary trading that occurs solely outside of the United States, even where the foreign banking entity has bank affiliates or a branch or agency in the United States.
Foreign Banking Entities Eligible for the Exemption	• The Proposed Regulations limit availability of the exemption to activities of foreign banking entities that are not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or any state. • The exemption is not available to (i) banking entities organized under the laws of the United States or any state, including their subsidiaries and branches (wherever organized or licensed) and (ii) United States subsidiaries or branches or agencies of foreign banking entities.

Requirement of Reliance on Section 4(c)(9) Authority	• To qualify for the exemption, a transaction must be conducted by the foreign banking entity in reliance on Section 4(c)(9) of the BHC Act, which permits foreign banking organizations to engage in a broad range of activities outside the United States (including activities that are not permissible for United States bank holding companies).
	• To rely on Section 4(c)(9), a foreign banking entity must be a "qualified foreign banking organization," or "QFBO," under the Board's Regulation K.
	  o To be a QFBO, a foreign company that is or is treated as a bank holding company for purposes of the BHC Act must meet tests for determining that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.
	  o The Proposed Regulations include a modified QFBO test for foreign banking entities that are subject to the Volcker Rule, but are not currently subject to the BHC Act (*e.g.*, a foreign company that is subject to the Volcker Rule solely because the foreign company controls a savings bank or industrial loan company in the United States).
	    • Such foreign banking entities must meet only the QFBO test's criteria for determining that more than half of its banking business is outside the United States.
	    • They do not need to have more than half of their worldwide business be banking.

When a Transaction is Considered to Have Occurred "Solely Outside the United States"	• A proprietary trading transaction must meet each of the following four criteria in order to have occurred "solely outside the United States":
	  o The banking entity engaging in the transaction must not be organized under United States or state law;
	  o No party to the transaction may be a United States resident (as defined under a definition that is similar, but not identical, to the definition of "U.S. person" in the SEC's Regulation S);
	  o No personnel of the banking entity who is directly involved in the transaction may be physically located within the United States (such personnel generally do not include persons performing purely administrative, clerical or ministerial functions); and
	  o The transaction must be executed wholly outside the United States.
	• These criteria are intended to ensure that the transaction does not involve United States counterparties, United States trading personnel, United States execution facilities or retention of risk in the United States.
	• It is not sufficient to evaluate solely whether the risk of transaction or management or decision-making with respect to the transaction rests outside the United States.

Permitted Fund Activity Outside of the United States	
Rule	• Certain foreign banking entities may engage in covered fund activity that occurs solely outside of the United States, even where the foreign banking entity has a bank affiliate or a branch or agency in the United States.
Foreign Banking Entities Eligible for the Exemption	• Same as exemption for proprietary trading activities by foreign banking entities (see above).
Requirement of Reliance on Section 4(c)(9) Authority	• Same as exemption for proprietary trading activities by foreign banking entities (see above). • Under the Board's Regulation K, there are strict limits on the U.S. activities of companies invested in under the authority of Section 4(c)(9).
When a Transaction is Considered to Have Occurred "Solely Outside the United States"	• No ownership interest in the covered fund may be offered for sale or sold to a resident of the United States. • In addition, the covered fund activity must meet each of the following three criteria in order to have occurred "solely outside the United States": o The banking entity engaging in the transaction must not be organized under United States or state law; o No subsidiary, affiliate or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund may be incorporated or physically located in the United States or in any state; and o No ownership interest in the covered fund may be offered for sale or sold to a resident of the United States. (This criterion for "solely outside the United States" appears to be redundant to the separate requirement prohibiting sales of fund ownership interests to United States residents described above.) • An employee or entity engaged in the offer or sale of an ownership interest (or booking such transaction) must be outside of the United States; however, an employee or entity with no customer relationship and involved solely in providing administrative services or "back office" services (such as clearing and settlement or maintaining and preserving records of the covered fund) would not be subject to this requirement.

Compliance, Internal Controls, Reporting and Recordkeeping

The Proposed Regulations would require banking entities to implement internal controls and compliance programs reasonably designed to ensure and monitor compliance with the Proposed Regulations, and to comply with reporting and recordkeeping requirements. The internal controls and compliance program must be appropriate for the size, scope and complexity of the activities and business structure of the banking entity. Those banking entities with more significant proprietary trading activities and/or covered fund activities would be subject to heightened internal control and compliance program standards, which are described in Appendix C. Those banking entities with significant proprietary trading activities would be required to comply with requirements to report and keep records regarding various quantitative measurements, as set forth in Appendix A. The regulators acknowledge in the Notice that the proposed compliance, internal control, reporting and recordkeeping requirements could impose material costs to banking entities.

Basic Elements of the Compliance Program	
Rule	• Banking entities would be required to implement compliance programs designed to ensure and monitor compliance with the Proposed Regulation's prohibitions on proprietary trading and investing in and sponsoring covered funds and restrictions on engaging in such activities under the exemptions of the Proposed Regulations.
Compliance Program Proposal	• All banking entities engaged in proprietary trading activities or that invest in or sponsor covered funds would be required to implement a compliance program. • Banking entities with significant proprietary trading activities or covered fund activities would be subject to heightened compliance program requirements in Appendix C, while those with lower levels of such activities would only be subject to the core compliance program requirements in the regulation itself. • Banking entities that do not engage in covered activities and investments would be required to ensure: o That their existing compliance procedures prevent them from engaging in covered activities and investments; or o That they have established the required compliance program before engaging in covered activities and investments.
Proposed Core Compliance Program	• The Proposed Regulations articulate core elements of a mandated compliance program for all banking entities. They are, in summary: o Internal written policies and procedures that document, describe and monitor covered activities to ensure compliance with the Proposed Regulations, including the commentary found in Appendix B; o Internal control systems designed to monitor and identify potential areas of noncompliance and to prevent prohibited activities; o A management framework that delineates responsibility and accountability for compliance; o Independent testing for the effectiveness of the compliance program;

	o Training for trading personnel and managers to implement and enforce the compliance program; and o Recordkeeping to demonstrate compliance, which the banking entity must provide upon request and retain for at least five years.
Proposed Heightened Compliance Program Requirements for Banking Entities with Significant Proprietary Trading Activities or Significant Investments or Relationships with Covered Funds	• A banking entity must meet the requirements and other standards specified in Appendix C, if any of the following apply: o The banking entity engages in proprietary trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion or equals 10 percent or more of its total assets; o The banking entity invests in, or has relationships with, a covered fund and has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each the four prior quarters, equal to or greater than $1 billion, or sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or o The appropriate regulator deems a heightened compliance program to be appropriate. • Although not required to comply with Appendix C, the regulators encourage banking entities engaged in a relatively small amount of covered fund activity to look to the standards in Appendix C for guidance regarding effective compliance programs. • The closer a banking entity gets to the thresholds, the more its compliance program should look like what is required by Appendix C. • Appendix C establishes that an effective heightened compliance program for a banking entity with significant proprietary activities or investments in or relationships with covered funds is one that: o Documents, describes and monitors the covered trading and fund activities or investments and the risks of the banking entity related to such activities or investments, identifies potential areas of noncompliance and prevents activities or investments prohibited by, or that do not comply with, the Proposed Regulation; o Addresses the varying nature of the activities or investments conducted by different units of the banking entity's organization, including size, scope, complexity and risks of the individual activity or investment; o Subjects the effectiveness of the compliance program to independent review and testing; o Requires senior management and intermediate managers to be accountable for the effective implementation of the compliance program and ensure that the CEO or the board of directors review the effectiveness of the program; and

    - Facilitates the supervision of the banking entity's covered trading activities and covered fund activities or investments by the regulators.
- Appendix C incorporates by reference the six elements that would be included in the core compliance program under the Proposed Regulations. Appendix C also articulates more specific minimum standards for each requirement, as set forth below.
- *Internal policies and procedures* for covered trading activities and covered fund activities and investments
- *Internal controls*
    - Designed to ensure that the covered activities are conducted in conformance with the trading unit's authorized risks, instruments and products, as documented in the banking entity's written policies and procedures.
    - Establish and enforce risk limits for each trading unit.
    - Perform robust analysis and quantitative measurement of covered trading activity for conformance with the Proposed Regulation. The analysis and quantitative measurement must be reasonably designed to:
        - Ensure that the activity of each trading unit is appropriate to the mission, strategy and risk of each trading unit, as documented in the banking entity's internal written policies and procedures;
        - Monitor and assist in the identification of potential and actual prohibited trading activity; and
        - Prevent the occurrence of prohibited proprietary trading.
- *Responsibility and accountability*
    - The board of directors and the CEO would be responsible for setting an appropriate culture of compliance and establishing policies regarding the management of covered trading activities and covered fund activities and investments.
    - This is similar to the requirement in the Sarbanes-Oxley Act, whereby the board of directors and the CEO must approve and ensure the effective implementation and enforcement of the compliance program.
    - The CEO and board of directors would be required to take corrective action if there is a failure in the compliance program.
    - Ultimately, the onus of compliance would be placed at the highest corporate levels.
- *Independent testing*
    - Banking entities would be required to ensure that the compliance program, policies and procedures, management procedures and actual compliance with each are independently tested by a qualified independent party, which could be a banking entity's internal audit department, outside auditors, consultants or other qualified independent parties.
- *Training*
    - The banking entity would be required to provide training to its trading personnel and managers to effectively implement and enforce the compliance program, with frequency appropriate to the size and risk profile of the banking entity's covered activities.

	o Specific training would be incorporated for personnel with discretionary authority to trade and advisory/investment management responsibilities to ensure they understand the differences between prohibited and permitted activities. • *Recordkeeping* o The banking entity would be required to maintain adequate records to demonstrate compliance and support the operation and effectiveness of the program. o The records would have to be maintained for a minimum of five years. • Appendix C would permit a banking entity to establish a heightened compliance program on an enterprise-wide basis. To do so, the banking entity's compliance program would need to: o Be clearly applicable, both by its terms and in operation, to all affiliates and subsidiaries; o Specifically address the requirements set forth in Appendix C; o Take into account and address the consolidated organization's business, structure, size and complexity, as well as the particular activities, risks and applicable legal requirements of each subsidiary and affiliate; and o Be determined through periodic independent testing to be effective for the banking entity and its subsidiaries and affiliates.

Reporting and Recordkeeping Applicable to All Proprietary Trading and Covered Fund Activities and Investments	
Rule	• All banking entities that engage in proprietary trading or covered fund activities and investments must comply with the reporting and recordkeeping requirements required for their compliance programs, as described above. • All banking entities must comply with such other reporting and recordkeeping requirements as the appropriate regulator deems necessary to appropriately evaluate the banking entity's compliance with the Proposed Regulations. • Additional reporting and recordkeeping under Appendix A is required by banking entities with significant proprietary trading activities, as described below.

Reporting and Recordkeeping Requirements Under Appendix A	
Rule	• Banking entities with significant trading activities must comply with the reporting and recordkeeping requirements of Appendix A, which requires the banking entity to furnish periodic reports to the relevant regulator regarding various quantitative measurements and keep records documenting the preparation and content of such reports.

Detailed Reporting and Recordkeeping Requirements for Banking Entities with Significant Trading Activities	• Appendix A sets forth specific reporting and recordkeeping requirements for a banking entity that, together with its affiliates and subsidiaries, has trading assets and liabilities equal to or greater than $1 billion, as measured as of the last day of the four previous calendar quarters. • Banking entities with gross trading assets and liabilities of $5 billion or more are required to submit certain quantitative measurements for all trading units engaged in permitted underwriting, market making, risk-mitigated hedging and trading in government obligations. • Banking entities with gross trading assets and liabilities between $1 billion and $5 billion must submit certain quantitative measurements for trading units that are engaged in permitted market making-related activities. • For both categories, each required quantitative measurement must be calculated for each trading day, and must be reported to the relevant regulator on a monthly basis. The quantitative reports must be documented within the banking entity.
The Nature of Required Quantitative Measurements	• The required quantitative measurements are grouped into the following five categories according to their purpose: o *Risk-management measurements* such as VaR, Stress VaR and Risk Factor Sensitivities; o *Source-of-revenue measurements* such as Comprehensive Profit and Loss, Portfolio Profit and Loss and Fee Income and Expense; o *Revenues-relative-to-risk measurements* such as Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss and Unprofitable Trading Days based on both Comprehensive and Portfolio Profit and Loss; o *Customer-facing activity measurements* such as Inventory Risk Turnover, Inventory Aging and Customer-Facing Trade Ratio; and o *Payment of fees, commissions and spreads measurements* such as Pay-to-Receive Spread Ratio. • The regulators recognize that the process of identifying useful quantitative measurements will require further review. Therefore, the regulators propose to use the two-year conformance period of the Volcker Rule to review data submitted by banking entities, further study the design and utility of the measurements, and if necessary, propose changes to the reporting requirements as the regulators believe are needed to ensure that the measurements are as effective as possible.
Recordkeeping	• A banking entity subject to the reporting requirements of Appendix A must create and retain records documenting the preparation and content of any quantitative measurement furnished by the banking entity, as well as such information as is necessary to permit the relevant regulator to verify the accuracy of such measurements, for a period of five years.

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