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The Volcker Rule: Compliance Considerations

January 2012

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Every banking organization will have compliance obligations under the Volcker Rule[1] published in November (the "Proposed Rule") by four of the federal financial regulatory agencies and, in January, by the Commodity Futures Trading Commission (collectively, the "Agencies").[2] The Volcker Rule broadly prohibits a banking entity from engaging in proprietary trading and from acquiring or retaining any kind of ownership interest in or sponsoring a hedge fund or private equity fund. The Rule permits certain kinds of trading or fund activity, however, and the Proposed Rule addresses the parameters of and possible conditions on these activities. Compliance with the requirements in the Proposed Rule and some suggestions for a more streamlined approach are the focus of this paper.[3]

This paper focuses on the compliance duties that the Proposed Rule creates for all banking organizations, even those not engaged in Volcker Rule activities. While the Proposed Rule is, of course, only a proposal, the time for compliance is running short. Volcker takes effect on July 21, 2012, for all banking entities, whether or not there is a final regulation. The Agencies specifically would require that, by July 21, 2012, the largest organizations begin keeping daily records and making monthly reports of their trading activities and have full compliance programs in place. There is a nominal two-year conformance period, but the Agencies plan to use that time to fine-tune many of the requirements—underscoring the obligation of banking organizations to have compliance programs up and running in short order. Given this timeframe, the Proposed Rule is the only blueprint for compliance.

The deadline for comments on the Proposed Rule is February 13, 2012. The Agencies have faced a daunting task in developing a regulation that implements the complex Volcker provisions in Dodd-Frank without imposing unnecessary burdens. The Proposed Rule nevertheless would impose some significant burdens not required by Dodd-Frank. As we explain below, various requirements could be streamlined without undermining the statutory purpose.

Highlights

The source of the compliance burdens is that, while the Proposed Rule appropriately attempts to calibrate obligations according to an institution's level of involvement in proprietary trading or fund-related activities, the Proposed Rule as written likely will force even those organizations that present few or no Volcker risks to adhere

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[1] The Volcker Rule ("Volcker" or the "Volcker Rule") is set forth in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) ("Dodd-Frank" or the "Act") and codified in section 13 of the Bank Holding Company Act, 12 U.S.C. § 1851.

[2] The Proposed Rule is at 76 Fed. Reg. 68846 (Nov. 7, 2011), http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf. The agencies that developed the Proposed Rule are the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), and the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC"). The CFTC version of the Proposed Rule is at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112c.pdf.

[3] For an overview of the Proposal Rule, please see our alert, The Volcker Rule Proposal: An Initial Review (Oct. 14, 2011), http://www.mofo.com/files/Uploads/Images/111014-Volcker-Rule.pdf.

to many, if not all, of the requirements applicable to riskier institutions. Additionally, for the largest banking organizations with businesses covered by Volcker, the Proposal sets forth a highly detailed compliance regime that may be less effective than a principles-based regime to be applied on an institution-specific basis. The principal requirements in the Proposed Rule that present these issues include the following:

- Every banking organization will be compelled to develop a six-point compliance program, even if the organization engages in no trading or fund work covered by Volcker. The Proposed Rule also requires that these organizations have specific compliance programs covering trading for liquidity management and avoidance of high risk in trading not covered by Volcker.

  - For an organization with no trading or fund-related businesses, a set of policies and procedures that bar the organization from trading or fund-related activities, together with the identification of an officer—in all likelihood, the chief compliance officer or chief risk officer—with oversight responsibility, should be sufficient.

- Smaller institutions that engage in trading or fund-related activities are expected to at least use the elaborate compliance program requirements for the largest institutions as a "model."

  - Because the volume of trading and fund-related work is concentrated in a relatively small number of large banking organizations in the United States, the smaller organizations should not be compelled to model their compliance programs on those of the largest organizations.

- A banking organization engaged in market making must collect large amounts of data and make several complex quantitative measurements without knowing whether the measurements will meet with regulatory approval. Additionally, every such organization, regardless of size, is required to make several calculations.

  - If the Agencies require detailed measurements, rather than relying on general principles, then the banking organization should identify the specific thresholds at which trading would be either permissible or impermissible.

  - As above, given the concentration of market making and proprietary trading in the largest U.S. banking organizations, smaller banks that undertake market making should be required only to demonstrate that their market-making revenues derive primarily from fees and other sources unrelated to short-term increases in the value of the instruments in which they make markets.

Covered Banking Entities

The Proposed Rule applies to every "covered banking entity" ("CBE"). A "banking entity" is essentially any organization that includes an insured depository institution.[4] The Proposed Rule creates three tiers of CBEs, for which compliance obligations are supposed to vary.

- The first tier (Tier 1) consists of CBEs not engaged in either of the businesses covered by Volcker—proprietary trading in securities or ownership or sponsorship of hedge funds or private equity funds. Notwithstanding what the Agencies say in the Proposed Rule, as a practical matter, even those banking entities within this group will need to create and maintain a compliance program.

- The second tier (Tier 2) is comprised of CBEs that engage in trading or fund activities and investments on a relatively small scale. Generally, if the value of the trading assets and liabilities of a CBE or of the assets of covered funds[5] that a CBE sponsors or in which it invests are less than $1 billion, then the CBE is in the second group.

- The third tier (Tier 3) is made up of CBEs that either

  - hold trading assets and liabilities (including those of all affiliates and subsidiaries on a worldwide basis), the average gross sum of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than either $1 billion or ten percent of the CBE's total assets;[6]

  - hold, together with their 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 of the four prior calendar quarters, equal to or greater than $1 billion; or

  - sponsor or advise, together with their 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.

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[4] If the only insured depository institution within an organization operates solely in a trust or fiduciary capacity, then the organization is not a banking entity.

[5] A "covered fund" under the Proposed Rule includes a hedge fund or a private equity fund as defined in Volcker, a commodity pool, and any issuer as defined in section 2(a)(22) of the Investment Company Act ("ICA") that is organized or offered outside of the United States and that would be a covered fund if it were organized or offered under the laws, or offered to one or more residents, of the United States.

[6] The Proposed Rule appears to say that the denominator in calculating the percentage consists of assets only of the CBE and not those of any affiliate or subsidiary, even though their trading assets and liabilities are included in the numerator. This approach does not seem internally consistent and would be one item to clarify in the final rule. Throughout this paper, we refer broadly to the minimum dollar amount as the "$1 billion threshold."

> Within the third group, CBEs that exceed a threshold of $5 billion for any of the activities above (Tier 3.5) are subject to certain data gathering and reporting requirements in addition to those applicable to CBEs over the $1 billion threshold. These additional requirements are best understood within the context of the obligations of all CBEs over the $1 billion threshold.

The understandable foundation of the Proposed Rule is that the more substantial the trading or fund activities of a CBE, the more extensive and rigorous the compliance regime should be. However, the obligations of one group in practice may drift into those of another. Tier 1 CBEs must develop policies and procedures to ensure that they do not enter into the restricted proprietary trading and fund businesses and that, if they do expand into these businesses, they will satisfy new compliance requirements, including the prudential risk management requirements (i.e., the prohibitions on "high-risk" trading and funds activities) which apply to every CBE that engages to any extent in the buying and selling of covered financial instruments or in any private funds investment or management activities. These obligations appear to mean that these Tier 1 CBEs will have to address some of the conditions in Volcker, even though the conditions do not technically apply under the terms of the Proposed Rule. In turn, Tier 2 CBEs will find themselves creating a variation on the detailed compliance program that is required for a Tier 3 CBE because the broader compliance program requirements apply to any CBE that engages to any extent in covered trading and funds activities.

Two additional cautionary notes are in order as to which group a CBE may belong. First, the $1 billion and the 10%-of-assets thresholds for Tier 2 CBEs are stated in the disjunctive and, as a result, smaller banking entities need to pay close attention to the impact of the Proposed Rule's percentage threshold on their investment and activities. The calculation of these dollar and percentage thresholds must include any trading or investment in securities exempt from Volcker restrictions, such as U.S. Treasury and agency securities and related covered financial positions ("CFPs"). For example, a smaller community bank that is actively engaged in Government securities trading activities could inadvertently become a Tier 2 CBE.

Compliance Programs

The compliance framework in the Proposed Rule consists of three sections and three appendices. Section __.20 requires the compliance program, with different requirements for the three different groups of CBEs. Section ___.20(b) sets forth the basic elements of the six-point program. Reporting and record-keeping requirements for trading activities are set forth in section __.7. Section ___.15 directs a CBE that owns or sponsors a permissible fund to comply with section __.20 and Appendix C "as applicable."

The three appendices provide greater detail on the required compliance program. The broadest of the three, Appendix C, describes a full compliance program for Tier 3 CBEs, covering both trading and fund-related activities. Appendix A nominally applies only to Tier 3 CBEs and requires certain quantitative measures to ensure (i) that market-

making activities are not a cover for proprietary trading and (ii) that other permissible trading activities are not high risk. Appendix B discusses in a more comprehensive manner than Appendix A the compliance program specifically for market making and applies to Tier 2 CBEs as well as those in Tier 3. The interplay between the two appendices presents complicated compliance issues. Appendix B incorporates by reference several of the quantitative measurements required by Appendix A. The result of that incorporation by reference is that substantial parts of Appendix A apply to the smaller Tier 3 CBEs and to Tier 2 CBEs, even though Appendix A does not impose such requirements. Indeed, in some cases, even Tier 1 CBEs may be compelled to fashion compliance programs based on portions of Appendices A and C.

The six-point program set forth in section __.20(b) for Tier 2 and 3 CBEs includes the following:

- Internal written policies and procedures reasonably designed to document, describe, and monitor permissible trading activities and activities and investments with respect to covered funds.

- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Volcker Rule in trading activities and investments in covered funds—and to prevent the occurrence of activities or investments that are prohibited by Volcker.

- A management framework that delineates responsibility and accountability for compliance with Volcker.

- Independent testing for the effectiveness of the compliance program. The testing may be conducted by "qualified" personnel of either the CBE or an outside party.

- Training for trading personnel and managers, as well as other "appropriate" personnel.

- The making and keeping of appropriate records and other written compliance documentation.

We consider each of the compliance tiers below.

Tier 1

A banking organization's confirmation that it is not covered by Volcker and therefore subject only to comparatively light compliance duties requires a detailed understanding of what constitutes impermissible proprietary trading and a prohibited relationship with or ownership interest in a hedge fund or private equity fund. Moreover, because of the need to develop and implement this understanding, many Tier 1 CBEs will find that the necessary elements of a Volcker Rule "compliance lite" program may not be

as "light" as first meets the eye. This determination requires a careful legal analysis and, as a starting point, the following table may be helpful.

Proprietary trading

A CBE is engaged in proprietary trading if its activities reflect any of the following:

- The CBE reports trading assets and liabilities on
  - Call report: RC, item 5; RI, items 1.e, 5.c
  - FR Y-9C: HC, item 5; HI, items 1.e, 5.c
- The CBE trades in a capacity other than or in addition to that of agent, broker, or custodian for a third party.
- The CBE trades securities and other instruments—not only loans, commodities, or foreign exchange or currency.
- The CBE holds securities for less than 60 days. Note that the 60-day cutoff is not absolute. An Agency would look to several factors relating to positions held for more than 60 days to determine whether to honor the presumption.
- All positions taken in securities are not limited to the following:
  - Repos and reverse repos
  - Securities borrowing and lending
  - *Bona fide* liquidity management
- The CBE and its insured depository institution affiliate are organized under U.S. federal or state law or conduct trading inside the United States.

Hedge funds and private equity funds

A CBE is engaged in restricted fund activities if the following three conditions are present:

- The fund in question is either:
  - An investment company as defined in section 2 of the ICA, but is exempt from registration under 3(c)(1) or (c)(7) of the ICA.
  - A commodity pool, as defined in section 1a(10) of the Commodity Exchange Act.
- With respect to the fund, the CBE:
  - Holds an ownership interest in the fund;
  - Manages the fund;
  - Controls the fund; or
  - Sponsors the fund.

  Note that a CBE may serve as an independent adviser to such a vehicle without triggering Volcker limits, other than the "Super 23A" restrictions discussed below.
- Every insured depository institution within the CBE is not trust only and either:
  - Takes deposits other than in a fiduciary capacity;
  - Markets insured deposits through an affiliate;
  - Accepts demand deposits or deposits that may be withdrawn by check or similar means;
  - Makes commercial loans;
  - Obtains Federal Reserve Bank payment services; or
  - Exercises discount or borrowing privileges.

With respect to proprietary trading, two interlocking definitions are critical. Proprietary trading is defined as "engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more CFPs."[7] If there is no trading account or CFP, then there is no proprietary trading.

- A "trading account" is an account used by a banking entity either to (i) take short-term "CFPs" (or otherwise benefit from short-term price movements) or (ii) acquire CFPs that are covered by the market-risk capital rule, if the entity is required to use that rule in risk-weighting its assets for capital calculations.[8]

  Accounts limited to certain CFPs, however, are not trading accounts; namely, accounts for repurchase and reverse repurchase agreements, accounts for temporary securities borrowing or lending transactions, and accounts for the *bona fide* purpose of liquidity management.[9] Certain prerequisites apply to each of these carve-outs, as do the general prudential limitations on high-risk trading activities.

  An account for the *bona fide* purpose of liquidity management is one that is used to manage liquidity in light of the CBE's risk profile, that limits its trades to highly liquid financial instruments that are not expected to give rise to appreciable profits or losses as a result of short-term price movements, that trades in amounts limited to near-term funding needs, and is consistent with the Agencies' supervisory guidance on liquidity management.[10]

- A CFP is any position in a security, a derivative, a commodity future contract, or any option on one of these instruments. Security, derivative, and commodity future have the standard definitions under the pertinent statutes; the term "derivative" encompasses several kinds of instruments. Loans, commodities, and foreign exchange or currency are not CFPs.

As to fund activity, the specific prohibition is that a banking entity may not, as principal, acquire any ownership interest in or sponsor certain types of hedge funds or private equity funds. Funds covered by Volcker are funds that are able to avoid regulation as investment companies under the ICA, by virtue of the exemptions in sections 3(c)(1) or 3(c)(7) of the ICA. These exemptions apply, respectively, to (in general terms) funds with fewer than 100 investors or with investors who all are qualified purchasers. Accordingly, Volcker does not reach three categories of funds: (i) those that are registered investment companies and are regulated as such by the SEC, (ii) those that

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[7] 12 C.F.R. § __.3(b)(1) (emphasis added).

[8] Certain banking entities are deemed to hold trading accounts solely on the basis of taking a CFP of any duration, if the entity is a registered dealer, municipal securities dealer, government securities dealer, swap dealer, or security-based swap dealer or is engaged in dealing, swap dealing, or security-based swap dealing outside of the United States and if the CFP relates to activities in these capacities.

[9] An account holding a position taken by a banking entity in its capacity as a derivatives clearing organization also is not a trading account.

[10] *See, e.g.,* FRB, SR Letter 10-6 (Mar. 17, 2010) (Intergency Policy Statement on Funding and Liquidity Risk Management).

are exempt from the definition of investment company to begin with under the definition in section 3(b) of the ICA, and (iii) those that are able to rely on a 3(c) exemption other than (3)(c)(1) or 3(c)(7).[11] In our experience, however, most funds in which a banking entity likely would have or be interested in sponsoring or taking an ownership interest in rely on the 3(c)(1) and 3(c)(7) exemptions. At the same time, the Proposed Rule extends the coverage of the Volcker Rule to commodity pools subject to the Commodity Exchange Act, as well as "but for" offshore private investment funds that, were they offered in the U.S. or to a United States resident, would have to rely on the 3(c)(1) and 3(c)(7) exemptions.

Turning to the compliance obligations in Tier 1, the Proposed Rule requires that

> the existing compliance policies and procedures include measures that are designed to prevent the [CBE] from becoming engaged in such activities or making such investments and which require the [CBE] to develop and provide for the compliance program required under paragraph (a) of this section prior to engaging in such activities or making such investments.

That is, a Tier 1 CBE must implement measures with two separate functions: (i) preventing the entity from becoming engaged in activities or investments covered by Volcker and (ii) requiring the necessary compliance plan for CBEs if the entity should enter any of these businesses. These measures unavoidably will include internal policies and procedures, internal controls to ensure that the policies are followed, and designation of responsible and accountable officers. Documentation of these measures also will be required. These Tier 1 measures match at least four of the elements of the required six-point compliance program. An Agency also could require a particular CBE to gather data in a way that that will resemble testing, and training may be appropriate. Accordingly, even a CBE that is not engaged and not planning to engage in Volcker-covered activities may have to implement a version of the six-point program.

Specific compliance programs are necessary for two activities of Tier 1 CBEs, which by definition are not otherwise subject to the Volcker Rule or the Proposed Rule. First, a Tier 1 CBE that is engaged in exempt trading activities must ensure that these activities are not high risk. This standard is the same as the requirement for Tier 2 and 3 CBEs in their permissible trading activities, which are covered by Appendices A and C (discussed further below in connection with Tier 3 CBEs). Among other things, Appendix C describes elements of a compliance program to manage trading risk, and Appendix A includes certain quantitative measurements to assess whether trading may be high risk. Accordingly, some Tier 1 CBEs may find it necessary to review Appendices A and C, even though they are otherwise outside the Volcker Rule.

Second, trading for liquidity management purposes is not subject to the Volcker Rule. However, a Tier 1 CBE may continue such trading only if it has a "documented liquidity management plan." This plan must contain five elements. First, it must

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[11] In addition, vehicles established for the securitization of loans are fully exempt from the Volcker Rule. The exemption may not, however, apply to entities that securitize certain non-loan assets.

authorize the specific instruments that may be used for liquidity purposes (in light of the CBE's risk profile) and the circumstances under which it may or must be used. Second, the plan must require that any authorized transaction be principally for the purpose of managing liquidity. The plan must be clear that the transaction is not for the purpose of short-term resale, benefitting from short-term price movements, or hedging a short-term position. Third, the plan must limit the instruments used to those that are highly liquid and with credit and market risks that are not expected to give rise to appreciable short-term profits or losses. Fourth, the plan must set forth limits on liquidity positions to amounts consistent with near-term funding needs. Fifth, the plan must reflect supervisory guidance on liquidity.

This regime that the Proposed Rule appears to contemplate, and that perhaps inadvertently may apply to Tier 1 CBEs, could be streamlined in many cases. A CBE can identify the bases on which it is not covered by Volcker and then create (if they do not already exist) safeguards to prevent entry into the covered business. For example, it should be sufficient for a Tier 1 CBE that takes financial positions over the long term to establish a policy against short-term trading and to designate an officer to enforce the policy and review possible trades.

At the same time, the requirement that a Tier 1 policy include some degree of anticipation that a CBE will enter Tier 2 is open-ended and is likely to force unnecessary compliance management work by many CBEs. If a Tier 1 CBE plans to engage in permissible trading or fund activity of any kind, it should be aware of the Tier 2 requiremetns and can put in place a compliance program at that point.

Tier 2

Tier 2 CBEs will have a different compliance focus from that of the Tier 1 CBEs. The Tier 2 institutions have made the decision to engage in certain trading or fund activities. The Volcker Rule enumerates these activities, the prerequisites for which are contained in Annex I to this paper. Briefly, six different types of trading are allowed: (i) trading as part of underwriting a security, (ii) trading in connection with market making-related activities, (iii) trading as part of hedging program, (iv) trading in certain government securities, (v) trading through a regulated insurance company, and (vi) trading on behalf of customers. On the fund side, a CBE may sponsor and hold *de minimis* positions in customer funds.[12]

The formal requirement for a CBE in the second group is the six-point compliance program, the substance of which will depend on the particular activity or investment. We review the compliance obligations in Tier 2 immediately below and then turn to the specific requirements in Appendix B for Tier 2 CBEs that undertake market-making-related activities.

[12] Securitizations that are not fully exempt from the Volcker Rule may constitute customer funds and would be subject to the same requirements.

Compliance obligations generally

The Proposed Rule differentiates between Tiers 2 and 3 and appears to impose fairly general requirements on the Tier 2 institutions and more stringent and detailed requirements on the Tier 3 CBEs. Section __.20(c)(1) states that the detailed requirements in Appendix C apply only to CBEs that are in Tier 3. Appendix A applies only to Tier 3 CBEs, according to section __.7(a).

On the other hand, Tier 2 CBEs are urged to consider the Tier 3 requirements as a model. "Banking entities engaged in a relatively small amount of covered fund activities are encouraged to look to the minimum standards of Appendix C for guidance."[13] Moreover, a part of Appendix C—the purpose of a compliance program—applies to Tier 2 CBEs. "[A]lthough this statement of purpose appears within the text of proposed Appendix C, the Agencies note the statement equally describes the general purpose of any compliance program required under subpart D of the proposed rule, regardless of whether proposed Appendix C specifically applies."[14] The statement of purpose in Appendix C is not merely a restatement of the six-point program outlined in general in section ___.20(b), but calls for a detailed description of, among other things, potential areas of noncompliance and the particular activities of the CBE. The Proposed Rule preamble also requires review of the effectiveness of the program by the board of directors or the CEO—a specific condition not included in the general description of the program in section ___.20(b).

In fact, Tier 2 CBEs that are engaged in market making have nearly the same compliance requirements as the CBEs in Tier 3. Appendix B, which is devoted to the market-making exception, applies equally to both Tiers and expressly requires that all of its provisions be incorporated in a compliance program. The duty to comply with Appendix B in turn means that most of the quantitative measurements in Appendix A will apply to Tier 2 CBEs, even though Appendix A and __.7(a) state that that appendix covers only Tier 3 CBEs.

Given the uncertainty of the distinctions between the compliance programs for Tiers 2 and 3, a Tier 2 CBE should become familiar at a bare minimum with most, if not all, of the full-blown Tier 3 requirements and in fact, may have to incorporate many of the Tier 3 compliance requirements into their programs. Some obligations—for example, the corporate governance structure described in Appendix C—may readily be undertaken by a CBE of any size, and the Agencies may have some expectation that Tier 2 CBEs will do so. In this regard, the Agencies encourage Tier 2 CBEs to look to Appendix C as a compliance model.

The prerequisites for specific activities that a compliance program is intended to cover are set forth in Annexes I and II to this paper. Annex I identifies the activity-specific requirements, and Annex II describes the broader prudential standards and the limits on transactions between a CBE and a covered fund. Suffice it to say, a program by

[13] *Id.*
[14] 76 Fed. Reg. 68846, 68918 (Nov. 7, 2011).

any CBE in Tier 2 must address how it will (i) satisfy all of the conditions for each of the permissible activities in which it is engaged and (ii) how it will manage the business in a way that is consistent with the prudential and other requirements in Volcker.

Appendix B

Appendix B applies to all Tier 2 (and Tier 3) CBEs engaged in trading as part of making a market in a particular security. The appendix identifies some relatively concrete factors that the Agencies will apply to market making. Some of the factors involve calculations that are described in Appendix A—thus applying to smaller CBEs guidance that otherwise nominally applies only to Tier 3 CBEs.[15] On a qualitative basis, Appendix B suggests that the source of revenues is the most critical factor in distinguishing permissible market making from impermissible proprietary trading. If fees and other payments by customers comprise most of the revenue, then the function likely will be deemed market making. An operation in which the bulk of the revenues are based on gains and losses in the purchase and sale of securities, based on changes in short-term value, is likely to be forbidden. There is no bright-line rule, however, and it seems unlikely that a unit that generates 51 percent of revenue from fees and other customer payments would automatically qualify as a market-making operation.

The six factors addressed in Appendix B are as follows:

- *Risk management*. The issue here is whether a CBE retains risk in excess of the size and type required to provide intermediation services to customers. Relevant factors include the amount of risk generally required to execute a particular market-making function; available hedging options, the CBE's prior levels of retained risk and hedging practices, and levels of retained risk and hedging for similar positions.

- *Source of revenue*. The basic question is whether the revenue from a market-making channel is derived "primarily" from short-term price movements or from customer revenues such as fees and commissions. The pertinent quantitative measures are Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, and Spread Profit and Loss. The measurements may be compared to one another.

- *Revenue relative to risk*. The trading activity (i) generates only very small or very large amounts of revenue per unit of risk taken, (ii) does not demonstrate consistent profitability, or (iii) demonstrates high earnings volatility. A key assumption of the Agencies in examining trading is that impermissible short-term trading is characterized by significant volatility in earnings, while market making

[15] Annex III lists all of the quantitative measurements required by Appendix A. Those measurements that are incorporated by reference in Appendix B are noted by superscript number 2.

(depending, as it does, on fees) should be a relatively stable source of revenue. There are several quantitative measures for each of these issues.[16]

- *Customer-facing activity*. This element encompasses two conclusions: (i) that the CBE transactions are with customers rather than noncustomers and (ii) that the CBE retains principal positions and risks calibrated to (and not in excess of) reasonably expected near-term customer demands.

- *Payment of fees, commissions, and spreads*. The CBE routinely earns, rather than pays, fees, commissions, or spreads. The underlying assumption is that the business of proprietary trading typically requires that the trading unit pay a variety of fees to third-party service providers (in addition to the fact that there are, by definition, no earnings from customers).

- *Compensation incentives*. These incentives do not "primarily" reward proprietary risk taking. This issue is one where the Agencies have not adopted a defined quantitative measurement, but the basic consideration is whether the incentives are based on revenue derived from price movements in trades or from customer revenues. The Agencies are likely to engage in some peer review.

Tier 3

CBEs in this tier have more extensive compliance requirements that are detailed in two appendices to the Proposed Rule. All of these CBEs must have robust compliance programs with all of the elements described in Appendix C. For CBEs in this tier that are engaged in trading over the $1 billion or $5 billion thresholds, the program must include mechanisms for making several quantitative measurements described in Appendix A. We discuss first the structural requirements in Appendix C, which cover all compliance programs whether involving trading or fund activities. The Agencies encourage Tier 2 CBEs to look to Appendix C as a model. We then turn to the related measurements in Appendix A, which apply to certain forms of permissible trading.

Appendix C

The program required under Appendix C is built around the same six-point framework that covers all Tier 2 CBEs, but is substantially more elaborate than the general six-point program. Certain Appendix C requirements, however, stand out.

[16] As to the generation of either very small or very large amounts of revenue, the quantitative measures are Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, the Comprehensive Profit and Loss to Volatility Ratio, the Portfolio Profit and Loss to Volatility Ratio, and Comprehensive Profit and Loss Attribution. Regarding consistency of profitability, the Agencies will review Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss. The measurements for high-earnings volatility are Skewness of Portfolio Profit and Loss and Kurtosis of Profit and Loss.

- For those banking organizations with more than one CBE, an enterprise-wide program is permissible, rather than separate programs for each CBE, if three conditions are met. First, the program must clearly apply to all Volcker-covered activities within the organization. Second, the program also must specifically address all of the requirements in Appendix C for all of the enterprise's Volcker-covered activities. The program must take into account the structure, size, and complexity of the whole organization, as well as the particular risks of and requirements for each relevant subsidiary or affiliate. Third, the organization must periodically test the effectiveness of the program in addressing all aspects of all of its covered activities.

  One ongoing regulatory issue for an organization with an enterprise-wide plan will be the scope of authority of the different Agencies with jurisdiction of at least one CBE in the structure. Appendix C attempts to limit each Agency to its own CBE(s) and to the relevant portions of the compliance program, but ultimately the jurisdictions will overlap. It is possible that an organization could be faced with competing agency requirements that are difficult to reconcile under an enterprise-wide program.

- A CBE must prepare a formal statement of mission and strategy. The mission will describe the nature and scope of the trading or fund businesses conducted; the strategy is the business model and execution plan for the generation of revenues. Among other things, the statement needs to explain how customers are identified, which business units will engage in covered activities, how covered activities will be measured and reported, and outline the nature and scope of relevant compensation arrangements.

- A CBE must establish specific lines of responsibility for compliance, running from the board of directors to individual traders. Important duties begin at the top.

  - The board of directors must approve a compliance plan, noting the approval in the minutes. The board also must review the capabilities of management in overseeing compliance and the incentives to support compliance. The board and the CEO are responsible for setting a culture of compliance.

  - Senior management is responsible for implementing and enforcing the compliance program and for communicating and reinforcing the culture of compliance. Senior management also must ensure that effective corrective action is taken when a compliance failure is found. Senior management must report to the board or an appropriate board committee on the effectiveness of the program. In connection with trading activities, senior management must review new products and strategies.

- Business-line managers that oversee one or more trading or asset management units are accountable for the effective implementation and enforcement of the compliance program as it applies to their units.

- For trading activities, each individual trader must receive trading "mandates." The mandates must clearly inform each trader of the Volcker Rule prohibitions and requirements and must contain four parameters: (i) the conditions for relying on the Volcker exceptions; (ii) the financial contracts, products, and underlying assets that the trader is permitted to trade; (iii) the risk limits of the trading unit and the types and levels of risk that may be taken; and (iv) the unit's hedging policy.

- Compliance testing must occur at least once every 12 months. The CBE's internal audit department may conduct the testing, but the department otherwise must be clearly separated from the trading and asset management units it reviews.

- Training may be conducted by internal personnel, as well as by third parties. Training should occur with "appropriate" frequency, but Appendix C does not specify a time period. While that internal training will need to be calibrated with the size, scope and sophistication of the CBE's covered trading and funds activities, all CBEs, including smaller Tier 1 CBEs, should expect to conduct at least annual Volcker Rule compliance training activities.

- Records sufficient to demonstrate compliance should be retained for five years. As discussed below in connection with Appendix B, there are far more extensive record-keeping requirements for trading activities.

- For trading activities, a CBE must establish and enforce risk limits appropriate for each trading unit, including limits based on probabilistic (VaR) and non-probabilistic (notional exposures) measures of potential loss, measured under normal and stress market conditions.

Appendix A

Appendix A requires a Tier 3 CBE to furnish various quantitative measures to its regulator in order for the regulator to make either or both of two determinations, one dealing with market making, the other with possible high-risk assets or strategies. First, so that the regulator may assess the assertion of a Tier 3 CBE over the $5 billion threshold that it is engaged solely in market making and not in proprietary trading, 17 different measurements are required. For other Tier 3 CBEs claiming the same exemption, eight of these measurements are necessary. Second, in order to determine whether a Tier 3 CBE (regardless of size) engaged in other forms of permissible proprietary trading, including underwriting, risk-mitigating hedging, trading in government securities, trading by a regulated insurance company, and trading outside the United States, is employing a high-risk strategy or is trading high-risk assets, five of the 17 measurements are necessary. The Agencies do not claim that the specific

measurements are the optimal or the only possibilities and have asked for comment on all of them. In assessing the impact of the measurements, a CBE should consider whether other approaches would be more effective.

By the terms of Appendix A, no one measurement or even group of measurements is decisive in determining whether a CBE has complied with the Proposed Rule. Indeed, there are no specified numerical targets. In a few situations, the Agencies have observed that a particular operation should rely "primarily" on a source of revenue and accordingly the required measurements include certain ratios. The Agencies have not indicated, however, an appropriate numerical ratio.

The quantitative measurements required by Appendix A fall into the following five categories. In broad terms, the categories look to the level of risk on a stand-alone basis, revenue from customers versus revenue from the appreciation in value of CFPs, stability of the revenue stream, the volume of trading for customers relative to total trading, and the receipt versus the payment of fees, commissions, and other expenses. Annex III to this paper identifies and defines the specific measurements. (We have identified these measurements in Appendix III.)

- *Risk management*. The Agencies look at the risks associated with permissible trading in two ways. First, trading in general should adhere to the prudential requirements in Volcker relating to high-risk assets and strategies. Second, a relatively high degree of risk reflects proprietary trading. Accordingly, the five measurements in this category are designed simply to measure the level of risk in the CFPs. The measurements in this category could produce two red flags. First, any abrupt change in the measurements that are inconsistent with prior experience or with measurements at similarly situated trading units could indicate proprietary trading. Second, indicators of unanticipated or unusual levels of risk, such as a significant number of VaR or breaches of Risk and Position Limits (as defined in Appendix III) would suggest undue risk that requires further analysis.

  Of the five measurements in this area that apply to Tier 3 CBEs with [trading assets in excess of $5 billion], __ nominally apply only to the other Tier 3 CBEs. However, Appendix B requires that all five will be necessary for all Tier 3 and Tier 3 CBEs.

- *Source of revenue*. The Agencies expect that a CBE engaged in permissible market making will generate profits by providing customers with intermediation and related services while maintaining (and minimizing) any inventory required to meet customer demand. Appendix C calls for five quantitative measurements in this category, which should provide information on how a CBE generates revenue. It is evident that if more than half of the revenues of a market-making unit derive from sources other than fees, commissions, and similar payments from customers, then an Agency may regard a CBE as engaging in proprietary trading. Of course, the Agencies may require that the percentage of revenues from customer payments be considerably higher than the implied 51%.

- *Revenue relative to risk*. The Agencies' effort here is to understand whether a CBE's trading business is producing revenues consistent with the degree of risk that is being assumed with typical market-making activities. Market-making revenues come in the form of fees, commissions, spreads and other customer revenue that, in the Agencies' view, are relatively insensitive to market fluctuations.

- *Customer-facing activity measurements*. This group of measurements should produce information about the extent to which trading activities are servicing the demands of customers as opposed to generating profits for CBEs directly through gains on the sale of CFPs.

- *Payment of fees, commissions, and spreads measurements*. This category of measurements reflects another way of looking at whether the purchase and sale of CFPs are for the benefit of customers or for the benefit of the CBE itself. In this case, the assumption is that market making generates more revenues, in the form of fees from customers for the market maker's intermediary services, than expenses that would have to be paid to other intermediaries to support customer transactions. In contrast, proprietary trading by definition generates no customer fees and the CBE involved is likely to pay substantial fees for the execution of trading strategies. Accordingly, the Agencies will look primarily to the Pay-to-Receive Spread Ratio, which, in lay terms, compares the revenues of a trading unit for facilitating buy and sell orders with its expenses for the execution of similar orders.

In developing or modifying the systems needed to take these measurements, each CBE should be aware that the measurements are required daily at the trading desk level. On a monthly basis, the data will be reported to the Agencies.

Compliance with the data-gathering requirements will be difficult, in part because the relevant data points that are required under the Proposed Rule most assuredly will change after the implementing regulations are adopted, and perhaps materially so, as the Agencies develop experience with the compliance management and oversight aspects of the Proposed Rule. By their own admission, the Agencies will use a "heuristic" approach, in plain English, trial-and-error, to the implementation of the quantitative measurements required by Appendix A, which means that as the Agencies learn over time which data points are useful and which are not, they will change the required quantitative measurements accordingly.

Some Concluding Observations

The Proposed Rule, if adopted in the form proposed, will require an elaborate compliance regime for the Volcker Rule that encompasses at least to some extent most, if not all, all U.S. banking organizations. Even those institutions not involved in the trading or fund activities covered by Volcker are likely to find themselves working through the

consequences of the Rule. The other institutions that do engage in at least some Volcker-covered activities will be required to implement fairly substantial programs. The Proposed Rule accordingly requires close review so that institutions can identify especially problematic elements for the Agencies and begin to prepare appropriate programs.

Could the Proposed Rule be modified in such a way as to achieve its desired objectives while not subjecting a large constituency of CBEs to unnecessarily costly and burdensome compliance management requirements? Several changes that would be helpful in this regard come to mind:

- *Establish clear compliance program parameters for CBEs.* One of the principal implementation issues for CBEs under the Proposed Rule is the potential for CBEs to become caught up in compliance program requirements that are disproportionate to the nature and scope of their covered activities. To address this issue, the Agencies should establish clear boundaries for the imposition of graduated compliance management requirements. For example, Tier 1 CBEs should be expressly excluded from any Volcker Rule compliance management requirements other than those that are needed to assure that they will not engage in covered activities. A related issue is the fact that a CBE may be subject to Tier 2 or even Tier 3 compliance obligations even if it engages solely in exempted trading or funds activity. In turn, the Agencies should consider excluding exempted trading and fund activities from the quantitative benchmarks used to identify Tier 2 and Tier 3 CBEs.

- *Create less elaborate compliance requirements for exempted activities.* Is it necessary for CBEs that engage in exempted trading and funds activities to be subject to a full panoply of Volcker Rule-specific compliance management requirements? In the case of many types of trading or funds activities, such as trading in U.S. government securities, a full Volcker Rule compliance infrastructure simply is not necessary to assure compliance with the Rule's prohibitions, because the line between permitted and prohibited activities is clear and easy to draw.

- *Rationalize the data collection and reporting requirements of the Proposed Rule*. In their collective eagerness to assure that CBEs do not surreptitiously engage in prohibited trading activities, the Agencies have created a highly elaborate and potentially expensive data collection and reporting infrastructure for certain types of trading activities. Compounding the compliance management issues here is the fact that the Agencies are unable to predict with any level of confidence at this time which data they will need to receive in order to oversee the Volcker Rule compliance process, an uncertainty which could materially complicate CBE and Agency compliance management and oversight activities going forward.

A more workable alternative for the Agencies to adopt at this time would be a principles-based compliance framework for CBEs that would allow them, subject to supervisory review and approval, to develop their own Volcker Rule compliance systems, taking into account the nature and scope of their covered activities. Failing this approach, however, at a minimum the Agencies should defer the adoption of required data collection and reporting requirements—such as those set forth in Appendix A—until they have developed a sufficient amount of hands-on experience with the administration of the Proposed Rule to understand better what data is needed for the performance of their supervisory oversight responsibilities.

Annex I – Conditions for permissible trading and fund activities

I. *Trading*

- *Underwriting*
  - Appropriate compliance program already in place
  - CFP is a security
  - Purchase or sale effected solely in connection with a distribution for which the CBE is acting as underwriter
  - Registration as dealer with appropriate regulator for making a market in specific CFP
  - Designed not to exceed reasonable near-term demands of investors
  - Designed to generate income through fees or other payments, not through appreciation in value of CFP
  - Compensation does not reward proprietary risk taking

The Proposed Rule describes underwriting as the purchase or sale of a security in connection with a distribution of securities for which the CBE is acting as underwriter. The Agencies explain that this definition is intended be in line with "common usage and understanding" of the term and that the specific words "distribution" and "underwriter" are "generally identical" to the use of the words in the SEC's Regulation M.[17] Under that regulation, a "distribution" is distinguished from other sales of securities by the "magnitude" of an offering and the need for "special selling efforts and selling methods." With respect to the definition of an "underwriter," the Agencies will consider the extent to which an entity assists an issuer in capital raising, performs due diligence, advises the issuer on market conditions and assists in the preparation of offering documents, purchasing securities from an issuer, a selling security holder, or another underwriter; participating in or organizing a syndicate of investment banks; marketing securities; and transacting to provide a post-issuance secondary market and to facilitate price discovery. None of these factors appears to be conclusive.

An entity that seeks to rely on the underwriting exception must either be: (i) a registered dealer under section 15 of the Exchange Act; (ii) for municipal securities, a municipal securities dealer registered with the SEC under section 15B of the Exchange Act; or (iii) for government securities, a government securities dealer registered with the SEC or that has filed notice under section 15C of the Exchange Act. A non-registered entity may rely on the underwriting exemption if it is explicitly exempt from registration under the relevant statute. The underwriting of security-based swaps, commercial paper, bankers' acceptances, and commercial bills does not require that the underwriter be registered or have a specific statutory exemption available.

[17] The definition of underwriting under the Proposed Rule is more expansive than the Regulation M definition in one respect: a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder is an underwriter itself for the purposes of the Proposed Rule.

- *Market-making-related activities*
  - Appropriate compliance program already in place
  - Trading unit holds itself out as a market maker for specific CFP on a regular or continuous basis
  - Designed not to exceed reasonable near term demands of investors
  - Designed to generate income through fees or other payments, not through appreciation in value of CFP
  - Registration as dealer with appropriate regulator for making a market in specific CFP
  - Consistent with Appendix B
  - Compensation does not reward proprietary risk taking
  - Record-keeping and reporting of certain quantitative measurements specified in Appendix A

How a CBE should demonstrate that its trading is in connection with market-making-related activities, rather than proprietary trading, is now the subject of intense debate. The Agencies' effort to distinguish the two kinds of trading requires market makers to erect an elaborate compliance framework. The Agencies describe a market-making unit as one that "hold[s] itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the CFP for its own account on a regular or continuous basis."[18] The Agencies also explain that the definition is similar to the definition of "market maker" in section 3(a)(38) of the Exchange Act.[19] The Agencies expect to take the same approach as the SEC in assessing whether a person is engaged in market making. The Agencies recognize that market making varies, depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location.

For relatively liquid positions, a market-making activity should, according to the Agencies, reflect several factors:

- Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;

- A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;

- Making continuous quotations that are at or near the market on both sides; and

- Providing widely accessible and broadly disseminated quotes.

[18] The Agencies note that block positioning may be a form of permissible market making.
[19] The Agencies also note similar criteria in the definition of "swap dealer" and "security-based swap dealer" in a recent proposed rule by the CFTC and SEC, 75 Fed. Reg. 80174, 80176 (Dec. 21, 2010).

For less liquid markets, such as over-the-counter markets for debt and equity securities or derivatives, market making would involve:

- Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;

- With respect to securities, regularly purchasing CFPs from, or selling the positions to, clients, customers, or counterparties in the secondary market; and

- Transaction volumes and risk proportionate to historical customer liquidity and investment needs.

There are two important limitations. The market-making exemption applies only to the specific position in which a market is made; a unit cannot otherwise rely on the exemption for trading in other positions. The exemption also is available only to the specific trading desk or other unit engaged in the trading; another desk or unit within the same legal entity may not invoke the exemption.

As with underwriting, regulatory status is important. A market maker must be (i) a registered dealer under section 15 of the Exchange Act; (ii) for swaps, a swap dealer registered with the CFTC under the Commodity Exchange Act; (iii) for security-based swaps, a registered security-based swap dealer under section 15F of the Exchange Act; (iv)for municipal securities, a municipal securities dealer registered with the SEC under section 15B of the Exchange Act; or (v) for government securities, a government securities dealer registered with the SEC or that has filed notice under section 15C of the Exchange Act. A non-registered entity may rely on the underwriting exemption if it is explicitly exempt from registration under the relevant statute. The exemption also is available to an unregistered CBE engaged in dealing securities, swaps, or security-based swaps outside of the United States, if the CBE is subject to substantive regulation in that jurisdiction.

- *Risk-mitigating hedging activities*
    - CBE has established internal compliance program, including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used or hedging, internal controls and monitoring procedures, and independent testing.
    - The purchase or sale:
        - Is made in accordance with the written policies, procedures and internal controls established by the CBE;
        - Hedges or otherwise mitigates 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 of a CBE;

    - Is reasonably correlated, based upon facts and circumstances, to the risks the purchase or sale is intended to hedge or otherwise mitigate;
    - Does 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 of a CBE and that are not hedged contemporaneously;
    - Is subject to continuing review, monitoring and management by the CBE that (i) is consistent with the CBE's written policies and procedures, (ii) maintains a reasonable level of correlation, based upon the facts and circumstances, to the risks the purchase or sale is intend to hedge, and (iii) mitigates any significant exposure arising out of the hedge after inception.
    - The compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk taking.
  - If the hedging transactions are conducted at a level of organization different from the level that acquired the positions the risk of which the hedge is designed to mitigate, the CBE must, at the time the hedging transactions are conducted, document:
    - The risk-mitigating purpose of the transactions;
    - The risks that the transactions are designed to reduce; and
    - The level of organization that is establishing the hedge.

- *Trading in certain U.S., state, and local government obligations*
  - Obligations of the United States or any agency thereof.
  - Obligations, participations, or other instrument of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, Farmer Mac, or a Farm Credit System institution.
  - Obligations of any state or any political subdivision thereof.
  - Obligations above include both general obligations and limited obligations, such as revenue bonds.

- *Trading on behalf of customers*
  - Purchase or sale must:
    - Be conducted by CBE acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the customer;
    - Be conducted for the account of the customer; and
    - Involve solely CFPs of which the customer, and not the CBE or any subsidiary or affiliate of the CBE is the beneficial owner (including as a result of having long or short exposure under the relevant CFP).
  - CBE acts as riskless principal in a transaction in which the CBE, after receiving an order to purchase (or sell) a CFP from a customer, purchases (or sells) the CFP for its own account to offset a contemporaneous sale to (or purchase from) the customer.
  - CBE is an insurance company that purchases or sells a CFP for a separate account if:

    - The insurance company is directly engaged in the business of insurance and subject to regulation by a state insurance regulator or foreign insurance regulator;
    - The insurance company purchases or sells the CFP solely for a separate account established by the insurance company in connection with one or more insurance policies issued by the company;
    - All profits and losses arising from the purchase or sale of a CFP are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the company; and
    - The purchase or sale is conducted in compliance with, and subject to, the insurance company investment other laws, regulations, and written guidance of the state or jurisdiction in which such company is domiciled.

- *Trading by a regulated insurance company (or any affiliate thereof)*
  - Company is directly engaged in the business of insurance and subject to regulation by a state insurance regulator or foreign insurance regulator;
  - The company or its affiliate purchases or sells the CFP solely for the company's general account;
  - Trading complies with and is subject to insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which the company is domiciled; and
  - The appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council ("FSOC") and the relevant insurance commissioners of the state, have not jointly determined, after notice and comment, that particular law, regulation, or written guidance in third bullet above is insufficient to protect the safety and soundness of the CBE, or of the financial stability of the United States.

- *Trading outside of the U.S.*
  - The CBE is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states;
  - The trade is conducted pursuant to paragraph (9) or (13) of the section 4(c) of the Bank Holding Company Act;
    - If the CBE is a foreign bank organization ("FBO"), the CBE is a qualifying FBO and is trading in compliance with Regulation K, subpart B; or
    - If the CBE is not an FBO, the two of three conditions must be met: (i) the CBE's total assets held outside the United States exceed CBE's total assets in the United States; (ii) the CBE's total revenues derived from the the CBE's business outside the United States exceed total revenues derived from the CBE's business in the United States; or (iii) total net income derived from the CBE's business outside the United States exceeds total net income derived from the CBE's business in the United States.
  - The trade occurs solely outside the United States.

- The CBE is not organized under laws of the United States or of one or more states;
- No party to the trade is a U.S. resident;
- No personnel directly involved in the trade is physically located in the United States; and
- The trade is executed wholly outside the United States.

II. Fund Organization and Offering

- *Customer fund*
  - CBE provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.
    - Fund may be organized and offered only in connection with services above; and
    - Fund may be offered only to customers of these services (but preexisting relationship not required), pursuant to a credible plan or similar documentation outlining how the CBE intends to provide these services through the organization and offering of the fund.
  - CBE acquires or obtains only a *de minimis* ownership interest in the fund.
    - Sufficient initial equity for investment to permit fund to attract unaffiliated investors. CBE must actively seek unaffiliated investors to reduce ownership interest;
    - Not later than one year after establishment of fund, CBE may not hold more than 3 percent of total amount or value of outstanding ownership interests in the fund (FRB may extend time for up to an additional 2 years); and
    - Aggregate value of ownership interests of CBE in all sponsored funds may not exceed 3 percent of CBE's Tier 1 capital.
  - CBE complies with "Super 23A and 23B" provisions.
  - CBE does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the fund or of any fund in which the fund invests.
  - Fund does not (i) share the same name or a variation of the same name with the CBE (or any affiliate or subsidiary of the CBE) or (ii) use the word "bank" in its name.
  - No director or employee of the CBE take s or retains an ownership interest in the fund, except for any director or employee of the CBE who is directly engaged in providing investment advisory or other services to the fund.
  - Individual ownership interests allowed only for CBE employees involved with a particular fund.
  - CBE clearly and conspicuously discloses in offering documents or elsewhere that
    - "Any losses in [such fund] will be borne solely by investors in [the fund] and not by [the CBE and its affiliates or subsidiaries]; therefore, [the CBE's and its affiliates' or subsidiaries'] losses in [such fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [CBE and its affiliates or subsidiaries] in their capacity as investors in the [fund]."
    - The investor should read the fund offering documents before investing in the fund;
    - The "ownership interests in the covered fund are not insured by the FDIC and are not deposits, obligations of or endorsed or guaranteed in any way, by any banking entity."

  - The role of the CBE and its affiliates, subsidiaries and employees in sponsoring or providing any services to the fund.

- *Small Business Investment Companies ("SBICs") and related investments*
  - SBICs as defined in section 102 of Small Business Investment Act of 1958.
  - Investment designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs).
  - Investment that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar state historic tax credit program.

- *Risk-mitigating hedging activities*
  - Investment made in connection with and related to individual or aggregated obligations or liabilities of the CBE that are;
    - Taken by the CBE when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the fund; or
    - Directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund.
  - Investment designed to reduce the specific risks to the CBE in connection with and related to such obligations or liabilities.
  - Internal compliance program established.
  - Acquisition or retention of interest:
    - Is made in accordance with the written policies, procedures and internal controls established by the CBE.
    - Hedges or otherwise mitigates an exposure to a covered fund through an offsetting exposure to the same fund and in the same amount of the ownership interest in that fund that either (i) arises out of a transaction conducted solely to accommodate a specific customer request with respect to, or (ii) is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, the fund.
    - Does not give rise, at the inception of the hedge, to significant exposures there were not already present in individual or aggregated positions, contracts, or other holding of a CBE and that are not hedged contemporaneously; and
    - Is subject to continuing review, monitoring and management by the CBE that is consistent with its written hedging policies and procedures, maintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances, to the risk or risks the trade is intended to hedge and mitigates any significant exposure arising out of the hedge after inception.

- Compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk taking.
- At the time the transaction is conducted, the CBE documents, with respect to the acquisition or retention of the ownership interest, (i) the risk-mitigating purpose of the interest, (ii) the risks that the interest is designed to reduce, and (iii) the level of organization that is establishing the hedge.

- *Fund activities and investments outside the United States*
  - CBE is not directly or indirectly controlled by a banking entity that is organized under U.S. law or state law.
  - Activity is conducted pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act.
    - If CBE is an FBO, CBE is a qualifying FBO and is trading in compliance with Regulation K, subpart B; or
    - If CBE is not an FBO, the two of three conditions must be met: (i) CBE's total assets held outside the United States exceed CBE's total assets in the United States; (ii) CBE's total revenues derived from CBE's business outside the United States exceed total revenues derived from CBE's business in the United States; or (iii) total net income derived from CBE's business outside the United States exceeds total net income derived the CBE's business in the United States.
  - No ownership interest in such fund is offered for sale or sold to a U.S. resident.
  - Activities occur solely outside the United States.
    - CBE is not organized under U.S. or state law;
    - No subsidiary, affiliate, or employee of the CBE that is involved in the offer or sale of an ownership interest in the covered fund incorporated or physically located in the U.S. or in one or more states; and
    - No ownership interest in such covered fund is offered for sale or sold to a U.S. resident.

- *Loan securitizations*
  - "Nothing in [the Volcker Rule] shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the [FRB] to sell or securitize loans in a manner otherwise permitted by law."[20]
  - Ownership interest in, or acting as sponsor to, a fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of loans; contractual rights or assets directly arising from those loans supporting the asset-backed securities; interest rate or foreign exchange derivatives that materially relate to the terms of such loans or contractual rights or assets and are used for hedging purposes with respect to the securitization structure.
  - Comment requested on whether the exemption should cover the securitization of derivatives and re-securitizations.

[20] Dodd-Frank § 619(g)(2), codified at 12 U.S.C. § 1851(g)(2).

- *Bank-owned life insurance*
  - Separate account used solely for the purpose of allowing a CBE to purchase a bank-owned life insurance (“BOLI”) policy, provided that CBE:
    - Does not control investment decisions regarding assets in the account; and
    - Holds its ownership interest in compliance with agency guidance on BOLI.

- *Joint venture*
  - Operating company
  - Does not engage in any prohibited activity or make any prohibited investments.

- *Acquisition vehicle*
  - Sole purpose and effect is to effectuate a transaction involving the acquisition or merger of one entity with or into the CBE or one of its affiliates.

- *Liquidity management subsidiary*
  - Engaged principally in performing *bona fide* liquidity management activities in accordance with a documented liquidity management plan that:
    - Specifically contemplates and authorizes the particular instrument to be used for liquidity management purposes, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the particular instrument may or must be used;
    - Requires that any transaction contemplated and authorized by the plan be principally for the purpose of managing the CBE’s liquidity and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;
    - Requires that any position taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which the CBE does not expect ot give rise to appreciable profits or losses as a result of short-term price movements;
    - Limits any positions taken for liquidity management purposes, together with any other positions taken for such purposes, to an amount that is consistent with the CBE’s near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan; and
    - Is consistent with the relevant agency’s supervisory requirements, guidance and expectations regarding liquidity management.
  - Carried on the CBE’s balance sheet.

- *Debt previously contracted*
  - Ownership interest in fund is acquired or retained in the ordinary course of collecting a debt previously contracted in good faith.
  - CBE must divest interest within the time period set by its federal regulator.

Annex II – Prudential requirements

Prudential requirements

In addition to the specific conditions for particular activities, Volcker imposes four broad prudential requirements or "backstops" that should be incorporated in any compliance program. Breach of any of these requirements—a judgment involving substantial discretion on the part of the regulator—can lead to a termination or divestiture, even if the specific conditions for the activity in question have been satisfied. The backstops are that a CBE may not engage in a permissible activity that would:

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

These backstops apply equally to permissible trading and fund activity. The Proposed Rule includes provisions for the first two backstops. The remaining two are not further addressed.

Material conflicts of interest

No trading activity is permissible if it would result in a CBE's interests being materially adverse to those of a client, customer, or counterparty. It is difficult to go beyond generalities. The Agencies explain a material conflict exists when CBE places its own interests ahead of its obligations to its clients or seeks to gain by treating one customer more favorably than another. A CBE that acquires confidential information about a client and then uses the information to profit from trades with the client also has engaged in a material conflict of interest. The fact that, as part of a *bona fide* and permissible trading activity, a CBE is on one side of a transaction an a client on the other does not by itself create a material conflict of interest, however.

A CBE accordingly will need to have a compliance framework in place to prevent material conflicts. The Agencies observe that they will have "elevated concerns" about conflicts where a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups, or involves a significant asymmetry of information or transactional data among participants. From a compliance perspective, a CBE's program should attempt to identify transactions that might have these characteristics and ensure that they are subject to careful review.

A CBE may take preventive steps that will, under the Proposed Rule, remove the conflict. There are two alternatives. First, the CBE may make full disclosure of the conflict with enough clarity for a client to understand the situation and in a manner that gives the client the opportunity to negate or substantially mitigate the adverse effect of the conflict. The timing of the disclosure presents a difficult judgment call. The disclosures must be made early enough so that a client has a reasonable opportunity to mitigate the effects of a conflict of interest, but not so early that a client could not meaningfully apply the disclosures to a later transaction.

Second, a CBE may erect “information barriers,” such as physical separation of personnel or functions or limitations on types of activities that are designed to prevent the materially adverse effect of a conflict of interest. The purpose of the barriers is to mitigate the effect of a conflict rather than to prevent the underlying conflict. The establishment of barriers does not conclude a CBE’s duties regarding conflicts of interest. If a CBE knows or reasonably should know that the barriers will not prevent a material adverse effect as a result of a conflict in a particular transaction, then it must make the required disclosures in order to complete a transaction. Accordingly, the use of information barriers entails continuous monitoring of each trading activity.

The meaning of a material conflict of interest and the means by which it may be mitigated will be finalized in conjunction with SEC’s finalization of a rule governing material conflicts of interest in connection with asst-backed securities. Section 621 of the Act adds a new section 27B to the Securities Act of 1933 that bars an underwriter, placement agent, initial purchaser, or sponsor (or any subsidiary or affiliate thereof) of an asset-backed security from engaging in a transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of the activity. The SEC proposed a rule to implement section 27B in ___. The agency consciously has linked its proposal to the Proposed Rule, and both have the same deadline for comments.

High-risk assets and trading strategies

Under the Proposed Rule, a CBE that holds an asset or engages in an activity that significantly increases the likelihood that the CBE would incur a substantial financial loss or would fail is an impermissible, high-risk asset or strategy. The Agencies have not discussed the term “high-risk” in any greater detail.

Prohibited transactions with funds

Additionally, with respect to permitted hedge fund and private equity fund activity, Volcker prohibits certain transactions between a CBE and these funds. The prohibitions have some important details. One of the prohibitions, for example, reaches beyond ownership or sponsorship to reach wholly permissible activities, such as advising a fund.

A CBE may not extend credit to or enter into certain other transactions with a fund. The universe of prohibited transactions is nearly the same universe of transactions between a bank and an affiliate that are restricted in section 23A of the Federal Reserve Act.[21] Most CBEs should be familiar with section 23A. Four points warrant emphasis here.

- The transactions between a CBE and a fund are completely barred under Volcker and not merely restricted as they would be under section 23A.

- The prohibition extends to transactions between a CBE and a fund that the CBE serves as investment manager, investment adviser, or commodity trading advisor, as well as as owner or sponsor. Volcker does not otherwise prohibit or restrict a CBE from acting in the management or advisory roles.

- The prohibition also extends to any affiliate of the CBE.

- The prohibition does not apply to a prime brokerage transaction between a CBE and a covered fund that is managed, sponsored, or advised by the CBE—or any affiliate or subsidiary of the CBE. In order to act as a prime broker under the Proposed Rule, a CBE must meet the requirements for organizing or offering a fund and the chief executive officer of the top-tier affiliate of the CBE certifies annually in writing that the CBE does not guarantee or support the performance of the fund or the assets in which it invests. (The FRB also must not have determined that the transaction is not unsafe or unsound with respect to the CBE.)

[21] One difference is that section 23A would treat an investment by a bank in an affiliate as a transaction subject to various restrictions. The Proposed Rule is clear that this provision does not apply to a CBE's permissible *de minimis* investment in a fund.

Annex III

Appendix A quantitative risk measurements for CBEs over the $5 billion threshold engaged in market making

Risk management	
Value-at-Risk[1 2 3]	Commonly used percentile measurement of the risk of future financial loss in the value of a given portfolio over a specified period of time, based on current market conditions. Appendix A requires a 1% VaR over a one-day period. That is, the VaR should reflect the loss that is likely to occur only 1% of the time.
Stress Value-at-Risk[2 3]	Similar measurement to VaR, except using market conditions during a period of significant financial stress. Appendix A does not identify the stress assumptions.
VaR Exceedance[2]	The difference between VaR and Portfolio Profit and Loss (net of Spread Profit and Loss).
Risk Factor Sensitivities[2 3]	Changes to Portfolio Profit and Loss (exclusive of Spread Profit and Loss) expected to occur in the event of a change in a trading unit's risk factors. This measurement should account for a "preponderance" of the price variation in a trading unit's holdings. The algorithm is left to a CBE to devise, but it should take account of commodity derivative positions, credit positions, credit-related derivative positions, equity positions, equity derivative positions, foreign exchange derivative positions, and interest rate positions (including interest rate derivative positions).
Risk and Position Limits[3]	These limits are the constraints that define the amount of risk that a trading unit is permitted to take at a point in time. Often expressed in terms of VaR or Risk Factor Sensitivities. If other criteria are used (such as net open positions), the value of the limits and of the variables used should be reported.
Source of Revenue Measurements	
Comprehensive Profit and Loss ("CPL")[1 2 3]	Net profit or loss of a trading unit's material sources of revenue over a specific period of time. Generally, this measurement should be the sum of Portfolio Profit and Loss and Fee Income. The calculation does not include the expenses of operating the unit or accounting reserves.
Portfolio Profit and Loss ("PPL")[1 2]	Net profit or loss on the market value of a trading unit's underlying holdings over a specified period of time, whether

	realized or unrealized. Expenses are not included unless directly related to the market value of the holdings.
Fee Income and Expense[1 2]	Direct fees, commissions and other distinct income for services provided by or to a trading unit.
Spread Profit and Loss[1 2]	The portion of PPL that generally includes revenue generated by the bid-ask spread on comparable instruments. The calculation includes spreads paid by a trading unit to initiate a transaction, typically a negative number. For many asset classes, spreads are widely disseminated; a CBE may use certain substitutes if there is not wide dissemination of the spread on a particular instrument.
Comprehensive Profit and Loss Attribution[1 2 3]	An analysis that divides CPL into separate sources of risk and revenue that have caused any observed variation in CPL. This measurement should show CPL can be attributed to specific market and risk factors that can be measured over time.
Revenue-Relative-to-Risk Measurements	
Volatility of CPL and Volatility of PPL[1 2]	Standard deviation of CPL and PPL estimated over a given calculation period. (PPL is exclusive of Spread Profit and Loss.)
CPL to Volatility and PPL[1 2]	The ratios of CPL and PPL to the two volatility metrics above. (Again, PPL is exclusive of Spread Profit and Loss.)
Unprofitable Trading Days based on CPL and on PPL[2]	Number or proportion of trading days on which the CPL or PPL is less than zero over a given period. The Agencies assume that it is rare for customer-facing trading to have unprofitable days, while proprietary trading is likely to include a material number of unprofitable days.
Skewness of Portfolio Profit and Loss[2]	Use of standard statistical methods.
Kurtosis of Portfolio Profit and Loss[2]	Use of standard statistical methods.
Customer-Facing Activity Measurements	
Inventory Risk Turnover[2]	Ratio of the amount of risk in a trading unit's inventory that is turned over by the trading unit over a specific period of time. A ratio is calculated for each Risk Factor Sensitivity: the numerator is the absolute value of the Risk Factor Sensitivity associated with each transaction over the calculation period, and the denominator should be the value of each Risk Factor Sensitivity for all of the trading unit's holdings at the beginning of the calculation period.

Inventory Aging[2]	The trading unit's aggregate assets and liabilities and the amount of time these assets have been held for: 0 to 30 days, 30-60 days, 60-90 days, 90 to 180 days, 180 days to 360 days, and greater than 360 days. The proprietary trading limitations are geared to positions held for 60 days or less; the greater the aging the better.
Customer-Facing Trade Ratio[2]	Ratio comparing the number of transactions involving a counterparty that is a customer of the trading unit to the number of transactions involving a noncustomer counterparty. Counterparties to a transaction executed on a designated contract market or a national securities exchange or that are broker-dealers, swap dealers or security-based swap dealers and noncustomers for the purpose of this measurement. A ratio below one would be a red flag.
Payment of Fees, Commissions, and Spreads Measurement	
Pay to Receive Spread Ratio[2]	Ratio of the sum of Spread Profit and Loss and Fee Income earned by a trading unit to the sum of the same items paid by the unit. A ratio below one would be problematic; how far above one the ratio should be is uncertain.

[1] Measurements for Tier 3 CBEs below the $5 billion threshold.
[2] Measurements for all Tier 2 and 3 CBEs engaged in market making.
[3] Measurements for all other permissible trading activities by Tier 3 CBEs.

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