GIBSON DUNN

December 13, 2013

# THE FINAL VOLCKER RULE

To Our Clients and Friends:

Almost three years and five months after the enactment of the Dodd-Frank Act, and about two years and two months after its implementing proposal was issued, the Volcker Rule is now final. In this Client Alert, we discuss the most important aspects of the final regulation issued on December 10th (Final Rule), as well as the principal ways in which the Rule has changed since being proposed on October 11, 2011 (Proposed Rule).

The Volcker Rule's statutory conformance period ends on July 21, 2014. On the same date as the Final Rule was issued, the Board of Governors of the Federal Reserve System (Federal Reserve) granted a one-year extension of the conformance period, to July 21, 2015.[1]

Significantly, however, banking entities with the largest proprietary trading activities -- U.S. entities with $50 billion or more in trading assets globally, and non-U.S. banking entities with $50 billion or more in U.S. trading assets, in each case, excluding U.S. government and agency issued and guaranteed obligations -- will be required to report metrics to the Volcker regulatory agencies (Agencies) beginning in July 2014. In addition, because the Final Rule imposes exceedingly complex and granular compliance program and governance requirements, banking entities will not be able to postpone conformance efforts.

The Final Rule was immediately controversial. Although the Federal Reserve and the Board of the Federal Deposit Insurance Corporation (FDIC) adopted the Final Rule unanimously, Commissioners Gallagher and Piwowar of the Securities and Exchange Commission (SEC) strenuously dissented, as did Commissioner O'Malia of the Commodity Futures Trading Commission (CFTC). Each of the three dissenting commissioners severely criticized the rulemaking process that led to adoption of the Final Rule, stating that there had not been sufficient time for reasoned and deliberate consideration.

In addition, Commissioner Gallagher took issue with the Final Rule's substance, stating that, because banking entities had shuttered or sold off their proprietary trading desks, the Volcker Rule continued to be "a solution in search of a problem," and that in the Final Rule, "to ensure that the final 1% of potentially proprietary trading [will] be hunted down and eliminated, the [A]gencies are willing to place at risk 99% of market-making activities."[2] He added that the Proposed Rule had been "simply a series of questions in search of a proposal,"[3] thus requiring a re-proposal rather than the adoption of the rule in final form.

Although the Final Rule has changed significantly from the Proposed Rule, we believe that it will nonetheless have the following principal effects:

- The substantial compliance costs necessary to ensure that permissible market-making activities do not become prohibited proprietary trading is likely to reduce the breadth of U.S. market-making and the number of participants in the markets subject to the Final Rule.

- This in turn is likely to result in reduced liquidity in these markets and higher costs for customers.

- The narrowness of the exemption for proprietary trading activities conducted by non-U.S. banks "solely outside the United States" is likely to diminish the market-making activities of non-U.S. banks active in U.S. markets, which will also likely reduce market liquidity and increase costs.

- The restrictions on permissible hedging activities -- and very substantial costs of constructing the detailed hedging compliance program mandated by the Final Rule -- are likely to reduce the creation and availability of financial products tailored to particular customer needs, because those products frequently require hedging by the creating banking entity. As a result, U.S. innovation in the creation of financial products is likely to suffer.

- Although the Final Rule ameliorates many of the perverse effects that the Proposed Rule would have had with respect to private fund activities, the Volcker statute's flat prohibition on banking entity ownership of third-party-sponsored covered funds and the still narrowed permitted activity for non-U.S. banks to retain covered fund interests "outside the United States" is likely to continue the pace of banking entity divestitures of third-party funds.

Finally, and perhaps most worthy of consideration by banking entities subject to the Final Rule, with respect to the permitted activities that are affected by the rule's proprietary trading ban -- market making, hedging, and underwriting -- the Final Rule requires strict compliance to what is in essence a fundamentally principles-based approach to regulation, with five different regulatory agencies, each with different supervisory agendas and enforcement practices, charged with the Final Rule's enforcement.

Because the Final Rule's distinction between permitted and prohibited proprietary trading activities is so principles-based, the Final Rule is not likely to be a meaningful check on enforcement discretion and may give rise to widely differing Agency enforcement approaches. This may become a significant issue for banking entities, especially those that may be subject to activities-based supervision (for example, swap dealing) in an entity that itself is supervised by a prudential bank regulator. In weighing what the Final Rule ultimately means for banking entities subject to its prohibitions, and whether it is indeed a material improvement over the Proposed Rule, this fundamental issue should be kept squarely in mind.

## HIGHLIGHTS OF THE FINAL RULE: PROPRIETARY TRADING

Proprietary Trading: Banking Entities Subject to the Prohibition

When compared with the Proposed Rule, the Final Rule reduces the number of "banking entities" that are subject to its prohibitions on proprietary trading and sponsoring and acquiring interests in covered private funds. All insured depository institutions (IDIs), companies that control such IDIs, and non-U.S. companies that are, or are regulated as, bank holding companies, and their subsidiaries and affiliates, are considered "banking entities," but the following entities are excluded:

- Any "covered fund" that is not itself a banking entity
- Any portfolio company held under the Federal Reserve's merchant banking authority or insurance company investment authority that is not itself a banking entity
- Any portfolio concern controlled by a small business investment company (SBIC) under the Small Business Investment Act that is not itself a banking entity
- The FDIC when acting in its corporate capacity, or as a conservator or receiver under the Federal Deposit Insurance Act or Dodd-Frank's Orderly Liquidation Authority (OLA)

Proprietary Trading: Generally Prohibited Unless a Permitted Activity Applies

The Final Rule retains the general structure of the Proposed Rule, under which all forms of "proprietary trading" are prohibited, unless the trading qualifies for a "permitted activity" like market-making, risk-mitigating hedging, or underwriting.

Proprietary Trading: Covered Financial Instruments Subject to the Prohibition

The Final Rule does not change the types of instruments that are subject to the proprietary trading ban -- securities, including options on securities; derivatives, including foreign exchange swaps and forwards, and options on derivatives; and contracts of sale of commodities for future delivery, and options thereon. Spot commodity, foreign exchange, and currency transactions, however, are ***excluded*** from the prohibition, as are loans.

Proprietary Trading: Definition of Trading Account

In addition to accounts used by banking entities to acquire financial instruments for the purpose of benefiting from short-term price appreciation, the Final Rule retains two alternatives for determining whether a financial instrument is in a "trading account" and thus potentially subject to the proprietary trading prohibition -- the so-called "Market Risk Capital Rule Test" and the so-called "status" test. Under the latter, ***all*** financial instruments purchased or sold by (i) banking entities that are registered dealers, including registered swap dealers and security-based swap dealers, or that are required to be so registered, in connection with their dealing activity and (ii) by banking entities that are engaged in the business of a dealer, swap-dealer, or security-based swap dealer outside the United

States in connection with their dealing business, are in the "trading account" and therefore must be analyzed to determine whether they are being held in compliance with the Final Rule's requirements.

Proprietary Trading: Rebuttable Presumption of Trading if Position Held for Fewer Than 60 Days

This rebuttable presumption, that a purchase or sale of a covered financial instrument that is held for fewer than 60 days is presumed to be proprietary trading, was retained in the Final Rule. The rebuttable presumption also applies to "basis trades," in which a banking entity buys one instrument and sells a substantially similar instrument or otherwise transfers the first instrument's risk.

Proprietary Trading: Additional Exclusions from the Definition

The Final Rule retains the Proposed Rule's exclusions from proprietary trading for repurchase agreements, reverse repurchase agreements, and securities lending agreements, and, subject to a highly granular set of conditions, for liquidity management activities. The Release accompanying the Final Rule notes that these exclusions do not, however, cover purchases and sales of securities taken in as collateral in repurchase agreement or securities lending transactions.

The Final Rule also adds exclusions for (i) "excluded clearing activities" -- particular core, clearing-related activities -- by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility, (ii) covering short sales or failures to deliver, (iii) purchasing and selling financial instruments at the direction of a judicial or regulatory body, (iv) purchasing and selling financial instruments through a deferred compensation, stock-bonus, profit-sharing, or pension plan, and (v) purchasing and selling financial instruments in satisfaction of debts previously contracted, such as in connection with a customer's failure to meet a margin call.

No express exclusion, however, was added for interaffiliate trading transactions, which must instead rely on one of the Final Rule's permitted activities.

Proprietary Trading: Market Making-Related Permitted Activity

Unlike the Proposed Rule, the Final Rule focuses on the "activities" of each "trading desk" of a banking entity. The Final Rule defines "trading desk" as the "smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate." An example of a trading desk provided by the Release is a desk "making markets in U.S. investment grade telecom corporate credits," with personnel in New York making markets in dollar-denominated bonds and personnel in London making markets in Euro-denominated bonds. This is a smaller unit than urged by many commenters.

The Final Rule then requires analysis of the overall "financial exposure" and "market-maker inventory" held by each trading desk. "Financial exposure" reflects the aggregate risks of the desk's financial instruments, and any associated loans, commodities, foreign exchange or currency held by the banking entity or an affiliate and managed by the trading desk. The "market-maker inventory" means all of the positions in financial instruments for which the trading desk stands ready to make a market that are managed by the desk, including the desk's open positions and exposures arising from open transactions.

Under the Final Rule, market making-related activities are permissible if:

- The trading desk that establishes and manages the "financial exposure" routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, ***in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.***

- The amount, types, and risks of the financial instruments in the trading desk's "market-maker inventory" are designed ***not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties***, based on: (A) ***the liquidity, maturity, and depth of the market for the relevant types of financial instrument(s)***; and (B) ***demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors*** regarding the amount, types, and risks, of or associated with, financial instruments in which the trading desk makes a market, including through block trades.

The italicized language above reflects the Agencies' attempts to reflect differing aspects of particular markets. In addition, the Final Rule removed one of the requirements in the Proposed Rule that had most concerned industry commenters: that revenues be principally derived from fees and commissions and bid-ask spreads rather than appreciation in the value of the instruments. It also materially reduced the number of required "metrics" on which banking entities with the most significant trading operations are required to report.

Although the Final Rule liberalized many conditions to the availability of the market-making permitted activity -- for example, in order to reflect market-making practices in both liquid and illiquid markets -- it nonetheless mandates a very detailed and strict internal compliance program for entities that have total consolidated assets of more than $10 billion.[4] Such a program must include reasonably designed written policies and procedures, internal controls, analysis, and independent testing, identifying and addressing, ***for each trading desk***:

- The financial instruments each trading desk stands ready to purchase and sell;

- The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposures; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

- Limits for each trading desk, which address the factors relating to the requirement that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory not exceed "the reasonably expected near term demand of clients, customers, or counterparties," on: (1) the amount, types, and risks of the trading desk's market-maker inventory; (2) the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes; (3) the level of exposures to relevant risk factors arising from its financial exposure; and (4) the period of time a financial instrument may be held;

- Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

- Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the market-maker exception, and independent review of such demonstrable analysis and approval.[5]

U.S. entities that have more than $50 billion in total consolidated assets and non-U.S. entities that have more than $50 billion in total consolidated assets in the United States, or that must report "metrics" in connection with their trading activities,[6] must have an even more granular compliance program, as described later in this Alert.

Although the Final Rule does take into account a wider variety of market conditions in which market-making activities are carried out, and does allow for more flexibility in creating market-making positions in more illiquid markets, the focused nature of the required compliance program and the need to justify each and every "trading desk's" market-making activities nonetheless mean that compliance with the Final Rule will impose very substantial costs on banking entities. When coupled with the absence of bright-line rules stating clearly what is prohibited proprietary trading, the Final Rule will almost assuredly raise the costs of market-making and lead to greater market illiquidity.

<u>Proprietary Trading: Underwriting Permitted Activity</u>

Similar to its approach to market making, the Final Rule clarifies that the underwriting permitted activity applies to a broader scope of securities offerings used than the Proposed Rule, but it subjects trading desks engaged in underwriting to substantial compliance obligations.

Responding to commenter concerns that the Agencies were requiring a transaction-by-transaction analysis, the Final Rule focuses on an "underwriting position" related to a particular securities distribution held by a banking entity and managed by a particular "trading desk" engaged in underwriting activities. Such a desk may manage an underwriting position held by different affiliated legal entities.

In addition, the Final Rule removes the concept of "magnitude" from its definition of a securities distribution, relying instead on the Regulation M definition of "special selling efforts and selling methods" and also including all offerings made pursuant to an effective registration statement, including shelf offerings, bought deals, and at-the-market offerings, whether issuer or selling shareholder driven, or as a result of a reverse inquiry. Furthermore, the Final Rule removes the requirement that the purchase or sale of a security be effected "solely" in connection with a distribution, thus clarifying that the following activities are permissible:

- Stabilization activities
- Syndicate shorting
- Aftermarket short covering
- Holding unsold allotments due to market conditions
- Entering into transactions like call-spread options

In a similar manner, the Final Rule expands the term "underwriter" to include participants in a distribution, thus more clearly including selling group members that do not have a written agreement with the underwriting syndicate or the lead underwriter, or are not in privity of contract with the issuer and selling security holder. It also removes the requirement that the banking entity generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to value appreciation.

Significantly, however, the Final Rule adds a requirement that the banking entity's trading desk make reasonable efforts to sell or otherwise reduce underwriting positions, taking into account the liquidity, maturity, and depth of the market for the relevant security, and be subject to a robust risk limit structure that is designed to prevent a trading desk from having an underwriting position that exceeds reasonably expected near term customer demand. The Release accompanying the Final Rule states that a trading desk must have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution, although the desk is not required to engage in book-building or similar marketing efforts in order to determine customer demand.

As with market making, the Agencies made certain enhancements to emphasize the importance of a strong internal compliance program. Most significantly, the Final Rule imposes requirements for limits at each trading desk, based on the nature of the trading desk's underwriting activities, and internal controls and ongoing monitoring and analysis of each trading desk's compliance with these limits. The Release accompanying the Final Rule states that requirements of the compliance program "must be appropriately tailored to the individual trading activities and strategies of each trading desk," and that limits should be designed "to prevent a trading desk from systematically retaining unsold allotments even when there is customer demand for the positions that remain in the trading desk's inventory."

Proprietary Trading: Risk-Mitigating Hedging Permitted Activity

With respect to risk-mitigating hedging, the Final Rule retains language from the Proposed Rule that allows banking entities to hedge "aggregated" as well as "individual" risks. Some forms of "portfolio hedging," therefore, are permitted by the Final Rule -- those that mitigate one or more specific risks arising from aggregated positions. The Release to the Final Rule, however, makes clear that a banking entity would violate the Final Rule if it sought to use the risk-mitigating hedging permitted activity to hedge "more generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists *[sic]* based on non-position-specific modeling or other considerations."

The Final Rule, therefore, can be said to tighten the requirements for the risk-mitigating hedging permitted activity, while at the same time imposing a more detailed compliance regime. In addition to the limitations on portfolio hedging of generalized risks, the Final Rule requires hedging to mitigate "specific, identifiable" risks that develop over time from hedging activities and the underlying positions. At the same time, however, the Final Rule requires only that "correlation analysis" be done before a hedging activity is undertaken, rather than requiring flatly that the hedge must maintain correlation, as in the Proposed Rule. In addition, the Final Rule, in continuing to permit anticipatory hedging, removes the requirement that the hedge be put on "shortly" before the risk is entered into.

The compliance regime in the Final Rule is more prescriptive, requiring, for example, that written policies and procedures be developed and implemented at the appropriate level of organization and expressly address the banking entity's requirements for escalation procedures, supervision, and governance. The Final Rule also requires "ongoing calibration of the hedging activity by the banking entity to ensure that the hedging activity is not . . . prohibited proprietary trading," and mandates additional documentation when hedging is not established by the specific trading desk responsible for the underlying positions, when hedging is effected through a means not specifically identified in the trading desk's written policies and procedures, and when hedging is established to hedge aggregated positions across two or more trading desks.

Proprietary Trading: Foreign Government Obligations and Permitted Trading Activities of Foreign Banking Entities

The Final Rule provides only a limited exemption from the proprietary trading ban for proprietary trading in foreign sovereign debt and related obligations. Such trading -- if it does not qualify for other exemptions such as underwriting, market-making, or trading "solely outside the United States" -- is permitted only as follows:

- The U.S. operations of non-U.S. banking entities[7] may engage in proprietary trading in the United States in the obligations of the foreign sovereign under whose laws the non-U.S. banking entity is organized, the obligations of any of that country's agencies or political subdivisions, and the obligations of any multinational central bank of which the foreign sovereign is a member, as long as the trading is not done by an insured depository institution. Thus, the U.S. operations of a Spanish bank regulated as a bank holding company -- other than an insured depository institution -- may trade in Spanish government obligations,

obligations of Spanish agencies and political subdivisions, and obligations of the European Central Bank (ECB).

- Non-U.S. banks and non-U.S. broker-dealers regulated as securities dealers controlled by a U.S. banking entity may engage in proprietary trading in the obligations of the foreign sovereign under whose laws they are organized, including agency and political subdivision obligations, as well as the obligations of any multinational central bank of which the foreign sovereign is a member. Thus, a German bank controlled by a U.S. bank holding company may engage in proprietary trading of German government obligations and the obligations of German government agencies and political subdivisions, as well as obligations of the ECB.

These exemptions, however, do ***not*** include derivatives on such foreign obligations, just as derivatives on U.S. government obligations are not *per se* excluded from the proprietary trading ban.

The Final Rule modifies the permitted activity for trading activities conducted "solely outside the United States" by non-U.S. banking entities from that in the Proposed Rule. A non-U.S. banking entity that is a qualifying foreign banking organization (QFBO) under the Federal Reserve's Regulation K, or, for any non-U.S. banking entity that controls a U.S. thrift or FDIC-insured industrial bank, that would meet a modified QFBO test, qualifies for the permitted activity if:

- The banking entity engaging in the trade, and any person of the entity or any affiliate that arranges, negotiates, or executes the trade, are not located in the U.S. or organized under U.S. law

- The banking entity and relevant personnel that make the decision to engage in the trade are not located in the U.S. or organized under U.S. law, and the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. law

- The trade, including any risk-mitigating hedging transactions, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate located in the United States or organized under U.S. law

- No financing for the trade is provided, directly or indirectly, by any branch or affiliate located in the United States or organized under U.S. law

- The trade is not conducted with or through any "U.S. entity," other than:

    - a purchase or sale with the foreign operations of a U.S. entity, if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale;

    - a purchase or sale with an unaffiliated market intermediary acting as principal, provided that the trade is promptly cleared or settled through a clearing agency or derivatives clearing organization (DCO) acting as a central counterparty; or

- a purchase or sale through an unaffiliated market intermediary, provided that the purchase or sale is conducted without either party's knowledge of the other party's identity on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or DCO acting as a central counterparty.

A "U.S. entity" is defined as "any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or any State," and includes a U.S. branch, agency, or subsidiary of a non-U.S. bank. A "unaffiliated market intermediary" is defined as an unaffiliated entity that acts as an intermediary that is: (i) a SEC-registered broker or dealer or exempt from registration or excluded from such regulation; (ii) a swap dealer registered with the CFTC or exempt from registration or excluded from such regulation; (iii) a security-based swap dealer registered with the SEC or exempt from registration or excluded from such regulation; or (iv) a futures commission merchant registered with the CFTC or exempt from registration or excluded from such regulation.

Although the Final Rule, in contrast to the Proposed Rule, does not prohibit a trade between a non-U.S. bank and a non-U.S. counterparty from being executed on a U.S. exchange, if the conditions set forth above are met, the fact that personnel of the non-U.S. bank responsible for arranging, negotiating or executing the trade cannot be located in the United States is still a substantial limitation on the permitted activity.

## PROPRIETARY TRADING: CORPORATE GOVERNANCE THE KEY TO COMPLIANCE

The Final Rule continues the Dodd-Frank implementation pattern of imposing prescriptive corporate governance requirements as a means of ensuring compliance. Banking entities that engage in the activities prohibited by the Volcker Rule and that have more than $10 billion in total consolidated assets must, in addition to the written policies and procedures described above, establish:

- a system of internal controls reasonably designed to monitor compliance with the Volcker Rule
- a management framework that clearly delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters requiring attention
- independent testing and audit conducted periodically by qualified personnel
- training for trading personnel and managers, and other appropriate personnel
- records sufficient to demonstrate compliance, to be retained for at least five years

U.S. banking entities that have $50 billion or more in total consolidated assets and non-U.S. banking entities that have total U.S. assets of $50 billion or more, or that, in each case, are required to report proprietary trading metrics, are subject to heightened governance requirements. This heightened framework requires:

- A written compliance program approved by the board of directors, an appropriate committee of the board, or equivalent governance body, and senior management

- Designation of appropriate senior management or a committee of senior management with authority to carry out management responsibilities for each trading desk

- Written procedures addressing the management of the activities of the banking entity reasonably designed to achieve compliance

- A description of the management system, including specific responsibilities of each person with respect to activities subject to the Volcker Rule

- Procedures for determining compensation arrangements for traders engaged in underwriting, market making, or risk mitigating hedging in compliance with the Volcker Rule

- Business line managers for one or more trading desks to be accountable for the effective enforcement of the compliance program

- The board of directors, or similar corporate body, and senior management to set and communicate an appropriate culture of compliance with respect to the Volcker Rule

- Senior management and control personnel charged with overseeing Volcker Rule compliance to review the compliance program periodically and report to the board of directors or an appropriate board committee on the effectiveness of the program at least annually

- The banking entity's chief executive officer to review and annually attest in writing that the banking entity has in place processes to maintain the compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule; in the case of a U.S. branch or agency of a non-U.S. banking entity, the attestation may be given by the senior management office of the U.S. operations who is located in the United States

- At least annual testing by a qualified independent party of the effectiveness of the compliance program

- Records sufficient to demonstrate compliance, to be retained for at least five years[8]

## HIGHLIGHTS OF THE FINAL RULE: PRIVATE FUND ACTIVITIES

<u>Investing in or Sponsoring Covered Funds Generally Prohibited Unless an Exclusion or Permitted Activity Applies</u>

The Final Rule retains the general structure of the Proposed Rule, under which banking entities are prohibited from investing in or sponsoring hedge funds and private equity funds (covered funds) "as principal," subject to certain exclusions and permitted activities.

Acting "As Principal" Clarified

The Final Rule clarifies the meaning of acting "as principal" by providing that the general prohibition does not apply to a banking entity's investment in a covered fund (i) if the banking entity is acting solely as agent, broker, or custodian; (ii) through a deferred compensation, stock-bonus, profit-sharing, or pension plan, if the ownership interest is held by the banking entity as trustee for the benefit of current or former employees of the banking entity or its affiliate; (iii) in the ordinary course of a debt previously contracted in good faith; or (iv) on behalf of customers as trustee or in a similar fiduciary capacity.

Covered Funds: Definition and Exclusions

The Final Rule improves substantially on the Proposed Rule by narrowing the universe of covered funds that are subject to the Volcker Rule's prohibitions. Excluded from the definition of "covered fund" in the Final Rule are:

- Issuers that may rely on an exemption from Investment Company Act registration other than Section 3(c)(1) or 3(c)(7), such as 3(C)(5)(c) funds
- Commodity pools other than those for which: (i) the commodity pool operator has claimed an exemption under 12 CFR § 4.7, or (ii) the commodity pool operator is registered with the CFTC in connection with the operation of the commodity pool, substantially all participation units of the commodity pool are owned by "qualified eligible persons," and participation units have not been offered to persons who are not "qualified eligible persons"
- Joint ventures that: (i) comprise no more than 10 co-venturers, (ii) are in the business of engaging in activities permissible for the banking entity or any affiliate, other than investing in securities for resale or disposition, and (iii) are not, and do not hold themselves out as being, entities that raise money from investors primarily for investing in securities for resale or disposition
- Acquisition vehicles
- Wholly-owned subsidiaries, including those not engaged in liquidity management, and permitting some *de minimis* third-party ownership under certain limited conditions
- Qualifying loan securitization vehicles, with liberalized conditions
- Qualifying asset-backed commercial paper conduits
- Vehicles created to hold assets relating to covered bonds, subject to certain conditions
- Registered investment companies, including those that are seeded as Section 3(c)(1) or 3(c)(7) funds, subject to certain conditions

- Separate accounts for bank-owned life insurance, subject to certain conditions
- Insurance company separate accounts, subject to certain conditions
- Foreign retirement and pension funds
- SBICs and public welfare investments
- Entities formed by the FDIC for the purpose of disposing of assets acquired by the FDIC as receiver or conservator (including under the OLA)

The Final Rule, however, does not provide a similar exclusion for employee securities companies (ESCs) that have not received the necessary order of exemption from the SEC under the Investment Company Act, nor exclusions requested by commenters for financial market utilities, cash collateral pools, pass-through REITs, municipal securities tender option bond transactions, credit funds, and venture capital funds. In addition, the Release accompanying the Final Rule states that the Agencies will be monitoring the development of pooled investment vehicles sponsored by the financial services industry to determine whether the Final Rule's exclusions remain appropriate, or whether they will lead to attempts at evasion of the Volcker Rule's requirements.

Covered Funds: Foreign Funds

The Final Rule mitigates the extraterritorial effect of the covered funds prohibition (and, thereby, the extraterritorial effect of Super 23A) by reducing the number of foreign funds that are considered "covered funds" and thus subject to the prohibition on banking entity ownership and sponsorship. The Final Rule rejected the Proposed Rule's definition under which a foreign fund was a covered fund if it would have been a covered fund if it were organized or offered under U.S. law or offered or sold to U.S. residents. Instead, the Final Rule excludes the following entities from the definition of "covered fund":

- Foreign public funds, subject to certain conditions
- Foreign funds that could rely on an Investment Company Act exemption other than Section 3(c)(1) and 3(c)(7) if they were offered in the United States

The Final Rule also provides that funds organized under non-U.S. law and offered and sold solely outside the United States are covered funds only with respect to U.S. banking entities and entities controlled by U.S. banking entities that may sponsor or invest in them. A non-U.S. banking entity not controlled by a U.S banking entity, therefore, may freely invest in such funds.

Covered Funds: Definition of "Ownership Interest"

The Final Rule provides additional gloss on the term "other similar interest" for purposes of determining whether a banking entity has an "ownership interest" in a covered fund. It defines "other similar interest" as an interest that:

- Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

- Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

- Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

- Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

- Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

- Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

- Any synthetic right to have, receive, or be allocated any of the rights above.

<u>Covered Funds: "Carried Interest"/"Restricted Profits Interest"</u>

The Final Rule changes the defined term "carried interest" -- a profits interest in a covered fund that does ***not*** count toward a banking entity's 3% per fund and 3% of Tier 1 capital aggregate investment limits -- to "restricted profits interest." In addition, the Final Rule lists investment management, investment advisory and commodity trading advisory services as examples of services for which the banking entity may be compensated with a restricted profits interest; provides that any undistributed profit related to the restricted profits interest may be retained by the covered fund solely for the purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses (*i.e.*, to permit "clawbacks); permits a banking entity to provide funds to the covered fund in connection with acquiring or retaining the restricted profits interest (although such amounts and any amounts provided by employees for such interests must count toward the 3% per-fund and aggregate investment limits); and permits the transfer of a restricted profits interest to a wider set of transferees than in the Proposed Rule.

The Final Rule also changes the fund disclosure required by the Asset Management permitted activity slightly in this regard, by adding that the banking entity's losses in any covered fund may also include losses as the beneficiary of a restricted profits interest.

Covered Funds: Asset Management Permitted Activity/Director and Employee Interests

The Release accompanying the Final Rule clarifies that, with respect to funds organized and offered under the Asset Management permitted activity, directors or employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, and administrative or other support services, may invest in the fund. In addition, a former director or employee may retain an interest in a covered fund if the director or employee acquired the interest while serving as a director or employee ***and*** providing investment advisory or other services to the covered fund.

Covered Funds: Acquisition of Interest in a Sponsored Qualifying Securitization Vehicle

The Final Rule confirms that a banking entity may acquire a greater interest in a sponsored qualifying securitization vehicle than 3% if so required by the securitization provisions of Dodd-Frank.

Covered Funds: Underwriting and Market-Making Activities

Unlike the Proposed Rule, the Final Rule states that a banking entity may acquire an ownership interest in a covered fund pursuant to (and in accordance with) the underwriting and market-making permitted activities applicable to other securities. It does, however, require the banking entity to comply with all the requirements applicable to those permitted activities, and generally requires the ownership interests acquired to be counted toward the 3% per-fund and aggregate investment limits and be subject to the Final Rule's required capital deduction.

Covered Funds: Risk-Mitigating Hedging Activities

With respect to risk-mitigating hedging, the Final Rule is noteworthy for narrowing the availability of permissible hedging of covered fund interests. In contrast to the Proposed Rule, the Final Rule does not permit hedging to allow a banking entity to act as principal in providing exposure to the profits and losses of a covered fund to a customer, even if the exposure is hedged by the banking entity. The Agencies state that they view such practices as "high risk strategies that could threaten the safety and soundness of the banking entity," without citing any evidence for the conclusion. This questionable determination will adversely affect the availability of fund-linked products and reduce the ability of banking entities to offer customers products meeting particular needs.

Covered Funds: Calculation of Per-Fund Investment Limit

The Final Rule greatly simplifies the calculation of the per-fund investment limit by removing the Proposed Rule's *pro rata* test for noncontrolled but greater than 5% indirect investments. In addition, the Final Rule removes the Proposed Rule's attribution of parallel investments by a banking entity with a sponsored covered fund to the banking entity, but the Release notes that "the Agencies continue to believe that the potential for evasion . . . may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors." For this reason, the Release states that if a banking entity decides to offer fund investors co-investment opportunities when the covered fund may not be able to take the whole investment, the banking entity sponsoring the covered fund should not itself make any additional side-by-side co-investment with the covered fund unless the value of the co-investment is less than 3% of the value of the total amount co-invested by the other investors. The Agencies further noted that if a banking entity makes investments side-by-side in substantially the same positions as the covered fund, then the value of the investments would be included for purposes of the 3% test.

In addition, the Final Rule clarifies that with respect to master-feeder structures and funds of funds, the ownership interest of a banking entity in the underlying covered fund for purposes of the per-fund limit includes any direct investment by the banking entity in the covered fund and the banking entity's *pro rata* share in the covered fund that it holds through a feeder fund or fund of funds. For master-feeder structures, the 3% test is measured only at the master fund level; for fund of funds structures, it is measured with respect to each fund.

Finally, employee and director interests in a covered fund -- other than restricted profits interests, which are treated as described above -- are counted toward the 3% per-fund limit only if the banking entity has provided financing to the employee or director for the purpose of acquiring the interests and the financing is used to acquire the interest.

<u>Covered Funds: Capital Treatment for Permitted Investments</u>

The Final Rule clarifies that for purposes of calculating compliance with regulatory capital requirements, a banking entity must deduct from the banking entity's Tier 1 capital the greater of:

- The sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest, together with any amounts paid by the entity or employee in connection with obtaining a restricted profits interest, on a historical cost basis, plus any earnings received; and

- The fair market value of the banking entity's ownership interests in the covered fund, together with any amounts paid by the entity or employee in connection with retaining a restricted profits interest, if the banking entity accounts for the profits or losses of the fund investment in its financial statements.

<u>Covered Funds: Permitted Activities Outside the United States</u>

With regard to the ability of a non-U.S. banking entity not controlled by a U.S. banking entity to invest in third-party non-U.S. funds that otherwise meet the "covered fund" definition and are ***not*** offered and sold solely outside of the United States, the Final Rule imposes certain additional conditions:

- the fund interests must not be or have been sold pursuant to an offering that targets residents of the United States;

- the banking entity, including relevant personnel, that makes the decision to acquire or retain the ownership interest are not located in the United States or organized under the laws of the United States or any State;

- the investment, including any transaction arising from risk-mitigating hedging, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under U.S. law

- no financing for the banking entity's ownership is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under U.S. law

The Release accompanying the Final Rule states that "[a]bsent circumstances otherwise indicating a nexus with residents of the United States, the sponsor of a foreign fund would not be viewed as targeting U.S. residents for purposes of the foreign fund exemption if it conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States."

<u>Super 23A: Transactions that are Exempt from Being Covered Transactions Under Section 23A and Regulation W Are Not Exempt Under Super 23A</u>

On an issue of considerable significance to custodian banks, the Agencies declined to interpret Super 23A to permit exceptions for Section 23A covered transactions that are exempt from coverage under Section 23A of the Federal Reserve Act and Regulation W, such as intraday extensions of credit, and extensions of credit secured by U.S. government obligations.

<u>Super 23A: Accepting Fund Securities As Collateral for a Third-Party Loan is Not a Covered Transaction</u>

The Agencies clarified that the Super 23A prohibition applies only to a banking entity's transactions directly "with" a covered fund, and not to a banking entity's transactions with a third party that is not a covered fund, such as if a banking entity accepts securities of a covered fund as collateral for a third-party loan.

## CONCLUSION

On many important issues, the Final Rule represents a significant shift away from the approach of the Proposed Rule -- taking a broader view of market-making related activities and correcting many of the flaws of the Proposed Rule's approach to covered funds. It is nonetheless very clear that the Final Rule will impose very substantial compliance costs on banking entities, in particular due to the "trading desk"-specific compliance program that the Final Rule requires with respect to its proprietary trading ban. These compliance costs, the uncertainty of how the Final Rule will be enforced by the five Agencies with supervisory jurisdiction, and, in the proprietary trading context, the lack of clear rules to channel supervisory discretion once the Volcker Rule begins to be enforced are all issues of substantial concern. They must be carefully considered as part of any overall evaluation of the Final Rule.

---

[1] The Federal Reserve retains the authority to grant two additional one-year extensions, or up to July 21, 2017, if the extensions are consistent with the purposes of the statute and would not be detrimental to the public interest. Additional time for conformance, up to July 21, 2022, may be permitted for so-called "illiquid funds." The Federal Reserve has stated, however, that banking entities should engage in "good faith" conformance, such that additional extensions of the conformance period will require showings of diligent attempts to conform before July 21, 2015.

[2] Commissioner Daniel M. Gallagher, Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule, December 10, 2013.

[3] Ibid.

[4] Banking entities with total consolidated assets of $10 billion or less are permitted to include in their existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule and adjustments as appropriate given the activities, size, scope, and complexity of the banking entity. If a banking entity does not engage in activities prohibited by the Volcker Rule, either with respect to proprietary trading or private funds, it need establish the required compliance program only before becoming engaged in either activity.

[5] The Final Rule also requires a trading desk to bring itself into compliance with the limits prescribed by the compliance program as promptly as possible after a limit is exceeded.

[6] Whether a banking entity is required to report metrics depends on the amount of its consolidated trading assets and liabilities, excluding U.S. government and agency issued and guaranteed obligations. The threshold amount at June 30, 2014 is $50 billion, and declines to $25 billion beginning on April 30, 2016, and declines further to $10 billion on December 31, 2016. For non-U.S. banking entities, the Final Rule considers the trading assets and liabilities of its U.S. operations. In addition, the Agencies retain the discretion to require metrics from other banking entities.

[7] Gibson, Dunn will be distributing shortly a separate Client Alert focusing on the significant Volcker Rule issues for non-U.S. banks.

[8] In addition to these governance requirements, such significant banking entities are made subject to extremely detailed compliance program requirements for both proprietary trading and private fund activities.

GIBSON DUNN

*Gibson, Dunn & Crutcher's Financial Institutions Practice Group lawyers are available to assist in addressing any questions you may have regarding these areas. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work, or the following:*


*Arthur S. Long - New York (+1 212-351-2426, along@gibsondunn.com)*
*Chuck Muckenfuss - Washington, D.C. (+1 202- 955-8514, cmuckenfuss@gibsondunn.com)*
*Michael D. Bopp - Washington, D.C. (+1 202-955-8256, mbopp@gibsondunn.com)*
*Nicolas H.R. Dumont - New York (+1 212-351-3837, ndumont@gibsondunn.com)*
*Alexander G. Acree - Washington, D.C. (+1 202-887-3725, aacree@gibsondunn.com)*
*Alfred J. Chianese - New York (+1 212-351-2353, achianese@gibsondunn.com)*
*Colin Richard - Washington, D.C. (+1 202-887-3732, crichard@gibsondunn.com*