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The Volcker Rule: A Legal Analysis

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The Volcker Rule: A Legal Analysis

Abstract
This report provides an introduction to the Volcker Rule, which is the regulatory regime imposed upon banking institutions and their affiliates under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203). The Volker Rule is designed to prohibit "banking entities" from engaging in all forms of "proprietary trading" (i.e., making investments for their own "trading accounts")—activities that former Federal Reserve Chairman Paul A. Volcker often condemned as contrary to conventional banking practices and a potential risk to financial stability. The statutory language provides only general outlines of prohibited activities and exceptions. Through it, however, Congress has empowered five federal financial regulators with authority to conduct coordinated rulemakings to fill in the details and complete the difficult task of crafting regulations to identify prohibited activities, while continuing to permit activities considered essential to the safety and soundness of banking institutions or to the maintenance of strong capital markets. In December 2014, more than two years after enactment of the law, coordinated implementing regulations were issued by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC).

The Rule is premised on a two-pronged central core restricting activities by "banking entities"—a term that includes all FDIC-insured bank and thrift institutions; all bank, thrift, or financial holding companies; all foreign banking operations with certain types of presence in the United States; and all affiliates and subsidiaries of any of these entities. Specifically, the Rule broadly prohibits banking entities from engaging in "proprietary trading" and from making investments in or having relationships with hedge and similar "covered funds" that are exempt from registering with the CFTC as commodity pool operators or with the SEC under the Investment Advisors Act. The Rule couples its broad prohibitions with numerous exclusions and by designating myriad activities as permissible so long as various terms and conditions are met, unless they otherwise would involve or result in a material conflict of interest; a material exposure to high-risk assets or high-risk trading strategies; pose a threat to the safety and soundness of the banking entity; or pose a threat to the financial stability of the United States.

The exceptions to the ban on proprietary trading include underwriting by securities underwriters; market-making "designed not to exceed the reasonably expected near term demands of clients"; trading in government securities; fiduciary activities; insurance company portfolio investments; and risk-mitigating hedging activities. The ban on investing in and owning "covered funds" exempts certain types of funds, under specified conditions, and permits de minimis investment in any such fund up to 3% of the outstanding ownership interests of the fund with an aggregate cap on the total ownership interest in "covered funds" of 3% of the banking entity's core capital.

To prevent evasion, the Rule has extensive requirements mandating comprehensive compliance programs that include ongoing management involvement, precise metrics measuring risk assessment, verification and documentation of any activities conducted under one of the Rule's exceptions or exclusions, and recurring reports and assessments. Full compliance is required by July 21, 2015, subject to the possibility that further extensions may be provided by the regulators. In the case of investments involving "illiquid funds" subject to contractual provisions seriously impacting their marketability or sale, full divestiture might not be required until July 21, 2022.

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Keywords
Volcker Rule, banking, proprietary trading, finance reform

Comments

Suggested Citation
Carpenter, D. H., & Murphy, M. M. (2014). *The Volcker Rule: A legal analysis*. Washington, DC: Congressional Research Service.

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The Volcker Rule: A Legal Analysis

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March 27, 2014

Congressional Research Service
7-5700
www.crs.gov
R43440

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

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Overview

On December 10, 2013, more than two years after the statutorily mandated deadline, five federal financial regulators published final regulations (hereinafter, the regulations)[1] implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter, Section 619 or the statute).[2] Together these are known as the Volcker Rule (hereinafter, the Volcker Rule or the Rule), which is designed to prohibit banks and their affiliates from engaging in risky, short-term, speculative trading and investing in private equity and hedge funds. These are practices long condemned by the Rule's namesake, former Federal Reserve Chairman Paul A. Volcker, for being at odds with conventional banking principles and potential risks to overall financial stability that could trigger the need for future bailouts.[3]

The same day that the regulations were issued, the Federal Reserve Board (FRB) set the date when conformance with the Rule is required as July 21, 2015, although that date could be extended an additional two years,[4] and banking institutions and their affiliates are under an obligation to undertake good faith efforts to meet that date with full compliance.

The Volcker Rule, which according to an analysis[5] by one of the issuing regulators might impose significant costs on covered institutions, prohibits "banking entities" from engaging in "proprietary trading" and from making investments in or having relationships with hedge and

[1] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5,535 (January 31, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf. The regulations were issued in a coordinated fashion, rather than issued jointly. As a result, there currently are some minor differences in the regulations issued by each federal regulator, and other differences may be implemented overtime. For example, the Commodity Futures Trading Commission (CFTC) issued "substantively similar" regulations separately from the other financial regulators. 79 Fed, Reg. 5,808 (January 31, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31476.pdf.

Each of the Volcker Rule regulations are codified in different sections of the Code Federal Regulations (C.F.R.) (12 C.F.R. Part 44 (Office of the Comptroller of the Currency (OCC)); 12 C.F.R. Part 248 (Board of Governors of the Federal Reserve System (FRB)); 12 C.F.R. Part 351 (Federal Deposit Insurance Corporation (FDIC)); 17 C.F.R. Part 255 (Securities and Exchange Commission (SEC)); and 15 C.F.R. Part 75 (CFTC)). Hereinafter, all citations to the regulations will leave references to the CFR title and section blank because they vary from regulator to regulator, and instead will be distinguished by subsections, which generally are consistent among all of the federal financial regulators (e.g., __ C.F.R. §__.1).

The regulations were accompanied by a brief fact sheet, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a3.pdf, and a nearly 900-page preamble, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf.

[2] P.L. 111-203 §1855; 124 Stat. 1375.

[3] Paul A. Volcker, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, Feb. 13, 2012, available at http://www.sec.gov/comments/s7-41-11/s74111-182.pdf (comments to the federal financial regulators on the proposed Volcker regulations).

[4] Federal Reserve System, Order Approving Conformance Period, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[5] *Analysis of 12 C.F.R. Part 44*, a draft document attributed to the Office of the Comptroller of the Currency (OCC) and made available by BNA's Banking Daily on March 21, 2014, available at http://op.bna.com/bar.nsf/id/jbar-9hdtcf/$File/volcker.pdf (estimating that the Volcker Rule may impose costs of between $412 million to $4.23 billion primarily on an estimated 46 OCC-regulated national banks).

similar "covered funds" that fall into certain exemptions from registering with the Commodity Futures Trading Commission (CFTC) as commodity pool operators or with the Securities and Exchange Commission (SEC) under the Investment Advisors Act. In concert with these broad prohibitions, the Rule carves out numerous exclusions and designates myriad activities as permissible so long as various terms and conditions are met. The statutory language provides only general outlines of prohibited activities and exceptions, while empowering the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the SEC, and CFTC (together, the federal financial regulators or the Agencies) to issue coordinated rulemakings to fill in the details and complete the difficult task of crafting regulations to distinguish prohibited activities from activities considered essential to the safety and soundness of banking institutions or to the maintenance of strong capital markets.[6]

What follows is a legal overview of the Volcker Rule. The report begins by analyzing the integral definition of "banking entity," which serves as the foundation for the applicability of the Rule. It then separately analyzes the two distinct components of the Rule: (1) restrictions on proprietary trading; and (2) restrictions on investing in and sponsoring covered funds. The basic framework of the Rule is to broadly prohibit banking entities from engaging in these two broad categories of activities, while also carving out specific exclusions from the scope of the two categories and exceptions for certain activities that otherwise would generally fall within the broad prohibitions. These excepted activities are designated as permissible under the Rule unless they would involve or result in a material conflict of interest; a material exposure to high-risk assets or high-risk trading strategies; pose a threat to the safety and soundness of the banking entity; or pose a threat to the financial stability of the United States. The report concludes by addressing other aspects of the Rule that apply generally to banking entities, including various compliance programs and reporting and recordkeeping obligations designed to implement the statute's anti-evasion provisions, as well as the requirements for divesting of legacy holdings and activities that do not conform with the Rule.

Statutory Delegation to the Financial Regulators

Congress has delegated extensive discretion to the federal financial regulators to craft the Volcker Rule to meet a list of widely divergent objectives. The statute states the prohibitions and conditions in very broad terms and applies them to an array of financial institutions subject to a variety of regulatory regimes and separate regulators, foreign and domestic. It applies to community and global banks, every variety of insurance firm, securities firms, and foreign banking institutions operating in the United States, among others.[7] The federal financial regulators have been tasked with diverse objectives, among which are the following: promoting safety and soundness of the entities covered by the Rule; protecting taxpayers and consumers; limiting inappropriate transfers of the safety net provided by FDIC deposit insurance; reducing conflicts of interests between the entities and their clients; limiting unduly risky activities by

[6] The statute also provides three rules of construction for interpreting Section 619: (1) "Except as provided in this section [619],... the prohibitions and restrictions under this section shall apply," notwithstanding the existence of other provisions of law authorizing such activities; (2) nothing in Section 619 is to "be construed to limit the ability of a banking entity or nonbank financial company … to sell or securitize loans in a manner otherwise permitted by law"; and (3) nothing in Section 619 is to "be construed to limit the inherent authority of any Federal agency or State regulatory authority under otherwise applicable provisions of law." 12 U.S.C. §1851(g).

[7] 12 U.S.C. §1851(h)(1); __ C.F.R. §§__.2(c).

these entities; "appropriately" accommodating the business of insurance; and "appropriately" timing divestiture of illiquid assets affected by the Rule.[8]

The statutory language requires the regulators to explicate such critical terms as "banking entity," "covered fund," "illiquid fund," "trading account," "hedge fund," "reasonably expected near term demands of clients," "specific risks," and "ownership interest." It includes a broad explicit delegation of discretion to exclude from the basic prohibitions of the statute "[s]uch other activity as the appropriate [federal financial regulators] determine, by rule ... would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[9]

Consequently, the Volcker Rule is not likely to remain static over time. Rather, regulators likely will modify and clarify the requirements through regulations and guidance to address unforeseen complexities. In fact, as is discussed in the "Definition of 'Ownership Interest'" section of this report, the regulators have already issued an interim final rule that makes changes to the regulations as originally issued on December 10, 2013.

Applicability—"Banking Entities"

The thrust of the Volcker Rule's restrictions applies to "banking entities." "Banking entity"[10] is defined as:

1. FDIC-insured depository institutions. This includes national and state banks, federal and state savings associations, thrifts, and similarly chartered banking institutions that offer FDIC-insured deposits.
2. Companies that own FDIC-insured depository institutions. This includes companies that own or control FDIC-insured depositories (by holding a certain percentage of voting stock or otherwise exerting a controlling influence over a company's decision making, such as the election of directors). Such companies are typically organized as bank holding companies (BHCs),[11] financial holding companies (FHCs),[12] or savings and loan or thrift holding companies.[13]
3. Foreign-based companies that are treated like bank holding companies pursuant to the International Banking Act of 1978. This includes foreign-based banks that are permitted to operate branches in the U.S. or that own certain other domestic

[8] 12 U.S.C. §1851(b)(1) requires the Financial Stability Oversight Council (FSOC) to study and make recommendations on implementing the statute with respect to these seven factors.

[9] 12 U.S.C. §1851(d)(1)(J). For example, the agencies used this authority to permit "a foreign banking entity to trade through an unaffiliated market intermediary if the trade is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization" and "to trade with an unaffiliated market intermediary acting in a principal capacity and effecting a market intermediate function." 79 Fed. Reg. 5,536, 5,657. __ C.F.R. §§__.6(e)(e)(3)(iv)(C) and (B).

[10] 12 U.S.C. §1851(h)(1).

[11] 12 U.S.C. §1841.

[12] A financial holding company (FHC) is a bank holding company (BHC) approved to engage in expanded financial activities, such as securities and insurance activities, under 12 U.S.C. §1843(l).

[13] 12 U.S.C. §1467a.

lending companies.[14] An affiliate is "any company that controls, is controlled by, or is under common control with [a company described in categories 1-3]."[15]

4. Affiliates and subsidiaries of companies described in 1-3. This covers "any company that controls, is controlled by, or is under common control with [a company described in categories 1-3]."[16]

In short, the Volcker Rule applies broadly to all depository institutions and to most companies that are owned by or have a common ownership interest with a depository. As a result, the Volcker Rule applies to the approximately 10,000 "community banks" scattered across the country. On the other side of the spectrum, the Volcker Rule applies to global financial conglomerates like Bank of America, Citigroup, JPMorgan, Wells Fargo, and Goldman Sachs, which are organized as FHCs and thus control at least one FDIC-insured depository institution. The rule also generally applies to hundreds of depository and non-depository affiliates and subsidiaries of these FHCs. However, the regulations provide certain exceptions to the definition of "banking entity," as discussed below.

Additionally, the applicability of certain exemptions, recordkeeping and reporting requirements, and other aspects of the Rule vary to some degree according to the organization or typical activities of a particular banking entity. For example, because they may engage in little or no activities that are banned by the Volcker Rule, the recordkeeping and reporting requirements and other compliance standards that apply to community banks and their subsidiaries and affiliates generally will not be as onerous as those imposed on the country's largest FHCs.[17] As another example, foreign banks and foreign affiliates of U.S. banking entities under certain circumstances will be permitted to trade foreign government obligations, but these activities generally are prohibited under the Volcker Rule's ban on proprietary trading for U.S.-based banking entities and U.S.-based affiliates of foreign banks.[18]

Restrictions on Proprietary Trading

The Volcker Rule establishes an outright prohibition on proprietary trading by a "banking entity." Subsequent provisions of the legislation, however, provide activities that are excluded from the definition of "proprietary trading," as well as exceptions to the general ban as long as various conditions are met. The exact language provides a broad prohibition. It reads, "a banking entity shall not … engage in proprietary trading, ..."[19] Under the statute, "proprietary trading" covers buying and selling of "financial instruments" by banking entities as "principal" for their "trading accounts."[20] "Financial instruments" include securities, derivatives, and contracts for future sale

[14] 31 U.S. C. §3106.

[15] __ C.F.R. §__.2(a) incorporates the definition of "affiliate" in 12 U.S.C. §1841(k).

[16] __ C.F.R. §__.2(a) incorporates the definition of "subsidiary" in 12 U.S.C. §1841(d).

[17] See the "Anti-Evasion Provisions: Compliance Programs, Reports, and Recordkeeping" section of this report. In conjunction with issuing the regulations, the five agencies provided information on "The Volcker Rule: Community Bank Applicability," available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a4.pdf.

[18] __ C.F.R. §__.6(b) requires that the foreign banking entity be organized under the foreign sovereign issuing the obligations; that it not be controlled by a U.S. banking entity, and the purchase or sale may not be made by an insured depository institution.

[19] 12 U.S.C. §1851(a)(1).

[20] "Proprietary trading" is "engaging as principal for the trading account of the banking entity or nonbank financial (continued...)

or for options on any commodity other than foreign exchange or currency, but not loans. However, as described more fully below, certain types of financial instruments and operations are excluded.

The regulation focuses on restricting short-term trades. It establishes a rebuttable presumption that any financial instrument held for fewer than 60 days is a banned proprietary trade unless all relevant facts and circumstances rebut the presumption.[21] It defines "trading account" as any account used to buy or sell one or more financial instruments "principally" for "short-term resale," to benefit from "short-term price movements," to realize "short-term arbitrage profits," or to hedge any of these.[22] "Trading account" also covers trades by banking entities that are securities dealers and swap or swap-based securities dealers—both in the United States and abroad—as well as market risk capital transactions and hedges of such transactions by banking entities that calculate such ratios under the banking agencies' Market Risk Capital Rules.[23]

Exclusions from Definition of "Proprietary Trading."

The Rule, embodied in the regulations, expressly provides that certain activities are not included in the definition of "proprietary trading," including the following:

- acquisitions or sales of financial products pursuant to a repurchase and reverse repurchase agreement;[24]
- acquisitions or sales of financial products pursuant to a securities lending agreement;[25]
- acquisitions or sales of "highly liquid" securities as part of a valid liquidity management plan, which "the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements";[26]
- various derivative clearing activities;[27]

(...continued)

company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or *any other security or financial instrument that the appropriate ... agencies ...may, by rule ... determine.*" 12 U.S.C. §1851(h)(4) (emphasis added).

21 __ C.F.R. §__.3(b)(2) reads: "The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section."

22 __ C.F.R. §__.3(b)(1)(i).

23 __ C.F.R. §§__.3(b)(1)(ii) and (iii). The OCC, FDIC, and FRB promulgated Market Risk Capital Rules on August 30, 2012, 77 Federal Register 53,060. On December 13, 2013, the FRB promulgated "technical changes" to these rules. 78 Fed. Reg. 76,521.

24 __ C.F.R. §__.3(d)(1).

25 __ C.F.R. §__.3(d)(2).

26 __ C.F.R. §§__.3(d)(3) and (4).

27 __ C.F.R. §__.3(d)(4).

- acquisitions or sales of financial products for the satisfaction of delivery obligations, such as in connection with a judicial or administrative proceeding;[28]
- acquisitions or sales of financial products "by a banking entity acting solely as agent, broker, or custodian";[29]
- acquisitions or sales of financial products while acting as a trustee for an employee compensation plan;[30] and
- acquisitions or sales of financial products in the "ordinary course of collecting a debt," as long as the products are divested "as soon as practicable."[31]

Permitted Proprietary Activities

In addition to the above exclusions from the definition of "proprietary trading," the Rule identifies exceptions to the blanket prohibition of proprietary trades by listing permitted activities and setting conditions under which those activities may be conducted.[32] However, it excludes from permitted activities any transaction or class of activities, otherwise permitted, that would involve or result in a material conflict of interest, a material exposure by the banking entity to "high-risk assets or high-risk trading strategies" as defined by the regulators, or a threat to safety and soundness of the banking entity or to the financial stability of the United States.[33] It provides standards by which the regulators may set further limits or conditions on these activities[34] and includes authority for the regulators to add to the list of permitted activities.[35] The regulators may impose additional capital and quantitative limits as "appropriate to protect the safety and soundness of banking entities engaged in such activities."[36]

Subject to those conditions, the exceptions or permitted activities are:

- **Underwriting Activities.** The statute's ban on proprietary trading does not apply to a banking entity's underwriting activities so long as its underwriting position is "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."[37] The regulations further stipulate that, to be permissible, such underwriting activities must be related to the banking entity's

[28] __ C.F.R. §__.3(d)(6).

[29] __ C.F.R. §__.3(d)(7).

[30] __ C.F.R. §__.3(d)(8).

[31] __ C.F.R. §__.3(d)(9).

[32] 12 U.S.C. §1851(d)(1).

[33] 12 U.S.C. §1851(d)(2)(A). Subsections .7(b), and (c) of the regulations provide definitions of "material conflict of interest" and "high-risk asset and high risk trading strategy." Under the definition, a "material conflict of interest" exists "if the banking entity engages in any transaction ... that would involve ... the banking entity's interests being materially adverse to the interests of its client ... and the banking entity has not taken at least one of [the following actions] [t]imely and effective disclosure,".... or [e]stablish, maintained, and enforced information barriers that are memorialized in written policies and procedures.... " __ C.F.R. §§__.7(b). A trade or asset is considered high risk if entering into or holding it, "significantly increase[s] the likelihood that the banking entity would incur substantial financial loss or would pose a threat to the financial stability of the United States." __ C.F.R. §__.7(c).

[34] 12 U.S.C. §1851(e).

[35] 12 U.S.C. §1851(d)(1)(J).

[36] 12 U.S.C. §1851(d)(3).

[37] 12 U.S.C. §1851(d)(1)(B).

role as a securities underwriter, the banking entity must have an internal compliance program, and certain other requirements must be met.[38]

- **Market Making Activities.** The statute's ban on proprietary trading does not apply to a banking entity's "market making activities, to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients.... "[39] In devising the provisions in the regulations regarding permissible market making, the agencies sought to provide covered institutions sufficient flexibility to engage in the full scope of current "market making-related activities" provided there are "clearly defined, verifiable, and monitored risk parameters."[40] The regulation's requirements include that "[t]he amount, types, and risks of the financial instruments ... are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties";[41] the banking entity "routinely stands ready to purchase and sell ... financial instruments ... in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market ... ";[42] and, that, in addition to other criteria, the banking entity has an internal compliance program.[43] Whether the goal of the agencies for flexibility sufficient to maintain robust capital markets has been achieved, particularly with respect to some specialty markets with limited participants, awaits time and experience.

- **Risk Mitigating Hedging Activities.** The statute authorizes "[r]isk-mitigating hedging activities" that are "related to individual or aggregated positions ... that are designed to reduce the specific risks to the banking entity in connection with and related to such positions.... "[44] The regulations track the language of the statute and permit "risk-mitigating hedging activities" that are "positions, contracts, or other holdings of the banking entity and designed to reduce ***specific*** risks to the banking entity in connection with and related to such ... holdings."[45] The final rule seeks to make it clear that portfolio hedging will not be permitted; banking entities will be required to document any investment undertaken as a hedge by linking it to the specific risks or exposures being offset.[46] This provision is aimed at preventing incidents like the $6 billion loss that JPMorgan & Co. suffered in 2012 as a result of derivatives trades, designed to hedge against risks of the entire financial conglomerate, which were conducted by a trader known as the London Whale and which were documented in a Senate investigation.[47]

[38] __ C.F.R. §__.4(a)(2).

[39] 12 U.S.C. §1851(d)(1)(B).

[40] 79 Fed. Reg. 5,536, 5,576.

[41] __ C.F.R. §__.4(b)(2)(B)(ii).

[42] __ C.F.R. §__4(b)(2)(B)(i).

[43] __ C.F.R. §__4(b)(2)(iii).

[44] 12 U.S.C. §1851(d)(1)(C).

[45] __ C.F.R. §__.5(a).

[46] In the preamble to the regulations, the agencies stated that they "intend to evaluate whether an activity complies with the hedging exemption under the final rule based on the totality of circumstances involving the products, techniques, and strategies used by a banking entity as part of its hedging activity." 79 Fed. Reg. 5,536, 5,528.

[47] Senate Permanent Subcommittee on Investigations, "JPMorgan Chase Whale Trades: A Case History of Derivatives (continued...)

- **Government and GSE Obligations.** The statute authorizes the purchase and sale of U.S. obligations; obligations of federal agencies; obligations of Ginnie Mae, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, Farmer Mac, and Farm Credit System institutions; and obligations of any state or political subdivision of a state.[48] Under the regulations, banking entities may purchase and sell "any municipal security" and other domestic government obligations without running afoul of the prohibition against proprietary trading.[49] Although foreign governments lobbied the financial regulators to include a similarly broad exclusion for foreign government obligations, under the final regulations, foreign banks and foreign affiliates of U.S. banks under certain circumstances will be permitted to trade foreign government obligations, but U.S. banks and U.S.-based affiliates of foreign banks generally may not.[50]
- **Fiduciary Activities.** The ban on proprietary trading does not apply to a banking entity's fiduciary activities that are conducted on behalf a customer and where the banking entity does not acquire a beneficial interest in the associated financial instruments.[51]
- **Riskless Principal Transactions.** Riskless principal transactions, where a banking entity buys or sells a financial product "to offset a contemporaneous sale or purchase" of a customer, are exempt from the Volcker Rule's ban on proprietary trading.[52]
- **Insurance Company Portfolio Investments.** The statute permits trading by insurance companies for their general accounts.[53] Under the regulation, a banking entity that is an insurance company or an affiliate of an insurance company is permitted to buy or sell financial instruments for its own account if the transaction "is conducted in compliance with, and subject to, the insurance company investments laws" of the applicable state.[54] However, the relevant federal banking regulators, in consultation with the Financial Stability Oversight Council (FSOC) and relevant state or foreign insurance regulators, may jointly proscribe otherwise permissible insurance company investment activities if the state regulation of those activities "is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States."[55]

(...continued)

Risks and Abuses," Mar. 15, 2013, available at http://www.hsgac.senate.gov/subcommittees/investigations/hearings/chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses.

48 12 U.S.C. §1851(d)(1)(A).

49 __ C.F.R. §__.6(a).

50 __ C.F.R. §__.6(b). See also *supra* n. 18.

51 12 U.S.C. §1851(d)(1)(D); __ C.F.R. §__.6(c)(1).

52 __ C.F.R. §__.6(c)(2) of the regulations. In the preamble accompanying the final regulations, the agencies indicated that any transaction conducted pursuant to the exemption for riskless principal activity must be customer-driven and may not expose the banking entity to gains (or losses) on the value of the traded instruments as principal." 79 Fed. Reg. 5,536, 5,649.

53 12 U.S.C. §1851(d)(1)(F).

54 __ C.F.R. §__.6(d).

55 __ C.F.R. §__.6(d)(3).

- **Proprietary Trading by Foreign Companies Conducted Outside the United States.** The statute authorizes investments permitted under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,[56] provided they are conducted solely outside the United States by a banking entity that is not "controlled by a banking entity organized under the laws of the United States or of one or more States."[57] The regulation also includes various other restrictions. [58] In the preamble accompanying the final regulations, the agencies stated that these conditions have been structured "to ensure that any foreign banking entity engaging in trading activity under this exemption does so in a manner that ensures the risk, decision-making, arrangement, negotiation, execution and financing of the activity resides solely outside the United States and limits the risk to the U.S. financial system from trades by foreign banking entities with or through U.S. entities."[59]
- **Other Investments.** The statute provides the agencies with discretion to permit proprietary trading for any other activity that they "determine, by rule, ... would permit promote and protect the safety soundness of the banking entity and the financial stability of the United States."[60] The agencies used this broad authority to define the scope of the permissible trading by foreign banking entities.[61]

Limitation on Relationships with Hedge Funds, Private Equity Funds, and Other "Covered Funds"

The Volcker Rule regulations broadly prohibit banking entities from, "directly or indirectly, acquir[ing] or retain[ing] any ownership interest in or sponsor[ing] a covered fund," as principal for its own account, rather for a customer.[62] Due to the customer focus of the following activities, the prohibition does not apply to holding an ownership interest in a covered fund, if the interest is acquired by a banking entity while

- "acting solely as agent, broker, or custodian," fiduciary, or trustee for a customer, as long as neither the banking entity nor its affiliates acquire a beneficial interest in the investments;
- acting as a trustee for an employee compensation plan organized for the benefit of the banking entity's current and former employees; and
- acting in the "ordinary course of collecting a debt," as long as the products are divested "as soon as practicable."[63]

[56] 12 U.S.C. §§1843(c)(3) and 1843(c)(9).

[57] 12 U.S.C. §1851(d)(1)(H).

[58] __ C.F.R. §__.6(e).

[59] 79 Fed. Reg. 5,536, 5,655.

[60] 12 U.S.C. §1851(d)(1)(J).

[61] __ C.F.R. §§__.6(e)(e)(3)(iv)(C) and (B); 79 Fed. Reg. 5,536, 5,657.

[62] __ C.F.R. §__.10(a). Under the statute, "a banking entity shall not ... acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or private equity fund" except as authorized in the statute. 12 U.S.C. §1851(a)(1)(B).

[63] __ C.F.R. §__.10(a)(2).

Definition of "Ownership Interest"

The Volcker Rule regulations broadly define "ownership interest" to mean "any equity, partnership, or other similar interest."[64] A banking entity's ownership interest in a covered fund will be considered an "other similar interest" if the banking entity has any of the following:

1. any control over the removal or hiring of a covered fund's managers, directors, or investment advisors, except when exercising creditor rights upon a default or acceleration trigger;
2. a right to share in a covered fund's "income, gains, or profits";
3. a right, other than rights as a creditor upon a default or acceleration trigger, to a covered fund's assets "after all other interests have been redeemed and/or paid in full";
4. a "right to receive all or a portion of excess spread" of a covered fund;
5. a duty to pay a covered fund for the ownership interest that could be reduced based on lower interest rates owed on such ownership interest or as a result of a loss in value of the fund's assets;
6. any earnings of pass-through income from the covered fund or of income that varies in accordance with the value of the covered fund's assets; or
7. "any synthetic right to have, receive, or be allocated any of the rights in [1-6]."[65]

The regulations state that, under certain circumstances, "restricted profit interests" held by a banking entity or one of its current or former employees that served as a trading or investment advisor, manager, or similar service provider is not considered an ownership interest for the purposes of the Volcker Rule.[66]

This broad definition of ownership interest, in particular the provision involving the control to hire or remove advisors, managers, and directors, has caused some consternation among banking entities.[67] For example, as a result of the definition of ownership, certain collateralized debt obligations (CDO) backed by trust preferred securities (TruPS), a type of financial instrument that many banking entities, particularly community banks, used as a way to raise capital, generally was a prohibited investment under the original Volcker Rule regulations, and thus would have to be divested.[68] The American Bankers Association and several community banking organizations promptly filed a lawsuit challenging this aspect of the financial regulators' interpretation of the Volcker Rule.[69] The financial regulators responded by issuing an interim final rule on January 14,

[64] __ C.F.R. §__.10(d)(6)(i).

[65] __ C.F.R. §__.10(d)(6)(i)(A)-(G).

[66] __ C.F.R. §__.10(d)(6)(ii)

[67] See, e.g., Joel Rosenblatt, *Volcker Rule Challenged in U.S. Court by Bank Group*, Blooomberg, Dec. 25, 2013, available at http://www.bloomberg.com/news/2013-12-25/volcker-rule-challenged-in-u-s-court-by-bank-industry-group.html.

[68] For more information on this topic, see CRS Legal Sidebar WSLG785, Financial Regulators Issue Volcker Companion Rule Providing Exemption for Certain Trust Preferred Securities Investments and Sponsorships, by David H. Carpenter and CRS Report IF00007, *Trust Preferred Securities (TruPS) (In Focus)*, by Edward V. Murphy.

[69] *Am. Bankers Assoc. v. Fed. Deposit Ins. Corp.*, Complaint, available at http://www.aba.com/Issues/Documents/12-24-13ABAComplaintforDeclaratotryandInjunctiveReliefonVolckerRule.pdf. The plaintiffs argue that the financial (continued...)

2014, that will serve as a companion to the December 10 Volcker Rule regulations, establishing terms and conditions by which banking entities will be permitted to continue to hold interests in and sponsor a CDO (or similar investment vehicle) backed by TruPS.[70] Shortly after the regulators issued the interim final rules, the plaintiffs withdrew their lawsuit.[71]

While the focus of the interim final rule is on TruPS issued and held by community banking organizations, similar issues likely exist regarding the applicability of the Volcker Rule to securities, issued and held by banking entities both large and small, that are backed by other types of debts, such as commercial paper, automobile loans, and mortgages.[72]

Definition of "Covered Fund"

The Volcker Rule regulations define "covered fund" to largely encompass entities that are exempt from various registration requirements with either the SEC or CFTC, as well as certain foreign funds.[73] More specifically, the term includes

- issuers that rely on Investment Company Act of 1940 Sections 3(c)(1) or 3(c)(7) to avoid being considered investment companies for the purpose of that law; [74]
- commodity pools that have an exempt status under CFTC Rule 4.7;[75]
- CFTC-registered commodity pools, whose participation units are substantially owned by and only offered to certain "qualified eligible persons" in accordance with CFTC regulations;[76] and
- foreign-based funds that raise money to sell or invest in securities and whose ownership interests are offered and sold exclusively outside the U.S., that either are sponsored by a banking entity or have ownership interests held by a banking entity, unless such funds could qualify for an exemption, other than exemptions under Section 3(c)(1) or Section 3(c)(7), from the Investment Company Act of 1940 if such funds were subject to U.S. securities laws.[77]

(...continued)

regulators exceeded their statutory authority by interpreting the Volcker Rule's proscription on investments and sponsorships of covered funds to include TruPS CDOs; by deviating so far from the proposed rule in its relevant definitions, the financial regulators violated the notice-and-comment requirements of the Administrative Procedure Act; and the regulators failed to take into account the costs of the regulations on community banking organizations as the Dodd-Frank Act requires. *Id*.

[70] *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities*, Interim Final Rule, Jan. 14, 2014, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114b1.pdf. The interim final rule is effective on the same date as the December 10 final rules—April 1, 2014.

[71] *ABA to Drop Lawsuit On Volcker Rule TruPS Provision*, Am. Bankers Assoc'n Press Release, Feb. 12, 2014, available at http://www.aba.com/Press/Pages/021214ABAtoDropVolckerLawsuit.aspx.

[72] See, e.g., *SIFMA and Other Associations Submit Additional Comments to US Federal Regulators on Ownership Interests in Connection with Certain CLO Debt Securities*, Sec. Indus. Fin. Markets Assoc'n, Mar. 13, 2014., available at http://www.sifma.org/issues/item.aspx?id=8589946766.

[73] __ C.F.R. §__.10(b).

[74] __ C.F.R. §__.10(b)(1)(i).

[75] __ C.F.R. §__.10(b)(1)(ii)(A). CFTC Rule 4.7 is 17 C.F.R. §4.7.

[76] __ C.F.R. §__.10(b)(i)(ii)(B).

[77] __ C.F.R. §__.10(b)(1)(iii).

Exclusions from the Definition of "Covered Fund"

The rule explicitly excludes a number of activities and products from the "covered fund" definition.[78] These exclusions include the following:

- **Foreign Public Funds.** Issuers that are not organized or established in the United States that "issue ownership interests to retail investors in [their] home jurisdiction" and such interests are sold "predominantly through one or more public offerings outside of the United States." This exemption only applies if "the ownership interests in the issuer are sold predominately to persons other than such sponsoring banking entity, such issuer," and their affiliates, directors, and employees.[79]
- **Wholly Owned Subsidiaries.** Entities that are directly or indirectly owned entirely[80] by the banking entity or one of its affiliates.
- **Joint Ventures.** Joint ventures between a banking entity or its affiliates and up to ten unaffiliated entities, as long as the venture is not raising money primarily by investing or trading in securities.[81]
- **Merger and Acquisition Vehicles.** Issuers established for the sole purpose of effectuating "a bona fide merger or acquisition."[82]
- **Foreign Retirement and Pension Funds.** Retirement or pension funds that are organized in, subject to regulation in, and provide benefits to residents or citizens of a foreign jurisdiction.[83]
- **Separate Insurance Accounts.** "A separate account, provided that no banking entity other than the insurance company participates in the account's profits and losses."[84]
- **Separate Life Insurance Accounts.** A separate account established for a banking entity (or multiple banking entities) to acquire life insurance policies for its benefit so long as the banking entity does not control the account's investment decisions and does not have an interest in the account's profits and losses except as permitted by regulatory guidance.[85]
- **Certain Asset-Backed Securitizations.** Issuers of certain asset-backed securitizations, including certain loans, foreign exchange derivatives, and interest

[78] __ C.F.R. §__.10(c).

[79] __ C.F.R. §__.10(c)(1).

[80] The regulations provide that up to five percent of ownership in the entity may be held by current or former employees or directors of the banking entity or its affiliates and up to half of one percent of ownership in the entity may be held by a third party "for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns." __ C.F.R. §__.10(c)(2).

[81] __ C.F.R. §__.10(c)(3).

[82] __ C.F.R. §__.10(c)(4).

[83] __ C.F.R. §__.10(c)(5).

[84] __ C.F.R. §__.10(c)(6).

[85] __ C.F.R. §__.10(c)(7).

rate derivatives, but generally excluding debt and equity securities, subject to various terms and conditions.[86]

- **Certain Asset-Backed Commercial Paper Conduits.** Issuers of an asset-backed commercial paper conduit "that issues only asset-backed securities comprised of a residual interest and securities with a legal maturity of 397 days or less," and that meet other conditions.[87]
- **Covered Bonds Vehicles.** Funds holding a pool of loans or certain other permissible assets "for the benefit of holders of covered bonds," which are issued or guaranteed by a foreign banking organization.[88]
- **Smaller Business Investment Companies (SBICs) and Other Public Welfare Investment Funds.** Small business investment companies and similar companies organized "to make investments [d]esigned primarily to promote the public welfare" or investments in certain qualified historic tax credit programs.[89]
- **Registered Investment Companies and Business Development Companies (BDCs).** Issuers registered under the Investment Company Act of 1940 and business development companies regulated by the SEC as business development companies and seeding vehicles intending to be registered investment companies or business development companies.[90]
- **FDIC Conservatorship or Receivership.** Issuers organized "to facilitate the disposal of assets acquired in the FDIC's capacity as a conservator or receiver [of a depository institution or non-bank financial institution supervised by the FRB]."[91]
- **Other Investments.** Any issuer that the federal financial regulators jointly determine to be excluded.[92]

Permitted Covered Fund Investments and Activities

In addition to outright exclusions from the definition of "covered fund," the Rule expressly exempts certain activities that otherwise would fall under the general prohibition against

[86] __ C.F.R. §__.10(c)(8).

[87] __ C.F.R. §__.10(c)(9).

[88] __ C.F.R. §__.10(c)(10). For more information on covered bonds, see CRS Report R41322, *Covered Bonds: Background and Policy Issues*, by Edward V. Murphy.

[89] __ C.F.R. §__.10(c)(11). This exclusion covers certain investments in Low Income Housing Tax Credit funds, certain Community Reinvestment Act-eligible investments, and certain Renewable Energy Investment Company funds. 79 Fed. Reg. 5,698 ("The Agencies believe that providing this exclusion will also allow banking entities to continue to provide capital to community-improving projects and in some instances promote capital formation.").

[90] __ C.F.R. §__.10(c)(12). According the preamble issued with the final regulations, "[t]he Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which *are* regulated by the SEC as investment companies.... The Agencies also recognize that an entity that becomes a registered investment company or business development might, during its seeding period, rely on section 3(c)(1) or 3(c)(7) ... [and] have determined to exclude these seeding vehicles from the covered fund definition." 79 Fed. Reg. 5,536, 5,699 (emphasis in original).

[91] __ C.F.R. §__.10(c)(13).

[92] __ C.F.R. §__.10(c)(14).

sponsoring or investing in a covered fund, subject to specified terms and conditions. However, even if a banking entity acquires an investment in or sponsorship of a covered fund that meets one of the permissible exceptions described below, it could still be barred by the Volcker Rule if it results in: "a material conflict of interest"; "a material exposure by the banking entity to high-risk assets or high-risk trading strategies" as defined by the regulators; or "a threat to the safety and soundness of [the] banking entity ... or to the financial stability of the United States."[93]

The Rule also provides standards by which the regulators may set further limits or conditions on these permissible activities[94] and includes authority for the regulators to add to the list of permitted activities.[95] The regulators may impose additional capital and quantitative limits as "appropriate to protect the safety and soundness of banking entities engaged in such activities."[96]

De Minimis Investments in Covered Funds

Banking entities, subject to certain limitations, are permitted to make and retain *de minimis* investments in covered funds, which are subject to both per fund and aggregate caps.[97]

Per Fund *De Minimis* Cap. A *de minimis* investment made by a banking entity and its affiliates must "not exceed 3 percent of the total number or value of the outstanding ownership interests of the fund," unless the banking entity, in the context of investing in an asset-backed securities issuer, is required to acquire a greater percentage to comply with the credit risk retention requirements of Section 15G(a)(3)[98] of the Exchange Act.[99] The Rule establishes various methods for calculating per fund *de minimis* investment caps based on the type of fund in question (i.e., asset-backed securities issuer, feeder funds, fund-of-funds, and all other types of covered funds).[100]

Aggregate *De Minimis* Cap. The total ownership interests in covered funds by a banking entity and its affiliates "may not exceed 3 percent of the tier 1 capital of the banking entity."[101] For those banking entities that must report tier 1 capital levels to appropriate banking regulators in accordance with other law, the calculation will remain the same for the purposes of the Volcker Rule. However, the final regulations establish how tier 1 capital should be calculated for those banking entities that are not otherwise required to maintain and report capital levels.[102]

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[93] __ C.F.R. §__.15(a). See also 12 U.S.C. §1851(d)(2).

[94] 12 U.S.C. §1851(e).

[95] For example, 12 U.S.C. §1851(d)(J) provides the regulators with authority to add to the list of permitted activities through rulemaking "[s]uch other activity as ... would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."

[96] 12 U.S.C §1851(d)(2).

[97] 12 U.S.C. §1851(d)(4); __ C.F.R. §__.12.

[98] 15 U.S.C. §78o-11. This subsection was included to give effect to Section 941 of the Dodd-Frank Act, 15 U.S.C. §78-o-11, which requires banking entities to retain a certain minimum interest in certain asset-backed securities. 79 Fed. Reg. 5,536, 5,720. "The Agencies believe that the requirements of the exemption ... provide limitations on a banking entity's securitization activities involving covered funds that are consistent with the limitations imposed with respect to organizing and offering a covered fund that is not an issuing entity of asset-backed securities." Id. at 5,671.

[99] __ C.F.R. §__.12(a)(ii).

[100] __ C.F.R. §__.12(a)(ii).

[101] 12 U.S.C. §1851(d)(4); __ C.F.R. §__.12(a)(iii).

[102] __ C.F.R. §__.12(c)(2).

Initial "Seed" Investments to Establish Covered Funds

Banking entities are permitted to make initial seed investments to establish covered funds and help make them become attractive investments for unaffiliated third parties, but to do so they must: actively work to replace their investments with that of unaffiliated third parties; comply with the ***aggregate*** *de minimis* investment requirements; and generally within one year of the establishment of the covered fund, be in compliance with the ***per fund*** *de minimis* investment cap. Upon an application by a banking entity, the FRB may provide up to two additional years to conform with the per fund *de minimis* cap if such an extension "would be consistent with safety and soundness and not detrimental to the public interest."[103]

Additionally, certain SEC-registered business development companies, investment companies, and foreign public funds, which generally are excluded from the definition of "covered fund" as described above, will not be considered an affiliate of a banking entity for the purposes of the *de minimis* seed investment limits if the banking entity

> (1) Does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or fund; and
>
> (2) Provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund.... "[104]

Organizing and Advising Covered Funds in Connection with Fiduciary or Trust Services

The Volcker Rule authorizes banking entities to acquire ownership interests in, sponsor, organize, and offer covered funds to the extent that (1) the banking entity provides "bona fide trust, fiduciary, or investment advisory services"; (2) "the fund is organized and offered only in connection with bona fide trust, fiduciary, or investment advisory services to persons that are customers of such services of the banking entity"; (3) the banking entity retains only a *de minimis* interest in the funds; (4) the banking entity and its affiliates engage in no transaction with the fund that would be designated as a "covered transaction" under Federal Reserve Act (FRA) Section 23A and other transactions with the fund are conducted only on terms specified in FRA Section 23B, as if the banking entity were a member bank and the fund an affiliate of that bank;[105] (5) the banking entity does not guaranty the obligations of the covered fund; (6) the covered fund does not have the word "bank" in its name or share a name with the banking entity; (7) no director or employee of the banking entity, other than those directly engaged in providing investment advisory or other services to the covered fund, acquires an interest in the fund; and (8) the banking entity takes certain steps to assure the investors in the covered fund that losses of the fund will be borne solely by its investors.[106]

[103] __ C.F.R. §__.12(a)(2)(i).

[104] __ C.F.R. §__.12(b)(1)(ii).

[105] For a more detailed discussion of FRA §233A and 23B, see the "Affiliations Restrictions with Covered Funds" section of this report.

[106] 12 U.S.C. §1851(d)(1)(G); __ C.F.R. §__.11(a).

Investing in, Sponsoring, Organizing, and Offering Asset-Backed Securities Issuers

The Volcker Rule allows banking entities to act as a securitizer or, in accordance with the credit risk retention requirements of Section 15G(a)(3)[107] of the Exchange Act, to hold investments in a covered fund that is an issuer of asset-backed securities so long as (1) the banking entity retains only a *de minimis* interest in the funds;[108] (2) the banking entity and its affiliates engage in no transaction with the fund that would be designated as a covered transaction under FRA Section 23A and other transactions with the fund are conducted only on terms specified in FRA Section 23B, as if the banking entity were a member bank and the fund an affiliate of that bank;[109] (3) the banking entity does not guaranty the obligations of the covered fund; (4) the covered fund does not have the word "bank" in its name or share a name with the banking entity; (5) no director or employee of the banking entity, other than those directly engaged in providing investment advisory or other services to the covered fund, acquires an interest in the fund; and (6) the banking entity takes certain steps to assure the investors in the hedge fund or private equity fund that losses of the fund will be borne solely by its investors.[110]

Underwriting and Market Making for Covered Funds

Although not explicitly excepted by the statute, pursuant to the regulations, banking entities generally may engage in underwriting and market making activities for covered funds so long as they meet the same terms and conditions necessary to comply with the exceptions for underwriting and market making from the ban on proprietary trading.[111] According to the preamble to the final regulations,

> [t]he Agencies believe that providing a separate provision relating to permitted underwriting and market making-related activities for ownership interests in covered funds is supported by [12 U.S.C. §1851(d)(1)(B)]. The exemption for underwriting and market making-activities ... by its terms, is a statutorily permitted activity and exemption from the prohibitions in [12 U.S.C. §1851(a)], whether on proprietary trading or on covered fund activities.[112]

For underwriting activities, the requirements include that the positions must relate to the banking entity's role as a securities underwriter; a banking entity's underwriting positions must be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"; and it must have an internal compliance program. For market making activities, the requirements include that the banking entity "routinely stands ready to purchase and sell ... financial instruments ... in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market ... "; its market making positions must be "designed not to exceed the reasonably expected near term demands of clients,

[107] 15 U.S.C. §78o-11. See also *supra* n. 98.

[108] For a more detailed discussion of permissible *de minimis* investments in covered funds, see the "*De Minimis* Investments in Covered Funds" section of this report.

[109] For a more detailed discussion of FRA §233A and 23B, see the "Affiliations Restrictions with Covered Funds" section of this report.

[110] __ C.F.R. §__.11(b).

[111] 12 U.S.C. §1851(d)(1)(B);__ C.F.R. §__.11(c), incorporating by reference subsections __.4(a) or __.4(b) relating to the underwriting and market-making exceptions to the prohibition on proprietary trading

[112] 79 Fed. Reg. 5,536, 5,722.

customers, or counterparties"; and the banking entity must have an internal compliance program.[113]

Additionally, any ownership interest acquired by a banking entity conducting underwriting or market making activities with a covered fund must be included in both the per fund and aggregate *de minimis* investment cap calculations discussed above.[114]

Hedging

Similar to the exemption from the ban on proprietary trading, banking entities are permitted to take ownership stakes in covered funds for hedging purposes subject to important limitations. Such acquisitions are only permissible to the extent that they are "designed to demonstrably reduce or otherwise significantly mitigate the ***specific, identifiable*** risk to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund."[115] The limitation to "specific, identifiable risk[s]" appears to prohibit portfolio hedging akin to the JPMorgan London Whale trades discussed in the Proprietary Trading section above. Additionally, banking entities must have written internal programs in place to ensure that hedges comply with the Volcker Rule both at the time of acquisition, as well as through the life of the investment.[116]

Foreign Activities

Banking entities that are organized in a foreign country and are not controlled, either directly or indirectly, by a U.S.-based banking entity may be exempt from the Volcker Rule's restrictions on investments in covered funds if several other terms and conditions are met, including that the investments in the covered fund are not held by or offered to U.S. residents, all associated activities with and investments in the covered fund are conducted outside of the U.S., and generally the majority of the banking entity's overall business takes place in a foreign country.[117]

Insurance Activities

Insurance companies and their affiliates generally may sponsor or acquire ownership interests in covered funds if those interests are retained solely for the insurance company's or its affiliate's own account and the company is subject to, and such investments comply with, a state insurance regulatory regime, unless the federal banking regulators jointly determined that the state law permitting such investments "is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States."[118]

[113] __ C.F.R. §__.11(c).

[114] __ C.F.R. §__.11(c)(3).

[115] __ C.F.R. §__.13(a)(1) (emphasis added); see also 12 U.S.C. §1851(d)(1)(C).

[116] __ C.F.R. §__.13(a).

[117] 12 U.S.C. §1851(d)(1)(l); __ C.F.R. §__.13(b).

[118] 12 U.S.C. §1851(d)(1)(F); __ C.F.R. §__.13(c). According to the preamble accompanying the final regulations, "[t]he Agencies believe that exempting insurance activities and investments from the covered fund restrictions is supported by the language of [12 U.S.C. §§1851(d)(1)(D) and (F)], and more fully carries out Congressional intent and statutory purpose of appropriately accommodating the business of insurance within an insurance company." 79 Fed. (continued...)

Affiliation Restrictions with Covered Funds

Except as otherwise permitted under one of the exceptions to the covered fund investment prohibition described above and for certain prime brokerage transactions, banking entities and their affiliates that provide advisory or investment management services to or hold a permissible interest in a covered fund are prohibited from entering into a transaction that would be considered a "covered transaction" for the purposes of FRA Section 23A with the covered fund.[119] Additionally, any permissible transactions between covered funds and banking entities and their affiliates must be entered into in accordance with the "arms-length" requirements of FRA Section 23B.[120]

Other General Provisions

Anti-Evasion Provisions: Compliance Program, Reports, and Recordkeeping Requirements

The statute requires the federal financial regulators to issue regulations to "insure compliance with [Section 619]."[121] In response, the final regulations require banking entities to develop and maintain compliance programs, internal controls, and recordkeeping systems to control and monitor the risk of trading and investment activities.[122] Compliance requirements vary in accordance with the size of the banking entity, as well as the scope, complexity, and types of trading and investment activities.

Banking entities conducting no proprietary trading activity (other than trading of federal, agency, or state and local obligations) and having no investments in covered funds are not required to develop a Volcker Rule-specific compliance program but must do so if they begin to conduct such activities.[123] Similarly, banking entities with total assets below $10 billion may fold Volcker Rule compliance measures into existing compliance programs.[124] The standard compliance requirements, which are set forth in Appendix A to the regulations,[125] apply to banking entities with assets of $10 billion[126] or more and for those banking entities that otherwise are required to

(...continued)

Reg. 5,536, 5,744.

[119] 12 U.S.C. §1851(f); __ C.F.R. §__.14. This is a more stringent application of FRA §23A (12 U.S.C. §371c) than applies to member banks and their affiliates, which are permitted to engage in "covered transactions" under specifications set forth in FRA §23A.

[120] 12 U.S.C. §1851(f); __ C.F.R. §__.14. FRA §23B (12 U.S.C. §371c-1) prescribes conditions under which member banks may conduct transactions with affiliates, directly or indirectly.

[121] 12 U.S.C. §1851(e).

[122] __ C.F.R. §__.20

[123] __ C.F.R. §__.20(f)(1).

[124] __ C.F.R. §__.20(f)(2).

[125] __ C.F.R. §§__.20(d); App'x A.

[126] Banking entities with $50 billion or more in assets on June 30, 2014, $25 billion or more in assets on April 30, 2016, and $10 billion or more in assets as of December 31, 2016 must comply with the reporting requirements of Appendix A. __ C.F.R. §__.20(d).

do so by the financial regulators.[127] In addition to complying with the standard compliance program, banking entities with assets of $50 billion or more are subject to Enhanced Minimum Standards, which are set forth in Appendix B to the regulations.[128]

The standard compliance program includes requirements for (1) written policies and procedures documenting compliance and verifying exemptions, (2) internal control systems, (3) management frameworks, (4) independent testing and review, (5) personnel training, and (6) recordkeeping.[129] For banking entities subject to the standard compliance program, the final regulations also require and establish methods of calculating quantitative measurements that banking entities must furnish for seven aspects of each trading desk: (1) risks and position limits and usage, (2) risk factor sensitivities, (3) value-at-risk and stress value-at-risk, (4) position limits and usage, (5) comprehensive profit and loss attribution, (6) inventory turnover and aging, and (7) customer facing trade ratio.[130]

Appendix A sets forth non-exclusive recordkeeping and reporting requirements,[131] including quantitative metrics, for banking entities with “significant trading assets and liabilities.”[132] The preamble to the final regulations make clear, however, that these are not safe harbors for banking entities, but that, helpful as these metrics may be, “banking entities [must ensure] that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within the risk tolerances established by the banking entity, and to monitor for compliance with proprietary trading restrictions in the proposed rule.”[133]

The Enhanced Minimum Standards include instructions as to the specific ingredients of the entity’s policies and procedures applicable to its trading desks and to its covered fund activities or investments. For the trading desks of banking entities that are subject to the heightened compliance program, there are specific requirements regarding how the trading desk “identif[ies], authoriz[es], and document[s] financial instruments to be purchased or sold”; “types and amounts of risks allocated” to each trading desk; how those risks will be measured; why those risks are appropriate; “the process for setting new or revised limits”; “the process for identifying, documenting and approving new products, trading strategies, and hedging strategies”; types of permissible customers and counterparties; and compensation arrangements.[134] There are also provisions on describing the firm’s risks and risk management process; how it authorizes risks, specific instruments, and products; what its hedging policies and procedures are; the specifics of its analytical policies and procedures and quantitative measurements; as well as how it will remediate violations.[135]

127 __ C.F.R. §__.20(d).

128 __ C.F.R. §§__.20(b); App’x B.

129 __ C.F.R. §__, App’x A.

130 __ C.F.R. §__, App’x A, IV.

131 Appendix A makes it clear that the measurements in the appendix are not intended to be dispositive of whether or not activities are permissible, that the agencies will review the data from the reports and records and perhaps revise requirements.

132 __ C.F.R. §__, App’x A, I.

133 79 Fed. Reg. 5,536, 5,561.

134 __ C.F.R. §__, App’x B, II.A.

135 __ C.F.R. §__, App’x B, II.A.

For covered fund activities or investments, the Enhanced Minimum Standards requirements include management involvement in reviewing and testing the identification and documentation of all covered funds sponsored or organized by components of the organization; identification of the lines of authority with respect to such funds; explanations of monitoring for and prohibition of material conflicts of interest, threats to safety and soundness, or exposure to high-risk assets or trading strategies; documentation of plans for seeking unaffiliated investors to meet investment limits; board of director and senior management involvement; and CEO attestation.[136]

Divestiture of Nonconforming Activities

Generally, the regulations require any banking entity engaging in any activity or making an investment in violation of the Volcker Rule to terminate the activity and divest the investment promptly.[137] They also authorize the agencies to "take any action permitted by law to enforce compliance ..., including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment."[138]

The statute generally requires divestiture of nonconforming activities within two years of the Rule becoming effective and provides the FRB with authority to extend this two-year period one year at a time, not to exceed an aggregate of three years.[139] Under the FRB's recent extension, the conformance date is July 21, 2015.[140] This means that a company that was a banking entity or a subsidiary or affiliate of a banking entity on July 21, 2010, must bring its activities into conformance before July 21, 2015. For a company that was not a banking entity or a subsidiary or affiliate of a banking entity on that date, conformance is required before the later of July 21, 2015, or two years after the date on which the company becomes a banking entity or a subsidiary or an affiliate of a banking entity. A company becoming a banking entity on July 21, 2015, thus, would have two years, until July 21, 2017, to conform its activities and investments.[141]

Good Faith Efforts

Banking entities are expected to engage in good faith efforts to be in compliance with the rules by July 21, 2015, by not expanding covered activities or expecting more time to conform, developing an appropriately specific conformance plan, and immediately terminating any stand-alone proprietary trading operations. During the conformance period, banking entities with

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136 __ C.F.R. §__, App'x B, II.B.

137 __ C.F.R. §__.21(a).

138 __ C.F.R. §__21(b).

139 12 U.S.C. §1851(c)(2).

140 12 C.F.R. §§225.180 – 182. On February 14, 2011, the FRB issued a regulation taking advantage of the statutory provision permitting a two-year conformance period until July 21, 2014. *Conformance Period for Entities Engaged in Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, 76 Fed. Reg. 8,265 (February 14, 2011). On December 31, 2013, the FRB extended the conformance period for an additional one year, setting July 21, 2015 as the general conformance date. Order Approving Extension of the Conformance Period, Federal Reserve System, Dec. 10, 2013, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

141 Order Approving Extension of the Conformance Period, Federal Reserve System, at. 3, n.4, Dec. 10, 2013 (citing 76 Fed. Reg. 8,265 (Feb. 14, 2011)).

significant trading operations will remain subject to the data reporting and recordkeeping requirements of the Rule that are discussed in the previous section of this report.[142]

Illiquid Funds

The July 15, 2015, conformance date may be extended by the FRB for one-year periods, not to exceed two additional years.[143] In addition to a two-year extension, if a banking entity is required by contract[144] to take or retain its ownership interest in, or provide additional capital to, an illiquid fund, the entity may apply to the FRB for an extension which may be granted for no more than five years; at the end of which divestiture would be required either at the end of the five years or on the contractual date—whichever is earlier.[145]

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[142] Order Approving Extension of the Conformance Period, Federal Reserve System, at. 3

[143] 12 U.S.C. §1851(c)(2).

[144] The contract must have been in legal effect no later than May 1, 2010.

[145] 12 U.S.C. §1851(c)(3).