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Financial Services & Products ADVISORY ■

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Summary of the Final Rule Implementing the Volcker Rule

On December 10, 2013, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "Agencies") each adopted a final rule (the "Final Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the "Volcker Rule."[1] The long-anticipated Final Rule was adopted over two years after the proposed rule was released, for which about 18,000 comment letters were received.

This advisory provides a high-level summary of the Final Rule only, and does not purport to be a complete explication of all of the details contained therein. The Final Rule is highly complex, reflecting 71 pages of rules and approximately 900 pages of supplemental materials (with over 2800 footnotes) from five different regulatory agencies, each of which has discretion to interpret the Final Rule. There will be numerous interpretive questions to be resolved by the Agencies in regulatory commentary, Q&A, bulletins, examination guidance and other releases going forward. Thus, banking entities engaged in, or wishing to engage in, activities potentially subject to the Final Rule should consult with their regular Alston & Bird lawyer or one of the lawyers listed at the end of this advisory to help assess particular concerns.

Broadly, the Final Rule prohibits banking entities[2] from (i) engaging in "proprietary trading" or (ii) acquiring or retaining an ownership interest in, sponsoring or having certain relationships with "covered funds."

Compliance requirements under the Final Rule, which will become effective on April 1, 2014, are staged over time. The Volcker Rule itself became effective on July 21, 2012, and provided for a two-year "conformance period" for banking entities to conform their proprietary trading and covered funds activities. However, when the Final Rule was adopted, the Federal Reserve extended the conformance period one year to July 21, 2015.[3] Good faith efforts to unwind clearly impermissible activities should begin immediately, and required implementation of data reporting and recordkeeping requirements applicable to certain banking entities come into play soon after the effective date of the Final Rule.

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1 The Final Rule is available at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

2 The term "banking entity" includes (i) any insured depository institution or any company controlling an insured depository institution; (ii) any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 and (iii) any affiliate or subsidiary of (i) or (ii).

3 The Final Rule permits additional extensions to be granted in certain circumstances.

While understanding of the nuances of the Final Rule will continue to emerge over time, it is recommended that banking entities begin to perform a gap analysis of their compliance with the Final Rule now to ensure adequate lead time for conformance of any impermissible activities and to ensure that appropriate governance, compliance programs and supporting information technology and reporting systems are implemented.

Proprietary Trading

The Volcker Rule generally prohibits banking entities from engaging in "proprietary trading," which is defined as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."

"Financial instruments" include any security, derivative, contract of sale of a commodity for future delivery or option on any of the foregoing. "Financial instruments" do not include loans, foreign exchange or currency, or commodities that are not (i) "excluded commodities," (ii) derivatives or (iii) contracts of sale of commodities for future delivery (or options on such contracts of sale).

A "trading account" is any account used by a banking entity to:

i. purchase or sell one or more financial instruments principally for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions resulting from any of the foregoing purchases or sales (Note: the purchase or sale of a financial instrument by a banking entity that is held for less than 60 days is presumed to be for the banking entity's trading account unless the banking entity can demonstrate that the position was not purchased or sold for any of these purposes);

ii. purchase or sell one or more financial instruments that are both covered positions and trading positions (or hedges of other covered positions) under the "market risk capital rule" applicable to certain larger banking entities; or

iii. purchase or sell one or more financial instruments for any purpose if the banking entity is required to be licensed or registered to engage in the business of a dealer, swap dealer or security-based swap dealer, or is engaged in such business outside of the United States, to the extent the instrument is purchased or sold in connection with such activities.

As with any good rule, there are always exceptions. The Final Rule provides that certain activities are by definition not "proprietary trading." In addition, the Final Rule provides express exemptions for proprietary trading that constitutes "underwriting," "market making," "risk-mitigating hedging" or other permitted activities if certain criteria are met. However, no transaction or activity may be deemed exempt from the Final Rule's general prohibition on proprietary trading if the transaction or activity would (i) involve or result in a "material conflict of interest" between the banking entity and its clients, customers or counterparties (without providing "timely and effective disclosures" or establishing "information barriers"); (ii) result, directly or indirectly, in a material exposure by the banking entity to a "high-risk asset" or a "high-risk trading strategy" or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Activities Excluded from the Definition of "Proprietary Trading"

The Final Rule lists certain activities that do not constitute "proprietary trading" by definition. Subject to certain more detailed criteria contained in the Final Rule, these activities broadly include the following:

i. certain financial instrument transactions under repurchase or reverse repurchase agreements;

ii. certain financial instrument transactions under securities lending agreements;

iii. certain financial instrument transactions for the purpose of liquidity management pursuant to a liquidity management plan meeting certain requirements;

iv. any purchase or sale of financial instruments by a banking entity that is a "derivatives clearing organization" or a "clearing agency" in connection with clearing financial instruments;

v. any "excluded clearing 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;"

vi. any purchase or sale of financial instruments satisfying any existing delivery obligation in connection with delivery, clearing or settlement activities, or an obligation arising from any judicial, administrative, self-regulatory organization or arbitration proceeding;

vii. any purchase or sale of financial instruments by a banking entity acting solely as agent, broker or custodian;

viii. any purchase or sale of financial instruments through a deferred compensation, stock-bonus, profit-sharing or pension plan if the purchase or sale is made by a banking entity as trustee for the benefit of current or former employees of the banking entity; and

ix. any purchase or sale of financial instruments in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable within an Agency-prescribed period.

Underwriting Activities

The general prohibition on proprietary trading expressly does not apply to a banking entity's underwriting activities, provided that:

i. the banking entity is acting as an "underwriter" for a "distribution" of securities and the "trading desk's" "underwriting position" is related to such distribution;

ii. the amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near-term demands of "clients, customers or counterparties," and reasonable efforts are made to sell or otherwise reduce the underwriting position in the context of the market for the security;

iii. the banking entity establishes, implements, maintains and enforces an internal compliance program meeting the Final Rule's requirements;

iv. compensation arrangements are designed not to reward or incentivize prohibited proprietary trading; *and*

v. the banking entity is licensed or registered to engage in the underwriting activity.

Market-Making Activities

The general prohibition on proprietary trading also expressly does not apply to a banking entity's market-making-related activities, provided that:

i. the relevant trading desk routinely stands ready to purchase and sell financial instruments related to its financial exposure and is willing and available to quote, purchase and sell in commercially reasonable amounts and throughout market cycles on a basis appropriate to the relevant market;

ii. the financial instruments in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties based on (a) the relevant market and (b) a demonstrable analysis of historical and anticipated customer demand, current inventory of financial instruments and other factors;

iii. the banking entity has established and implements, maintains and enforces an internal compliance program meeting the Final Rule's requirements;

iv. to the extent certain trading limits are exceeded, the trading desk takes action to comply as promptly as possible after the limit is exceeded;

v. the compensation arrangements of persons performing the market-making-related activities are designed not to reward or incentivize prohibited proprietary trading; and

vi. the banking entity is licensed or registered to engage in the market-making-related activity.

Risk-Mitigating Hedging Activities

In addition, the general prohibition on proprietary trading expressly does not apply to certain risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts or other holdings that are designed to reduce specific risks to the banking entity in connection with and related to such positions, contracts or other holdings. The Final Rule contains numerous very specific requirements that must be met in order for risk-mitigating hedging activities to be permissible, including but not limited to the following:

i. the banking entity has established and implements, maintains and enforces an internal compliance program that complies with the Final Rule;

ii. the activity is designed to (*and demonstrably does*) reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts or other holdings of the banking entity;

iii. the activity does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously;

iv. the activity is subject to continuing review, monitoring and management; *and*

v. the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.

Overall, the Final Rule sets a high standard for banking entities to meet in order to qualify for the risk-mitigating hedging exemption, particularly regarding documentation requirements applicable to hedging activities not executed by and for positions of the same trading desk under its unique policies and procedures.

Other Permitted Activities

Subject to certain criteria, the Final Rule also exempts the following activities from the general prohibition on proprietary trading:

i. trading in domestic government obligations such as U.S. Treasuries, GSE securities, municipal securities and obligations of the FDIC;

ii. trading in foreign government obligations;

iii. trading on behalf of customers in a fiduciary capacity or as riskless principal;

iv. trading by a regulated insurance company solely for a general or separate account and as permissible under applicable state law; and

v. certain permitted trading activities of foreign banking entities conducted outside of the United States.

Covered Funds Activities and Investments

The Volcker Rule generally prohibits banking entities from, as principal, directly or indirectly acquiring or retaining any "ownership interest" in, or "sponsoring," a "covered fund."

An "ownership interest" is broadly defined to include any equity, partnership or "other similar interest," but excludes certain "restricted profit interests."

"Sponsoring" includes (i) serving as a general partner, managing member or trustee of a covered fund or serving as a commodity pool operator with respect to a covered fund; (ii) selecting or controlling in any manner (including having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or (iii) sharing with a covered fund the same name or variation of the same name for corporate, marketing, promotional or other purposes.

With certain exceptions, a "covered fund" is:

i. an issuer that would be an "investment company" as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act (e.g., most private equity, venture capital and hedge funds);

ii. certain "commodity pools" under Section 1a(10) of the Commodity Exchange Act; or

iii. for U.S. banking entities, certain foreign funds that are similar to U.S. covered funds.

Funds Excluded from the Definition of "Covered Fund"

Subject to various requirements, the Final Rule excludes from the definition of "covered fund" certain entities, including:

i. foreign public funds;

ii. wholly owned subsidiaries;

iii. joint ventures between a banking entity or any of its affiliates and one or more unaffiliated persons;

iv. acquisition vehicles;

v. foreign pension or retirement funds;

vi. insurance company separate accounts;

vii. bank-owned life insurance;

viii. issuing entities for asset-backed securities (generally made up of loans) that satisfy various conditions;

ix. qualifying asset-backed commercial paper conduits;

x. an entity owning or holding a dynamic or fixed pool of loans or other assets for the benefit of the holders of covered bonds;

xi. SBICs and public welfare investment funds;

xii. registered investment companies and excluded entities;

xiii. issuers in conjunction with the FDIC's receivership or conservatorship operations; and

xiv. any issuer that the appropriate Agency determines should be excluded from the definition of "covered fund."

Because these entities are not considered "covered funds," the Final Rule does not contain any restrictions or prohibitions on relationships between banking entities and the entities listed above. However, the Agencies may prohibit a banking entity from investing in or sponsoring any of the above entities if the banking entity is attempting to circumvent the requirements of the Volcker Rule.

Activities Excluded from the General Prohibitions on Relationships with Covered Funds

The Final Rule provides that the general prohibitions on relationships with covered funds do not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

i. acting solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest;

ii. through a deferred compensation, stock-bonus, profit-sharing or pension plan if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of current or former employees of the banking entity or an affiliate thereof;

iii. in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests such ownership as soon as practicable within an Agency-prescribed period; or

iv. on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

Covered Funds Activities Deemed Permissible under the Final Rule

The Final Rule expressly provides that certain "organizing and offering" and other activities with respect to covered funds are exempt from the prohibition. However, similar to the proprietary trading rules, no transaction or activity relating to the relationship between a banking entity and a covered fund may be deemed permissible if the transaction or activity would (i) involve or result in a "material conflict of interest" between the banking entity and its clients, customers or counterparties (without providing "timely and effective disclosures" or establishing "information barriers"); (ii) result, directly or indirectly, in a material exposure by the banking entity to a "high-risk asset" or a "high-risk trading strategy" or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Permissible "Organizing and Offering" Activities

Subject to certain time and amount limits, a banking entity may acquire or retain an ownership interest in, or act as sponsor to, a covered fund in connection with directly or indirectly organizing and offering a covered fund if *all* of the following conditions are met:

i. the banking entity (or an affiliate thereof) provides bona fide trust, fiduciary, investment advisory or commodity trading advisory services;

ii. the covered fund is organized and offered only in connection with the provision of such services and only to persons who are customers of such services, pursuant to a written plan meeting certain requirements;

iii. the banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except within certain limits;

iv. the banking entity and its affiliates comply with certain limitations on relationships and transactions with a covered fund (including restrictions on transactions that would be "covered transactions" under Section 23A, and subject to the "arms-length" requirements of Section 23B, of the Federal Reserve Act);

v. the banking entity and its affiliates do not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

vi. the covered fund does not share the same name or a variation of the same name with the banking entity or an affiliate thereof and does not use the word "bank" in its name;

vii. no director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing permissible services to the covered fund at the time the director or employee takes the ownership interest; and

viii. the banking entity makes certain disclosures, in writing, to any prospective and actual investor in the covered fund.

Other Permitted Covered Funds Activities

Banking entities are not prohibited from certain activities as "securitizer" of a covered fund that is an issuing entity for asset-backed securities, so long as the banking entity and its affiliates comply with the requirements described in items (iii) through (viii) above.

Subject to certain limits, banking entities may engage in underwriting and market-making activities with regard to interests in a covered fund, subject to the exemptions for the proprietary trading prohibition.

Subject to certain limits (similar to those for risk-mitigating hedging exempt from the proprietary trading prohibition), banking entities may also acquire or retain an ownership interest that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks 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 if certain criteria are met.

Certain covered funds activities conducted outside of the United States by foreign banks, and by regulated insurance companies solely for a general or separate account and as permissible under applicable state law, are also exempt.

Compliance Program and Other Requirements

In general, all banking entities engaging in proprietary trading or covered funds activities subject to the Final Rule must adopt a compliance program, including meeting certain documentation and reporting requirements. The Agencies make clear, however, that the terms, scope and detail of the compliance program depend on the types, size, scope and complexity of the activities and business structure of the banking entity.

A banking entity with total consolidated assets exceeding $10 billion as reported on December 31 of the previous two calendar years must develop a compliance program containing, at minimum:

i. written policies and procedures reasonably designed to document, describe, monitor and limit trading activities subject to the Final Rule;

ii. a system of internal controls reasonably designed to monitor compliance and to prevent the occurrence of prohibited activities or investments;

iii. a management framework delineating responsibility and accountability for compliance;

iv. periodic independent testing and audit of the effectiveness of the compliance program;

v. training for trading personnel and managers, as well as other appropriate personnel; and

vi. records sufficient to demonstrate compliance, which a banking entity must retain for at least five years and promptly provide to an Agency upon request.

A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years may satisfy the Final Rule's compliance program requirements by including in its existing policies and procedures relevant references to the requirements of the Final Rule that address just the activities that the banking entity conducts, with adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

Notwithstanding the foregoing requirements, a banking entity that does not engage in proprietary trading or covered funds activities addressed in the Final Rule (other than permissible trading in domestic government obligations, such as U.S. Treasuries, GSE securities, municipal securities and obligations of the FDIC) is not subject to these compliance program requirements. However, if the banking entity decides in the future to engage in any such activities, it will need to establish the required compliance program prior to becoming engaged in the activities.

The Final Rule also contains additional required documentation and reporting requirements that depend upon the asset size and extent of activities of the banking entity.

As noted above, the Final Rule contains many exceptions to and intricacies with respect to the general prohibitions on proprietary trading and relationships between banking entities and covered funds. Thus, banking entities engaged in or seeking to engage in such activities should consult with their regular Alston & Bird lawyer or one of the lawyers listed below to determine whether, and if so, how, such activities can be conducted in compliance with the Volcker Rule.

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