



FINANCIAL INSTITUTION REGULATION UPDATE

Proposed Regulations Implementing the Volcker Rule

On October 11, 2011, the Board of Governors of the Federal Reserve System (the “Board”), the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC”) issued a proposed rule implementing the requirements of new Section 13 of the Bank Holding Company Act of 1956 (the “BHC Act”), the so-called “Volcker Rule”.¹ Section 13 was added to the BHC Act by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The Securities and Exchange Commission (the “SEC”) and, together with the Board, the OCC and the FDIC, the “Agencies”) also proposed the same rule on October 12, 2011.²

The proposed rule generally prohibits a “banking entity” from:

1. engaging in proprietary trading for its own account,
2. acquiring or retaining an ownership interest in or sponsoring a “covered fund”, and
3. entering into certain relationships with a “covered fund”,

in each case, subject to various exceptions.

The proposed rule also clarifies certain activities that banking entities may continue to engage in, such as underwriting, market-making and trading on behalf of clients. Comments on the proposed rule are due by January 13, 2012.

The Volcker Rule will take effect on July 21, 2012. However, banking entities will not need to fully bring their activities, investments and relationships into compliance until July 21, 2014 and are permitted to retain certain investments for an even longer period of time pursuant to a conformance and extended transition period rule issued by the Board in February 2011.³ Even so, in the commentary to the proposed rule, the Agencies state that banking entities are required to begin complying with the proposed rule’s reporting and recordkeeping and compliance requirements on the July 21, 2012 effective date. Further, the Agencies state that they expect a banking entity to fully conform all investments and activities to the requirements of the proposed rule “as soon as practicable” within the conformance period provided by the Board’s rule.

¹ The proposed rule is available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111011a1.pdf>.

² The Commodity Futures Trading Commission (the “CFTC”) has indicated that it is taking a “wait and see” approach. Commissioner Scott O’Malia said that the CFTC might “put forward... a virtually identical proposal with the other regulators, or we could go it alone.”

³ Such rule is found in 76 Fed. Reg. 8265 (Feb. 14, 2011), available at http://www.federalreserve.gov/reportforms/formsreview/RegY1_20110214_ffr.pdf.

Title I of the Dodd-Frank Act gives the Board supervisory authority over certain nonbank financial companies that the Financial Stability Oversight Council (the “Council”) determines to be systemically important. While such companies are not “banking entities” for purposes of the Volcker Rule, Section 13 of the BHC Act provides for such companies to be subject to additional capital charges, quantitative limitations or other restrictions if they engage in proprietary trading activities or acquire or retain ownership interests in covered funds. In the commentary to the proposed rule, the Agencies indicate that the Board believes that it would be premature to propose any such requirements, limits or restrictions at this time because no such nonbank financial companies have yet been designated.

“Banking Entity” Under the Proposed Rule

“Banking entity” is defined in the proposed rule to include:

1. insured depository institutions (other than certain limited purpose trust institutions);
2. any company that controls an insured depository institution;
3. any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (which includes all foreign banks with a branch or agency (and certain other presences) in the United States); and
4. any affiliate or subsidiary of any of the foregoing, other than (A) an affiliate or subsidiary that is a covered fund that is organized, offered and held by a banking entity pursuant to, and in accordance with, the proposed rule or (B) any entity that is controlled by such a covered fund.

The proposed rule does not limit its reach to U.S. organizations or offices. Accordingly, foreign organizations and offices (including foreign offices of U.S. banking entities) are subject to the proposed rule unless an exemption is available.

The Proposed Rule’s Prohibition on Proprietary Trading

Under the proposed rule’s prohibition on propriety trading, a banking entity is generally barred from engaging in the purchase or sale of any **covered financial position** as principal for the **trading account** of such banking entity.⁴

“Covered Financial Position”

A “covered financial position” for purposes of the proposed rule is any long, short, synthetic or other position in: (i) a security, including an option on a security; (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or an option on such a contract. The definition of “covered financial position” *does not* include any position that is itself a loan, a commodity, or foreign exchange or currency (*e.g.*, the spot purchase of a commodity) (there is also a specific exemption from the proposed rule for trading in government obligations addressed below).

“Trading Account”

The definition of “trading account” comprises three independent prongs. If any one of these **three prongs** is met, then that account will fall within the definition of “trading account”:

1. Any account that is used by a banking entity to acquire or take a covered financial position for the purpose of: (i) short term resale;⁵ (ii) benefitting from actual or expected short-term price movement; (iii) realizing short term-

⁴“Proprietary trading” does not contemplate a banking entity acting as agent, broker, or custodian for an unaffiliated third party.

⁵ According to the proposed rule, “near-term” for purposes of classifying trading activities is “generally measured in hours and days rather than months or years.”

arbitrage profits; or (iv) hedging one or more such positions. Under this first prong, there is a **rebuttable presumption** that any account used to take a covered financial position held for sixty days or less is a trading account.⁶

2. Any account that is subject to the Market Risk Capital Rules.⁷
3. Any account used by a banking entity that is (i) a SEC-registered securities or municipal securities dealer; (ii) a government securities dealer that registered, or that has filed notice, with an appropriate regulatory agency; (iii) a CFTC-registered swap dealer; or (iv) a SEC-registered security-based swap dealer.

The definition of “trading account” *does not* include accounts used for: (i) repurchase or reverse repurchase agreements or securities lending transactions; (ii) positions for bona fide liquidity management purposes;⁸ or (iii) certain positions held by derivatives clearing organizations or clearing agencies.

Permitted Trading Activities

Notwithstanding the prohibition on proprietary trading, a banking entity may engage in certain underwriting, market-making related, and other activities.

Underwriting

A banking entity is permitted to purchase or sell a covered financial position in connection with the banking entity’s underwriting activities to the extent that such activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties provided that **seven criteria** are met:

1. The banking entity must have established the internal compliance program required by subpart D of the proposed rule and described below in the section entitled “Compliance Program”.
2. The covered financial position must be a security.
3. The transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter.^{9 10}
4. The banking entity must have the appropriate dealer registration or otherwise be exempt from registration or excluded from regulation as a dealer.
5. The underwriting activity must be designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties.

⁶ According to the proposed rule, these presumptions that arise by reason of a position’s holding period are designed to help determine whether a transaction is within the definition of “proprietary trading”, not whether a transaction is permissible under Section 13 of the BHC Act. A transaction may fall within the definition of “proprietary trading” and yet be permissible if it meets one of the exemptions provided in the proposed rule.

⁷ The Market Risk Capital Rules apply to banks and bank holding companies with trading activity that equals 10 percent or more of the institution’s total assets or \$1 billion or more. *See* 12 CFR 3 (OCC), Appendix B, 12 CFR 208, Appendix E and 12 CFR 225, Appendix E (Board), and 12 CFR 325, Appendix C (FDIC).

⁸ Acquiring or taking liquidity management positions will not be deemed to constitute proprietary trading to the extent such activities are used to ensure that the banking entity has sufficient, readily-marketable assets available to meet its expected short-term liquidity needs. The proposed rule requires that the transaction be conducted in accordance with a documented liquidity management plan which requires, *inter alia*, that any positions taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which are not expected to give rise to appreciable profits or losses as a result of short-term price movements.

⁹ An underwriter may hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would be able to dispose of such securities at a later time without such activities being prohibited proprietary trading activities.

¹⁰ The definitions of the terms “distribution of securities” and “underwriter” are generally identical to the definitions of the same terms provided for by the SEC’s Regulation M.

6. The underwriting activity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, and not from appreciation in the value of covered positions held related to such activities or the hedging of such covered financial position.
7. The compensation arrangement of persons performing the underwriting must be designed not to encourage proprietary risk-taking.¹¹

Market Making

A banking entity is permitted to purchase or sell a covered financial position in connection with the entity's market making-related activities. Like the underwriting exception, the banking entity's market-making activities must meet **seven criteria**:

1. The banking entity must establish a comprehensive compliance program to monitor and control its market making related activities.
2. Any activity must be *bona fide* market making.¹²

The determination of whether a banking entity is engaged in *bona fide* market making differs depending upon the nature of the relevant market.

- **In liquid markets**, market making activities should include: (i) making continuous, two sided quotes and holding oneself out as willing to buy and sell on a continuous basis; (ii) a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; (iii) making continuous quotations that are at or near the market on both sides; and (iv) providing widely accessible and broadly disseminated quotes.¹³
- **In less liquid markets** (*i.e.*, OTC markets) market making-related activities should generally include: (i) holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis; (ii) with respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and (iii) transaction volumes and risk proportionate to historical customer liquidity and investments needs.

Under either analysis, the market making exemption would only exempt the activities of a trading desk or other organizational unit to the extent such activities relate to a covered financial position to the extent that such trading desk or other organizational unit is actually engaged in market making relating to such covered financial position.

Bona fide market making would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading. In addition, *bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.

3. The market making-related activities of the banking entity must be designed not to exceed the reasonably expected near-term demands of clients, customers, and counterparties.¹⁴

¹¹ Incentive structures should primarily reward client revenues and effective client service, not proprietary risk-taking.

¹² The language used to describe *bona fide* market making-related activity is similar to the definition of "market maker" under section 3(a)(38) of the Securities Exchange Act of 1934 (the "Securities Exchange Act").

¹³ These indicia are generally consistent with the indicia of *bona fide* market making in equity markets articulated by the SEC for the purpose of describing the exception to locate requirement of the SEC's Regulation SHO for market makers engaged in *bona fide* market making activities.

¹⁴ Such expectations must be based on more than an expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects. Rather, a banking entity's expectation should generally be based on the unique customer base

4. The banking entity must be appropriately registered as a dealer, or exempt from registration or excluded from regulation as a dealer, under applicable securities or commodities laws.
5. The market making-related activities of the banking entity must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions or the hedging of such positions.
6. The compensation arrangements of persons performing market making-related activities must be designed not to encourage or reward proprietary risk-taking.
7. The market making-related activities of the banking entity must be consistent with the commentary provided in Appendix B of the proposed rule.

Risk-Mitigating Hedging Activities

A banking entity is permitted to purchase or sell a covered financial position if the transaction is made in connection with, and related to, individual or aggregated positions, contracts, or other holdings of a banking entity and is designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. In order to rely on this hedging exemption, **seven criteria** must be met:

1. The banking entity must have established an internal compliance program consistent with the requirements of subpart D of the proposed rule.
2. The hedging activity must have been made in accordance with written policies, procedures, and internal controls established by the banking entity pursuant to subpart D.
3. The transaction must hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity. This prong reflects the ability of a banking entity to hedge risks on an aggregated **portfolio basis** (*i.e.*, positions across different trading desks). This exemption requires that the banking entity either be: (i) already exposed to the specific risks being hedged; or (ii) engage in anticipatory hedging that: (A) is consistent with appropriate risk management practices; (B) otherwise meets the terms of the hedging exemption; and (C) does not involve the potential for speculative profit.
4. Each hedging transaction must be **reasonably** correlated to the underlying position. The hedge need not be fully correlated, but cannot be tangentially related. Such reasonable correlation is determined by consideration of the circumstances and the availability of alternative hedging options.¹⁵
5. At its inception, the hedging transaction cannot give rise to significant exposures that are not themselves hedged in a contemporaneous transaction (*i.e.*, over-hedging, correlation trading).
6. Any transaction conducted in reliance on the hedging exemption must be subject to continuing review, monitoring and management after the hedge position is established (*i.e.*, ongoing requirements to maintain a reasonable level of correlation and mitigate any significant risk exposure).
7. The compensation arrangements of persons performing the risk-mitigating hedging activities must be designed not to reward proprietary risk-taking.

Trading in Government Obligations

of the banking entity's specific market-making business lines and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation.

¹⁵ Regardless of the degree of correlation, if profits on hedging are appreciably more than expected/potential losses on related positions, such hedge positions are at risk of being prohibited proprietary trades.

A banking entity is generally permitted to trade in government obligations. Such obligations include: (i) an obligation of the United States or any agency thereof; (ii) an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*); and (iii) an obligation issued by any State or any political subdivision thereof. Government obligations do not include obligations of foreign governments and international and multinational development banks, or options or other derivatives referencing the enumerated government obligations. However, the Agencies solicit comment on whether these instruments should be encompassed in the exemption.

Trading on Behalf of Customers

Section 13(d)(1)(D) of the BHC Act permits a banking entity to purchase or sell a covered financial position on behalf of customers.¹⁶ The proposed rule identifies **three categories** of transactions that appear to be on behalf of customers within the purpose and meaning of the BHC Act:

1. Where the transaction (i) is conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for a customer and for the account of that customer, and (ii) involves solely covered financial positions of which the banking entity's customer, and not the banking entity or any subsidiary or affiliate of the banking entity, is beneficial owner.
2. Where the banking entity is acting as riskless principal.¹⁷
3. Where the banking entity is trading for the separate account of insurance policyholders, in which case the purchase or sale of a covered financial position is on behalf of customers if:
 - a. the banking entity is an insurance company engaging in the transaction for a separate account;
 - b. the banking entity is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;
 - c. the banking entity purchases or sells the covered financial position solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
 - d. all profits and losses are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies (and not the banking entity); and
 - e. the trading is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

Permitted Trading by a Regulated Insurance Company

Subject to **four conditions** which must all be met, the proposed rule permits a banking entity to purchase or sell a covered financial position if the banking entity is a regulated insurance company acting for its general account or an affiliate of an insurance company acting for the insurance company's general account;^{18 19}

¹⁶ The definition of customer remains open for comment, though it appears the Agencies will permit current and prospective customers and counterparties to be treated as "customers" for purposes of this exemption.

¹⁷ The proposed language describing riskless principal transactions generally mirrors that used in the Board's Regulation Y, OCC interpretive letters, and the SEC's Rule 3a5-1 under the Securities Exchange Act.

¹⁸ The proposed rule defines "general account" as all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law.

¹⁹ The proposed rule does not contain an analogous exception permitting a regulated insurance company to acquire or retain ownership in or sponsor a covered fund.

1. The insurance company must directly engage in the business of insurance and be subject to regulation by a State insurance regulator or foreign insurance regulator;
2. The insurance company or its affiliate must purchase or sell the covered financial position solely for the general account of the insurance company;
3. The purchase or sale must be conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
4. The appropriate Federal banking agencies, after consultation with the Council and the relevant insurance commissioners of the States, must not have jointly determined, after notice and comment, that a particular law, regulation, or written guidance described above is insufficient to protect the safety and soundness of the banking entity or of the financial stability of the United States.²⁰

Trading Solely Outside the United States

Certain foreign banking entities are permitted to engage in proprietary trading that occurs **solely** outside of the United States.

To qualify as a foreign banking entity, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. A U.S. subsidiary or branch of a foreign banking entity would not qualify for the exemption. In addition, a transaction will be considered to have occurred solely outside of the United States only if all four of the following conditions are met:

1. The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;
2. No party to the transaction is a resident of the United States;²¹
3. No personnel of the banking entity that is directly involved in the transaction is physically located in the United States;²² and
4. The transaction is executed wholly outside the United States.

Discretionary Exemptions

The Agencies may grant, by rule, other exemptions from the prohibition on proprietary trading if the Agencies determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

Reporting and Recordkeeping for Covered Trading Activities

A banking entity that engages in any proprietary trading activity is subject to (i) the proposed rule's recordkeeping requirements as described further below in the section entitled "Compliance Programs" and (ii) any additional requirements that the relevant regulatory agency may deem necessary. Additionally, if any such banking entity, together with its affiliates and subsidiaries, has trading assets and liabilities with a gross sum equal to or greater than \$1 billion, as measured on the last day of each of the four prior calendar quarters, the banking entity will be subject to the reporting

²⁰ No such determination is currently being formulated.

²¹ The Agencies note that the proposed definition is similar but not identical to the definition of "U.S. person" for purposes of the SEC's Regulation S.

²² According to the commentary, persons performing purely administrative, clerical or ministerial functions would generally not be viewed as being directly involved in the transaction.

and recordkeeping requirements for various quantitative measures of its covered trading activities set forth in Appendix A to the proposed rule.

The Proposed Rule’s Prohibition on Covered Funds Activities and Investments

Under the proposed rule’s prohibition on covered funds activities and investments, a banking entity generally may not, as principal, directly or indirectly, acquire or retain any **ownership interest** in or **sponsor** a **covered fund**. It is important to note that the proposed rule does not restrict acquisition or retention of ownership in a covered fund (i) by a banking entity acting in a fiduciary role,²³ (ii) by a banking entity acting in good faith as a custodian, broker, or agent for customers, (iii) by a banking entity as trustee for an employee pension plan, *i.e.*, acting as a trustee of a “qualified plan”,²⁴ or (iv) by a director or employee of a banking entity who provides advisory services to the covered fund, except as discussed below in the section entitled “Organizing and Offering a Covered Fund”.

“Ownership Interest”

An “ownership interest” is defined as any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest.²⁵ The definition of “ownership interest” *does not* include **carried interest**, which is defined as an interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which such person serves in an advisory capacity, so long as the following **four requirements** are met:

1. The sole purpose and effect of the interest is for such person to share in profits of the covered fund as compensation for advisory services.
2. All such profit, once allocated, is distributed to such person promptly after being earned or, if not so distributed, the reinvested profit does not share in the subsequent profits and losses of the covered fund.²⁶
3. No such person provides funds to the fund to acquire or retain the interest; and
4. The interest is not transferrable other than to affiliate or subsidiary of such person.

“Sponsor”

An entity serves as a “sponsor” of a covered fund if it (i) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund;²⁷ (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

²³ This exclusion does not apply where an ownership interest is held under a trust that constitutes a company as defined in Section 2(b) of the BHC Act (*e.g.*, a business trust or a statutory trust).

²⁴ “Qualified plan” is as defined in Section 401 of the Internal Revenue Code.

²⁵ According to the Agencies, this definition is intended to focus on the substance of the interest over its form, *i.e.*, whether an interest provides a banking entity with economic exposure to the profits and losses of the covered fund. As such, a covered fund’s debt or other securities could fall within this definition if they exhibit the characteristics of equity.

²⁶ Note that this is inconsistent with the current industry practice for hedge funds, where it is common for any allocations as covered interest to be maintained in the fund and subject to subsequent profit sharing and loss.

²⁷ The proposed rule focuses on the banking entity’s control over the decision-making and operational functions of the fund. Generally, service as a trustee of a covered fund falls within the definition of acting as a “sponsor”, however the proposed rule explicitly excludes a trustee that does not exercise investment discretion with respect to the covered fund, including a directed trustee under the Employee Retirement Income Security Act of 1974.

“Covered Fund”

An entity is considered a “covered fund” if it is any one of the following: (i) an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the “Investment Company Act”), *but for* Section 3(c)(1) or 3(c)(7) thereof;²⁸ (ii) a commodity pool;²⁹ (iii) any issuer, as defined in Section 2(a)(22) of the Investment Company Act, that is organized or offered outside of the United States that would otherwise be a covered fund under the proposed rule, were it organized or offered under the laws of, or offered to one or more residents, of the United States or of one or more States; or (iv) any such similar fund as an appropriate Agency may determine by rule.

Permitted Covered Fund Activities and Investments

Notwithstanding the general prohibition on covered banking entities from owning or retaining an ownership interest in or sponsoring a covered fund, banking entities may perform certain activities with respect to, and make certain investments in, covered funds.

Organizing and Offering a Covered Fund

Under this carve-out to the general rule, banking entities are permitted to engage in certain traditional asset management and advisory businesses. A banking entity may organize and offer a covered fund if it meets the following **eight criteria**:

1. The banking entity provides *bona fide* trust, fiduciary, investment advisory or commodity trading services.
2. The covered fund is organized and offered only in connection with the provision of such services to customers of such services pursuant to a credible plan outlining how the banking entity intends to provide such services through organizing or offering such fund.
3. The banking entity meets the investment limits set forth in the proposed rule and discussed below in the section entitled “Permitted Investment in a Covered Fund”.
4. The banking entity complies with the limitations on affiliate transactions set forth in the proposed rule and discussed below in the section entitled “Limitations on Relationships with a Covered Fund”.
5. The banking entity does not guarantee, assume or otherwise insure the obligations or performance of the covered fund or any covered fund in which such fund invests.
6. The covered fund does not share the same name or variation thereof with the banking entity (or any affiliate or subsidiary thereof) and does not use the word “bank” in its name.
7. No director or employee of the banking entity takes or retains an ownership interest in the covered fund, except for any director or employee who provides investment advisory or other services to the covered fund.
8. The banking entity makes certain disclosures to investors regarding the risks associated with their investment and complies with additional rules of the relevant regulator to ensure that losses are borne solely by investors and not the banking entity.

²⁸ These two exclusions (the so-called “100 holder” and “qualified purchaser” exemptions) from the definition of “investment company” are commonly relied on by hedge funds and private equity funds as well as many other entities that would not customarily be considered a hedge fund or private equity fund, *e.g.*, joint ventures, acquisition vehicles, certain wholly-owned subsidiaries and other widely-utilized corporate structures, thereby bringing these entities within the coverage of the proposed rule but for the exclusion described further below under the section entitled “Permitted Covered Fund Activities”.

²⁹ As defined in the Commodity Exchange Act, a “commodity pool” means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests. Unlike hedge funds and private equity funds, which are unregistered entities qualifying for exemption under Section 3(c)(1) or (3)(c)(7) of the Investment Company Act, nothing in the proposed rule distinguishes between treatment of registered and unregistered commodity pools the securities of which are or are not registered under the Securities Act of 1933 (the “Securities Act”).

These eight criteria closely track those set forth in Section 13(d)(1)(G) of the BHC Act with various important clarifications. First, and likely of greatest importance to banking entities that currently sponsor covered funds, the Agencies have not narrowed the “customers of such services” requirement to pre-existing customers, thus permitting banks to utilize this exemption to organize and offer funds to new customers in connection with their trust, fiduciary and investment advisory or commodity trading advisory services. The commentary indicates that a customer can obtain the investment advisory services of a banking entity simply by acquiring an interest in a covered fund organized and offered by the banking entity. The proposed rule does not expressly address the situation in which a banking entity organizes or offers a fund, for which it does not technically serve in an advisory role, to make a pooled investment in another fund. Such a “feeder fund” may not qualify for an exclusion from the general prohibition pursuant to this section of the proposed rule.

Second, the restrictions on a funds name apply to sharing a name with both the banking entity that organizes and offers or serves as sponsor to a fund *and* any affiliates or subsidiaries of the banking entity. Third, directors or employees of a banking entity that are investment advisers are generally permitted to align their interests with those of the banking entity’s customers by investing in the covered funds they advise; however, the Agencies have scaled back this exception in the case where the banking entity extends credit to any such director or employee to purchase their ownership interests or otherwise guarantees any such director or employee against loss from participating in the covered fund. In this case, the commentary indicates that the director or employee’s ownership interest would generally be imputed to the employing banking entity.

Permitted Investment in a Covered Fund

The prohibition on acquiring and retaining ownership interest in a covered fund does not apply to a banking entity or an affiliate or subsidiary thereof that organizes and offers a covered fund for one of the following **two purposes**:

1. Establishing the fund and providing initial seed capital to attract investors; or
2. Making and retaining an investment in a fund that does not exceed three percent of the total outstanding ownership interest in the fund.³⁰

As to seed investments in funds, the banking entity must actively seek unaffiliated investors so as to reduce its ownership no more than 3 percent of the total amount or value of outstanding ownership interests in the fund within one year after establishment of the fund (or up to an additional two years upon grant of an extension from the Board if it finds an extension would be consistent with safety and soundness and not detrimental to the public interest).

Furthermore, in no event shall the aggregate value of all ownership interests of the banking entity in all covered funds that it organizes or offers exceed three percent of the tier 1 capital of the banking entity.³¹ For purposes of calculating capital pursuant to the applicable capital rules, a banking entity must deduct the aggregate value of all permitted investments in covered funds from its tier 1 capital.

³⁰ The methodology for a banking entity to determine its outstanding ownership in a covered fund is set forth in the proposed rule and generally requires using the same standards and frequency utilized by the covered fund for determining its aggregate value of assets and ownership interests. The Agencies also note that since many funds do not calculate their valuation on a daily basis, a banking entity’s calculation of its ownership in a covered fund need only occur quarterly (unless the covered fund does calculate its valuation on a daily basis, in which case the banking entity must also do so). A banking entity’s amount and value of a permitted investment in a single covered fund must include (i) any ownership interest held under this section of the proposed rule by any entity that is controlled, directly or indirectly by the covered banking entity and (ii) the *pro rata* share of any ownership interest held under this section of the proposed rule by any covered fund that is not controlled by the banking entity but in which the banking entity owns, controls, or holds with the power to vote more than 5% of the voting shares.

³¹ The methodology for calculation of tier 1 capital is set forth in the proposed rule and generally requires determining tier 1 capital on a quarterly and based on the type of banking entity, *e.g.*, depository institution or bank holding company. If a banking entity is not required to report tier 1 capital (and is not a subsidiary of a depository institution or bank holding company that reports tier 1 capital), such banking entity’s tier 1 capital will be the total amount of shareholders’ equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended.

Note that the *de minimis* exceptions for a banking entity to own a total amount or value of outstanding ownership interests in a single covered fund of up to 3% and for a banking entity to own an aggregate value of all ownership interests across covered funds apply *only* to those covered funds that the banking entity organizes and offers pursuant to the proposed rule. These authorizations are not general exceptions for investments in third party funds.

Other Permitted Covered Fund Activities and Investments

The prohibition on acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund by a banking entity does not apply to investments that meet any of **four criteria**:

1. Investment in small business investment companies; investments to promote the public welfare; or certain qualified rehabilitation expenditures within the Internal Revenue Code or similar State historic tax credit programs.
2. Permitted risk-mitigating hedge activity.³²
3. Investment in an issuer of asset-backed securities as described in more detail in the section below entitled “The Section .13(d) Exemption For Loan Securitizations”.
4. Activity undertaken by certain foreign banking entities.

As with the exception to the general ban on proprietary trading discussed above in the section entitled “Trading Solely Outside of the United States”, foreign banking entities may rely on an exception to the prohibition on acquiring or retaining ownership interest in or sponsoring a covered fund. Any such activity must meet the following **four criteria**:

1. The banking entity involved must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;
2. The banking entity must be a qualifying foreign banking organization under the Board’s Regulation K, or if not, it must meet **at least two** of the following requirements: (i) total assets held outside of the United States exceed total assets held in the United States; (ii) total revenues derived from business outside of the United States exceed total revenues derived from business in the United States; or (iii) total net income derived from business outside the United States exceeds total net income derived from business in the United States;
3. No ownership interest in such fund is offered for sale or sold to a resident of the United States; and
4. The activity occurs solely outside of the United States.³³

Permissible Covered Fund Activities

The proposed rule permits banking entities to rely on an exception for certain types of covered funds to enable them to manage risk and structure their businesses as they see necessary to carry out their businesses. The prohibition on acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund by a banking entity does not apply to covered funds that have one of the following characteristics:

³² The criteria for permitted risk-mitigating hedging activities involving a covered fund are substantially similar to the risk-mitigating criteria that apply to proprietary trading, as discussed above in the section entitled “Risk-Mitigating Hedging Activities”. A banking entity may acquire an outstanding interest in a covered fund if it is made in connection with and related to individual or aggregated obligations or liabilities of the banking entity under circumstances (i) arising when it acts as intermediary on behalf of a third-party client or directly connected to its compensation of an employee investment adviser; (ii) the acquisition or retention of an ownership interest in a covered fund must mitigate a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in such covered fund; and (iii) at the time of any such transaction, the banking entity must document the risk-mitigating purposes of the transaction and identify the risks to be reduced. This exemption is likely to prove valuable to banking entities that offer structured products the performance of which references a covered fund.

³³ To qualify under this requirement, the following three criteria must be met: (i) the banking entity engaging in the activity is not organized under the laws of the United States or of one or more States; (ii) no subsidiary, affiliate or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States or in one or more States; and (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

1. Such covered funds are separate accounts used solely for the purpose of purchasing bank owned life insurance policies.³⁴
2. Such covered funds are one of the following types of entities:
 - a. joint ventures that are operating companies and do not make investments prohibited under the proposed rule;
 - b. acquisition vehicles with a sole purpose to effectuate a merger or acquisition;
 - c. wholly-owned subsidiaries engaged in bona fide liquidity management activities;³⁵ and
 - d. certain issuers of asset-backed securities as described below in the sections entitled “The Section .14(a)(2)(iii) Exemption For Dodd-Frank Act Mandated Credit Risk Retention” and “The Section .14(a)(2)(v) Exemption for Loan Securitizations”.

Furthermore, the general prohibition under the proposed rule as to ownership and retention of an ownership interest in a covered fund does not apply to ownership interests acquired or retained by a banking entity: (i) in the ordinary course of collecting a debt previously contracted in good faith, if done within the applicable time periods provided by the relevant Agency; and (ii) pursuant to and in compliance with the Board’s conformance the implementing rules.³⁶

Internal Controls, Reporting and Recordkeeping for Covered Fund Activities

A banking entity that engages in any covered fund activity or acquiring or retaining an ownership interest as permitted by the proposed rule is subject to (i) the proposed rule’s internal controls, reporting and recordkeeping requirements as described further below in the section entitled “Compliance Programs” and (ii) any additional requirements that the relevant regulatory agency may deem necessary.

Limitations on Relationships with a Covered Fund

The proposed rule implements the BHC Act closely with respect to affiliate transactions. Section 13(f)(1) of the BHC Act and the proposed rule prohibit a banking entity and its affiliates that serve, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, from entering into certain “covered transactions” as defined in Section 23A of the Federal Reserve Act (a restriction that is being referred to as “Super 23A”) with a covered fund or with any other covered fund that is controlled by such covered fund (an “Affiliated Covered Fund”):

1. A loan to the Affiliated Covered Fund, including a purchase of assets subject to an agreement to repurchase.
2. A purchase of or investment in securities issued by the Affiliated Covered Fund.
3. A purchase of assets from the Affiliated Covered Fund.
4. Acceptance of securities or other debt issued by the Affiliated Covered Fund as collateral for any loan.
5. Issuing any guarantee, acceptance or letter of credit on behalf of the Affiliated Covered Fund.

³⁴ The Agencies recognize that prohibiting investments in bank owned life insurance policies would eliminate an investment that helps banking entities reduce risk, however, they have restricted the exception consistent with the purpose of the proposed rule, such that the banking entity does not control the investment decisions regarding the underlying assets or holdings of any separate account and holds its ownership interest in compliance with applicable supervisory guidance regarding bank owned life insurance.

³⁵ These are the same *bona fide* liquidity management requirements pursuant to a liquidity management plan as referenced in the section above entitled “Trading Activities”.

³⁶ Such implementing rules generally provide that a banking entity may continue certain existing relationships with a covered fund without complying with the restrictions of Section 13 of the BHC Act and the proposed rule until July 21, 2014, as such date may be extended by up to three one-year periods by the Board. To the contrary, a banking entity would usually not be permitted establish a new relationship with a covered fund after July 21, 2012 without being in compliance with the proposed rule.

6. The borrowing or lending of securities to the extent that such transaction causes a member bank or subsidiary to have credit exposure to the Affiliated Covered Fund.
7. Certain derivative transactions that cause a member bank or a subsidiary to have credit exposure to the Affiliated Covered Fund.

Significantly, the proposed rule, like Section 13(f) of the BHC Act, does not incorporate the exemptions in Section 23A for specified transactions and the Board's Regulation W with respect to Section 23A for specified transactions (*e.g.*, making loans secured by U.S. government securities, purchasing certain liquid assets, marketable securities and municipal securities, making qualifying intraday extensions of credit, and engaging in certain riskless principal transactions).

The proposed rule provides that a banking entity may, notwithstanding the Super 23A limitations, acquire or retain an ownership interest in a covered fund in accordance with the other provisions of the proposed rule.

Section 13(f)(3)(A) of the BHC Act is also implemented in the proposed rule, which allows banking entities to enter into **prime brokerage transactions**³⁷ with Affiliated Covered Funds so long as the statutory requirements are met: (i) the banking entity is in compliance with the section of the proposed rule regarding organizing and offering a fund; (ii) the chief executive officer makes an annual certification that the banking entity is not providing any guarantee of any Affiliated Covered Fund or fund in which such Affiliated Covered Fund invests; and (iii) the transaction does not violate safety and soundness principles of the banking entity.

Finally, the proposed rule implements Sections 13(f)(2) and 13(f)(3)(B) of the BHC Act by generally requiring that covered transactions with Affiliated Covered Funds must be on arm's-length terms as provided in Section 23B of the Federal Reserve Act.³⁸

Other Limitations on Permitted Covered Funds Activities

The proposed rule also states that no transaction, class of transactions or activity is permissible if the transaction, class of transactions or activity would (i) involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; (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.

Application of the Volcker Rule to Securitization Transactions

Status of Issuers of Asset-Backed Securities as "Covered Funds"

Under the proposed rule, if an issuer of an asset-backed security³⁹ is considered to be a "covered fund" then, among other things, a banking entity would not be able to sponsor such an issuer, to acquire or retain an ownership interest in such an issuer, or to have certain relationships with such issuer, except as permitted under the proposed rule.

³⁷ "Prime brokerage transaction" is defined to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.

³⁸ Section 23B of the Federal Reserve Act provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to such banking entity as those prevailing at the time for comparable transactions with or involving other unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.

³⁹ The Agencies do not define the term "asset-backed security" in the proposed rule. Instead, when discussing possible exemptions from the covered fund provisions with respect to asset-backed securities they request comment on what definition of "asset-backed security" (*e.g.*, that in Section 3(a)(77) of the Securities Exchange Act or that in the SEC's Regulation AB) would most effectively implement the proposed rule.

As discussed above, the proposed rule defines a “covered fund” to include an issuer that would be an investment company as defined in the Investment Company Act but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act (the so-called “100 holder” and “qualified purchaser” exemptions). Many issuers of asset-backed securities rely exclusively on Section 3(c)(1) or 3(c)(7) of the Investment Company Act for an exception from the definition of “investment company”, and therefore would be “covered funds” under the proposed rule.

Helpfully, the Agencies state in the commentary to the proposed rule that an issuer of asset-backed securities that meets the requirements for an exemption under Rule 3a-7 under the Investment Company Act,⁴⁰ Section 3(c)(5) of the Investment Company Act⁴¹ or any exclusion or exemption (other than Section 3(c)(1) or 3(c)(7)) from the definition of “investment company” under the Investment Company Act, will not be deemed to be a covered fund under the proposed rule. The commentary also states that an issuer of asset-backed securities that is subject to legal documents mandating compliance with the conditions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act will not be deemed a covered fund if such issuer can also satisfy all of the conditions for an alternative exclusion or exemption (*e.g.*, Rule 3a-7 or Section 3(c)(5)) for which it is eligible.

Exemption from Ownership, Retention and Sponsoring Prohibitions For Certain Issuers of Asset-Backed Securities That Are Covered Funds

For issuers of asset-backed securities that rely exclusively on the Section 3(c)(1) or 3(c)(7) exemption and would therefore be covered funds under the proposed rule, the proposed rule contains several exemptions that permit a banking entity to acquire and retain an ownership interest in, or act as sponsor of, such an issuer.

The Section .13(d) Exemption For Loan Securitizations

Section .13(d) of the proposed rule permits a banking entity to acquire or retain an ownership interest in, or act as sponsor of, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are comprised of:

1. loans;
2. contractual rights or assets directly arising from those loans supporting the asset-backed securities; and
3. interest rate or foreign exchange derivatives that (A) “materially relate to” the terms of such loans or contractual rights or assets, and (B) are used for hedging purposes with respect to the securitization structure.

The commentary indicates that this exemption is intended to implement Section 13(g)(2) of the BHC Act (as added by the Dodd-Frank Act) which provides that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law.

⁴⁰ Rule 3a-7, promulgated by the SEC in 1992, exempts certain issuers of asset-backed securities from the definition of investment company in the Investment Company Act. The SEC recently released an advance notice of proposed rulemaking requesting comment on the treatment of asset-backed securities under the Investment Company Act including: (i) whether the rating requirements in Rule 3a-7 should be changed and whether other modifications to that rule may be appropriate, and (ii) whether Section 3(c)(5) of the Investment Company Act should be amended by Congress to exclude reliance by asset-backed issuers or whether the SEC should use its rulemaking authority to limit the use of Section 3(c)(5) by certain issuers of asset-backed securities. Any such changes could affect whether an asset-backed securities issuer may continue to rely upon such exemptions and therefore the status of an asset-backed issuer as a “covered company” under the proposed rule. We discuss the advance notice of proposed rulemaking in a client alert dated September 15, 2011, available at <http://www.sidley.com/files/News/63fd0c87-f09d-40a1-aecc-fd55e9191a11/Presentation/NewsAttachment/99255282-6d5d-4e03-8216-ffb3f6ac128/Global%20Finance%20Update%20-%209.15.11%20-%20SEC%20Requests%20Comment%20on%20Proposed%20Rulemaking.pdf>.

⁴¹ Section 3(c)(5) of the Investment Company Act exempts certain entities primarily engaged in the business of acquiring mortgages or certain other receivables or making certain loans from the definition of investment company.

The proposed rule defines “loan” as any loan, lease or extension of credit, or secured or unsecured receivable. The commentary is explicit that “loan” *does not* include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans. The commentary also notes that the requirement that an interest rate or foreign exchange derivative “materially relate to the terms of such loans” is intended to quantitatively limit the derivatives permitted in a securitization of loans under Section .13(d) to include only those derivatives where the notional amount of the derivative is tied to the principal balance of the loans supporting the asset-backed securities of the issuer, either individually or in the aggregate. Additionally, the requirement that derivatives be used for hedging purposes means that they must be used solely to hedge the risk that results from a mismatch between the loans and the asset-backed securities, and would not allow the use of credit default swaps. Consequently, issuers of asset-backed securities that are backed by asset-backed securities or credit default swaps would not be eligible for this exemption.

Section .14(a)(2)(iii) Exemption For Dodd-Frank Act Mandated Credit Risk Retention

Section .14(a)(2)(iii) of the proposed rule contains an exemption that permits a banking entity to acquire or retain an ownership interest in or act as a sponsor to an issuer of asset-backed securities that is retained by the banking entity as “securitizer” or “originator” in order to comply with the credit risk retention (“skin-in-the-game”) requirements of Section 15G of the Securities Exchange Act (as added by Section 941 of the Dodd-Frank Act) and any implementing regulations thereunder,⁴² but only with respect to that amount or value of economic interest or portion of the credit risk that is required to be retained by those provisions. In what may have been an unintentional oversight, the proposed rule does not contain a similar exemption for ownership interests that are required to be retained by a banking entity in order to meet the credit risk retention requirements of the FDIC’s Safe Harbor Rule regarding treatment of securitizations of depository institutions in an FDIC receivership or under other risk-retention requirements, such as those resulting from Article 122a of the European Capital Requirements Directive.⁴³

The commentary indicates that the Section .14(a)(2)(iii) exemption and the Section .14(a)(2)(v) exemption discussed below are intended to implement new Section 13(d)(1)(J) of the BHC Act, which permits a banking entity to engage in any covered fund activity or investment that the Agencies determine promotes and protects the financial soundness of banking entities and the financial stability of the United States.⁴⁴

The Section .14(a)(2)(v) Exemption For Loan Securitizations

The wording of the exemption set forth in Section .14(a)(2)(v) of the proposed rule largely tracks the Section .13(d) exemption. However, in the commentary the Agencies state that Section .14(a)(2)(v) is meant to augment Section .13(d) and permit a banking entity to engage in the purchase (and not only the sale or securitization) of loans through authorizing the acquisition or retention of an ownership interest in loan securitization vehicles that the banking entity does not organize and offer and for which it does not act as sponsor.

⁴² We discuss the Section 15G credit risk retention requirement and proposed regulations thereunder (which have yet to be finalized) in a client alert dated April 13, 2011, *available at* <http://www.sidley.com/files/News/2fb2035a-77bd-4189-ae2a-003f71349437/Presentation/NewsAttachment/2e1c49fd-1e89-47d9-b66a-b8bffe8d4edc/Structured%20Finance%20Update%20-%204.13.11.pdf>.

⁴³ We discuss the FDIC Safe Harbor Rule, including its credit risk retention requirement, in a client alert dated October 4, 2010, *available at* [http://www.sidley.com/files/News/9d40e7c6-f5c9-4830-b104-150b0a3f5385/Presentation/NewsAttachment/2141a781-362f-4fe2-87fc-01c092a7e5bc/Structured%20Finance%20and%20Securitization%2010%2004%202010%20FDIC%20Adopts%20\(2\).pdf](http://www.sidley.com/files/News/9d40e7c6-f5c9-4830-b104-150b0a3f5385/Presentation/NewsAttachment/2141a781-362f-4fe2-87fc-01c092a7e5bc/Structured%20Finance%20and%20Securitization%2010%2004%202010%20FDIC%20Adopts%20(2).pdf).

⁴⁴ In the commentary, the Agencies note that certain existing asset-backed securities may have a term that exceeds the Volcker Rule conformance or extended transition periods, and request comment on whether the Agencies should also consider using their Section 13(d)(1)(J) authority to permit a banking entity to acquire or retain an ownership interest in existing asset-backed issuers and/or to exclude those existing asset-backed securities from the proposed rule’s definition of “ownership interest”.

Application of “Super 23A” to Issuers of Asset-Backed Securities

As discussed above, under the proposed rule, as under Section 13 of the BHC Act, banking entities are subject to the “Super 23A” restriction which prohibits a banking entity that serves as investment manager, investment adviser, commodity trading advisor or sponsor of a covered fund from entering into any covered transaction with the covered fund. “Covered transactions” include extensions of credit, purchases of or investment in securities, purchases of assets, and the issuance of guarantees (including letters of credit). Because banking entities that serve in the specified capacities frequently engage in such transactions with issuers of asset-backed securities that would be covered funds under the proposed rule, this provision of the proposed rule could pose significant operational issues for many securitizations. The proposed rule does not address such issues.

Status of Issuers of Asset-Backed Securities as “Banking Entities”

The proposed rule generally includes in the definition of “banking entity” an affiliate or subsidiary of a banking entity, but excludes from the definition of “banking entity” any such affiliate or subsidiary that is a “covered fund” offered and held by a banking entity pursuant to the proposed rule. However, as discussed above, certain issuers of asset-backed securities would not be “covered funds”. Accordingly, any such issuer that is an affiliate or subsidiary of a banking entity would be a “banking entity” under the proposed rule. Such an issuer would therefore be subject to requirements of the proposed rule applicable to “banking entities”, including:

1. the proposed rule’s limitation on proprietary trading;
2. the proposed rule’s limitations on investments by a banking entity in, and relationships by a banking entity with, a covered fund;
3. the compliance program requirements of the proposed rule; and
4. the proposed rule’s recordkeeping and reporting requirements.

The proposed rule defines (by reference to the BHC Act) “affiliate” as any company that controls, is controlled by, or is under common control with another company and “subsidiary” of a company as any company 25% or more of whose voting shares are directly or indirectly controlled by the company, or the election of a majority of whose directors are controlled by the company, or with respect to the management or policies of which the company has the power to exercise a controlling influence, as determined by the Board, after an opportunity for a hearing. Given the breadth of these definitions, it is possible that, under the proposed rule, some securitization vehicles that rely on the Rule 3a-7 or Section 3(c)(5) exemptions in the Investment Company Act will be considered “banking entities” and subject to the above limitations.⁴⁵ The Agencies request comment on the potential effect of the proposed definition of “banking entity” on securitizations, including whether all issuers of asset-backed securities should be excluded from the definition of “banking entity”.

“Sponsor” in the Securitization Context

The definition of sponsor is discussed above in the section entitled “Sponsor”. Through this definition the Agencies seek to capture entities with “the ability to control the decision-making and operational functions of the fund”. The Agencies request comment on whether this is the appropriate definition of “sponsor” in the securitization context, or whether an alternative definition, such as that set forth in the SEC’s Regulation AB,⁴⁶ might be more appropriate. The Agencies also pose the question whether servicers and managers should be considered the “sponsor” of a securitization

⁴⁵ For example, it is possible that the ownership requirement in the credit risk retention rule set forth in Section 941 of the Dodd-Frank Act combined with control inherent in the position of servicer or investment manager could cause some securitization vehicles that rely on the Rule 3a-7 or Section 3(c)(5) exemptions to be deemed to be affiliated with a banking entity and therefore to themselves be “banking entities”.

⁴⁶ Under Regulation AB a sponsor is a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, directly or indirectly, to the issuing entity.

transaction (while stating later in the commentary that servicers and managers have such control and decision making authority).

“Ownership Interest” in the Securitization Context

The definition of ownership interest is discussed above in the section entitled “Ownership Interest”. The Agencies request comment on whether such definition should be modified in the securitization context, particularly in light of the fact that the distinction between debt and equity in such context may be complicated and legal, accounting and tax treatment may differ for the same instrument.

Status of Asset-Backed Securities as Covered Financial Positions under the Volcker Rule’s Restrictions on Proprietary Trading

Although the proposed rule provides that covered financial positions subject to the restrictions on proprietary trading do not include “loans”, there is no similar blanket exemption for asset-backed securities. However, as discussed above, pass-through securities issued and guaranteed by certain government-sponsored entities (*e.g.*, the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with their securitization activities are exempted under the proposed rule’s exemption from its proprietary trading restrictions for permitted trading in governmental obligations. There is no similar exemption for non-GSE pass-through securities. Further, in connection with the proposed rule’s underwriting exemption from its proprietary trading restrictions, discussed above, the Agencies request comment on whether the sale of a security by a banking entity to an intermediate entity as part of the creation of a structured security or “repackaging” should be permitted either under the underwriting exemption or the exemption for market-making contained in the proposed rule.

Interaction of the Volcker Rule’s Conflict of Interest Limitation with Section 27B of the Securities Act

As discussed above, the proposed rule, like the statute itself, places certain limitations on permitted trading activities (*e.g.*, permitted market-making activities, risk-mitigating hedging, etc.) in which a banking entity may engage, including that no such permitted activity may involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties. The commentary makes clear that the proposed rule’s conflict of interest limitations, and related disclosure provisions, do not affect a banking entity’s obligation to comply with other laws, including Section 27B of the Securities Act (as added by Section 621 of the Dodd-Frank Act), which governs conflicts of interest relating to certain securitization transactions.⁴⁷ However, the Agencies request comment on what the potential relationship between the proposed rule and Section 27B should be.

Compliance Programs

Under the proposed rule, a banking entity engaged in covered trading activities or covered fund activities and investments must establish compliance programs appropriate for the size, scope and complexity of activities and business structure of such banking entity. At a minimum, such compliance programs should contain the following specific, core elements:

1. Internal written policies and procedures to document, describe and monitor activities and investments for compliance with the proposed rule.

⁴⁷ We discuss Section 27B of the Securities Act and the SEC’s recently proposed rules thereunder in a client alert dated September 26, 2011, available at <http://www.sidley.com/files/News/67aacc6e-591a-4d80-9198-ceedb3c73e9/Presentation/NewsAttachment/49d2bbbc-548f-48d0-93ac-1e3c04f9304f/Global%20Finance%20Update%209.26.11%20-%20Securities%20and%20Exchange%20Commission%20issues%20proposed%20rules%20under%20the%20D.pdf>.

2. Internal controls to identify potential noncompliance and prevent prohibited activities.
3. A management framework that clearly delineates responsibility and accountability for compliance.
4. Independent testing for the effectiveness of the compliance program conducted by qualified banking personnel or a qualified outside party.
5. Training for trading personnel and managers and other appropriate personnel to implement and enforce the compliance program.
6. Making and keeping records sufficient to demonstrate compliance for a period of no less than five years upon request of a supervisory agency.

If a banking entity's activities are significant enough, the banking entity will have to achieve a more enhanced set of minimum standards for these core elements as set forth in Appendix C to the proposed rule. A banking entity will be considered to have significant activities and thus need to achieve the enhanced standards if the relevant Agency deems it appropriate and, as of the last day of each of the four prior calendar quarters, the banking entity, together with its affiliates and subsidiaries:

1. Has trading assets and liabilities with a gross sum (i) equal to or greater than \$1 billion or (ii) equal to 10 percent or more of its total assets; and
2. (i) Has aggregate investments in funds with an average value equal to or greater than \$1 billion or (ii) sponsors or advises funds with average total assets equal to or greater than \$1 billion.

Furthermore, if a banking entity does not engage in covered trading activities or covered fund activities and investments, it must (i) ensure that its existing compliance policies and procedures adequately prevent the banking entity from participating in such activities and making such investments and (ii) develop and provide for the required compliance program prior to engaging in such activities or making such investment.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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