Volcker Rule

A Practical Guidance® Practice Note by Eric S. Yoon, K&L Gates LLP

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This practice note provides an overview of the Volcker Rule, which was enacted in 2010 as Section 619 of the comprehensive Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and codified as Section 13 of the Bank Holding Company Act of 1956 (BHC Act), 12 U.S.C. §1851. The final regulations implementing the Volcker Rule, which were proposed by the responsible U.S. federal agencies (Responsible Federal Agencies)—the Board of Governors of the Federal Reserve System (Federal Reserve), the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)—were promulgated on December 10, 2013, and became effective on April 1, 2014. 12 C.F.R. Parts 44, 248 and 351; 17 C.F.R. Parts 75 and 255.

This practice note addresses:

- Volcker Rule Background
- Legislative and Regulatory Updates
- Proprietary Trading
- Covered Funds Activities
- Compliance and Penalties

For more information on the Volcker Rule as it relates to collateralized loan obligations, or CLOs, see Collateralized Loan Obligations under the Volcker Rule.

Volcker Rule Background

The Volcker Rule contains two prohibitions aimed at "banking entities": A banking entity may not (1) engage in "proprietary trading" or (2) as principal, directly or indirectly, acquire or retain any ownership interest in, or sponsor, "covered funds," which essentially are private equity funds and hedge funds. The Rule is named after former Federal Reserve chairman Paul A. Volcker Jr., who proposed these restrictions under the stated belief that certain types of speculative activities—namely, the types intended to be covered under the Rule—had contributed to the onset of the financial crisis of 2007–2010.

The following banking entities are subject to the Volcker Rule:

- Any insured depository institution (i.e., any bank or savings association the deposits of which are insured by the FDIC)
- Any company that controls an insured depository institution
- Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., any foreign banking organization that is a registered bank holding company or has a U.S. branch, agency, or commercial lending company subsidiary, but not merely a representative office)
- Any affiliate or subsidiary of any of the foregoing entities

As the last bullet indicates, the definition of a banking entity encompasses a surprisingly broad range of entities. It may not seem intuitive to include some of these entities within such definition. For instance, suppose your client is a foreign insurance company with no U.S. presence, and the ultimate parent of this insurance company is a foreign holding company that has a local bank subsidiary with a small branch in New York City. That holding company and *each* of its subsidiaries worldwide, including your client insurance company, is a banking entity within the meaning of the Volcker Rule and therefore is subject to the Volcker Rule prohibitions and restrictions described in this practice note.

"Proprietary trading," the first of the two restricted activities under the Volcker Rule, is defined very broadly to cover purchase or sale, as principal, of "financial instruments" (again, defined rather broadly) by a banking entity for one of its "trading accounts." Similarly, the second Volcker Rule-mandated restriction—direct or indirect acquisition or retention of any "ownership interest" in, or sponsorship of, a "covered fund" by banking entities—on its face curbs a bewildering array of fund formation / investment management activities. Moreover, each banking entity must have in place a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions under the Volcker Rule. The compliance program must include, among other things, written policies and procedures reasonably designed to document, describe, monitor, and limit the activities in question; a system of internal controls reasonably designed to monitor compliance; independent testing and audit; and a minimum five-year record maintenance requirement. In counseling your banking entity clients regarding the risk of noncompliance, you should also remind them that because the Volcker Rule has been codified as part of the BHC Act, this statute's civil *and* criminal sanctions regime could apply to contraventions and violations of the Rule.

Recognizing the risk of overregulation, as well as the heightened compliance burden, associated with this vastly complicated rule, Congress and the Responsible Federal Agencies have attempted to lessen the unintended consequences of the Volcker Rule in two principal ways. First, there are definitional exclusions, both statutory and regulatory, from broadly defined terms such as "financial instrument," "trading account," "covered fund," and "ownership interest." Second, there is a fairly broad array of exemptions for certain types of activities and investments—presumably those that fall safely outside the speculation-curbing intent behind this regime—that remain within the defined proscriptions and therefore would otherwise be impermissible for banking entities. This practice note provides a general summary of the definitional exclusions and policy-driven exemptions regarding (1) proprietary trading and (2) investment in and sponsorship of covered funds, in that order.

Legislative and Regulatory Updates

In a 2017 development, the U.S. Treasury Department issued in June 2017 a document titled "A Financial System That Creates Economic Opportunities Banks and Credit Unions". This document was a report in response to President Trump's Executive Order 13772 of February 3, 2017, which established the policy of his administration to regulate the U.S. financial system in a manner consistent with a set of "Core Principles" set forth therein. The Treasury report identified laws, treaties, regulations, guidance, reporting and record keeping requirements, and other government policies that it said "inhibit Federal regulation of the U.S. financial system."

The Treasury report contains a detailed list of recommendations to Congress and the Responsible Federal Agencies to further this aim. Some of the salient recommendations in the report for "improving the Volcker Rule" include revisions to the following provisions (all of which are discussed below in this practice note):

- Exempt from the Volcker Rule banking entities with $10 billion or less in assets.
- Exempt from the proprietary trading prohibitions of the Volcker Rule banking entities with over $10 billion in assets that are not subject to the market risk capital rules.
- Eliminate the 60-day rebuttable presumption from the definition of proprietary trading.
- Regulators should give banks additional flexibility to adjust their determinations of the reasonable amount of market-making inventory:
    - For illiquid securities, banks should have greater leeway to anticipate changes in markets.
    - For over-the-counter derivatives, regulators should focus more on ensuring that banks appropriately hedge the positions they maintain.
    - Banks that have not yet established a market-making presence in a particular asset class should have more discretion to meet the reasonably expected near-term demands (RENTD) condition.

    - Banking entities should be able to enter into block trades even if they involve a trading volume outside of historical averages.
- Eliminate the requirement to maintain documentation of the specific assets and risks being hedged.
- The existing "enhanced" compliance program under the regulations should apply only to those banking entities with at least $10 billion in trading assets and liabilities on a consolidated basis; the original application was to all banking entities with over $50 billion in total consolidated assets.
- Banks should be given greater ability to tailor their compliance programs to the particular activities engaged in by the bank and the particular risk profile of that activity.
- Regulators should adopt a simple definition of covered funds that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed.
- The exemptions in Section 23A of the Federal Reserve Act should be restored in the Volcker Rule so that they apply to banking entities' transactions with their covered funds.
- The initial "seeding period" exemption from the covered funds investment restriction should be extended to three years, rather than one year, to provide banking entities with additional time to stand up new funds and allow them to establish the track records they need to attract investors.
- Banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor, provided that the separate identity of the funds is clearly disclosed to investors.
- An exemption of the Volcker Rule's definition of banking entity should be provided for foreign funds owned or controlled by a foreign affiliate of a U.S. bank or a foreign bank with U.S. operations.
- Consideration should be given to permitting a banking entity that is sufficiently well-capitalized—such that the risks posed by its proprietary trading are adequately mitigated by its capital—to opt out of the Volcker Rule altogether, if the institution remains subject to trader mandates and ongoing supervision and examination to reduce risks to the safety net.

Coordinated Reviews for Qualifying Foreign Excluded Funds

On July 21, 2017, the Responsible Federal Agencies announced that they are coordinating their respective reviews of the treatment of certain foreign funds under the Volcker Rule. These "foreign excluded funds" are investment funds organized and offered outside of the United States that are excluded from the definition of "covered fund" and, as such, the restrictions of the Volcker Rule generally would not apply to investments in, or sponsorship of, such funds by a foreign banking entity.

However, complexities in the statute and the implementing regulations may result in certain foreign excluded funds becoming subject to the Volcker Rule and, as such, a number of foreign banking entities, foreign government officials, and other market participants have expressed concern about possible unintended consequences and extraterritorial impact. In particular, they have contended that certain foreign excluded funds may fall within the definition of "banking entity" under the Volcker Rule if they are an affiliate of a foreign banking entity under the BHC Act by virtue of typical corporate governance structures for funds sponsored by a foreign banking entity in a foreign jurisdiction or by virtue of investment by the foreign banking entity in the fund. For instance, where a foreign banking entity owns a large amount of the fund, selects the board of directors of the fund, or acts as general partner or trustee of the fund, the foreign bank may be deemed by law to "control" the foreign fund. A foreign fund thus deemed to be controlled by a foreign banking entity would be an affiliate of the foreign bank under the BHC Act, and the statute by its terms subjects an affiliate of a banking entity to the restrictions on covered fund and proprietary trading activities in the United States.

The July 21, 2017 announcement stated that staffs of the Responsible Federal Agencies are considering ways in which the implementing regulation may be amended, or other appropriate action may be taken, to address any unintended consequences of the Volcker Rule for foreign excluded funds in foreign jurisdictions. The announcement left open the possibility that Congressional action may be necessary to fully address the issue.

The announcement further noted that, in order to provide additional time, the Responsible Federal Agencies will not propose to take action during the one-year period ending July 21, 2018, against a foreign banking entity based on attribution of the activities and investments of qualifying

foreign excluded funds (QFEF)to the foreign banking entity, or against a qualifying foreign excluded fund as a banking entity, in each case where the foreign banking entity's acquisition or retention of any ownership interest in, or sponsorship of, the qualifying foreign excluded fund would meet the requirements for permitted covered fund activities and investments solely outside the United States, as more fully described below in this practice note.

The Economic Growth Act and 2019 Amendments

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act) was signed into law. The Economic Growth Act, among other things, benefits community banks— institutions with $10 billion or less in assets—and makes key changes to enhanced prudential standards and supervision requirements and provides that banking organizations with less than $10 billion in aggregate assets will no longer be subject to the Volcker Rule. Section 204 of the Economic Growth Act further amends the Volcker Rule by removing the restriction that generally prohibits hedge funds and private equity funds from having the same name, or a variation of the same name, as a "banking entity" that is an investment adviser to the fund. This amendment, however, keeps in place the prohibition on sharing a name with a bank.

In June 2018, the Responsible Federal Agencies issued a Notice of Proposed Rulemaking (2018 NPR) proposing several changes to the Volcker Rule. The 2018 NPR proposed significant changes to the Volcker Rule's proprietary trading restrictions, a new tiered system of compliance, and a streamlined set of compliance metrics.

2019 Amendments

In August through October 2019, the Responsible Federal Agencies adopted, in a series of separate actions, several amendments to the Volcker Rule (2019 Amendments), which adopted certain aspects of the 2018 NPR that narrow and simplify some of the restrictions thereunder while leaving other aspects to be dealt with in future regulatory action. The effective date for the 2019 Amendments is January 1, 2020, and banking entities must comply with them by January 1, 2021. The existing rule will remain in effect until the compliance date, but a banking entity may voluntarily comply, in whole or in part, with the 2019 Amendments prior to the compliance date, except that, in the case of metric reporting, early application is subject to the Responsible Federal Agencies' adoption of certain requisite technological updates. Since the 2019 Amendments represent a narrowing of Volcker Rule restrictions, there would be no practical reason for the typical banking entity to delay instituting an otherwise permitted accelerated compliance. As such, in this practice note those provisions of the Volcker Rule that were amended by the 2019 Amendments are described as though they are currently in effect. Also, where appropriate, some of the salient aspects of the 2019 Amendments are noted below as annotations to the existing rules.

2020 Amendments

In January 2020, the Responsible Federal Agencies issued a Notice of Proposed Rulemaking (2020 NPR) proposing additional changes to the Volcker Rule. On June 25, 2020, the Responsible Federal Agencies approved a final rule that adopted various amendments to the Volcker Rule (2020 Amendments) largely along the lines of the 2020 NPR. The 2020 Amendments, which became effective on October 1, 2020, made, among other things, the following changes to the Volcker Rule: make permanent (with some modifications) the current no-action position that foreign funds operated by non-U.S. banking entities and not offered to U.S. investors are not "banking entities" subject to the Volcker Rule (the qualifying foreign excluded funds referred to above); simplify the "foreign public funds" exemption for foreign funds that are primarily offered outside the U.S. and that conduct at least one public offering subject to investor protection requirements; modify the definition of "ownership interest" to limit its impact on loans by a bank to third-party funds that have standard loan covenants; repeal an 2013 interpretation that had treated banking entities' investments into portfolio companies alongside their sponsored or advised private funds as investments by the baking entities in the private fund subject to the 3% limit; and create new exemptions from the Super 23A exemption. The 2020 Amendments also created new exclusions from the definition of "covered fund" (with their own affiliate transaction restrictions) for lending funds, "venture capital" funds (as defined in SEC rules); single family-owned funds; funds designed to facilitate business with a single client; and Small Business Investment Corporations (SBICs) during the wind-down period. Where appropriate, some of the salient aspects of the 2020 Amendments are noted below as annotations to the existing rules.

Proprietary Trading

Nature of the Proprietary Trading Prohibition

The first part of the Volcker Rule prohibits a banking entity from engaging in proprietary trading. "Proprietary trading"

is defined to mean engaging as principal for the "trading account" of the banking entity in any purchase or sale of one or more financial instruments.

"Financial instrument" includes a security, a derivative, and a contract of sale of a commodity for future delivery, or an option on any of the foregoing. The term "security" includes any note, stock, security future, bond, debenture, certificate of interest, or participation in any profit-sharing agreement, any collateral-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security." The term "derivative" includes any swap (as defined in the Commodity Exchange Act), security-based swap (as defined in the Securities Exchange Act of 1934), purchase or sale of a commodity for deferred delivery that is intended to be physically settled, or any foreign exchange forward or foreign exchange swap. Swaps include ISDA master agreements.

In other words, financial instruments cover an extensive array of financial products and contracts. The term financial instrument, however, does not include:

- A loan
- A commodity, unless it is (1) an excluded commodity (other than foreign exchange or currency), (2) a derivative, (3) a contract of sale of a commodity for future delivery, or (4) an option on a contract of sale of a commodity for future delivery
- Foreign exchange or currency

The term trading account is also defined broadly. If an account meets one of the following three tests, then such account is a trading account under the Volcker Rule:

- **Purpose test.** Is the account used to purchase or sell financial instruments principally for the purpose of (1) short-term resale, (2) benefitting from actual or expected short-term price movements, (3) realizing short-term arbitrage profits, or (4) hedging one or more positions resulting from the purchases or sales described in (1) through (3)? The 2019 Amendments reversed the presumption in this short-term purpose prong, which previously held that the purchase/sale of a financial instrument is presumed to be for the trading account if the banking entity holds the instrument for fewer than 60 days or substantially transfers the risk of the instrument within 60 days of the purchase/sale, unless the banking entity can demonstrate that it did not purchase/sell the instrument principally for any of the aforementioned purposes. The new presumption, adopted in the 2019 Amendments, is that the purchase/sale of a financial instrument is presumed not to be for the trading account if the banking entity holds the instrument for 60 days or longer and does not transfer substantially all of the risk of the instrument within 60 days of the purchase/sale.
- **Dealer registration test.** If the account is used by a banking entity to purchase/sell financial instruments for any purpose, is the banking entity (1) a U.S. licensed or registered securities dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased/sold in connection with the activities that require the banking entity to be so licensed or registered; or (2) engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased/sold in connection with the activities of such business? If the answer to either of the foregoing questions is yes, then the account in question is a Volcker Rule trading account.
- **Market risk capital rule test.** If the account is used to purchase/sell financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), is the banking entity or any affiliate thereof an FDIC-insured depository institution, bank holding company, or savings and loan holding company that calculates risk-based capital under the market risk capital rule? Again, if the answer to this question is yes, then the account is a trading account. Under the 2019 Amendments, institutions subject to the U.S. market risk capital rule are now required to look only to the market risk capital prong and the dealer prong (i.e., the test described in the preceding paragraph), in what amounts to a two (rather than three)-pronged condition. If an account does not fall under the "trading account" definition under either of those two tests, then the banking entity may, without further applying the third, intent-based purpose test to see if that prong is triggered, determine that the account is not a Volcker Rule trading account.

The 2018 NPR proposed to replace the intent-based purpose test of the proprietary trading definition and the related 60-day rebuttable presumption, all described above, with a new accounting prong that captures positions recorded at fair value on a recurring basis, which

the Responsible Federal Agencies believed would cover derivatives, trading securities, and available-for-sale (AFS) securities. However, this proposal was widely criticized by commentators raising concerns that the new accounting prong may create, perhaps in an unintended way, a new set of questions regarding its scope and application. The 2019 Amendments left intact the three-pronged test as is, and did not adopt the proposed accounting prong that had been proposed in the 2018 NPR.

Exclusions from the "proprietary trading" definition. The following types of transactions are not deemed to constitute proprietary trading and therefore are outside the purview of the Volcker Rule prohibition on the same:

- Repo and reverse repo transactions
- Securities lending transactions
- Purchase/sale pursuant to a liquidity management plan. The liquidity management plan must be documented; specifically contemplate and authorize the particular securities to be so used; and specify the permissible amount, types, and risks of the attendant securities (e.g., must be highly liquid securities). The 2019 Amendments expanded the liquidity management exclusion beyond securities to also permit FX forwards, swaps, and cross-currency swaps.
- Purchase/sale by a derivatives clearing organization or a clearing agency in connection with clearing financial instruments
- Excluded clearing activities by a member of a clearing agency, a member of a derivatives clearing agency, or a member of a designated financial market utility
- Purchase/sale in satisfaction of (1) an existing delivery obligation of the banking entity or its customers (e.g., prevention or closeout of a failure to deliver) in connection with delivery, clearing, or settlement activity or (2) an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization (SRO), or arbitration proceeding
- Purchase/sale by a banking entity acting solely as agent, broker, or custodian
- Purchase/sale through a deferred-compensation, stock-bonus, profit-sharing, or pension plan of the banking entity in its capacity as trustee for the benefit of current or former employees
- Purchase/sale 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

The 2019 Amendments adopted the following new or expanded exclusions from the "proprietary trading" definition:

- Purchase/sale of one or more financial instruments that was made in error by a banking entity in the course of conducting a permitted or excluded activity or is a subsequent transaction to correct such an error
- Contemporaneously entering into a customer-driven swap or customer-driven security-based swap and a matched swap or security based-swap if (i) the banking entity retains no more than minimal price risk; and (ii) the banking entity is not a registered dealer, swap dealer, or security-based swap dealer
- Purchase/sale of one or more financial instruments that the banking entity uses to hedge mortgage servicing rights or mortgage servicing assets in accordance with a documented hedging strategy
- Purchase/sale of a financial instrument that does not meet the definition of trading asset or trading liability under the applicable reporting form for a banking entity as of January 1, 2020

As you can see, the exceptions from the definition of "proprietary trading" are quite numerous. In counseling your banking entity client, it is therefore critical to examine the entire list of exceptions at the outset to determine whether a particular activity may fall under an exception, because once an activity is outside the definition of proprietary trading, you are in the clear as far as that activity is concerned.

Permitted Proprietary Trading Activities

To recap, the Volcker Rule prohibits a banking entity from engaging in proprietary trading, which is defined to mean engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments. As noted above under *Nature of the Proprietary Trading Prohibition*, certain trading activities that would otherwise fall within the definition of proprietary trading are expressly excluded from it. There is an array of proprietary trading activities that would normally fall within the definition but, for a variety of policy reasons, are permitted for banking entities, typically because they do not constitute the type of speculative trading that the Volcker Rule is intended to curb.

These permitted proprietary trading activities include (1) underwriting activities, (2) market making–related activities, (3) risk-mitigating hedging activities, (4) trading in U.S. and non-U.S. government securities, (5) trading on behalf of customers, (6) trading by a regulated insurance company,

and (7) trading activities of foreign banking entities. Each of these activities is discussed in further detail below.

Underwriting Activities

Underwriting activities are permitted subject to the following criteria, which are designed to limit and detect evasive transactions:

- 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.
- The amount and types of securities in the underwriting position are designed not to exceed the reasonably expected near-term demands, and reasonable efforts are made to reduce the underwriting position within a reasonable period.
- The banking entity has established the requisite internal compliance program.
- The compensation arrangements are designed not to reward or incentivize prohibited proprietary trading.

Market Making–Related Activities

Market making-related activities are permitted only if:

- The trading desk routinely stands ready to purchase and sell the types of financial instruments related to the financial exposure and is willing and available to quote, purchase, and sell in commercially reasonable amounts
- The amount, types and risks in the trading desk's inventory are designed not to exceed the reasonably expected near-term demands (RENTD), based on (1) the liquidity, maturity, and depth of the market and (2) demonstrable analysis of historical customer demand, current inventory, and market and other factors
- If any established limit for a trading desk is exceeded, the trading desk takes actions to come back into compliance promptly
- The banking entity has established the requisite internal compliance program
- The compensation arrangements are designed not to reward or incentivize prohibited proprietary trading

In the context of this market-making exemption to the proprietary trading prohibition, as well as in the context of recordkeeping and reporting requirements discussed under "Compliance Program Requirements," "Proprietary Trading Reporting Requirements," and "New Three-Pronged Compliance and Reporting Requirements" in Compliance and Penalties, the concept of a "trading desk" is important because the relevant provisions center around the question of what is, in fact, a trading desk. The term was originally defined as the smallest discrete organized unit of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Responsible Federal Agencies expected a trading desk to be managed and operated as an individual unit and to reflect the level at which the profit and loss of the traders is attributed. The Agencies apparently believe that this approach helps to manage risks of trading activity more effectively by requiring the establishment of limits, management oversight, and accountability at the level where the trading activity occurs. Significantly, this meant, and still to an extent means that a trading desk may span more than one legal entity, employees of a single trading desk may be working on behalf of multiple affiliated legal entities, and trades and positions managed by the desk may be booked in different affiliated entities. If a single trading desk books positions in different affiliated legal entities, it must have records that identify all positions included in the trading desk's financial exposure and the legal entities where such positions are held.

The 2019 Amendments now define the term "trading desk" to mean "the smallest discrete *unit of organization of a banking entity* that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof." The subtle shift from the former wording "organized unit of a banking entity" to the new wording apparently was intended to achieve an alignment with criteria used to establish trading desks for other operational, management, and compliance purposes. The criteria include a well-defined unit that engages in coordinated trading activity, operates subject to a common set of risk levels and limits, submits information to management as a unit, and books its trades together. In this regard, the new definition of "trading desk" alleviates some of the confusion that arose under the former definition as to exactly what a particular trading desk for a specific financial instrument was.

As had been proposed in the 2018 NPR, the 2019 Amendments provide that compliance with RENTD under the market-making and underwriting exemptions would be presumed if the banking entity maintains and enforces internal risk limits for each trading desk. Therefore, banking entities are now permitted to base risk and other desk limits on internal models and analyses, rather than having to conduct any externally-formulated mandatory analysis. Internal limits for underwriting desks must be set for (i) the amount, types, and risks of the desk's underwriting positions; (ii) the level of exposure to relevant risk factors arising from the desk's underwriting positions; and (iii) the period of time a security may be held. Internal limits for market-making desks must be set for (i) the amount, types,

and risks of the desk's market-maker positions; (ii) the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes; (iii) the level of exposure to relevant risk factors arising from the desk's financial exposure; and (iv) the period of time a financial instrument may be held.

Risk-Mitigating Hedging Activities

The prohibition against proprietary trading does not apply to risk-mitigating hedging activities in connection with individual or aggregated positions, contracts, or other holdings designed to reduce the specific risks in connection therewith, if:

- The banking entity has established the requisite internal compliance program
- The hedging activity, at its inception, is designed to reduce or mitigate specific, identifiable risks (e.g., market risk, counterparty risk) arising in connection with identified positions and does not give rise to any significant new or additional risk that is not hedged at the same time
- The compensation arrangements are not designed to reward or incentivize prohibited proprietary trading

As had been proposed in the 2018 NPR, the 2019 Amendments removed the requirements for correlation analysis, as well as a showing that the hedge "demonstrably reduces or otherwise significantly mitigates" an identifiable risk.

Trading in U.S. and Non-U.S. Government Securities

Proprietary trading in the following financial instruments is permitted:

- U.S. federal, state, and local government obligations: A financial instrument that is an obligation of: (1) the U.S. government, 2) an agency of the United States or a U.S. government–sponsored enterprise (including Ginnie Mae, Fannie Mae, and Freddie Mac), (3) a U.S. state or a political subdivision thereof, including any municipal security or (4) the FDIC (including in its capacity as conservator or receiver)
- A financial instrument that is an obligation of a non-U.S. sovereign (or any agency or political subdivision thereof), so long as: (1) the banking entity making the purchase/sale is organized under (or is controlled by a banking entity organized under) the laws of a foreign sovereign and is not controlled by a top-tier banking entity that is organized under the laws of the United States, (2) the financial instrument is an obligation of the foreign sovereign under the laws of which the foreign bank entity referred to below is organized (e.g., in the case of a Spanish banking entity, the financial instrument must be a Spanish government obligation) and (3) the purchase/sale is not made by an FDIC-insured depository institution (Note this exemption is only available to affiliates of foreign banking entities in the United States.)

Trading on Behalf of Customers

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments as follows:

- **Fiduciary transactions.** Purchase or sale by a banking entity acting as trustee or in a similar fiduciary capacity, as long as (1) the transaction is conducted for the account of, or on behalf of, a customer; and (2) the banking entity does not have or retain beneficial ownership of the financial instrument.
- **Riskless principal transactions.** Purchase or sale by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving from a customer an order to purchase a financial instrument, purchases the financial instrument for its own account to offset a contemporaneous sale to the customer.

Trading by a Regulated Insurance Company

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments by a banking entity that is an insurance company (or an affiliate thereof) if all of the following conditions are met:

- The insurance company or its affiliate purchases or sells the financial instruments solely for the general account of the insurance company or a separate account established by the insurance company.
- The purchase or sale is conducted in compliance with the insurance company investment laws, regulations, and written guidance of the U.S. state or the jurisdiction of domicile of such insurance company.
- The appropriate Responsible Federal Agencies have not determined that the particular law, regulation, or written guidance referred to above is insufficient to protect the safety and soundness of the covered banking entity or the financial stability of the United States.

For purposes of this exemption, the following defined terms apply:

"Insurance company" means a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsurance risks underwritten by insurance companies, subject to

supervision as such by a U.S. state insurance regulator or a foreign insurance regulator.

"General account" means all of the assets of an insurance company except those allocated to one or more separate accounts.

"Separate account" means an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses (whether or not realized) from assets allocated to such account are credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

Trading Activities of Foreign Banking Entities

The prohibition against proprietary trading does not apply to the purchase or sale of financial instruments by a foreign banking entity under the following conditions.

1. The banking entity is not organized (or controlled by a banking entity that is organized) under the laws of the United States or any U.S. state.

2. The purchase or sale is made pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act. A foreign banking organization, more than half of whose worldwide business is banking and more than half of whose banking business is outside the United States (a qualifying foreign banking organization, or QFBO), by meeting at least two of the three quantitative tests measuring its consolidated assets, revenues, and net income, is allowed some relief from the extraterritorial reach of the BHC Act.

3. The transaction takes place solely outside the United States (TOTUS). TOTUS means:

    a) The banking entity engaging as principal in the purchase or sale (including relevant personnel) is not located in the United States or organized under the laws of the United States or any U.S. state

    b) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or any U.S. state

    c) The purchase or sale (including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold) is not accounted for as principal on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or any U.S. state

As had been proposed in the 2018 NPR, the 2019 Amendments removed several conditions from the TOTUS trading exemption, including (1) the prohibition against the purchase or sale being conducted with or through a U.S. entity, (2) the prohibition against provision of financing for the transaction by any U.S. branch or entity and (3) the requirement that no U.S. personnel be involved in arranging, negotiating, or executing the transaction.

To say that foreign banks and their affiliates play a major role in the U.S. banking, trading, and investment management spheres is an understatement. As such, if your client is a foreign banking entity, it would be prudent to query at the outset whether a TOTUS exemption may apply with respect to a trading activity (or, as noted below, a fund investment/sponsorship activity) that may otherwise be covered by and restricted under the Volcker Rule.

Backstop Prohibition

None of the activities discussed above under "Permitted Proprietary Trading Activities" in Proprietary Trading (including underwriting, market making, risk-mitigating hedging, trading in government securities, and SOTUS trading) is permissible if the transaction or activity would:

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

A high-risk asset is an asset that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. A high-risk trading strategy is a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

In order to mitigate potential conflicts of interest, prior to effecting the transactions in question, the banking entity must take one of the following actions:

- The banking entity must make clear, timely, and effective disclosure of the nature of the conflict of interest and other required information; and make such disclosure

explicitly and effectively, in a manner that provides the recipient of the disclosed information the opportunity to negate any material adverse effect of the purported conflict.

- The banking entity must establish, maintain, and enforce certain prescribed information barriers (such as physical separation of personnel or functions, or limitations on types of activity) that are memorialized in written policies and procedures.

Covered Funds Activities

Nature of the Covered Funds Prohibition

We now turn to the second prohibition under the Volcker Rule, which provides that a banking entity shall not, as principal, directly or indirectly, acquire or retain any "ownership interest" in, or "sponsor," a "covered fund."

A covered fund means either:

- An issuer of securities that is excluded from the definition of "investment company" based solely on Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (individual investments of at least $5 million) of the Investment Company Act of 1940 (1940 Act) –or–
- A commodity pool (1) for which the commodity pool operator has claimed an exemption under 17 CFR 4.7 or (2) for which a CFTC-registered commodity pool operator is the commodity pool operator, substantially all participation units of which are owned by qualified eligible persons (QEPs), and participation units of which have not been publicly offered to non-QEPs.

The apparent legislative intent behind this somewhat convoluted definition of covered fund is to bring within the purview of the Volcker Rule only those funds that are commonly referred to as private equity funds or hedge funds. However, as you can see, the definition can cover many other types of pooled investment vehicles, most of which presumably had, or will have, little to do with banking entities' imprudent involvement with speculative instruments. Be that as it may, the question of whether a particular fund or vehicle is or is not a Volcker Rule "covered fund" has been and likely will continue to be a source of some confusion among practitioners. For instance, the SEC has stated that, "certain federally sponsored structured financings, such as those sponsored by the Federal National Mortgage Association, are exempted from the [1940 Act] under Section 2(b), which exempts, among other things, activities of United States Government instrumentalities and wholly owned corporations of such instrumentalities." See, e.g., Federal National Mortgage Association, SEC No-Action Letter (May 25, 1988). If an issuer may rely on Section 2(b) of the 1940 Act, it would be relying on a 1940 Act exemption other than the exclusions contained in Section 3(c)(1) or 3(c)(7), and thus would be excluded from the definition of "covered fund."

Covered funds also include, for any banking entity that is (or is controlled by a banking entity that is) located in or organized under the laws of the United States or any U.S. state, an entity (1) that is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (2) that is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or otherwise trading in securities; and (3) (A) whose sponsor is that banking entity or an affiliate thereof; or (B) that has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

For this purpose, a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States. However, the foreign bank that operates or controls that branch, agency or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. In other words, generally speaking, a banking entity whose ultimate parent is a foreign bank or holding company can, in a way that one whose ultimate parent is a U.S. entity cannot, engage in certain types of covered funds–related activities offshore as long as there is no U.S. entity in the chain of ownership leading from the ultimate foreign parent to the would-be covered fund in question.

Ownership interests subject to the Volcker Rule include any equity, partnership, or other similar interest in a covered fund, whether voting or nonvoting, or any derivative of such interest. Determinative factors for "other similar interests" include (1) the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event); (2) the right to receive a share of the income, gains, or profits of the fund; (3) the right to receive the underlying assets of the fund after all other interests have been redeemed or paid in full; (4) the right to receive all or a portion of excess spread; (5) a provision that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund; (6) receipt of income on a pass-through basis from the covered fund, or a rate of

return that is determined by reference to the performance of the underlying assets of the covered fund; and (7) any synthetic right to have, receive, or be allocated any of the foregoing.

With respect to the clause (1) prong of the ownership interests determinative factors set forth in the preceding paragraph, the 2020 Amendments clarified that creditors' rights that are permissible upon default or acceleration events would include the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal. The 2020 Amendments also expanded the types of voting rights that debt holders may have with respect to an investment manager without triggering the "ownership interest' definition.

The term ownership interest, however, does not include "restricted profit interest" (or carried interest), which is an interest held by an entity (or a current or former employee thereof) in a covered fund for which the entity (or the employee) serves as investment manager, investment advisor, commodity trading advisor, or other service provider. Some of the factors that determine the designation of restricted profit interest are:

- The sole purpose and effect of the interest is to allow the entity (or the employee) to share in the profits of the fund as compensation for the services provided, along with certain obligations to return previously received profits
- All such profits, once allocated, are distributed promptly after being earned or are retained for the sole purpose of establishing a reserve amount for subsequent losses
- Investment limits described below in subsection 4 (Investing in a Fund Organized by a Banking Entity) under "Permitted Covered Funds Activities" in Covered Funds Activities
- Transfer restrictions to nonaffiliates.

Moreover, the 2020 Amendments created a new safe harbor exclusion from the "ownership interest" definition. This exclusion limits the circumstances under which a debt interest would be characterized as an ownership interest under the "other similar interest" prong of that definition.

A banking entity is a "sponsor" of a covered fund if such banking entity:

- Serves as a general partner, managing member, trustee or commodity pool operator of the fund
- In any manner selects or controls a majority of the directors, trustees or management of the fund –or–
- Shares with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name

The following types of funds, vehicles, and products are excluded from the definition of covered funds:

- Foreign public funds
- Wholly owned subsidiaries
- Joint ventures
- Acquisition vehicles
- Foreign pension or retirement funds
- Insurance company separate accounts
- Bank-owned life insurance
- Loan securitizations
- Qualifying asset-backed commercial paper conduits
- Qualifying covered bonds
- SBICs and public welfare investment funds
- Registered investment companies and excluded entities (Note, again, that an issuer of securities that may rely on an exclusion or exemption from the definition of investment company under the 1940 Act other than the exclusions contained in Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (individual investments of at least $5 million) would not be a "covered fund.")
- Issuers in conjunction with the FDIC's receivership or conservatorship
- Any issuer that the Responsible Federal Agencies jointly determine should be excluded from the covered fund definition

The 2020 Amendments created the following new exclusions from the definition of covered funds:

- Credit funds that make loans, invest in debt, or otherwise extend the type of credit that a banking entity may extend directly, subject to certain asset and activities restrictions and conditions
- Venture capital funds as defined in SEC Rule 203(l)-1 (17 C.F.R. § 275.203(l)-1)
- Family wealth management vehicles that do not hold themselves out as being an entity that raises money from investors primarily for the purpose of investing in securities for resale or disposition or otherwise trading in securities, and meeting certain other ownership requirements and conditions
- Customer facilitation vehicles formed by or at the request of a banking entity's customer for the purpose of

providing that customer with exposure to a transaction, investment strategy, or other service provided by the banking entity

Permitted Covered Funds Activities

To recap, the Volcker Rule prohibits a banking entity, as principal, directly or indirectly, from acquiring or retaining any ownership interest in, or sponsoring, a covered fund. As noted above under "Nature of the Covered Funds Prohibition" in Covered Funds Activities, certain funds and other investment vehicles that would ordinarily fall within the definition of covered funds are expressly excluded from it. There is also an array of covered funds investment and sponsorship activities that would fall within the relevant definitions which, for a variety of policy reasons, are permitted for banking entities. They include the following seven circumstances: (1) acting as an agent, broker, or custodian, (2) permitted organizing and offering, (3) permitted underwriting and market making, (4) investing in a fund organized by a banking entity, (5) risk-mitigating hedging activities, (6) activities and investments outside of the United States, and (7) regulated investment companies. Each of these is discussed in greater detail below.

1. Agent, Broker, or Custodian

   The general prohibition against a banking entity acquiring or retaining any ownership interest in or sponsoring a covered fund does not apply to the following situations:

   - Banking entity 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 does not have or retain beneficial ownership of such interest
   - If the ownership interest is held by the banking entity as trustee for the benefit of its current or former employees through a deferred compensation, pension, or other similar plan
   - In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable and within the period prescribed by the applicable U.S. regulatory agency

2. Permitted Organizing and Offering

   In general, a banking entity may acquire or retain an ownership interest in or sponsor a covered fund in connection with organizing and offering such fund, if all of the following conditions are met:

   (a) The banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services

   (b) The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services, and only to persons that are customers of such services offered by the banking entity

   (c) The banking entity and its affiliates do not acquire or retain an ownership interest in the fund except to the extent described below in subsection 4 (Investing in a Fund Organized by a Banking Entity)

   (d) The banking entity and its affiliates comply with the so-called Super 23A and 23B requirements to the extent described below in Permitted Covered Funds Activities – Limitations on Covered Fund Relationships

   (e) The banking entity does not guarantee, assume, or otherwise insure the obligations or performance of the covered fund (or any other covered fund in which the covered fund invests)

   (f) The covered fund, for corporate, marketing, promotional, or other purposes, does not (1) share the same name or a variation of the same name with the banking entity and (2) does not use the word "bank" in its name

   (g) No director or employee of the banking entity takes or retains an ownership interest in the covered fund, except for those who are directly engaged in providing relevant services to the fund at the time of taking such ownership interest

   (h) The banking entity clearly and conspicuously discloses to any prospective and actual investor in the covered fund:

   - That any losses in the fund will be borne solely by the investors and not by the banking entity; therefore, the banking entity's losses will be limited to losses attributable to the ownership interests in the fund held by the banking entity in its capacity as investor
   - That the ownership interests in the fund are not insured by the FDIC, and are not deposits at, obligations of, or endorsed or guaranteed in any way by any banking entity (unless that is the case)

- The role of the banking entity in sponsoring or providing any services to the fund

3. Permitted Underwriting and Market Making

   A banking entity may engage in underwriting or market making–related activities involving a covered fund, subject to the following conditions:

   (a) Such activities are conducted in accordance with the requirements described above with respect to underwriting and market making-related activities in "Permitted Proprietary Trading Activities" under Proprietary Trading.

   (b) Any ownership interests acquired in connection with underwriting and market making–related activities are included in the calculation of ownership interests permitted to be held under the limitations described immediately below in subsection 4 (Investing in a Fund Organized by a Banking Entity).

   (c) The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired under the permitted organizing, offering, underwriting, and market making authorities are included in the same calculation of ownership interests referred to in clause (b) above.

   The 2019 Amendments eliminated (i) the application of the 3% aggregate and per-fund limits and the capital deduction to ownership interests in third-party covered funds that are acquired by a banking entity in reliance on the underwriting and market-making exemptions, as well as (ii) the application of 3% per-fund limit to positions in third-party covered funds acquired in underwriting or market-making capacity where a banking entity guarantees, assumes, or otherwise insures the obligations or performance of such third-party funds.

4. Investing in a Fund Organized by a Banking Entity

   A banking entity may acquire and retain an ownership interest in a covered fund organized and offered by it, for two distinct purposes:

   (a) *Provision of initial equity in connection with the establishment of a fund*, in order to attract unaffiliated investors, subject to a seeding period limit as well as an aggregate limit.

   - **Seeding period.** The banking entity (1) must actively seek unaffiliated investors to reduce (through redemption, etc.) the aggregate amount of all ownership interests of the banking entity in the fund to the de minimis limits discussed below and (2) must, no later than one year after the date of establishment of the fund (i.e., the date on which the investment adviser begins making investments pursuant to the investment strategy for the fund), conform its ownership interest in the fund to the per-fund limits discussed below. This one-year period can be extended for up to two additional years by the Federal Reserve.

   (b) *De minimis investment*, subject to per-fund limits and an aggregate limit.

   - **Per-fund limits.** A de minimis investment in any covered fund may not exceed 3% of the total number or value of the outstanding ownership interests of the fund.
   - **Aggregate limit.** The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under the authority of either (1) providing initial equity in connection with establishment of a fund or (2) de minimis investment may not exceed 3% of the tier 1 capital of the banking entity, as calculated as of the last day of each calendar quarter. For this purpose, the aggregate value of all ownership interests held by a banking entity is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds, on a historical cost basis.

5. Risk-Mitigating Hedging Activities (as revised under the 2019 Amendments)

   An ownership interest in a covered fund that is designed to 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; or (ii) a position taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, is permitted only if:

   (a) The banking entity has established a compliance program that includes (i) reasonably designed policies and procedures and (ii) internal controls and ongoing monitoring, management and authorization procedures

   (b) The acquisition of the ownership interest (i) is made in accordance with the requisite policies, procedures

and internal controls; (ii) is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising (A) out of a transaction conducted solely to accommodate a specific customer request with respect to the covered fund or (B) in connection with the compensation arrangement with the employee who directly provides investment advisory, commodity trading, or other services to the covered fund; (iii) does not give rise to any significant new or additional risk that is not hedged contemporaneously; and (iv) is subject to continuing review, monitoring, and management

(c) Where applicable, the compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate has acquired an ownership interest pursuant to this exception, and such arrangement provides that any losses incurred by the banking entity on such interest will be offset by corresponding decreases in amounts payable under such arrangement

6. Activities and Investments Outside of the United States

Covered fund activities and investments outside of the United States are permitted only if:

(a) The banking entity is not organized (or controlled by a banking entity that is organized) under the laws of the United States or any U.S. state

(b) The activity or investment is made pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act (See QFBO discussion above in "Permitted Proprietary Trading Activities" – Trading Activities of Foreign Banking Entities in connection with SOTUS trading exemption.)

(c) No ownership interest in the covered fund is offered for sale or sold to a "resident of the U.S." Under the relaxed condition contained in the 2019 Amendments, in order to meet this requirement, such ownership interest may not be sold pursuant to an offering that targets residents of the U.S. in which the banking entity or any affiliate thereof participates. If the banking entity or an affiliate thereof sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator, or commodity trading advisor to a covered fund, then the banking entity or affiliate will be deemed to participate in any offer or sale by the covered fund of ownership interests in such covered fund.

(d) The activity or investment occurs solely outside of the United States (SOTUS)

"Resident of the U.S." has the same meaning as "U.S. person" under Regulation S of the SEC and therefore includes the following:

- Any natural person resident in the United States
- Any partnership or corporation organized or incorporated under the laws of the United States
- Any estate of which any executor or administrator is a U.S. person
- Any trust of which any trustee is a U.S. person
- Any agency or branch of a foreign entity located in the United States
- Any nondiscretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person
- Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States

The following are *not* "residents of the U.S.":

- Any discretionary account or similar account held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or resident in the United States
- An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country
- Any agency or branch of a U.S. person located outside the United States if (1) the agency or branch operates for valid business reasons and (2) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located
- The International Monetary Fund, the International Bank for Reconstruction and Development, the Asian Development Bank, the United Nations, and their agencies, affiliates, and pension plans, and any other similar international organizations, their agencies, affiliates, and pension plans

An ownership interest is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold pursuant to an "offering that targets residents of the U.S." The sponsor of a foreign fund would not be viewed as targeting U.S. residents if it:

- Conducts an offering directed to residents of one or more countries other than the United States
- Includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States
- Includes other reasonable procedures so that access to offering and subscription materials would be restricted only to persons that are not residents of the United States

If ownership interests that are issued in a foreign offering are listed on a foreign exchange, secondary market transactions could be undertaken by the banking entity outside the United States in accordance with Regulation S. Foreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States. Sponsors of covered funds established outside of the United States must examine the facts and circumstances of their particular offerings and confirm that the offering does not target residents of the United States.

A covered fund activity of investment occurs solely outside the United States only if:

- The banking entity acting as sponsor, or engaging as principal in the acquisition of the ownership interest, is not (and is not controlled by) a banking entity located in the United States or organized under the laws of the United States or any U.S. state
- The banking entity (including relevant personnel) that makes the decision to acquire the ownership interest or act as sponsor to the fund is not located in the United States or organized under the laws of the United States or any U.S. state
- The investment or sponsorship (including any transaction arising from risk-mitigating hedging related to an ownership interest) is not accounted for as principal on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or any U.S. state

  The 2019 Amendments eliminated the previous SOTUS eligibility requirement that no financing for the banking entity's ownership or sponsorship may be provided by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or any U.S. state.

7. Regulated Investment Companies

   The prohibition against ownership and sponsorship of covered funds does not apply to investments and activities by an insurance company if:

   - The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or a separate account established by the insurance company
   - The acquisition and retention of the ownership interest is conducted in compliance with the insurance company investment laws, regulations and written guidance of the U.S. state or the jurisdiction of domicile of such insurance company
   - The appropriate U.S. federal banking agencies have not determined that a particular law, regulation or written guidance referred to immediately above is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States

Qualifying Foreign Excluded Funds (QFEFs)

The 2020 Amendments made permanent the formerly temporary relief (discussed above) that the Responsible Federal Agencies began to provide in July 2017 with respect to qualifying foreign excluded funds (QFEFs). A QFEF — that is, a fund that meets the requirements set forth below — is exempt from the proprietary trading and covered fund restrictions, and compliance programs, under the Volcker Rule:

- is organized or established outside the U.S. and the ownership interests of which are offered and sold solely outside the U.S.
- would be a covered fund if the entity were organized or established in the U.S. or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments
- would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the fund
- is established and operated as part of a bona fide asset management business

- is not operated in a manner that enables the banking entity that sponsors or controls the fund, or any of its affiliates, to evade the Volcker Rule

Furthermore, in order to avail itself of the benefits of the QFEF relief, the foreign banking entity may acquire or retain an ownership interest in, or sponsor, the foreign excluded fund only in compliance with the SOTUS exemption requirements discussed above.

Limitations on Covered Fund Relationships

No banking entity that (1) serves as the investment manager or sponsor to a covered fund or (2) organizes and offers a covered fund pursuant to the permitted organization and offering exception discussed above under "Permitted Covered Funds Activities" in Covered Funds Activities, and no affiliate of such entity, may enter into a transaction with the covered fund that would be a "covered transaction" as defined in Section 23A of the Federal Reserve Act, as if such banking entity and the affiliate thereof were a member of the Federal Reserve System and the covered fund were an affiliate thereof. Moreover, a banking entity that (1) serves as the investment manager or sponsor to a covered fund or (2) organizes and offers a covered fund pursuant to the permitted organization and offering exception will be subject to Section 23B of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate thereof.

Under Section 23A of the Federal Reserve Act, a "covered transaction" means with respect to an affiliate of a member bank:

- A loan or extension of credit to the affiliate, including a repo transaction
- A purchase of securities issued by the affiliate
- A purchase of assets from the affiliate, except such purchase of property as may be specifically exempted by the Federal Reserve
- The acceptance of securities or other debt obligations issued by the affiliate as collateral for a loan or extension of credit
- The issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate
- A transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a bank to have credit exposure to the affiliate
- A derivative transaction, as defined in 12 U.S.C. 84(b), with an affiliate, to the extent that the transaction causes a bank to have credit exposure to the affiliate

Notwithstanding the general rule with respect to Federal Reserve Act Section 23A described above, a banking entity may:

- Acquire and retain any ownership interest in a covered fund in accordance with the various exemptions discussed above
- Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity has taken an ownership interest, if certain specified requirements are met

Under Section 23B of the Federal Reserve Act, a member bank or its subsidiary:

- May not purchase as fiduciary any securities or other assets from any affiliate, unless such purchase is permitted (1) under the instrument creating the fiduciary relationship, (2) by court order, or (3) by law of the jurisdiction governing the fiduciary relationship
- Whether acting as principal or fiduciary, may not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank

Backstop Prohibition

None of the permitted investments or activities discussed above under *Permitted Covered Funds Activities* (including permitted organizing and offering, underwriting, market making, investments, risk-mitigating hedging, and SOTUS covered fund activities) is permissible if the transaction or activity would:

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

The terms high-risk asset and high-risk trading strategy have the same meanings as those used in the Backstop Prohibition section above under "Permitted Proprietary Trading Activities" in Proprietary Trading.

Compliance and Penalties

Compliance Program Requirements

Subject to the three-tiered compliance framework described below, which was adopted in the 2019 Amendments, each banking entity must develop and administer a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments described above. The compliance program, at a minimum, must include:

- Written policies and procedures reasonably designed to document, describe, monitor, and limit proprietary trading activities (including setting, monitoring, and managing required limits) and covered fund activities and investments conducted by the banking entity to ensure compliance
- A system of internal controls reasonably designed to monitor compliance and to prevent the occurrence of prohibited activities or investments
- A management framework that clearly delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters requiring attention
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or a qualified outside party
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program
- Records sufficient to demonstrate compliance, which the banking entity must promptly provide to the applicable U.S. federal agency (most likely, the Federal Reserve) upon request and retain for at least five years

Proprietary Trading Reporting Requirements

The Volcker Rule, as originally adopted, provided that a foreign banking entity engaged in permitted proprietary trading activity must comply with the reporting requirements described in Appendix A of the Federal Reserve's Regulation VV if the average gross sum of the trading assets and liabilities of the combined U.S. operations of such foreign banking entity (including all subsidiaries, affiliates, branches, and agencies of the foreign banking entity operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $10 billion, beginning on December 31, 2016.

A banking entity with $50 billion or more in trading assets and liabilities (as calculated in the manner described above) was required to report the information required by Appendix A of Regulation VV for each calendar month within 30 days of the end of the relevant calendar month.

Beginning with information for the month of January 2015, such information must be reported within ten days of the end of each calendar month.

Any other banking entity subject to Appendix A was required to report the information required by Appendix A for each calendar quarter within 30 days of the end of that calendar quarter unless the Federal Reserve notifies the banking entity in writing that it must report on a different basis.

New Three-Pronged Compliance and Reporting Requirements

Following, for the most part, the elements of the 2018 NPR, the 2019 Amendments implemented the following three-tiered compliance and reporting requirements, based on a banking organization's gross trading assets and trading liabilities (TAL):

- Significant TAL: TAL of $20 billion or more (according to the Responsible Federal Agencies, approximately 93% of TAL held in the U.S. banking system are attributable to significant TAL institutions)
- Moderate TAL: TAL in the range of $1 billion to $20 billion -and-
- Limited TAL: TAL of less than $1 billion

For foreign banking organizations, the TAL figure can be calculated only on the basis of their combined U.S. operations.

Banking Entities with Significant TAL

Banking entities with significant TAL are subject to the most stringent requirements, consisting of the following elements:

- A six-pillar compliance program consisting of: written policies and procedures; internal controls to monitor compliance; a management framework that delineates responsibility and accountability; independent testing and audit of the compliance program; training; and recordkeeping.
- Metric reporting requirements

- Covered funds documentation requirements
- Exemption-specific and more prescriptive compliance program requirements, applicable to those relying on the market-making and underwriting exemptions
- CEO attestation requirement

Banking Entities with Moderate TAL

Banking entities with moderate TAL are subject to the newly simplified requirements, consisting of the following elements:

- These entities are not required to implement the above-described six-pillar compliance program that are mandatory for banking entities with significant TAL. They may satisfy the compliance program requirement by including in their existing compliance policies and procedures references to the Volcker Rule requirements as may be appropriate in light of their respective activities, size, scope and complexity of the organization.
- Banking entities in this category are no longer subject to the CEO attestation requirement and, in certain instances, trading desk metrics reporting requirements.

Banking Entities with Limited TAL

Banking entities with limited TAL may now avail themselves of the relief and benefits of a rebuttable presumption of compliance. They no longer have an obligation to demonstrate Volcker Rule compliance on an ongoing basis, "unless and until the appropriate [responsible federal] agency, based on a review of the banking entity's activities determines that the banking entity must establish the simplified compliance program." *Preamble to the 2018 NPR*. The rebuttable presumption of compliance can be rebutted by an agency if the agency determines that the banking entity has engaged in proprietary trading or covered fund activities that are otherwise prohibited under the Volcker Rule. As such, so long as the presumption of compliance holds, banking entities with limited TAL are no longer subject to a compliance program requirement.

Penalties for Violations

As noted above, the Volcker Rule is embodied in Section 13 of the BHC Act; therefore, any violation of the Rule is subject to the penalty provisions of that Act.

Criminal penalty

- Whoever knowingly violates any provision of the BHC Act or Federal Reserve regulation issued under the BHC Act shall be imprisoned not more than one year, fined not more than $100,000 per day for each day during which the violation continues, or both.
- Whoever, with the intent to deceive, defraud, or profit significantly, knowingly violates any provision of the BHC Act shall be imprisoned not more than five years, fined not more than $1,000,000 per day for each day during which the violation continues, or both.
- Every officer, director, agent, and employee of a bank holding company shall be subject to penalties for false entries in any book, report, or statement of such bank holding company

Civil money penalty

Any company that violates, and any individual who participates in a violation of, any provision of the BHC Act, or any regulation or order issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $25,000 for each day during which such violation continues. The term "violate" includes any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

- **First tier.** Any company that (A) maintains procedures reasonably adapted to avoid any inadvertent error and, unintentionally and as a result of such an error, (i) fails to make such reports within the period of time specified by the Federal Reserve or (ii) submits any false or misleading report; or (B) inadvertently transmits any report that is minimally late, shall be subject to a penalty of not more than $2,000 for each day during which such failure continues or such false or misleading information is not corrected.
- **Second tier.** Any company that (A) fails to make such reports as may be required under the BHC Act within the period of time specified by the Federal Reserve or (B) submits any false or misleading report in a manner not described in the first tier shall be subject to a penalty of not more than $20,000 for each day during which such failure continues or such false or misleading information is not corrected.
- **Third tier.** If any company knowingly or with reckless disregard for the accuracy of any information or report described in the second tier submits any false or misleading report, the Federal Reserve may, in its discretion, assess a penalty of not more than $1,000,000 or 1% of total assets of such company, whichever is less, per day for each day during which such failure continues or such false or misleading information is not corrected.

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Eric Yoon is a partner at K&L Gates LLP, splitting time evenly between its New York and Seoul offices. Eric focuses his practice in banking and financial services regulation, cross-border M&A, and financings. He has represented major multinational corporations, global financial institutions, and foreign sovereign entities in the regulatory and transactional aspects of their geographic and product-line expansions as well as strategic divestitures.

Eric has significant experience representing non-U.S. banks and financial institutions with respect to regulatory aspects of their activities in the United States. He has represented his clients before various federal and state regulatory agencies and is expert in the Bank Holding Company Act (including the Volcker Rule) and the Dodd-Frank Act.