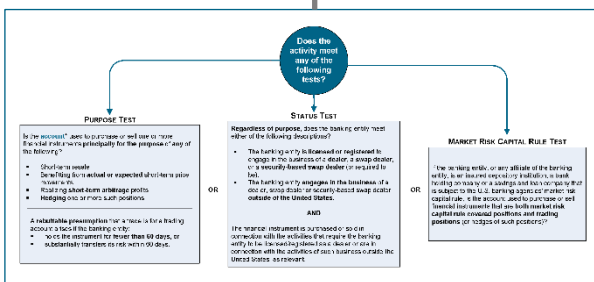
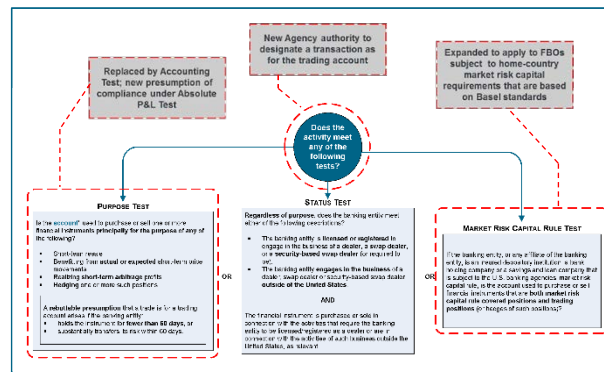
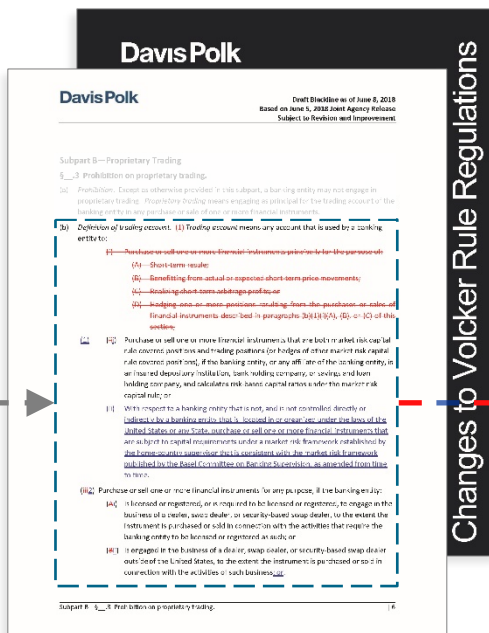


## Changes to Volcker Rule Regulations



# Proposed Amendments to the Volcker Rule Regulations

June 18, 2018

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# I. Introduction

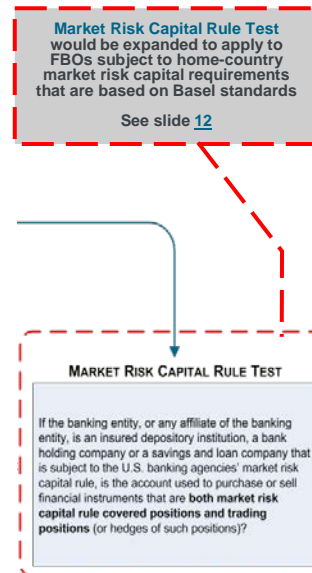
# Introduction

- **Proposal.** The Federal Reserve, FDIC, OCC, CFTC and SEC (the **Agencies**) recently issued proposed changes to the Volcker Rule regulations.
- **Proprietary trading.** The proposal is weighted towards proprietary trading and includes many amendments to the proprietary trading portion of the final rule adopted in December 2013 (**Final Rule**), as well as a large number of requests for comment.
- **Covered funds.** The Agencies propose few amendments to the covered funds portion of the Final Rule. Similar to the proprietary trading section, however, they include a large number of requests for comment about possible additional amendments.
- **Invitation to comment.** The proposal includes extensive requests for comment, with 1,008 questions contained in 342 numbered groups.
- **Bipartisan Banking Act.** The Agencies state in the preamble that they plan to address the statutory amendments made by the Economic Growth, Regulatory Relief, and Consumer Protection Act—otherwise known as the Bipartisan Banking Act—in a separate rulemaking process. The Agencies make it clear that to the extent the recent statutory amendments conflict with the existing and proposed Volcker Rule regulations, the statutory amendments control with immediate effect.

Vice Chairman for Supervision Quarles stated, “I view this proposal as an important milestone in comprehensive Volcker rule reform, but not the completion of our work. The proposal seeks comment on a variety of fronts, ranging from narrow to broad, and I encourage views from all sides to weigh in on how the proposal can be improved while maintaining the safety and soundness of firms and complying with statutory requirements. We will genuinely listen to those comments and take them into account as we formulate a final rule.”

# Guide to this Visual Memorandum

- This visual memorandum incorporates elements of Davis Polk’s flowcharts on the proprietary trading and covered funds provisions of the Final Rule.
- Visual depictions of the proposed changes to the Final Rule and key requests for comment on the Final Rule are shown by overlaying red dotted lines and grey boxes over our Final Rule flowcharts, as depicted in the example below.



- Following each visual depiction, we describe the proposed changes and requests for comment in a more detailed narrative.
- Topics covered by the Final Rule flowcharts that are not addressed in this visual memorandum would not be changed by the proposal.

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## II. Three-Tiered Classification of Banking Entities

# Three-Tiered Classification System

## Overview

- The proposal would classify banking entities into three tiers, to facilitate a more tailored application of compliance program and certain proprietary trading requirements.

Banking Entity Tier	Trading Assets and Liabilities Thresholds	Method of Calculating Trading Assets and Liabilities	
		U.S. BHCs	Foreign Banking Organizations
Banking entity with significant trading assets and liabilities <b>(Significant TAL Banking Entity)</b>	\$10 billion or more	Worldwide consolidated basis	Combined U.S. operations
Banking entity with moderate trading assets and liabilities <b>(Moderate TAL Banking Entity)</b>	At least \$1 billion but less than \$10 billion	Worldwide consolidated basis	\$10 billion ceiling determined by combined U.S. operations (\$1 billion floor determined on a worldwide consolidated basis)
Banking entity with limited trading assets and liabilities <b>(Limited TAL Banking Entity)</b>	Less than \$1 billion	Worldwide consolidated basis	Worldwide consolidated basis

- Expected size of compliance tiers.** The Agencies estimate that about 40 of the largest banking groups would have either significant or moderate trading assets and liabilities, and that the rest would be classified as having limited trading assets and liabilities.
- Statutory exemption.** The Bipartisan Banking Act exempts from the Volcker Rule any insured depository institution and any affiliate of an insured depository institution that meets (and is not controlled by a company that does not itself meet) the following requirements: (i) total consolidated assets of \$10 billion or less and (ii) total trading assets and liabilities of 5% or less of total assets.

# Three-Tiered Classification System

## Impact

- **Impact.** The proposal would tailor the application of the following requirements based on the three-tiered classification system:
  - compliance requirements for the market-making exemption (see slides [18](#), [20](#));
  - compliance requirements for the underwriting exemption (see slides [22](#), [24](#));
  - compliance requirements for the risk-mitigating hedging exemption (see slides [25–29](#)); and
  - general compliance program requirements (see slides [52–54](#)).

The Agencies explain that through tailoring, they “aim to further reduce compliance obligations for small and mid-sized firms that do not have large trading operations and therefore reduce costs and uncertainty faced by smaller and mid-size firms in complying with the final rule, relative to their amount of trading activity.”

The Agencies state that in their experience, “the costs and uncertainty faced by smaller and mid-sized firms in complying with the 2013 final rule can be disproportionately high relative to the amount of trading activity typically undertaken by these firms.”



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# Three-Tiered Classification System

## Calculation Details

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- **Calculation methodology for trading assets and liabilities unchanged.** The method of calculating trading assets and liabilities generally would remain unchanged from the Final Rule. As is currently the case:
  - obligations of or guaranteed by the United States or any agency of the United States would be excluded; and
  - the relevant measure would be calculated over the trailing four quarters.
- **Combined U.S. operations.** Where the TAL of the combined U.S. operations is relevant, an FBO or a subsidiary of an FBO would be required to measure the trading assets and liabilities of the combined U.S. operations of its top-tier FBO (including all subsidiaries, affiliates, branches, and agencies of the FBO operating, located or organized in the United States).
  - This is the same scope of combined U.S. operations as under the Final Rule.
  - The proposal clarifies that a U.S. branch, agency or subsidiary of an FBO would be deemed to be located in the United States for this purpose, but the FBO that operates or controls that branch, agency or subsidiary would not be considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency or subsidiary.

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## III. Proprietary Trading

# Overview of Changes to Proprietary Trading Provisions

Step  
**1**

## IS A BANKING ENTITY ENGAGED IN PROPRIETARY TRADING UNDER THE VOLCKER RULE?

- Is a **banking entity** trading?
- Does the activity or transaction involve a purchase or sale of one or more **financial instruments**?
- Is the entity trading as principal for a **trading account**?
- Is an **exclusion** from proprietary trading available?

Proposes changes to:

- definition of **trading account** (see slides [11–13](#)); and
- exclusions from definition of **proprietary trading** (see slides [14–15](#)).

Step  
**2**

## IS THE TRADING PERMITTED UNDER THE VOLCKER RULE?

- |                                      |  |
|--------------------------------------|--|
| ▪ Market Making-Related Activities   | ▪ Trading in Government Obligations  |
| ▪ Underwriting Activities            | ▪ Trading on Behalf of Customers   |
| ▪ Risk-Mitigating Hedging Activities | ▪ Trading by a Regulated Insurance Company                                 |
|                                      | ▪ Trading Activities of Foreign Banking Entities Outside the United States |

Proposes changes to exemptions for:

- market making-related activities (see slides [18–21](#));
- underwriting activities (see slides [22–24](#));
- risk-mitigating hedging activities (see slides [25–29](#)); and
- trading activities of FBOs outside the United States (**TOTUS**) (see slides [30–32](#)).

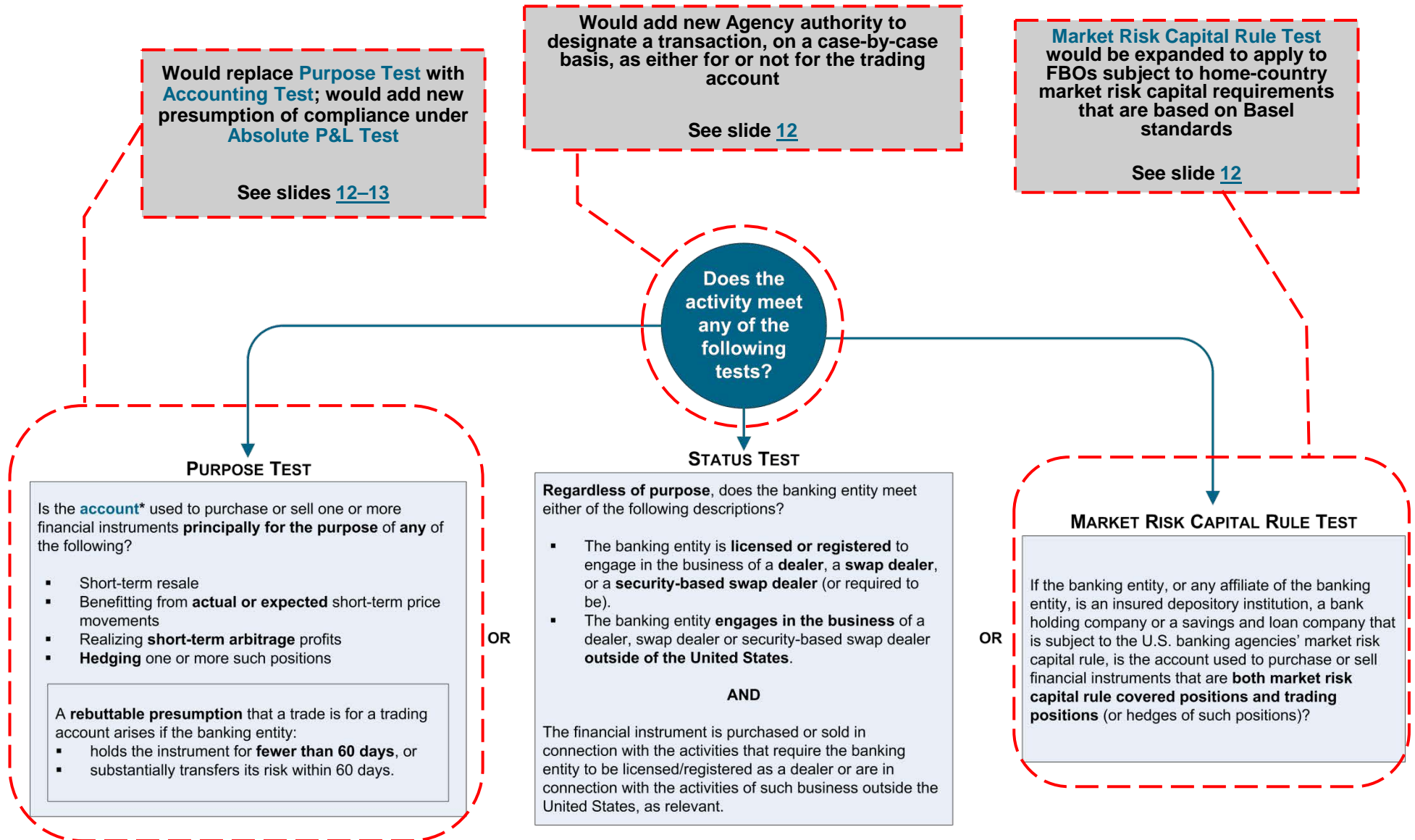
Step  
**3**

## IS THE ACTIVITY PRECLUDED BY A BACKSTOP PROHIBITION?

- Does the activity:
- Involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties?
  - Result in a material exposure by the banking entity to high-risk assets or trading strategies?
  - Pose a threat to the safety and soundness of the banking entity or U.S. financial stability?

# Definition of Trading Account

## Current Definition and Overview of Proposed Amendments



# Definition of Trading Account

## Proposed Amendments: Overview

- The Agencies propose making the trading account tests more objective by:
  - eliminating the **Purpose Test**, including the 60-day rebuttable presumption;
  - introducing a new **Accounting Test**, under which the purchase or sale of a financial instrument is for the trading account if it is recorded at fair value on a recurring basis under applicable accounting standards;
  - retaining the **Status Test** without modification; and
  - expanding the **Market Risk Capital Rule Test** by applying it to FBOs subject to home-country market risk capital requirements that are based on Basel standards.
- The Agencies propose adding a **reservation of authority** that would allow an Agency to determine on a case-by-case basis that a purchase or sale of a financial instrument is or is not for the trading account.
  - An Agency using this authority to determine that a transaction is for the trading account would need to provide the banking entity with a written notice and explanation of such determination and an opportunity to respond.

### Impact of the Accounting Test

**unclear.** Banking entities will need to analyze their portfolios to determine the impact of replacing the Purpose Test with the Accounting Test.

- The preamble states that financial instruments recorded at fair value on a recurring basis generally include but are not limited to derivatives, trading securities and available-for-sale securities.
- The Agencies asked, among other questions, whether there are differences in the application of IFRS and GAAP that they should consider, whether the proposal could incentivize banking entities to modify their accounting treatment of certain financial instruments, and whether they should include all financial instruments that are recorded at fair value (e.g., available-for-sale securities, all derivatives) or whether the scope should be narrowed.

# Definition of Trading Account

## Proposed Amendments: Presumption of Compliance

- For trading desks that are not subject to the Status Test or the Market Risk Capital Rule Test, the proposal would introduce a **presumption of compliance** with the proprietary trading provisions.
  - The presumption would be available where a trading desk has a rolling 90-day **Absolute P&L** that does not exceed \$25 million.
  - Rolling 90-day Absolute P&L would be the sum of the absolute values of the daily net gain or loss on the trading desk's portfolio of financial instruments, reflecting realized and unrealized gains and losses each business day since the previous business day, based on the banking entity's fair value for such financial instruments, aggregated over the preceding 90-calendar-day period.
  - A trading desk that operates under this presumption and exceeds the \$25 million rolling 90-day Absolute P&L threshold would be required to promptly notify the appropriate Agency and demonstrate that the trading desk complies and will maintain compliance with the Volcker Rule's proprietary trading provisions.
  - The preamble states that the presumption is not intended to be a safe harbor from the prohibition on proprietary trading.
  - An Agency would be able to rebut this presumption by providing written notice to the banking entity.

# Exclusions from the Definition of Proprietary Trading

## Current Exclusions and Overview of Proposed Amendments

Does the purchase or sale meet any of the following criteria?

### REPO AND REVERSE REPO

**Repo or reverse repo** pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at a stated price and on stated dates or on demand with the same counterparty.

### SECURITIES LENDING

**Securities lending transaction** in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties.

### LIQUIDITY MANAGEMENT PLAN

Purchase or sale of a security for the purpose of **liquidity management** in accordance with a documented liquidity management plan of the banking entity.

### DCO/CLEARING AGENCY TRANSACTIONS

By a banking entity that is a **derivatives clearing organization** or a **clearing agency** in connection with clearing financial instruments.

### LIMITED CLEARING MEMBER ACTIVITIES

By a banking entity that is a member of a **clearing agency, derivatives clearing organization or designated financial market utility**, in specified circumstances.

### SATISFY AN EXISTING DELIVERY OR LEGAL OBLIGATION

To satisfy:

- an **existing delivery obligation** of the banking entity or its customers, including to prevent or close out a failure to deliver.
- an obligation of the banking entity in connection with a **judicial, administrative, self-regulatory organization or arbitration proceeding**.

### ACTING AS AGENT, BROKER OR CUSTODIAN

Acting solely as **agent, broker or custodian**.

### EMPLOYEE COMPENSATION PLANS

Through a **deferred compensation, stock-bonus, profit-sharing or pension plan of the banking entity** that is established in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity **as trustee** for the benefit of persons who are or were employees of the banking entity.

### DEBT PREVIOUSLY CONTRACTED

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, and does not retain such investment for longer than the period permitted by its primary regulatory agency.

### ERROR TRADES

**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, and the erroneously purchased (or sold) financial instrument is promptly transferred to a **separately-managed account** for disposition.

Would be expanded to include physically-settled FX derivatives

See slide [15](#)

Would add new error trades exclusion

See slide [15](#)

# Exclusions from the Definition of Proprietary Trading

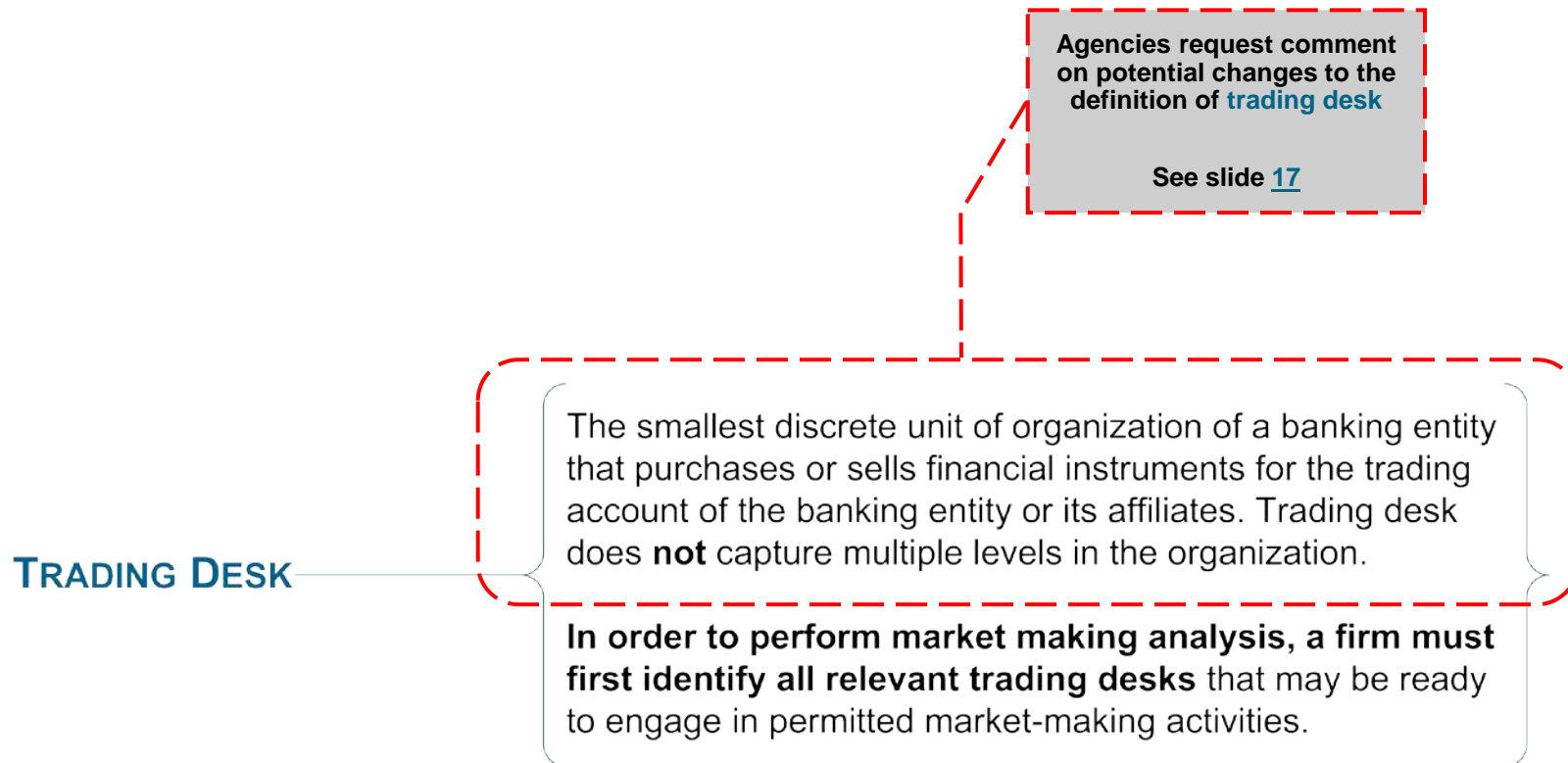
## Proposed Amendments

- **Eligibility of physically-settled FX derivatives for liquidity management exclusion.** The proposal would expand the liquidity management exclusion, currently available only for securities, to include physically-settled FX forwards and FX swaps, and physically-settled cross-currency swaps, subject to the requirements of the Final Rule's liquidity management exclusion.
- **Addition of error trade exclusion.** The Agencies propose adding an exclusion for a purchase or sale by a banking entity made in error in the course of conducting a permitted or excluded activity and a subsequent transaction to correct such an error.
  - The erroneously purchased or sold financial instrument would be required to be transferred promptly to a separately-managed trade error account for disposition.
  - The Agencies state that the separately-managed trade error account should be monitored and managed by personnel independent from those who made the error, and the banking entity should be required to monitor and manage trade error corrections and accounts.



# Definition of Trading Desk

## Current Definition and Overview of Requests for Comment on Potential Amendments



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# Definition of Trading Desk

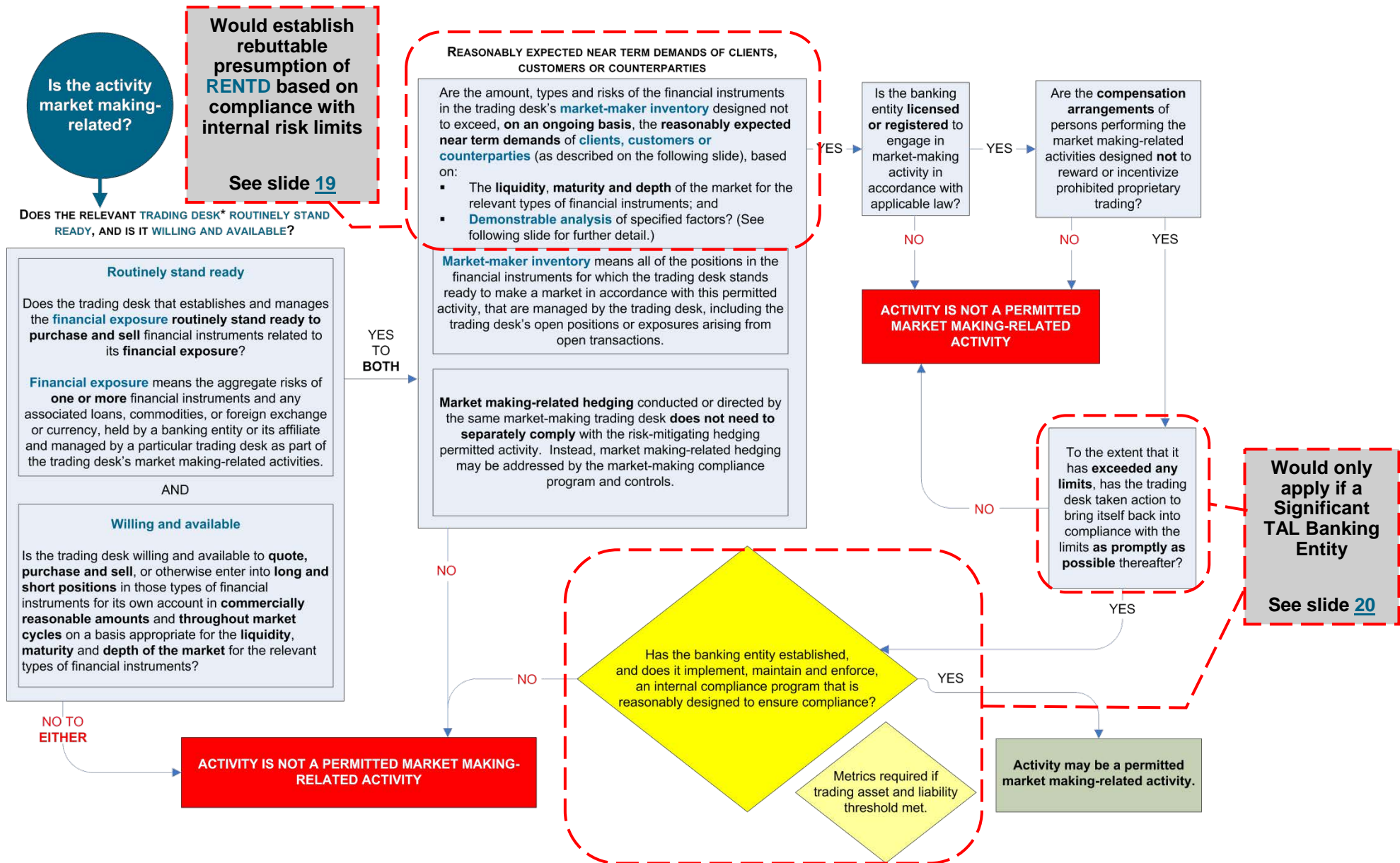
## Requests for Comment on Potential Amendments to Existing Definition

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- **Suggested definition.** The preamble requests comment on the definition and suggests redefining trading desk as a unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or another entity and that is:
  - structured by the banking entity to establish efficient trading for a market sector;
  - organized to ensure appropriate setting, monitoring and management review of the desk's trading and hedging limits, current and potential future loss exposures, strategies, and compensation incentives; and
  - characterized by a clearly-defined unit of personnel that typically:
    - engages in coordinated trading activity with a unified approach to its key elements;
    - operates subject to a common and calibrated set of risk metrics, risk levels and joint trading limits;
    - submits compliance reports and other information as a unit for monitoring by management; and
    - books its trades together.

# Market Making-Related Permitted Activity

## Current Exemption and Overview of Proposed Amendments



# Market Making-Related Permitted Activity

## Proposed Amendments

- **Presumption of RENTD based on compliance with internal risk limits.** The proposal would create a presumption that a banking entity is in compliance with the statutory requirement that permitted market-making activities are designed not to exceed RENTD if it conducts such activities in compliance with internal risk limits.
  - The internal risk limits would be required to be “designed not to exceed the [RENTD] of clients, customers or counterparties, based on the nature and amount of the trading desk’s market making-related activities, on the:
    - amount, types and risks of its market-maker positions;
    - amount, types and risks of the products, instruments and exposures the trading desk may use for risk management purposes;
    - level of exposures to relevant risk factors arising from its financial exposure; and
    - period of time a financial instrument may be held.”
  - There is no mandated analysis a banking entity would be required to follow for establishing internal risk limits; however, the limits would be subject to Agency review to assess whether they are designed not to exceed the RENTD of “clients, customers or counterparties” (the definition of which would remain unchanged).
- **RENTD analysis.** The proposal would remove the requirement to set RENTD limits in accordance with a demonstrable analysis of historical demand, current inventory of financial instruments, and market and other factors regarding the amount, types and risks of or associated with financial instruments in which the trading desk makes a market, including through block trades.

# Market Making-Related Permitted Activity

## Proposed Amendments

- **Supervision.** A banking entity's internal risk limits would be subject to ongoing supervisory review and oversight by the appropriate Agency.
- **Risk limit breach and limit increase reporting.** The proposal would require a banking entity using internal risk limits to promptly report breaches of and permanent and temporary increases to those limits to the appropriate Agency.
- **Agencies retain ability to rebut presumption.** An Agency would be able to rebut the presumption of compliance for market-making activities by providing written notice if it determined that a trading desk was engaging in activity that was not based on the trading desk's RENTD on an ongoing basis.
- **Tailored compliance program for Moderate and Limited TAL Banking Entities.** Although the preamble makes clear that all banking entities would still be required to comply with the rule, the proposal seeks to tailor the market-making exemption's compliance program requirements by making them mandatory only for Significant TAL Banking Entities.
  - Significant TAL Banking Entities would be required, as under the Final Rule, to establish, implement, maintain and enforce a comprehensive internal compliance program to rely on the market-making exemption.
  - For Moderate and Limited TAL Banking Entities, the proposal would provide more flexibility in how the compliance requirements of this exemption are satisfied, including whether to take the steps necessary to rely on the internal risk limit presumption of compliance with the RENTD requirement.

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# Market Making-Related Permitted Activity

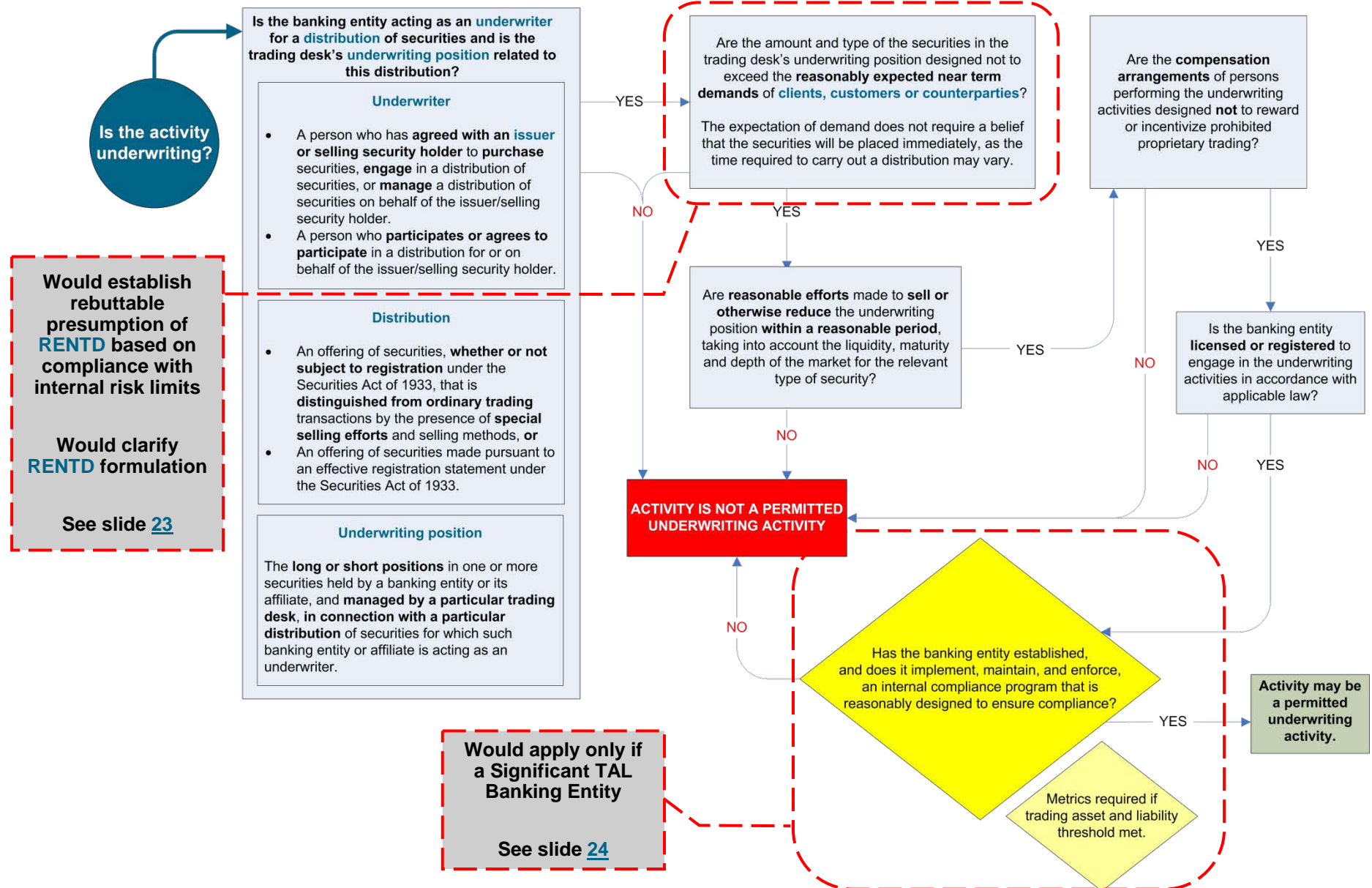
## Requests for Comment

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- **Loan-related swaps.** The preamble discusses the treatment of swaps entered into by a banking entity in connection with a loan to a customer where the banking entity immediately offsets the swap with a third party (loan-related swaps). The Agencies note various challenges in fitting this activity within the market-making exemption and ask whether market making is the appropriate exemption for this activity or whether loan-related swaps either should be excluded from the definition of proprietary trading or exempted through a new permitted activity.
- **Trading between affiliated trading desks.** While not making any concrete proposals, the Agencies recognize the interpretive challenges under the market-making exemption for trades within a banking entity or among affiliates and, in particular, whether a trading desk may treat an affiliated trading desk as a client, customer or counterparty for purposes of the RENTD requirement; and whether and under what circumstances one trading desk may undertake market-making risk management activities for one or more other trading desks. The preamble requests comment on how several scenarios should be treated under the market-making exemption, including:
  - transfer of a portion of risk from one market-making desk to another desk that may or may not separately engage in market making-related activity;
  - swaps entered into between two affiliated market-making desks within their applicable limits; and
  - hedging by an affiliated desk on behalf of a market-making desk.

# Underwriting Permitted Activity

## Current Exemption and Overview of Proposed Amendments



# Underwriting Permitted Activity

## Proposed Amendments

- **RENTD standard clarified.** The proposal would clarify that, in determining RENTD for purposes of the underwriting exemption, banking entities would be permitted to take into account the liquidity, maturity and depth of the market for the relevant type of the security, matching the existing formulation of RENTD for the market-making exemption.
- **Presumption of RENTD based on compliance with internal risk limits.** Similar to the proposed market-making exemption, the proposal would create a presumption that a banking entity is in compliance with the statutory requirement that permitted underwriting activities are designed not to exceed RENTD if it conducts such activities in compliance with internal risk limits.
  - The internal risk limits would be required to be “designed not to exceed the [RENTD] of clients, customers or counterparties, based on the nature and amount of the trading desk’s underwriting activities, on the:
    - amount, types and risk of its underwriting position;
    - level of exposures to relevant risk factors arising from its underwriting position; and
    - period of time a security may be held.”
  - There is no mandated analysis a banking entity would be required to follow for establishing internal risk limits; however, the limits would be subject to Agency review to assess whether they are designed not to exceed the RENTD of “clients, customers or counterparties” (the definition of which would remain unchanged).



# Underwriting Permitted Activity

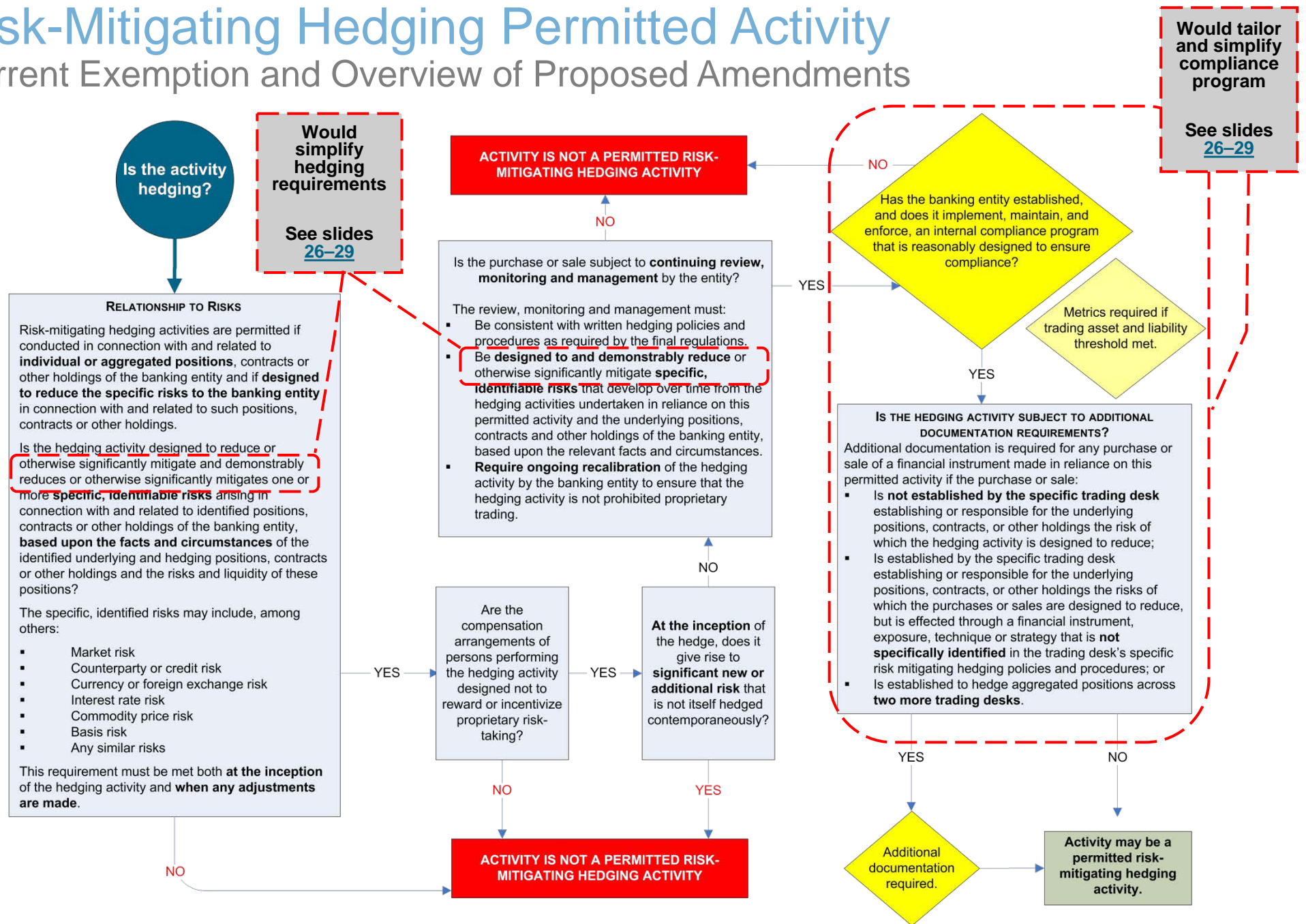
## Proposed Amendments

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- **Supervision.** A banking entity's internal risk limits would be subject to ongoing supervisory review and oversight by the appropriate Agency.
- **Risk limit breach and limit increase reporting.** The proposal would require a banking entity using internal risk limits to promptly report breaches of and permanent and temporary increases to those limits to the appropriate Agency.
- **Agencies retain ability to rebut presumption.** An Agency would be able to rebut the presumption of compliance for underwriting activities by providing written notice if it determined that a trading desk was engaging in activity that was not based on the trading desk's RENTD on an ongoing basis.
- **Tailored compliance program for Moderate and Limited TAL Banking Entities.** Although the preamble makes clear that all banking entities would still be required to comply with the rule, the proposal seeks to tailor the underwriting exemption's compliance program requirements by making them mandatory only for Significant TAL Banking Entities.
  - Significant TAL Banking Entities would be required (as under the Final Rule) to establish, implement, maintain and enforce a comprehensive internal compliance program to rely on the underwriting exemption.
  - For Moderate and Limited TAL Banking Entities, the proposal would provide more flexibility in how the compliance requirements of this exemption are satisfied, including whether to take the steps necessary to rely on the internal risk limit presumption of compliance with the RENTD requirement.

# Risk-Mitigating Hedging Permitted Activity

## Current Exemption and Overview of Proposed Amendments



# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments

- Tailored and simplified compliance program.** The proposal would require Significant TAL Banking Entities to satisfy compliance requirements generally similar to the Final Rule, although it would remove some existing requirements; it would require Moderate and Limited TAL Banking Entities to comply with a much simpler set of compliance requirements. The table below, which continues on the next three pages, summarizes the proposed changes.

Requirement	Final Rule	Proposal
<p>Establish, implement, maintain and enforce an internal compliance program reasonably designed to ensure compliance with the exemption</p>	<ul style="list-style-type: none"> <li>Applies to all banking entities</li> <li>Includes a requirement for analysis and independent testing designed to ensure that positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged</li> <li>Includes a requirement for correlation analysis that demonstrates that hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged</li> </ul>	<ul style="list-style-type: none"> <li>Would apply to Significant TAL Banking Entities only</li> <li>As reflected in the blackline below showing proposed changes to rule text (§__.5(b)(1)(i)(C)), would eliminate:             <ul style="list-style-type: none"> <li>“Demonstrably” in analysis and independent testing requirement</li> <li>Correlation analysis requirement</li> </ul> </li> </ul> <div style="border: 1px solid black; padding: 5px; margin-top: 10px;"> <p>(iiiC) The conduct of analysis, <del>including correlation analysis,</del> and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to <b>demonstrably</b> reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged, <del>and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged;</del></p> </div>
<p>Conduct risk-mitigating hedging activity in accordance with written policies, procedures and internal controls</p>	<ul style="list-style-type: none"> <li>Applies to all banking entities</li> </ul>	<ul style="list-style-type: none"> <li>Would apply to Significant TAL Banking Entities only</li> </ul>

# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments

Requirement	Final Rule	Proposal
<p>At inception and when any adjustments are made, design hedging position to reduce or otherwise significantly mitigate one or more specific, identifiable risks</p>	<ul style="list-style-type: none"> <li>• Applies to all banking entities</li> <li>• Also includes a requirement for the hedging position to demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks</li> </ul>	<ul style="list-style-type: none"> <li>• Would apply to all banking entities</li> <li>• As reflected in the blackline below showing proposed changes to rule text (§___.5(b)(1)(ii)(B)), would eliminate the requirement for the hedging position to demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks</li> </ul> <div data-bbox="1129 651 1913 1057" style="border: 1px solid black; padding: 5px;"> <p>(#B) At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, is designed to reduce or otherwise significantly mitigate <del>and demonstrably reduces or otherwise significantly mitigates</del> one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;</p> </div>
<p>At inception, hedging position must not give rise to significant new or additional risk that is not itself hedged contemporaneously</p>	<ul style="list-style-type: none"> <li>• Applies to all banking entities</li> </ul>	<ul style="list-style-type: none"> <li>• Would apply to Significant TAL Banking Entities only</li> </ul>

# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments

Requirement	Final Rule	Proposal
<p>Hedging activity must be subject to continuing review, monitoring and management by the banking entity</p>	<ul style="list-style-type: none"> <li>Applies to all banking entities</li> </ul>	<ul style="list-style-type: none"> <li>Would apply to Significant TAL Banking Entities only</li> <li>As reflected in the blackline below showing proposed changes to rule text (§__.5(b)(1)(ii)(D)(2)), would eliminate the requirement for review, monitoring and management to demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks</li> </ul> <div style="border: 1px solid black; padding: 5px; margin-top: 10px;"> <p>(ivD) Is subject to continuing review, monitoring and management by the banking entity that:</p> <ul style="list-style-type: none"> <li>(B2) Is designed to reduce or otherwise significantly mitigate <del>and demonstrably reduces or otherwise significantly mitigates</del> the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying positions, contracts, and other holdings of the banking entity, based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof;</li> </ul> </div>
<p>Hedging activity must be subject to ongoing recalibration to ensure it satisfies requirements of exemption</p>	<ul style="list-style-type: none"> <li>Applies to all banking entities</li> </ul>	<ul style="list-style-type: none"> <li>Would apply to all banking entities, but ongoing recalibration would only be required “as appropriate” for Moderate and Limited TAL Banking Entities</li> </ul>
<p>Compensation arrangements of persons performing hedging activity must be designed not to reward or incentivize prohibited proprietary trading</p>	<ul style="list-style-type: none"> <li>Applies to all banking entities</li> </ul>	<ul style="list-style-type: none"> <li>Would apply to Significant TAL Banking Entities only</li> </ul>

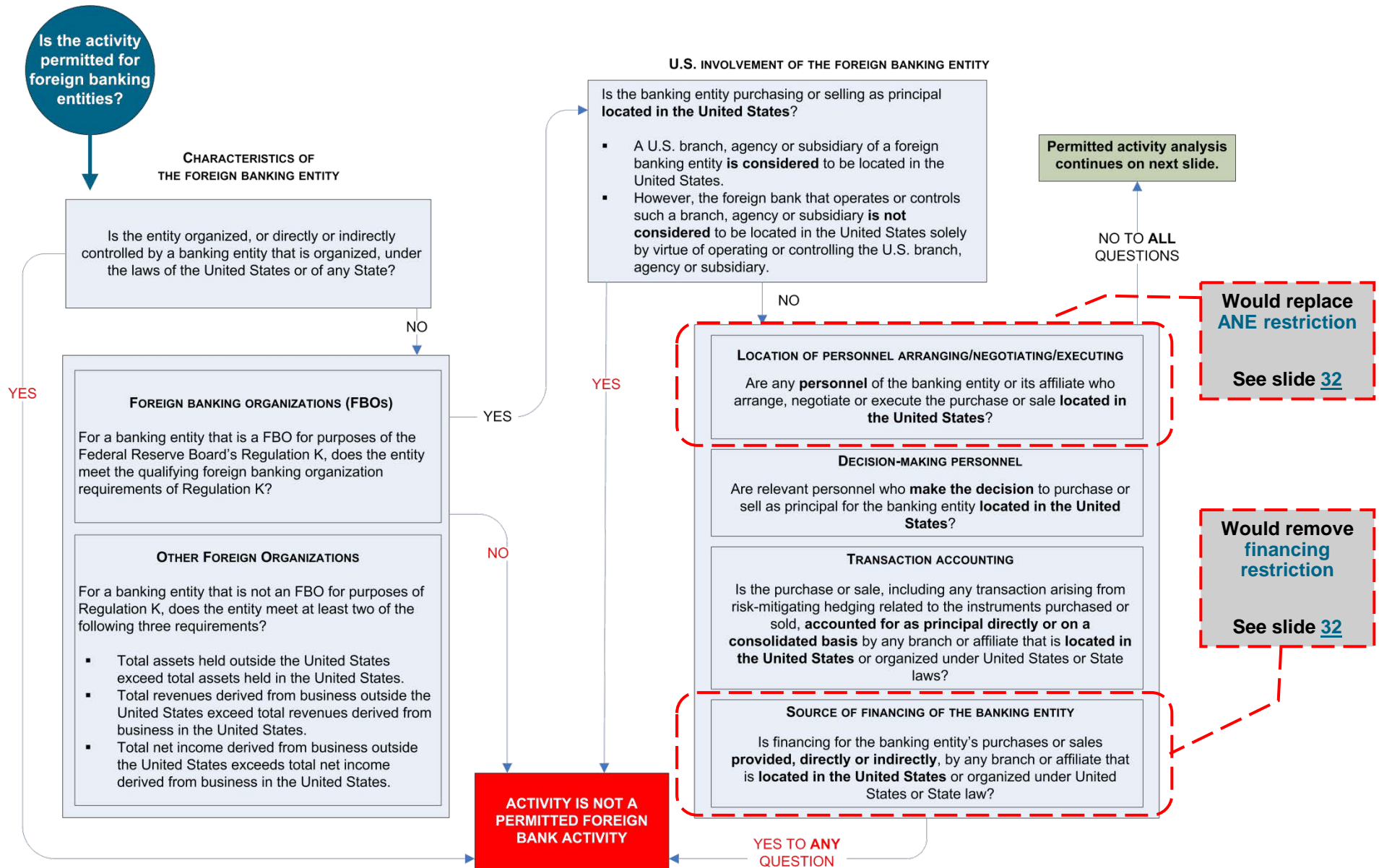
# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments

Requirement	Final Rule	Proposal
<p>Create and retain additional documentation if hedging activity involves one or more scenarios specified in the rule triggering heightened requirements</p>	<ul style="list-style-type: none"><li>• Applies to all banking entities</li></ul>	<ul style="list-style-type: none"><li>• Would apply to Significant TAL Banking Entities only</li><li>• Would add exception from additional documentation requirement when a trading desk is engaging in hedging activities that are commonly entered into by the banking entity, provided that the hedging activities are in instruments on a pre-approved list and subject to pre-approved limits appropriate for the particular common hedging activity, and provided that other specified conditions in the proposed rule are satisfied</li></ul>

# TOTUS Permitted Activity

## Current Exemption and Overview of Proposed Amendments



# TOTUS Permitted Activity

## Current Exemption and Overview of Proposed Amendments

### POTENTIAL U.S. INVOLVEMENT OF THE COUNTERPARTY

CONTINUED FROM  
PREVIOUS SLIDE

Is the purchase or sale conducted **with or through a U.S. entity**?

**U.S. entity** means any entity that **is**, or is **controlled by**, or is acting **on behalf of**, or **at the direction of**, any other entity that is, **located in the United States or organized** under U.S. or State law.

YES

IF SO, DO ANY OF THE FOLLOWING APPLY?

Is the purchase or sale with the foreign operations of a U.S. entity, where no personnel of the U.S. entity that are located in the United States are involved in its arrangement, negotiation or execution? Back-office functions such as clearing and settlement of trades do **not** constitute arrangement, negotiation or execution.

OR

Is it a purchase or sale with an **unaffiliated market intermediary** acting as principal, where the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty?

An **unaffiliated market intermediary** is an unaffiliated entity acting as an intermediary that is registered as a broker, dealer, swap dealer, security-based swap dealer or FCM, or excluded from regulation as such.

OR

Is it a purchase or sale through an **unaffiliated market intermediary** acting as agent, where the transaction is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty?

NO TO ALL  
QUESTIONS

NO

YES TO  
ANY  
QUESTION

NO

Metrics not  
required.

Has the banking entity established, and does it implement, maintain and enforce, an internal compliance program that is reasonably designed to ensure compliance?

YES

Activity may be a permitted  
foreign banking activity.

ACTIVITY IS NOT A PERMITTED  
FOREIGN BANK ACTIVITY

Would remove  
limitation on  
TOTUS-eligible  
counterparties

See slide [32](#)



# TOTUS Permitted Activity

## Proposed Amendments and Requests for Comment

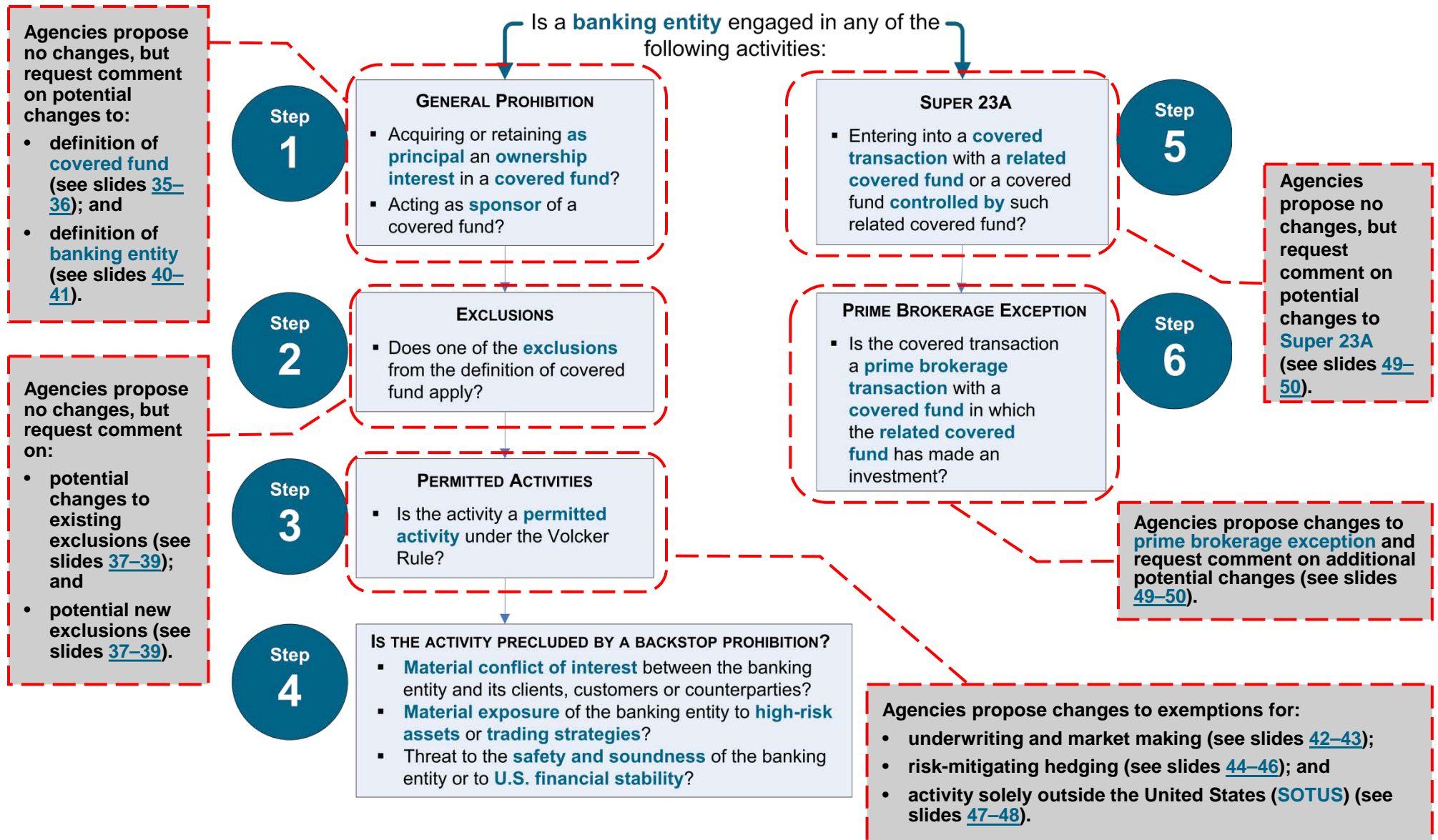
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- **Concern about lack of use.** The Agencies express concern in the preamble that the TOTUS exemption as crafted in the Final Rule is rarely used by foreign banking entities, suggesting that its requirements may be overly restrictive.
- **Removes limitation on TOTUS-eligible counterparties.** The Agencies propose eliminating the additional restrictions for a foreign banking entity that is trading “with or through” a U.S. entity.
- **Replaces ANE restriction.** The Final Rule requires that personnel of the banking entity that arrange, negotiate or execute (**ANE**) a transaction or that make the decision to purchase or sell be located outside of the United States. The proposal would remove the requirement that personnel who “arrange, negotiate or execute” must be located outside the United States and would replace it with a requirement that “relevant personnel” be located outside the United States, although the proposal would retain the requirement that personnel making the decision to purchase or sell be located outside the United States.
  - The Agencies state in the preamble that the purpose of the modification is to make clear that some limited involvement by U.S. personnel, including arranging or negotiating, is permitted under the TOTUS exemption.
- **Removes financing restriction.** The Agencies propose eliminating the requirement that no financing for a banking entity’s purchase or sale of financial instruments under the TOTUS exemption may be provided by a branch or affiliate in the United States.
- **Competitive dynamics.** The Agencies request comment on the impact of these changes to the competitive landscape between U.S. and non-U.S. firms.

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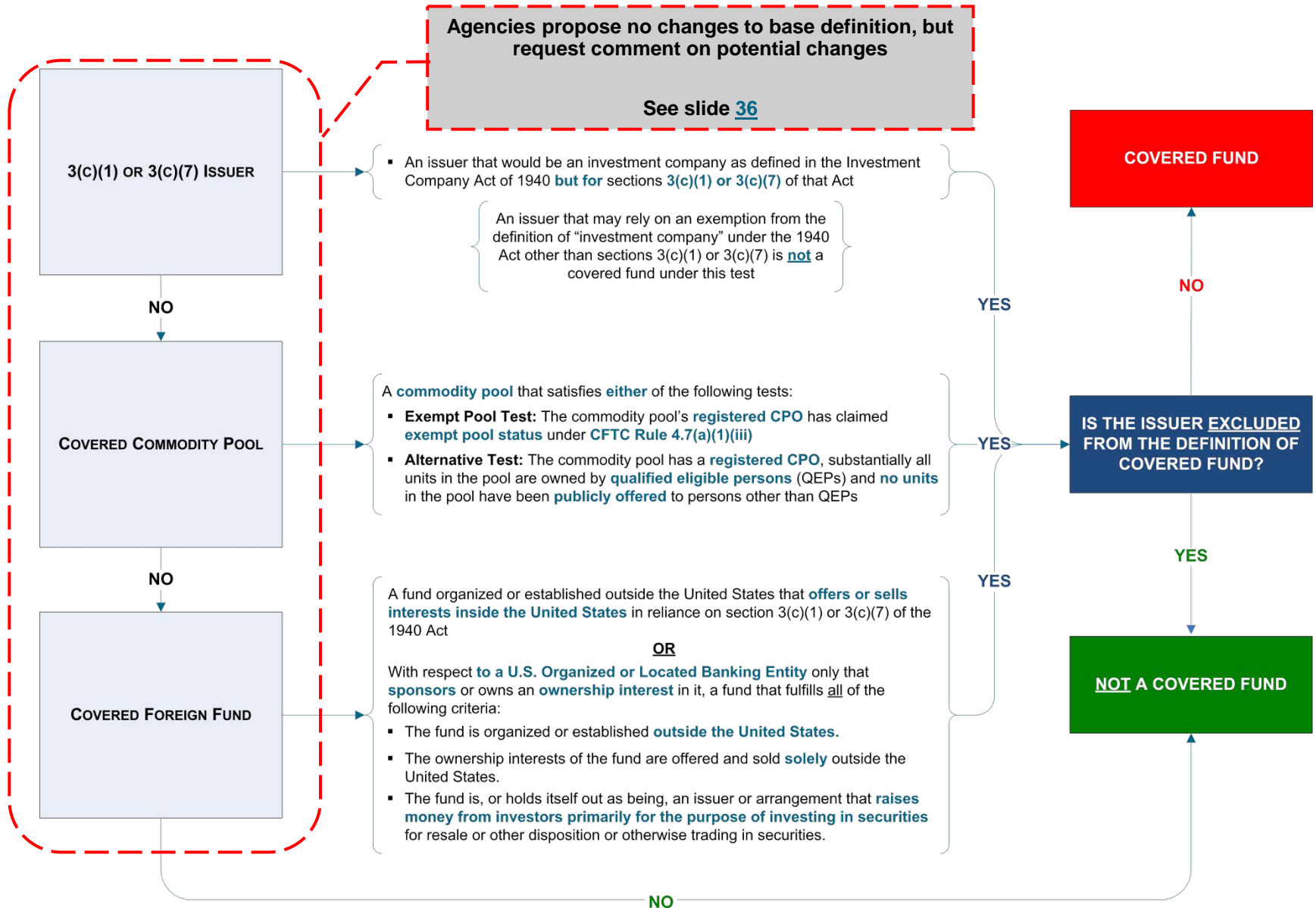
## IV. Covered Funds

# Overview of Changes to Covered Funds Provisions



# Base Definition of Covered Fund

## Current Definition and Overview of Requests for Comment on Potential Amendments



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# Base Definition of Covered Fund

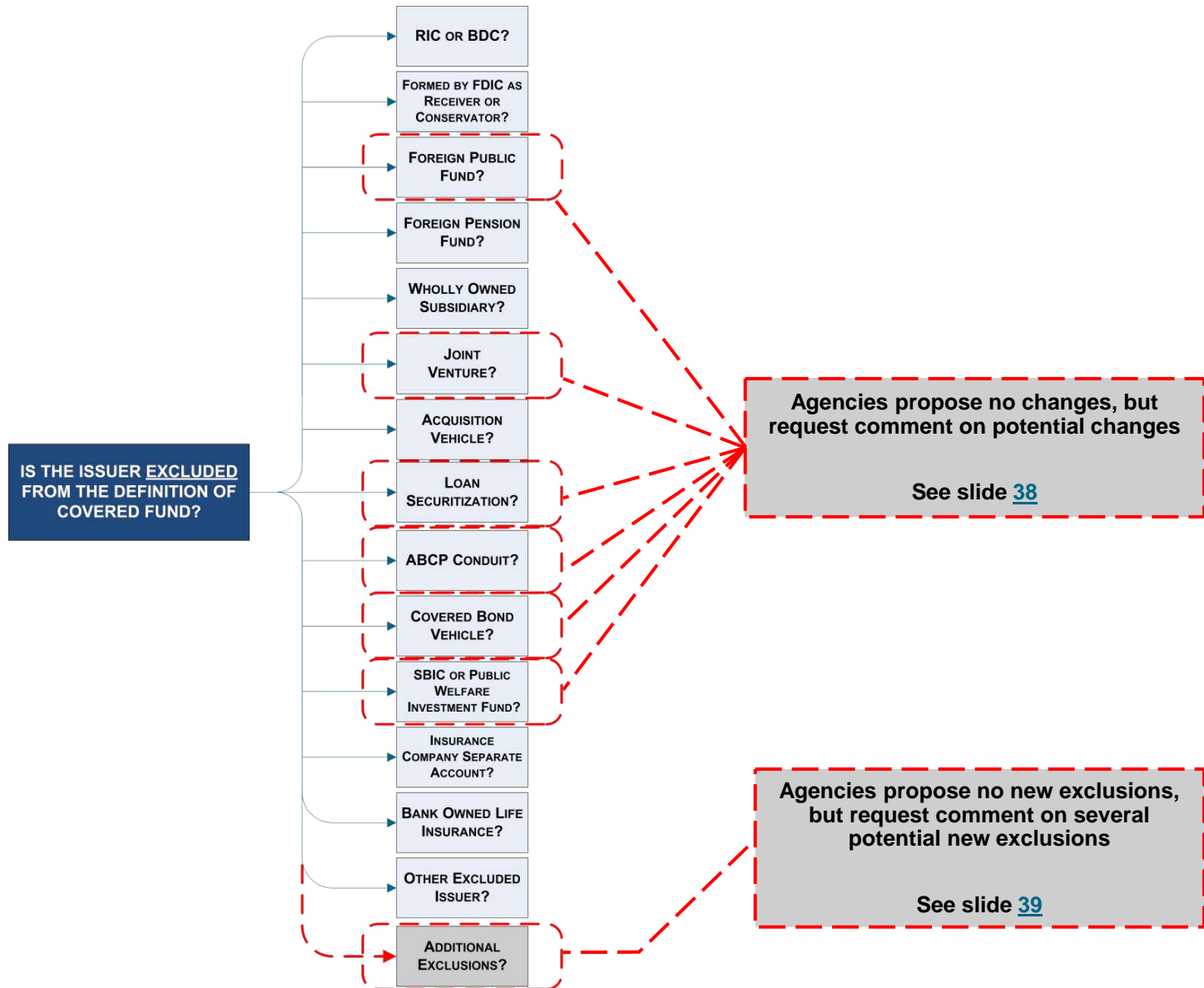
## Requests for Comment on Potential Amendments to Existing Definition

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- **Base definition of covered fund.** The Agencies do not directly propose any changes to the three-pronged base definition of covered fund. Rather, the preamble includes numerous requests for comment on possible approaches to modifying the base definition.
  - **Common characteristics.** The Agencies ask whether they should adopt separate base definitions for “hedge fund” and “private equity fund” based on characteristics commonly associated with a hedge fund or private equity fund (e.g., those contained in the SEC’s [Form PF](#)).
  - **Foreign covered fund and commodity pool prongs.** The Agencies ask whether the foreign covered fund and covered commodity pool prongs of the base definition of covered fund should be modified to better address the “circumvention concerns” that gave rise to these prongs.
  - **Compliance costs.** The Agencies request comment on the compliance and other costs that banking entities have incurred in analyzing whether particular issuers are covered funds and implementing compliance programs for covered fund activities. They also ask whether banking entities would expect to incur significant costs or burdens in order to become compliant with a modified base definition of covered fund, if the Agencies were to adopt changes to that definition.

# Exclusions from the Definition of Covered Fund

## Current Exclusions and Overview of Requests for Comment on Potential Amendments



# Exclusions from the Definition of Covered Fund

## Requests for Comment on Potential Amendments to Existing Exclusions

- The Agencies do not directly propose any changes to the existing exclusions from the base definition of covered fund. The preamble does, however, include requests for comment on several existing exclusions.
- Requests for comment on potential amendments to the existing exclusions include:
  - **Foreign public funds (FPFs)**. The Agencies request comment on all aspects of the FPF exclusion, including whether that exclusion is effective in identifying foreign funds that may be sufficiently similar to registered investment companies (**RICs**) and permitting U.S. banking entities to engage in traditional asset management businesses abroad.
    - Of note, the Agencies acknowledge the compliance challenges posed by the existing exclusion's **85 percent test** and request comment on how to revise this requirement.
  - **Securitizations**. The Agencies request comment on the existing exclusions for **loan securitizations**, qualifying **ABCP conduits** and qualifying **covered bonds**. They ask whether permitting a loan securitization vehicle to hold up to 5 percent or 10 percent of assets that are debt securities may be appropriate.
    - The proposal asks whether the definition of “**ownership interest**” should be modified for securitization vehicles. This is the only discussion of that definition in the proposal.
  - **Joint ventures**. The Agencies request comment on whether the existing exclusion for joint ventures is adequate and whether [FAQ 15](#) (which provides additional details regarding the views of staffs of the Agencies on joint ventures) should be incorporated into the rule text.
  - **SBICs**. The Agencies ask for input on whether to modify the existing exclusion for small business investment companies (**SBICs**) to include an SBIC whose license has been relinquished.

# Exclusions from the Definition of Covered Fund

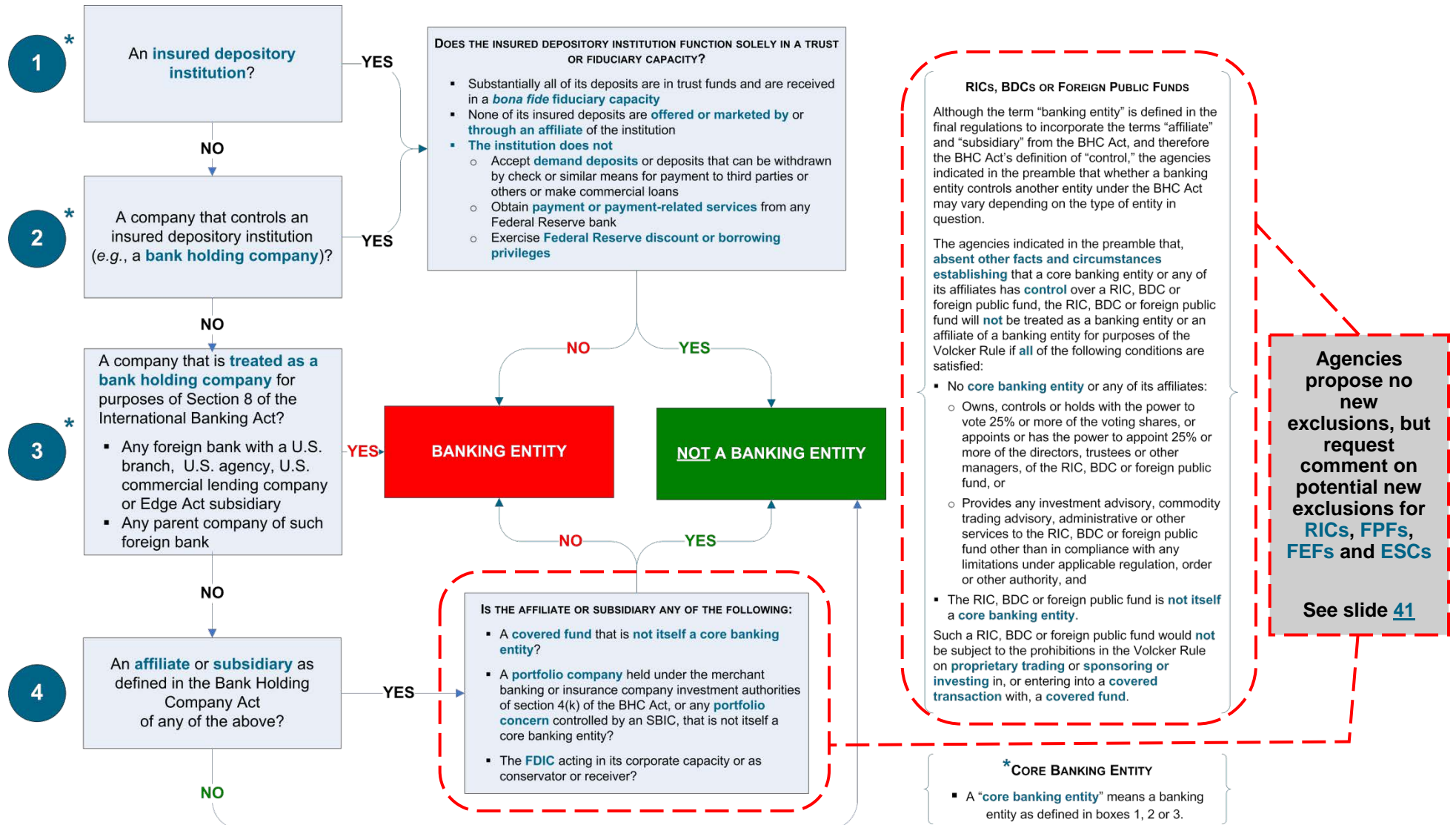
## Requests for Comment on Potential New Exclusions

- The Agencies do not propose any new exclusions from the base definition of covered fund. The preamble does include, however, requests for comment on potential new exclusions.
- Requests for comment on potential new exclusions include:
  - **Absence of common characteristics.** As an alternative to revising the base definition of covered fund based on characteristics commonly associated with hedge funds or private equity funds, the Agencies seek comment on whether to expressly exclude from that definition entities that lack characteristics commonly associated with hedge funds or private equity funds. They cite to the SEC's Form PF as a potential source for formulating this exclusion.
  - **No proprietary trading or illiquid assets.** The Agencies also seek comment on whether to add an exclusion for a fund that (i) is not engaged in proprietary trading and (ii) does not invest in illiquid assets, such as portfolio companies, real estate investments and venture capital investments.
  - **Family wealth vehicles.** The Agencies recognize concerns about banking entities being subject to Super 23A restrictions on covered transactions with family wealth management vehicles that fall within the definition of covered fund and seek comment on whether such vehicles should be excluded from the definition of covered fund.
    - The proposal refers to the definition of “family client” under the Investment Advisers Act of 1940 as a potential avenue to define family wealth management vehicles that should be excluded.
  - **TOBs and other issuers.** The Agencies ask whether to add an exclusion for a municipal securities tender option bond (**TOB**) vehicle. They do not address, however, whether an exclusion should apply to other vehicles such as financing vehicles similar to muni TOBs or special purpose vehicles used to structure transactions.



# Definition of Banking Entity

## Current Definition and Overview of Requests for Comment on Potential Amendments



# Definition of Banking Entity

## Requests for Comment on Potential New Exclusions

- **No concrete proposals for additional exclusions.** The Agencies do not propose changes to the definition of banking entity.
- **U.S. registered investment companies (RICs), foreign public funds (FPFs) and foreign excluded funds (FEFs).** The Agencies appear open to comments on whether to completely exclude RICs, FPFs and FEFs from the definition of banking entity.
  - The Agencies acknowledge concerns that certain funds that are not captured by or are expressly excluded from the definition of covered fund—such as RICs, FPFs and FEFs—could be treated as banking entities under the Final Rule and state that the proposal **does not modify application of the FAQs** released by the staffs of the Agencies to address these issues (e.g., [FAQ 14](#) on FPFs and [FAQ 16](#) on seeding periods for RICs and FPFs).
  - In the preamble, the Agencies also **extended the relief** provided in the [July 21, 2017 policy statement](#) for foreign banking entities' investments in and activities with certain FEFs for another year **until July 21, 2019**.
  - The proposal includes several requests for comment on the sufficiency of the FAQs and the policy statement in dealing with the issues faced by applying the Volcker Rule to these funds.
- **Employees' securities companies (ESCs).** The Agencies acknowledge that, much as with RICs, FPFs and FEFs, a similar banking entity issue arises for ESCs. The Agencies request comment on whether other entities such as ESCs should receive relief from being treated as banking entities.

**FAQ 14** provides the Agencies' view that an FPF would not be a banking entity if (i) the FPF meets the requirements of the FPF exclusion from the definition of covered fund in section 10(c)(1) and (ii) no banking entity owns 25% or more of the voting securities of the FPF (after the permitted seeding period). It also clarifies that the activities and investments of an FPF that meets the above conditions would not be attributed to a banking entity that owns less than 25% of the voting securities of the FPF (after the permitted seeding period), even if the banking entity provides investment advisory, administrative or other services to the FPF.

**FAQ 16** provides that the Agencies would not treat a RIC or FPF as a banking entity solely on the basis of the level of ownership of the RIC or FPF by a banking entity during a seeding period and clarifies that the seeding period may take some time, such as three years.

The **policy statement** provides that the Agencies would 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 a qualifying foreign excluded fund (**QFEF**) (as defined in the policy statement) to the foreign banking entity, or against a QFEF 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 QFEF would meet the requirements of the Volcker Rule's SOTUS exemption, as if the QFEF were a covered fund.

# Underwriting and Market-Making Permitted Activities

## Current Exemption and Overview of Proposed Amendments

1

A banking entity may acquire or retain ownership interests in a covered fund as underwriter or market maker if:

**CONDUCTED IN ACCORDANCE WITH REQUIREMENTS APPLICABLE TO THE RELEVANT PROP TRADING PERMITTED ACTIVITY**

The underwriting or market making-related activities are conducted in accordance with the requirements for permitted **underwriting** or **market making-related activities** in the proprietary trading provisions of the final regulations.

See slides 18–24 for changes to these proprietary trading permitted activities

**SUMMARY OF KEY APPLICABLE REQUIREMENTS – UNDERWRITING (§ 4(a))**

- Banking entity is acting as an underwriter for a distribution of ownership interests in a covered fund and the trading desk's underwriting position is related to such distribution
- Amount and type of ownership interests in the trading desk's underwriting position are designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties
- Reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period
- Internal compliance program established and enforced (may include metrics requirements)
- Compensation arrangements designed not to reward or incentivize prohibited prop trading
- Banking entity is licensed or registered to engage in underwriting, if required

**SUMMARY OF KEY REQUIREMENTS – MARKET MAKING (§ 4(b))**

- Trading desk that acquires ownership interests in a covered fund routinely stands ready to purchase and sell such ownership interests
- Such trading desk is willing and available to quote, purchase and sell such ownership interests for its own account in commercially reasonable amounts throughout market cycles
- Amount, types and risks of ownership interests in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near-term demand of clients, customers or counterparties
- Internal compliance program established and enforced (may include metrics requirements)
- Prompt return to compliance when any limits exceeded
- Compensation arrangements designed not to reward or incentivize prohibited prop trading
- Banking entity is licensed or registered to engage in market making-related activities, if required

**THIRD PARTY COVERED FUNDS**

The underwriting and market-making exemption applies to ownership interests in any covered fund, including covered funds organized, offered, sponsored, advised or controlled by an unaffiliated third party.

2

**SUBJECT TO INVESTMENT LIMITS, AS APPLICABLE**

Aggregate limit and capital deduction would no longer apply to third-party covered funds

See slide 43

**3% PER FUND LIMITS**

Ownership interests acquired or retained by a banking entity pursuant to the underwriting and market-making exemption are subject to the 3% per fund limits if they are or were issued by a covered fund:

- Asset management or ABS issuer exemptions.** As to which the banking entity is a sponsor or in which the banking entity acquires and retains an ownership interest pursuant to the asset management or ABS issuer exemptions, or
- Other related covered funds:**
  - As to which the banking entity is otherwise a sponsor, investment adviser or commodity trading advisor, or
  - As to which the banking entity **directly or indirectly guarantees, assumes or otherwise insures** the obligations or performance of such fund or any covered fund in which such fund invests.
    - The agencies indicated in the preamble that a banking entity would **not** be treated as guaranteeing the obligations or performance of a covered fund if it enters into arrangements, such as providing liquidity facilities or letters of credit, that are not entered into for the purpose of guaranteeing the obligations or performance of the covered fund

The 3% per fund limit **does not apply** to ownership interests acquired or retained pursuant to the underwriting and market making exemption in any covered fund organized and offered by the banking entity pursuant to the asset management or ABS exemptions during the **seeding period** for such fund.

The 3% per fund limit is calculated as of the **end of each quarter**, but the agencies indicated in the preamble that if a banking entity becomes aware that it has exceeded the 3% limit for a given fund at any time, the agencies expect the banking entity to take steps to ensure that it complies promptly with the 3% per fund limit.

**AGGREGATE 3% OF TIER 1 CAPITAL LIMIT AND CAPITAL DEDUCTIONS**

Ownership interests in any covered fund, including a third-party fund, which are acquired and retained by a banking entity pursuant to the underwriting and market-making exemption are subject to the aggregate 3% of Tier 1 capital limits and capital deductions.

- The aggregate 3% of Tier 1 capital limit is **calculated as of the end of each quarter**, but the agencies indicated in the preamble that they expect banking entities to monitor their investments in covered funds regularly and remain in compliance with the aggregate 3% of Tier 1 capital limit throughout the quarter.

Would remove this triggering relationship

See slide 43

# Underwriting and Market-Making Permitted Activities

## Proposed Amendments

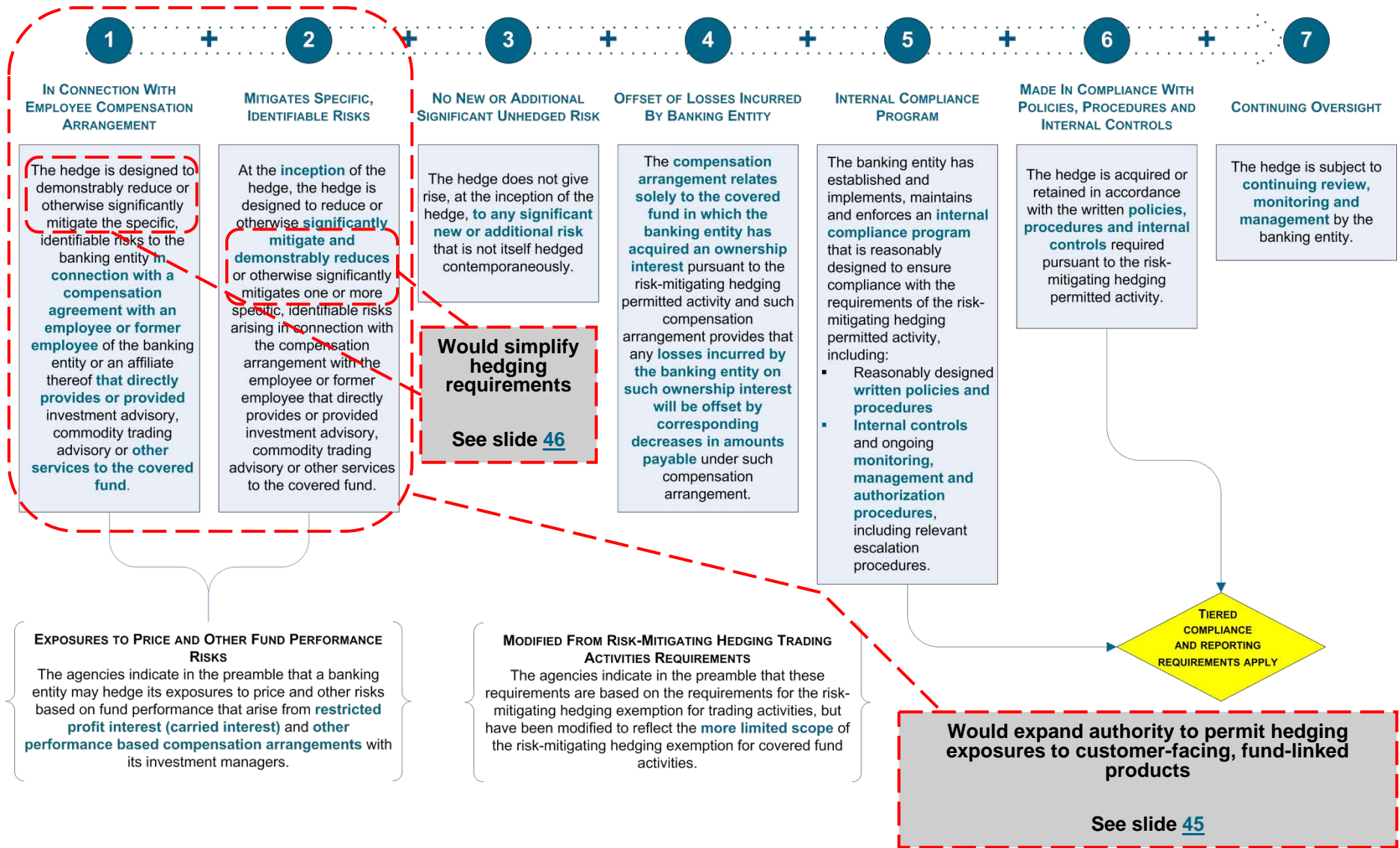
- **Scope of aggregate limit and capital deduction.** The Final Rule requires a banking entity to include within the aggregate covered fund investment limit and Tier 1 capital deduction all covered fund ownership interests acquired or retained under the market-making and underwriting exemptions. The proposal would eliminate this requirement for ownership interests in third-party funds, but would retain it for ownership interests in related covered funds, as summarized in the table below.

	Applicable Limits and Deductions Under Final Rule	Applicable Limits and Deductions Under Proposal
<b>Related Covered Funds</b>	<ul style="list-style-type: none"><li>• 3% per fund limit</li><li>• Aggregate covered fund limit</li><li>• Tier 1 capital deduction</li></ul>	<ul style="list-style-type: none"><li>• 3% per fund limit</li><li>• Aggregate covered fund limit</li><li>• Tier 1 capital deduction</li></ul>
<b>Third-Party Covered Funds</b>	<ul style="list-style-type: none"><li>• Aggregate covered fund limit</li><li>• Tier 1 capital deduction</li></ul>	<ul style="list-style-type: none"><li>• None</li></ul>

- **Scope of related covered funds.** The proposal would eliminate a guarantee as a triggering relationship that requires a banking entity to treat a covered fund as a “related covered fund” for purposes of these exemptions.
  - **Guarantee.** Under the proposal, a banking entity would no longer be required to treat a covered fund as a related covered fund for purposes of these exemptions by virtue of directly or indirectly guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or of any covered fund in which that fund invests.
  - **Sponsoring or advising.** The proposal would retain the other existing triggering relationships for treatment of a covered fund as a related covered fund, including sponsoring or advising the covered fund.

# Risk-Mitigating Hedging Permitted Activity

## Current Exemption and Overview of Proposed Amendments



# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments and Request for Comment

- **Hedging authority for fund-linked products.** The proposal would expand the risk-mitigating hedging exemption for ownership interests in covered funds, which is currently limited to hedging in connection with employee compensation arrangements, to additionally permit banking entities to hedge exposures to customer-facing, fund-linked products by hedging in covered fund ownership interests.
- The table below summarizes key criteria for the existing and proposed expanded risk-mitigating hedging exemption.

	<b>A banking entity may acquire or retain an ownership interest in a covered fund to hedge in connection with:</b>	<b>At inception, the hedge must be designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising:</b>
<b>Existing Authority for Compensation Arrangements</b>	<ul style="list-style-type: none"> <li>• 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</li> </ul>	<ul style="list-style-type: none"> <li>• In connection with the compensation arrangement with the employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund</li> </ul>
<b>Proposed Additional Authority for Fund-Linked Products</b>	<ul style="list-style-type: none"> <li>• 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</li> </ul>	<ul style="list-style-type: none"> <li>• Out of a transaction conducted solely to accommodate a specific customer request with respect to the covered fund</li> </ul>

# Risk-Mitigating Hedging Permitted Activity

## Proposed Amendments and Request for Comment

- **Would simplify hedging requirements.** The proposal would also simplify the hedging requirements, in line with the proposed changes to the risk-mitigating hedging exemption from the proprietary trading requirements (see slides [25–29](#)), as reflected in the blackline below showing proposed changes to rule text (§ \_\_.13(a)(1), (a)(2)(ii)B).

- The proposal would remove the word “demonstrably” from the Final Rule’s requirement that a hedge be designed to demonstrably reduce or otherwise significantly mitigate specific, identifiable risks to the banking entity.

(1) The prohibition contained in § \_\_.10(a) of this subpart does not apply with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to ~~demonstrably~~ reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with

- It would also eliminate the requirement for a hedging position to demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks (as opposed to merely being designed to reduce or otherwise significantly mitigate such risks).

(2) Requirements. The risk-mitigating hedging activities of a banking entity are permitted under this paragraph (a) only if:  
[...]  
(ii) The acquisition or retention of the ownership interest:  
[...]  
(B) At the inception of the hedge, is designed to reduce or otherwise significantly mitigate ~~and demonstrably reduces or otherwise significantly mitigates~~ one or more specific, identifiable risks arising [\(1\) out of a transaction conducted solely to accommodate a specific customer request with respect to the covered fund or \(2\)](#) in connection with the compensation arrangement with the employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund;

- **Commentary on high-risk strategy.** The Agencies request comment on whether banking entity activities involving fund-linked products and related hedging in covered fund interests constitute a high-risk strategy or threaten safety and soundness. The proposal encourages commenters to provide specific information on this issue.

# SOTUS Permitted Activity

## Current Exemption and Overview of Proposed Amendments

### HOW TO COMPLY WITH SECTION 4(c)(9) OF THE BHC ACT FOR PURPOSES OF OFFSHORE EXEMPTION

The activity or investment is deemed to comply with the offshore exemption in the BHC Act if:

- **FBOs.** If the banking entity is an **FBO**, it meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Federal Reserve's Regulation K.
- **Non-FBOs.** If the banking entity is **not** an FBO, then the banking entity is not organized under U.S. law and it meets **at least two** of the following tests on a fully consolidated basis:
  - Total assets held outside the U.S. exceed total assets held in the U.S.
  - Total revenues derived from the business of the banking entity outside the U.S. exceed total revenues derived from business in the U.S.
  - Total net income derived from the business of the banking entity outside the U.S. exceeds total net income derived from business in the U.S.
- The activity or investment is conducted in accordance with the requirements of the Volcker Rule regulations.

### TARGET RESIDENTS OF THE U.S.

The agencies indicate in the preamble that the sponsor of a foreign fund would **not** be viewed as "**targeting**" residents of the U.S. if all of the following are true:

- It conducts an offering directed to residents of one or more countries **other than the U.S.**
- It includes in the offering materials a **prominent disclaimer** that the securities are not being offered in the U.S. or to residents of the U.S.
- It includes **other reasonable procedures** to restrict access to offering and subscription materials to persons that are not residents of the U.S.

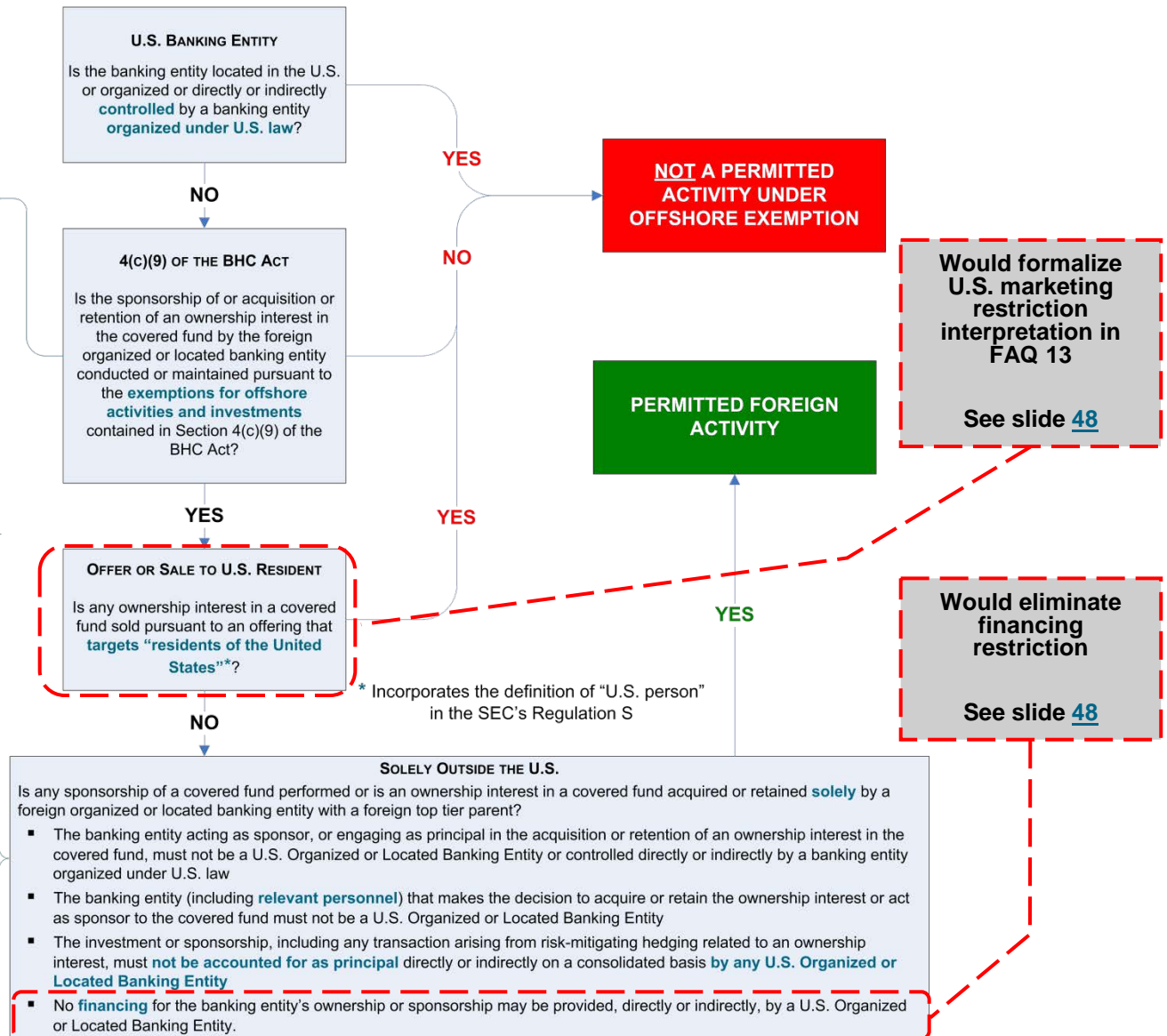
### U.S. PERSONNEL

The agencies indicate in the preamble that the personnel of any U.S. Organized or Located Banking Entities with a foreign top tier parent are **permitted to act as investment adviser** to a covered fund in certain circumstances.

- For instance, such personnel may provide **investment advice** and **recommend investment selections** to the manager or general partner of a covered fund so long as that investment advisory activity in the U.S. does not result in such personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the U.S.

The agencies indicate in the preamble that such personnel may engage in "**back office**" activities in connection with one or more covered funds.

- This allows **administrative services** or similar functions to be provided by such personnel to a covered fund as an incident to activity conducted under the offshore exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund).





# SOTUS Permitted Activity

## Proposed Amendments

- **Financing restriction.** The proposal would eliminate the restriction on a foreign banking entity receiving financing from a U.S. branch or U.S. affiliate of the banking entity for the purchase or sale of a covered fund ownership interest or for covered fund sponsorship under the exemption, similar to the proposed TOTUS exemption revisions (see slides [30–32](#)).
- **U.S. marketing restriction interpretation.** The proposal would amend the SOTUS exemption to formalize [FAQ 13](#)'s interpretation of the SOTUS exemption's marketing restriction, under which the SOTUS exemption is available only for a banking entity that does not offer for sale or sell ownership interests in the covered fund to a resident of the United States.
  - As under [FAQ 13](#), a foreign banking entity that sponsors or serves directly or indirectly as investment manager, investment adviser or commodity trading advisor to a covered fund will be deemed to participate in any offer or sale of that covered fund.

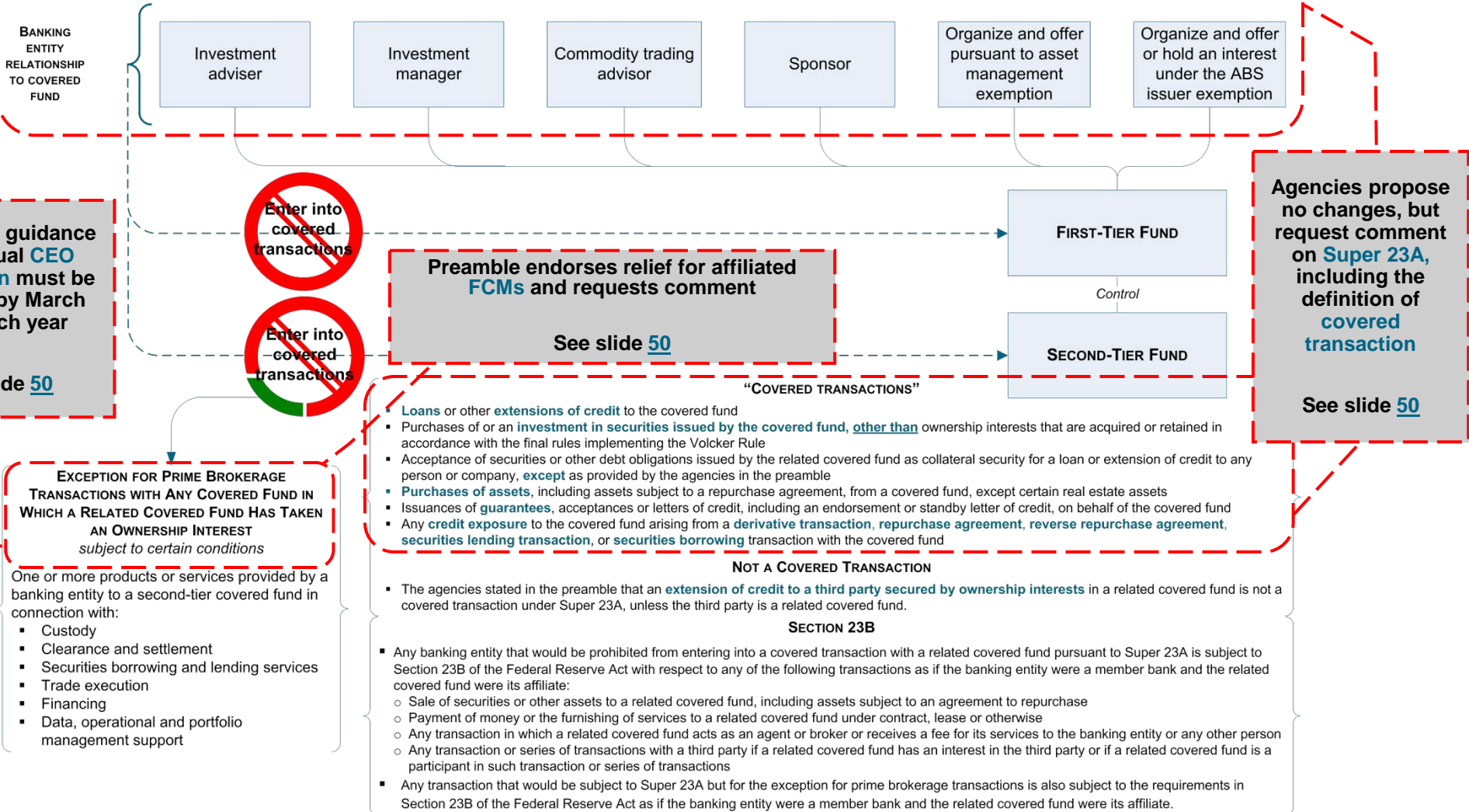
**FAQ 13** clarified that the scope of the marketing restriction in the SOTUS exemption depends on the relationship of the foreign banking entity to the covered fund.

- **Related covered funds.** Where the foreign banking entity sponsors or serves directly or indirectly as the investment manager, investment adviser or commodity trading advisor to a covered fund, the marketing restriction applies to **both** the activities of the foreign banking entity and the activities of the related covered fund.
- **Third-party covered funds.** Where the foreign banking entity does **not** sponsor or serve directly or indirectly as the investment manager, investment adviser or commodity trading advisor to a covered fund, **only** the activities of the foreign banking entity in offering or selling interests will be subject to the marketing restriction. The third-party covered fund's activities will not otherwise be subject to the marketing restriction.

# Super 23A

## Current Restrictions and Overview of Proposed Amendments

No banking entity or its affiliate that serves, directly or indirectly, as the **investment adviser, investment manager, commodity trading advisor, or sponsor** to a covered fund, or that **organizes and offers a covered fund under the asset management or ABS issuer exemption, or that retains an ownership interest under the ABS issuer exemption**, may enter into a transaction with the covered fund, or with any other covered fund **controlled** by such covered fund, that would be a covered transaction as defined in Section 23A of the Federal Reserve Act as if the banking entity were a member bank and the related covered fund were its affiliate



# Super 23A

## Proposed Amendments

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- **Super 23A.** The Agencies do not directly propose any changes to Super 23A. The preamble includes a wide range of questions about how Super 23A could or should be modified.
  - The Agencies ask whether they should amend Super 23A, including the definition of “**covered transaction**,” to incorporate some or all of the Section 23A and Regulation W exemptions or quantitative limits, and what effect such a change would have on banking entities’ ability to meet client needs and demands.
- **Prime brokerage exception.** The Agencies propose amending the prime brokerage exception to formalize in the regulations [FAQ 18](#)’s guidance that a banking entity must provide the annual CEO certification no later than March 31 of each year.
  - The Agencies also request comment on whether the Final Rule’s definition of prime brokerage transaction is appropriate and whether any additional transactions should be included in the definition of “prime brokerage transaction.”
- **Relief for FCMs.** The proposal endorses a [no-action position taken by CFTC staff in 2017](#) with respect to the applicability of Super 23A to futures commission merchants that provide clearing services to related covered funds. The proposal provides that “[t]he other Agencies do not object to the relief provided to the FCMs” as set out in the CFTC staff letter.

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## V. Compliance

# Compliance Program Requirements

## Current Requirements and Overview of Proposed Amendments

**ALL COMPLIANCE PROGRAMS MUST, AT A MINIMUM, INCLUDE:**

### INTERNAL POLICIES AND PROCEDURES

Written policies and procedures reasonably designed to document, describe, monitor and limit exempted trading activities conducted by the banking entity (including setting, monitoring and managing limits required under the market making-related, underwriting and risk-mitigating hedging permitted activities) to ensure that all activities comply with the Volcker Rule.

### INTERNAL CONTROLS

A system of internal controls reasonably designed to monitor compliance and to prevent the occurrence of activities that are prohibited by the Volcker Rule.

### MANAGEMENT FRAMEWORK—RESPONSIBILITY AND ACCOUNTABILITY

A management framework that clearly delineates responsibility and accountability for compliance with the Volcker Rule and that includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the Volcker Rule or by management as requiring attention.

### INDEPENDENT TESTING

Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party.

### TRAINING

Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program.

### RECORDKEEPING

Records sufficient to demonstrate compliance with the Volcker Rule, which a banking entity must promptly provide to regulators upon request and retain for a period of no fewer than 5 years or such longer period as required by regulators. This must include the specified records required to be maintained in connection with the additional document requests for risk-mitigating hedging permitted activity, as applicable.

**BANKING ENTITIES SUBJECT TO THE ENHANCED PROGRAM REQUIREMENT UNDER APPENDIX B OF THE FINAL RULE AND/OR METRICS REPORTING MUST SUPPLEMENT THE STANDARD PROGRAM WITH ADDITIONAL REQUIREMENTS.**

Would limit applicability of six-pillar compliance program requirement to Significant TAL Banking Entities only

Would subject Moderate TAL Banking Entities to simplified requirement available for <\$10B banking entities only under the Final Rule

See slide [54](#)

The terms, scope and detail of the compliance program must be appropriate for the types, size, scope and complexity of the activities and business structure of the banking entity.

Would remove Appendix B requirements for all banking entities, but would retain CEO attestation requirement for Significant and Moderate TAL Banking Entities

See slide [54](#)

# Compliance Program Requirements

## Current Requirements and Overview of Proposed Amendments

### ENHANCED COMPLIANCE PROGRAMS FOR PROPRIETARY TRADING MUST:

- **Identify, document, monitor and report** permitted trading activities, and promptly address risks and potential areas of noncompliance and prevent activities prohibited by, or that do not comply with, the Volcker Rule.
- **Establish and enforce appropriate limits** on covered trading activities, including limits on the size, scope, complexity and risks of the individual activities.
- Provide for periodic **independent review and testing** and ensure the internal audit, corporate compliance and internal control functions are effective and independent.
- Make **senior management** and others, as appropriate, **accountable** and ensure review of the compliance program by the **Board and CEO** (or equivalent).
- **Facilitate** supervision and examination by regulators of permitted activities.

### REQUIREMENTS FOR COMPLIANCE PROGRAMS FOR PROPRIETARY TRADING

A banking entity must **establish, maintain and enforce a compliance program** that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities. Adequate resources and knowledgeable personnel must be used, and the program must be updated with a frequency sufficient to account for changes in activities, testing results, identification of weaknesses and legal/regulatory/other changes. Must provide for revision before expanding trading activities.

**TRADING DESKS:** A banking entity must have **written policies governing each trading desk** that include descriptions of the financial instruments the desk may purchase and sell, the type of trading activity the desk may conduct, the risks that the desk may take on, and other information relating to the desk's trading activities.

**DESCRIPTION OF RISKS AND RISK MANAGEMENT PROCESSES:** The compliance program must include a comprehensive **description of the entity's risk management** program. This must include a description of the governance, approval, reporting, escalation, review and other extensive procedures used to ensure compliance with the Volcker Rule.

**AUTHORIZED RISKS, INSTRUMENTS AND PRODUCTS:** A banking entity must implement and enforce **limits and internal controls** for each trading desk that are reasonably designed to ensure that trading activity is conducted in compliance with the law and the entity's policies and procedures. Risk limits must be based on specified criteria.

**HEDGING POLICIES AND PROCEDURES:** A banking entity must establish, maintain and enforce **written policies and procedures** regarding the **use of risk-mitigating hedging instruments and strategies**.

**ANALYSIS AND QUANTITATIVE MEASUREMENTS:** A banking entity must perform **robust analysis and quantitative measurement** of trading activities reasonably designed to ensure that the trading activity of each trading desk is consistent with the entity's compliance program. This includes any quantitative metrics specifically tailored to the banking entity's particular risks, practices and strategies

**OTHER COMPLIANCE MATTERS:** Additional requirements apply to identify and monitor permitted trading activities, activities excluded from the definition of proprietary trading, high-risk assets and trading strategies and potential conflicts of interest.

**REMEDATION OF VIOLATIONS:** The compliance program must describe procedures for identifying violations of the Volcker Rule and **require prompt documentation and remediation** of any violation and document all proposed and actual remediation efforts. Written policies and procedures must provide for assessment of the extent to which program modifications are needed and implemented, as well as **prompt notification of material weaknesses or significant deficiencies** in program design or implementation to senior management and the board of directors.

### INDEPENDENT TESTING

**Independent testing** of the compliance program, internal controls and management procedures **must occur** with a frequency appropriate to the size, scope and risk profile of the banking entity's trading and covered fund activities or investments, **at least annually**. Testing may be conducted by the banking entity's internal audit department, compliance personnel or risk managers outside the organizational unit tested, outside auditors/consultants, or other qualified independent parties.

### TRAINING

A banking entity must provide **adequate training** to personnel and managers of the banking entity engaged in covered activities and to other appropriate supervisory, risk, independent testing, and audit personnel, to effectively implement and enforce the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking entity's trading activities.

### RECORDKEEPING

A banking entity must create and retain **records sufficient to demonstrate compliance and support** the operations and effectiveness of the compliance program. A banking entity must retain these records for a period of **no fewer than 5 years** or such longer period as required by regulators in a form that allows it to promptly produce such records to regulators on request.

Would remove **Appendix B** requirements for all banking entities, but would retain the CEO attestation requirement for Significant and Moderate TAL Banking Entities

See slide [54](#)

# Compliance Program Requirements

## Proposed Amendments

■ **Tailored, three-tiered approach to compliance obligations.** The proposal would apply different Volcker compliance program requirements to each of the three tiers of banking entities (described on slide 6), as summarized in the chart to the right.

■ **Agency authority to review applicable tier.** The Agencies would reserve the authority to review the tier applicable to a banking entity and could require a banking entity to comply with requirements otherwise applicable to a “higher” tier entity.

■ **Increased flexibility for compliance programs through removal of Appendix B.** The proposal would remove Appendix B, the detailed enhanced compliance program requirements of the Final Rule.

■ **CEO attestation would remain for Significant and Moderate TAL Banking Entities.** The CEO attestation requirement would remain for Significant and Moderate TAL Banking Entities and any other banking entity as notified by its primary Volcker regulator.

Banking Entity Tier	Proposed Compliance Requirements
<b>Significant TAL Banking Entities</b>	<ul style="list-style-type: none"> <li>• CEO attestation</li> <li>• Existing § 20(b) six-pillar compliance program, appropriately tailored to risks and activities of each banking entity</li> <li>• Metrics reporting</li> <li>• Covered fund documentation requirements in existing § 20(e)</li> </ul>
<b>Moderate TAL Banking Entities</b>	<ul style="list-style-type: none"> <li>• CEO attestation</li> <li>• Simplified compliance program that is available for banking entities with \$10 billion or less in total consolidated assets under the Final Rule</li> </ul>
<b>Limited TAL Banking Entities</b>	<ul style="list-style-type: none"> <li>• Presumed compliance (no ongoing obligation to demonstrate compliance unless directed by primary Agency)</li> </ul>

**Scope of entities subject to CEO attestation requirement.** While all Significant TAL Banking Entities would be entities that are currently subject to the Final Rule’s CEO attestation requirement, the Moderate TAL Banking Entity tier may pick up some banking organizations that are not currently required to submit a CEO attestation.

# Metrics Requirements

## Current Requirements and Overview of Proposed Amendments

### METRICS

<b>Risk Management</b>	<ul style="list-style-type: none"> <li>▪ Risk and Position Limits and Usage</li> <li>▪ Risk Factor Sensitivities</li> <li>▪ Value at Risk (VaR) and Stress Value at Risk (Stress VaR)</li> </ul>
<b>Source of Revenue</b>	<ul style="list-style-type: none"> <li>▪ Comprehensive Profit and Loss Attribution</li> </ul>
<b>Customer-Facing Activity</b>	<ul style="list-style-type: none"> <li>▪ Inventory Turnover</li> <li>▪ Inventory Aging</li> <li>▪ Customer-Facing Trade Ratio – Trade Count Based and Value Based</li> </ul>
<b>Qualitative Information</b>	<ul style="list-style-type: none"> <li>▪ Trading Desk Information</li> <li>▪ Quantitative Measurements Identifying Information</li> <li>▪ Narrative Statement</li> </ul>

Would replace the metrics for customer-facing activities with **Positions, Securities Inventory Aging and Transaction Volumes** metrics that would apply only to trading desks that rely on the underwriting or market-making exemptions

See slide [57](#)

Would add new informational requirements

See slide [56](#)

### KEY PROCEDURES AND LOGISTICS

<b>Certain Reporting Remains Optional</b>	<ul style="list-style-type: none"> <li>▪ <b>Reporting required:</b> Metrics in respect of trading conducted pursuant to the <b>underwriting-related, market making-related, risk-mitigating hedging and U.S./ foreign government obligation</b> permitted activities</li> <li>▪ <b>Reporting optional:</b> Metrics in respect of trading conducted pursuant to an <b>exclusion</b> from the scope of proprietary trading, or pursuant to the <b>on behalf of customers, regulated insurance company or foreign bank</b> permitted activities</li> </ul>
<b>Level of Measurement</b>	<ul style="list-style-type: none"> <li>▪ Each <b>trading desk</b>, defined as 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 of the banking entity. This may span across legal entities.</li> </ul>
<b>Regulatory Reporting Frequency</b>	<ul style="list-style-type: none"> <li>▪ For banking entities with \$50 billion or more in trading assets and liabilities: for each <b>calendar month</b>, within 30 days of the end of the relevant month (beginning with information for January 2015, <b>within 10 days of month end</b>)</li> <li>▪ For other banking entities: for each <b>calendar quarter</b>, within 30 days of quarter end</li> </ul>
<b>Record Retention</b>	<ul style="list-style-type: none"> <li>▪ <b>5 years</b>; records documenting preparation/content of reports submitted and information necessary to permit regulators to verify accuracy of reports</li> </ul>

Would expand option to include additional positions and instruments

See slide [57](#)

Would revise to require reporting within **20** days of end of calendar month for banking entities with \$50B or more of TAL

See slide [57](#)



# Metrics Requirements

## Proposed Amendments

- **Modified metrics requirements; significant new obligations.** The Agencies propose extensive changes to the Appendix A metrics reporting requirements. These include not only revisions to some of the metrics themselves (and their names) in recognition of the limited utility of existing requirements, but also additions of several granular informational requirements likely to require new procedures and programming and increase reporting burdens.
- **New informational requirements.** The proposal would require a banking entity to provide a significant amount of new qualitative data in addition to the seven quantitative metrics.
  - **Extensive new trading desk information.** The proposal would require a banking entity to provide a significant amount of identifying information about each trading desk and the desk's associated metrics, including name, identifier, description of the desk's general trading strategy, types of financial instruments and other products traded by the desk, and the legal entities to which the desk books transactions, among other information.
  - **Quantitative measurements identifying information.** The proposal would require a banking entity to provide descriptive information about the desk's reported quantitative metrics, including schedules describing risk limits, risk factor sensitivities, risk factor attribution information, and schedules cross-referencing between (i) limits and risk factor sensitivities and (ii) risk factor sensitivities and risk factor attribution.
  - **Narrative statement.** The proposal would require a banking entity to provide a narrative statement describing (i) any changes in metrics calculation methods, trading desk structure and trading desk strategy, and the reasons and timing for any of these changes, (ii) an explanation for the inability to report any quantitative measurement, (iii) a notice if the banking entity changes its approach to including or excluding metrics on non-financial instruments and (iv) any other information the banking entity views as relevant.

# Metrics Requirements

## Proposed Amendments

### ■ Changes to existing metrics and processes.

- **Inventory Turnover → Positions.** The proposal would replace the Inventory Turnover metric with a daily Positions metric.
- **Customer-Facing Trade Ratio → Transaction Volumes.** The proposal would replace the Customer-Facing Trade Ratio metric with a daily Transaction Volumes metric.
- **Inventory Aging → Securities Inventory Aging.** The proposal would limit the scope of the Inventory Aging metric to a trading desk's securities positions (excluding derivatives) and would rename that metric Securities Inventory Aging.
- **Some metrics apply based on activity.** The Positions, Transaction Volumes and Securities Inventory Aging metrics generally would apply only to trading desks that rely on the underwriting or market-making exemptions. In-scope trading desks would be required to reflect all covered trading activities conducted by that desk, not only underwriting or market making-related activity.
- **Option to include additional positions and instruments.** Banking entities would have the discretion, but not the obligation, to report metrics on activities including liquidity management and trading conducted under the trading on behalf of customers, insurance company, or TOTUS exemptions. The Agencies also note that a banking entity would be permitted to calculate metrics based on positions in products that are not financial instruments or positions that do not represent covered trading activity; however, a banking entity would be permitted to decide to include these metrics where doing so provides a more accurate picture of the risks associated with the trading desk, though the Agencies caution that any such approach should be consistent over time.
- **Reporting deadline.** Banking entities with \$50 billion or more in trading assets and liabilities would be required to report the information required by the Appendix within 20 days after the end of each calendar month, as opposed to the current 10 days.

# Davis Polk Contacts

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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