Regulatory Practice Letter

December 2013 – RPL 13-21

Prohibitions and Restrictions on Proprietary Trading and Relationships with Hedge Funds and Private Equity Funds (Volcker Rule) - Final Rule

Executive Summary

The Federal Reserve Board, FDIC, OCC, SEC, and CFTC[1] (collectively, the Agencies) adopted final rules implementing Section 619 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which is commonly referred to as the Volcker Rule, on December 10, 2013. As finalized, the implementing rules to the Volcker Rule (hereinafter, Volcker Rule or Rule) generally prohibit banking entities from:

- Engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account. The Rule still permits proprietary trading in U.S. government, agency, state, and municipal obligations and also permits, in more limited circumstances, proprietary trading in the obligations of a foreign sovereign or its political subdivisions. (*Subpart B – Proprietary Trading Prohibitions and Exemptions*)
- Owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as "covered funds." (*Subpart C – Covered Fund Activities and Investments)*

The Volcker Rule provides a number of exemptions for certain activities, including market making, underwriting, risk-mitigating hedging, trading in certain government obligations, and organizing and offering a hedge fund or private equity fund, among others. Activities that occur solely outside of the U.S. and insurance company activities are also permitted.

The Volcker Rule requires banking entities to establish an internal compliance program to "help ensure and monitor compliance with the prohibitions and restrictions of the statute." Additionally, the Chief Executive Officer (CEO) of a banking entity with significant activities must, annually, attest in writing to the relevant agency that the banking entity has in place a compliance program "reasonably designed" to achieve compliance with the final rules. (*Subpart D – Compliance Program Requirement*)

[1] Board of Governors of the Federal Reserve System (Federal Reserve Board), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC).

The Volcker Rule will become effective April 1, 2014. However, the Federal Reserve Board has extended the conformance period until July 21, 2015. Beginning June 30, 2014, banking entities with $50 billion or more in consolidated trading assets and liabilities will be required to report quantitative measurements. Banking entities with at least $25 billion in consolidated trading assets and liabilities will become subject to this requirement on April 30, 2016. Banking entities with at least $10 billion in consolidated trading assets and liabilities will become subject to the requirement on December 31, 2016. The Agencies state they will review the data collected prior to September 30, 2015, and revise the collection requirement as appropriate.

Modifications to the Rules

As finalized, the Volcker Rule is largely consistent with the approach outlined in the Agencies' proposed rule, with some modifications. However, it is likely to prove to be one of the most complex and controversial regulatory regimes to be introduced into the financial services industry. Indeed, Federal Reserve Board Governor Tarullo acknowledged the complexity of the Volcker Rule, stating that the final iteration had been only "modestly simplified."

Perhaps the most significant change to the proposed rule is that the final Volcker Rule generally does not prohibit proprietary trading by foreign banks, provided the trading decisions and principal risks of the foreign bank occur and are held outside of the U.S. These transactions may involve U.S. entities only under certain circumstances. A transaction is considered exempt if it occurs: a) with the foreign operations of U.S. entities; b) in cleared transactions with an unaffiliated market intermediary acting as principal; or c) in cleared transactions through an unaffiliated market intermediary acting as agent, conducted anonymously on an exchange or similar trading facility.

Additionally, the final Volcker Rule reduces the number of metrics required to measure and monitor compliance from 17 to seven and increased the relevant reporting threshold from $1 billion to $10 billion of consolidated trading assets and liabilities. The CEO written attestation is a new requirement as are clarifications regarding the restrictions on compensation for traders conducting prohibited proprietary trading activity.

Initial Key Takeaways

Market Making

- While the framework recognizes differences in market making activities by asset classes, certain products will be more challenged to meet the Volcker Rule requirements than others (e.g. structured products and fixed income).
- The Volcker Rule requires that market making activities be "demonstrably related to satisfying reasonable near term customer demands" and other market making activities. Customer demand may not be well documented at institutions and may require some effort to develop.
- The Volcker Rule allows trading desks to conduct hedging activity associated with market making activity, without those hedging activities being included in the requirements for permitted risk mitigating hedging activity. While this is a positive overall for the industry, it could lead to more decentralized hedging within institutions.

- The Volcker Rule's compliance requirements, and position and risk limits, will likely cause institutions to have less flexibility reacting to market developments.

Foreign Sovereign Bonds

- Foreign affiliates of U.S. entities are permitted to trade in the sovereign bonds of the host country in which they are registered, similar to the provisions for U.S. government bonds (e.g. a U.K. affiliate of a U.S. institution could engage in proprietary trades in U.K. government bonds). The foreign affiliate would not be able to engage in proprietary trades in the sovereign bonds of other countries. The U.S. affiliate (not an insured depository institution) of a foreign banking entity may trade in sovereign bonds of the country in which it is organized.
- Institutions may look to establish trading desks in other foreign affiliates to take advantage of the sovereign bond exclusion. It is unclear whether branches of U.S. banking institutions are considered foreign affiliates for the sovereign bond exemption.

Non US Banking Entities Trading, Solely Outside the United States (SOTUS)

- Foreign banks can engage in proprietary trades with foreign customers if the SOTUS provision is met, that is, conducted solely outside the U.S. This provision will likely place U.S institutions at a competitive disadvantage to foreign institutions in their overseas operations.
- It is unclear whether foreign banks operating in the U.S. will need to provide metric information to the Agencies for non-U.S. trading activity.
- U.S. affiliates of foreign entities that engage in back to back transactions with their foreign entity to centrally manage risk, will need to assess this approach to risk management to ensure that their foreign affiliate is not subject to Volcker Rule restrictions.

Covered Funds

- The addition of carve-outs from the definition of covered funds narrows the scope of vehicles covered by the restrictions on acquiring or retaining any equity, partnership, or other ownership interest in, sponsoring or having certain other relationships with hedge or private equity funds. However, firms availing themselves of these exceptions will be subject to more stringent compliance obligations.
- An exclusion for loan securitizations will prevent most collateralized loan obligation (CLO) structures from relying on Sections 3(c)(1) or 3(c)(7) of the *Investment Company Act* at the risk of being designated a covered fund. CLOs currently relying on these provisions are not grandfathered and will need to limit holdings to loans, defined by the rule as excluding most securities and derivatives, by July 21, 2015. New issuances will similarly need to limit holdings to those not restricted by the rule.

Compliance Program

- The compliance program will require a heavy infrastructure investment for most institutions. Institutions will have to evaluate how they want to organize their trading desks, trading accounts, and hedging activity under the Volcker Rule.

- Institutions are likely to use a Sarbanes Oxley[2] type certification approach to meet the CEO attestation requirement.

Background

The Federal Reserve Board, FDIC, OCC, and SEC released proposed rules to implement the Volcker Rule in October 2011 (please refer to KPMG Regulatory Practice Letter 11-24). The CFTC separately released a proposal on the "same common rule" in January 2012.

For purposes of the Rule, a "banking entity" is defined as: 1) any insured depository institution; 2) any company that controls an insured depository institution; 2) any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act; and 4) any affiliate or subsidiary of any of these entities. The Volcker Rule also applies to any nonbank financial company supervised by the Federal Reserve Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in, or sponsors a hedge fund or private equity fund with regard to those activities. The Federal Reserve Board indicates in the Rule that two of the three nonbank financial companies subject to supervision by the Federal Reserve Board are affiliated with insured depository institutions and so covered by the Rule. The Federal Reserve Board is continuing to evaluate whether the third company engages in any activities subject to the Rule and what if any requirements under the Rule would apply to that company.

Description

Subpart B – Proprietary Trading Prohibitions and Exemptions

The Volcker Rule generally prohibits a banking entity from engaging in short-term proprietary trading of financial instruments for their own accounts. Financial instruments include securities, derivatives, commodity futures, and options on these instruments, but do not include loans, spot foreign exchange, or spot physical commodities. The Rule only defines a trading account as any account that is used to take positions principally for the purpose of short-term resale, benefitting from short-term price movements, locking in short-term arbitrage profits, or hedging another trading account position.

The prohibition on proprietary trading would exempt:

- Market making-related activities that are genuinely client-facing and designed not to exceed the reasonably expected near term demands of clients (the Volcker Rule does not require market making activities to be designed to generate revenues primarily from fees or other customer revenues)
- Underwriting activities that are genuinely client-facing and designed not to exceed the reasonably expected near term demands of clients
- Risk-mitigating hedging activities
- Permitted liquidity management programs designed to ensure that the banking entity can meet its obligations as they come due
- Trading for the general account of regulated insurance companies or their affiliates

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[2] Sarbanes-Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002).

- Trading by foreign banking entities where the risk as principal, the decision-making, and the accounting for it occurs solely outside of the U.S.
- U.S. government, U.S. government agency, specified government sponsored entity agency, state, and municipal obligations, although the exemption does not extend to derivatives on those obligations
- Trading on behalf of customers
- Trading by the U.S. operations of a foreign banking entity, other than an insured depository institution, in obligations of the home chartering authority of the foreign banking entity (including obligations of any agency or political subdivision thereof)
- Trading by a foreign bank or foreign securities broker-dealer owned by a U.S. banking entity in obligations of the foreign sovereign that charters the foreign bank or foreign broker-dealer (including obligations of any agency or political subdivision thereof).

Market Making Exemption

The Volcker Rule includes a number of requirements designed to ensure that exempt market making-related activity is genuinely client-facing and not designed to exceed the reasonably expected near-term demands of clients, customers, or counterparties, and requires any banking entity relying on the market-making exemption to:

- Routinely stand ready to purchase and sell one or more types of financial instruments for its own account in "commercially reasonable amounts" and throughout market cycles taking account of the liquidity, maturity and depth of the market for the relevant financial instruments
- Ensure that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on the liquidity, maturity, and depth of market and demonstrable analysis of historical and projected customer demand (exclusive of trading with other large market-making competitors)
- Establish and comply with written policies and procedures that include:
  - A description of the financial instruments in which the trading desk makes a market
  - The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure
  - Limits for each desk on its market-maker inventory, financial exposures, allowable risks, and market-making hedging activities
  - Authorization and escalation procedures for trading activity that would exceed the trading desk's limits
  - Appropriate internal controls and monitoring of compliance with limits by each trading desk.
- Compensate the relevant employees in a way that does not reward or incentivize prohibited proprietary trading
- Be appropriately registered as a dealer under relevant securities or commodities laws.

The Volcker Rule does not require market making-related activities to be designed to generate revenues primarily from fees or other customer revenues; however, banking entities with significant trading activities are required to report data regarding patterns of revenue generation by market-making trading desks involved in market-making activities that may warrant further review of the desk's activities and may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation.

Foreign Banking Entities Exemption

The Volcker Rule permits foreign banking organizations to engage in proprietary trading solely outside of the U.S. A foreign banking entity may rely on the exemption only if:

- The foreign banking entity acts as principal in the purchase or sale outside the U.S.
- The banking entity (including relevant personnel) that makes the decision to purchase or sell is not located in the U.S.
- The purchase or sale, including any related hedging transactions, is not accounted for as principal in the U.S.
- No financing for the banking entity's purchase or sale is provided by a U.S. affiliate of the foreign banking entity
- The purchase or sale is not conducted with or through any U.S. entity, other than on an anonymous basis on a U.S. exchange or through an unaffiliated intermediary in a transaction cleared through a U.S. central counterparty, or in a transaction with the foreign operations of a U.S. entity.

Permitted Risk-Mitigating Hedging Activities

The Volcker Rule permits risk-mitigating hedging activity, subject to a number of requirements intended to ensure that the exemption permits only hedging that is risk-mitigating and related to identifiable financial positions of the banking entity. These limitations include requirements that any permitted hedging activity, at the inception of the hedge, be designed to reduce or otherwise significantly mitigate and demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks to the banking entity in connection with and related to positions, contracts or other holdings of the banking entity. Additionally, the hedging activity may not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with the hedging exemption, and the hedging activity must be monitored and managed over time. The Rule also requires the banking entity to compensate employees engaged in hedging activity in a way that does not reward or incentivize prohibited proprietary trading.

Additionally, risk-mitigating hedging of both individual and aggregated positions, contracts or other holdings of the banking entity are permitted. However, to prevent abuse of this statutory exemption, the Volcker Rule requires that the hedging be related to identified positions, contracts and other holdings of the banking entity.

As finalized, the Volcker Rule is more restrictive than the proposal in several aspects to prevent banking entities from conducting prohibited proprietary trading under the guise of hedging, requiring:

- Hedging to be conducted in compliance with a written program that documents authorized hedging instruments, positions, limits, strategies, and techniques that may be used for hedging
- A written program that includes internal controls and ongoing monitoring and authorization procedures, including independent testing of limits and escalation procedures to exceed or change limits

- The written program must document authorized hedging instruments, positions, limits, strategies, and techniques that may be used for hedging, and also include internal controls and ongoing monitoring and authorization procedures, including independent testing of limits and escalation procedures to exceed or change limits
- The banking entity must conduct analysis and independent testing to ensure that hedging positions, techniques, and strategies may reasonably be expected to "demonstrably reduce or otherwise significantly mitigate" risk being hedged.

The Volcker Rule contains a requirement that a banking entity document hedging activity that is conducted by a unit of the banking entity other than the trading desk responsible for the position, contract, or other holding being hedged, and also document any hedging done by a trading desk using a technique, strategy or instrument that is not identified in the written hedging policy governing that trading desk.

Subpart C – Covered Fund Activities and Investments

Prohibitions and Restrictions on Ownership Interests in, and Certain Relationships with, Covered Funds

In addition to the proprietary trading restrictions of Subpart B, the Volcker Rule also prohibits banking entities from "acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund," which are more generally referred to as covered funds.

"Covered funds" include issuers that would be an investment company <u>but for</u> section 3(c)(1) or 3(c)(7) of the *Investment Company Act* (i.e., hedge fund or private equity fund) or similar funds the Agencies determine by rule. Covered funds also include commodity pools meeting certain specified conditions (generally those that share the characteristics of an entity excluded from the *Investment Company Act* under the exclusions in section 3(c)(1) or 3(c)(7)), as well as any foreign banking entity that is owned directly or indirectly by a U.S. banking entity and for which: the ownership interest is sold solely outside of the U.S., the entity 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 other disposition or otherwise trading in securities; and is sponsored or owned by the U.S. banking entity or its affiliate. Further, a foreign issuer that could rely on an exemption or exclusion from the *Investment Company Act*, other than the section 3(c)(1) or 3(c)(7) exclusion, would not be considered a covered fund.

Excluded from the definition of covered funds are[3]:

- Foreign public funds
- Wholly-owned subsidiaries
- Joint ventures that do not engage in investing money for others
- Acquisition vehicles
- Foreign pension or retirement funds
- Insurance company separate accounts
- Bank-owned life insurance

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[3] The Agencies may rescind an exclusion if it is being used to evade the requirements of the statute or to exclude other entities from the definition of covered fund if appropriate.

- Loan securitizations
- Qualified asset-backed commercial paper conduits
- Qualifying covered bonds
- SBICs (Small Business Investment Companies) and public welfare investment funds
- Registered investment companies
- Issuers in conjunction with FDIC receivership or conservatorship
- Other issuers excluded by the Agencies.

Additionally, Subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in Subpart D of the Rule, as well as Appendix B, to the extent applicable. (Please see discussion following Subpart C for additional detail.)

Exemptions from the Prohibition on Ownership of a Covered Fund[4]

The following exemptions from the covered fund activities prohibition are allowed:

- Investing in a covered fund in connection with organizing and offering the covered fund for customers of the banking entity's trust, fiduciary, or advisory services
- Underwriting and market making-related activities that are designed not to exceed the reasonably expected near term demands of clients, customers, and counterparties
- Risk-mitigating hedging activities
- Trading for the general account of a registered insurance company
- Trading on behalf of customers
- Sponsoring and investment in loan securitizations and related servicing assets
- Any activity with a covered fund by a foreign banking entity solely outside of the U.S.

Permitted Investments in Covered Funds

Notwithstanding the prohibition against investing or sponsoring a covered fund, a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or its affiliate organizes and offers for the purposes of:

- Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, provided it meets the per fund and aggregate limits set by the Rule within one year of establishing the fund.
    - Ownership interests must only be sold to customers of the banking entity's bona fide trust, fiduciary, or advisory services
    - The fund must be subject to a written plan that outlines how advisory or similar services will be provided to the customers
    - The banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the fund or any covered fund in which such fund invests
    - The fund may not share the same name or a variation of the same name with the banking entity for corporate, marketing, promotion, or other purposes or use the word "bank" in its name.

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[4] The investment in the fund cannot, after one year from the date the fund is established, exceed 3 percent of the total outstanding ownership interests in the fund.

Making and retaining an investment in the covered fund is subject to the following limits:

- *Per fund limit*: an investment by the banking entity and its affiliates may not exceed 3 percent of the total number or value of the outstanding ownership interests of the fund. However, a banking entity is permitted to hold ownership interests in a securitization up to the amount required to comply with the minimum requirements of Section 15G of the *Securities Exchange Act* and any implementing regulations, which generally requires the securitizer to retain ownership interests that represent 5 percent of the risk of the securitization
- *Aggregate limit*: the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained may not exceed 3 percent of the tier 1 capital of the banking entity as of the last day of the calendar quarter
- For funds that a banking entity establishes, the banking entity may apply to the Federal Reserve Board to receive up to two years of additional time to attract unaffiliated investors and achieve the statutory investment limits provided the Federal Reserve Board determines that such an extension would be consistent with safety and soundness and would not be detrimental to the public interest.

A foreign banking organization (not a U.S. banking entity or its foreign subsidiaries and affiliates) may acquire or retain any ownership interest in, or act as sponsor to, a covered fund as long as the activity is: conducted "solely outside of the United States"; and no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S. The Rule permits a foreign banking entity to rely on this exemption only if:

- The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the U.S.
- The investment or sponsorship, including any related hedging transactions, is not accounted for as principal in the U.S.
- Ownership interests in the covered fund are not targeted to residents of the U.S.
- No financing for the banking entity's ownership or sponsorship is provided by a U.S. affiliate of the foreign banking entity.

Limitations on Permitted Covered Fund Activities and Investments

The statute prohibits any banking entity that serves as the investment manager, adviser, or sponsor to a covered fund from entering into a transaction with the covered fund that would be a covered transaction for purposes of Section 23A of the *Federal Reserve Act*. A narrow exemption to this general prohibition is available for a prime brokerage transaction with a covered fund that is owned by another covered fund sponsored or advised by the banking entity. Permitted prime brokerage transactions would be subject to Section 23B of the *Federal Reserve Act.*

Restrictions on All Permitted Activities

No transaction, class of transactions, or activity may be deemed permissible if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties
- Result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy

- Pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.

Compliance Program Requirements and Rulemaking Framework of Subpart D applicable to Covered Fund Activities and Investments

Banking organizations with $10 billion or more in total assets must have a compliance program that, at a minimum, includes the following elements:
- Written policies and procedures that establish trading and exposure limits for the activities conducted by the banking entity and are designed to ensure compliance with the requirements of the Rule
- Internal controls
- A management framework that delineates responsibility and accountability for compliance with the Rule
- Independent testing and audit
- Training
- Recordkeeping.

Banking entities with significant covered fund operations must satisfy additional requirements to ensure that they have "robust risk management processes, remediation processes, independent testing and reporting, and other compliance controls to cover its fund activities. The CEO of a banking entity with significant covered funds activities or investment must, annually, attest in writing to the relevant agency that the banking entity has in place a compliance program reasonably designed to achieve compliance with the Rule.

Subpart D – Compliance Program Requirement

Each banking entity engaged in proprietary trading or covered fund activities and investments must develop and provide for the continued administration of a program "reasonably designed to ensure and monitor compliance" with the Volcker Rule prohibitions and restrictions on proprietary trading and covered fund activities and investments (as outlined in Subparts B and C). The compliance program would be required to be appropriate for the size, scope and complexity of activities and business structure of the banking entity.

For entities with $10 billion or more in total assets, the compliance program would be required to include, at a minimum:
- Internal written policies and procedures reasonably designed to document, describe, and monitor trading activities subject to Subpart B and activities and investments with respect to a covered fund activities subject to Subpart C
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance in the covered banking entity's trading activities and covered fund activities and investments, and to prevent the occurrence of activities or investments that are prohibited
- A management framework that clearly delineates responsibility and accountability for compliance
- Independent testing for the effectiveness of the compliance program conducted by qualified personnel of the covered banking entity or by a qualified outside party
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program

- Making and keeping records sufficient to demonstrate compliance. The covered banking entity must promptly provide such records upon request and retain the records for a period of no less than 5 years.

Less Active Banks

Banking entities that engage in activities and investments covered by the proprietary trading and covered fund provisions and that have had total consolidated assets of $10 billion or less for the previous two calendar years may satisfy the compliance program requirements by including in their existing compliance policies and procedures appropriate references to the Volcker Rule compliance requirements and any adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

Banking entities that do not engage in proprietary activities or covered prohibited or restricted activities covered by the Volcker Rule are required to establish a compliance program meeting the rule requirements *prior to* engaging in such activities or making such investments.

Additional Standards (Appendix B)

Additional requirements and standards (delineated in Appendix B, *Enhanced Minimum Standards*) would be expected to be included in the compliance programs of banking entities that:

- Engage in proprietary trading permitted under Subpart B and are required to comply with reporting requirements outlined in the rule (i.e., generally entities with more than $10 billion in total consolidated trading assets and liabilities – see below)
- Have total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the U.S.)
- Have been notified by their primary Federal regulator that they must satisfy the additional standards.

For proprietary trading activities, these additional standards (in Appendix B) include, among other things:

- Written policies and procedures governing each trading desk, including identification of activities that will be conducted in reliance on exemptions
- A comprehensive description of the risk management program for the trading activity, including monitoring for material exposure to high risk activities
- Limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with final rule and with the banking entity's written policies and procedures, and are implemented and enforced
- Written policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that are established, maintained, and enforced
- Robust analysis and quantitative measurement of the trading activities that is reasonably designed to: ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in

the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading

- A description of procedures for identifying and remedying violations of the final rule that include, at a minimum, a requirement to promptly document, address and remedy any violation and document all proposed and actual remediation efforts.

For covered funds activities, these additional standards require, among other things:

- A compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity
- A process, which must include appropriate management review and independent testing, for identifying and documenting covered funds that each unit within the banking entity's organization sponsors or organizes and offers, or invests
- Identification and documentation of each unit within the organization that is permitted to acquire or hold an interest in any covered fund or sponsor any covered fund and mapping of each unit to the division, business line, or other organizational structure that will be responsible for managing and overseeing that unit's activities and investments
- Internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of the Rule and are appropriate given the limits on risk established by the banking entity
- Effective monitoring and identification for further analysis of any covered fund activity or investment that may indicate potential violations and to prevent actual violations of the Rule.

Responsibility and Accountability – Including Compensation and Attestation

Entities must adopt a written compliance program for corporate governance that is approved by the board of directors. A governance framework must be established, maintained, and enforced, and include designation of senior management to carry out the management responsibilities for each trading desk and organization unit involved in covered fund activities. The framework must include:

- A description of the management system, including the titles, qualifications, and locations of managers and the specific responsibilities of each person with respect to the banking entity's activities
- Procedures for determining compensation arrangements for traders engaged in underwriting or market making-related activities or risk-mitigating hedging activities so that such compensation arrangements are designed not to reward or incentivize prohibited proprietary trading and appropriately balance risk and financial results in a manner that does not encourage employees to expose the banking entity to excessive or imprudent risk
- A requirement that business line managers with responsibility for one or more trading desks be accountable for the effective implementation of the compliance program with regard to those trading desks
- Boards of directors responsibilities that include:
    - Setting and communicating an appropriate culture of compliance
    - Ensuring that senior management is fully capable, qualified, and properly motivated to manage compliance in light of the organization's business activities and the expectations of the board of directors
    - Ensuring that senior management has established appropriate incentives and adequate resources to support compliance with the Rule, including the

implementation of a compliance program meeting the requirements for management goals and compensation structures.

- Senior management responsibilities that include:
  - Implementing and enforcing the approved compliance program
  - Ensuring that effective corrective action is taken when failures in compliance are identified
  - Reviewing the compliance program periodically and reporting to the board, or an appropriate committee thereof, on the effectiveness of the compliance program and compliance matters with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading activities and covered fund activities or investments, but at least annually.
- A requirement for the CEO to review and annually attest in writing to the relevant Agency that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the required compliance program in a manner reasonably designed to achieve compliance
  - For foreign banking entities, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations of the foreign banking entity that is located in the United States.

Independent Testing

Independent testing 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 but at least annually and include an evaluation of the:

- Overall adequacy and effectiveness of the banking entity's compliance program, including an analysis of the extent to which the program contains all the required elements
- Effectiveness of the banking entity's internal controls, including an analysis and documentation of instances in which such internal controls have been breached, and how such breaches were addressed and resolved
- Effectiveness of the banking entity's management procedures.

The independent testing may be conducted by a banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, or by outside auditors, consultants, or other qualified independent parties. The entity must promptly take appropriate action to remedy any significant deficiencies or material weaknesses identified in its compliance program and to terminate any violations.

Metrics Reporting (Appendix A)

Entities that together with their affiliates and subsidiaries, have significant trading assets (see below) and liabilities are required to: 1) furnish periodic reports to the relevant Agency regarding a variety of quantitative measurements of their covered trading activities, which vary depending on the scope and size of covered trading activities; and 2) create and maintain records documenting the preparation and content of these reports. (The Agencies note that "the quantitative measurements that must be furnished pursuant to this appendix are not intended to serve as a dispositive tool for the identification of permissible or impermissible activities.")

However, the Agencies anticipate that banking entities may need to develop and implement quantitative measurements in order to effectively monitor covered trading activities for compliance.

In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure that the activities are within risk tolerances established by the banking entity, and to monitor and examine for compliance with the proprietary trading restrictions in the Rule.

On an ongoing basis, banking entities must carefully monitor, review, and evaluate all furnished quantitative measurements, as well as any others that they choose to utilize in order to maintain compliance with the Rule. All measurement results that indicate a heightened risk of impermissible proprietary trading, including with respect to otherwise-permitted activities, or that result in a material exposure to high-risk assets or high-risk trading strategies, must be escalated within the banking entity.

Quantitative Measures

The following quantitative measurements are required to be reported for each trading desk of the banking entity, calculated in accordance with Appendix A. No quantitative thresholds are provided as part of the Rule.

- Risk and Position Limits and Usage
- Risk Factor Sensitivities
- Value-at-Risk and Stress VaR
- Comprehensive Profit and Loss Attribution
- Inventory Turnover
- Inventory Aging
- Customer-Facing Trade Ratio.

The Agencies state (in the Federal Reserve Board staff memo) that the quantitative measurements include many that banking entities already calculate for internal risk management or other purposes, but expect that calculating and reporting the metrics according to the standardized specifications described in the Rule will likely require the creation and implementation of new processes, which will entail compliance costs and burdens.

Reporting Schedule

Banking entities are required to comply with the reporting requirements when the banking entity have more than $10 billion in worldwide *trading* assets and liabilities (excluding trading assets and liabilities that are obligations of or guaranteed by the U.S. of any agency of the U.S.), or for foreign entities if their total U.S. consolidated *trading* assets and liabilities (excluding liabilities that are obligations of or guaranteed by the U.S.) in accordance with the following schedule:

- Entities meeting or exceeding a $50 billion threshold must begin reporting on June 30, 2014 and must report monthly within 30 days of each month-end, shifting to 10 days beginning January 2015
- Entities meeting or exceeding a $25 billion threshold but less than $50 billion must begin reporting quarterly on April 30, 2016 within 30 days of the quarter end
- Entities meeting or exceeding a $10 billion threshold but less than $25 billion must begin reporting quarterly on December 31, 2016 within 30 days of the quarter end.

Commentary

Implementation of the Volcker Rule is likely to prove to be one of the most complex and controversial regulatory regimes ever to be introduced into the financial services industry. Firms will need to make significant investments in technology and infrastructure in order to comply with its intensive monitoring and reporting requirements. The compliance program will likely require a heavy infrastructure investment for most firms, and institutions will need to evaluate how they want to organize their trading desks, trading accounts, and hedging activities under the Volcker Rule.

While our "Initial Key Takeaways" are highlighted in the Executive Summary beginning on page two of this Letter, we believe the full impact of the Rule on both institutions and the financial markets more generally, will take time to unfold. It is notable, then, that already there has been what appears to be an unintended effect or consequence resulting from the Rule – namely that certain accounting practices triggered by the implementing regulations could subject institutions to imminent financial losses (related to the potential for institutions to be required to divest collateralized debt obligations backed by Trust Preferred Securities or investments backed by non-qualifying assets). Indeed, the American Bankers Association, together with all state banking associations, has written to the regulatory agencies stating, "…there is an urgency to this issue due to the rapidly approaching end of the quarter and the calendar year."

Banking entities should anticipate that this will likely not be the only unintended effect from the Volcker Rule. KPMG LLP in the U.S. and other member firms of the KPMG network of independent firms will continue to assess the impact of the Volcker Rule so that we can assist financial institutions to better understand the full scope of this new regulation, its potential impact on their businesses and what measures will need to be implemented to comply.

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