
Joint Release

Board of Governors of the Federal Reserve System
Commodity Futures Trading Commission
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Securities and Exchange Commission

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Final Rules to Implement the “Volcker Rule”

Five financial regulatory agencies are considering adopting final rules implementing a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the Volcker Rule. The final rules generally would prohibit banking entities from:

- engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account.
- owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to as ‘covered funds.’

As required by section 619 of the Dodd-Frank Act, the final rules, which would be adopted under the Bank Holding Company Act, would provide exemptions for certain activities, including market making, underwriting, hedging, trading in certain government obligations, and organizing and offering a hedge fund or private equity fund, among others. Like the Dodd-Frank Act, the final rules would limit these exemptions if they involve a material conflict of interest; a material exposure to high-risk assets or trading strategies; or a threat to the safety and soundness of the banking entity or to U.S. financial stability.

The five agencies -- the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission -- proposed the same common rules in 2011 and 2012. Those proposals generated more than 18,000 comment letters.

The Final Rules

The final rules would provide key definitions and identify characteristics of prohibited and permitted activities and investments.

Proprietary Trading Prohibition – The final rules would prohibit proprietary trading by banking entities. As required by the Dodd-Frank Act, the final rules would include exemptions for:

Underwriting: This exemption would require that a banking entity act as an underwriter for a distribution of securities (including both public and private offerings) and that the trading desk’s underwriting position be related to that distribution. Consistent with the Dodd-Frank Act, the underwriting position must be designed not to exceed the reasonably expected near-term demands of customers.

Market making-related activities: Under this exemption, a trading desk would be required to routinely stand ready to purchase and sell one or more types of financial instruments. If the rules are adopted, the trading desk’s inventory in these types of financial instruments would have to be designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of customers. Under the final rules,

determining customer demand would be based on such things as historical demand and consideration of market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk-management procedures required under the final rules.

Risk-mitigating hedging: This exemption would apply to hedging activity that is designed to reduce, and demonstrably reduces or significantly mitigates, specific, identifiable risks of individual or aggregated positions of the banking entity. The banking entity would also be required to conduct an analysis (including correlation analysis) supporting its hedging strategy, and the effectiveness of hedges must be monitored and recalibrated as necessary on an ongoing basis. The final rules also would require banking entities to document, contemporaneously with the transaction, the hedging rationale for certain transactions that present heightened compliance risks.

Trading in certain government obligations. The final rules would permit a banking entity to continue to engage in proprietary trading in U.S. government, agency, state, and municipal obligations. They also would permit, in more limited circumstances, proprietary trading in the obligations of a foreign sovereign or its political subdivisions.

Certain trading activities of foreign banking entities: The final rules generally would not prohibit trading by foreign banking entities, provided the trading decisions and principal risks of the foreign banking entity occur and are held outside of the United States. Such transactions may involve U.S. entities only under certain circumstances. Specifically, an exempt transaction may occur 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.

Other permitted activities: The final rules would exempt, provided certain requirements are met, trading on behalf of a customer in a fiduciary capacity or in riskless principal trades and activities of an insurance company for its general or separate account.

Clarifying exclusions: The final rules would clarify which activities are not considered proprietary trading, provided certain requirements are met, including trading solely as an agent, broker, or custodian; through a deferred compensation or similar plan; to satisfy a debt previously contracted; under certain repurchase and securities lending agreements; for liquidity management in accordance with a documented liquidity plan; in connection with certain clearing activities; or to satisfy certain existing legal obligations.

Covered Fund Prohibitions – The final rules would prohibit banking entities from owning and sponsoring hedge funds and private equity funds, referred to as “covered funds.” Under the final rules, the definition of covered funds encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act, section 3(c)(1) or 3(c)(7). The final rules also would include in the definition of covered funds certain foreign funds and commodity pools, but defined in a more limited manner than under the proposed rule.

Exclusions: The final rules would exclude from the definition of covered fund certain entities with more general corporate purposes such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles, as well as SEC-registered investment companies and business development companies. Other exclusions would apply to certain foreign funds publicly offered abroad, loan securitizations, insurance company separate accounts, and small business investment company and public welfare investments.

Permitted activities: As provided by the Dodd-Frank Act, the final rules would permit a banking entity, subject to appropriate conditions, to invest in or sponsor a covered fund in connection with: organizing

and offering the covered fund; underwriting or market making-related activities; certain types of risk-mitigating hedging activities; activities that occur solely outside of the United States and insurance company activities.

Clarifying Exclusions. The final rules would clarify that, provided certain requirements are met, a banking entity is not engaging in prohibited covered fund activities or investments when it acts on behalf of customers as an agent, broker, custodian, or trustee or similar fiduciary capacity; through a deferred compensation or similar plan; or in the ordinary course of collecting a debt previously contracted.

Compliance Requirements – The final rules would provide compliance requirements that vary based on the size of the banking entity and the amount of activities conducted, reducing the burden on smaller, less complex entities. Banking entities that do not engage in activities covered by the final rules would have no compliance program requirements.

Compliance program: The final rules generally would require banking entities to establish an internal compliance program reasonably designed to ensure and monitor compliance with the final rules. Larger banking entities would have to establish a more detailed compliance program, including a required CEO attestation; smaller entities engaged in modest activities would be subject to a simplified compliance regime. Banking entities that do not engage in any activity subject to the final rules, other than trading in exempt government and municipal obligations, would not be required to establish a compliance program.

Documentation: The final rules would require the banking entities to maintain documentation so that the agencies can monitor their activities for instances of evasion.

Metrics reporting: The final rules would require banking entities with significant trading operations to report certain quantitative measurements designed to monitor certain trading activities. The reporting requirements would be phased in based on the type and size of the firm's trading activities.

What's Next?

The final rules would become effective April 1, 2014. 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 would be required to report quantitative measurements. Banking entities with at least \$25 billion, but less than \$50 billion, in consolidated trading assets and liabilities would become subject to this requirement on April 30, 2016. Those with at least \$10 billion, but less than \$25 billion, in consolidated trading assets and liabilities would become subject to the requirement on Dec. 31, 2016. The agencies will review the data collected prior to Sept. 30, 2015, and revise the collection requirement as appropriate.