

# Volcker Conformance and Compliance: What's Next for \$50 Billion+ Regional BHCs



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**Davis Polk**

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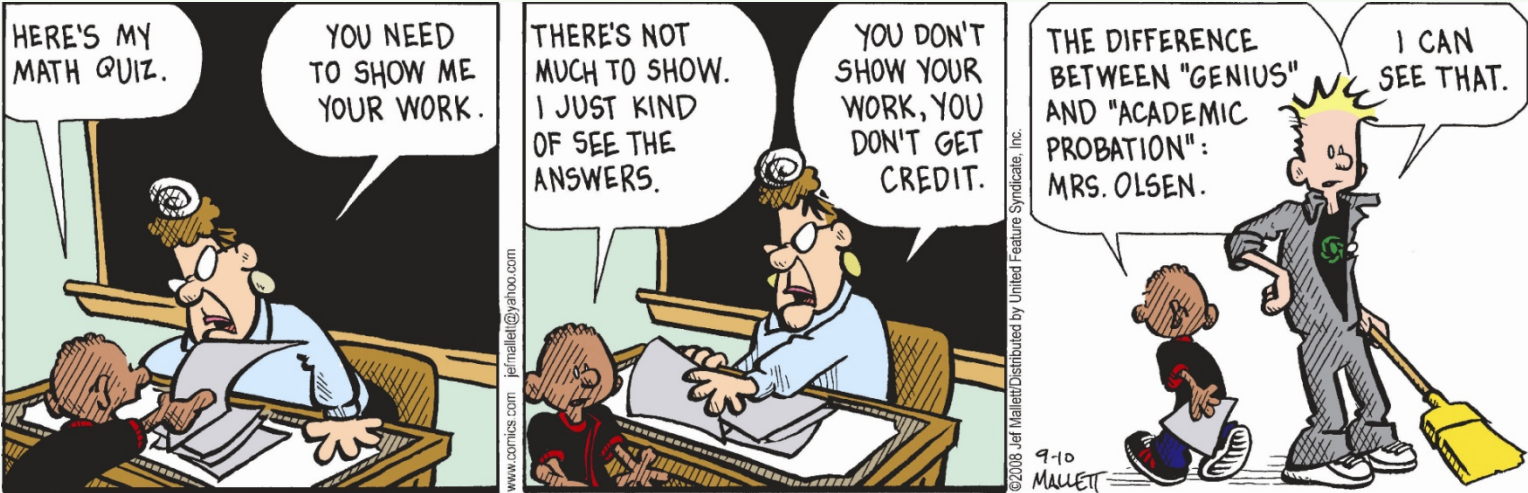
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# Purpose of Today's Discussion

- These slides are meant to be read together with our more technical flowcharts on proprietary trading and covered funds
  - Our Funds slides are available [here](#).
  - Our Trading slides are available [here](#).
  - Additional compliance slides are available upon request.

*Find it at [www.volckerrule.com](http://www.volckerrule.com)*

# The Key to Volcker Compliance: Show Your Work!



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# Volcker Essentials for Regional BHCs

- **Next Steps for Regional BHCs—Run a Diagnostic on Trading and Covered Funds**

- **Trading:**

- Asset Liability Management
- What's a Trading Account?
- What's a Trading Desk?
- What are Trading Assets and Liabilities?
- Risk-Mitigating Hedging
- Trading in Treasuries and Agencies
- Trading in Municipal Obligations
- Underwriting
- Market-Making
- Employee Pension Plans

- **Covered Fund Activities & Investments:**

- Covered Fund Activities and Investments
- Can You Keep an Investment in a Covered Fund Past July 21, 2015?
- Key Exclusions for Regional BHCs
- Is Your Investment an Ownership Interest under Volcker?
- Do you Sponsor or Advise Covered Funds?
- CDOs, CLOs, Commercial Paper Conduits and Other Securitizations
- TruPS CDOs: The Bottom Line
- Credit Risk Retention & Covered Funds
- Super 23A
- Registered Investment Companies and BDCs
- Venture Capital Funds
- SBICs and Public Welfare Investment Funds

- **Compliance:**

- Enhanced Compliance Requirements
- Board to Business Unit
- Enhanced Compliance Program – Funds
- Enhanced Compliance Program – Trading
- Review of Compensation

# Run a Diagnostic on Trading and Covered Funds Activities

- Which **activities** will be treated as trading activities?
- Are there **investments** in covered funds in your investment portfolio?
  - Do you have to divest them?
  - By when?
- Do you **sponsor or advise** any covered funds?
- **Watch out for tricks and traps**
  - Volcker connection not always obvious as a business matter
- After the diagnostic — getting to **compliance** by July 21, 2015

*These slides discuss where and how to run your diagnostic on trading and covered funds*

# What is a Trading Account?

- Does not match the common business understanding
- Does not match the accounting definition
- Essentially means that there is a **short-term trading intent**
  - You will have to prove your work as to short-term trading intent
- **Three ways** to fall into the trading account definition
  - Less than 60 days
  - Broker-dealer / swap dealer activities
  - For those subject to the market risk capital rule, treated as a covered position and a trading position
- All roads lead to short-term trading intent

# What is a Trading Desk?

- A trading desk is the **smallest discrete unit** that purchases or sells financial instruments for the trading account, and can span across legal entities
- For regional bank holding companies, we expect:
  - **Treasury** will be treated as a trading desk
  - Unlike the largest trading banks, many regional bank holding companies will have trading desks contained **within one legal entity**
    - Underwriting in the broker-dealer
    - Market-making and market making-related hedging also likely in the broker-dealer
  - Asset liability management activities are likely to be contained within the chartered bank

*Review current market-making, underwriting, hedging, and asset-liability management activities with trading desk design in mind*

# Trading Desk Design

- A review of your trading desks is a **crucial first step**
- Regional banks should optimize their trading desk design so as to minimize compliance burdens
- In most situations, this will mean keeping the trading desk in **one legal entity** and limiting exceptions, if possible

*Review current market-making, underwriting, hedging, and asset-liability management activities with trading desk design in mind*



# What are Trading Assets and Liabilities?

- Our assumption is that most regional bank holding companies will **never need to report metrics**
- But all enhanced compliance banks will need to report some quantitative measures, limits and validate their models. There is no escape from some quantitative reporting
- Larger regional bank holding companies should, however, **evaluate** their trading assets and liabilities
  - Start with trading assets and liabilities on Form FR Y-9C at schedule HC-D and back out all U.S. government and agency obligations

# Asset Liability Management

- **No ALM exemption – only for liquidity management**
  - The liquidity plan exemption covers **securities** but **not derivatives**, such as interest rate and forex hedges
  - Review and assess your current liquidity management plan for Volcker compliance
    - Must specifically authorize **particular securities**; describe the **amount, types, and risks** of securities that are consistent with the liquidity management needs; and the **liquidity circumstances** in which they may be used
    - Regulators expect that a Volcker-compliant liquidity management plan will define High Quality Liquid Assets in the same way as the **U.S. Basel III liquidity coverage ratio**
    - Should also take into account forthcoming Dodd-Frank **enhanced prudential standards** around liquidity risk management

*We expect compliance around asset liability management to be a major part of the Volcker compliance workstream for regional bank holding companies*

# Asset Liability Management *(Cont'd)*

- **Review** and **assess** your asset liability management policies and procedures for Volcker compliance. Until regulators specify otherwise, we are of the view that:
  - **Long-term hedges** of long term assets or liabilities (i.e., in the banking book) to hedge own risk or for customer accommodation (done contemporaneously) should not be in the trading account and need not comply with the Volcker hedging exemption, documentation and procedures
    - Back-to-back swaps entered into in connection with long-term hedges can likely rebut the 60-day presumption and be excluded from trading account
  - **Short-term derivatives used solely for liquidity management** can likely rebut the 60-day presumption and be excluded from the trading account
  - **Short-term hedges** of long-term assets or liabilities (i.e., in the banking book) will need to be in the trading account and comply with the Volcker hedging exemption
  - **Derivatives** entered into for **trading purposes** or **customer accommodation** are likely to be viewed as trading and must find a Volcker compliant exemption
  - Accounting treatment is not dispositive

*We expect compliance around asset liability management to be a major source of work for the Volcker compliance efforts of regional bank holding companies*

# Risk-Mitigating Hedging

- Requires a facts and circumstances analysis
- Must be designed to reduce or otherwise significantly mitigate one or more specific identifiable risks arising in connection with and related to identified positions, contracts or other holdings

## Risks listed in the regulation:

- Market risk
- Counterparty or other credit risk
- Forex or currency risk
- Interest rate risk
- Basis risk
- Similar risks

## Likely uses of exemption:

- Interest rate swaps
- Forex swaps
- Mortgage servicing rights
- Mortgage pipeline

- Ongoing assessment at inception and when any adjustments are made
- Continuing review, monitoring and management

# Risk-Mitigating Hedging *(Cont'd)*

- **Additional documentation** required when:
  - The hedging is not conducted by the trading desk that established the underlying positions, contracts, or other holdings
  - The hedges are for **aggregated** positions **across two or more desks**
  - The hedge is effected through a financial instrument, technique, or strategy that is **not specifically identified** in the trading desk's **written policies and procedures**

# Trading in Treasuries and Agencies

- All **U.S. government obligations** benefit from an exemption
- All U.S. **agencies** and **GSEs** benefit from an exemption, including:
  - GinnieMae
  - FannieMae
  - FreddieMac
  - FHLB obligations
- **Derivatives** on these instruments are **not exempted**
- We read **TBA**s to be within the exemption

*Trading desk design and enhanced compliance still required*

# Trading in State and Municipal Obligations

- Both **general obligation** and **revenue bonds** issued by states and municipalities are covered by the exemption
- Also state and municipal agencies and other instrumentalities, such as:
  - Port authority and subway system bonds
  - Issuances to fund toll roads, airports, schools
- But watch out—tender offer bonds are not covered under an exemption

*Trading desk design and enhanced compliance still required*

# Underwriting

- Exemption for underwriting:
  - Includes selling group members
  - Covers registered and private placements
- **Unsold allotments** permitted
  - Holding unsold allotments allowed but must make “reasonable efforts” to sell or otherwise reduce the underwriting position
  - Should help with mid-market deals
- Treatment of **bridge loans** will be a facts and circumstances test but based on an expectation of demand at the time of the commitment

*Trading desk design and enhanced compliance required*



# Market-Making

- Regional banks should decide whether to limit their market-making activities to their broker-dealer or to allow it in the bank

*Trading desk design and enhanced compliance required*

# Employee Pension Plans

- There is an exemption for the **purchase or sale** of financial instruments through an **employee pension, deferred compensation** or other benefit plan, which will not be attributed to a banking entity if:
  - The purchase or sale is made directly or indirectly by the banking entity **as trustee** for the benefit of employees or immediate family members

# Covered Fund Activities and Investments

- We assume that most regional banks rarely sponsor or organize traditional hedge funds or private equity funds
  - But many common types of securitizations will be covered funds
    - See the recent TruPS CDO episode
- The divestiture requirement applies to **both** minority investments in third-party funds **and** investments in sponsored funds
- Investments in traditional third-party hedge funds and private equity funds bear the full brunt of the Volcker Rule
- Since banking entities by definition can't rely on one of the permitted activities exemptions for sponsoring covered funds to hold on to principal investments in third-party hedge funds and private equity funds, they will have to be divested
- The key issue will likely be whether investments in covered funds have to be divested before July 21, 2015
- The following slides set forth where we think most regional bank holding companies should start their covered funds analysis

# Can You Keep an Investment in a Covered Fund Past July 21, 2015?

- The Fed extended the general conformance period for everyone until July 21, 2015
- Banking entities can apply for **two additional one-year extensions**, the first through July 21, 2016 and the second through July 21, 2017
  - Have to apply by January 22 of each year
  - The Fed alone has discretion to grant an application
- An additional, up to **5-year extension** for “illiquid funds” is also available after the two one-year extensions, but has very tight eligibility criteria
  - Among other things, the following conditions must be met:
    - The fund investment must be **necessary** to fulfill **a contractual obligation** that was in effect on **May 1, 2010**;
    - If the fund documents include a well-drafted “**regulatory out**” **clause**, it may not be possible to argue that retaining the investment is “necessary”
    - Have to use **reasonable best efforts** to obtain GP or other required **third party consent** to transfer the investment

# Key Exclusions for Regional BHCs

- Many vehicles won't be covered funds in the first place due to their status under the **1940 Act**
- But for those that are, an exclusion may be available under the final regulations that would keep the vehicles out of Volcker entirely
  - Key exclusions for regionals include:
    - Loan securitizations
    - ABCP conduits
    - Wholly-owned subs
    - JVs
    - Registered investment companies (mutual funds, ETFs, many auction rate securities issuers)
    - SBICs, public welfare funds (including tax credit funds)
- Non-obvious conditions apply to each exclusion

# Is Your Investment an Ownership Interest under Volcker?

- If an investment in a covered fund isn't an "ownership interest" under the final regulations, it's outside Volcker
- An **ownership interest** is:
  - An **equity** or **partnership** interest; or
  - An **other similar interest**
- An **other similar interest** is an interest that has any of seven specified characteristics
  - Tricks and traps — even some senior and mezzanine debt securities can be ownership interests under this test

# Do You Sponsor or Advise Covered Funds?

- Most regional bank holding companies won't actively sponsor traditional hedge funds and private equity funds, but watch out for tricks and traps
- The definition of sponsor is broad
  - Retaining an investment in a securitization vehicle because of risk retention requirements is treated as the functional equivalent of sponsoring
  - So is controlling the **initial selection of a majority of the board, trustees or management** of a covered fund
  - But see potential paths to terminating sponsorship
- Show your work — have to determine the covered fund status of every subsidiary or other affiliate that issues securities

*More on sponsoring in our Funds flow charts at pp. 10, available [here](#)*

# CDOs, CLOs, Commercial Paper Conduits and Other Securitizations

- What kind of securitizations are generally **out** of Volcker?
  - Most **static pools**, including many vehicles established to securitize:
    - RMBS and CMBS
    - Credit card receivables
    - Auto loans
- What kind of securitizations are **in**?
  - CDOs, CLOs and CMOs that aren't backed by 100% loan collateral — can't have a **bond bucket** or otherwise hold asset-backed securities, CDS, or other derivatives except interest rate and currency hedging instruments
- ABCP conduits subject to similar restrictions, but can hold some ABS and collateral certificates with loan-only underlyings



# TruPS CDOs: The Bottom Line

- On January 14, 2014, the U.S. regulators issued an **interim final rule** on Volcker TruPS CDOs
  - **Very helpful** for most TruPS CDOs
  - **No relief for CLOs** or other securitizations
- The interim final rule permits **any** bank to retain an interest in TruPS CDO if:
  - The TruPS CDO was established before May 19, 2010;
  - The banking entity **reasonably believes** that the offering proceeds received by the issuer were **invested primarily in Qualifying TruPS Collateral**; and
    - The TruPS CDOs must have been issued by a bank holding company with \$15 billion or less
  - The banking entity's interest in the vehicle was acquired on or before **December 10, 2013** (unless acquired pursuant to a **merger or acquisition**)

The reasonably believes standard can be met by reference to a non-exclusive list of qualifying TruPS CDOs published by U.S. regulators

# Credit Risk Retention and Covered Funds

- The **credit risk retention** requirements of Section 15G of the Securities Exchange Act can trigger Volcker Rule restrictions
  - If risk retention requirements mandate that a banking entity retain a piece of a securitization to which it has transferred loans — the banking entity has **organized and offered** the securitization for Volcker purposes, and will have to observe the **restrictions of the ABS issuer exemption**
  - While the ABS issuer exemption is a **permitted activity** under Volcker, it comes with restrictions, including a **cap on ownership** (which is likely maxed out by the risk retention holding) and the Super 23A **prohibition on** entering into transactions with the securitization vehicle to **provide liquidity** or credit support to it

# Super 23A

- Super 23A **applies** to any related covered – that is, any covered fund that a banking entity **sponsors or advises**, or that is deemed to organize and offer as a result of risk retention requirements
  - Super 23A imposes a **flat prohibition** on lending to, buying assets from, or entering into derivative or securities borrowing or lending transactions with covered funds to which it applies
  - The flat prohibition not only applies to covered transactions between an insured bank and a covered fund, but between all bank and **non-bank affiliates in a banking group** and a related covered fund
  - Exception for **prime brokerage** transactions with underlying funds

# Registered Investment Companies and BDCs

- If a special purpose vehicle or fund is registered under the 1940 Act, it is not a covered fund
- Relevant for regional BHCs:
  - Retail mutual funds
  - Retail money market funds
  - ETFs
  - Registered auction rate securities issuers and similar vehicles
- SEC-regulated **business development companies** also excluded — examples include:
  - American Capital (ACAS); Ares Capital (ARCC); BlackRock Kelso (BKCC); Fifth Street (FSC)
- If a RIC or BDC (while not a covered fund itself) is **controlled** by a BHC, it is a “banking entity,” and thus subjects itself to the both the proprietary trading and covered funds restrictions

***You will have to be able to show evidence of registered/regulated status as part of your compliance program***

# Venture Capital Funds

- There is **no** specific exclusion for venture capital funds
- We expect that most investments in venture capital funds will have to be either sold or an extension sought
- Nonetheless, there may be some hope for finding an exemption for some venture capital funds under:
  - The joint venture exemption, for venture debt investments, if no more than 10 investors
  - If the venture fund is a licensed Small Business Investment Company, it will also be excluded

# SBICs and Public Welfare Investment Funds

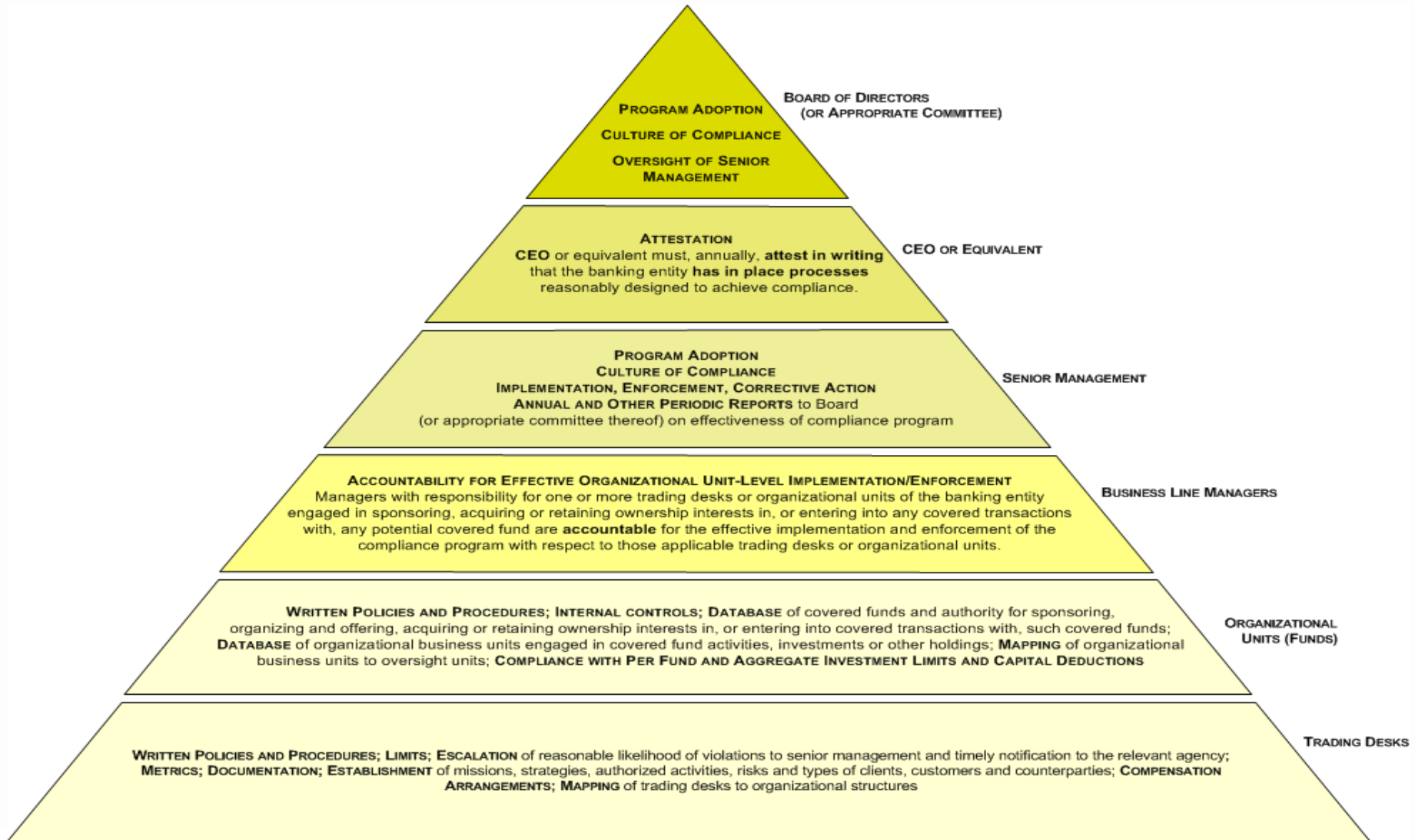
- Small Business Investment Companies are **excluded** from the definition of covered fund
  - Must have an **active license** or unrevoked notice to proceed to qualify for one
  - Not uncommon to let licenses lapse after active investment period, so **check that yours is up-to-date**
- **Public welfare funds** are also excluded
- Includes funds that make investments designed primarily to promote the public welfare **of the type** permitted under 12 U.S.C. 24(Eleventh), including **CRA-eligible investments**, certain **tax credit investments** and investments promoting the welfare of **low- and moderate-income** communities or individuals
  - Generally includes:
    - Low Income Housing Tax Credit funds
    - New Markets Tax Credit funds
    - Renewable Energy Tax Credit funds
    - Rural Business Investment Company funds

*You will have to be able to produce SBIC licenses in good standing, evidence eligibility for the public welfare fund exclusion as part of your compliance program*

# Enhanced Compliance Program Requirements

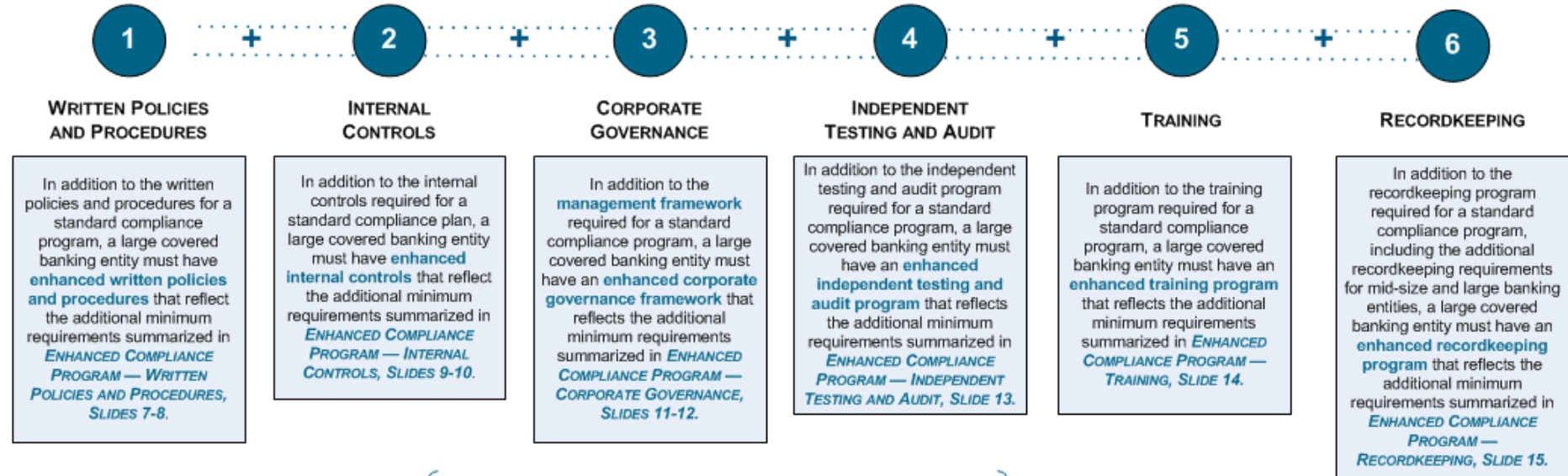
- A regional bank holding company with more than \$50 billion in assets will be required to have an ***enhanced compliance program*** in addition to the standard compliance program requirements
- **Standard Compliance Program Requires:**
  - Written policies and procedures
  - Internal controls
  - Management framework
  - Independent testing and audit
  - Training
  - Records
- **Key Elements of an Enhanced Compliance Program Include:**
  - Board approval of policies and annual review
  - CEO annual attestation
    - Will require downward certifications à la SOXA
  - Trading desk design
  - Documentation around determinations with respect to fund investments
  - And much, much more

# Board to Business Unit





A covered banking entity with total consolidated assets\* of \$50 billion or more (or with certain trading assets and liabilities of at least \$10 billion) must comply with **all** of the requirements of a standard compliance program, **plus** all of the additional requirements of an enhanced compliance program. The following additional requirements summarize the **minimum** additional requirements for such an enhanced program.



**OVERALL REQUIREMENT**

Must be reasonably designed to **identify, document, monitor, and report** the **permitted covered fund activities** of the banking entity; identify, monitor and promptly address **the risks** of these covered activities and **potential areas of noncompliance**; and **prevent activities or investments prohibited** by, or that do not comply with, the Volcker Rule or its implementing regulations

**DATABASE OF COVERED FUNDS**

An important part of an enhanced compliance program is the establishment and maintenance of a **database that identifies every covered fund** in or as to which a large covered banking entity **either**:

- Organizes and offers or acts as a **sponsor, or**
- Acquires or **holds an ownership interest** as investor, underwriting or market maker

The database must be capable of **producing a list** for the agencies showing the covered funds and **how** the covered fund activities, investments or other holdings of the banking entity **comply** with or will be **conformed** to the Volcker Rule and its implementing regulations. The banking entity must have written **policies and procedures** for establishing and maintaining a database, and must subject the database to appropriate **management review** and **independent testing**.

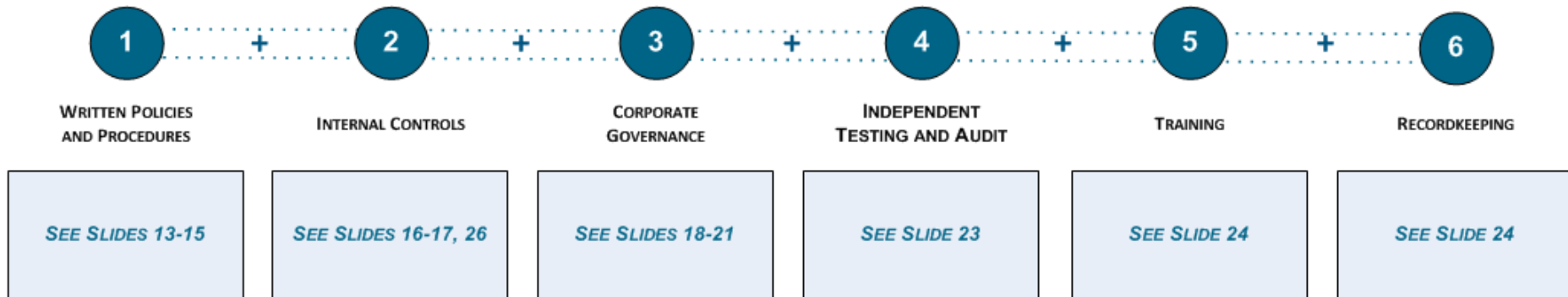
**MINIMUM REQUIREMENTS**

- It is important to stress that the elements described above are the **minimum additional requirements** for an **enhanced compliance program**. They may need to be **supplemented** by other elements, if necessary for the enhanced compliance program of a particular banking entity to be **reasonably designed to ensure and monitor compliance** with the Volcker Rule and its implementing regulations.
- The terms, scope and detail of the enhanced compliance program must be **appropriate for the types, size, scope and complexity of the activities and business structure** of the banking entity.

\* In the case of banking entities with a top tier foreign parent, the relevant measure is total U.S. assets. SEE WHAT SORT OF COMPLIANCE PROGRAM IS REQUIRED?, "FOREIGN BANKING ENTITIES", SLIDE 2.

The program requirements for the enhanced compliance program include **all standard** program requirements, **plus** additional requirements specific to the enhanced compliance program.

Overall, the enhanced compliance program must be reasonably designed to **identify, document, monitor, and report** the **permitted trading activities** of the banking entity; identify, monitor and promptly address **the risks** of these activities and **potential areas of noncompliance**; and **prevent activities prohibited** by, or that do not comply with, the Volcker Rule.



### GENERAL REQUIREMENTS FOR ENHANCED COMPLIANCE PROGRAM

- Program **must facilitate supervision and examination** by the agencies of the banking entity's permitted trading activities.
- Program **may be tailored to the types of trading activities** conducted by the banking entity, and must include a detailed description of controls established by the banking entity to reasonably ensure that its trading activities are conducted in accordance with the requirements and limitations applicable under the Volcker Rule, and **provide for appropriate revision** of the compliance program **before expansion** of the trading activities of the banking entity.
- A banking entity must **devote adequate resources** and **use knowledgeable personnel** in conducting, supervising and managing its trading activities, and promote consistency, independence and rigor in implementing its risk controls and compliance efforts.
- Program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program, and changes in legal, regulatory or other requirements.

### MINIMUM REQUIREMENTS

- It is important to stress that the elements described in the following slides and Attachment A are the **minimum additional requirements** for an **enhanced compliance program**. They may need to be **supplemented** by other elements, if necessary for the enhanced compliance program of a particular banking entity to be **reasonably designed to ensure and monitor compliance** with the Volcker Rule and its implementing regulations.
- The terms, scope and detail of the enhanced compliance program must be **appropriate for the types, size, scope and complexity of the activities and business structure** of the banking entity.

# Review of Compensation

- Volcker compliance will involve a review of the compensation arrangements for those employees who engage in:
  - Hedging
  - Underwriting
  - Market-making
- Their compensation may not reward or incentivize prohibited proprietary trading
- The board's compensation committee as well as HR should review the procedures around compensation arrangements
- Written policies and procedures on a trading desk by trading desk basis required

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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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**Related Resources:** Davis Polk's background materials and interactive tools on the Volcker Rule are available at [www.volckerrule.com](http://www.volckerrule.com)