THE VOLCKER RULE

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The Final Regulations Implementing the Volcker Rule include 71 pages of rule text, almost 900 pages of explanatory commentary with over 2,800 footnotes (the “Final Rule”) and were issued in December 2013 after over two years of proposed rule making, industry comment and debate. The Final Rule implements Section 619 of the Dodd Frank Act which added a new Section 13 to the Bank Holding Company Act (together with the Final Rule, the “Volcker Rule”).

Applicable to “banking entities” which include both insured depository institutions and bank holding companies as well as their affiliates and subsidiaries.

Effective Date and Conformance Period: while technically effective on April 1, 2014, banking entities have until July 21, 2015 to comply with the Volcker Rule as a result of the Federal Reserve granting a one-year extension of the conformance period. Thereafter, two additional one-year extensions may be available at the discretion of the Federal Reserve upon a determination that an extension would not be detrimental to the public interest (there is also an additional five-year extension for “illiquid funds” but there are very strict eligibility criteria).

- Banking entities with significant trading activities will be required to report quantitative metrics on their trading activities beginning in July 2014.
- Must use good faith efforts during the conformance period to conform to the Volcker Rule, promptly cease any “stand-alone” proprietary trading and not expand covered activities with an expectation that the Fed will grant an extension. Good faith efforts also include: (i) evaluating the extent to which a banking entity is engaged in activities/investments covered by the Volcker Rule; and (ii) developing a plan to cease such activities or divest such investments by the end of the conformance period.

What does the Volcker Rule cover?

- Two Primary Restrictions:
  - Prohibition on “proprietary trading”, unless an exemption is available; and
  - Restrictions on certain relationships with “covered funds” (e.g., hedge funds, private equity funds and certain other private funds).
- Requirement to implement a rigorous compliance regime.
“PROPRIETARY TRADING”

“Proprietary trading” is defined as: engaging as principal for the “trading account” of the banking entity in any purchase or sale of one or more “financial instruments”. Captures many activities not traditionally thought of as “prop trading”.

“TRADING ACCOUNT”

“Trading Account”: A statutory concept which does not refer to an actual account.

Included in “trading account” (and thus “proprietary trading”):

- Any account that is used by a banking entity for short-term trading purposes to:
  - Purchase or sell one or more financial instruments principally for the purpose of:
    - *Short-term resale*;
    - Benefitting from actual or expected *short-term price movements*;
    - Realizing short-term arbitrage profits; or
    - Hedging positions described above;
  - Rebuttable presumption: A purchase (or sale) of a financial instrument is presumed to be for the trading account if the banking entity holds the financial instrument for fewer than 60 days, unless the banking entity can demonstrate that the purchase (or sale) was not principally for a prohibitive purpose.

- Purchase or sell one or more financial instruments that are both *market risk capital rule covered positions and trading positions* (or hedges of other market risk capital rule covered positions); or

- Purchase or sell one or more financial instruments *for any purpose*, if the banking entity is licensed or registered, or is required to be licensed or registered, to engage in the business of a *broker-dealer, swap dealer*, or *security-based swap dealer*, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such.

Excluded from “proprietary trading” includes the following:

- Repo or Reverse Repo
- Securities Lending
- Transactions in securities for the purpose of “Liquidity Management” under a documented liquidity management plan (See below).
- Transactions solely as agent, broker or custodian
- Certain transactions in connection with pension and deferred compensation arrangements
- Positions acquired in connection with a debt previously contracted
“FINANCIAL INSTRUMENT”

Included in “Financial Instrument”:
- securities,
- derivatives,
- forwards and futures on commodities including FX forwards and swaps, and
- options on any of the above.

Excluded from “Financial Instrument”:
- Loans, leases, receivables,
- Most spot commodity transactions including spot FX transactions, and
- Deposits, bankers’ acceptances, letters of credit and loan participations sold to banks or other sophisticated purchasers (so-called “identified banking products”).
Securities transactions via a documented liquidity management plan are excluded from proprietary trading provided the plan:

- Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used;

- Requires that any purchase or sale of securities under the plan be principally for the purpose of managing the liquidity of the banking entity and not for the purpose of short-term resale, benefitting from short-term price movements or obtaining arbitrage profits;

- Requires that any securities purchased or sold be highly liquid and limited to securities which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;

- Limits any securities purchased or sold to an amount that is consistent with the banking entity’s near-term funding needs;

- Includes written policies and procedures, internal controls, analysis, and independent testing to ensure that the purchase and sale of securities that are not otherwise permitted are for the purpose of liquidity management and in accordance with the liquidity management plan; and

- Is consistent with the supervisory requirements, guidance, and expectations regarding liquidity management applicable to the banking entity.
Permitted Proprietary Trading Activities

- **Underwriter Exemption:** Acting as an Underwriter for a distribution of securities.
  - The underwriting position must be designed not to exceed the reasonably expected near term demands of clients and reasonable efforts must be made to sell or otherwise reduce the underwriting position within a reasonable period;
  - Subject to establishment of policies and procedures and compliance limits; and
  - Compensation is designed not to reward or incentivize prohibited proprietary trading.

- **Market Making Exemption:** Market-making related activities permitted if:
  - The trading desk that establishes and manages the “financial exposure” *routinely stands ready to purchase and sell* one or more types of financial instruments related to its financial exposure and is *willing and available to quote, purchase and sell*, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and *throughout market cycles* on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;
  - 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;
  - The banking entity has established and implements, maintains, and enforces a specified robust internal compliance program;
  - If any limits are breached, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible;
  - Compensation is designed not to reward or incentivize prohibited proprietary trading; and
  - The banking entity is licensed or registered to engage in the activity in accordance with applicable law.
Risk-Mitigating Hedging Exemption: Generally permits a banking entity to trade financial instruments to hedge specific risks arising in connection with the individual or aggregated positions, contracts, or other holdings of the banking entity. Requirements include:

- Establishment and compliance with specific and robust policies and procedures and internal controls;
- The hedging activity is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates 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;
- Does not give rise to any significant new or additional risk that is not itself hedged contemporaneously;
- Is subject to continuing review, monitoring and management;
- Compensation arrangements are designed not to reward or incentivize prohibited proprietary trading; and
- Additional documentation if hedging aggregated positions across two or more trading desks, a hedge is established by a trading desk not responsible for the specific risk, or the hedge involves a financial instrument which is outside of the desk’s written hedging policies and procedures.

Treatment of Aggregated Positions: Permitted which indicates that some degree of portfolio hedging should be possible, but designed to prevent what the regulators perceived to be “London Whale” type “hedging”; must be able to specifically identify the risk factors arising from the aggregated set of positions.

Treatment of Anticipatory Hedging: Permitted if conducted in accord with conditions noted above.
Other Permitted Activities

- **Trading in U.S. Government Obligations:** Securities issued or guaranteed by the U.S. or any agency thereof, GNMA, FNMA, Freddie Mac, Farmer Mac, FHLB or Farm Credit System Institution securities, as well as State and municipal securities (collectively, “U.S. Government Obligations”).

- **Trading on Behalf of Customers:** Banking entities can trade financial instruments on behalf of, or for the account of, customers in either of the following two ways:
  - **Trades as a Fiduciary or Trustee** for the account of or on behalf of a customer and the banking entity does not have beneficial ownership.
  - **Riskless Principal Transactions** in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.
Basic Rule: A banking entity may not, as principal, directly or indirectly, acquire or retain any "ownership interest" in, “sponsor”, or have certain other relationships with, a “covered fund.”

Included in the Definition of “Covered Fund”:

- Any issuer that would be an “investment company” under the Investment Company Act of 1940 (the “1940 Act”), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act. Examples include:
  - Hedge funds,
  - Private equity funds
  - CDOs,
  - CLOs with a “bond bucket”
  - Other private funds and collective investment vehicles unless an exemption is available.
- Certain commodity funds
- Foreign funds other than those which if offered in the U.S. could rely on an exclusion from the 1940 Act other than 3(c)(1) or 3(c)(7) such as many real estate funds.

Excluded from the Definition of “Covered Fund”:

- Foreign Public Funds offered predominantly outside the U.S.
- Wholly Owned Subsidiaries
- Joint Ventures with up to 10 unaffiliated co-venturers
- Acquisition vehicles
- Loan Only Securitizations, including CLOs with no “bond bucket”. “Loans” includes leases, extensions of credit, or secured or unsecured receivables that are not securities or derivatives. The securitization may include limited interest rate or fx derivatives to reduce interest rate or fx risk.
- Small Business Investment Companies and Public Welfare Funds (e.g., Low Income Housing and New Markets Tax Credit Funds)
- Registered Investment Companies
- Business Development Companies
- TRUPs CDOs acquired prior to the issuance of the final regs. implementing the Volcker Rule on 12/10/13 (technically a covered fund, but may continue to be held pursuant to a 01/14 rule making)
- BOLI separate accounts
“Ownership Interest”: any equity, partnership, or other similar interest.  
   - An “other similar interest” is defined to include traditional indicia of equity or ownership, but includes the right to participate in the selection or removal of a general partner or investment manager.  
   This may capture some CLO securities that clearly are “debt” and not equity.  Additional guidance from regulators is expected on the treatment of CLOs as covered funds.

“Sponsor”:
   - Serve as a general partner, managing member, or trustee of a covered fund;
   - In any manner select or to control a majority of the directors, trustees, or management of a covered fund; or
   - To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Permitted Organizing and Offering of a Covered Fund (so-called Asset Management or Customer Fund Exemption)

Organizational Requirements:
- Covered fund must be organized and offered in connection with providing bona fide trust, fiduciary, investment advisory or commodity trading advisory services to customers;
- Banking entity must not guarantee the covered fund’s performance;
- Covered fund must not share a name with the banking entity or use the word “bank” in its name;
- Clear and conspicuous mandated disclosures; and
- Banking entity must comply with “Super 23A” with respect to the covered fund.

Ownership Limitation:
- Banking entity generally may not own more than 3% of a covered fund after a one-year “seeding period”;
- Aggregate value of all ownership interests in all covered funds must not exceed 3% of the banking entity’s Tier 1 capital and must also be deducted from the banking entity’s Tier 1 capital; and
- Ownership of a covered fund by directors and employees of the banking entity limited to those providing services to the covered fund.
“Super 23A”: No banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor to, or sponsor of, a covered fund, and no affiliate of such banking entity, may enter into a transaction with the covered fund that would be a “covered transaction” as defined in section 23A of the Federal Reserve Act, as if such banking entity (or its affiliate) were a member bank and the covered fund were an affiliate thereof.

Section 23A defines a “covered transaction” to include:

- Loans and other extensions of credit;
- A purchase of securities issued by an affiliate or most types of assets from an affiliate;
- The issuance of a guarantee on behalf of an affiliate; and
- A derivative transaction to the extent it causes the bank to have credit exposure to the affiliate.
Banking entities must establish a compliance program “as soon as practicable and in no case later than the end of the conformance period.”

- There are 5 potential levels of Compliance:
  - **None:** Banking entities with no prop trading or covered fund activities other than trading in U.S. Government Obligations.
  - **Simplified:** A banking entity with *total consolidated assets of $10 billion or less* that engages in proprietary trading (other than permitted trading in U.S. Government Obligations) or covered fund-related activities or investments may satisfy the requirement to establish a compliance program by including in its existing compliance policies and procedures appropriate references to the requirements of the Volcker Rule.
  - **Core:** A banking entity with *total consolidated assets of between $10 billion and $50 billion* that are not engaged in significant trading requiring metrics reporting described below that engages in proprietary trading (other than permitted trading in US Government Obligations) or covered fund-related activities or investments, must implement and maintain a compliance program that meets six minimum requirements:
    - Written policies and procedures reasonably designed to document, describe, monitor and limit proprietary trading—including permitted proprietary trading—and covered fund activities and investments to ensure that such activities comply with the Volcker Rule;
    - Internal controls reasonably designed to monitor compliance with, and prevent the occurrence of activities prohibited by, the Volcker Rule;
• A management framework delineating responsibility and accountability for Volcker Rule compliance;
• Independent testing and audit of the effectiveness of the Volcker Rule compliance program conducted “periodically” by qualified personnel of the banking entity or by a qualified third party;
• Volcker Rule training for trading personnel, managers, and any other appropriate personnel of the banking entity; and
• Maintenance of records sufficient to demonstrate Volcker Rule compliance, which must be provided promptly upon Agency request and retained for a minimum of five years.

- Documentation of Fund Activities
  - The core compliance program also includes additional documentation requirements for fund sponsorship activities. Significantly, these documentation requirements extend to funds that are not covered funds. Banking entities sponsoring funds that are not covered funds are required to document the alternative 1940 Act exemption(s) being relied upon and/or the banking entity’s determination that the fund is not a covered fund pursuant to one of the exclusions noted above. The documentation requirements do not appear to apply to funds in which a banking entity is merely a third-party investor, but not the sponsor.
Enhanced: In addition to implementing the core program, a banking entity must implement and maintain a significantly more comprehensive “enhanced” program if the banking entity has reported total consolidated assets of $50 billion or more. The enhanced program includes, in addition to specific minimum standards for prop trading at the trading desk level and covered fund activities, the following governance and management framework:

• Board: The Board or an appropriate committee thereof to establish the “tone at the top”, approve the compliance program and review its effectiveness annually. They are also to ensure that senior management has the appropriate skills, resources and incentives to run an effective compliance program.
• CEO: Also responsible for setting the “tone at the top”. Must also provide an annual attestation to the regulators that the banking entity has in place an effective compliance program. The exact timing of the first attestation is unclear at this point but should not be earlier than 7/15.
• Senior Management: Also responsible for setting the “tone at the top” and reinforcing it. Must approve the compliance program and review its effectiveness and report to the Board with a frequency appropriate to the scope of the banking entity’s trading and covered fund activities but at least annually. Otherwise, responsible for implementing and enforcing the compliance program and taking corrective action as required. Senior managers are not specifically defined but presumably they are managers of business line managers.
• Business Line Managers: They are the trading desk managers accountable for the implementation and enforcement of the compliance program.

Enhanced Plus Metrics Reporting: In addition to implementing the enhanced program, a banking entity is required to calculate and report certain quantitative measurements on its trading activities to the relevant Agencies if the banking entity has total “trading assets and liabilities” (excluding trading assets and liabilities from U.S. government and agency obligations), the average gross sum of which equals or exceeds $10 billion.

• Only a small number of the largest banks responsible for the vast majority of trading assets are expected to be subject to the enhanced plus metrics reporting compliance program.
Swaps Issues for Banks and Bank Holding Companies

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Title VII of the Dodd-Frank Act governs the regulation of derivatives markets and their participants

- Creates parallel regulatory regimes for the CFTC and SEC. In general, CFTC has applied many aspects of the existing regulatory framework for on-exchange futures to swaps and the SEC is regulating security-based swaps as securities.
- Through not identical, the two regimes have many common elements
  - Product (e.g., swap and security-based swap) and Entity (e.g., swap dealer and major swaps participants) definitions.
  - Swap Dealer/Major Swap Participant regulation: Margin Requirements, Capital Requirements and Business Conduct Standards.
  - Market regulation: Clearing, Trade Execution, Swap Data Reporting and Real-Time Transaction Reporting.

Threshold Inquiry: Is it a swap or a security-based swap?

For convenience, references to “swaps” include both swaps and security–based swaps; references to “swap dealers” include both swap dealers and security-based swap dealers; and references to “major swap participants” or “MSPs” include both major swap participants and major security-based swap participants.
Swaps

- Broad definition that includes (among other things):
  - Options, with certain exclusions
  - Any agreement, contract, or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic or commercial consequence
  - Swaps
  - Security-based swap agreements

- But excludes (among other things):
  - Spot FX
  - Sales of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled
  - Any option on any security or group or index of securities that is subject to the 33/34 Acts
  - Any forward on one or more securities that is subject to the 33/34 Acts
  - Any note, bond, or evidence of indebtedness that is a security
  - “Identified banking products”, including CDs
  - Security-based swaps, other than mixed swaps
November 20, 2012: Treasury Department issued a determination that exempts FX swaps and FX forwards from the definition of “swap”. This determination does not exempt other FX derivatives such as currency options, currency swaps and non-deliverable forwards.

Notwithstanding such determination:
- All FX swaps and FX forwards must be reported to a swap data repository or, in the absence of one, the CFTC
- Parties to FX swaps and FX forwards that are swap dealers or major swap participants must still conform to CFTC business conduct standards
Security-Based Swaps

- Any agreement, contract, or transaction that is a swap and is based on:
  - Narrow-based security index (generally, 9 or fewer component securities)
  - Single security or loan
  - CDS relating to:
    - Single issuer of a security
    - Issuers of securities in a narrow-based security index
Any person who:
• Holds itself out as a dealer in swaps;
• Makes a market in swaps;
• Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
• Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps

De minimis exception:
• No more than $8 billion national over the preceding 12 months, and no more than $25 million notional of swaps with “Special Entities”. The $8 billion threshold may eventually be reduced to $3 billion by the CFTC. The CFTC recently issued a no-action letter which excludes swaps with certain public utilities from the $25 million Special Entity threshold.
• Excludes swaps entered into by an insured depository institution with a customer in connection with the origination of a loan with that customer.

In October 2011, SEC estimated that there will be about fifty security-based swap dealers (See Registration of Security-Based Swap Dealers and Major Security-Based Participants, 76 Fed Reg. 65808 (Oct. 24, 2011)).

In November 2010, CFTC Chairman Gensler estimated that as many as 200 entities will register with the CFTC as swap dealers (See Remarks before the Practicing Law Institute's 42nd Annual Institute on Securities Regulation, November 11, 2010).

As of March 2014, approximately 102 swap dealers have registered, although many of that number include affiliates of major firms.
Any person who is not a swap dealer and meets any of the following:

- Maintains a substantial position (to be defined by rule) in swaps for any of the major swap categories (i.e. rates, credit, equity and other commodities), excluding:
  - Positions held for hedging or mitigating commercial risk
  - Positions maintained by any pension plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan
  - Its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets
  - Is a financial entity that (i) is highly leveraged relative to the amount of capital that it holds, (ii) is not subject to a Federal banking agency’s capital requirements, and (iii) maintains a substantial position in outstanding swaps in any major category

Only for MSPs (not major security-based swap participants)

- Excludes qualifying finance affiliates of manufacturers using derivatives to hedge commercial risks relating to interest rate and FX exposures

At December 2010 CFTC public meeting, its General Counsel indicated that they expect only a “handful”, or at most, “two handfuls” of market participants to qualify as MSPs. As of March 2014, two MSPs have registered.

In October 2011, SEC estimated that there will be up to five major security-based swap participants (See Registration of Security-Based Swap Dealers and Major Security-Based Participants, 76 Fed.Reg. 65808 (Oct. 24, 2011)).
Margin Requirements

- Swap dealers and MSPs will be subject to initial and variation margin requirements for non-cleared swaps
  - Banking regulators to adopt rules for bank swap dealers and bank MSPs
  - CFTC or SEC to adopt rules for non-bank swap dealers and non-bank MSPs
- The banking regulators and the CFTC proposed rules whereby the amount of margin to be collected, the frequency of collection of variation margin and the segregation requirements for collected initial margin vary depending upon the type of counterparty. There are three proposed types of counterparties: (1) swap dealers and MSPs, (2) high and low risk financial end users, and (3) non-financial or commercial end users. Under these proposals, most community and small regional banks are expected to be low risk financial end users who would only be required to post initial and daily variation margin when and if the swap exposure exceeds the lesser of: (a) $15-45 million, and (b) 0.1-0.3% of the swap dealer's/MSP's Tier 1 capital.
- The SEC’s proposed margin rules are generally modeled on the margin requirements set for broker-dealers by self-regulatory organizations. Under proposed Rule 18a-3, a security-based swap dealer would need to collect margin collateral from counterparties to non-cleared security-based swap transactions to cover current exposure and potential future exposure (i.e., variation and initial margin) unless an exception applies (including an exception for security-based swaps with commercial end-users).
- The Dodd-Frank Act permits use of noncash collateral and the banking regulators and the CFTC have generally adopted this approach for commercial end users in their rule proposals.
- Issue as to whether margin requirements apply retroactively not yet fully resolved

Absence of Exception to Margin Requirements

- Senate bill provided an exception to the margin requirements if one of the counterparties is a commercial end user
- Act does not appear to have this exception, though it could be implemented via rulemaking. CFTC and SEC have proposed to take this approach while the banking regulators have proposed a narrower exception.
Segregation of Margin

- The Dodd-Frank Act imposes new obligations on a swap dealer to notify its counterparties that they have a right to require segregation of any “initial margin” (“IM”) they post in connection with uncleared swaps at an independent custodian. In October 2013, the CFTC approved final rules requiring that swap dealers obtain: (i) confirmation that the appropriate person at the counterparty received the notice, and (ii) a counterparty’s election to either require or not require IM segregation in accordance with the CFTC’s regulations.

- Counterparties that receive a notice of the right to elect IM segregation from a swap dealer must confirm receipt of such notice and make an election to either require segregation of IM in accordance with the CFTC rules or not. Failure to do so may prevent a swap dealer from trading uncleared swaps with a counterparty. The segregation rules do not apply to variation margin.

- The segregation rule became effective on January 6, 2014. For market participants that became “new counterparties” of a swap dealer after that date (e.g., by putting in place an ISDA Master Agreement in order to begin trading uncleared swaps), the relevant swap dealer must comply with the rule by May 5, 2014. For market participants that were existing counterparties on or prior to January 6, 2014, the compliance date is November 3, 2014.
Swap dealers and MSPs will be subject to minimum capital requirements

- Banking regulators to adopt rules for bank swap dealers and bank MSPs
- CFTC or SEC to adopt rules for non-bank swap dealers and non-bank MSPs
  - April 2011, Federal banking regulators proposed to apply the existing regulatory capital regime applicable to OTC derivatives and noted that they will be updating this regime shortly based on Basel III
  - May 2011, CFTC proposed that swap dealers and MSPs which are: (1) FCMs to comply with the CFTC’s existing capital requirements for FCMs, (2) non-bank subsidiaries of bank holding companies to comply with the Fed’s capital requirements subject to a minimum $20 million Tier 1 capital requirement, and (3) neither FCMs nor part of a bank holding company to have capital measured by tangible net equity equal or in excess of $20 million plus its OTC derivatives credit and market risk requirements as determined by the CFTC.

- Under the SEC’s proposed capital rules, the capital requirements for security-based swap dealers would be modeled closely on the rule that governs capital for broker-dealers (Rule 15c3-1), and would be designed to accommodate both security-based swap dealers that are dually registered as broker-dealers (broker-dealer SBSDs) and those that are not dually registered (stand-alone SBSDs).

- In general, the minimum capital requirements would distinguish between broker-dealer SBSDs and stand-alone SBSDs, and also would depend on whether a firm has been approved by the SEC to use internal models in calculating its regulatory capital. Firms that use models would be subject to a “tentative net capital” requirement, in addition to a “minimum net capital” amount. In general, the term “tentative net capital” refers to a firm’s net liquid assets, before deductions for market risk of a firm’s proprietary positions.

- The SEC proposal would establish a fixed dollar minimum as well as a ratio requirement equal to 8% of the margin required for cleared and non-cleared security-based swaps. In addition, broker-dealer SBSDs would be subject to ratio requirements that presently apply to broker-dealers under Rule 15c3-1.

- Finally, the fixed minimum capital requirement for all “alternative net capital regime” broker-dealers (whether or not they also register as security-based swap dealers) would be increased from $500 million to $1 billion.
Swap dealers and MSPs are subject to business conduct standards.

January 2012, CFTC finalized regulations for swap dealers and MSPs

June 2011, SEC proposed regulations for security-based swap dealers and major security-based swap participants

Among other things, the new standards and requirements:

- Require swap dealers and MSPs to disclose to non-swap dealer and non-MSPs:
  - Information about the material risks and characteristics of the swap
  - Any material incentives or conflicts of interest that the swap dealer or MSP may have
  - Upon request, the daily mark from the clearing organization for cleared swaps
  - The daily mark for non-cleared swaps
- Establish a duty for a swap dealer or MSP to communicate in a fair and balanced manner based on principles of fair dealing and good faith
- Require swap dealers and MSPs when making any recommendation to a counterparty of a swap to have a reasonable basis to believe it is suitable for the counterparty
- Prohibit fraud, manipulation, and other abusive practices involving swaps
Business Conduct Standards

- New standards with respect to *special entities*
  - States, municipalities, and State and Federal agencies
  - Pension plans, governmental plans, and endowments

- A swap dealer that acts as an “advisor” to a special entity must act *in the best interest of* the special entity

- A swap dealer or MSP that acts as a counterparty to a special entity must have a *reasonable basis* to believe that the special entity is advised by a qualified independent representative

- All uncleared swaps must be documented under a written agreement (e.g., ISDA Master Agreement)

- Many of the notices and agreements required by the business conduct standards are satisfied through the two ISDA “Dodd-Frank Protocols” available through MarKit or each swap dealer’s “bilateral” Dodd-Frank Agreement.
Swaps must be cleared if:

- Applicable regulator determines that it is required to be cleared; AND
- Clearing organization accepts it for clearing

As of March 2014, the CFTC has made a mandatory clearing determination for certain LIBOR and EURIBOR interest rate swaps and certain credit fault swaps (CDX and iTraxx)
Clearing Exceptions

- **Commercial End-User Exemption:** Mandatory clearing requirement does not apply if one of the parties
  - Is not a “financial entity”
  - Is using swaps to hedge or mitigate commercial risk; AND
  - Notifies the applicable regulator how it generally meets its financial obligations associated with entering into non-cleared swaps
  - **Note** – Application of the clearing exception is solely at the discretion of the commercial hedging entity

- **Financial entity**
  - Swap dealers, MSPs, commodity pools, certain private funds as defined under Section 202(a) of the Investment Advisers Act of 1940, pension plans
  - Persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature
  - CFTC has exempted small banks, savings associations, farm credit system institutions, and credit unions with total assets of $10B or less
  - Excludes qualifying finance affiliates of manufactures (only for swaps; see MSP definition)

- **Inter-affiliate Exemption:** certain swaps between eligible affiliates need not be cleared:
  - Eligible Affiliates: One counterparty directly or indirectly holds a majority ownership interest in the other, or where a third party directly or indirectly holds a majority ownership interest in both counterparties. In addition, both counterparties must report their financial statements on the same consolidated financial statements; in essence the rule requires that the financial statements of the majority interest holder are subject to consolidation under accounting standards and must include either the other affiliate counterparty’s or both majority owned affiliate counterparties’ financial results.
• Trading Documentation: The swap must be formally documented.
• Risk Management: The inter-affiliate swap must be subject to a centralized risk management program.
• Requirement to Clear All Swaps with Unaffiliated Counterparties: In order to prevent evasion by eligible non-U.S. affiliates entering into swaps with unaffiliated counterparties in jurisdictions without a clearing requirement, certain swaps with unaffiliated counterparties must still be cleared or be exempt from clearing.
• Exemption Election: The “reporting counterparty” must report to a swap data repository (or in the absence of a swap data repository, the CFTC), certain information specified in the rule.
If a swap is subject to the clearing requirement, it must be executed on an exchange or swap execution facility ("SEF") if the CFTC determines that the swap is “made available to trade” (“MAT”).

As of March 2014, certain of the fixed-to-floating interest rate swaps and CDS subject to the clearing requirement have been deemed “made available to trade” and are thus subject to the trade execution requirement.
The reporting of swap data to swap data repositories ("SDRs") by clearinghouses, exchanges, SEFs, swap dealers, MSPs and swap counterparties who are not swap dealers or MSPs is required so that the regulators can effectively oversee the markets in terms of systemic risk mitigation, market monitoring, and market abuse prevention. Generally, the entity which has the easiest, fastest, and cheapest access to the data will be required to report.

- No exemption for inter-affiliate transactions.
- Trades with asset managers must be reported twice; once at the manager level and again at the underlying counterparty level.

December 2011, CFTC finalized its swap data reporting rules.

What must be reported:

- Creation data: primary economic terms and confirmation data upon creation of the swap
- Continuation data: all changes to primary economic terms and all valuation data through the life of the swap

Who must report data to the SDR:

- Creation Data:
  - Swaps executed on a SEF or exchange: the SEF or exchange
  - OTC swaps accepted for clearing: the clearinghouse
  - OTC swaps not cleared or not accepted for clearing: the reporting counterparty
  - The reporting counterparty will be determined as follows:
    » If one party is a swap dealer and the other an MSP, the swap dealer is the reporting counterparty
    » If one party is a swap dealer/MSP and the other is not a swap dealer/MSP, the swap dealer/MSP is the reporting counterparty
    » If neither party is a swap dealer or a MSP but one party is a financial entity (as defined under Section 723 of Dodd-Frank and is an entity that is required to clear), the financial entity is the reporting counterparty.
    » In all other cases, as agreed by the parties to the swap: DTCC has published a detailed set of market conventions to determine the reporting party as between swap dealers.
Swap Data Reporting

- Continuation Data:
  - Cleared swaps: clearinghouse (plus swap dealer and MSP reporting valuation data)
  - Uncleared swaps: the reporting counterparty
Real-time public reporting of swap transaction and pricing data for all swap transactions is required in order to enhance price discovery.

December 2011, CFTC finalized its real-time swap reporting rules.

- The rules require real time reporting of price and other trade data relating to a “publicly reportable swap transaction” to a SDR as soon as technologically practicable, by either: (i) for trades executed on a SEF or exchange, the SEF/exchange, or (ii) for trades not executed on a SEF or exchange, the reporting party identified under the rules.

- The reporting party varies depending upon the parties to the transaction: (i) if only one counterparty is a swap dealer/MSP, the swap dealer/MSP is the reporting party; (ii) if one counterparty is a swap dealer and the other is a MSP, the swap dealer is the reporting party, and (iii) in all other cases, the parties will select the reporting party (except that where both parties are non-swap dealers/MSPs and one is a financial entity, the financial entity will be the reporting party).

- A publically reportable swap transaction must be either: (i) an arm’s length transaction between two parties that results in a change to the market risk position between the two parties, or (ii) a termination, assignment, novation, exchange, transfer, amendment, conveyance or extinguishing of rights and obligations of a swap that changes the pricing of the swap. The CFTC has indicated that certain inter-affiliate transactions and portfolio compression exercises may not be publically reportable.

- In addition, the final rules require the SDR to publically disseminate such data, within specified timeframes depending on: (i) the manner of execution (i.e., on a SEF/exchange versus OTC, and block v. non-block trades); (ii) underlying asset class; and (iii) type of market participant (i.e., swap dealer/MSP vs. non-swap dealer/MSP). Reporting is anonymous and does not identify the parties to the transaction.

- While, the methodology for determining block-size thresholds is not included in the final rules, the timeframes within which block trades must be reported are addressed in the rules.

- The final rule includes a masking of the publicly displayed swap notional sizes above specified thresholds.
From June 10, 2013, community banks became subject to the mandatory swap clearing requirement unless they avail themselves of the exemption for commercial end users or the exemption for inter-affiliate swaps.

- Small banks will need to comply with the end-user exception for any hedging swaps they elect not to clear. In particular, small banks as end users will need to:
  - determine whether the derivatives they use are required to be cleared or to be traded on a regulated execution facility and, if so, whether they are eligible for, and have completed the steps necessary to, elect the end-user exception (e.g., small banks must either annually file notice of the election with the CFTC or make arrangements with dealer counterparties to file for them);
  - obtain legal entity identifiers (LEI/GMEI, formerly the CICI) for the purpose of public and regulatory reporting requirements;
  - maintain full, complete and systematic records with respect to their swap transactions;
  - enter into the Dodd-Frank Protocols or otherwise amend existing swap agreements with a swap dealer’s “bilateral” Dodd-Frank agreement; and
  - If a community bank is a public company or a subsidiary of a public company, then an appropriate committee of the bank’s board must review and approve the bank’s decision to use a clearing exemption.

- As between a small bank and its commercial end-user clients, the small bank is the reporting counterparty because it is a “financial entity”. Some firms are offering reporting services to enable small banks to comply with the CFTC reporting regime.

Each of the federal banking regulators issued advisories to the financial institutions which they supervise reminding them as to the application of the swap clearing requirement from June 10, 2013 and the need to either make clearing arrangements or avail themselves of an applicable exemption.

Note that community banks and other small banks may not be able to elect the end-user exception when providing a swap as part of its business to another financial entity such as an insurance company (i.e., if it is not hedging). Neither party in this scenario would be able to elect the end-user exception and must clear the swap, although the small bank is likely to elect the end-user exemption for any hedge of the cleared swap.
Section 716 of Dodd-Frank generally prohibits the provision of certain types of federal assistance (e.g., access to the Fed discount window and FDIC deposit insurance) to registered swap dealers, security-based swap dealers, major swap participants and major security-based swap participants. Any registered major swaps participant or major security-based swap participant that is an insured depository institution is excluded and, therefore, a bank which registers as a swap dealer will not be eligible for such federal assistance unless it pushes out certain non-exempt swaps activities ("Non-Exempt Swaps") to a non-bank affiliate or ceases to engage in Non-Exempt Swaps activities, subject to any transition period or grandfathering provision. Section 716 became effective on July 16, 2013.

- **Non-Exempt Swaps:** Include all swaps other than swaps used to hedge or mitigate risk and swaps involving rates or national bank-eligible assets (e.g., rate swaps and swaps which reference currencies, bullion, loans or bank-eligible debt securities), other than uncleared credit default swaps. Common examples of Non-Exempt Swaps include uncleared credit default swaps, commodity and equity swaps.

- **Grandfathering:** The swap push-out only applies to swaps entered into by an insured depository institution after the end of the transition period.

- **Transition Period:** Section 716 authorizes the appropriate U.S. banking agency, after consulting with the CFTC and SEC, to provide an insured depository institution a transition period of up to two years, which can be extended by one additional year.

- **OCC** issued guidance in January 2013 notifying federally chartered insured depository institutions that it will consider granting applications which address specified points to delay compliance with Section 716 for up to two years. Applications were due by January 31, 2013. In June 2013, the OCC notified uninsured U.S. branches and agencies of foreign banks that they may request a transition period. The OCC has granted the applications of Australia and New Zealand Banking Group, Bank of America, Citibank, Commonwealth Bank of Australia, HSBC, JPMC, KeyBank, Morgan Stanley, PNC, Royal Bank of Canada, U.S. Bank, Wells Fargo and Westpac.

- **Federal Reserve** issued an interim final rule in June 2013 and a Final Rule in December 2013 adopting without change the interim final rule: (a) clarifying that uninsured U.S. branches and agencies of foreign banks are treated as insured depository institutions under Section 716, and (b) setting forth the process for state member banks and uninsured state branches or agencies of foreign banks to apply for a transition period of up to two years. The Federal Reserve has granted the applications of Bank of Montreal, Bank of New York Mellon, Canadian Imperial Bank of Commerce, Credit Agricole, Deutsche Bank, Goldman Sachs Bank USA, Natixis North America, Societe Generale, Standard Chartered, SunTrust Bank, The Bank of Nova Scotia and Toronto Dominion.
Dodd Frank Act Update—What’s Been Done and What We Need to Work on Now

University of North Carolina Banking Institute
April 3-4, 2014

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Today’s Agenda

• Reviewing what has been done to implement the Dodd-Frank Act and what remains to be done

• We will cover:
  – Recent developments – an overview
  – The Volcker Rule and implementing regulations
  – Prudential regulation
  – Title VII (derivatives regulation)
  – Municipal advisors
  – Executive compensation
  – What to expect in the next 12 months
Recent Developments – An Overview

• Major rules issued since March 2013:
  
  – A final rule implementing section 619 of the Dodd-Frank Act (the “Volcker Rule”) (December 2013)

  – A final rule implementing section 165 of the Dodd-Frank Act, which requires enhanced prudential standards for large U.S. bank holding companies and foreign banking organizations (February 2014)

  – A final rule establishing annual assessment fees for systemically important bank holding companies and savings and loan holding companies with $50 billion or more in total consolidated assets and designated nonbank financial companies (August 2013)

  – A final rule establishing the requirements for determining when a company is “predominantly engaged in financial activities” for purposes of the FSOC’s designation of a nonbank financial company for Federal Reserve supervision (April 2013)
Recent Developments – An Overview

- Major rules issued since March 2013 (cont.):
  - A final rule implementing the Basel III regulatory capital reforms and certain changes required by the Dodd-Frank Act (July 2013)
  - A final rule clarifying the treatment of uninsured U.S. branches and agencies of foreign banks under section 716 of the Dodd-Frank Act, commonly known as the swaps “push out” provision (December 2013)
  - Notwithstanding this activity, considerable work remains to be done
    - Examples include risk retention requirements of section 941; Single Point of Entry Strategy for the orderly resolution of systemically important financial institutions; liquidity rules under section 165; source of strength regulations under section 616(b); final rules on banking organization executive compensation.
The Volcker Rule

• The Final Regulations Implementing the Volcker Rule
  – The Final Regulations implement Section 619 of the Dodd Frank Act which added a new Section 13 to the Bank Holding Company Act
  – They were issued in December 2013 after over two years of proposed rulemaking, industry comment and debate

• The rules are applicable to “banking entities”
  – Insured depository institutions and bank holding companies
  – Their affiliates and subsidiaries
  – Foreign banks treated as bank holding companies under the International Banking Act of 1978
The Volcker Rule

- **Effective Date and Conformance Period:**
  - The regulations are technically effective on April 1, 2014
  - There is a conformance period ending July 21, 2015 for banking organizations to come into compliance with the Volcker Rule
  - Two additional one-year extensions may be available at the discretion of the Federal Reserve; an additional (but limited) five-year extension for “illiquid funds” is also available
  - Banking entities with significant trading activities must report quantitative metrics on their trading activities beginning in July 2014
  - Banking organizations must use “good faith efforts” during the conformance period to conform to the Volcker Rule
The Volcker Rule

• **Volcker Rule coverage**
  – Two primary restrictions:
    • Prohibition on “proprietary trading”, unless an exemption or exclusion is available
    • Restrictions on “sponsorship” of, or investments in, “covered funds” (e.g., hedge funds, private equity funds and certain other private funds), unless an exemption or exclusion is available

• Restrictions on conflicts of interests and high risk transactions and activities

• Requirement to implement a rigorous compliance regime
The Volcker Rule

• Proprietary trading
  – Prohibitions apply to “financial instruments”
    • Securities, derivatives
    • Exclude loans/leases, spot transactions, banking products
  – Principal exclusions:
    • Liquidity management exclusion
    • Others
  – Exemptions
    • Underwriting
    • Market making
    • Risk mitigating hedging
    • Trading in government obligations
    • Trading “on behalf of customers”
    • Trading “solely outside the United States” (“SOTUS”)

8
The Volcker Rule

- **Relationships with “covered funds”**
  - What is a covered fund?
    - Exempt under Investment Company Act sections 3(c)(1) or 3(c)(7); private commodity pools; foreign private funds of U.S. banks
    - Numerous important exclusions. Principal exclusions:
      - Wholly-owned subsidiaries; joint ventures; acquisition vehicles
      - Foreign public funds; qualified ABS and ABCP issuers; pension funds; BOLI; and insurance separate accounts
      - SBIC and public welfare investments
  - Exemptions
    - Funds “organized and offered” to advisory/fiduciary clients; numerous conditions for this exemptions
    - Funds organized and offered “solely outside the U.S.”; several important risk-based conditions
The Volcker Rule

• Limitations on financial relationships with “covered funds” – Super 23A
  – Applicability extends to banking organization sponsors and investment managers/advisers of covered funds
  – Regulatory definition of “covered transactions”
    • Loans and other extensions of credit to the fund
    • A purchase of securities issued by an affiliate (excluding permitted ownership interests) or of assets from the fund
    • The issuance of a guarantee on behalf of the fund
    • A derivative transaction to the extent it causes the banking organization to have credit exposure to the fund
The Volcker Rule

- Limitations on conflicts of interest and high-risk trading activities and investments
- Mandatory compliance program
  - General compliance program -- mandatory components:
    - Written policies
    - System of internal controls
    - Management framework for oversight/review/accountability
    - Independent testing and audit
    - Training
    - Required recordkeeping
  - Enhanced compliance program for larger banking organizations, or those with significant trading activities
  - Documentation and reporting requirements and metrics
The Volcker Rule

- **Implementation and compliance challenges**
  - The final rules closely hew to the statute; so, statutory challenges have become implementation challenges
    - Five-agency agreement on the final regulations proved to be a challenge and will continue to affect interpretive and implementation issues
  - One immediate impact felt in the covered funds provisions of the final rules, which technically include TruPS CDOs
    - Banking entities holding TruPS CDO interests faced immediate and certain write-downs
      - Addressed by all five agencies following ABA lawsuit
    - Banking entities holding other types of CLO interests still may face the risk of fire sale divestitures
      - The issue still is under review by the Volcker Rule “interagency task force”
The Volcker Rule

• Implementation and compliance challenges
  – Proprietary trading issues are mostly localized in the larger banks; however, many more banks are captured by the Volcker Rule and now are beginning to realize that fact
    • State banks with equity investment authority may have to create compliance programs or divest
  – The conformance period is insufficient
  – The way forward is not clear
    • Although the “interagency task force” is up and running, it is opaque
    • Examinations and metrics review entirely uncertain
    • No compliance guidance available, and two of the five agencies have no history of issuing examiner guidance
Prudential Regulation

• **Dodd-Frank Act Section 165(d) Rules**
  - These rules implement the Dodd-Frank Act requirement for enhanced prudential regulation and supervision of bank and savings and loan holding companies with $50 billion or more in assets, and designated nonbank financial companies (collectively known as systemically important financial institutions, or SIFIs)
  - Rules were adopted in December 2013 after a two-year rulemaking proceeding marked by extensive commentary and controversy
    • Rules for large domestic bank holding companies were proposed in December 2011
    • Rules for foreign banking organizations (FBOs) with $50 billion or more of consolidated worldwide assets were proposed in December 2012
The final rules have several components that generally apply equally to U.S. and foreign SIFIs:

- Capital planning
- Risk-based and leverage capital requirements
- Stress testing
- Risk management and risk committees
- Liquidity management
- Debt-to equity limits
Prudential Regulation

- The final rules require a covered FBO with $10 billion or more of U.S. non-branch assets to establish an intermediate holding company that must comply with U.S. regulatory capital requirements.

- The final rules require risk committees for publicly-traded bank holding companies, and FBOs, with consolidated assets of more than $10 billion and less than $50 billion.

- Rules are generally effective for covered domestic bank holding companies on July 1, 2015, and for covered FBOs on July 1, 2016.

- Not covered in the final rules:
  - Single counterparty credit limits
  - Early remediation standards
Prudential Regulation

• Regulatory capital

  – In July 2013, the federal banking agencies adopted final rules implementing the Basel III regulatory capital accord and certain changes required by section 171 (the Collins Amendment) of the Dodd-Frank Act

  – Highlights of the final rules (from 100,000 feet)
    • New requirements for common equity Tier 1 (CET1) (4.5% CET1 on a fully-phased in basis) capital with strict eligibility standards, and several required adjustments and exclusions
    • Phase-out of TruPS and other non-qualifying Tier 1 capital instruments, with certain exceptions for community banks
    • New risk-weighting framework for bank assets and off-balance sheet exposures based on the Basel Committee “standardized approach” to the risk-weighting of assets and exposures
• Regulatory capital
  – Highlights of the final rules (continued)
    • New leverage capital requirements (4% for all banks), plus a proposed supplementary leverage requirement for the largest banking organizations
    • A new capital conservation requirement (2.5% CET1 on a fully-phased in basis)
    • A new countercyclical capital requirement (2.5% CET1 on a fully-phased in basis) for large banks
    • Effectiveness transition period begins January 1, 2014 for large banks, and January 1, 2015 for other banks
Prudential Regulation

- **Liquidity requirements**
  - The Federal Reserve Board has proposed a minimum liquidity coverage ratio (LCR) for large and internationally active banking organizations and nonbank SIFIs (October 2013)
    - Modified proposal would apply to depository institution holding companies with more than $50 billion in assets
  - The proposal is based on international LCR standards previously adopted by the Basel Committee, and also is designed to implement the liquidity standards required under Dodd-Frank Act section 165
Other rulemaking developments

- In April 2013, the Federal Reserve Board adopted a final rule establishing the requirements for determining when a company is “predominantly engaged in financial activities” for purposes of the Financial Stability Oversight Council’s (FSOC) designation of a nonbank financial company for Federal Reserve Board supervision
  - To date, three financial companies have been designated by FSOC
- In August 2013, the Federal Reserve Board adopted a rule establishing annual assessment fees for bank and nonbank SIFIs
  - The intent here is to cover the costs of the enhanced supervision required under Title I of the Dodd-Frank Act
• Other regulatory/supervisory developments
  
  – Capital planning and stress testing
    
    • March 2014: The Federal Reserve Board released its 2014 Comprehensive Capital Analysis and Review (CCAR) results for large bank holding companies; 25 banks passed, five did not.
    
    • March 2014: The Federal banking agencies release final supervisory guidance for company-run stress testing requirements for bank and savings and loan holding companies with more than $10 billion and less than $50 billion in assets (required under Dodd-Frank Act section 165(i)). The emphasis is on formal written policies, strategic planning, and board of directors accountability.
Prudential Regulation

• **Other regulatory/supervisory developments**
  
  – **Risk management and governance**
    • The OCC has issued a proposal to formalize its risk governance expectations of large banks (January 2014), which would apply heightened risk management and governance expectations to national banks, federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of $50 billion or more.

  – **Resolution/orderly liquidation**
    • Resolution plans (“living wills”) progress report
    • Proposed single point of entry strategy for the resolution of SIFIs (FDIC, December 2013). This proposal is intended, among other things, to further the implementation of the Orderly Liquidation Authority (OLA) for the resolution of large U.S. banking organizations and nonbank firms under Title II of the Dodd-Frank Act.
• **Stress testing** – at the core of capital planning

  – $10 billion to $50 billion – Company-run testing requirements
    • Forward projection 9 quarters – first round does not include Basel III capital changes
    • Used by supervisors – could prompt dividend restrictions
    • Disclosed to the public starting 2015, and just in 1934 Act filings
    • First round based on September 30, 2013 numbers submitted end-of-March 2014
    • The expectation is that stress testing will drive capital levels on a forward looking basis
• Stress testing (cont.)

  – $50+ billion – Company run and Fed run
    • Forward projection 9 quarters – includes Basel III capital changes
      – 2x/year company run based on March and September data
      – 1x/year Fed run based on September data
    • Used by supervisors – if minimums not met over time horizon, dividends are restricted
    • Disclosure of company and Fed run results – stress testing results and capital plan
    • Currently a bifurcated disclosure to permit capital plan revisions
    • Stress testing now driving capital levels on a forward looking basis
Stress testing (cont.)

- Experiences to date for $10-50 billion
  - Preparation difficulty varies depending on past institutional experience conducting stress testing internally
  - The Fed is very engaged with this cohort of banks
  - Typical “first round” process issues occurring
  - Strong message from the Fed that disclosure in 2014 is not necessary; unclear interaction with 1934 Act requirements

- A word about the >$50 billion experience
  - 2013 and 2104 results point to the relevancy of quantitative and qualitative factors
    - 2014 results: 4 of 5 banks faced qualitative objections
  - Continuing concern about the “black box” nature of the Fed run test, as well as results that are a surprise
Title VII -- Derivatives

- Dodd-Frank Act Title VII creates a new framework for the regulation and supervision of swaps and security-based swaps (hereinafter “swaps” unless otherwise indicated). Major elements of the framework are:
  - Registration and regulation of swap dealers/security-based swap dealers (collectively “SDs”), and major swap participants/security-based swap participants (collectively “MSPs”)
  - Capital, margin, business conduct and recordkeeping/reporting requirements for regulated participants
  - Mandatory trading of designated swaps on regulated trading and swap execution facilities
  - Mandatory clearing of designated swaps through designated central clearinghouses
  - Swap data reporting requirements
Title VII -- Derivatives

• Regulatory implementation activities:
  – The CFTC and the SEC share primary regulatory responsibility for the implementation of Title VII’s requirements (the CFTC for swaps, and the SEC for security-based swaps)
  – Both agencies have adopted a number of regulations that largely implement the regulatory framework of Title VII. See Appendix E for a more complete discussion of these regulatory activities

• Areas of interest to banking organizations:
  – Impact of Title VII on smaller banking organizations
  – The Lincoln Amendment (Dodd-Frank Act section 716), or swaps “push out” rule
Title VII -- Derivatives

- **Title VII and smaller banks**
  - As of June 10, 2013, community banks became subject to the mandatory swap clearing requirement unless they avail themselves of the exemption for commercial end users or the exemption for inter-affiliate swaps.
  - Each federal banking agency has issued an advisory to its supervised financial institutions reminding them as to the application of the swap clearing requirement from June 10, 2013 and the need to either make clearing arrangements or avail themselves of an applicable exemption.
  - Community banks and other small banks may not be able to elect the end-user exception when providing a swap as part of its business to another financial entity such as an insurance company (i.e., if it is not hedging). Neither party in this scenario would be able to elect the end-user exception and must clear the swap, although the small bank is likely to elect the end-user exemption for any hedge of the cleared swap.
Title VII -- Derivatives

• Section 716 – Swaps push-out rule
  – Section 716 generally prohibits the provision of certain types of federal assistance (e.g., access to the Fed discount window and FDIC deposit insurance) to registered SDs and MSPs
  – Any registered MSP that is an insured depository institution is excluded. Therefore, a bank which registers as a SD will not be eligible for such federal assistance unless it pushes out certain non-exempt swaps activities (“Non-Exempt Swaps”) to a non-bank affiliate or ceases to engage in Non-Exempt Swaps activities, subject to any transition period or grandfathering provision.
  – Section 716 became effective on July 16, 2013
Title VII -- Derivatives

• Section 716 – Swaps push-out rule

  – **Non-Exempt Swaps:** Include all swaps other than swaps used to hedge or mitigate risk and swaps involving rates or national bank-eligible assets (e.g., rate swaps and swaps which reference currencies, bullion, loans or bank-eligible debt securities), other than uncleared credit default swaps. Common examples of Non-Exempt Swaps include uncleared credit default swaps, commodity and equity swaps.

  – **Grandfathering:** The swap push-out only applies to swaps entered into by an insured depository institution after the end of the transition period.

  – **Transition Period:** Section 716 authorizes the appropriate U.S. banking agency, after consulting with the CFTC and SEC, to provide an insured depository institution a transition period of up to two years, which can be extended by one additional year.
Title VII -- Derivatives

- **Section 716 -- Swaps push-out rule**
  - **OCC** issued guidance in January 2013 notifying federally chartered insured depository institutions that it will consider granting applications which address specified points to delay compliance with Section 716 for up to two years. Applications were due by January 31, 2013. In June 2013, the OCC notified uninsured U.S. branches and agencies of foreign banks that they may request a transition period. The OCC has granted several applications.
  - **Federal Reserve** issued an interim final rule in June 2013 and a Final Rule in December 2013 adopting without change the interim final rule: (a) clarifying that uninsured U.S. branches and agencies of foreign banks are treated as insured depository institutions under Section 716, and (b) setting forth the process for state member banks and uninsured state branches or agencies of foreign banks to apply for a transition period of up to two years. The Federal Reserve also has granted several applications.
Title VII -- Derivatives

- **Swaps**
  - Major elements of new infrastructure in place
    - Swap dealers registered
      - NFA examinations in process; some cooperation with OCC
    - Reporting started
    - Clearing started for all groups
    - Swap execution facilities (SEFs) just getting registered
  - Scope requires further work
    - Banks with nominal activity
    - International application
  - Margin requirements remain to be implemented in the U.S., although international agreement largely settled
Are you providing advice that requires registration?

Is it regarding:
- Issuance of Muni Securities
- Municipal Derivatives
- Guaranteed Investment Contracts (GICs)
- Investment Strategies
  - Proceeds
  - Muni Escrow Investments
- Municipal Derivatives

Are you making a:
- Recommendation
- Suggestion
- Pitch

Are you providing:
- Education
- Advertising

Is an exemption available?
- Banks:
  - Extensions of credit (loans)
  - Deposit Accounts
  - Sweep Accounts
  - Indenture Trustee
- Responses to RFPs or RFQs
- Independent Municipal Advisor
- Registered Investment Advisor
- Underwriter
- Swap Dealers and Commodity Trading Advisors
- 529 Plans

No registration needed

Municipal Advisor registration required
Municipal Advisors

- Municipal advisor registration
  - Final rule issued
  - MSRB proposals issued regarding:
    - Fiduciary duty (comment period closed)
    - Supervisory and compliance obligations (comment period open until April 28)
    - Professional qualifications (comment period open until May 16)
  - Final registration phased-in starting July, 2014 using temporary registration file numbers for phase-in dates
• Municipal advisor registration (cont.)
  – FAQs for brokers and investment advisers issued; more to come
  – FAQs for banks pending, covering banking and fiduciary issues
    • One subject that may be covered is the applicability of municipal advisor rules to bank collective investment fund activities
  – MSRB fiduciary duty proposal problematic especially with respect to “principal” restrictions
  – MSRB professional qualifications proposal follows the broker-dealer qualifications scheme and may prove problematic for bank trust departments
  – Similarly, MSRB supervisory and compliance proposal follows the broker-dealer supervision/compliance scheme and also may be problematic for bank trust departments
Executive Compensation

The Dodd-Frank framework:

- Section 951: Shareholder “say on pay” requirements and disclosures (SEC)
- Section 952: Compensation consultant disclosures (SEC)
- Section 953: Pay-for-performance and compensation ratio disclosures (SEC)
- Section 954: Exchange listing standards; clawback requirements (SEC)
- Section 955: Disclosures of director/employee hedging in issuer stock (SEC)
- Section 956: Reporting of compensation arrangements; prohibitions on certain arrangements (federal financial agencies)
Executive Compensation

• Rules adopted
  – SEC
    • January 2012 -- Adopted “say on pay” rules for shareholder approval of executive compensation and golden parachute arrangements (section 951)
    • June 2012 -- Adopted rules directing national securities exchanges to adopt listing standards governing committee and compensation advisor activities and disclosures (section 952). The major exchanges subsequently adopted listing standards, which were approved by the SEC in January 2013

• Proposed rules -- SEC
  – September 2013: Proposed rules for disclosures regarding CEO compensation as a ratio of median total compensation of all employees. To be implemented via amendments to SEC Regulation S-K, Item 402
Executive Compensation

• Proposed rules – Federal financial agencies
  – April 2011: Proposed rules that would implement the incentive-based compensation requirements of Dodd-Frank Act section 956
  – Proposal would apply to all “covered financial institutions,” which would include the following financial institutions with consolidated assets of $1 billion or more:
    • insured banks and savings institutions
    • bank and savings and loan holding companies
    • insured and uninsured U.S. branches and agencies of foreign banks
    • credit unions
    • registered broker-dealers and investment advisers
  – Persons who would be subject to the requirements would include all directors, executive officers, employees and principal shareholders (“covered persons”)
Executive Compensation

• Proposed rules – Federal financial agencies (cont.):
  – Components of the proposed April 2011 rules

  • Prohibit incentive-based compensation arrangements that encourage covered persons to expose the institution to “inappropriate risks” by providing the covered person with “excessive compensation”

  • Prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks by the covered financial institution that could lead to material financial loss

  • Require appropriate policies and procedures to help ensure compliance with requirements

  • Require covered financial institutions to report certain incentive compensation arrangement information to their primary regulatory agencies
What to Expect in the Upcoming 12 months
Appendix Materials

- Appendix A – Presentation: Volcker Rule (detailed)
- Appendix B – Article: Volcker Rule compliance
- Appendix C – Article: Section 165 rules
- Appendix D – Article: OCC risk management guidance
- Appendix E – Presentation: Title VII (detailed)
January 27, 2014

OCC Seeks to Formalize Risk Governance Expectations of Large Banks

The proposed guidelines demonstrate the Office of the Comptroller of the Currency’s continued emphasis on strong risk management for large banks.

On January 16, the Office of the Comptroller of the Currency (OCC) issued proposed rules and guidelines establishing minimum risk governance standards for certain large insured financial institutions (the Proposed Guidelines). The content of the Proposed Guidelines is not unexpected; as the OCC states in its commentary to the Proposed Guidelines, its intention is to formalize the “heightened expectations” that it has been applying for the last several years during its supervision and examination process. Overall, the Proposed Guidelines are a continuation on a regulatory theme that has been paramount since the financial crisis—robust risk management and risk management accountability. However, the potentially broad scope of applicability of the Proposed Guidelines, as well as the formalization of what have been softer regulatory “expectations,” may result in unforeseen consequences for some financial institutions that would otherwise not expect to be subject to the same risk management expectations as large banks.

Scope of Applicability

The Proposed Guidelines would generally apply to insured national banks, insured federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of $50 billion or more (each a Bank, and collectively Banks). The OCC retains the authority to apply the Proposed Guidelines to a financial institution whose total consolidated assets are below $50 billion if the OCC determines that such entity’s operations are highly complex or otherwise present a heightened risk as to require compliance with the Proposed Guidelines. The Proposed Guidelines would require the risk governance standards to be developed at the Bank level, unless the risk profiles of the Bank’s parent company and the Bank are “substantially the same,” in which case, the Bank may use its parent’s risk governance framework. In turn, parent company and Bank risk profiles would be considered “substantially the same” if the Bank’s total consolidated assets, total assets under management, or total off-balance sheet exposures represent 95% or more of the parent company’s corresponding assets, assets under management, or off-balance sheet exposures.

The OCC notes that it may apply the Proposed Guidelines to smaller banks (with less than $50 billion in total consolidated assets) that are subsidiaries of the same parent company if the total consolidated assets of the banks and their holding company is $50 billion or more. The OCC also asks for input on whether the Proposed Guidelines should apply to uninsured entities, such as trust banks and federal branches or agencies of foreign banks. Currently, the heightened expectations regarding risk management are applied informally to a select number of these uninsured entities.

In addition, the OCC is applying a version of the “Hotel California rule” to the applicability of the Proposed Guidelines—meaning that once a Bank becomes subject to the Proposed Guidelines, it would be required to comply with the Proposed Guidelines even if its average total consolidated assets drop below $50 billion, unless

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or until the OCC determines otherwise. The OCC retains the discretion to determine whether continued compliance is necessary. There is no formal procedure for a Bank to petition the OCC for relief from the applicability of the Proposed Guidelines.  

Requirements Under the Guidelines

The Proposed Guidelines set an expectation that a Bank will establish a formal, written risk management policy (Framework) that covers credit risk, interest rate risk, liquidity risk, price risk, operational risk, compliance risk, strategic risk, and reputation risk. The Framework would be required to be reviewed and updated on at least an annual basis. The Proposed Guidelines identify three key organizational units—“front line units,” “independent risk management,” and “internal audit”—that are charged with the development, implementation, and testing of the Framework. In turn, the Proposed Guidelines set out, in some detail, the expected roles and responsibilities of the front line units and independent risk management in developing and implementing the Framework, with the overarching focus being on communication, independence, accuracy, and responsibility and “ownership.”

Banks would also be required to develop a written three-year strategic plan that is developed by the CEO with input from the applicable business units (front line, risk management, and internal audit). The Bank’s board of directors (Board) would be required to evaluate, approve, and actively monitor implementation of the strategic plan. In addition, each Bank will be required to have a comprehensive written statement (containing qualitative components and quantitative limits) that articulates that Bank’s risk appetite; the written statement would serve as the basis for the Bank’s Framework.

The Proposed Guidelines also set out heightened expectations of the Bank’s Board, mostly concerning the independence of the Board from the Bank’s parent company and the Board’s role in managing and overseeing risk management. Significantly, each Bank’s Board would be required to have at least two independent members who are not part of the Bank’s or its parent company’s management.

Enforcement Authority

The Proposed Guidelines were issued pursuant to the OCC’s safety and soundness authority under section 39 of the Federal Deposit Insurance Act (FDIA). In proposing to issue the heightened expectation standards as “guidelines” rather than “regulations,” the OCC stated that it will have more flexibility in determining corrective action for a financial institution’s failure to comply with the Proposed Guidelines. Although such flexibility could be beneficial to a financial institution in that the OCC would not be required to seek a formal remedial plan and remediation can be individually tailored, such flexibility also risks injecting an element of uncertainty into the supervision and enforcement process. Decisions and conclusions will apparently be made by the OCC on a case-by-case basis.

In addition, if the OCC makes the determination to take formal corrective action, then the enforcement and compliance apparatus for such corrective action comes fully into play. By folding the Proposed Guidelines into the OCC’s section 39 authority, the OCC would have the ability to initiate a formal, public enforcement action against a financial institution that the OCC finds to be not in compliance with the Proposed Guidelines. There would also be the possibility of civil money penalties for failure to comply with the Proposed Guidelines.

Comments to the Proposed Guidelines are due 60 days after their publication in the Federal Register.

Ramifications

As mentioned, the Proposed Guidelines formalize what the OCC has been informally expecting during its examination process. This formalization may benefit banks in providing clarity and transparency to the OCC’s risk

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2. The notice and response procedures of 12 C.F.R. § 30.4 would apply to any determination by the OCC that the Proposed Guidelines should no longer apply to a particular Bank. These procedures, however, are OCC-initiated only.

management expectations as well as more specific guideposts for establishing a satisfactory risk management Framework. Compliance with the Proposed Guidelines will likely involve a great deal of time and effort; the OCC’s official burden hour estimate is more than 7,000 hours per Bank, which may be low, especially if a Bank cannot rely on its parent company’s Framework. Yet, in the postcrisis regulatory environment, a strong and well-documented risk management Framework has become an essential best practice. However, under the Proposed Guidelines, the OCC would have enforcement authority for failure to establish adequate risk management controls, including formal orders and civil money penalties for failure to comply.

Another notable feature of the Proposed Guidelines is the OCC’s statement of agency expectations for a Bank’s Board. By specifying the actions that Boards are required to take under the Proposed Guidelines, the OCC is taking steps, backed by the regulatory enforcement process, to formalize a key aspect of the overall board of directors governance process. The OCC will almost certainly be taking a close look during examinations for evidence of the independence of Bank Boards and robust Board oversight.

Additionally, one important issue that remains unclear is the effect of the Proposed Guidelines on banks below the $50 billion threshold and uninsured institutions and whether the OCC will apply the Proposed Guidelines to those institutions formally or informally. Given the flexibility that the OCC has given itself to apply the Proposed Guidelines based on an overall assessment of the risk profile of the institution, certain smaller banks or uninsured institutions conceivably may find themselves being placed under the Proposed Guidelines and faced with a burdensome administrative process if they attempt to challenge the OCC’s determination, although the OCC suggests that would be an infrequent occurrence. Perhaps more interesting is the possibility that the Framework standards, which presumably are intended to reflect a “gold standard” in bank risk management, may filter down into the risk management supervisory activities and expectations of the OCC examination corps across the board.

Finally, there has yet to be any indication from the Federal Reserve or the Federal Deposit Insurance Corporation (FDIC) as to whether they plan to issue similar risk management guidelines. In this regard, FDIA section 39 requires the Federal Reserve and the FDIC, as well as the OCC, to prescribe safety and soundness standards for insured depository institutions in general. This is typically done on an interagency basis—the original safety and soundness standards were jointly issued by the Federal Reserve, the OCC, and the FDIC (and the now-defunct Office of Thrift Supervision).4 Therefore, it would not be unexpected for the other two regulatory agencies to weigh in with their own guidelines, although the Federal Reserve and the FDIC combined currently supervise significantly fewer banks of $50 billion or more than does the OCC. If the other banking agencies elect to propose risk governance standards for their constituent depository institutions, we would anticipate a coordinated approach among the agencies and the proposal of substantively similar requirements by the other agencies.

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4. These guidelines are found in Appendix D-1 to 12 CFR Part 208.
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Federal Reserve Finalizes U.S. and Foreign Bank Prudential Standards

The long-awaited standards establish significant structural, liquidity, risk management, and capital requirements for the largest U.S. and foreign banks operating in the United States, including new intermediate holding company requirements for foreign banks.

The Federal Reserve Board (Federal Reserve) has adopted final rules (Final Rules) implementing the enhanced prudential standards of section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for U.S. bank holding companies and foreign banking organizations (FBOs) with $50 billion or more in total consolidated assets.1 The Final Rules, adopted on February 18, are based on the Federal Reserve’s previously proposed rules to implement section 165 of the Dodd-Frank Act for domestic bank holding companies (domestic proposal) and FBOs (foreign proposal) (collectively, the Proposed Rules), published in December 2011 and December 2012, respectively.2

The Final Rules establish enhanced liquidity and risk management requirements for U.S. top-tier bank holding companies with total consolidated assets of $50 billion or more. In addition, the Final Rules impose a U.S. intermediate holding company requirement for FBOs with $50 billion or more in U.S. non-branch/agency assets, and they impose enhanced risk-based and leverage capital requirements, liquidity requirements, risk management requirements, and stress-testing requirements on FBOs with total consolidated worldwide assets of $50 billion or more. Lastly, the Final Rules establish a risk committee requirement for publicly traded bank holding companies and FBOs with total consolidated assets of $10 billion or more and a stress-testing requirement for FBOs with total consolidated assets of $10 billion or more.

The Final Rules will be effective for covered U.S. top-tier bank holding companies beginning on January 1, 2015 and covered FBOs beginning on July 1, 2016.

Enhanced Prudential Standards for U.S. Bank Holding Companies

Capital Planning and Stress Testing. The Federal Reserve previously adopted enhanced risk-based and leverage capital requirements and stress-testing requirements for large bank holding companies. In 2011, the Federal Reserve issued a capital plan rule requiring capital plans and governing capital distributions for bank holding companies with total consolidated assets of $50 billion or more. Thereafter, in 2012, the Federal Reserve issued final stress-test rules for bank holding companies with total consolidated assets of more than $10 billion. The Final Rules confirm these previously adopted rules and require compliance with the Federal Reserve’s regulations regarding capital planning and stress testing.

Liquidity and Risk Management Requirements. The Final Rules impose new liquidity and risk management requirements on large domestic bank holding companies. Under the new liquidity requirements, a bank holding company with total consolidated assets of $50 billion or more must meet liquidity risk management standards.

conduct internal liquidity stress tests, and maintain a 30-day buffer of highly liquid assets. Liquidity risk management strategies, policies, and procedures must be established by the bank holding company’s senior management and approved by its board of directors and must also be subject to annual independent review.

The Final Rules further require a bank holding company with total consolidated assets of $50 billion or more to establish an enterprise-wide risk committee chaired by an independent director and to have at least one member with experience in identifying, assessing, and managing risk exposures of large, complex financial firms. A bank holding company with total consolidated assets of $50 billion or more must also appoint a chief risk officer. Publicly traded bank holding companies with total consolidated assets of $10 billion or more but less than $50 billion are also required to establish a risk committee chaired by an independent director that includes at least one member having experience in identifying, assessing, and managing risk exposures of large, complex firms.

Enhanced Prudential Standards for FBOs
The Final Rules establish enhanced prudential standards for FBOs, including new requirements for the establishment of intermediate holding companies, risk-based and leverage capital, liquidity, and risk management.

Intermediate Holding Companies. Under the Final Rules, an FBO with U.S. non-branch/agency assets of $50 billion or more is required to hold its U.S. subsidiaries under an intermediate holding company. The intermediate holding company would be subject to enhanced prudential standards on a consolidated basis. U.S. branches and agencies of an FBO, as well as foreign companies with limited U.S. operations (known as section 2(h)(2) companies), may continue to operate outside of the intermediate holding company.

Capital Requirements. The Final Rules subject an intermediate holding company of an FBO to the standardized risk-based and leverage capital standards applicable to U.S. bank holding companies; the U.S. “advanced approaches” capital rules, however, will not apply unless an FBO specifically opts in to the advanced approaches. The intermediate holding company will also be subject to the Federal Reserve’s capital plan rule. In addition, an FBO with total global consolidated assets of $50 billion or more must certify that it meets consolidated capital adequacy standards established by its home country supervisor that are consistent with the Basel Capital Framework.

Liquidity and Risk Management. The Final Rules require the U.S. operations of an FBO with combined U.S. assets of $50 billion or more (in this case, including U.S. branch/agency assets) to meet liquidity risk management standards and conduct internal liquidity stress tests. The U.S. branches and agencies of an FBO must maintain a liquidity buffer in the United States for the first 14 days of a 30-day liquidity stress test. The intermediate holding company is required to maintain a liquidity buffer in the United States for a 30-day liquidity stress test. An FBO with total consolidated assets of $50 billion or more, but with combined U.S. assets of less than $50 billion, is not required to perform a separate stress test for its U.S. operations, but instead it may report the results of an internal liquidity stress test (either on a consolidated basis or for its combined U.S. operations) to the Federal Reserve on an annual basis.

Consistent with the requirements for U.S. bank holding companies, an FBO with combined U.S. assets of $50 billion or more is required to establish a U.S. risk committee—at either its intermediate holding company board of directors or its FBO board of directors—that oversees the risk management function for its combined U.S. operations (branch/agency and non-branch/agency activities). The FBO must also appoint a U.S. chief risk officer in the United States. If the risk committee for the FBO’s combined U.S. operations is not at the intermediate holding company, the intermediate holding company must have its own risk committee that oversees the risk management function for the intermediate holding company’s operations. The FBO’s risk committee may also serve as the U.S. risk committee for the combined U.S. operations.

Debt-to-Equity Limits for U.S. Bank Holding Companies and FBOs
Under section 165 of the Dodd-Frank Act, upon a determination by the Financial Stability Oversight Council that a company poses a grave threat to U.S. financial stability and that the imposition of the requirement is necessary to
mitigate that risk, the Federal Reserve must require a bank holding company and an FBO with $50 billion or more in total consolidated assets, as well as a nonbank financial company supervised by the Federal Reserve, to maintain a debt-to-equity ratio of no more than 15-to-1. Consistent with the Dodd-Frank Act, the Final Rules define the 15-to-1 debt-to-equity limitation and adopt procedures for its implementation.

Differences from the Proposed Rules

The Proposed Rules set forth enhanced prudential standards for (i) bank holding companies with total consolidated assets of $50 billion or more, (ii) FBOs with total consolidated assets of $50 billion or more, and (iii) any domestic and foreign nonbank financial company supervised by the Federal Reserve; although, in the case of nonbank financial companies, they provided little detail as to the specifics of those standards. Furthermore, the foreign proposal required a U.S. intermediate holding company for an FBO with total consolidated assets of $50 billion or more and combined U.S. assets (other than held by a U.S. branch, agency, or section 2(h)(2) company) of $10 billion or more.

In most material respects, the Final Rules are substantively similar to the Proposed Rules, but the following are some differences that warrant separate mention:

- The threshold for the requirement for an FBO to form a U.S. intermediate bank holding company has been raised from $10 billion of U.S. non-branch/agency assets to $50 billion of U.S. non-branch/agency assets. The Federal Reserve said that it believes raising the threshold accomplishes the goal of enhanced prudential regulation of the foreign banks that pose the greatest risk to the U.S. financial markets while, at the same time, not overburdening FBOs that have minimal activities in the United States and do not pose as much of a systemic threat. In addition, the Federal Reserve has postponed the applicability to intermediate holding companies of U.S. leverage capital requirements (previously adopted in July 2013) to January 1, 2018.

- The FBO deadline for forming an intermediate holding company and moving all non-branch/agency subsidiaries under that holding company has been extended from July 1, 2015 to July 1, 2016. The Federal Reserve believes this additional time will better enable foreign banks to reorganize as necessary under the Final Rule and to bring their activities into compliance with the enhanced prudential standards. Similarly, if an FBO not currently subject to the enhanced prudential standards has U.S. non-branch/agency assets that exceed the $50 billion threshold after July 1, 2015, that FBO has two years to come into compliance with the Final Rule, rather than the one-year compliance period set out in the Proposed Rules.

- The Final Rules will not be applicable to nonbank financial companies supervised by the Federal Reserve. Instead, the Federal Reserve proposes to take a more individualized approach to each nonbank financial company it supervises in order to determine how the enhanced prudential standards should apply, and it expects to apply the enhanced prudential standards to nonbank financial companies though order or rule. The Federal Reserve states that it believes that this individually tailored approach better accomplishes the goals of enhanced prudential regulation while, at the same time, not subjecting the nonbank financial companies to bank-like prudential standards that may be more burdensome than required or generally inappropriate for the organization.

- The Federal Reserve has decided to postpone the adoption of the single counterparty credit limits that were contained in the Proposed Rules. Although such limits are required under Dodd-Frank Act section 165, the Federal Reserve intends, at this time, to work with the Basel Committee on Banking Supervision in the development of global single counterparty credit limits and proposes to take these international initiatives into account in developing U.S. counterparty limits in the future.

- The Federal Reserve also is deferring the implementation of the early remediation measures that are required under section 166 of the Dodd-Frank Act, stating simply that it is “continuing to review the comments” on this topic.

Some Observations on the Final Rules

The Final Rules, which are generally required under the Dodd-Frank Act and therefore not unexpected, establish a significant new regime of prudential (risk-based) regulation for both domestic bank holding companies and FBOs that are covered by the rules. The Final Rules demonstrate the Federal Reserve’s continued insistence on
the importance of strong risk management and accountability for risk management oversight of senior management and the boards of directors of financial institutions.

By and large, the Final Rules do not differ in material respects from the Proposed Rules, although some adjustments around the edges have been made to address various comments on the Proposed Rules. The Final Rules make a notable change in the regulation of large foreign banks operating in the United States by subjecting them to a number of risk management requirements and, in the case of the FBOs with the largest U.S. operations, requiring an organizational structure that would allow them to be regulated in a manner that is substantially similar to the regulation of large U.S. bank holding companies. The most notable—and controversial—element of the Final Rules is the intermediate holding company requirement, which was adopted by the Federal Reserve without material changes in its substance other than to raise the threshold for its application from $10 billion in U.S. assets to $50 billion. Commenters raised concerns about the implications of the intermediate holding company requirement for established U.S. regulatory principles of national treatment, suggesting that the intermediate holding company requirement could disrupt the global operations of covered FBOs and that it is at odds with prevailing principles of international cooperation on financial supervision matters. The Federal Reserve, however, was only modestly swayed by these arguments and agreed only to raise the dollar threshold for the application of the intermediate holding company requirement.

Although the intermediate holding company requirement now will apply only to a small number of FBOs, all of the affected FBOs, by definition, have large U.S. operations, and all also are very large, globally active banks. As a consequence, the impact of the new requirement on aggregate foreign banking operations in the United States may be considerable. Besides requiring affected FBOs to maintain substantial regulatory capital in the United States, the intermediate holding company requirements will affect the corporate governance, risk management, funding, and liquidity management activities of covered FBOs. Also, while the intermediate holding company framework does exclude U.S. branch and agency assets, the movement of large amounts of FBO operations or assets to a branch or agency in order to avoid this requirement is probably not realistic in many cases, given the fact that U.S. branches and agencies of FBOs are significantly more constrained in the activities in which they may engage, in contrast to the materially greater activity flexibility enjoyed by nonbank subsidiaries of these FBOs under U.S. financial services laws. In addition, the new regulatory focus on applying separate and extensive U.S. regulatory and prudential requirements to FBO activities may be viewed by international supervisors as protectionist in nature and as a departure from accepted norms of international cooperation on financial regulatory matters, thus potentially compromising ongoing multilateral cooperative efforts in financial services supervision.

There is little question that the Final Rules will increase the risk management and governance requirements and costs of large U.S. banking organizations, as well as the 140-odd FBOs that have U.S. operations and meet or exceed the asset thresholds in the Final Rules. Apart from the intermediate holding company requirements that apply to FBOs with large U.S. operations, the risk committee, stress testing (albeit already largely in effect at the present time), risk management oversight, and liquidity requirements will result in a number of necessary organizational, reporting, and governance/oversight changes and may result in changes in funding, liquidity management, and asset/liability management activities as the Final Rules come into effect. That said, the downstream effects of the Final Rules are not likely to become evident for some time.

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Volcker Rule Action Plan and Model Board Documents: *The Conformance and Compliance Effort Begins*

The recently issued final rules implementing section 619 of the Dodd-Frank Act (the “Volcker Rule”) start the clock on banking entities’ efforts to comply with the Volcker Rule’s prohibition on short-term proprietary trading in securities or derivatives and limitation on relationships with “covered funds.” Both prohibitions are subject to detailed and highly technical exceptions spelled out in the Volcker Rule and the final implementing rules. Banking entities should now turn their attention to the process of conforming investments and activities to the basic prohibitions and limitations of the Volcker Rule and establishing required governance structures and compliance programs.

The final implementing rules become effective on April 1, 2014. The Federal Reserve Board has extended the period for banking entities to conform their investments and activities until July 21, 2015. New activities and investments should be conformed from the present, and proprietary trading activities should be promptly brought into conformity with the final implementing rules, well ahead of the 2015 conformity date. Certain banking entities with substantial trading assets and liabilities will be required to report quantitative measurements for trading activities beginning on June 30, 2014.

**Attached is a Volcker Rule Action Plan and a series of model corporate documents for use in planning Volcker Rule conformance efforts.** Like the Volcker Rule obligations themselves, the Action Plan and model corporate documents should be adapted based on a banking entity’s size and the scope and nature of its activities.

**The Volcker Rule Requires Tailored Compliance Programs**

In addition to the basic prohibitions and limitation requirements, the final implementing rules impose a series of corporate governance, compliance and control programs, recordkeeping, regulatory reporting, training, and audit requirements on almost all banking entities.

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entities. These requirements become more stringent and detailed for larger banking organizations, and as the scope and complexity of a banking organization’s covered activities increases, as follows:

- **Tier 1: No Compliance Program.** If a banking entity has no investments in covered funds, and does not engage in proprietary trading (other than in domestic government obligations), it is not required to have a Volcker Rule compliance program. It would only be required to implement such a program before it engages in any covered activities. As a matter of best practices, however, even the smallest banking entity should implement some sort of control infrastructure to prevent it from wandering into restricted territory.

- **Tier 2: Limited Compliance Program.** The new regulations provide that banking entities with total consolidated assets of US$10 billion or less may satisfy the compliance program requirements by including in their existing compliance and control policies and procedures appropriate provisions referencing the Volcker Rule and its final implementing rules. Even smaller institutions with significant covered fund or proprietary trading activities may want to implement more robust Volcker Rule compliance and control programs.

- **Tier 3: General Compliance Program.** Banking entities with more than US$10 billion in consolidated assets will be required to implement a separate Volcker Rule compliance and control program to ensure and monitor compliance. The regulations require that programs must, at a minimum, include written policies and procedures, internal controls to monitor activities and prevent violations, a framework to delineate management responsibility and accountability, independent testing and audit of the compliance program, training, and recordkeeping.

- **Tier 4: Enhanced Compliance Program.** Where a banking entity has total consolidated assets of US$50 billion or more, or is subject to the reporting obligations for significant trading discussed below, or is directed by regulators, it will be subject to the most detailed and stringent compliance program requirements. In general, these requirements expand upon those specified for the general program (e.g., internal controls, training, management frameworks, etc.). For example, the CEO of a banking entity that falls under this program requirement will have to attest annually in writing to regulators as to the maintenance of an appropriate compliance program.

During the regulatory conformance period, the Volcker Rule essentially requires banking entities, as part of the process of conforming existing activities and investments and building a compliance program, to map out existing trading and covered funds activities and investments, the trading desks, business units and legal entities in which they are conducted, and the personnel responsible for them. These activities and investments must be compared to the requirements of the Volcker Rule, a gap analysis performed to determine whether the existing activities and investments meet the Volcker Rule’s requirements and what aspects are in non-conformity, and a plan developed to conform, terminate or divest them within the conformance period.

The Volcker Rule requires board oversight of the rule’s compliance effort. Generally, this includes assignment to a board committee of oversight responsibility, designation of specific management officials by the board to conduct those trading and covered fund activities subject to the restrictions of the Volcker Rule, designation of a compliance officer for Volcker Rule activities, and a reporting line for management and reporting personnel to periodically provide updates to the board or a board committee regarding the compliance effort. For the largest banking organizations (those with US$50 billion or more in consolidated assets) and others notified by regulators, the Volcker Rule also requires CEO attestation of the existence and effectiveness of compliance and control programs.

The attached documents include:

- **The Volcker Rule Action Plan:** This summary document contains simple checklists for board and management actions, measuring and mapping proprietary trading activities and covered fund relationships, conforming activities and investments, and developing and implementing a compliance and control program.


Model Board Policy for Compliance with the Volcker Rule: The model board policy sets out appropriate governance structures; directs senior management to, among other things, develop risk management requirements, internal controls, and documentation for proprietary trading activities and investments in covered funds; provides standards for the remediation of violations, independent testing, training, and recordkeeping; and directs senior management to develop a conformance plan and report on its progress against the plan. A separate management-level set of written compliance procedures will also be required.

Model Board Resolutions Implementing the Volcker Rule Compliance Program: The model board resolutions establish a Volcker Rule Committee of the board, adopt a committee charter, and designate managers and compliance officers responsible for conducting and revising the banking entity’s Volcker Rule-related activities.

Model Volcker Rule Committee Charter: The model committee charter creates a committee of the board to assist in fulfilling the board’s oversight and monitoring obligations under the Volcker Rule.

Each banking entity should conduct a comprehensive and tailored review its investments or activities and determine the scope of the appropriate compliance program.

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Volcker Rule Action Plan

Timing:
Effective date of implementing rules: April 1, 2014.
Compliance program in place in part by April 1, 2014;
Reporting on proprietary trading phased in by size from June 30, 2014 through Dec. 31, 2016;
Compliance/conformity date for investments and activities: July 21, 2015.

Board actions:
Adopt board-level policies.
Designate oversight board committee.
Designate compliance officer.
Assign responsibility to specific senior management/reporting lines.
Require periodic reporting to committee.
Adopt timeline for implementation.

Management actions:
Prepare proposal for board consideration.
Assign staff and specific responsibilities.
Develop implementation plan and timeline.
Determine which level of compliance program required and timeline required by rule.
Measure & map, conform activities, develop and implement compliance & control program.
Report periodically to board committee on progress.
CEO attestation on compliance program.

Proprietary trading module:

Measure and Map

Map out where proprietary trading occurs within organization, by whom, what instruments, how frequently, in what amounts, in what accounts, for what purposes.

Compare activity to exclusions and exemptions:
- Buy and hold/not short-term trading or arbitrage;
- Exempted instruments (govis, munis, FX, etc.);
- Assets and instruments that are not “securities,” swaps, options or other derivatives (such as bank deposits, non-variable insurance contracts that are not derivatives, physical precious metals and currencies, loans, real estate);
- Issuance and repurchase by banking entity of its own securities;
- Cash management;
- Bona fide risk-mitigating hedging;
- Dealing and underwriting book at regulated dealer entities within defined limits to meet customer needs;
- Insurance company accounts;
- Offshore trading (foreign organizations only);
- Customer accounts (fiduciary, custody, advisory, etc.);
- Pension plans of banking entity and its clients.
Volcker Rule Action Plan

Report to board on current status and what needs to be changed on what timeline.

Conform

Develop plan to conform, terminate or divest trading activities.

- Compare map of all business units and activities that are engaged in short-term trading or arbitrage to exemptions and identify what needs to change.
- Demarcate and separate permitted cash management activities, define permitted cash investments, maturities, portfolio duration, risk and strategy (keeping also in mind 12 CFR Part 1, and LCR rule requirements) and conduct through separate accounts.
- Demarcate and separate permitted U.S. government and agency securities and municipal government securities investment and trading activities from other trading and investment activities. Define permitted investments, maturities, portfolio duration, risk and strategy and conduct through separate accounts.
- Define permitted risk-reducing hedging activities, set strategy, permitted instruments, metrics, tracking to hedged asset, controls, business units and assets hedged (note that diversification is not considered “hedging” for this purpose).
- Define permitted dealing and underwriting activities and positions in regulated dealer units, define and conform book size, holding periods and position limits, compensation program for traders.
- Review, define and conform permitted FX, interest rate swaps, contracts and trading.
- Review loan portfolio for anything that might be a “security” and conform as necessary.
- Review, define and conform “buy and hold” investment positions, separate from trading accounts and arbitrage activities. Establish system to monitor and detect any short-term trading.
- Figure out what is left, and determine whether and how to conform or terminate it.

Implement controls and measurements.

Assign timelines, specific responsibilities, internal reporting for conforming activities.

Report to board on progress and status of conforming activities.

Develop and Implement Compliance and Control Program

Development and implementation of compliance program for proprietary trading:

- Determine what level and type of compliance program required by rules based on size of organization and nature and extent of proprietary trading;
- Develop timelines, assign specific responsibilities, internal reporting for developing and implementing compliance program;
- Develop written compliance program;
- Written description of management responsibilities and management systems;
- Develop record-keeping system;
- Develop management information system;
Volcker Rule Action Plan

- Develop system for internal compliance reporting;
- Develop system for regulatory compliance reporting;
- Develop quantitative risk measurement systems—
  - 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;
- If applicable, develop “Appendix B” programs—
  - Trading desk policies and procedures
  - Description of risks and risk-management procedures
  - Limits and internal controls on risks, instruments and products
  - Hedging policies and procedures
  - Enhanced analysis and quantitative measurements
  - Other compliance requirements;
- Develop system of internal controls;
- Assign internal audit team/retain external testing group to test compliance;
- Develop internal audit program;
- Develop risk management policies, procedures and controls, position limits, etc.;
- Develop conflicts of interest policies, procedures and controls;
- Develop compliance training program;
- Develop formal compliance and approval process for approving new investment and trading activities and changes to activities; and
- CEO attestation as to compliance program.

Implement compliance and control programs.

Report to board on progress in developing and implementing compliance and control program.

Periodic independent testing of compliance program.

Periodically review and update compliance and control programs.

Covered funds module:

Measure and Map

Look carefully at:
- Private investment funds sponsored or advised by banking entity or provided to clients;
- Securitization vehicles in which banking entity invests as principal;
- Securitization vehicles sponsored, used or serviced by banking entity;
Volcker Rule Action Plan

- All principal investments in BOLI, CRA/SBIC, leveraged leasing structures, loan and other asset participations, interests in lease and loan pools, CLOs, CDOs, TruPs, tax-credit partnerships, two-tiered real estate structures, private REITs, private equity, venture capital, hedge funds and other investment funds or privately-placed structured investments or pools;
- Anything that has a private placement memorandum, or that is offered in a private placement, 144A transaction, is restricted as to transfer, is limited to 100 or fewer beneficial owners, or that mentions Sections 3(c)(1) or 3(c)(7) of Investment Company Act, “qualified purchasers” or “qualified institutional buyers”; and
- What business units involved in investing in, sponsoring or servicing private investment funds.

Develop list of covered funds–
- In which the banking entity is an investor as principal (along with measure against 3%/3% test);
- For which the banking entity is a “sponsor”;
- To which the banking entity provides advisory or other services;
- With which the banking entity does business as a principal; or
- That are “controlled” by the banking entity (as defined in BHC Act).

Document exclusions from being a “covered fund” and exemptions for sponsorship of, servicing or investment in covered funds.

Determine options for:
- Disposing of or decreasing investments as principal;
- Eliminating sponsorship (e.g., change fund name, restructure so not a trustee, general partner, managing member and not in control of board, no guarantee of fund);
- Eliminating “control” of covered fund by banking entity.

Consider options for restructuring covered funds into something else (e.g., registration under Investment Company Act, business development company, common trust fund, conforming asset securitization, etc.).

Consider options for fitting fund relationships within an exemption for “sponsorship” or investment (fiduciary fund exemption, SBIC/CRA fund exemption, securitization exemption, hedging, BOLI insurance exemption) and map requirements of exemption against current structure.

What changes would be required to conform the fund? What approvals needed from other investors and service providers? What are steps/timeframe to accomplish changes?

Evaluate accounting treatment of principal positions that cannot be conformed (available for sale?).

Analyze servicing relationships for conformity to affiliate transaction restrictions of Volcker Rule–
Volcker Rule Action Plan

- No guarantees;
- No direct or indirect extensions of credit or other 23A “covered transactions” with covered funds;
- 23B conformity/not less favorable to banking entity than arms’ length terms;
- No investment as principal (except within narrow limits permitted by rules);
- No purchases of assets.

Analyze risk exposures and conflicts of interests involving covered funds and banking entity.

Calculate and model projected capital haircuts for retained investments in covered funds.

Report to board on current status and what needs to be changed on what timeline.

Conform

Change name of covered funds to eliminate any similarity to name of banking entity or use of word “bank”.

Restructure and conform covered fund structures and relationships to permitted relationships.

Divest or redeem principal investments in covered funds to permitted limits.

If cannot be divested or conformed, consider seeking time extension from Federal Reserve.

Implement steps to reduce or eliminate risk exposures and conflicts of interest.

Update disclosure documents of covered funds (and/or send supplemental disclosures to existing investors) to include Volcker Rule items.

Update Form PF, Form D, Form 99, Form ADV Schedule D and Part 2, and other filings of funds to conform to name and other changes to covered funds.

Report to board on progress and status of conforming activities.

Develop and Implement Compliance and Control Program

Development and implementation of compliance program for covered funds activities:

- Determine what level and type of compliance program required by rules based on size of organization and nature and extent of covered funds activities;
- Develop timelines, assign specific responsibilities, internal reporting for developing and implementing compliance program;
- Implement process for identifying and documenting covered funds and exemptions, business units involved in covered funds activities and their permitted activities;
- Develop written compliance program;
- Description of compliance program meeting “Appendix B” requirements;
Volcker Rule Action Plan

- Valuation/pricing program and requirements;
- Written description of management responsibilities and management systems;
- Program for monitoring/limiting investments as principal in covered funds;
- Program for monitoring/limiting aggregate investments in SBICs, CRA, historic tax credit funds;
- Program for disclosures to investors in covered funds;
- Program for monitoring/compliance with covered transaction restrictions;
- Develop record-keeping system;
- Develop management information system;
- Develop system for internal compliance reporting;
- Develop system for regulatory compliance reporting;
- Develop system of internal controls;
- Assign internal audit team/retain external testing group to test compliance;
- Develop internal audit program;
- Develop risk identification and management policies, procedures and controls;
- Develop conflicts of interest policies, procedures and controls;
- Develop compliance training program;
- Develop formal compliance and approval process for approving new fund relationships, modification of existing fund relationships; and
- CEO attestation as to compliance program.

Implement compliance and control programs.

Report to board on progress in developing and implementing compliance and control program.

Periodic independent testing of compliance program.

Periodically review and update compliance and control programs.
The board of directors ("Board") is responsible for oversight of the Bank’s establishment, maintenance, and enforcement of a compliance and control program for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the Bank Holding Company Act (together with the implementing regulations, the “Volcker Rule”).

The implementing regulations become effective on April 1, 2014. The Federal Reserve Board has extended the conformance period until July 21, 2015, but the Bank will be required to report quantitative measurements for its trading activities beginning on June 30, 2014.

The Board adopts this policy to ensure that the Bank complies with the Volcker Rule. Management of the Bank shall prepare and implement a detailed program of control and compliance regarding “proprietary trading” and “covered funds” activities consistent with the requirements of the Volcker Rule and principles of safe and sound banking.

I. General Governance Matters

A. Establishment of and Delegation to the Board’s Volcker Rule Committee

The Board has established a Volcker Rule Committee and delegated the responsibility for overseeing the Bank’s compliance with the Volcker Rule to its Volcker Rule Committee. The Volcker Rule Committee must review and approve the Bank’s Volcker Rule compliance program prepared by senior management and any update to it. The Volcker Rule Committee shall receive and review reports from senior management relating to the compliance program and take necessary action.

B. Compliance Program

The Board directs senior management of the Bank to establish a compliance and control program for ensuring and monitoring compliance with the Volcker Rule before [December 31, 2014], except that senior management must ensure that the Bank will be able to report quantitative measurements for its trading activities beginning on June 30, 2014. The compliance program shall be designed to meet the requirements of the Volcker Rule, including the requirements of Subpart D of the implementing regulations and the enhanced standards in Appendix B to the implementing regulations. A summary of these requirements, which represents the Board’s expectation for the minimum breadth of the compliance program, is set forth below as part of this policy.

Senior management shall review and update the compliance program as necessary, but at least annually. If the business activities of the Bank that are subject to the Volcker Rule change materially, the compliance program must be updated accordingly.

Senior management shall report to the Volcker Rule Committee on the implementation of the compliance program at least monthly through July, 2015, and thereafter quarterly or more
frequently if required by the compliance program (for example, in connection with remediation of violations).

C. Assignment of Responsibility

Senior management is responsible for implementing the compliance and control program. Under the implementing regulations, the Chief Executive Officer of the Bank is required to attest in writing to the [Agency], annually, that the Bank has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule.

For each trading desk and each organizational unit engaged in covered fund activities and investments, senior management shall appoint a manager who is responsible for implementing the compliance program with respect to the trading desk or organizational unit.

Senior management shall maintain a schedule that sets out, by name and title, (a) each senior executive officer who is responsible for the enterprise-wide implementation of the compliance program, (b) each manager who is responsible for the implementation of the compliance program at each trading desk or organizational unit engaged in covered fund activities and investments, and (c) a clear reporting line showing a chain of responsibility.

The Volcker Rule Committee shall designate senior executive officers to be responsible for the enterprise-wide implementation of the compliance program. The performance review and compensation of any such senior executive officer shall take into account the officer’s effectiveness in implementing the compliance program and ensuring compliance with the Volcker Rule.

Senior management shall establish a compensation structure that provides appropriate incentives for implementing the compliance program. The performance review and compensation of each manager responsible for implementing the compliance program at each trading desk and each organizational unit engaged in covered fund activities and investments shall take into account the manager’s effectiveness in implementing the compliance program and ensuring compliance with the Volcker Rule. Compensation arrangements for traders engaged in underwriting or market making-related activities or risk-mitigating hedging activities shall not reward or incentivize prohibited proprietary trading, or encourage excessive or imprudent risk-taking and shall instead conform to the requirements of the implementing rules.

II. Proprietary Trading Module of the Compliance Program

A. Risk Management Processes

The risk management processes shall include the following elements:
1. The reporting line for managing the risks of trading activity, including processes for initial and senior-level review of new products and new strategies;
2. The process for using models in managing the risks of trading activity and related positions, including periodic independent testing of the reliability and accuracy of the models;
3. The process for establishing and reviewing limits for each trading desk;
4. The management review process, including escalation procedures, for approving any temporary exceptions or permanent adjustments to limits for each trading desk; and
5. The process for the audit, compliance, and risk management functions to conduct independent testing of trading and hedging activities, techniques, and strategies.

B. Policies and Procedures for Each Trading Desk

Written policies and procedures governing each trading desk shall include:
1. The process for identifying, authorizing, and documenting financial instruments the trading desk may trade, with separate documentation for market making-related activities and for risk-mitigating hedging activities;
2. Mapping the trading desk to the division, business line, or other organizational structure that is responsible for managing and overseeing the trading desk’s activities;
3. The type of trading activity (e.g., market making or trading in sovereign debt) and strategy of the trading desk;
4. The activities that the trading desk is authorized to conduct, including (i) authorized instruments and products, and (ii) authorized hedging strategies, techniques, and instruments;
5. Limits on the types and amount of risks the trading desk may incur;
6. Description of how the risks will be measured;
7. Discussion on why the permitted levels of risks are appropriate to the activities authorized for the trading desk;
8. Limits on the holding period of, and the risk associated with, financial instruments under the responsibility of the trading desk;
9. The process for setting new or revised limits, as well as escalation procedures for granting exceptions to any limits or to any policies or procedures governing the desk, the required analysis to support revising limits or granting exceptions, and the process for independently reviewing and documenting those exceptions and the underlying analysis;
10. The process for introducing new products, trading strategies, and hedging strategies;
11. The type of clients, customers, and counterparties with whom the trading desk may trade; and
12. The compensation arrangements, including incentive compensation, which shall be designed not to reward or incentivize prohibited proprietary trading or excessive or imprudent risk-taking.

C. Hedging Policies and Procedures

Written policies and procedures for the use of risk-mitigating hedging instruments and strategies shall describe:
1. The positions, techniques, and strategies that each trading desk may use to hedge the risk of its positions;
2. How the Bank will identify risks and determine that those risks have been properly and effectively hedged;
3. The level of the organization at which hedging activity and management will occur;
4. Who will monitor hedging strategies and how;
5. The risk management processes for controlling unhedged or residual risks; and
6. How each trading desk and the Bank as a whole engages in hedging in reliance on the exemption for risk-mitigating hedging activities.

D. **Internal Controls for Authorized Risks, Instruments, and Products**

Internal controls shall monitor and enforce limits on:
1. The financial instruments (by type and exposure) that each trading desk may trade;
2. The types and levels of risks that each trading desk may take; and
3. The types of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged.

E. **Analysis and Quantitative Measurements**

Analysis and quantitative measurements shall be tailored to the particular risks, activities, and strategies of each trading desk. They shall include:
1. Quantitative measurements for each trading desk, including:
   a. Risk and position limits and usage;
   b. Risk factor sensitivities;
   c. Value-at-Risk and Stress VaR;
   d. Comprehensive Profit and Loss Attribution;
   e. Inventory Turnover;
   f. Inventory Aging; and
   g. Customer-Facing Trade Ratio; and
2. Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;
3. Ongoing, timely monitoring and review of calculated quantitative measurements;
4. Numerical thresholds for each trading desk and heightened review of trading activity not consistent with the thresholds, including related analysis, escalation procedures, and documentation; and
5. Immediate review and investigation of the trading desk’s activities, escalation to senior management with oversight responsibilities for the trading desk, timely notification to the regulator, appropriate remedial action, and documentation of the investigation findings and remedial action taken, in the event of a finding of a reasonable likelihood that the trading desk violated the Volcker Rule.

F. **Liquidity Management Plan**

To distinguish between trading for liquidity management purposes and prohibited proprietary trading, the Bank shall maintain a written liquidity management plan that:
1. Sets out the securities authorized for liquidity management, limits on the amount, types, and risks of those securities, and the liquidity circumstances in which the securities may or must be traded;
2. Requires trading in securities under the plan be principally for the purpose of liquidity management;
3. Requires that the securities traded be highly liquid and their market, credit, and other risks not give rise to appreciable profits or losses as a result of short-term price movements;
4. Limits trading for liquidity management purposes to an amount that is consistent with the Bank’s near-term funding needs; and
5. Includes written policies and procedures, internal controls, analysis, and independent testing.

G. Overall Compliance Requirements

The compliance program shall:

1. Identify activities of each trading desk that will be conducted in reliance on exemptions from the prohibitions on proprietary trading, including an explanation of:
   a. How and where in the Bank the activity occurs, and
   b. Which exemption is being relied on and how the activity meets the specific requirements for reliance on the exemption.
2. Establish policies for monitoring and preventing material conflicts of interest between the Bank and its clients, customers, or counterparties.
3. Describe how the Bank monitors for and prohibits material exposure to high-risk assets or high-risk trading strategies presented by each trading desk that relies on an exemption from the prohibitions on proprietary trading.

III. Covered Fund Activities or Investments Module of the Compliance Program

A. Identification of Covered Funds

The compliance program shall include a process for identifying and documenting covered funds that each organizational unit invests in, sponsors, or organizes and offers. The documentation shall identify the exemption or exclusion under which the Bank is permitted to invest in or sponsor each covered fund under the Volcker Rule.

B. Identification of Covered Fund Activities and Investments

The compliance program shall identify each organizational unit that is permitted to invest in or sponsor any covered fund and map each such unit to the division, business line, or other organizational structure that is responsible for managing and overseeing that unit’s activities and investments.
C. Documentation of Covered Fund Activities and Investments

For each organizational unit engaged in covered fund activities and investments, the compliance program shall document:
1. The covered fund activities and investments that the unit is authorized to conduct;
2. The Bank’s plan for actively seeking unaffiliated investors to ensure that any investment by the Bank conforms to the investment limits or that the fund becomes registered under the securities laws and thereby exempt from the limits within the required period; and
3. How the unit complies with the requirements of the Volcker Rule.

D. Overall Compliance Requirements

The compliance program shall include processes and safeguards with respect to the Bank’s covered fund activities and investments to prevent:
1. Material conflicts of interest between the Bank and its clients, customers, or counterparties;
2. Any threat to the safety and soundness of the Bank; and
3. Material exposure to high-risk assets or high-risk trading strategies.

E. Internal Controls

The Bank shall establish internal controls that:
1. Monitor and limit the Bank’s individual and aggregate investments in covered funds;
2. Monitor the amount and timing of seed capital investments, and the effectiveness of efforts to seek unaffiliated investors;
3. Monitor required disclosures to prospective and actual investors in any covered fund sponsored by the Bank;
4. Monitor for and prevent any relationship or transaction between the Bank and a covered fund that is prohibited under the Volcker Rule; and
5. Require appropriate management review and supervision on an enterprise-wide basis to ensure that services and products provided by all affiliated entities comply with the limitations of the Volcker Rule.

IV. Remediation of Violations

The compliance program shall provide for remediation of violations. The program shall:
1. Effectively monitor and identify for further analysis any trading activity, or covered fund activity or investment, that may indicate potential violations;
2. Establish procedures for identifying and remedying violations, including a requirement to promptly document and remedy any violation and document all proposed and actual remediation efforts;
3. Include specific written policies and procedures reasonably designed to assess the extent to which any activity or investment indicates that modification to the Bank’s
compliance program is warranted and to ensure that appropriate modifications are implemented; and
4. Provide for prompt notification to appropriate management, including senior management and the Board’s Volcker Rule Committee, any material weakness or significant deficiencies in the design or implementation of the compliance program.

V. Independent Testing

The compliance program shall provide for independent testing at least annually. The independent testing shall be conducted by either the internal audit department or outside auditors. It shall include an evaluation of:
1. The overall adequacy and effectiveness of the Bank’s compliance program;
2. The effectiveness of the Bank’s internal controls; and
3. The effectiveness of the Bank’s management processes.

VI. Training

The compliance program shall include an appropriate training program.

VII. Recordkeeping

The compliance program shall include appropriate recordkeeping requirements and procedures, consistent with the requirements of the implementing regulations and Appendix A to the implementing regulations.

VIII. Conforming Existing Activities and Investments

Senior management shall proceed to promptly identify, map and document existing trading and covered funds activities; develop and present to the Volcker Rule Committee a plan to conform or terminate those existing trading and covered funds activities on or before July 21, 2015 consistent with the requirements of the Volcker Rule; and periodically report to the Volcker Rule Committee on progress in implementing that plan. The conformance plan shall include a process for demarcating and carrying on permitted trading activities (such as cash management, government securities and municipal securities trading) separately from buy-and-hold investment activities through different accounts. To the extent any activities or investments are determined not to be able to be conformed or divested on or before July 21, 2015, senior management shall promptly report to the Volcker Rule Committee. If an application for an extension is necessary, it should be submitted to the Federal Reserve no later than January 20, 2015 and must be submitted no later than April 21, 2015.
[FORM OF BOARD OF DIRECTORS RESOLUTIONS TO IMPLEMENT VOLCKER RULE GOVERNANCE PROGRAM]

The members of the Board of Directors (the “Board”) of ______________ (the “Bank”), present in person or by telephone at a meeting of the Board held on _______, 2014, at which a quorum was present and acting throughout, hereby adopt the following Resolutions:

WHEREAS, on December 10, 2013 the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission adopted final rules (the “Final Rules”) implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Section 619,” and, together with the Final Rules, as they may be amended from time to time, the “Volcker Rule”); and

WHEREAS, the Final Rules become effective on April 1, 2014 and require that banking entities, including the Bank, develop and implement a compliance program reasonably designed to ensure and monitor compliance with the prohibitions on proprietary trading and covered fund activities and investments set forth in the Volcker Rule; and

WHEREAS, the Bank is required to conform all activities and investments to the requirements of the Volcker Rule by July 21, 2015 (the “Conformance Date”) and to commence reporting on its covered trading activities beginning on [Date] (the “Initial Reporting Date”); and

WHEREAS, the Board has determined that it is in the best interests of the Bank to establish a comprehensive program for compliance with the Volcker Rule, commensurate with the type, size and scope of the Bank’s activities, including, without limitation, ongoing Board oversight, the adoption of appropriate policies and procedures and the implementation of those policies and procedures by Bank Management (the “Volcker Rule Compliance Program”); and

WHEREAS, the Board, in furtherance of these objectives, has reviewed the Volcker Rule Committee Charter attached to these Resolutions as Annex A and the Board Policy for Compliance with the Volcker Rule (the “Board Policy”) attached to these Resolutions as Annex B; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby establishes a Board “Volcker Rule Committee,” to be initially composed of ___________, __________, and __________, and thereafter of at least three members of the Board chosen by the full Board from time to time, to serve at the discretion of the full Board and until such time as their successors shall be appointed; provided, that, in order for a director to be eligible to serve on the Committee, he or she must be “independent” as that term is defined in the Volcker Rule Committee Charter; and

BE IT FURTHER RESOLVED, that the Volcker Rule Committee shall have the primary responsibility, subject to review and ratification or adjustment by the full Board, for oversight of the Bank’s compliance activities, in accordance with the terms of the Volcker Rule Committee Charter; and
BE IT FURTHER RESOLVED, that the Volcker Rule Committee Charter is hereby approved and adopted in the form attached to these Resolutions; and

BE IT FURTHER RESOLVED, that the Board hereby establishes the position of Chief Volcker Rule Compliance Officer (the “Chief Compliance Officer”), who shall supervise Bank officers and employees tasked with maintaining Bank Compliance with the Volcker Rule and hereby appoints __________ as the Chief Compliance Officer; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall serve at the pleasure of the Board and until a successor is appointed by the Board and shall report directly to the Volcker Rule Committee and be available to report to the full Board when and as required; and

BE IT FURTHER RESOLVED, that __________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the “Proprietary Trading Officer,” and shall oversee the operations of the Bank’s proprietary trading activities; and

BE IT FURTHER RESOLVED, that __________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the “Covered Funds Officer,” and shall oversee the operations of the Bank’s covered funds activities; and

BE IT FURTHER RESOLVED, that the Proprietary Trading Officer and the Covered Funds Officer shall each report directly to the Bank’s Chief Executive Officer with respect to the operations under his or her supervision and shall consult from time to time with the Chief Compliance Officer as appropriate with regards to the implementation and effectiveness of the Volcker Rule Compliance Program as it relates to such operations; and

BE IT FURTHER RESOLVED, that __________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the “Volcker Rule Audit Officer,” and shall oversee any internal audit and testing activities undertaking to assess the Bank’s ongoing compliance with the Volcker Rule Compliance Program; and

BE IT FURTHER RESOLVED, that the Volcker Rule Audit Officer shall report directly to [insert whichever officer has oversight responsibility for the internal audit function] and shall consult from time to time with the Chief Compliance Officer as appropriate with regards to the implementation and effectiveness of the Volcker Rule Compliance Program as assessed through and internal audit or testing; and

BE IT FURTHER RESOLVED, that the Board Policy is hereby approved and adopted in the form attached to these Resolutions; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer is hereby authorized and directed to work with Bank Management, Bank employees and third parties, including outside counsel and consultants, to develop the Volcker Rule Compliance Program in accordance with the Board Policy and satisfying the applicable requirements of the Volcker Rule, as summarized in the Board Policy; and
BE IT FURTHER RESOLVED, that without limiting in any way its scope, the Volcker Rule Compliance Program shall address:

- The preparation of appropriate written policies and procedures;
- Internal controls for monitoring compliance and preventing prohibited activities and investments;
- A management framework that clearly delineates responsibility and accountability for compliance;
- Independent testing and audit of effectiveness of the compliance program;
- Training personnel as necessary or appropriate to assure effective implementation and enforcement of the compliance program; and
- Record keeping sufficient to demonstrate compliance; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall report to the Volcker Rule Committee or a designee thereof on the progress of implementation of the Volcker Rule Compliance Program not less frequently than monthly through the Conformance Date, and thereafter not less frequently than quarterly (and more often as the Volcker Rule Committee shall deem necessary or appropriate), with copies of any materials relating to such implementation to be promptly provided to the full Board; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall be available to respond to questions from members of the Volcker Rule Committee or the full Board in a timely manner; and

BE IT FURTHER RESOLVED, that not later than _____________, 2014, the Chief Compliance Officer shall deliver to the Volcker Rule Committee a detailed schedule of timing and responsibility for full implementation of the Volcker Rule Compliance Program, including, without limitation, (1) the preparation of all written policies and procedures, and all other documentation necessary or appropriate for the Program; (2) full implementation of the conformance of all activities and investments to the requirements of the Volcker Rule by the Conformance Date; (3) full implementation of all required reporting of covered trading activities by the Initial Reporting Date; and (4) full compliance with any other requirements of the Volcker Rule that may become effective prior to the Conformance Date on or before such earlier date; and

BE IT FURTHER RESOLVED, that the Bank, the Board, the Volcker Rule Committee and the Chief Compliance Officer shall take all necessary and appropriate actions to ensure full and timely implementation of the Volcker Rule Compliance Program; and
BE IT FURTHER RESOLVED, that the proper officers of the Bank are authorized in the name and on behalf of the Bank, to take or cause to be taken all such further actions and to execute and deliver or cause to be executed and delivered all such further agreements, documents, certificates, applications, filings and undertakings and to incur all such fees and expenses as in their judgment shall be necessary, appropriate or convenient to carry into effect the purpose and intent of any and all of the foregoing resolutions; and

BE IT FURTHER RESOLVED, that the proper officers of the Bank for purposes of the foregoing resolutions are, and shall be, _____________________.


Purpose

The Volcker Rule Committee (the “Committee”) of the Board of Directors (“Board”) of [Bank], is established to assist the Board in fulfilling its oversight responsibilities regarding compliance with Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Section 619”) and the final rules adopted by the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission to implement Section 619 (the “Final Rules”) (the Final Rules, as they may be amended from time to time, together with Section 619, constituting the “Volcker Rule”).

Membership

The Committee shall be comprised of at least [three] directors, all of whom shall be “independent” directors (as defined herein), who will serve as “Committee Members” (see Appendix A). Committee Members shall be appointed by the Board. The Bank’s [_________________] shall serve as the Committee Secretary. The Board shall determine each Committee Member’s independence at least annually.

To be considered independent, a director must be free of any relationship that would render the director beholden to the Bank, its affiliates or their management. Generally, a director will not be considered independent if such director:

- Is, or has been within the preceding three years, an officer, employee or consultant of the Bank or an affiliate.

- Is, or has been within the preceding three years, a member of the immediate family of a current officer or employee of the Bank or an affiliate.

- Is an executive officer, partner or affiliate, or directly or indirectly owns or controls (or has directly or indirectly owned or controlled within the preceding three years) assets representing 10 percent or more of any outstanding class of voting securities, of an institution that has a significant commercial, legal, consulting, advisory or charitable relationship with the Bank or an affiliate.

- Has a material relationship which, in the opinion of the Board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a committee member.
Meetings

The Committee shall meet at not less frequently than monthly through July 21, 2015 (the date by which the Bank is required to conform all activities and investments to the requirements of the Volcker Rule), and thereafter not less frequently than quarterly, and more frequently as the Committee shall deem necessary or appropriate. The Committee shall meet at a time and place determined by the Committee Chair, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its Chair. Members of the Committee may participate in a meeting of the Committee by means of conference call or a similar communication method by means of which all persons participating in the meeting can hear each other.

A majority of the members of the Committee shall constitute a quorum. All matters to be determined by the Committee shall be determined by a majority vote of the members present at a meeting at which a quorum is present. In the event of a tie vote on any matter, the Chair’s vote shall determine the matter. The Committee Chair shall be a member that is nominated by the Chief Executive Officer (“CEO”) of the Bank and approved by the Committee.

The Committee shall meet periodically with the Chief Volcker Rule Compliance Officer (the “Chief Compliance Officer”) and the CEO and such other members of Bank Management as it deems appropriate, in combined or separate sessions, and have such other direct and independent interaction with such persons from time to time, as the members of the Committee deem appropriate.

Resources and Cooperation

The Committee shall have the authority to meet with and seek any information it requires from employees, officers or directors of the Bank or any of its affiliates and may also retain legal counsel or other independent consultants, as it deems appropriate, to facilitate the discharge of the Committee’s responsibilities. The Committee is empowered to conduct its own investigations into issues related to its responsibilities.

The Bank shall provide for appropriate funding, as determined by the Committee, for payment of compensation to any consultants or advisors retained by the Committee and for administrative expenses of the Committee.

Responsibilities and Duties

The Committee shall assist the Board in fulfilling oversight responsibilities with respect to corporate-wide satisfaction of Volcker Rule compliance requirements. In particular, the Committee shall:
1. Oversee and monitor the Bank’s and affiliates’ Volcker Rule Compliance Program (the “Compliance Program”) and maintenance of required policies and procedures, which shall include:

   o The systems, controls, policies, procedures and processes designed to ensure that the Bank complies with the requirements of the Volcker Rule and prevent the occurrence of prohibited activities or investments.

   o A system of internal controls reasonably designed to monitor compliance with the Volcker Rule.

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

   o Independent testing and audit of the effectiveness of the compliance program, conducted periodically.

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

   o Appropriate record-keeping and periodic reporting requirements consistent with the standards laid out in the Final Rules.

   o Regular reporting by the Bank’s management, including the Chief Compliance Officer, to the Committee, and, as appropriate, the Board, regarding the status of the Bank’s compliance efforts.

2. Recommend to the Board the appointment of the Chief Compliance Officer.

3. Oversee the activities of the Chief Compliance Officer, who shall have a reporting line to the Committee.

4. Assess with Management, the Chief Compliance Officer, and with legal or other advisors, the Bank’s compliance with the Volcker Rule, and any significant legal and regulatory exposures or concerns identified with respect to Volcker Rule compliance.

5. Regularly report to the Board regarding the Committee’s activities, including its assessment of the adequacy of the Bank’s Volcker Rule compliance, including applicable policies and procedures and Management’s effectiveness in the execution thereof.
6. Oversee and monitor the ongoing effectiveness of communications with Federal agencies engaged in any Volcker Rule compliance review or examination of the Bank. The Committee shall receive regular reporting by Management and the Chief Compliance Officer regarding communications with such government agencies, including providing to the Committee copies of all written communications to and from such agencies.

7. Oversee and monitor Management’s compliance with the Volcker Rule, including any terms and conditions required from time to time by any action, formal or informal, of any federal regulatory agency, and oversee Management’s timely responses to any inquiries from any such agency, ensuring that the appropriate corrective and preventive actions have been implemented by Management.

8. Review and reassess the adequacy of this Charter at least annually and recommend any changes to the Board for approval.

9. Evaluate the Committee’s performance on an annual basis and establish criteria for such evaluation. The results of the annual evaluation will be discussed with the Board.

10. Oversee and monitor Management’s program and process for identifying, documenting and conforming, divesting or terminating existing proprietary trading and covered funds activities and investments as required by July 21, 2015.

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Appendix A

COMMITTEE COMPOSITION