The Volcker Rule: Community Bank Applicability

This document provides an overview of the final inter-Agency regulation implementing the Volcker Rule provision of the Dodd-Frank Act (Final Rule) as it applies to banking entities with less than $10 billion in total consolidated assets. The vast majority of these community banks have little or no involvement in prohibited proprietary trading or investment activities in covered funds. Accordingly, community banks do not have any compliance obligations under the Final Rule if they do not engage in any covered activities other than trading in certain government, agency, State or municipal obligations. The Final Rule is designed to place minimal burden on community banks given the nature of their activities.

Proprietary Trading

The Final Rule places limits on the trading activity of insured depository institutions (except for certain limited purpose trust companies) and entities affiliated with a depository institution and provides a number of exceptions. Trading activity includes any purchase or sale as principal of any security, derivative, commodity future, or option on any such instrument for the purpose of benefitting from short-term price movements or realizing short-term profits.

Few community banks engage in trading activity of the types covered by the Final Rule. Most community banks that engage in trading limit their activity to US government, agency and/or municipal obligations that are specifically **exempted** from the prohibition on proprietary trading. As such, community banks may continue these trading activities. Moreover, if a community bank's existing policies and procedures already restrict its trading activities to these instruments, it would not need to revise its internal compliance programs. Specifically, the types of obligations that are exempt from the trading restrictions in the Final Rule include the following:

- US Treasuries: Obligations of, or guaranteed by, the U.S Government;
- GSE Agencies: Obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution;
- Municipals: Obligations of any State or of any political subdivision thereof (e.g., municipal obligations);
- FDIC: Obligations of the FDIC, or any entity formed by, or on behalf of, the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's corporate, receiver, or conservator capacity.

The Final Rule also contains a number of other exceptions for trading activities, including:

- as agent, broker or custodian;
- through a deferred compensation or pension plan;
- as trustee or in a fiduciary capacity on behalf of customers;

- to satisfy a debt previously contracted;
- repurchase and securities lending agreements; and
- risk-mitigating hedging activities.

Community banks that manage their liquidity through trading activities covered by the Final Rule may need to adopt an appropriate liquidity management plan. Many community banks already comply with the Final Rule as their existing policies and procedures contain elements necessary to qualify them as *bona fide* liquidity management plans. Under the Final Rule, a *bona fide* liquidity management plan:

- specifically authorizes the particular securities;
- specifies securities are principally for the purpose of managing liquidity;
- requires securities to be highly liquid;
- does not give rise to other risks or appreciable profits as a result of short term price movements;
- is limited to an amount that is consistent with near-term funding needs; and
- includes written policies and procedures, internal controls, analysis and independent testing that are consistent with existing supervisory requirements, guidance and expectations.

Covered Funds

The Final Rule prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund ("covered funds") unless an exception applies. Only a few community banks actually sponsor or invest in covered funds. A covered fund generally includes an issuer that would be an investment company under the Investment Company Act of 1940 but for two-widely used exemptions under sections 3(c)(1) or 3(c)(7) of that Act. These exemptions are generally available to privately offered companies whose securities are beneficially owned by 100 or fewer persons or owned exclusively by qualified purchasers.

The Final Rule recognizes that many of the types of entities that rely on these exemptions are not engaged in the types of investment activities typically conducted by hedge funds or private equity funds In particular, the following types of entities are not considered "covered funds" under the Final Rule:

- wholly owned subsidiaries;
- joint ventures and acquisition vehicles;
- foreign pension or retirement funds;
- insurance company separate accounts (including bank-owned life insurance);
- public welfare investment funds; and
- any entity formed by, or on behalf of, the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's corporate, conservatorship, or receivership capacity.

Also exempt from the definition of a covered fund is any issuer of securities backed entirely by loans subject to certain asset restrictions. Accordingly, covered funds do not generally include securitizations such as Residential Mortgage Backed Securities (RMBS) (including GSE exposures), Commercial Mortgage Backed Securities (CMBS), auto securitizations, credit card securitizations, and commercial

paper backed by conforming asset-backed commercial paper conduits. Many community banks already have policies and procedures restricting their fund investments to these types of securitizations, and therefore they would not need to take any steps to comply with the prohibition. If a community bank holds investments in asset-backed securities that do not meet all of the restrictions of the exemption, the bank will have to divest them in accordance with the conformance period in the Final Rule.

Only a small number of community banks own collateralized loan obligations (CLOs)[1] or collateralized debt obligations (CDOs) (including CDOs backed by trust-preferred securities) that meet the definition of covered funds in the Final Rule. If a community bank did not organize and offer the particular covered fund (e.g., act as the securitizer or asset manager), the bank will have to divest in accordance with the conformance period in the Final Rule.[2]

Compliance Program Requirements

As a general matter, a community bank is exempt from all of the compliance program requirements under the Final Rule if it does not engage in any of the covered activities defined in the Final Rule other than trading in certain government, agency, State and municipal obligations[3]. For those community banks that do engage in one or more covered activities beyond trading in those types of obligations, the compliance program requirements can be met by simply including references to the relevant portions of the Final Rule within the community bank's existing policies and procedures to address just the activities that the community bank actually conducts.

To the extent that a community bank engages in activities that are subject to the Final Rule, an extended period (until July 21, 2015) has been granted to permit time for the bank to conform its activities and policies to the Final Rule.

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[1] Certain CLOs structures have a limited amount of underlying exposure that consists of securities and/or other non-loan assets. These CLO structures could be covered funds if the non-loan exposures are impermissible assets as described in section ___.10(c)(8)(ii) of the Final Rule. However, CLOs are allowed to divest of impermissible assets during the conformance period and avoid becoming a covered fund.

[2] If a community bank were to retain an ownership interest in a covered fund that it organized and offered, the Final Rule places a number of limitations on those ownership interests. In particular, the community bank (including all its affiliates) must limit its total interest in each covered fund to no more than 3 percent of the ownership interests issued by the covered fund, and to no more than 3 percent of the value of the entire covered fund. In addition, the aggregate of all interests the community bank (together with its affiliates) has in all covered funds may not exceed 3 percent of the community bank's tier 1 capital. Finally, the community bank must deduct the value of all its (and its affiliates') interests in covered funds and any retained earnings from its capital for purposes of applying the regulatory capital standards.

[3] A community bank that does not engage in any covered activity, but decides to do so in the future is only expected to adjust its existing policies and procedures to include appropriate references before it starts activities that are covered by the Final Rule.