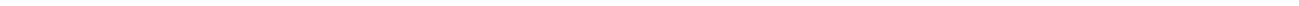


# Volcker Rule Interim Examination Procedures

Office of the Comptroller of the Currency

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# Contents

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<b>Volcker Rule Interim Examination Procedures.....</b>	<b>1</b>
Background.....	1
General Procedures .....	2
Proprietary Trading.....	7
Covered Funds .....	14
Conclusions.....	19
<b>Glossary .....</b>	<b>20</b>

# Volcker Rule Interim Examination Procedures

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## Background

In December 2013, the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), U.S. Securities and Exchange Commission (SEC), and U.S. Commodity Futures Trading Commission issued regulations implementing section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, commonly known as the Volcker Rule. Banks of all sizes are subject to the Volcker Rule; examiners should note, however, that compliance requirements under the regulations vary according to several factors, including the absolute size of a bank’s assets and the size of a bank’s trading assets and liabilities. Unless the Federal Reserve Board extends the conformance period, banks must conform their activities and investments to the regulations’ requirements by July 2015.<sup>1</sup>

The purpose of these interim examination procedures is to help examiners determine whether banks have business activities or investments that are subject to the regulations and, if so, to guide examiners in assessing plans that banks have developed and are implementing to comply with the regulations. During the conformance period, the OCC will augment these interim procedures with in-depth procedures that examiners should use to assess banks’ ongoing adherence to the regulations.

These procedures apply to examinations of national banks (other than certain limited-purpose trust banks), federal savings associations, and federal branches and agencies of foreign banks (collectively, banks). As noted in the procedures below, however, banks that do not have *ownership interest* in, *sponsor*, or have certain relationships with *covered funds* and limit their proprietary trading to *domestic government obligations* do not need to adopt compliance programs or report metrics and examiners do not need to conduct the additional procedures.

Throughout this document, unless otherwise specified, the term *regulations* refers to 12 CFR 44, the OCC’s implementation of the Volcker Rule. Italicized words are defined in the “Glossary” section, which follows the procedures.

These procedures present a simplified version of the regulations’ requirements. Examiners should consult 12 CFR 44 for additional details.

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<sup>1</sup> On April 7, 2014, the Federal Reserve Board issued a news release announcing its intent to exercise its authority to give banking entities two additional one-year extensions to conform their *ownership interests* in, and *sponsorship* of, certain collateralized loan obligations (CLO) to meet the Volcker Rule’s requirements. This extension moves the conformance date to July 21, 2017. Only CLOs owned as of December 31, 2013, that do not qualify for the exclusion in the final rule for *loan securitizations* would be eligible for the extension. See [“Statement Regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act”](#) (April 7, 2014).

## General Procedures

**Objective:** Assess the bank's progress toward identifying activities subject to the regulations.

**Background:** Except as the regulations permit, a bank may not engage in proprietary trading or acquire or retain an *ownership interest* in or *sponsor a covered fund*. See 12 CFR 44.3(a) and 12 CFR 44.10(a).

1. Assess the bank's progress toward identifying the *banking entities* that engage in activities subject to the regulations.
2. Assess the bank's progress toward identifying its proprietary trading.
  - The bank must identify purchases and sales of *financial instruments* for specified short-term purposes. See 12 CFR 44.3(a), (b), and (d).
    - These include
      - *trading positions* in *financial instruments* that are subject to the market risk capital rule or are hedges of other positions subject to the market risk capital rule. See 12 CFR 3, appendix B.
      - purchases and sales of *financial instruments* that are part of the bank's swaps-dealing business.
      - positions in *financial instruments* held for fewer than 60 days, unless the *banking entity* can demonstrate that it did not purchase (or sell) the *financial instruments* principally for (i) short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging a *trading position*. These positions in *financial instruments* also include basis trades in which a *banking entity* buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk) within 60 days.
    - These exclude
      - trades as an agent, broker, or custodian.
      - repurchase and reverse repurchase agreements.
      - securities borrowing and lending.
      - purchasing and selling securities for liquidity management in accordance with the bank's written liquidity management plan.
      - certain clearing activities.
      - trades to satisfy an existing delivery obligation.
      - trades as *trustee* for a pension plan of the bank.
      - trades in the ordinary course of collecting a debt previously contracted in good faith.
      - trades as required by a court, administrative agency, self-regulatory organization, or arbitrator.
  - The bank must identify the *trading desks* (the smallest discrete unit of organization) responsible for the short-term trading identified above. *Trading desks* may span multiple legal entities or geographic locations.

- For each *trading desk*, the bank must determine on which permitted activities the desk will rely to conduct its proprietary trading:
    - Trading in *domestic government obligations*.
    - Trading in foreign sovereign obligations.
    - Underwriting.
    - Market-making.
    - Risk-mitigating hedging.
3. Assess the bank’s progress toward identifying its *ownership interests in covered funds*.
- The bank must include *ownership interests* held
    - in the investment portfolio (held-to-maturity and available-for-sale).
    - in the trading book.
    - as part of the AM business (seed capital and “skin-in-the-game” capital).
    - other holdings on- or off-balance-sheet.
  - The bank need not include *ownership interests* held
    - as agent, broker, or custodian.
    - through a deferred compensation or similar plan of the entity.
    - in the ordinary course of collecting a debt previously contracted in good faith.
    - on behalf of customers as a *trustee* or in a similar fiduciary capacity.
  - The bank must determine whether asset-backed securities (ABS) are *ownership interests in covered funds*.
    - Assess the bank’s progress toward identifying holdings of ABS.
    - Obtain and evaluate the bank’s analysis regarding whether its ABS holdings qualify as *ownership interests in covered funds*.
    - Obtain and evaluate the bank’s analysis regarding whether the securitization’s special purpose vehicle (SPV) is a *covered fund*.
      - Securitization SPVs are, in general, *covered funds*. The most common ways in which they avoid being *covered funds* are
        - relying on Rule 3a-7 under the Investment Company Act (static securitization pools).
        - relying on section 3(c)(5)(C) of the Investment Company Act (real estate securitizations).
        - being *loan securitizations*.
        - being qualifying asset-backed commercial paper (ABCP) conduits.
    - Determine whether the bank has satisfied or is taking actions to meet the *covered fund* exclusion requirements for *loan securitizations*.
      - Securitizations that qualify for this exclusion may only have loans, related servicing assets, related interest rate or foreign exchange (FX) hedges, and special units of beneficial interest or collateral certificates.
      - Securitizations that contain assets other than loans and certain other permitted assets (e.g., collateralized debt obligations (CDO), municipal tender option bonds, collateralized loan obligations (CLO) with non-loan assets, and auction rate securities) do not qualify for the exclusion.

- Determine whether the bank’s holdings of CDO obligations backed primarily by trust preferred securities (TruPS) are on the list of permissible TruPS CDO investments or meet the qualifications for permissible TruPS CDOs.
4. Assess the bank’s progress toward identifying the *covered funds* that the bank *sponsors* or advises.
  5. Assess the bank’s progress toward identifying its *ownership interests* in and *sponsorships* of entities that rely on one of the regulations’ exclusions from the definition of *covered fund*. These issuers include
    - foreign public funds.
    - wholly owned subsidiaries.
    - joint ventures.
    - acquisition vehicles.
    - foreign pension or retirement funds.
    - insurance company separate accounts.
    - bank owned life insurance.
    - *loan securitizations*.
    - qualifying ABCP conduits.
    - qualifying covered bonds.
    - Small Business Investment Companies, public welfare investment funds, and historic tax credit funds.
    - SEC-registered investment companies, business development companies, and companies that may rely on an exemption or exclusion from “investment company” other than section 3(c)(1) or (7) of the Investment Company Act.
    - issuers in conjunction with the FDIC’s receivership or conservatorship.

**Objective:** Assess the bank’s progress toward establishing a compliance program.

**Background:** In addition to specific compliance obligations for each permitted activity, banks must satisfy certain compliance program requirements under the regulations. Banks must establish a compliance program as soon as practicable, but in no event later than the end of the conformance period.

1. Determine what type of compliance program is required. See 12 CFR 44.20.
  - **None:** Banks do not need a compliance program if they do not have an *ownership interest* in, *sponsor*, or have certain relationships with *covered funds* and limit their proprietary trading to *domestic government obligations*. No additional procedures need to be satisfied.
  - **Simplified compliance program:** Banks with total consolidated assets of \$10 billion or less must update existing compliance policies and procedures by including references to the requirements of the regulations as appropriate to their activities, size, scope, and complexity. See 12 CFR 44.20(f).

- Assess the bank’s progress in updating the relevant policies and procedures in a manner that is appropriate in light of the bank’s activities, size, scope, and complexity.
- **Standard compliance program:** Banks with total consolidated assets greater than \$10 billion and less than \$50 billion, unless they report metrics, must develop and administer the standard compliance program, which, at a minimum, must include six elements. See 12 CFR 44.20(b). Assess the bank’s progress toward
  - creating written policies and procedures to document, describe, monitor, and limit
    - permitted proprietary trading.
    - permitted *covered fund* activities.
  - establishing a system of internal controls to monitor compliance with the regulations.
  - establishing a management framework and governance structure that (i) clearly delineates responsibility and accountability for compliance with the regulations and (ii) includes appropriate management review of trading limits, strategies, hedging activities, investments, and incentive compensation.
  - creating a framework for having qualified persons of the bank or an outside party periodically conduct independent testing and audit of the effectiveness of the compliance program.
  - providing training for traders and managers to effectively implement and enforce the compliance program.
  - creating a system to document compliance with the regulations.
- **Enhanced compliance program:** Banks that report metrics or have total consolidated assets of \$50 billion or more must establish the enhanced compliance program. See 12 CFR 44.20(c) and (d) and 12 CFR 44, appendixes A and B. Appendix B to the regulations describes the enhanced compliance program. Overall, the enhanced program contains the six elements set forth in the standard compliance program but contains specific instructions for satisfying these elements. The enhanced program also requires additional documentation demonstrating the bank’s compliance with the regulations. Crucially, the enhanced compliance program must include annual independent testing by qualified personnel, likely internal auditors, and a chief executive officer attestation that the bank’s compliance program is reasonably designed to achieve compliance with the Volcker Rule and the regulations. See 12 CFR 44, appendix B.IV.
  - Assess the progress of internal audit in the process of making changes to its audit programs to address requirements under the regulations.
  - Determine whether the audit department plans to play a role in the chief executive officer attestation regarding the compliance program.
  - Assess any areas that internal audit has identified as concerns in the bank’s project plan.
- **Fund documentation:** Banks with total consolidated assets of \$10 billion or more must document for each fund the bank *sponsors* why the fund is not a *covered fund*. If applicable, assess the bank’s progress in developing required fund documentation.
  - This could be an Investment Company Act exclusion (other than section 3(c)(1) or (7)) or an exclusion in the regulations’ definition of *covered fund*.

- If the fund is relying on one of the following exclusions from the *covered fund* definition, the bank must document why it satisfies the terms of the exclusion: foreign public funds; foreign pension or retirement funds; *loan securitizations*; ABCP conduits; covered bonds; and seeding vehicles for a registered investment company or an SEC-regulated business development company.
2. Assess the bank's progress in developing a compliance program that appropriately incorporates the compliance obligations required for specific permitted activities (e.g., market-making, underwriting, risk-mitigating hedging, and *covered fund* permitted activities and investments).
  3. Assess the bank's progress toward reviewing and modifying, as necessary, its compensation arrangements to ensure that they do not reward or incentivize impermissible proprietary trading.
  4. Determine whether the bank is devoting sufficient resources and developing effective processes to have the required compliance program by the end of the conformance period.
  5. Assess whether audit and risk management have accounted for the Volcker Rule compliance risks in their risk assessments and review plans.

**Objective:** Assess the bank's plan for avoiding *material conflicts of interest* and material exposures to *high-risk assets* and *high-risk trading strategies*.

**Background:** The regulations prohibit any transaction, class of transactions, or activity that involves or results in a *material conflict of interest* between the bank and its clients or results, directly or indirectly, in a material exposure to *high-risk assets* or *high-risk trading strategies*. This prohibition applies to otherwise-permitted proprietary trading and *covered fund* activities and investments.

1. Assess the bank's plan for identifying and addressing *material conflicts of interest*. See 12 CFR 44.7(b) and 12 CFR 44.15(b).
  - Assess the bank's criteria for identifying *material conflicts of interest*.
  - Assess the bank's plan for addressing *material conflicts of interest* through timely and effective disclosure of the conflicts or reasonably designed information barriers.
2. Assess the bank's plan for avoiding material exposures to *high-risk assets* and *high-risk trading strategies*. See 12 CFR 44.7(c) and 12 CFR 44.15(c).
  - Assess the bank's criteria for identifying a *high-risk asset* or *high-risk trading strategy*.
  - Assess the bank's criteria for identifying a material exposure.

- The enhanced compliance program requires banks to take into account exposure to seven types of assets. See 12 CFR 44, appendix B.II.A, under the heading “Other Compliance Matters.”
3. Determine whether the bank is devoting sufficient resources and developing effective processes to identify and address *material conflicts of interest* and avoid material exposures to *high-risk assets* and *high-risk trading strategies*.

## Proprietary Trading

**Objective:** Assess the bank’s progress toward reporting metrics as and when required.

**Background:** Banks will compute and report, for each *trading desk*, at least seven metrics that help the bank and the OCC identify impermissible proprietary trading. See 12 CFR 44, appendix A. Many of these metrics are familiar to banks, but some require additional systems and processes (appendix A.III).

1. Determine whether the bank is subject to metrics reporting and, if so, when reporting begins. See 12 CFR 44.20(d)(iii)(2).
  - Banks with trading assets and liabilities of \$50 billion or more start collecting metrics on July 1, 2014. The first set of metrics is due on September 2, 2014, with subsequent metrics due within 30 days of the end of each reporting month. Beginning in January 2015, metrics are due within 10 days of the end of each reporting month.
  - Metrics reporting for banks with trading assets and liabilities of less than \$50 billion is not required until after the end of the conformance period in July 2015 and is therefore not addressed in these interim procedures.
  - Banks with trading assets and liabilities of less than \$10 billion are not subject to the metrics reporting requirement. For purposes of determining whether a bank must report metrics, its trading assets and liabilities equal the average gross sum over the four prior calendar quarters of its—and its affiliates’—trading assets and liabilities, excluding trading assets and liabilities involving obligations of or guaranteed by the United States or a U.S. agency. For purposes of determining whether a federal branch or agency must report metrics, its trading assets and liabilities equal the average gross sum of the trading assets and liabilities of its combined U.S. operations, including those of its affiliates, branches, and agencies operating, located, or organized in the United States, but excluding trading assets and liabilities involving obligations of or guaranteed by the United States or a U.S. agency.
2. Assess the bank’s progress toward identifying the *trading desks* that will compute and report metrics.
  - Determine how many *trading desks* will report metrics.
  - Determine whether the number of *trading desks* is reasonable.
    - Some banks may combine previously delineated *trading desks* into a single *trading desk*.

- That may be acceptable, provided the desks have similar strategies, the combination has a legitimate business purpose, and the combination allows the bank to more accurately reflect the positions and fluctuations of its proprietary trading.
- Multiple units with disparate strategies being combined into a single desk, however, could suggest a bank’s attempt to dilute the ability of the metrics to monitor proprietary trading. Relevant factors for identifying *trading desks* include whether the *trading desk* is managed and operated as an individual unit and whether the profit and loss of employees engaged in a particular activity is attributed at that level.

3. Assess the bank’s ability to calculate the required metrics.

- For the customer-facing trade ratio, determine how the bank will identify whether the counterparty is a *client, customer, or counterparty* (collectively, *customers*).
  - Systems need to record both the number and dollar amounts of transactions with *customers* and entities that are not *customers*.
  - This metric requires the bank to “tag” each trade as customer-facing or not. Inter-dealer trading typically does not count as customer-facing because a banking entity with trading assets and liabilities of \$50 billion<sup>2</sup> or more is not a *customer* unless the bank documents why it is appropriate to treat the counterparty as a customer. Trading conducted anonymously on an anonymous exchange or similar trading facility open to a broad range of market participants is customer-facing regardless of the counterparty.
- For the inventory turnover ratio and inventory aging, determine whether the bank’s systems can compute delta-adjusted notional value and 10-year bond equivalent values. (For options, value means delta-adjusted notional value; for other interest rate derivatives, value means 10-year bond equivalent value).
- For comprehensive profit and loss (P&L) attribution, determine whether bank systems can segregate P&L into the required three categories:
  - P&L associated with the *trading desk’s* existing positions (i.e., those held at the end of the prior day) and reflecting changes in value on the day. P&L must be further attributed as applicable to changes in market risk factors and any other applicable elements—such as cash flows, carry, changes in reserves, or trade amendments, cancellation, or exercise.
  - P&L associated with new positions (i.e., executed during the day) including commissions, fee income and expenses, and market gains or losses. P&L from new positions may be reported in aggregate and does not need to be further attributed.
  - Residual P&L that cannot be explained by existing and new positions.
- For value-at-risk (VaR) and stress VaR, determine whether the bank can compute these metrics for each *trading desk*.

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<sup>2</sup> For this purpose, calculate a bank’s trading assets and liabilities in the same way as for determining whether the bank must report metrics.

- Determine whether the bank's systems can report risk sensitivities on a sufficiently granular basis to account for a preponderance of the expected price variation in the *trading desk's* holdings.
  - For risk and position limits, if the bank uses, or plans to use, criteria other than VaR or risk factor sensitivities to define risk and position limits (e.g., net open positions), determine whether the bank reports (or plans to report) both the value of the risk and position limits and the variables used to determine whether these limits have been breached.
  - Determine whether the bank has concluded that risk factor sensitivities and VaR and stress VaR are demonstrably ineffective for measuring and monitoring the risks of the *trading desk*. When this is the case, the bank does not have to set limits using those particular metrics or sensitivities, but it must report those sensitivities or limits.
    - If the bank has made such a conclusion, assess its reasonableness. For example, if a *trading desk* does not use a VaR limit, ensure that the bank documents why using that limit would be ineffective.
4. Assess the bank's control framework and governance program to ensure that reported metrics across all *trading desks* capture all of the bank's trading risk from underwriting, market-making-related activities, risk-mitigating hedging, and trading in *domestic government obligations* or foreign government obligations.

**Objective:** Assess the bank's progress toward using the metrics to monitor for impermissible proprietary trading.

**Background:** Some metrics might prove more useful than others; the agencies plan to review the data collected and revise this collection requirement, as appropriate, based on a review of data collected before September 30, 2015. A successful beta test requires ensuring data integrity and comparability so the OCC may glean insight from the metrics. See 12 CFR 44, appendix A.I.

1. Assess the bank's progress toward ensuring that its metrics reports are meaningful.
  - Determine whether the bank consistently applies, across its *trading desks*, methodologies for calculating sensitivities to a common factor shared by multiple *trading desks* (e.g., an equity price factor) so that these sensitivities can be compared across *trading desks*.
  - Evaluate the bank's quality control efforts to ensure the data are meaningful.
  - Determine whether the bank produces, or plans to produce, other quantitative measurements to identify impermissible proprietary trading. The regulations note that the bank may need to develop its own metrics, in addition to the required metrics, to effectively monitor its covered trading activities for compliance.
  - Determine how the bank plans to monitor, review, and evaluate all required metrics, as well as any others it chooses to maintain compliance with the regulations.

2. Assess the bank’s policy and practice for escalating to its governing body and the OCC, for further review, measurement results that indicate a heightened risk of impermissible proprietary trading, along with analysis and explanation.
3. Assess the bank’s policy for reviewing activities and positions whose metrics indicate a heightened risk of impermissible proprietary trading.

**Objective:** Assess the bank’s progress toward identifying its market-making-related activities, *market-maker inventory*, and reasonably expected near-term demand (*RENTD*).

**Background:** Banks must begin measuring demand for their market-making services because a market-making desk must ensure that its *market-maker inventory* is designed not to exceed *RENTD*. Banks must also develop systems to separately measure—so they can separately manage—each desk’s *market-maker inventory* and overall *financial exposure*. See 12 CFR 44.4(b).

1. Assess the bank’s progress toward identifying its *trading desks* that engage in market-making-related activities (market-making desks). A market-making desk must
  - routinely stand ready to purchase or sell one or more *financial instruments* related to its *financial exposure*.
  - routinely stand ready to enter into long and short positions in those types of *financial instruments*
    - for its own account.
    - in commercially reasonable amounts.
    - throughout market cycles.
    - on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of *financial instruments*.
2. Assess the bank’s progress toward documenting, for each market-making desk, the securities, derivatives, and futures in which the desk makes a market.
  - Determine whether the bank documents the *ownership interests* in *covered funds* in which the desk makes a market, if relevant.
3. Assess the bank’s progress toward developing the capability to separately identify, monitor, and manage each market-making desk’s
  - *market-maker inventory*.
  - *financial exposure*.
  - *RENTD*.
  - *financial instruments* that contribute to its *financial exposure* but are not included in *market-maker inventory*. (Generally speaking, these instruments will be used to manage the risks of the desk’s *market-maker inventory* and *financial exposure*.)

4. Assess the bank's progress toward developing a process for measuring and documenting *RENTD* for each market-making desk.
  - Assess the bank's understanding of the factors on which *RENTD* will be based:
    - The liquidity, maturity, and depth of the market for the relevant types of *financial instruments*.
    - Demonstrable analysis of historical customer demand, current inventory of *financial instruments*, and market and other factors regarding the amount, types, and risks of or associated with *financial instruments* in which the *trading desk* makes a market, including through block trades.
  - Assess the bank's understanding of the composition of each market-making desk's clients, customers, or counterparties.

**Objective:** Assess the bank's progress toward establishing a compliance program for permitted market-making-related activities.

**Background:** The compliance program specific to market-making requires detailed desk mandates and limits for each desk's inventory and *financial exposure*, based on risk appetite and *RENTD*.

1. Assess the bank's progress toward establishing and implementing an internal compliance program. The program must be reasonably designed to ensure compliance with the requirements of the regulations governing market-making activities. The program must also include reasonably designed written policies and procedures, internal controls, analysis, and independent testing that identifies and addresses
  - limits for each market-making desk, based on the nature and amount of the desk's market-making-related activities, including the *RENTD* of clients, customers, or counterparties, on the
    - amount, types, and risks of its *market-maker inventory*.
    - amount, types, and risks of the products, instruments, and exposures the *trading desk* may use for risk management purposes.
    - level of exposures to relevant risk factors arising from its *financial exposure*.
    - period of time each type of *financial instrument* may be held.
  - *financial instruments* each market-making desk stands ready to purchase and sell.
  - products, instruments, and exposures each market-making desk may use for risk management purposes.
  - actions the *trading desk* will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its *financial exposure* consistent with its required limits.
  - techniques and strategies each market-making desk may use to manage the risks of its market-making-related activities and inventory.
  - process, strategies, and personnel responsible for ensuring that actions taken by the market-making desk to mitigate these risks are and continue to be effective.

2. Assess the quality of internal controls and ongoing monitoring and analysis of each *trading desk's* compliance with its limits.
3. Assess the bank's progress toward developing authorization procedures, including escalation procedures, that require review and approval of any trade that would exceed a *trading desk's* limit(s). These procedures must
  - include demonstrable analysis that the basis for any temporary or permanent increase to a *trading desk's* limit(s) is consistent with the requirements of approved market-making activities.
  - include independent review of such demonstrable analysis and approval.
  - require that the *trading desk* take action to bring the *trading desk* into compliance with the limits as promptly as possible after the limit is exceeded.
4. Determine whether the bank is licensed or registered in accordance with applicable law to engage in market-making activity.

**Objective:** Assess the bank's progress toward establishing a compliance program for its underwriting activity.

**Background:** The compliance program specific to underwriting requires detailed desk mandates and limits for each desk's underwriting position, based on the nature and amount of the desk's underwriting activities and *RENTD*. See 12 CFR 44.4(a).

1. Assess the bank's progress toward establishing and implementing an internal compliance program that is reasonably designed to ensure the bank's compliance with the requirements of the regulations governing underwriting activities, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing that identifies and addresses
  - products, instruments, or exposures each *trading desk* may purchase, sell, or manage as part of its underwriting activities.
  - limits for each *trading desk*, based on the nature and amount of the *trading desk's* underwriting activities, including the *RENTD* of clients, customers, or counterparties, on the
    - amount, types, and risk of its underwriting position.
    - level of exposures to relevant risk factors arising from its underwriting position.
    - period of time a security may be held.
  - internal controls and ongoing monitoring and analysis of each *trading desk's* compliance with its limits.
  - authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a *trading desk's* limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a *trading desk's* limit(s), and independent review of such demonstrable analysis and approval.

2. Assess the bank's understanding of the composition of each *trading desk's* clients, customers, or counterparties.
3. Assess the bank's progress toward developing a process for measuring and documenting *RENTD* for each underwriting desk.
4. Determine whether the bank is licensed or registered in accordance with applicable law to engage in the bank's underwriting activity.

**Objective:** Assess the bank's progress toward establishing a compliance program for its risk-mitigating hedging activity and satisfying the regulations' documentation requirements.

**Background:** Not all hedges rely on the risk-mitigating hedging permitted activity. For example, hedging that occurs as part of market-making-related activity is covered by the market-making permitted activity. Trades that rely on the risk-mitigating hedging permitted activity are likely to be short-term derivatives that involve multiple *trading desks* or legal entities. See 12 CFR 44.5.

1. Assess the bank's progress toward developing written policies and procedures regarding the positions, techniques, and strategies that it may use for risk-mitigating hedging.
  - These policies must list what positions, contracts, or other holdings a *trading desk* may use in its risk-mitigating hedging.
  - These policies must document the procedures used to establish position and aging limits.
2. Assess the bank's progress toward developing procedures and controls to continuously review, monitor, and manage risk-mitigating hedging activity to ensure that the bank meets the requirements of the risk-mitigating hedging exemption. Note that under the regulations the risk-mitigating hedging activity cannot be designed to
  - reduce risks associated with
    - the bank's assets or liabilities generally.
    - general market movements or broad economic conditions.
  - profit in the case of a general economic downturn.
  - counterbalance revenue declines generally.
  - arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the bank.
3. Assess the bank's progress toward developing policies and procedures for satisfying the documentation requirements. See 12 CFR 44.5(c).
  - For risk-mitigating hedges established
    - by a unit of the bank other than the one which holds the actual underlying hedged risk,

- using a *financial instrument*, exposure, technique, or strategy that is not identified in the specific *trading desk's* written policies and procedures, or
- to hedge aggregated positions across two or more *trading desks*, the documentation must identify the
  - specific, identifiable risk(s) being hedged.
  - specific risk-mitigating strategy that is being fulfilled by the hedge.
  - *trading desk* or other business unit that established and is responsible for the hedge.
- Assess the bank's progress toward developing systems and processes to create and retain the hedging documentation for at least five years and in a manner that allows the bank to produce promptly those records to the OCC.

## Covered Funds

**Objective:** Assess the bank's plan for conforming asset management (AM) and *sponsorship* activities.

**Background:** Subject to conditions, a bank may acquire or retain an *ownership interest* in, *sponsor*, or organize and offer a *covered fund* as part of its trust, fiduciary, or investment advisory business. See 12 CFR 44.11(a). Among other conditions, a bank that serves as the investment manager, investment adviser, or *sponsor* to a *covered fund*, or that organizes and offers a *covered fund*, may not enter into a *covered transaction* (as defined in section 23A of the Federal Reserve Act) with the fund. Certain exceptions apply. A bank must also engage in all transactions with a *covered fund* on market terms in accordance with section 23B of the Federal Reserve Act.

1. Assess the bank's progress toward identifying the *covered funds* that the bank organizes and offers to investors as part of providing trust, fiduciary, or investment advisory services (AM funds). For each AM fund, assess the bank's progress toward creating a written plan outlining how the bank intends to organize and offer the fund through its trust, fiduciary, or investment advisory services.
2. Assess the bank's progress toward identifying AM funds that share the same name or a variation of the same name with the bank or an affiliate of the bank, or have "bank" in their names. Assess the bank's plan for changing these names.
3. Assess the bank's progress toward identifying employee and director investments in AM funds. Assess the bank's plan for determining the permissibility of these investments and for redeeming impermissible employee and director investments in these funds. (Employees and directors may only have investments that they made while they were directly providing investment advisory or other services to the fund.) Assess the bank's plan for preventing impermissible employee and director investments.
4. Assess the bank's plan for providing the required written disclosures in a clear and conspicuous manner to prospective and actual investors in the AM fund that, among other

disclosures, informs the investors that they—and not the bank—bear any losses in the fund beyond the bank’s permitted investment in the fund.

5. Assess the bank’s progress toward identifying transactions between the bank and AM funds for which the bank is the investment manager, investment adviser, *sponsor*, or organizer and offeror.
  - Assess the bank’s plan for unwinding *covered transactions* between the bank and AM funds. (In certain cases, a bank may enter into *prime brokerage transactions* with a *covered fund* that the bank indirectly owns through a *covered fund* that the bank manages, *sponsors*, or advises.)
  - Assess the bank’s plan for ensuring that all transactions between the bank and AM funds are on arm’s-length terms pursuant to section 23B of the Federal Reserve Act.
  - Assess the bank’s plan for ensuring that future transactions with AM funds are not *covered transactions* and are on arm’s-length terms.
  - Assess the bank’s plans for ensuring that the bank does not guarantee the performance of or bail out an AM fund.
6. Determine whether the bank is devoting sufficient resources and developing effective processes to be compliant by the end of the conformance period.

**Objective:** Assess the bank’s plan for conforming securitization activities involving a securitization vehicle that is a *covered fund*.

**Background:** Banks may organize and offer securitizations on the same terms as they may permissibly offer *covered funds* to their trust, fiduciary, and investment advisory clients, except that securitizations need not be part of the bank’s trust, fiduciary, or investment advisory services. See 12 CFR 44.11(b).

1. Assess the bank’s progress toward identifying securitizations in which the securitization vehicle is a *covered fund* and (i) for which the bank was the securitizer under the risk retention rule (once finalized) or (ii) in which the bank acquired or retained an *ownership interest* as the risk retention rule requires.<sup>3</sup>
2. Of these securitizations, assess the bank’s progress toward identifying securitization vehicles that share the bank’s name, have a variation of the bank’s name, or have “bank” in their names. Assess the bank’s plan for changing these names.
3. Assess the bank’s progress toward identifying employee and director investments in these securitizations. Determine whether these investments are permissible and assess the bank’s plan for redeeming impermissible employee and director investments in these funds. (Employees and directors may only have investments that they made while they

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<sup>3</sup> See 15 USC 78o-11.

were directly providing investment advisory or other services to the fund.) Assess the bank's plan for preventing impermissible employee and director investments.

4. Assess the bank's progress toward identifying the bank's plan for providing the required written disclosures in a clear and conspicuous manner to prospective and actual securitization investors that, among other disclosures, informs the investors that they—and not the bank—will bear any losses in the securitization beyond the bank's permitted investment in the securitization.
5. Assess the bank's progress toward identifying transactions between the bank and the securitization vehicles for which the bank is the investment manager, investment adviser, *sponsor*, or securitizer, or in which the bank retains an *ownership interest* as required by the risk retention rule.
  - Assess the bank's plan for unwinding *covered transactions* between the bank and these securitization vehicles.
  - Assess the bank's plan for ensuring that all transactions between the bank and these securitization vehicles are on arm's-length terms, pursuant to section 23B of the Federal Reserve Act.
  - Assess the bank's plan for ensuring that future transactions with these securitization vehicles are not *covered transactions* and are on arm's-length terms.
  - Assess the bank's plans for ensuring that the bank does not guarantee the performance of or bail out a securitization that the bank *sponsors* or organizes and offers.
6. Determine whether the bank is devoting sufficient resources and developing effective processes to be compliant by the end of the conformance period.

**Objective:** Assess the bank's plan for conforming underwriting and market-making activities in *covered funds*.

**Background:** A bank may hold an *ownership interest* in a *covered fund* as part of its underwriting activities or market-making-related activities. See 12 CFR 44.11(c).

1. Assess the bank's progress toward identifying the underwriting and market-making-related activities involving *covered funds*.
2. Assess the bank's plan for ensuring that the bank conducts those activities in accordance with the proprietary trading underwriting or market-making requirements under the regulations.
3. Determine whether the bank is devoting sufficient resources and developing effective processes to be compliant by the end of the conformance period.

**Objective:** Assess the bank’s progress in ensuring compliance with the de minimis ownership limits on investments in *covered funds* relevant to the permitted AM, securitization, underwriting, and market-making activities.

**Background:** Under a permitted activity, a bank may own no more than 3 percent of any individual *covered fund*. In the aggregate, a bank’s investments in all *covered funds* may not exceed 3 percent of the bank’s tier 1 capital. See 12 CFR 44.12.

1. Assess the bank’s progress toward developing the capability to test for compliance with the 3 percent limits quarterly.
  - The relevant systems must incorporate the regulations’ attribution rules:
    - Affiliates’ investments are attributed to the bank—but mutual funds, business development companies, and *covered funds* are **not** deemed affiliates in this context if, among other things, the bank does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or the fund. See 12 CFR 44.12(b)(1)(ii).
    - Employees’ and directors’ investments in bank-sponsored *covered funds* are attributed to the bank if the bank financed the investment.
    - Multi-tier fund structures (e.g., master-feeder and fund of funds) have special attribution rules.
  - The relevant systems must identify the securitization transactions for which the bank is the “securitizer” under the risk retention rule. The bank may own up to 5 percent of these securitizations, if required under the risk retention rule.
  - The relevant systems must capture *ownership interests* in *covered funds* related to the bank’s
    - underwriting.
    - market-making-related activities.
    - organizing and offering of AM funds.
    - organizing and offering of securitizations.
  
2. Assess the bank’s plan for deducting its *ownership interests* in *covered funds* from its capital.
  
3. Determine whether the bank’s records are sufficient to test for compliance with the 3 percent limits quarterly.
  - Determine whether the bank’s records reflect both the fair value and historical (cost) value of each *covered fund* investment.
    - The bank must use fair value to calculate the value of its investments for the individual fund limit (unless fair value cannot be determined) and historical cost to calculate the value of its investments for the aggregate limit.
  - Determine whether the bank documents the date of establishment of each *covered fund* that it organizes and offers to unaffiliated investors.

- The 3 percent limits do not apply for one year from the date the fund manager began executing the fund’s written investment strategy. The bank may ask the Federal Reserve Board to extend this period for up to two years.
- 4. Assess the bank’s plans for satisfying the de minimis limits, including identifying *ownership interests* that exceed the 3 percent per fund and 3 percent aggregate limits.
- 5. Determine whether the bank is devoting sufficient resources and developing effective processes to be compliant by the end of the conformance period.

**Objective:** Assess the bank’s plan for conforming hedging activities using *covered funds*.

**Background:** Using *covered funds* to hedge is permitted only to hedge compensation obligations toward an employee who provides investment advisory or other services to a *covered fund*. For example, subject to conditions, a bank may invest in a *covered fund* as a hedge for compensation obligations to the fund manager based on the value of the fund. See 12 CFR 44.13(a).

1. Assess the bank’s progress toward identifying investments in *covered funds* that the bank keeps as hedges for compensation arrangements.
2. Assess the bank’s plan for
  - establishing the policies, procedures, internal controls, and ongoing monitoring that the regulations require for hedging with *covered funds*.
  - documenting that these investments are risk-mitigating hedges of the compensation obligation.
  - documenting that these investments do not create significant new unhedged risk.

**Objective:** Assess the bank’s plan for divesting nonconforming investments in *covered funds*.

**Background:** Unless the Federal Reserve extends the conformance period, banks must conform their investments in *covered funds* by July 2015. See 12 CFR 225.181.<sup>4</sup>

1. Assess the bank’s plan for identifying any illiquid investments for which it plans to seek a special five-year conformance period extension.
  - Assess whether the bank has identified illiquid investments that qualify for consideration for an extension of the conformance period by being “contractually committed to principally invest.”

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<sup>4</sup> As noted in footnote 1, the Federal Reserve Board intends to extend, through July 2017, the conformance period for CLOs that banks owned as of December 31, 2013.

2. Assess the bank's plan for conforming illiquid investments that are not eligible for the five-year extension.
3. Assess the bank's plan for conforming ABS investments.
  - Assess the bank's plan for identifying ABS issued by securitization vehicles that can rely on an exclusion from the Investment Company Act other than section 3(c)(1) or (7).
  - Assess the bank's analysis of other securitization vehicles that could, if modified, rely on an exclusion other than section 3(c)(1) or (7). Assess the bank's plan to advocate for any such modifications and the likelihood of the securitization *sponsor* agreeing.
4. Assess the bank's plan for conforming other *covered fund* investments.
5. Determine whether the bank has engaged its accountants to advise on the accounting consequences of different divestiture options.
6. Determine whether the bank is devoting sufficient resources and developing effective processes to be compliant by the end of the conformance period.

## Conclusions

**Objective:** Assess the bank's overall progress in taking the necessary actions to meet the requirements of the regulations within the conformance period.

**Background:** Except as the regulations permit, banks may not engage in proprietary trading, acquire or retain an *ownership interest* in a *covered fund*, or *sponsor* a *covered fund*. See 12 CFR 44.3(a) and 12 CFR 44.10(a). Banks need to meet specific compliance obligations for each permitted activity and develop an overarching compliance program.

1. Assess the bank's progress in identifying the banking entities that engage in activity subject to the regulations.
2. Assess the bank's progress in identifying its proprietary trading activities and work plans for meeting compliance and reporting requirements.
3. Assess the bank's progress in identifying its *covered funds* activities and work plans for meeting compliance and reporting requirements.
4. Assess the bank's progress in developing a compliance program as required.
5. Identify potentially significant gaps in the bank's efforts to conform its activities and investments to the regulations. If there are any gaps, take appropriate remedial action, considering the significance of the gap, the remaining conformance period, the bank's efforts, and other relevant factors.

# Glossary

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## ***Banking entity***

- Any insured depository institution, except for nondepository trust companies described in section 2(c)(2)(D) of the Bank Holding Company Act.
- Any company that controls an insured depository institution.
- Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 USC 3106).
- Any affiliate or subsidiary of any entity described above, except for a
  - *covered fund*.
  - portfolio company held under Bank Holding Company Act merchant banking or insurance company investment authorities.
  - portfolio concern controlled by a small business investment company.

## ***Covered fund***

This term has a broad initial definition and there are long lists of exclusions found in the regulations, the Investment Company Act of 1940, and the act's rules. To start with, a *covered fund* is

- an issuer that would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or (7) of the act.
- a commodity pool for which the commodity pool operator has claimed an exemption from registration under 17 CFR 4.7.
- a commodity pool operated by a registered commodity pool operator whose participation units are owned by "qualified eligible persons" (institutional investors) and have not been offered publicly to other persons.
- a fund not offered or sold in the United States that is or holds itself out as being an entity or arrangement that raises money from investors primarily for the purpose of investing in or trading securities.

Sections 3(c)(1) and (7) of the act's exemptions are available to companies that invest in or trade securities that privately offer securities beneficially owned by no more than 100 accredited investors or that are owned exclusively by qualified purchasers. The commodity pool tests cover similar companies that trade in futures, swaps, or options. These exemptions are commonly used by hedge funds and private equity funds but also by many other types of private issuers, such as CDOs, CLOs, re-REMICs (re-securitized real estate mortgage investment conduits), municipal tender option bonds, securities lending cash collateral reinvestment vehicles, pass-through real estate investment trusts, venture capital funds, credit funds, and employee securities companies.

***Covered transaction***

This term is defined in section 23A of the Federal Reserve Act to include loans, extensions of credit, repurchase agreements, asset purchases, guarantees, letters of credit, securities lending, and derivatives.

***Client, customer, or counterparty***

In the context of market-making, these terms refer to the market participants that use the bank's market-making-related services by obtaining those services, responding to quotations, or entering into a continuing relationship with respect to those services. Another *banking entity* is not a *client, customer, or counterparty* unless the

- other *banking entity* has trading assets and liabilities of less than \$50 billion;
- bank conducts the transaction anonymously on an exchange or similar trading facility that permits trading on behalf of broad range of market participants; or
- bank documents how and why the other *banking entity* should be treated as a *client, customer, or counterparty*.

In the context of underwriting, these terms refer to market participants that may transact with the bank in connection with a particular securities distribution for which the bank is acting as underwriter.

***Domestic government obligation***

These include the following (but not their derivatives):

- An obligation of, or issued or guaranteed by, the United States.
- An obligation, participation, or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 USC 2001 et seq.).
- An obligation of any state or any political subdivision thereof, including any municipal security; or
- An obligation of the FDIC or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act.

***Financial exposure***

This refers to the aggregate risks, managed by a particular *trading desk* as part of its market-making-related activities, of one or more *financial instruments* and their associated loans, commodities, and foreign exchange (FX) or currency.

***Financial instrument***

This is a security, future, or derivative. Loans, spot FX or currency, and spot commodities are not *financial instruments*. See 12 CFR 44.3(c).

***High-risk asset***

This means an asset or group of related assets that would, if held, significantly increase the likelihood that the bank would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

***High-risk trading strategy***

This means a trading strategy that would, if executed, significantly increase the likelihood that the bank would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

***Loan securitization***

This means an issuing entity for ABS backed solely by

- loans.
- rights or assets that support the servicing of the fund's assets.
- rights or assets that are related or incidental to acquiring and holding the loans.
- risk-reducing interest rate and FX derivatives that relate to qualifying loans and assets held by the securitization vehicle.
- special units of beneficial interests or collateral certificates.

Securitizations that contain the following impermissible assets do not meet the *loan securitization* exclusion from the *covered fund* definition:

- A security, including an ABS, or an interest in an equity or debt security, unless that security is acquired in satisfaction of a debt previously contracted or is a cash equivalent.
- A derivative that does not meet the standards above.
- A commodity forward contract.

***Market-maker inventory***

This comprises all of the positions in the *financial instruments* that a *trading desk* manages and for which it stands ready to make a market, including the desk's open positions or exposures arising from open transactions.

***Material conflict of interest***

This exists when the bank's interests are materially adverse to the interests of its clients, customers, or counterparties.

***Ownership interest***

This means an equity, partnership, or other similar interest. An "other similar interest" is one that

- has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or *trustees*, investment manager, investment adviser, or commodity trading advisor of the *covered fund* (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).
- has the right to receive a share of the income, gains, or profits of the *covered fund*.
- has the right to receive the underlying assets of the *covered fund* after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies on the occurrence of an event of default or an acceleration event).
- has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the *covered fund* and the aggregate interest paid to the holders of other outstanding interests).
- provides that the amounts payable under the interest could be reduced based on losses arising from the underlying assets of the *covered fund*, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest.
- receives income on a pass-through basis from the *covered fund* or that has a rate of return determined by reference to the performance of the fund's underlying assets.
- is a synthetic right to any of the rights described above.

Carried interest, in most cases, is not an *ownership interest*.

***Prime brokerage transaction***

This means any transaction that would be a *covered transaction*, as defined in section 23A(b)(7) of the Federal Reserve Act (12 USC 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

***RENTD***

This is an abbreviation for "reasonably expected near-term demand" of clients, customers, and counterparties.

### ***Sponsor***

- Serves as general partner, managing member, *trustee*, or commodity pool operator to a *covered fund*.
- Selects or controls (or has employees, officers, directors, or agents who constitute) a majority of the directors, *trustees*, or management of a *covered fund*.
- Shares with a *covered fund* the same name or a variation of the same name.

### ***Trading desk***

This means the smallest discrete unit of organization of a *banking entity* that engages in proprietary trading.

### ***Trading position***

This refers to a position held for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.

### ***Trustee***

*Trustee* does not include a person who does not exercise investment discretion over the *covered fund* (e.g., an Employee Retirement Income Security Act trustee) or a trustee who is subject to substantially equivalent fiduciary standards under foreign law.