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together

# Impact of the Volcker Rule on ETFs and Authorized Participants

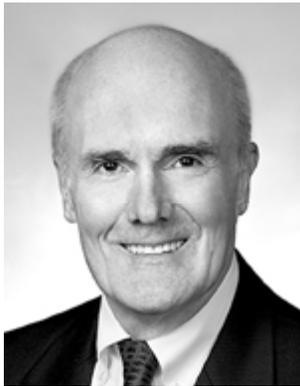
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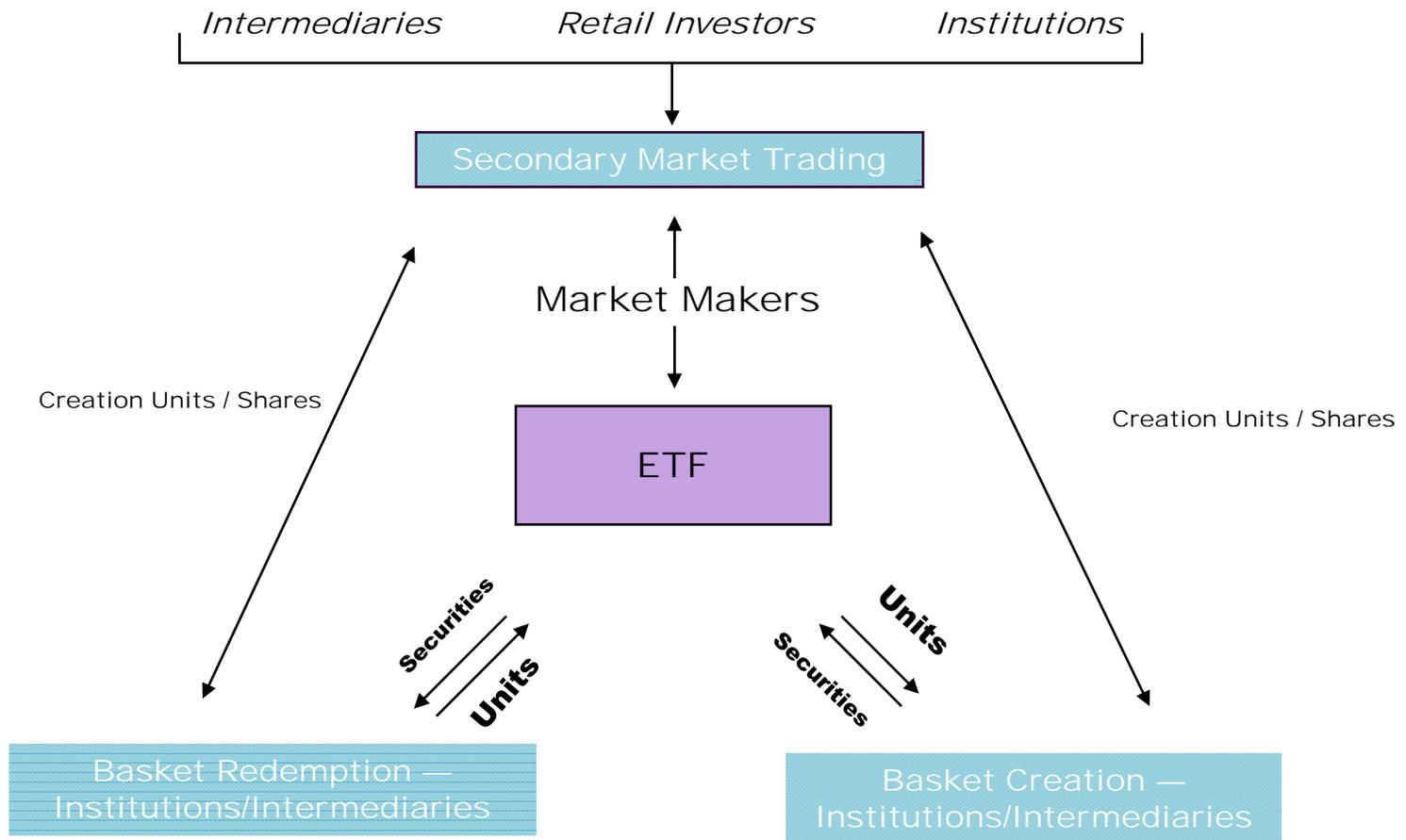
# Today's Agenda

- ETFs and trading activity by authorized participants (“APs”)
- Overview of Volcker Rule prohibitions and exemptions as applied to AP activity
- Availability of, and impact of reliance on, exemptions and related risks
- Compliance program requirements and issues; open questions

# ETFs

- Most ETFs are open-ended, collective investment vehicles whose shares are listed and traded on organized securities exchanges
  - ETF shares are traded on exchanges at market prices which may differ from the net asset value (“NAV”) per share of the ETF
  - Unlike mutual funds, ETF shares may only be purchased directly from the ETF and sold directly to the ETF through creation and redemption orders placed by broker-dealers who have entered into agreements to act as APs and only in block size, referred to as “creation units”
- Varieties in structure are increasing, and many ETFs are investing in commodities
  - Approximately 78 ETFs representing roughly \$120 billion assets as of year-end 2012 specialized in commodity, currency and futures investments (ICI Factbook)
- ETFs typically track the performance of indexes of securities or commodities or hold a single type of commodity or currency
- Since 2008, ETFs may be actively managed
- The large majority of ETFs are Investment Company Act registered

# How ETFs Trade



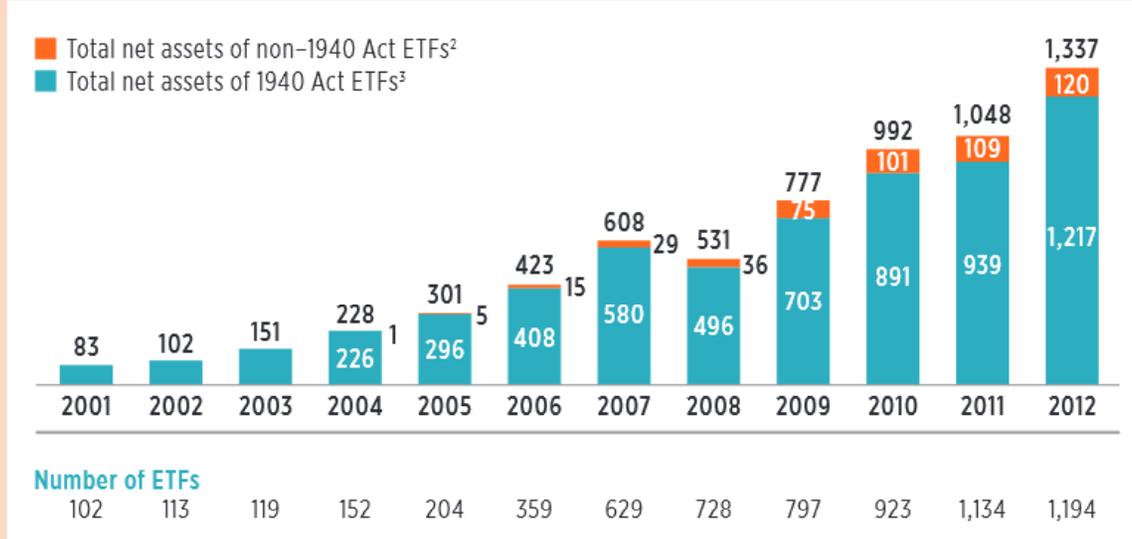
Source: State Street Global Advisors

# The ETF Market

FIGURE 3.1

## Total Net Assets and Number of ETFs<sup>1</sup>

Billions of dollars, year-end, 2001–2012



<sup>1</sup> Data for ETFs that invest primarily in other ETFs are excluded from the totals.

<sup>2</sup> The funds in this category are not registered under the Investment Company Act of 1940 and invest primarily in commodities, currencies, and futures.

<sup>3</sup> The funds in this category are registered under the Investment Company Act of 1940.

Note: Components may not add to the total because of rounding.

Source:  
ICI 2013  
Factbook

# The ETF Market

FIGURE 3.3

## Net Issuance of ETF Shares<sup>1</sup>

Billions of dollars, 2001–2012



<sup>1</sup> Data for ETFs that invest primarily in other ETFs are excluded from the totals.

<sup>2</sup> The funds in this category are not registered under the Investment Company Act of 1940 and invest primarily in commodities, currencies, and futures.

<sup>3</sup> The funds in this category are registered under the Investment Company Act of 1940.

Note: Components may not add to the total because of rounding.

Source:  
ICI 2013  
Factbook

# The ETF Market

FIGURE 3.6

## Number of ETFs<sup>1</sup>

2001-2012

	Created	Liquidated	Total at year-end
2001	22	0	102
2002	14	3	113
2003	10	4	119
2004	35	2	152
2005	52	0	204
2006	156	1	359
2007	270	0	629
2008	149	50	728
2009	120	49	797 <sup>2</sup>
2010	177	51	923
2011	226	15	1,134
2012	141	81	1,194

Source:  
ICI 2013  
Factbook

<sup>1</sup> ETF data include ETFs not registered under the Investment Company Act of 1940 but exclude ETFs that invest primarily in other ETFs.

<sup>2</sup> In 2009, two ETFs converted from holding securities directly to investing primarily in other ETFs.

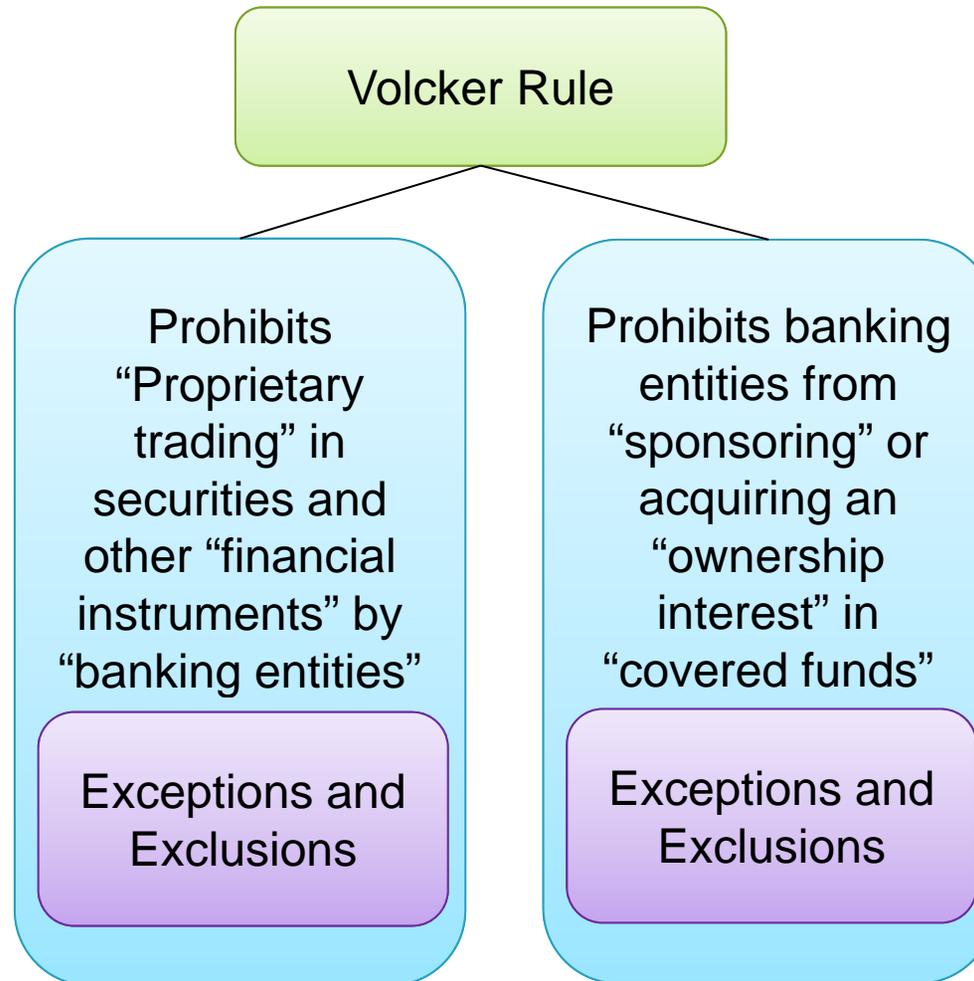
# AP Trading Activity

- Seeding new ETFs
  - Entering one or more initial creation units and refraining from selling into the market until ETF is stable
- Market making
  - Arbitrage trading to keep traded price in line with NAV
  - Buying shares from ETF and selling on to investor
  - Secondary market trading for own account or on behalf of clients
  - Agreements with exchanges to provide liquidity for certain listed ETF shares
- Create-to-lend transactions (hedging)
  - Creation of new ETF shares and lending to AP customer
  - Customer hedges exposure to assets underlying ETF
- Derivative instruments with customers (e.g., swap) with ETF shares as reference assets

# Introduction

- Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act
- Final interagency regulations (“Regulations”) adopted by the Federal Reserve, the OCC, the FDIC, the SEC and the CFTC (“Agencies”) on December 10, 2013
- Initially proposed for comment two years earlier

# Overview of Volcker Rule



# Proprietary Trading – Key Terms

- “Banking entity”
  - insured depository institutions, companies affiliated with insured depository institutions, and foreign banks with U.S. banking operations
- “Proprietary trading”
  - engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments
- “Trading account”
  - an account that is used to purchase or sell financial instruments principally for the purpose of short-term resale and similar enumerated purposes
- “Financial instrument”
  - any security, commodity forward, or derivative; not included are loans, spot commodities or spot foreign exchange or currency

# Proprietary Trading – Definitional Exclusions

- Excluded transactions and activities include:
  - Qualifying repo and reverse repo transactions
  - Purchases or sales of securities in connection with qualifying securities lending and borrowing transactions
  - Purchases and sales of securities for liquidity management purposes
  - Purchases or sales of financial instruments by a derivatives clearing organization (“DCO”) or a clearing agency in connection with clearing financial instruments
  - Excluded clearing activities by members of a clearing agency, DCO, or a designated financial market utility

# Proprietary Trading – Definitional Exclusions

- Excluded transactions and activities include:
  - Purchases and sales of financial instruments to satisfy existing delivery obligations of the banking entity or its customers, or to satisfy an obligation in connection with a legal proceeding
  - Purchases and sales of financial instruments by a banking entity that is acting solely as agent, broker, or custodian
  - Purchases and sales of financial instruments through a qualifying domestic or foreign deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity for the benefit of plan participants
  - Qualifying debt-previously-contracted (DPC) purchases or sales of financial instruments

# Proprietary Trading – Exempt Activities

- Exempted activities include:
  - Permitted underwriting and market making (§4 of Regulations)
  - Permitted risk-mitigating hedging activities (§5 of Regulations)
  - Other permitted proprietary trading activities (§6 of Regulations)
    - *Permitting trading in domestic government obligations (§6(a))*
    - *Permitting trading in foreign government obligations (§6(b))*
    - *Permitting trading on behalf of customers (§6(c))*
      - **Fiduciary transactions**
      - **Riskless principal transactions**
    - *Permitting trading by regulated insurance company (§6(d))*
    - *Permitting trading activities of foreign banking entities (§6(e))*

# Proprietary Trading – Underwriting Exemption

- The Regulations exempt from the prohibition of proprietary trading qualifying underwriting activities
- The underwriting exemption requires a banking entity to comply with five core elements or standards
  - Must act as an “underwriter” for a “distribution” of “securities,” and the underwriting position must be “related to” such a distribution
  - Amount and types of securities not to exceed near-term demands and efforts must be made to reduce the position within a reasonable period
  - Must establish, implement, maintain, and enforce an internal compliance program
  - Compensation arrangements may not be designed to “reward or incentivize” prohibited proprietary trading
  - Must be licensed or registered as required to engage in such activity

# Proprietary Trading – Underwriting Exemption

- Selected aspects of the underwriting exemption
  - Limited to distributions of “securities”
  - Applied at the trading desk level and on a distribution-by-distribution basis (not transaction-by-transaction)
  - “Underwriter” is defined by reference to SEC regulations and standards and includes syndicate and selling group members; privity of contract is not required
  - Requires “reasonable efforts” to reduce unsold allotments within a “reasonable period”
  - No specific requirements on types of fees allowed other than not encouraging proprietary trading
  - Compliance program, addressing specific elements, is required

# Proprietary Trading – Market Making Exemption

- The Regulations' implementation of the statutory exemption for market making activities contains several key conditions:
  - Must “routinely” stand ready to purchase and sell, and quote specified financial instruments related to its financial exposure
  - Inventory must not exceed, on an ongoing basis, “reasonably expected” near-term client demands
  - Internal compliance program is required
  - Prompt remedial action is required if limits exceeded
  - Trader compensation scheme cannot reward or incentivize prohibited proprietary trading
  - Must be licensed as necessary to engage in such activity

# Proprietary Trading – Market Making Exemption

- Selected features of the market making exemption:
  - Conditions of exemption are more favorable than proposed
  - Exemption is not nearly as “equities-centric” as was proposed
  - Focus is on the trading desk and its financial instrument inventories and related financial exposures; not a trade-by-trade analysis
  - Regulations recognize variations in financial instruments and nature of relevant markets
  - Metrics for measuring market making activities are fewer and more relevant to actual market making activities
  - Proposed Appendix B has been removed
  - Compliance program, addressing specific elements, is required

# Proprietary Trading – Risk-Mitigating Hedging Exemption

- The Regulations exempt a banking entity's risk-mitigating hedging activities in connection with and related to positions, contracts or other holdings that are designed to reduce the specific risks associated with such positions, contracts or holdings
  - A banking entity may only hedge risks that are specific and identifiable in order to avail itself of this exemption
  - A banking entity must be able to identify the specific financial instrument or components of the financial instrument positions that are being hedged
  - No scenario or non-specific hedging activities allowed

# Proprietary Trading – Risk-Mitigating Hedging Exemption

- Other elements of the risk-mitigating hedging exemption:
  - Express correlation to hedged position is not required, but a correlation analysis is required
  - Analysis and independent testing are required
  - Compliance program is required; elements of the compliance program are specified
  - Written policies and procedures are required.

# Proprietary Trading – Trading on Behalf of Customers Exemption

- The Regulations' prohibition on proprietary trading does not apply to:
  - Purchasing or selling financial instruments while acting as a trustee or in a similar fiduciary capacity, where the transaction is conducted for a customer account or on behalf of a customer and the banking entity does not have or retain beneficial ownership
  - Purchasing or selling financial instruments while acting as riskless principal where a banking entity purchases (or sells) for a financial instrument for its own account after receiving an order to purchase (or sell) the financial instrument from a customer

# Regulators on ETF AP Activity and the Volcker Rule

- “[T]he Agencies believe that many AP activities, such as conducting general creations and redemptions of ETF shares, are better suited for analysis under the market-making exemption [rather than the underwriting exemption] because they are driven by the demands of other market participants rather than the issuer, the ETF.”
- “Whether an AP may rely on the underwriting exemption for its activities in an ETF will depend on the facts and circumstances, including, among other things, whether the AP meets the definition of ‘underwriter’ and the offering of ETF shares qualifies as a ‘distribution.’”

# Regulators on ETF AP Activity and the Volcker Rule

- “[A]n AP may buy ETF shares from market participants who would like to redeem those shares for cash or a basket of instruments upon which the ETF is based. To provide this service, the AP may in turn redeem these shares from the ETF itself. Similarly, an AP may receive cash or financial instruments from a market participant seeking to purchase ETF shares, in which case the AP may use that cash or set of financial instruments to create shares from the ETF. In either case, for the purpose of the market-making exemption, such market participants as well as the ETF itself would be considered clients, customers or counterparties of the AP. The inventory of ETF shares or underlying instruments held by the AP can therefore be evaluated under the criteria of the market-making exemption, such as how these holdings related to reasonably expected near term customer demand.”
  - “This does not imply that the AP must perfectly predict future customer demand, but rather that there is a demonstrable, statistical, or historical basis for the size of the inventory held.”
- “These criteria can be similarly applied to other activities of the AP, such as building inventory to ‘seed’ a new ETF or engaging in ETF-loan related transactions.”

# Regulators on ETF AP Activity and the Volcker Rule

- “[T]he Agencies continue to take the view that a trading desk would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading or other trading that is not in response to, or driven by, the demands of clients, customers or counterparties.”
  - “A trading desk may, however, act as market maker to a customer engaged in a statistical arbitrage strategy.”
- The Agencies have not specifically addressed the availability of the risk-mitigation hedging exemption, or the exemption for riskless principal transactions, in the context of AP activities.

# Proprietary Trading – Open Issue

- Expressly excluded from the definition of “banking entity” under the Regulations are “covered funds” (e.g., 3(c)(1) or 3(c)(7) private funds and privately offered commodity pools) that:
  - Are not insured depository institutions,
  - Do not control an insured depository institution, or
  - Are not treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978.
- This express exclusion does not extend to registered investment companies or publicly traded commodity pools (e.g., mutual funds, ETFs). Therefore any such entity that is an “affiliate” of a banking entity could itself be considered a banking entity subject to proprietary trading restrictions.

# Covered Funds – Prohibition and Restrictions

- The Regulations prohibit any banking entity from acquiring or retaining an “ownership interest” in, or “sponsoring,” a “covered fund,” subject to certain exemptions, including:
  - investment and sponsorship activities in connection with “organizing and offering” a covered fund
  - small business and public welfare fund activities
  - covered fund activities of foreign banking entities occurring “solely outside of the U.S.”
- The prohibition on covered fund activities and investments applies to the consolidated, worldwide operations of U.S. banking entities

# Definition of “Covered Fund”

- The statutory Volcker Rule:
  - any entity that would be an investment company under the Investment Company Act of 1940 but for the exclusions under sections 3(c)(1) and 3(c)(7) of that act, or such similar funds as the Agencies may, by rule, determine
- The Regulations
  - generally extended the definition to commodity pools offered to qualified eligible persons, as well as to foreign private funds owned or sponsored by U.S. banking entities that, in substance, would rely on the Investment Company Act section 3(c)(1) or 3(c)(7) exemption were they offered in the United States

# Definition of “Covered Fund”

- Funds excluded from the definition of a “covered fund”:
  - foreign public funds
  - wholly owned subsidiaries of banking entities: up to 5% of these entities may be owned by directors and employees of the banking entity
  - joint ventures that do not engage in investing money for others, and are limited to not more than 10 investors other than the banking entity
  - acquisition vehicles
  - foreign pension or retirement funds

# Definition of “Covered Fund”

- Funds excluded from the definition of a “covered fund”:
  - insurance company separate accounts
  - separate accounts used to purchase qualifying bank-owned life insurance
  - certain loan securitization vehicles
  - qualifying asset-backed commercial paper conduits
  - qualifying covered bonds (non-U.S. jurisdiction)
  - SBICs and qualifying public welfare investment funds
  - registered investment companies
  - any other issuer excluded by joint action of the Agencies

# Other “Covered Fund” Definitions

- “Sponsor”:
  - Serves as general partner, managing member or similar capacity
  - Selects or controls, or has officers/directors/ employees who constitute, a majority of fund directors, trustees or similar persons
  - Shares a name/variation of a name with a covered fund
- “Ownership interest”:
  - Equity, partnership or “similar interest”
  - Does not include carried interest (“restricted profit interest”)
- “U.S. resident”:
  - Relies on SEC Regulation S “U.S. person” definition

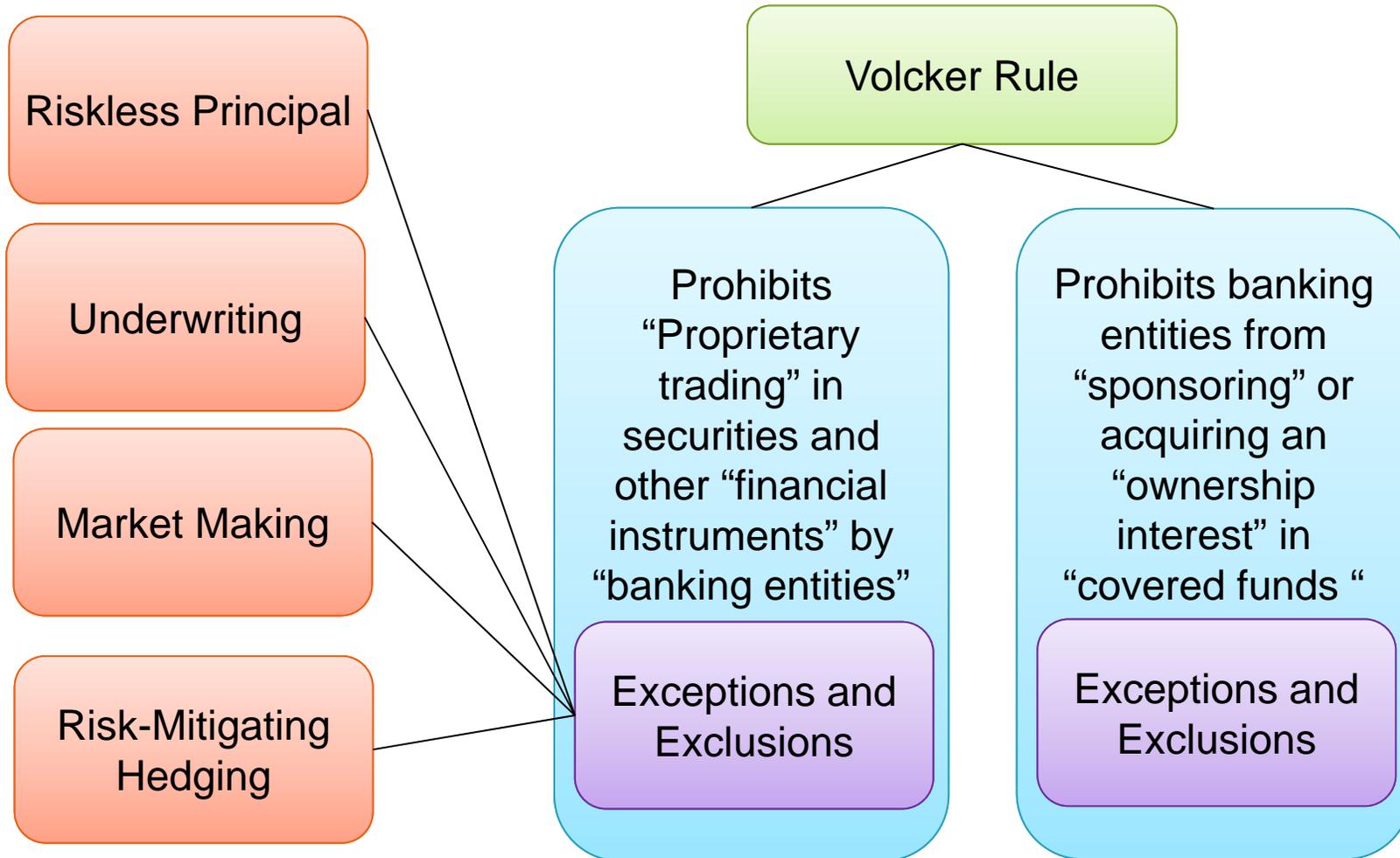
# Covered Funds— “Organized and Offered” Exemption

- A banking entity may sponsor/hold an ownership interest in a covered fund in connection with “organizing and offering” the fund to fiduciary and asset management clients, subject to certain conditions:
  - Must provide “bona fide trust, fiduciary, or advisory services” and may only offer to customers of these trust, fiduciary or advisory services
  - May establish the customer relationship for these services through or in connection with the organization and offering of the covered fund
  - Must develop a written plan or similar documentation
  - May not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance
  - Must make specified written disclosures to investors
  - May not share or use certain names

# Covered Funds— Permitted Investments

- “*De minimis*” investment exemption for “organized and offered” funds only
  - 3% per-fund investment limitation
  - 3%-of-capital aggregate investment limitation
- Seeding activities: one year
- Attribution of ownership interests
  - Only to banking organization controlled entities
  - Co-investments
- Extensions of permitted investment periods
- Permitted hedging activities (limited)

# Overview of Volcker Rule



# Underwriter Risk

- Because creation of shares is ongoing, ETFs are deemed to be in continuous distribution under the 1933 Act.
- Depending on facts and circumstances, APs could be treated as statutory underwriters. Those APs that go beyond normal market making may have to rely on the “underwriter” exemption from the prohibition on proprietary trading.
- Agencies implied a broad interpretation of “market making,” but did not expressly state whether seeding an ETF could rely on market making exemption.
- 1933 Act: underwriters are liable for
  - material misstatements/omissions in registration statement (§11)
  - material misstatements/omissions in prospectus (§12(a)(2))

# Underwriter Risk

- 1933 Act provides affirmative due diligence defense – “reasonable investigation” (§11) and “exercise of reasonable care” (§12)
  - What is the right framework within which to perform due diligence on a fund in continuous distribution?
  - Scope of diligence
  - Creating, maintaining and refreshing a diligence file
- Other ways to mitigate underwriter risk:
  - Representations, covenants and warranties in the AP agreement
  - Representations, covenants and warranties from the ETF issuer and/or ETF sponsor/adviser
  - Indemnification

# Compliance and Reporting Requirements

- Banking entities engaged in proprietary trading or covered fund activities and investments must develop and administer a compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule and the Regulations, based on a tiered approach calibrated to the size, complexity and activities of a banking organization.
  - Each of the underwriting and market making exemptions requires an internal compliance program as required by Subpart D of the Regulations
- The Regulations specify a variety of data collection and reporting requirements that are applicable primarily to banking entities that are engaged in proprietary trading activities.

# Authority to Address Violations, or Terminate Activities or Investments

- The Regulations include a separate provision broadly allowing the Agencies to require the termination of impermissible trading and covered fund activities, and impose penalties for violations of the Volcker Rule and the Regulations
  - The Regulations do not require coordinated supervisory or regulatory actions by the Agencies
- The Agencies have announced the creation of an interagency working group that will coordinate the Agencies' efforts to implement and enforce the Volcker Rule and the Regulations

# Effective Date and Conformance Period

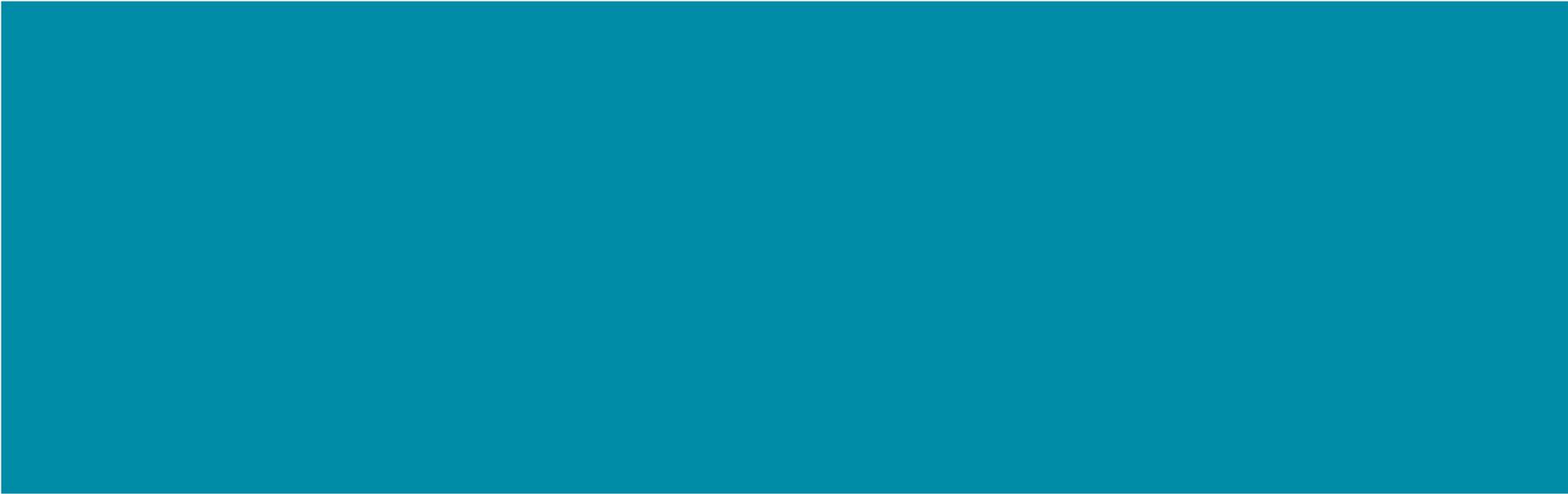
- The Regulations became effective on April 1, 2014; affected banking organizations generally will have until July 21, 2015 to bring proprietary trading and private fund activities into conformance
- Banking organizations are expected to engage in “good faith efforts” to bring all of their covered activities into compliance by the July 2015 conformance date
- But, banking entities that expand activities and make investments during the conformance period will not be given additional time to conform those activities or investments
- SEC staff has informally acknowledged they will not be looking for “gotchas” in recognition of fact that this is a new rule, but has also indicated that compliance is not a foreign topic to affected firms

# Compliance Considerations

- Compliance and reporting requirements – banking organizations must document compliance with the Volcker Rule
- All major exemptions require a plan or program that is specific to the exempted activity in question
  - Ad hoc approaches to conducting permitted activities are effectively not possible
- Compliance will be a work in progress, at least for the short- to medium-term, for industry and the regulators
- The Agencies' Volcker Rule working group hopefully will enable the Agencies to coordinate their Volcker Rule regulatory and supervisory activities, but this is not a guaranteed outcome

# Compliance Considerations

- An effective compliance program will require, at a minimum:
  - Written policies and procedures:
    - *covering all affected activities*
    - *activity-specific but also enterprise-level*
    - *risk-focused*
  - Strong recordkeeping and reporting systems
  - Active senior management involvement in the compliance management process, and ongoing board of directors oversight
- “Volcker Teams” should include representatives of all lines of business to ensure communication and consistency
- Volcker compliance should be built into existing compliance structures and should utilize existing resources



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