IMPLEMENTING VOLCKER, VICKERS AND LIIKANEN
COMPARATIVE ANALYSIS OF BANK STRUCTURE REFORMS

Ingediend door
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INTRODUCTION

After the global financial crisis of 2008, various reforms were suggested and implemented to restore faith in the financial system. One of these was the separation of commercial banking activities from risky activities. The first proposal was the Volcker Rule in the US, which introduces a ban on proprietary trading. Later, in the UK a report was issued by the Independent Commission on Banking, known as the Vickers Report, which proposed to ring-fence the core banking services so that they would be protected from harm from the financial system. Finally, the EU also issued a report, known as the Liikanen Report. This report is said to hold the middle between the Volcker Rule and the Vickers Report, because it separates more trading activities than Volcker, but allows those activities to stay within the group, such as in the ring-fencing proposal.¹

A lot has been written about these proposals, but mainly from an economic perspective. The present dissertation is mainly concerned with the implementation of the separation requirements of the various reports and the legal problems this entails. So while it is the intention to frame differences in implementation by looking at the different underlying visions, this dissertation will not try to answer the question of which idea is the best or the most efficient.

Therefore the main question this dissertation will try to answer is: How were the separation requirements from the Volcker Rule, the Vickers Report and Liikanen Report implemented in the US, the UK, France, Germany and Belgium? What are the main differences and how can they be explained by the different underlying visions?

Structure-wise all rules are first discussed independently before they are compared. The first intention was to select the main problems and compare how the various rules dealt with those. In the economic discussions, the possibility to define economic concepts into adequate legal rules is often a key issue. The focus would be on those concepts, such as market making or the independence of an entity within a group. However, the rules are often formed in an entirely different way, even if the result is similar. This would make the intended type of analyses too disorderly and complex and could easily lead to important omissions or mistakes. Therefore a more traditional structure of first describing and then comparing was chosen. Conclusions at the end of descriptive parts will often also contain a short comparison to the report from which it is derived, though the main discussion about the implementation is usually left for the comparison sections. In

these comparisons links will inevitably be made to the contested subjects, even if they are no longer at the centre of the dissertation.

The structure of the chapters mainly follows the structure of the US rules. The Volcker Rule first describes the prohibited activities and then the relationship with funds that carry on those activities. This was not the only option. The Liikanen Report and its implementations in continental Europe treat relationships with hedge funds as a type of trading activities that need to be separated. In part IV, which deals with these relationships, intra-group exposures are also discussed.

Consequently, after introductory parts on the purpose (part I) and scope (part II) of each rule, there are two main parts. Part III will look into the prohibited activities and part IV into all relationships with entities which carry on those activities, be it within the group or outside it.

This dissertation mainly relies on primary sources, e.g. legislation, preparatory works and the reports on which the rules are based. Because the rules are fairly recent, there are not many legal works available yet on the subject. Most documents on the subject are summaries made by law firms to inform their clients. Occasionally a slightly more in depth rule by rule analysis can be found, although these are mostly limited to restating the existing legislation. This is of course natural, because not all rules are even in force yet, so more practical information is simply not available at the moment. Nevertheless, for the purpose of writing this work, directly consulting the legislation and preparatory works often gave a more complete picture than relying on selected information. For instance, the supplementary information added to the regulation implementing the Volcker Rule is one of the most quoted sources.2 The economical works on the subject are often written as a response to or in order to influence the reports and contain very little information on the concrete application of the rules.

Although this is mostly left to the comparison sections, the other rules can sometimes also be a source for subsequent legislation in another country. This has determined the order in which the countries are presented. Often references to and comparisons with older reports or rules can be found in later reports or preparatory works.

Of course there are also limits to this work. The first is history. In itself this idea was not new and

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2 In this dissertation simply referred to as “Regulation”, followed by the page numbers in the Federal Register (79 Fed. Reg. 5535-6076).
for instance, the Volcker Rule has been compared to the Glass-Steagall Act of 1933. This legislation was enacted as a solution to conflicts of interest between banks and their customers. Over time more and more exemptions were inserted until the Act was finally repealed in 1999. This time, the separation is suggested for a different reason, at a different time with its own distinct features. Therefore I decided not to compare with historical rules which required separation.

Further, the number of countries is limited. The US and UK have implemented or are implementing the first two and most diverse rules, which serve as a basis for any further attempt. France and Germany are the two most influential countries in the European Union and are also one of the main sources of inspiration for the Belgian rule. Since this dissertation is written at a Belgian university, it was only natural to include Belgium in the analysis.

Another limitation is that the other financial reforms will not be discussed, nor will other existing banking laws, unless this is necessary for the comprehension of the present rules. This means that the rules under discussion will be treated partly without their context. For example, other existing rules could impose another prohibition which had to be expressly proscribed in another country or a described weakness could be solved by another proposed or enacted post-crisis financial reform. One element that should not go unmentioned is the requirement for banks in the EU to draw up a recovery and resolution plan. If this plan is deemed insufficient to ensure that a bank can be dissolved with a minimal impact on the deposits, the regulator can impose extra separation requirements.

Certain parts of the rules will also not be treated in detail. The most important of these is without a doubt compliance programmes and other reporting requirements. These requirements are not only related to supervision and enforcement, but in some cases the authorities also want to use them to fine-tune the rules as more information becomes available. Commenting on what information has

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6 For instance Regulation, 5631 mentions this for the Volcker Rule.
to be provided is unlikely to lead to any useful insights. This would of course be different if, in the future, some of these reports would become publicly available.

Another element left out of the dissertation is the international application of the rules. Sometimes the rules apply only partly or differently to international entities. The Volcker Rule, for one, has a broad international scope. On the other hand, a member state of the European Union cannot restrict entities which have a permission to operate a bank in another member state. As a result, comparing the international rules would lead to other problems, which are outside the core issue of this work.

Next, there are some specific rules for insurance companies. These are sometimes shortly mentioned, but not included in any conclusion or comparison. Mostly these are only details and not including them does not fundamentally alter any conclusions.

For the same reason pension liabilities, which are only restricted in the UK ring-fencing rule, are also left out of the picture; so is the problem with CDOs backed by TruPS in the US.

The last element that is not included are the EU proposals. At the time of writing, the EU has not yet enacted a regulation and it is uncertain if they ever will. After the last proposal was rejected by the European Parliament, there was some doubt if a new proposal would even be tried and even though a new proposal was launched, nothing seems to be moving forward. Without a definitive regulation, it seemed better to focus on the applicable rules in three continental European countries which are based on the same report and which will undoubtedly influence the regulation, if one is ever successfully passed.

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PART I PURPOSE
The aim of the present dissertation is to explain the differences in the rules by looking at the objectives of the underlying proposals. Therefore in this first part, we will try to establish what the purpose of each of the rules is and where those objectives differ.

I. Purpose of the Volcker rule

In the US, the rule prohibiting proprietary trading by banking entities is known as the Volcker Rule.\(^9\) As its name suggests, this Rule was proposed by Mr. Paul Volcker, former chairman of the FRB.\(^10\) In a hearing before the Committee on Banking, Housing and Urban affairs of the U.S. Senate, he clearly explained his views on the matter.\(^11\) According to him, all banking activities contain a certain risk. Yet, not all risks should be protected by the government. Commercial banking activities have an essential function in the economy and for that reason, they deserve protection. Proprietary trading, on the other hand, does not benefit anyone other than the person engaged in it. Thus, the first aim of the Rule is to remove the implicit protection from those speculative activities,\(^12\) and, in the process, to provide incentives to encourage commercial banking.\(^13\)

The second aim is to avoid conflicts of interest between the bank and its customers. Generally, financial institutions that are engaged in both customer related and proprietary activities are required to erect information barriers, the so-called “Chinese walls”. However, according to Mr. Volcker, these walls are never impermeable.\(^14\) As we shall see, even in those instances where the Rule allows proprietary trading, additional measures have been taken to avoid conflicts of interest.\(^15\)

It is not the aim of the Rule to remove risks from banking entities or to control risks in the entire financial system. Various other measures were taken or suggested in that respect (e.g. stricter capital

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9 Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, hereafter referred to as the “Volcker Rule” or the “Rule”.
12 Hearing, 5.
13 Hearing, 34.
14 Hearing, 18.
and liquidity requirement rules, mandatory central clearing for certain instruments, …).\(^{16}\) This does not mean that the Volcker Rule is not concerned with risk at all. For instance, exempted activities are impermissible if they involve high-risk assets or high-risk trading strategies\(^ {17}\) or if they pose a threat to the safety and soundness of the banking entity or the financial stability of the U.S.\(^ {18}\)

**II. Purpose of retail ring-fencing in the UK**

In the UK, the Independent Commission on Banking, chaired by Sir John Vickers, issued a report favouring the ring-fencing approach, where certain activities are placed in a separate entity within the group.\(^ {19}\) This report, also called the Vickers Report, emphasises the importance of maintaining the continuity of those vital services without the taxpayers' support.\(^ {20}\) It does so by making it easier to sort those activities from the others and by reducing the possibility of banks to take excessive risks.\(^ {21}\) Vital services are those financial services of which the disruption would cause much harm to the economy, mostly because the customers, consisting mainly of households and SMEs, have generally not taken measures to protect themselves against such discontinuity.\(^ {22}\)

The essential element here is not whether or not the deposits are guaranteed, the reason being that even if there is no guarantee for certain services, the government will likely bail out the creditor if this is the only way to avoid a much larger detriment to the economy.\(^ {23}\)

In all this, the benefit of diversification should not be forgotten. The aim is to retain the positive effects for the vital activities, while assuring that risks from other activities will not effect them.\(^ {24}\)

\(^{16}\) Hearing, 6, 28-29.

\(^{17}\) Regulation, § .7(a)(2).

\(^{18}\) Regulation, § .7(a)(3).


\(^{20}\) Vickers Report, 35, n\(^{o}\) 3.3.

\(^{21}\) Vickers Report, 35, n\(^{o}\) 3.3.

\(^{22}\) Vickers Report, 36, n\(^{o}\) 3.8.

\(^{23}\) Vickers Report, 36, n\(^{o}\) 3.8.

\(^{24}\) Vickers Report, 64-65, n\(^{o}\) 3.64-3.66.
III. Purpose of the separation in the Liikanen Report and its application in continental Europe

The European Commission ordered a report to be issued, concerning structural banking reform. This report is known as the Liikanen Report.\textsuperscript{25} It suggests a separation of proprietary trading and other significant trading activities.\textsuperscript{26} Contrary to the retail ring-fencing rule in the UK, here the trading activities are singled out.

The objectives of the separation requirement are most clearly described in the executive summary of the Liikanen Report. It means to avoid excessive risk taking with insured deposits and prevent the covering up of trading losses with the funds of deposits. Additionally, the money that can no longer go to the financial sector, will improve the availability of money in the non-financial sector. Further, the interconnectedness within the banking system will be reduced. Finally, the separation will also ensure a more level playing field, since nobody can rely on implicit guarantees any longer.\textsuperscript{27} Meanwhile, by allowing the separated activities to be carried out within the group, some advantages of diversification are maintained.\textsuperscript{28}

Further in the report, the same aim is described differently as making the vital parts of banking groups, with which not only deposits, but also financial services to the non-financial sector are meant, safer and less connected to trading activities.\textsuperscript{29} Again curtailing implicit guarantees is mentioned.\textsuperscript{30}

The first country to adopt a statute, incorporating the principles of the Liikanen Report was France.\textsuperscript{31} As rational for the separation, the statute mentions the stability of the financial system, the protection of deposits, the prevention of conflicts of interest with clients and the positive effect on

\textsuperscript{26} Liikanen Report, v.
\textsuperscript{27} Liikanen Report, vi.
\textsuperscript{28} Liikanen Report, 102.
\textsuperscript{29} Liikanen Report, 100.
\textsuperscript{30} Liikanen Report, 100.
\textsuperscript{31} K. BERGER, “Projet de loi de séparation et de régulation des activités bancaires. Présentation générale de la réforme”, \textit{Revue de Droit bancaire et financier}, n° 4, October 2013.
the availability of funds for the non-financial sector.\textsuperscript{32}

Two elements of this rational were not derived from the Liikanen Report. According to the French minister of economy and finance at the time, Mr. Pierre Moscovici, the stability of the financial system will improve, because, as a result of the restrictions, the level of proprietary trading will never be able to reach its pre-crisis levels.\textsuperscript{33}

The other element that is not mentioned in the Liikanen Report, is the avoidance of conflicts of interest. Some senators proposed to add it as part of a larger change, more similar to the Volcker Rule.\textsuperscript{34} After extensive discussions in the Senate\textsuperscript{35}, this was added to the text of the statute, without the other amendments.

More or less at the same time as France, Germany also discussed the adoption of a law along the lines of the Liikanen Report.\textsuperscript{36} Das Trennbankengesetz, was enacted shortly after the French statute.\textsuperscript{37} The proposition of the statute marks the separation as part of the measures taken to diminish the risk of speculative activities and to secure the stability of the financial system. It will improve the solvency of credit institutions and remove client deposits from excessive risks.\textsuperscript{38} As a consequence, it will be easier to dissolve bankrupt trading entities, without having to rely on taxpayers money.\textsuperscript{39}

Contrary to the Liikanen Report, the benefits to the real economy are not alluded to. Also, just like

\textsuperscript{32} Art. L.511-47 Code monétaire et financier.
\textsuperscript{33} ASSEMBLÉE NATIONALE, première séance du mardi 12 février 2013, \url{http://www.assemblee-nationale.fr/14/cri/2012-2013/20130144.asp}.
\textsuperscript{34} SÉNAT, séance du mercredi 20 mars 2013, \url{http://www.senat.fr/seances/s201303/s20130320/s20130320.pdf}, 2154-2155
\textsuperscript{35} SÉNAT, séance du mercredi 20 mars 2013, \url{http://www.senat.fr/seances/s201303/s20130320/s20130320.pdf}, cfr. amongst others p. 2154 and 2163.
\textsuperscript{36} DEUTSCHE BUNDESTAG, drucksache 17/19539, 5 May 2013, \url{http://dipbt.bundestag.de/dip21/btd/17/135/1713539.pdf}, 5.
\textsuperscript{37} Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen vom 7 August 2013. Hereafter: “Trennbankengesetz”.
\textsuperscript{38} DEUTSCHE BUNDESTAG, drucksache 17/12601, 4 March 2013, \url{http://dipbt.bundestag.de/dip21/btd/17/126/1712601.pdf}, 2.
\textsuperscript{39} DEUTSCHE BUNDESTAG, drucksache 17/12601, 4 March 2013, \url{http://dipbt.bundestag.de/dip21/btd/17/126/1712601.pdf}, 27.
in France, the German legislator mentions the stability of the financial system, though there is a different reasoning behind it. According to the German proposition the improvement of the solvency of its participants, will improve the stability of the system as well.\textsuperscript{40}

Finally, also Belgium opted to require a separation of trading activities. They incorporated this into the new Banking Act of 2014.\textsuperscript{41} The Belgian legislator had the advantage of being able to rely on the work previously done in other countries, especially France and Germany, which have the same purpose of anticipating a European adaptation of the Liikanen Report.\textsuperscript{42} In their proposal, they note that all previous rules, including Volcker and Vickers, have had the aim to protect deposits from excessive risk, thus curtailing implicit guarantees and in the meantime improving the availability of credit for the real economy.\textsuperscript{43}

In the following parts the applicable principles from the Liikanen Report will always be examined first, before having a look at the implementation in the three selected continental European countries.

\textbf{IV. Comparison and conclusions}

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>UK</th>
<th>EU</th>
<th>Fr</th>
<th>De</th>
<th>Be</th>
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</thead>
<tbody>
<tr>
<td>1. Curtailing implicit guarantees/avoiding bail-outs</td>
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<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>2. Avoiding excessive risk taking</td>
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<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>3. Remove/diminish risks from the financial system</td>
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<tr>
<td>4. Avoid conflicts of interest</td>
<td>X</td>
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<td>5. Keep advantages of diversification</td>
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<td>X</td>
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<tr>
<td>6. Improve financing of the real economy</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>7. More level playing field</td>
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<td>X</td>
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</tbody>
</table>

Table: Rational behind the different rules

\textsuperscript{41} Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen. Hereafter: “Belgian Banking Act”.
At first sight the rational of all rules under discussion is similar: to avoid that in future crises, the taxpayer bears the burden of risks taken by the banks for their own profit. Therefore all systems mention curtailing implicit guarantees or avoiding bail-out (1) as a rational. Nevertheless there is a difference between those stressing the avoidance of excessive risks (2), which is done by those systems based on the Liikanen Report, as opposed to those systems stressing the avoidance of bail-outs. This will be apparent in the following parts of this dissertation. A second distinction worth noting is that whereas most systems focus on insured deposits to determine the risk of implicit guarantees, the UK focuses on vital services.

The differences between the systems grow even bigger if we look at the other reasons in the table. Only France and Germany seem to look at the stability of the financial system itself (3), although with a different reasoning. In France the idea is that proprietary trading will not be able to reach its pre-crisis levels, whereas according to the German legislator, the improved solvency of the market participants, will improve the stability of the financial markets. This should be compared to the Volcker Rule, where it is made apparent that avoiding risks is not the aim of the rule, only making sure that the person who takes the risk is the one who turns up for it when things go wrong.

Avoiding conflicts of interest (4) is only shared by the Volcker Rule and the French statute, though it seems more important in the former case than in the latter, where it was adopted without taking over the rest of the proposed amendment.

Keeping advantages of diversification (5) was introduced to advocate allowing the prohibited activities from being carried on in a separate entity within the same group. Therefore it should be seen as an underlying principle of the French, German and Belgian rules, although it cannot be found there as such.

Improving the financing of the real economy (6) and creating a more level playing field for banks (7) are useful economic side-effects of these rules. Even so, they are only given by some to endorse the rule's approval.

This concludes the comparison of the purpose of the different rules. When discussing the specific elements of the rules in the following parts, reference will be made to the basic principles that were established here.
PART II SCOPE OF APPLICATION
In this part, we turn to the question to which entities the rules apply. This question is of special importance in the UK, because this also answers the question which activities should be protected by the ring-fence.

I. United States

The Volcker Rule\footnote{Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, hereafter referred to as the “Volcker Rule” or the “Rule”.
} applies to all banking entities, as defined in Section 2(c) of the Regulation.\footnote{Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, Final Rule, 79 Fed. Reg. 5535-6076. Hereafter: “Final Rule” or “Regulation”.
} In this section, a banking entity is defined as:\footnote{There are some minor exemptions to the list above, which are not covered.
}

- Any insured depository institution, which means any bank or savings association the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC).\footnote{Section 3(c)(2) of the Federal Deposit Insurance Act of 1950.
} Under US law, banks are not required to apply for deposit insurance. An application is available on the website of the FDIC to find out if a bank is insured.\footnote{https://research.fdic.gov/bankfind/}
- Any company that controls an insured depository institution. As a result of its control, this company will be deemed a bank holding company under section 2 of the Bank Holding Company Act of 1956 (or a savings and loan holding company).\footnote{R. LEDIG, C. ROSE, D. HARRIS, T. VARTARIAN, D. VAUGHAN AND C. WILLIAMS, The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 41.
}
- An international company that is treated as a bank holding company. As mentioned in the introduction, the international aspect of the Volcker Rule will not be treated in detail.
- Any affiliate or subsidiary of the above. Both terms are defined in the Bank Holding Company Act of 1956. An affiliate is a company that controls, is controlled by, or is under common control with another company.\footnote{Section 2(k) Bank Holding Company Act of 1956.
} A subsidiary is a company directly or indirectly controlled by another company.\footnote{R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 54.
}

In the definitions above, the term control plays an important part. According to section 2 of the Bank Holding Company Act of 1956, a company has control over another company if it directly or indirectly holds 25\% or more of any class of voting securities of that company, it has the power to
control the election of the majority of the directors or trustees, or Board of Governors of the Federal Reserve System (FRB) determines that there is control.\textsuperscript{52}

A company holding less than 5\%, will be presumed not to have control.\textsuperscript{53} In practice, however, a company can hold up to 10\% without having to worry about being regarded as having control by the FRB.\textsuperscript{54}

There are three exclusions from the definition of a banking entity.

The first of those are covered funds that are only a banking entity under the fourth point of the definition of a banking entity.\textsuperscript{55} As a general rule, to avoid circumvention of the Rule, banking entities are not allowed to have an ownership interest in or sponsor certain companies that carry on prohibited activities.\textsuperscript{56} These are referred to as covered funds. The exceptions to this prohibition may lead the covered fund to conform with the definition of a banking entity because it has a connection with a banking entity, meaning they would have to comply with the Volcker Rule. In order to avoid this unwanted side-effect, this exclusion was necessary.\textsuperscript{57}

The second exclusion concerns portfolio companies, again under the condition that they only qualify as a banking entity under the fourth point of the definition.\textsuperscript{58} Under the Gramm-Leach-Bliley Act, a financial holding company is under certain circumstances allowed to invest in a company that carries out activities that it is not permitted to carry out itself. Those companies are called portfolio companies.\textsuperscript{59}

Finally the FDIC itself is also excluded from being a banking entity.\textsuperscript{60}

\textsuperscript{52} Section 2(a)(2) of the Bank Holding Company Act of 1956.
\textsuperscript{53} Section 2(a)(3) of the Bank Holding Company Act 1956.
\textsuperscript{54} R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 38.
\textsuperscript{55} Regulation, § _.2(c)(2)(i).
\textsuperscript{56} Regulation, § _.10. This will be discussed in Part IV of this dissertation.
\textsuperscript{57} R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 42-43.
\textsuperscript{58} Regulation, § _.2(c)(2)(ii).
\textsuperscript{59} R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 43.
\textsuperscript{60} Regulation, § _.2(c)(2)(iii).
The scope of application of the Volcker Rule is logical in relation to the rational behind the Rule, which is protecting deposits from the risk of speculative activities and hence lifting the implicit protection of speculation. Barring some minor exceptions, the Rule applies to all insured depository institutions and all entities that have a close relationship with them.
II. United Kingdom

The FSMA\textsuperscript{61} requires certain ‘core activities’ to be conducted within a separate body. Apart from the exemptions discussed hereafter, these entities are considered to be ‘ring-fenced bodies’, to which the rules discussed in this dissertation are applicable.\textsuperscript{62}

A. Core activities

At the moment, the only core activity is accepting certain deposits. The FSMA allows the Treasury to establish other core activities, but it has not chosen to do this.\textsuperscript{63}

The deposits referred to in the previous paragraph have to be ‘core deposits’. Those are deposits held with a UK deposit-taker in a branch of that deposit-taker within the EEA.\textsuperscript{64} A UK deposit-taker is an institution that has permission under Part 4A of the FSMA to carry on regulated activities.\textsuperscript{65} Firms that already have permission in another EEA state, do not need to obtain this permission.\textsuperscript{66} As a consequence, they will never be a UK deposit-taker or a ring-fenced body.

The identity of the account holder, can also influence its status of core deposit. The accounts of four types of account holder are not considered to be core deposits.

The first of those are the relevant financial institutions as listed in article 2 of the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014. These are credit institutions, investment firms, various types of investment funds, systemically important insurers and structured finance vehicles.\textsuperscript{67} Exceptions to this list are provided for ring-fenced bodies and other institutions that carry on similar activities, institutions that are not allowed to carry on excluded activities\textsuperscript{68}, certain international institutions listed in the schedule and recognised clearing

\textsuperscript{61} Financial Services and Markets Act 2000. Hereafter: “FSMA”.
\textsuperscript{62} Section 142A(1) FSMA.
\textsuperscript{63} Section 142B(5) FSMA.
\textsuperscript{64} Art. 2(3) Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
\textsuperscript{65} Art. 1(3) Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
\textsuperscript{66} Section 40(3) FSMA.
\textsuperscript{67} Art. 2 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014. More details can be found in part IV of this dissertation, discussing the permitted relationships of ring-fenced bodies to financial institutions.
\textsuperscript{68} Excluded activities will be discussed in part III of this dissertation.
houses and central counterparties.\textsuperscript{69}

It should be noted that, as a rule, the deposits of financial institutions cannot apply for the deposit guarantee scheme\textsuperscript{70}, since, if this were possible, there would be a risk that they would artificially increase the protection offered by this scheme. Therefore there is no fear of an implicit guarantee by not including these deposits in the ring-fence.

The second category of account holders whose accounts are not core deposits is that of a qualifying organisation. In order to qualify as such an organisation, bodies corporate or partnerships have to make a qualifying statement and meet at least one of the following conditions:

\begin{itemize}
\item have a turnover of at least £6.5 million;
\item have a balance sheet total of at least £3.26 million; or
\item have at least 50 employees.\textsuperscript{71}
\end{itemize}

Organisations that are not one of two aforementioned forms, are required to have a gross income, as defined in article 5 of the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014, of at least £6.5 million.\textsuperscript{72}

The qualifying statement must contain a statement that the conditions were met in the fiscal year preceding the fiscal year in which the statement was given. Special rules exist for organisation willing to make this statement in their first fiscal year. The statement must either be accompanied by a copy of the annual accounts or by a confirming statement by a recognised accountant.\textsuperscript{73}

The qualifying statement gives organisations that meet the minimum requirement the choice whether or not they want their deposits to be protected by the ring-fence. In its report, the ICB indeed recognised that not all organisations are in need of the protection offered by the ring-fence, because they are less vulnerable to an interruption to their banking services, amongst other things because larger companies are less likely to have all their funds with one bank.\textsuperscript{74} According to the

\begin{flushleft}
\textsuperscript{69} Art. 2(3) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
\textsuperscript{70} Financial Conduct Authority, \textit{FCA and PRA Handbook},
\textsuperscript{71} Art. 4 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
\textsuperscript{72} Art. 5 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
\textsuperscript{73} Art. 3 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
\textsuperscript{74} Independent Commission on Banking, \textit{Final Report}, 2011, 40, n° 3.17,
http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final
\end{flushleft}
report, the vast majority of the SMEs, however, cannot plan for a disruption of these services and should be included in the ring-fence. Despite this, the minimum criteria used in order to determine if an organisation can qualify as a qualifying organisation, are those of a small company\(^{75}\), which is a much too low threshold. Instead, the criteria for being an SME, which are significantly higher, were suggested by the ICB.\(^{76}\)

The reason for the use the criteria of small companies might be that they are also used to determine if a company’s deposits can benefit from the Financial Services Compensation Scheme.\(^{77}\) One could reason that if they are not protected by this scheme, there is no harm in letting them be held outside the ring-fenced body, because there is no risk of an implicit guarantee. There are two problems with this. The first, which has already been touched upon in the previous paragraph, is that the purpose of the ring-fencing rule is not only to curtail implicit guarantees by way of the deposit guarantee scheme, but also to ensure continuity of financial services.\(^{78}\) Only organisations for which this is not an issue, should be able to bypass the protection. If not, the government might need to intervene anyway, to avoid mass bankruptcies of those SMEs.

The second is that in the meantime a new directive on deposit scheme guarantees has been enacted.\(^{79}\) Under this new directive, the deposits of large companies are no longer excluded.\(^{80}\) With the definition used by the ICB, only a small amount of insured deposits would be held in non ring-fenced bodies.\(^{81}\) With the definition used in the Order, however, the discrepancy could be bigger. If too many insured deposits are held outside the ring-fenced body by SMEs that are not prepared for the disruption of the services, then the risk that of a government bail-out will greatly increase.

The third category of account holders whose accounts are not core deposits is that of the qualifying...
group member. These are group members of qualifying organisations. As with the second category, a statement by the organisation is required in order to achieve this status. This qualifying group member declaration must be accompanied by a qualifying organisation declaration by the relevant qualifying organisation, unless the UK deposit-taker has already received the latter declaration prior to the former.\footnote{Art. 8 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.} The arguments from the previous category against allowing certain organisations to hold deposits outside the ring-fenced body, are even stronger here, because the organisations in this category do not even meet the criteria on their own. In case of an interruption of the financial services, they would likely become dependent upon the larger group member, which might be confronted with the same problem and thus unable to help.

The fourth and final category is that of the eligible individual. An individual is an eligible individual if he makes a declaration of eligibility and holds money and transferable securities\footnote{Art. 10(5) Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.} of at least £250,000 on average during a period of at least 12 months, ending not more than 3 months before the date of the declaration. The declaration must be accompanied by a confirming statement by a recognised accountant, although the UK deposit-taker can waive this requirement if it is satisfied that the declaration is true.\footnote{Art. 9 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.}

This category was introduced in the Vickers Report as high net worth individuals.\footnote{Vickers Report, 40, n° 3.17.} The same logic applies that individuals with this amount of money, are expected to hold deposits in more than one bank. This is especially true since the deposit guarantee limit is applied per person per firm.\footnote{Financial Services Compensation Scheme, Compensation limits, \url{http://www.fscs.org.uk/what-we-cover/eligibility-rules/compensation-limits/} (Consulted 2 February 2016).} Even though the deposit guarantee scheme still applies to those deposits, the pressure on the deposit guarantee scheme is not likely to increase too much because of this exemption, because of the very limited amount of people meeting the criteria.\footnote{HM Treasury, Banking reform: delivering stability and supporting a sustainable economy, 2012, \url{https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32556/whitepaper_banking_reform_140512.pdf}, 17, n° 2.16.}
B. Exemptions

Despite accepting core deposits, an organisation is not required to become a ring-fenced body if it meets one of the following exemptions.

The first exemption is the core deposit level condition. If at no time the average core deposit total exceeds £25 billion, the UK deposit-taker is not required to ring-fence those activities. In a group, the sum of the average core deposit totals of all relevant group members, i.e. UK deposit-takers apart from those carrying out or effecting insurance contracts as a principal, is taken into account to determine whether the threshold has been exceeded. In some cases of transfers or acquisitions, the newly acquired deposits may be excluded from the calculations for maximum four years.

The ICB was very critical of this exemption, arguing that the exemption might be confusing for consumers and that even the resolution of small banks could be very complex. Additionally, through a lot of small banks, the contagion by the financial markets could spread to the retail banking system. There is also the risk of competitive distortion, as banks aim to remain under the minimum size. Last, the fact that most smaller banks do not carry out any prohibited services also means that the ring-fencing rule will not have any adverse affects on most of them. Despite these arguments, the Treasury nevertheless included the exemption.

The second exemption is the relevant event condition, which is similar to the exclusion of certain transfers in the first exemption. The UK deposit-taker can rely on this exemption if he would not be a ring-fenced body, if the relevant event had not occurred. A relevant event must be a transfer under the Banking Act 2009, which deals primarily with bank insolvency and resolution, within the last four years. It will probably facilitate transfers of deposits from those troubled banks.

The remaining exemptions can be grouped together as entities organised under another legal form with its own special rules. Not considered ring-fenced bodies are building societies, registered societies, Northern Ireland industrial and provident societies, Northern Ireland credit unions or UK

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90 Vickers Report, 39, no 3.15.
91 Art. 11 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
92 Section 142A(2)(a) FSMA.
deposit-takers that carry out the regulated activity of effecting and carrying out contracts of insurance as a principal under Part 4A of the FSMA.\textsuperscript{94}

\textbf{C. Requirement for UK deposit-takers that are not ring-fenced bodies}

Non ring-fenced bodies, which are not covered under the exemptions in B, are required to inform individuals who are account-holders or are planning to open an account of its activities that would be prohibited or excluded activities if it was a ring-fenced body.\textsuperscript{95}

The only individuals with the possibility of holding accounts with non exempted non ring-fenced bodies are the eligible individuals mentioned above. Since their accounts will be guaranteed, one could question the usefulness of this obligation to inform.

\textsuperscript{94} Art. 11(1)(a) Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.

\textsuperscript{95} Art. 14 Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014.
III. Continental Europe

A. Liikanen Report

According to the Liikanen Report, a separation within a banking group is only required if the activities to be separated from the entity holding insured deposits reach a certain amount\(^{96}\), but once this amount is met, all those activities should be transferred to the trading entity.\(^{97}\) A small amount of trading activities are assumed to be “inherently linked to client needs” and a small level of trading risk on deposits can be tolerated.\(^{98}\) Therefore the Report is in favour of a *de minimis* threshold.\(^{99}\) In their proposal, an amount of all assets held for trading and assets available-for-sale exceeding a relative threshold of 15-25% of the total assets or an absolute threshold of € 100 billion would trigger an examination in which a supervisor would investigate the need for separation, basing its decision on the amount of assets that would need to be transferred.\(^{100}\) Very small banks should always be exempted.\(^{101}\) To which assets this transfer requirement applies, will be examined in part III. For now it is sufficient to note that the activities used to determine if the threshold, that triggers further investigation by the supervisor, has been exceeded, is not completely identical to the activities that will have to be separated once it is established that the threshold has been surpassed.

The willingness of the Liikanen Report to accept a *de minimis* exemption, as opposed to the Vickers Report, can be explained by looking at the underlying principles of both reports. Whereas Vickers clearly wants to separate the trading risks from the vital services, the Liikanen Report aims at removing excessive risks, believing that this is sufficient protection in combination with other measures such as higher capital requirements and bank resolution plans.

After the separation, the trading entity cannot take insured deposits or supply retail payment services.\(^{102}\)


\(^{97}\) Liikanen Report, 101.

\(^{98}\) Liikanen Report, 94-95.

\(^{99}\) Liikanen Report, 94-95.

\(^{100}\) Liikanen Report, 101.

\(^{101}\) Liikanen Report, 101.

\(^{102}\) Liikanen Report, 102.
B. France

In France, the separation requirement applies to credit institutions, financial holding companies and mixed financial holding companies, the trading in financial instruments of which exceeds a threshold established by the Government. The definitions of the relevant entities is largely taken over from EU law.

Credit institutions are enterprises that carry out the activity of accepting deposits and other repayable funds and providing credits in a professional capacity and providing payment services. These activities are forbidden for other entities.

A financial holding company is a financial institution whose subsidiaries are exclusively or mainly institutions or other financial institutions, as defined further. If the parent company is not a financial institution or an institution and at least one of the subsidiaries is an institution, this parent company will be qualified as a mixed financial holding company.

In order to get a clear grasp on this definition, the terms 'financial institution', 'institution' and 'subsidiary' need further explanation. Since both financial holding companies and mixed financial holding companies are subject to the separation requirement, it is not necessary to look into the exact meaning of 'mainly'.

A financial institution is an enterprise, other than an institution, whose main activities consist of holding participations, which in the present context means directly or indirectly holding 20% in another company or holding rights in the company which lead to a durable link and which are intended to contribute to the activity of that company, or carrying on the activities in points 2-12 and 15 of annex I of Directive 2013/36/EU. The annex referred to, lists the activities subject to

104 Definitions introduced by Ordonnance n° 2014-158 du 20 février 2014 portant diverses dispositions d'adaptation de la législation au droit de l'Union européenne en matière financière.
105 Art. L511-1 Code monétaire et financier.
106 Art. 511-5 Code monétaire et financier.
108 Art. L517-4-1 Code monétaire et financier.
110 Art. L511-21 Code monétaire et financier.
mutual recognition.\textsuperscript{111}

An institution is a credit institution, as defined above, or an investment firm according to Directive 2004/39/EC,\textsuperscript{112} which is a legal person whose regular occupation or business is that of providing investment services or performing investment activities.\textsuperscript{113} Those activities are those listed in section A of annex I in connection with the financial instruments listed in section C of the same annex.\textsuperscript{114}

Not considered investment firms are credit institutions, local firms and firms providing only the activities in point 1, 2, 4 and 5 of section A of the aforementioned annex and which is not allowed to provide ancillary services, listed in section B of the same annex, or hold money or securities of clients.\textsuperscript{115} A local firm is a firm which is only active for its own account on cash markets and derivative markets, the latter for the sole purpose of hedging its activities, or that deals on those markets for the account of other members, its performance being guaranteed by clearing members of those markets.\textsuperscript{116}

The final concept that needs clarification is that of “subsidiary”. A company is a subsidiary if it is controlled by another company or in case of a dominating influence on that company caused by durable and important links with another company as a result of financial engagements, common management or common services.\textsuperscript{117} A subsidiary of a subsidiary is also counted as a subsidiary of the top parent company.\textsuperscript{118}


\textsuperscript{114} This annex is taken up as annex to the present dissertation.

\textsuperscript{115} Art. (4)(1)(2)(c) CRR.

\textsuperscript{116} Art. (4)(1)(4) CRR.

\textsuperscript{117} Art. 511-20 Code monétaire et financier.

\textsuperscript{118} Art. 511-20 Code monétaire et financier.
There is control if the parent company directly or indirectly has the majority of the voting rights, if it was able to appoint the members of the board of directors, the management or the supervisory body on two consecutive occasions, or if it has a dominating influence resulting from the articles of association or a shareholders agreement.\textsuperscript{119}

With the above definitions, it is clear that both institutions and parents of institutions will have to comply with the separation requirements if the threshold is exceeded. The calculation of this threshold is the next point under examination.

The French parliament left the decision of the height of the threshold to the government, with mandatory advice of the Conseil d'Etat.\textsuperscript{120} If the value of the trading activities in financial instruments exceeds 7.5% of the total assets of the company, the threshold is breached.\textsuperscript{121} In groups, this percentage is calculated on a consolidated basis.\textsuperscript{122} A group consists of a parent with all its subsidiaries and all companies in which either of those has a participation, as well as other companies with a board of directors, management or supervisory body largely consisting of the same members as similar bodies in a company of the group.\textsuperscript{123}

7.5% is half of the lowest percentage set in the Liikanen Report. As a result, France will most likely comply with any future EU rule in this respect.

So what assets should be considered in order to determine this percentage? The trading assets are those financial assets, as defined in IAS 32, which are booked as 'financial asset at fair value through profit or loss' in accordance with IAS 39.\textsuperscript{124} Financial assets refers to cash, equity instruments of another entity, contractual rights to receive cash or other financial assets or to exchange them under potentially favourable conditions, or certain derivatives or non-derivative contracts relating to the entity's own shares.\textsuperscript{125} Their fair value is that which a third party would be

\textsuperscript{119} Art. 233-16 Code de Commerce.
\textsuperscript{120} Art. L511-47 Code monétaire et financier.
\textsuperscript{121} Art. R511-16(1) Code monétaire et financier.
\textsuperscript{122} Art. R511-16(2) Code monétaire et financier.
\textsuperscript{123} Art. L511-20 Code monétaire et financier.
\textsuperscript{124} Art. R511-16(1) Code monétaire et financier.

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willing to pay for it in a transaction at arm’s length.\textsuperscript{126}

The financial assets that are booked as ‘financial asset at fair value through profit or loss’ are those that are held for trading, meaning they were either acquired for the purpose of reselling them, they are part of a portfolio in which a pattern of short-term profit-taking can be observed or they are derivatives.\textsuperscript{127}

A derivative is a financial instrument or any other contract the value of which changes in response to another variable. In case of a non-financial variable, this change may not be dependent upon a party to the contract. Further it is required that there is no initial net investment, or a smaller one than other contracts that respond similarly to the same changes in market factors. The final characteristic is that a derivative is settled at a future date.\textsuperscript{128}

Two kinds of derivatives will not be classified as held for trading. The first are derivatives that are financial guarantee contracts. These are contracts that require the issuer to pay a specified amount to the holder when the original debtor fails to do so in accordance with the terms of a debt instrument.\textsuperscript{129} The second are designated and effective hedging instruments, which meet a series of requirements under IAS 39.

Apart from those classified for trading, sometimes financial assets can be designated upon initial recognition as fair value through profit and loss. This is the case if there is a derivative embedded within a larger contract or, in some instances, if doing so results in more relevant information.\textsuperscript{130}

For those companies not subjected to the International Accounting Standards, the value of the trading assets will be that of the “titres de transaction” (trading securities) under French accounting standards.\textsuperscript{131} While this definition is similar to the one described above, there could be differences which possibly deviate from the intention of the Liikanen Report.

\begin{itemize}
  \item\textsuperscript{126} IAS 32(11).
  \item\textsuperscript{128} IAS 39(9).
  \item\textsuperscript{129} IAS 39(9).
  \item\textsuperscript{130} IAS 39(9).
  \item\textsuperscript{131} Art. R511-16(1) Code monétaire et financier.
\end{itemize}
So, while the French rules use a much lower percentage, they do not take into account all assets determined in the Liikanen Report, because assets available-for-sale are not included. Just like the Liikanen Report, the statute prohibits the trading entity from accepting insured deposits or providing payment services to customers holding insured deposits.\(^{132}\)

**C. Germany**

Since both Germany and France based their legislation on the same report and both legislators were keeping an eye out for what the other was doing, it shouldn't be surprising that both rules are largely similar. For instance, in a discussion in the French parliament, Mr. Moscovisci responded: “*Puisque vous aimez nous comparer toujours à l’Allemagne, regardez ce qui se passe là-bas. Ce pays est en train de définir un projet de loi quasiment identique au nôtre.*”\(^ {133}\)

The entities covered by the German legislation are CRR-credit institutions and enterprises that are part of a *Instutsgruppe*, financial holding group, mixed financial holding group or a financial conglomerate that has at list one institution as a member.\(^ {134}\) These are groups with an institution, financial holding company or a mixed financial holding company, respectively, as parent.\(^ {135}\) All those terms are to be defined in accordance with the CRR. Therefore the same entities are envisaged as under French law.

Comparing the wording of the French and German text, we see that the German rule refers to the group and the French to the individual companies, but since the threshold is calculated on group basis, the application should be the same for both countries.

Where the relevant entities are the same, the applicable threshold is not. In Germany, the threshold is exceeded if the value of the trading assets is higher than 100 billion Euros or amounts to more than 20% of the total assets.\(^ {136}\) There is an exemption for small entities or groups: the 20% threshold is only applicable if the total assets exceeded 90 billion Euros on the balance sheet date of the past

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\(^ {133}\) ASSEMBLÉE NATIONALE, deuxième séance du mardi 12 février 2013, [http://www.assemblee-nationale.fr/14/cri/2012-2013/20130145.asp](http://www.assemblee-nationale.fr/14/cri/2012-2013/20130145.asp). Translation: “Since you are always comparing us with Germany, let's look over there for a moment. That country is in the process of discussing a law proposal that almost identical to ours.”

\(^ {134}\) Kreditwesengesetz, §3 Absatz 2. Hereafter: “KWG”.

\(^ {135}\) KWG, §10A.

\(^ {136}\) KWG, §3 Absatz 2.
three years. In the proposal for this statute, it is specified that 20% was chosen because it is in the middle of the spread of 15% to 25% provided in the Liikanen Report.

Also the relevant trading assets are not entirely similar to the French. Whereas the French rules uses all the financial asset at fair value through profit or loss of IAS 39, the German statute only refers to the financial assets held for trading and not those that are designated as at fair value through profit and loss. Further, they also take the available-for-sale financial assets into account. Those are financial assets that are designated as such by the entity or financial assets that are not classified as loans and receivables, held-to-maturity investments or financial assets at fair value through profit or loss.

For entities not subjected to international accounting standards, the relevant assets are determined according to German accounting standards. There is a risk that under these rules, assets might fall in another category than they would under IAS.

As can be seen, the German rule is a more literal transposition of the Liikanen Report with regard to the threshold. Despite that, just as its French counterpart, the second part of the test was omitted, so there is no second opinion of the supervisor, making its application more straightforward. Also different is that the German statute does not explicitly repeat that the trading entity may not accept deposits or provide retail payment services, although the rules will have that effect.

137 KWG, §3 Absatz 2.
139 KWG, §3 Absatz 2, Satz 1 Nummer 1.
140 KWG, §3 Absatz 2, Satz 1 Nummer 1.
141 IAS 39(9).
142 KWG, §3 Absatz 2 Satz 1 Nummer 2.
D. Belgium

The Belgian rule follows a different path than that of its two neighbouring countries. The Belgian Banking Act contains a prohibition on proprietary trading that is applicable to all credit institutions, again using the EU definition\(^\text{143}\), covered by the Belgian deposit guarantee.\(^\text{144}\) All credit institutions active in Belgium are covered, unless they are a branch of a credit institution of another EU member state or of a third state with a similar deposit guarantee scheme.\(^\text{145}\) The Belgian government acknowledges that future EU legislation will only apply to large banks, but thought it necessary to require all banks to comply.\(^\text{146}\)

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\(^{143}\) Art. 1, §3 wet van 25 April 2014 op het statuut van en het toezicht op kredietinstellingen. Hereafter: “Belgian Banking Act”.

\(^{144}\) Art. 117 Belgian Banking Act.

\(^{145}\) Art. 380 Belgian Banking Act.

IV. Comparison and conclusions

In all jurisdictions, the main qualifying element is holding insured deposits. This is only natural since they all aim to protect those deposits and avoid government bail-outs. On the level of the entity itself, both the US and Belgium require all deposit banks to comply, while France, Germany and the UK have a so called *de minimis* exemption, although in the case of the UK this is in direct opposition to the Vickers Report. In the UK, there is an absolute threshold of holding £25 billion in core deposits, France has a relative threshold of 7.5% trading assets, while Germany has both an absolute and a relative threshold of €100 billion or 20% trading assets respectively, with an exemption for banks with total assets of less than €90 billion. It is interesting that France and Germany do not calculate the percentage using the same assets, with Germany following the Liikanen Report and designating both financial asset at fair value through profit or loss\(^{147}\) and assets available-for-sale, while France only uses the former category. Although this could lead to some distortions, the much lower percentage probably makes up for that. Incidentally, the national accounting standards, applicable in case of a smaller bank that is not subjected to IAS, could also create different outcomes in certain cases. It should be noted that the Liikanen Report was the only report in favour of the exemption. This is because it only wanted to avoid excessive risk taking, while other reports saw more danger in the cumulative effect that exposing a lot of smaller banks to trading activities might lead to.

In the UK, there is also an exemption to the ring-fencing requirement to facilitate the purchase of assets from a distressed bank and for different types of entities which are subject to their own legislation with its own limitations on activities. Other countries do not have similar rules.

On a group level, we see that the US extends the prohibition to group members, which means that the prohibited activities will not be permissible in the entire group, unless it meets the exception which was inserted to allow certain relationships with covered funds.\(^{148}\) In the UK, France and Germany, the threshold for the *de minimis* exemption is calculated on a consolidated basis, which means that as a result the entire group is affected and will have to separate its trading activities or ring-fence its commercial banking activities. In Belgium, all credit institutions are affected and their relationships with trading entities are regulated, but not entirely prohibited.\(^{149}\)

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147 With a slight deviation, since Germany does not include the designated financial assets at fair value through profit and loss.
148 See part IV.
149 See part IV.
In most jurisdictions, the activities which have to remain in the deposit bank are all insured deposits, in the continental European countries retail payment services is added to this. In the UK, however, things are more complex, with some deposits being allowed outside the ring-fence, even if they are insured. This is not always in line with the Vickers Report, which imposed much higher requirements for qualifying organisations and which did not include an option for group members of the qualifying organisation to place their deposits outside the ring-fence as well.
PART III PROHIBITED ACTIVITIES
This part is the first of the two main parts. Its subject will be the determination of which activities are prohibited by the various rules. The concepts explained here are proprietary trading in the US, excluded activities in the UK and trading activities in France, Germany and Belgium. After describing these concepts for each country individually, the final chapter will make a comparison between the countries and relate the findings of this comparison to the underlying objectives of the rules.

I. United States

A. Introduction to the prohibition

The Agencies\textsuperscript{150} implementing the prohibition on proprietary trading, were faced with the task of defining the relevant terms in such a way as to accomplish the goals of the Rule, without negatively impacting valuable commercial banking activities.\textsuperscript{151} Although Mr. Volcker insists that: “Bankers know what proprietary trading is and what it is not”\textsuperscript{152}, he too acknowledges that striking the right balance is far from easy.\textsuperscript{153} Mr. Neal Wolin, the Deputy Secretary of the Department of the Treasury at the time, summarised the basic principle as follows: “[... that if it is not customer-related, that it is proscribed.”\textsuperscript{154} For an activity to qualify as customer-related, it is sufficient that this relationship is incidental.\textsuperscript{155}

The Final Rule\textsuperscript{156} deals with this complexity by first giving a broad definition and then providing exclusions and exemptions. The difference between ‘exclusions’ and ‘exemptions’ is that the former are not considered to be proprietary trading and thus are not forbidden, despite potentially meeting the definition. On the contrary, the latter are considered proprietary trading and as a consequence,

\textsuperscript{150}The Agencies refers collectively to five agencies responsible for implementing the Volcker Rule: the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC).


\textsuperscript{152}Hearing, 37.

\textsuperscript{153}Hearing, 10-11.

\textsuperscript{154}Hearing, 11.

\textsuperscript{155}Hearing, 10.

\textsuperscript{156}Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5535-6076. Hereafter: “Final Rule” or “Regulation”.

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they are only allowed if all the conditions set out in the Regulation are met.\(^{157}\)

This chapter will follow the structure of the Regulation. First, the general definition of proprietary trading will be discussed. Next, we will look at the exclusions from the definition and the third and final point of this chapter will be about the exemptions.

### B. Proprietary Trading

The Regulation implementing the Volcker Rule defines proprietary trading as: “engaging as a principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments”.\(^{158}\)

In order to gain a better understanding of this definition, the terms trading account and financial instruments will need further explanation.

1. **Trading account**

First of all, it should be noted that the term trading account does not necessarily refer to an actual account. The Agencies have clarified that “it is simply a nomenclature for a set of transactions that are subject to the final rule’s restrictions on proprietary trading”.\(^{159}\)

The Regulation has three prongs to determine whether a financial instrument is part of the trading account of the banking entity. The second and third of those were primarily added to provide additional guidance to entities that are subject to the Acts those prongs refer to.\(^{160}\) Moreover, by using the definitions of those other statutes, they reinforce consistency between the various financial acts and regulations.\(^{161}\)

2. **Short-term Intent**

This first prong is very similar to the statutory definition of trading account.\(^{162}\) It focuses on the intention of the banking entity to realise short-term profits through short-term resale, short-term price movements or short-term arbitrage.\(^{163}\) Acquiring financial instruments for this purpose is

\(^{157}\) R. LEDIG et al., *The Volcker Rule: Commentary and Analysis, s.l.*, Thomson Reuters, 2014, 57.

\(^{158}\) Regulation § _.3(a).

\(^{159}\) Regulation, 5548.


\(^{161}\) Regulation, 5548.


\(^{163}\) Regulation, § _.3(b)(1)(i).
considered to be speculation and is therefore impermissible.

Additionally, the Agencies included the hedging of the aforementioned positions in the definition, because they do not believe the hedges will be kept any longer than the underlying positions.\textsuperscript{164}

For the qualification as short-term, a rebuttable presumption of sixty days is included in the Regulation.\textsuperscript{165} This presumption does not proscribe holding financial instruments for less than sixty days, nor does it provide a safe harbour for positions held for a longer period.\textsuperscript{166} It does, however, require banking entities to indicate why such positions do not constitute proprietary trading.

The principal goal of this presumption is to guide smaller banking entities, to which the market risk capital rules do not apply and which are not a dealer, a swap dealer or a security-based swap dealer.\textsuperscript{167} Other banking entities can rely on the second and third prong to provide additional guidance.

It was clarified that the sixty day presumption is also applicable to basis trades, \textit{i.e.} where a financial instrument is bought while a substantially similar instrument is sold.\textsuperscript{168}

\textbf{b. Market Risk Capital Rule}

The second prong refers to financial instruments that are both a covered position and a trading position under the market risk capital rule. This is logical, because only the financial instruments held for trading purposes, are used to calculate market risk.\textsuperscript{169} As in the first prong, hedges of those positions are included in the definition.\textsuperscript{170}

The Regulation points to several other regulations that contain market risk capital rules, applicable to different kinds of banking entities. Fortunately, the relevant Agencies\textsuperscript{171} worked out a joint final

\begin{footnotes}
  \footnote[164]{\textsuperscript{164} Regulation, 5548.}
  \footnote[165]{\textsuperscript{165} Regulation, § .3(b)(2).}
  \footnote[166]{\textsuperscript{166} R. \textsc{Ledig et al.}, \textit{The Volcker Rule: Commentary and Analysis}, s.l., Thomson Reuters, 2014, 62-63.}
  \footnote[167]{\textsuperscript{167} Regulation, 5549-5550.}
  \footnote[168]{\textsuperscript{168} Regulation, 5550.}
  \footnote[169]{\textsuperscript{169} D. \textsc{Ballegeer}, “Basel III: The New Capital Regime for Banks”, \textit{Dr. Banc. Fin.} 2011, afl. 3, (147) 148.}
  \footnote[170]{\textsuperscript{170} Regulation, § .3(b)(1)(ii).}
  \footnote[171]{\textsuperscript{171} The OCC, the FRB and the FDIC.}
\end{footnotes}
rule\textsuperscript{172}, so the definition used in all market risk capital rules is the same.

To qualify as a covered position under this joint final rule, the financial instrument must be a trading asset or liability for the purpose of the U.S. Generally Accepted Accounting Principles (GAAP). This is a necessary, but not a sufficient condition.\textsuperscript{173} The position must also be a trading position or hedge another covered position.\textsuperscript{174} Moreover, the position should be free of any restrictive covenants on its tradability or the bank should be able to hedge the material risk elements of the position.\textsuperscript{175}

Foreign exchange or commodity positions are also considered to be covered positions. However, this is of little significance to the Volcker Rule, because, as we will see, those elements are excluded from the definition of financial instruments.

The joint final rule also provides several exclusions, which will not be discussed because they are either not prohibited by the Volcker Rule, for example because they do not satisfy the definition of financial instrument, or because they are proscribed on another basis. For example hedging outside the scope of the banking entity’s hedging strategy is not a covered position, because this would allow to many evading opportunities\textsuperscript{176}, but this is not allowed by the Volcker Rule anyway.\textsuperscript{177}

The definition of trading position is very similar to the short-term intent of the first prong. Again it refers to short-term resale, short-term price movements and arbitrage profits.\textsuperscript{178} As this is, at the same time, the most important element of the definition of covered position, it should not come as a surprise that the first and second prong are almost identical, as intended by the Agencies.\textsuperscript{179}

\textsuperscript{173} 77 Fed. Reg. 53063.
\textsuperscript{174} 77 Fed. Reg. 53100, § 2.
\textsuperscript{175} 77 Fed. Reg. 53100, § 2.
\textsuperscript{176} 77 Fed. Reg. 53064.
\textsuperscript{177} Regulation, § _.5(b)(2)(i).
\textsuperscript{178} 77 Fed. Reg. 53100, § 2.
\textsuperscript{179} 77 Fed. Reg. 53066.
c. Dealer, Swap Dealer or Security-based Swap Dealer

The third prong is connected with activities for which a licence or registration as a dealer, swap dealer or security-based swap dealer is required.\textsuperscript{180} The Agencies specified that it only applies to the activities for which the registration is required.\textsuperscript{181}

In practice, banking entities that are registered as a dealer, swap dealer or security-based swap dealer, will have to make a distinction between activities for which registration is necessary and other activities; an analysis which is not currently done by some of them.\textsuperscript{182} The effect of this prong will be that all activities in the former category are prohibited, unless an exemption applies.\textsuperscript{183}

A dealer is defined in the Securities Exchange Act of 1934 as “\textit{any person engaged in the business of buying and selling securities […] for such person's own account through a broker or otherwise.}” An exception is made for persons for whom the trading is not part of a regular business.\textsuperscript{184} Since a banking entity that is not a dealer cannot meaningfully use this prong as a guidance, this dealer/trader distinction, is not useful for determining the scope of the Volcker Rule. Note that there are also some exceptions for certain bank activities, which under the conditions prescribed in the Securities Exchange Act, do not require registration.\textsuperscript{185}

The definition of security-based swap dealer in the Securities Exchange Act of 1934 and of swap dealer in the Commodity Exchange Act of 1936 are very similar and for that reason, a joint final rule was made by the SEC and the CFTC for their interpretation.\textsuperscript{186} Despite those common principles, the concrete interpretation might differ in certain respects, because of the specificities of the market in both instruments.\textsuperscript{187}

There are four prongs to determine whether an entity is a swap dealer or security-based swap

\textsuperscript{180} Regulation, § _.3(b)(1)(iii).
\textsuperscript{181} Regulation, 5549.
\textsuperscript{182} Regulation, 5549.
\textsuperscript{183} R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 61.
\textsuperscript{184} Section 3(5)(A) and (B) of the Securities Exchange Act of 1934.
\textsuperscript{185} Section 3(5)(C) of the Securities Exchange Act of 1934.
\textsuperscript{187} 77 Fed. Reg. 30606.
dealer. The first and fourth of those are either holding oneself out to be a (security-based) swap dealer, or being commonly known in trade as one. The SEC and the CFTC have supplied a list of activities that could indicate that a person is acting as a (security-based) swap dealer.

The second prong is market making in swaps or security-based swaps, which will be treated under the exemptions.

The third prong, and final point to be discussed, is regularly entering into swaps or security-based swaps as an ordinary course of business for its own account. This prong closely resembles the definition of a dealer under the Securities Exchange Act of 1934. Again the ordinary course of business is used to distinguish dealers from traders. The SEC and the CFTC agreed with commentators that if the swaps agreements are entered into for the risk management of the other party, that this is an indication of entering into swaps as an ordinary course of business.

According to the Agencies, activities as a dealer, swap dealer or security-based swap dealer are generally held with short-term intent and hence they should be included in the definition of a trading account. As mentioned above, the intent of this prong is to prohibit all those activities, unless they fall within the scope of one of the exemptions. This prong does, however, not cover all proscribed activities. Thus, for non-dealer activities, it will remain necessary to check if it is in conformity with the other two prongs.

2. Financial instrument

Financial instruments include any security, derivative or option on a security or derivative. Precluded are loans and foreign exchange or currency.

For commodities the situation is more complex. As a general rule commodities are not financial

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190 See, p. 51 of this dissertation.
192 Regulation, 5549.
193 Regulation, 5549.
194 Regulation, §_.3(c)(1)(i) and (ii).
195 Regulation, §_.3(c)(2)(i) and (iii).
instruments. On the other hand, contracts of sale of a commodity for future delivery and excluded commodities, other than foreign exchange or currency, do qualify as financial instruments.

<table>
<thead>
<tr>
<th>Box 1: Excluded commodity – Commodity Exchange Act, section 1a(19)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The term “excluded commodity” means—</td>
</tr>
<tr>
<td>(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;</td>
</tr>
<tr>
<td>(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is—</td>
</tr>
<tr>
<td>(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or</td>
</tr>
<tr>
<td>(II) based solely on one or more commodities that have no cash market;</td>
</tr>
<tr>
<td>(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or</td>
</tr>
<tr>
<td>(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is—</td>
</tr>
<tr>
<td>(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and</td>
</tr>
<tr>
<td>(II) associated with a financial, commercial, or economic consequence.</td>
</tr>
</tbody>
</table>

C. Exclusions

Because of the broad definition, some elements are captured, or seem to be captured, without this being the intention of the Agencies. To resolve those issues, the Regulation contains nine exclusions.

The first and second exclusion both relate to transactions that have the function of a secured loan, instead of being driven by expected movement of the price. In the former, buying and selling financial instruments under repurchase and reverse repurchase agreements are excluded, while the

196 Regulation, §.3(c)(2)(ii).
197 Regulation, §.3(c)(1)(iii).
198 Regulation, §.3(c)(2)(ii)(A).
199 Regulation, §.3(d).
200 Regulation, 5553.
201 Regulation, §.3(d)(1).
latter is concerned with buying and selling of financial instruments under a securities lending agreement.\textsuperscript{202} It should be noted that only the transactions themselves are excluded and not, for instance, the collateral or the position that is being financed using one of the above techniques.\textsuperscript{203} Some commenter had advised to expand this exclusion to cover all transactions, regardless of the form, if their main purpose was to extend credit. However, the Agencies thought this would make the exclusion to difficult to assess and therefore allow to much opportunity for evasion.\textsuperscript{204}

The third exclusion is the purchase or sale of securities for the purpose of liquidity management.\textsuperscript{205} Other financial instrument than securities cannot be used for this purpose.\textsuperscript{206} To assure that this exclusion is not misused to sidestep the prohibition, the purchase or sale has to be in accordance with a detailed liquidity management plan, drawn up by the banking entity, that contains, amongst other things, both internal policies and procedures, as well as independent testing.\textsuperscript{207} It also details the amount, types and risks of the securities that can be held for this purpose.\textsuperscript{208} Those securities should, in any case, be highly liquid\textsuperscript{209}, which, according to the Agencies, cannot be identified in advance, but instead depends on the specific facts and circumstances.\textsuperscript{210}

The fourth exclusion is related to buying and selling financial instruments by a central counterparty in connection with its clearing and settlement activities.\textsuperscript{211} Clearing services are useful and other parts of the Dodd-Frank Wall Street Reform and Consumer Protection Act are even geared towards promoting central clearing of financial transactions.\textsuperscript{212} There are two types of central counterparties: clearing agencies, with respect to securities, and derivatives clearing organisations.\textsuperscript{213}

Commenters of the proposal had argued that the default management process of clearinghouses may force its members to engage in activities that, if not excluded, would constitute proprietary trading.

\begin{footnotes}
\item[202] Regulation, §_.3(d)(2).
\item[203] Regulation, 5554.
\item[204] Regulation, 5554.
\item[205] Regulation, §_.3(d)(3).
\item[206] Regulation, 5555.
\item[207] Regulation, §_.3(d)(2)(vi).
\item[208] Regulation, §_.3(d)(2)(i).
\item[209] Regulation, §_.3(d)(2)(iii).
\item[210] Regulation, 5555, footnote 241.
\item[211] Regulation, §_.3(d)(4).
\item[212] Regulation, 5556.
\item[213] Regulation, §_.3(d)(4).
\end{footnotes}
For instance, because certain of the applied techniques force the members to take over the defaulting member’s positions.\textsuperscript{214} Therefore, the Agencies created the fifth exclusion, as an extension to the previous one, which allows members of a clearing agency, derivatives clearing organisation or designated market utility to engage in those activities, demanded for the proper functioning of the clearing process.\textsuperscript{215} However, in order to limit evasion opportunities, the Agencies identified the excluded clearing activities very strictly, preferring to only grant further guidance or relief if needed.\textsuperscript{216}

In addition to clearing agencies and derivative clearing organisations, members of other designated financial market utilities can also benefit from this exclusion. The Dodd-Frank Wall Street Reform and Consumer Protection Act defines financial market utilities as: “\textit{any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person}.”\textsuperscript{217} Designated means that the financial market utility is labelled as systematically important by the FSOC.\textsuperscript{218}

The sixth exclusion allows banking entities to purchase or sell financial instruments to prevent or close out a failure to deliver\textsuperscript{219}, related to its clients trading activities, or its own, if done in compliance with the rules.\textsuperscript{220} Sometimes other rules will even force the banking entity to engage in this particular transaction.\textsuperscript{221} Additionally, this exclusion also covers those transactions ordered by a judicial, administrative or self-regulatory organisation, or an arbitration proceeding.\textsuperscript{222} If not for this exclusion, there would be an increased chance of conflicting legal requirements.\textsuperscript{223}

The seventh exclusion is for banking entities acting solely as an agent, broker or custodian.\textsuperscript{224} Under

\begin{footnotesize}
\begin{enumerate}
\item Regulation, 5556.
\item Regulation, §.3(d)(5).
\item Regulation, 5557.
\item Section 803(6) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
\item Section 803(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
\item Regulation, §.3(d)(6)(i).
\item Regulation, 5557.
\item Regulation, 5557-5558.
\item Regulation, §.3(d)(6)(ii).
\item R. LEDIG \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis}, s.l., Thomson Reuters, 2014, 71.
\item Regulation, §.3(d)(7).
\end{enumerate}
\end{footnotesize}
the final rule, the person for whom the banking entity acts, may be its affiliate. In that case, however, the affiliate must comply with the Volcker Rule.\textsuperscript{225} If a banking entity acts in one of those capacities, it does not act as a principal, so the activity would not be proprietary trading anyway.\textsuperscript{226}

The second to last exclusion refers to pension plans or other deferred compensation plans or similar plans.\textsuperscript{227} This exclusion is analogous to and was introduced in order to ensure the effectiveness of a similar exclusion provided in relation to certain covered funds, as described in part IV.\textsuperscript{228} 229

Finally, buying or selling shares in relation to debt previously contracted is also excepted.\textsuperscript{230} This allows banking entities to collect and dispose of collateral.\textsuperscript{231} As a result of this exception, banking entities will continue to be able to provide margin loans.\textsuperscript{232} The financial instruments collected under this exception, should be divested as soon as possible.\textsuperscript{233}

D. Exemptions

Contrary to the exclusions, the exempted activities do constitute proprietary trading. Therefore they are only permitted if a series of strict criteria are met and even in that case, they must stay within certain limits. These limits will be treated after the discussion of the exemptions. In the regulation, those exemptions are grouped into three categories: underwriting and market making, risk-mitigating hedging and a third category of minor exemptions. For clarities sake, the first category will be subdivided further into, on the one hand, underwriting, and on the other, market making.

1. Underwriting activities

Underwriting activities play an important role in giving issuers access to funding.\textsuperscript{234} Nevertheless, detailed prescriptions were necessary to allow these activities, without giving banking entities additional opportunities to engage in speculative activities. This explanation is split into three parts,

\begin{itemize}
\item \textsuperscript{225} R. Lедиг \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis, s.l.}, Thomson Reuters, 2014, 71.
\item \textsuperscript{226} R. Lедиг \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis, s.l.}, Thomson Reuters, 2014, 71.
\item \textsuperscript{227} Regulation, §\textsubscript{-3}(d)(8).
\item \textsuperscript{228} R. Lедиг \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis, s.l.}, Thomson Reuters, 2014, 72.
\item \textsuperscript{229} See p. 95 of this dissertation.
\item \textsuperscript{230} Regulation, §\textsubscript{-3}(d)(9).
\item \textsuperscript{231} Regulation, 5558.
\item \textsuperscript{232} Regulation, 5559.
\item \textsuperscript{233} Regulation, §\textsubscript{-3}(d)(9).
\item \textsuperscript{234} Regulation, 5561.
\end{itemize}
the first dealing with the relevant activities, the second with the basis on which these activities are assessed and the final part deals with the other requirements.

a. **Relevant activities**

The relevant activities are described as: “Acting as an underwriter for a distribution of securities”. 235 From the outset, it should be noted that this exemption is only applicable to securities and not to other financial instruments. 236

Since the concept of distribution is essential for a clear understanding of this exemption and for its distinction from prohibited proprietary trading 237, defining this will be the starting point. An offering of securities is a distribution if it is characterised by special selling efforts and selling methods, setting it apart from ordinary trading transactions. 238 The presence of these efforts and methods is determined in the same way as under Regulation M. This regulation contains anti-manipulation rules, with which distributions have to comply. 239 As examples the Agencies give: issuing a prospectus, conducting road shows or receiving a larger compensation than for secondary trades. 240

Additionally, an offering of securities can also be a distribution, regardless of the use of special selling efforts or methods, if it is done pursuant to an effective registration statement. 241 This registration is usually required, although there are some exceptions, the most important being: private offerings to a limited number of persons or institutions, offerings of limited size, intrastate offerings and offerings of securities of municipal, state, and federal governments. 242 In the view of the Agencies, this bright-line rule makes the exemption easier to apply, while it is hard to believe that banking entities would actually go through the registration procedure to escape the prohibition. 243

As a side note, it is worth mentioning that there was some discussion about whether or not to allow

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235 Regulation, § .4(a)(2)(i).
236 Regulation, 5559.
237 Regulation, 5565.
238 Regulation, § .4(a)(3)(i).
239 Regulation, 5565.
240 Regulation, 5566.
241 Regulation, § .4(a)(3)(ii).
243 Regulation, 5566.

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the underwriting of private placements under this exemption. Since in the first prong it is irrelevant whether or not the securities are registered, underwriting private placements is indeed possible. The Agencies consider the 'near term customer demand' criteria a sufficient safeguard against the banking entity retaining unsold securities for speculative purposes.244

The next important concept is that of an underwriter, since a banking entity is only allowed to act in that capacity under this exemption. In first instance, an underwriter is a person who has an agreement with an issuer or selling security holder, which is any person apart from an issuer on whose behalf a distribution is made.245 Under this agreement he either purchases the securities from the other party for distribution or he manages or engages in a distribution of the securities for or on behalf of that party.246 On the other hand, a person can also be an underwriter without such a direct agreement with the issuer or selling security holder, if he has agreed to participate in or is participating in the distribution on behalf of either of those.247 Allowing selling group members to participate, despite not being a member of the underwriting syndicate, is beneficial for the successful realisation of the distribution, which is why the Agencies thought it consistent with the purpose of this exemption.248

The Agencies provided a list of activities, indicative of underwriting. However, they warned that the precise activities will depend on the liquidity of the securities involved and the type of distribution. Therefore not all of the following activities will always be present.

**Box 2: List of activities indicative of underwriting – taken from Regulation, 5567**

- assisting an issuer in capital-raising;
- performing a due diligence;
- advising on the market conditions;
- assisting with the registration statement or other offering documents;
- purchasing securities from the issuer, selling security holder or underwriter for resale to the public;
- participating or organising a syndicate of investment banks;

244 Regulation, 5566.
245 Regulation, §.4(a)(5).
246 Regulation, §.4(a)(4)(i).
247 Regulation, §.4(a)(4)(ii).
248 Regulation, 5567.
marketing securities; and
post-issuance secondary market transactions. (Although these activities will have to take place under the market making exemption\(^{249}\)).\(^{250}\)

By removing the phrase “solely in connection with” from the definition of underwriting position, the Agencies have made clear that stabilisation activities are allowed under this exemption. Because these activities are governed by their own rules and are now additionally subjected to the restrictions applicable to underwriting position, the risk of evasion of the prohibition is minimal.\(^{251}\)

However this does not mean that every activity showing some connection with the distribution is allowed. The Agencies give a number of examples. The first is purchasing a financial instrument to help determine the price of the security that has to be distributed.\(^{252}\) This is not permitted because other techniques, such as book-building, which do not require taking positions are much more frequently used.\(^{253}\) The second example is hedging the underwriter's risk exposure, which has to be done under the hedging exemption. Finally product development is also not included in this exemption. Hence, developing structured finance products can only be done by a banking entity if another exemption is available. Similarly, for the securitisation or resecuritisation, it will have to be the responsibility of the sponsor or issuer of the structured product to accumulate the needed securities or other assets.\(^{254}\) However, this is not the case for the accumulation of loans, because those are not financial instruments.\(^{255}\)

\(b. \quad \text{Assessment basis}\)

Some commenters were afraid the exemption would be assessed on a transaction-by-transaction basis.\(^{256}\) To answer this concern, the Regulation now holds that it shall be applied to the trading desk's underwriting position.\(^{257}\) An underwriting position includes all securities positions held in relation to a single distribution for which the banking entity acts as an underwriter. It is possible for these positions to be held at separate legal entities. Positions from different distributions cannot be

\(^{249}\) Regulation, 5567, footnote 395.
\(^{250}\) Regulation, 5567.
\(^{251}\) Regulation, 5568.
\(^{252}\) Regulation, 5568.
\(^{253}\) Regulation, 5568, footnote 409.
\(^{254}\) Regulation, 5568.
\(^{255}\) Regulation, 5568, footnote 412.
\(^{256}\) Regulation, 5564-5565.
\(^{257}\) Regulation, §_.4(a)(2)(i).
combined, but a single trading desk may have multiple underwriting positions. As a result, compliance will be judged on a distribution-by-distribution basis, which does not overburden the banking entity, while still ensuring that a position can be associated to a distribution for which the banking entity is an underwriter.\textsuperscript{258}

As can be seen in the previous paragraph, underwriting positions are examined at trading desk level. This is due to concerns that allowing the assessment to take place on a higher level, could increase evasion opportunities.\textsuperscript{259} Consequently, a trading unit is defined as: “the smallest discrete unit of organisation of a banking entity that buys or sells financial instruments for the trading account of the banking entity of an affiliate thereof.”\textsuperscript{260} A trading unit can comprise members of different legal entities, but it is always managed and operated as an individual unit. It must have records identifying its financial positions and where they are held.\textsuperscript{261}

c. **Other requirements**

In titles a and b above, the activities which can be exempted and the level on which the requirements are applied, were established. Here we will see which other conditions have to be met.

When conducting its underwriting activities, the banking entity must make sure its underwriting positions do not exceed the reasonably expectable near term customer demand.\textsuperscript{262} After the publication of the proposal, a discussion erupted about the holding of a residual positions. Objectors argued that if this were allowed, banking entities could intentionally retain securities for speculative purposes. In opposition, other commenters held that proscribing this, could impede the availability of these services for those distributions, which present a risk that there will not be a demand for all securities, or alternatively, the fees for such activities could raise significantly to account for the risk of fire sales.\textsuperscript{263}

Taking into account the grievances of both parties, the Final Rule still allows unsold allotments to be held, but it requires that reasonable efforts are made to dispose of them within a reasonable

\textsuperscript{258} Regulation, 5565.
\textsuperscript{259} Regulation, 5565.
\textsuperscript{260} Regulation, §.3(e)(13).
\textsuperscript{261} Regulation, 5591.
\textsuperscript{262} Regulation, §.4(a)(2)(ii).
\textsuperscript{263} Regulation, 5568-5570.
period. The Rule adds that the liquidity, maturity and depth of the market will be taken into account when determining this period.264

A second condition which makes the exemption harder to be abused, is that a banking entity has to draw up and enforce a compliance programme. This programme will contain stipulations on, amongst others, the type of securities, the acceptable level of exposure, internal controls, which will be enforced on trading desk level.265

The final two requirements are that the compensation schemes of the persons involved should be designed not to encourage evasion attempts266 and that the banking entity should be licensed to carry on the underwriting activities it engages in.267

2. Market making activities

While market making activities serve a useful purpose, because they increase liquidity in the market, they are not easily distinguishable from prohibited proprietary trading.268 The essential difference is that the latter is aimed at achieving profits through short-term price movements269, while the former is concerned with providing an intermediation and liquidity service to the market.270 Just as with the underwriting exemption, we will first look at the description of the activities. After that, the concepts used for the assessment will be analysed. The final point will deal with the additional conditions which have to be satisfied, the most important again being the near term customer demand requirement.

264 Regulation, §__.4(a)(2)(ii).
265 Regulation, §__.4(a)(2)(iii).
266 Regulation, §__.4(a)(2)(iv).
267 Regulation, §__.4(a)(2)(v).
268 Regulation, 5577.
269 Cfr. amongst others, Regulation, 5621.
270 Regulation, 5576.
a. Relevant activities

Market making should ultimately revolve around meeting the customers needs. Market-makers form a link between the needs of their customers, which facilitates trades and should in the end lead to a more liquid market. Which criteria the Agencies will use to distinguish market making activities from non-exempted proprietary trading can best be deduced from the requirement in § 4(b)(2)(i) of the Regulation stating:

“The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.”

This definition is not directly based on existing definitions of market making in other legislation, so it is possible for an act to be market making under this Regulation, while this is not the case in the other law or regulation.

The proposed market making exemption drew a lot of comments, claiming that it was either too restrictive, having an adverse effect on liquidity, or too broad, allowing to many evasion opportunities or risks. The debate about this definition and the subsequent changes, can help clarify how it should be interpreted.

The word 'routinely' in the first line seems rather vague. It replaces the phrase 'on a regular and continuous basis' used in the proposal. At the same time, the Agencies added that the liquidity, maturity and depth of the market for the instrument would be taken into account. The purpose of both these changes is to allow market making in illiquid assets. For highly illiquid assets, this may

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271 Regulation, 5577.
272 Regulation, 5580.
273 Regulation, § 4(b)(2)(i).
274 Regulation, 5590.
275 Regulation, 5576-5577.
276 Regulation, 5589.
277 Regulation, 5595.
even involve trading by appointment, in which quotes are only provided on demand. \textsuperscript{278}

Some commenters wanted more assurance that a banking entity could not cover up speculative proprietary trading activities, by quoting unrealistic prizes. \textsuperscript{279} This critique is especially relevant to highly illiquid financial instruments, which they in fact proposed to ban entirely from the exemption, because there was no sufficient market in those assets for a reliable valuation, which would, in turn, make monitoring more difficult. \textsuperscript{280} Therefore in the final version of the definition, as quoted above, the trading desk must show that it has a pattern of quoting prizes and trading on both sides of the market. Simply occasionally quoting prizes will not be enough. \textsuperscript{281} Moreover, the Agencies stressed that sufficient protection against abuse is provided by the near term customer demand requirement. \textsuperscript{282}

The requirement that the market making activity must be present throughout the market cycle, will make it difficult for most algorithmic trading strategies to comply with the exemption. However, despite the opinion of some commenters, there is no ban on all high-frequency trading activities. \textsuperscript{283} Another type of activity which led to a lot of discussion was anticipatory market making. \textsuperscript{284} Here, the Agencies again referred to the near term customer demand requirement. If the trading desk can reasonably expect that there will be a demand for a financial instrument, then it can take positions in anticipation of that demand. \textsuperscript{285}

In addition to the financial instruments in which the banking entity acts as a market-maker, hedging instruments related to the market making activities are also held under this exemption. \textsuperscript{286} The reason not to require those hedging activities to be held separately under the hedging exemption, as was the case in the underwriting exemption above, is that due to its dynamic nature, in market making, certain positions may unintendently hedge each other. Therefore, separation would in this case be

\begin{footnotes}
\textsuperscript{278} Regulation, 5596.
\textsuperscript{279} Regulation, 5588.
\textsuperscript{280} Regulation, 5586-5587.
\textsuperscript{281} Regulation, 5596.
\textsuperscript{282} Regulation, 5597.
\textsuperscript{283} Regulation, 5597, footnote 742.
\textsuperscript{284} Regulation, 5588-5589.
\textsuperscript{285} Regulation, 5597.
\textsuperscript{286} Regulation, 5616-5618.
\end{footnotes}
impractical.\textsuperscript{287} The hedging positions under the market making exemption do not need to comply with the hedging exemption as well.\textsuperscript{288} In contrast, if the hedging is done on another level than the trading desk involved, there is no difficulty to split off the hedging activities, so this will have to be done. Consequently, those hedging activities will have to be held under the hedging instead of the market making exemption. This is justified by the Agencies, because using a different organisational unit raises the threat of evasion.\textsuperscript{289}

Hedging and risk-mitigating is seen by the Agencies as one of the key differences between market making and speculative proprietary trading, because while a market-maker tries to minimise some of the risk involved, a speculator is actually trying to make profits through them.\textsuperscript{290}

\textit{b. Assessment basis}

Just like in the underwriting exemption, the assessment is done on the level of the trading desk.\textsuperscript{291} It will not take place on an instrument-by-instrument basis. Instead similar financial instruments will be grouped together.\textsuperscript{292} However, due to its complex nature, two concepts are used to adequately monitor the market making activities: the market-maker inventory and the financial exposure. The former contains all the positions in financial instruments for which the trading desk acts as a market maker\textsuperscript{293}, but only those, while the latter is a broader concept, reflecting the risk of all activities relating to market making.\textsuperscript{294}

Both concepts serve another purpose. The financial exposure helps assess the financial exposure.\textsuperscript{295} Because of their influence on the exposure, the Regulation expressly allows to take associated loans, commodities and foreign exchange into account, even though these are not subject to the Volcker Rule.\textsuperscript{296} The market-maker inventory, on the other hand, will make the near term customer

\begin{itemize}
\item \textsuperscript{287} Regulation, 5568, footnote 410.
\item \textsuperscript{288} Regulation, 5517.
\item \textsuperscript{289} Regulation, 5618.
\item \textsuperscript{290} Regulation, 5618.
\item \textsuperscript{291} Regulation, § 4(b).
\item \textsuperscript{292} Regulation, 5596, footnote 736.
\item \textsuperscript{293} Regulation, § 4(b)(5).
\item \textsuperscript{294} Regulation, § 4(b)(4).
\item \textsuperscript{295} Regulation, 5593.
\item \textsuperscript{296} Regulation, 5592, footnote 717.
\end{itemize}
demand easier to evaluate.\textsuperscript{297} The combination of both concepts is also useful to isolate the hedging positions in financial instruments, related to market making, but in which the trading desk is not involved as a market-maker.\textsuperscript{298}

c. Other requirements

As we can see from the description of the relevant activities, near term customer need is essential to distinguish market making from prohibited proprietary trading.\textsuperscript{299} Just like in the underwriting exemption, the liquidity, maturity and depth of the market are taken into account, to enable market making in illiquid assets.\textsuperscript{300} But this exemption also has a second standard. There has to be a demonstrable analyses of certain factors, which include both historical analyses and estimates for the future, to determine the reasonably expectable customer demand.\textsuperscript{301} The Agencies recognise that this is a prediction which will not always be fulfilled. That being said, repeated overestimations will be taken as a sign that the trading desk is not in compliance with this exemption.\textsuperscript{302}

The customer demand must be assessed on an ongoing basis. Additionally, retaining positions, despite customer demand, is clearly not consistent with the intent of this exemption.\textsuperscript{303}

There were concerns about some activities, because of this requirement. Anticipatory trading, whereby the trading desk acquires financial instruments in anticipation of future demand, is not excluded.\textsuperscript{304} Likewise, interdealer trading is also allowed, if it is done to acquire positions or dispose of customer-related positions.\textsuperscript{305} On the other hand, arbitrage trading is prohibited, because it has no relation to customers.\textsuperscript{306}

For the application of this exemption, “customer” does not include banking entities with $50 billion or more in trading assets, unless the trade is done anonymously, for instance through an exchange, or the trading unit documents why its counterparty should be seen as a customer for the present

\textsuperscript{297} Regulation, 5593.
\textsuperscript{298} Regulation, 5593.
\textsuperscript{299} Regulation, 5597.
\textsuperscript{300} Regulation, 5605.
\textsuperscript{301} Regulation, 5610.
\textsuperscript{302} Regulation, 5611-5612.
\textsuperscript{303} Regulation, 5606.
\textsuperscript{304} Regulation, 5588-5589.
\textsuperscript{305} Regulation, 5609.
\textsuperscript{306} Regulation, 5608.
transaction.\textsuperscript{307} Some commenters had requested to exclude all banking entities, but the Agencies acknowledged the potential liquidity needs of smaller entities.\textsuperscript{308}

In parallel with the underwriting exemption, the next requirement is that a compliance programme has to be drawn up. The two programmes are similar, with the exception that in the compliance programme relating to the market making exemption, an extra part has to be added with regard to risk-mitigating.\textsuperscript{309} Of course a trading desk may not willingly surpass the limits established in this programme, but in the event that the limits are exceeded due to market movements, the trading desk is also required to bring its positions back into compliance as soon as possible.\textsuperscript{310}

Finally, again just like in the underwriting exemption, the compensation schemes of the persons involved should be designed not to encourage evasion attempts\textsuperscript{311} and the banking entity should be licensed to carry on the market making activities it engages in.\textsuperscript{312}

A key difference between market making and speculative trading activities, which has already been mentioned, is the way both activities generate profits. The proposal therefore contained a provision that profits from market making activities had to result from fees, commissions and bid/ask spreads and not from changes in value of the financial instrument.\textsuperscript{313} This requirement raised to many concerns so it was eventually not incorporated in the Final Rule as such. Analyses of the revenues, especially those from price movements of the assets, will, however, still be used as an element in the monitoring of the market making activities.\textsuperscript{314}

\textsuperscript{307} Regulation, § 4(b)(3).
\textsuperscript{308} Regulation, 5606, footnote 899.
\textsuperscript{309} Regulation, § 4(b)(2)(iii).
\textsuperscript{310} Regulation, § 4(b)(2)(iv).
\textsuperscript{311} Regulation, § 4(b)(2)(v).
\textsuperscript{312} Regulation, § 4(b)(2)(vi).
\textsuperscript{313} Regulation, 5621.
\textsuperscript{314} Regulation, 5623-5624.
3. Risk-mitigating hedging activities

Hedging activities are allowed if they are truly designed to reduce risks. As with the other exemptions, measures were taken to assure that the exemption is not abused to mask speculation.\textsuperscript{315} The banking entity will have to establish a compliance programme, containing the policies and procedures, internal controls and necessary analyses related to its hedging activities.\textsuperscript{316} One important element in this programme is the analyses of how the hedging positions correlate to the underlying positions. This was originally introduced as a separate requirement, but because a lack of negative correlation does not always mean that it is a bad hedge, the requirement was replaced by the obligation to analyse and if correlation cannot be demonstrated to explain why it nevertheless complies with the exemption.\textsuperscript{317}

Apart from being in accordance with the limits set in the compliance programme, hedging positions must also be designed to mitigate one or more specific risks (as opposed to general market risks or general risks relating to the assets of the banking entity, etc).\textsuperscript{318} These risks may result from an aggregated position, but both the underlying position and risk should be identifiable at all times.\textsuperscript{319} Moreover the positions must also demonstrably reduce the aforementioned risks.\textsuperscript{320} Some commenters wanted to go even further, by forcing the trading desk to always choose the ‘best hedge’, but the Agencies declined to follow this approach, which they considered impractical, because determining the best hedge is complex and often subjective.\textsuperscript{321} Other commenters had remarked, albeit in the context of the market making exemption, that perfect hedges are often unavailable.\textsuperscript{322} Considering that the underlying risks change over time, the Regulation clarifies that the effectiveness of the hedge has to be demonstrated at the inception of the hedge.\textsuperscript{323} Even so, the hedging activities should be continuously monitored and adapted if needed.\textsuperscript{324}

\textsuperscript{315} Regulation, 5629.
\textsuperscript{316} Regulation, §_.5(b)(1).
\textsuperscript{317} Regulation, 5631, 5635-5636.
\textsuperscript{318} Regulation, 5635.
\textsuperscript{319} Regulation, §_.5(b)(2)(ii).
\textsuperscript{320} Regulation, 5634-5635.
\textsuperscript{321} Regulation, §_.5(b)(2)(ii).
\textsuperscript{322} Regulation, 5632-5634.
\textsuperscript{323} Regulation, 5622.
\textsuperscript{324} Regulation, §_.5(b)(2)(ii).
\textsuperscript{325} Regulation, §_.5(b)(2)(iv).
Anticipatory hedging is still allowed under the Regulation, although in that case the hedging is done before the banking entity is exposed to the risk. The same monitoring requirement applies, so the hedge will have to be extinguished if the predicted risk does not materialise.\(^\text{326}\)

For the hedging activity to be exempted, it may not create a significant new or additional risk, unless this risk is immediately hedged as well.\(^\text{327}\) This requirement further decreases the possibility of disguising prohibited proprietary trading as hedging.\(^\text{328}\) The Regulation contains no indication about the interpretation of “significant”.

Just like the previous exemptions, the compensation schemes of the persons involved should be designed not to encourage evasion attempts.\(^\text{329}\)

As a final point, some activities are more likely to be used for evasion attempts and are therefore subject to an additional documentation requirement.\(^\text{330}\) These activities are hedging activities by another trading desk than the trading desk responsible for the underlying position, this includes the case where one trading desk hedges the aggregated position held across multiple trading desks and all hedging activities conducted outside the policies of the compliance programme.\(^\text{331}\) This document should identify the hedged risk, the hedging strategy that is used and the trading desk responsible for the hedge.\(^\text{332}\)

4. Other exemptions

Paragraph 6 of the Regulation contains some other exemptions, the most of which are outside the scope of the present dissertation. For instance, insurance companies are allowed to trade for their general account or for a separate account, provided they comply with the insurance laws.\(^\text{333}\)

Further, the Volcker Rule has a strong extra-territorial effect, so the Regulation provides an exemption for activities by foreign banking entities which do not have a certain connection with the

\(^{326}\) Regulation, 5636-5637.
\(^{327}\) Regulation, §_.5(b)(2)(iii).
\(^{328}\) Regulation, 5633.
\(^{329}\) Regulation, §_.5(b)(3).
\(^{330}\) Regulation, 5638.
\(^{331}\) Regulation, §_.5(c)(1).
\(^{332}\) Regulation, §_.5(c)(2).
\(^{333}\) Regulation, §_.6(d).
The Regulation also allows proprietary trading in US government obligations. Proprietary trading in foreign government obligations is only permissible if the US banking entity is controlled by a foreign banking entity or if the banking entity purchasing the obligations is a foreign banking entity, even if it is controlled by a US entity. In both cases additional restrictions apply to limit the US financial system's exposure to risk from these activities. Derivatives of government obligations are not included in this exemption.

This leaves the exemption for permitted trading on behalf of customers. The intent of this exemption is to allow banking entities to use their own funds when acting for customers. Two types of activities are mentioned here in the Regulation. The first is fiduciary transactions, which are carried out for the account of the customer. To comply, the banking entity may not retain any beneficial ownership. The second type are transactions where the banking entity acts as a riskless principal. These are transactions where the banking entity, after receiving an order to purchase or sell, immediately enters into another transaction to offset the initial transaction. This second type of transactions is only permissible if a customer order was first received. Additionally, it may not expose the banking entity to changes in value of the traded instruments. This type of transaction is often used by agents to execute their customers orders.

5. Limitations to the permitted activities

There are three limitations applicable to all exemptions. The first is that the transaction may not lead to a material conflict of interest with the banking entity's customer, which would be contrary

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334 Regulation, §.6(e).
335 Regulation, §.6(a).
336 Regulation, §.6(b).
337 Regulation, 5644.
338 Regulation, 5640.
339 Regulation, §.6(c).
340 Regulation, 5648.
341 Regulation, §.6(c)(1).
342 Regulation, §.6(c)(2).
343 Regulation, 5649.
344 Regulation, 5649.
345 Regulation, §.7(a)(1).
to the intent of the Volcker Rule\textsuperscript{346}, unless the banking entity discloses the information in such a way that the customer understands it and has the opportunity to mitigate its negative effect.\textsuperscript{347} Alternatively, the banking entity could also establish information barriers, although it cannot rely on them against reasonable expectation of an adverse effect on the counterparty.\textsuperscript{348} As mentioned in part I, Mr. Volcker does not believe in the impermeability of information barriers\textsuperscript{349}, however the Agencies consider this measure to be sufficient.\textsuperscript{350}

The other two limits, prove the point that, although the Volcker Rule is not primarily aimed at removing risks from the banking entities, it is not entirely unconcerned with it. These limits proscribe the application of the exemptions in cases where this would lead to an exposure of the banking entity to high-risk assets or a high-risk trading strategy\textsuperscript{351} or which would pose a threat to the safety and soundness of the financial stability of the US.\textsuperscript{352} High-risk assets or trading strategies are those assets or strategies that would significantly increase the chance of substantial financial losses.\textsuperscript{353} The definition was deliberately kept broad by the Agencies.\textsuperscript{354} The compliance programmes, required in most exemptions, will help to monitor the compliance with this limitation.\textsuperscript{355}

\textsuperscript{346} See p. 7 of this dissertation.
\textsuperscript{347} Regulation, §.7(b)(2)(i).
\textsuperscript{348} Regulation, §.7(b)(2)(ii).
\textsuperscript{349} See p. 7 of this dissertation.
\textsuperscript{350} Regulation, 5664.
\textsuperscript{351} Regulation, §.7(a)(2).
\textsuperscript{352} Regulation, §.7(a)(3).
\textsuperscript{353} Regulation, §.7(c).
\textsuperscript{354} Regulation, 5666.
\textsuperscript{355} Regulation, 5666.
E. Conclusion

Despite not being exhaustive, the description above gives a good idea of the level of detail of the Regulation implementing the Volcker Rule. In a lot of places, the Agencies were confronted with the question of how to achieve the objectives of the Rule, without adversely impacting the commercial banking sector or relevant activities. If the right balance has been struck, can partly only be answered once it has been effect long enough. For now, it is sufficient to say that a lot of effort has been put into balancing the opposing views and that the creator of the Rule himself, has in an interview said that he thinks it is OK.\textsuperscript{356}

II. United Kingdom

Once it is established that an entity is a ring-fenced body, it can no longer carry out the excluded activity of dealing in investments as a principal.\textsuperscript{357} To this the Treasury added commodities trading as a second excluded activity.\textsuperscript{358} The Treasury was also given the task to provide exceptions in relation to the excluded activities and make a further list of prohibited activities.\textsuperscript{359} This was done in the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

A. Excluded activities

There are two categories of excluded activities: dealing in investments as a principal and commodities trading, which a ring-fenced body cannot enter into, unless this is done in accordance with one of the exceptions. Most exceptions apply to both excluded activities, although some are only useful for the former. A large part of the exceptions contains rules relating to the use of derivatives. Those will be treated under a separate heading.

1. Dealing in investments as a principal

To describe this first excluded activity, reference was made to the existing definition in the Regulated Activities Order 2001.\textsuperscript{360} Dealing in investments as a principal is buying, selling, subscribing for or underwriting securities, listed in articles 76 to 82, or contractually based investments, meaning the investments listed in articles 83 to 85 or rights under a qualifying contract of insurance, as a principal.\textsuperscript{363} The contractually based investment of article 87 (funeral plan contracts) is explicitly excluded from the definition.\textsuperscript{364}

\textsuperscript{357} Section 142B(2) Financial Services and Markets Act 2000. Hereafter: “FSMA”.
\textsuperscript{358} Art. 5 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
\textsuperscript{359} Section 142E FSMA.
\textsuperscript{360} Art. 4 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
From the above, the following list of investments can be derived:

<table>
<thead>
<tr>
<th>Securities (articles 76-82)</th>
<th>contractually based investments (articles 83-85)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares (art. 76)</td>
<td>Derivatives:</td>
</tr>
<tr>
<td>Debentures and similar debt instruments (art. 77)</td>
<td>- Options (art. 83)</td>
</tr>
<tr>
<td>Government and public securities (art. 78)</td>
<td>- Futures (art. 84)</td>
</tr>
<tr>
<td>Warrants and other instruments entitling the holder to one of the instruments listed above (art. 79)</td>
<td>- Contracts for differences/swaps (art. 85)</td>
</tr>
<tr>
<td>Certificates representing any of the above instruments (art. 80)</td>
<td>Qualifying contracts of insurance</td>
</tr>
<tr>
<td>Units in a collective investment scheme (art. 81)</td>
<td></td>
</tr>
<tr>
<td>Rights under a stakeholder pension scheme (art. 82)</td>
<td></td>
</tr>
</tbody>
</table>

Qualifying contracts of insurance are certain long-term insurances. A complete list of the various kinds of long-term insurances can be found in part II of schedule 1 of the Regulated Activities Order. As a general matter, certain life insurances, various social insurance schemes and similar insurances are included.

There are a couple of exclusions to the definition of dealing in investments as a principal in the Excluded Activities Order. Of those, only three are applicable to the ring-fenced body. The first excludes instruments creating or acknowledging loans, credits, guarantees and similar acts. This article has to be seen in the light of a long discussion about the boundaries of the concept of “debenture”. Further, the issuing by a company of its own shares, debentures or warrants for its own shares or debentures is also excluded. The final of the three applicable exclusions from the definition is dealing by a company in its own shares, in accordance with the Companies Act 2006.

Purchases of own shares may only be done with distributable profits or for a very low amount.\textsuperscript{373} Once held, the shares may at any time be sold\textsuperscript{374}, entered into an employees' share scheme\textsuperscript{375} or be cancelled\textsuperscript{376}.

2. **Commodities trading**

In the Vickers Report, reference was made to trading book assets, to be interpreted in accordance with EU law.\textsuperscript{377} In the Capital Requirements Regulation, commodities held with trading intent are included in the definition of trading book.\textsuperscript{378} However, they are not part of the excluded activity of dealing in investments as a principal, as can be seen above. Therefore the Treasury used its legislative power to include dealing in commodities. By adding this second prohibited activity, the Treasury believes that it has now covered all trading activities intended by the ICB.\textsuperscript{379}

Dealing in commodities, meaning buying or selling them as a principal, is excluded.\textsuperscript{380} Commodities are described as: "any goods of a fungible nature that are capable of being delivered [...]".\textsuperscript{381} Naturally, commodities may be purchased for the ring-fenced bodies own use, or for use by its subsidiary.\textsuperscript{382} Dealing in commodities is also not prohibited if it is done to take or realise a security interest or under a collateral arrangement.\textsuperscript{383}

\textsuperscript{373} Section 724(1) Companies Act 2006. The low amount is capped at maximum 5% of the share capital, with an absolute maximum of £15,000 (Section 692(1)(b) Companies Act 2006).

\textsuperscript{374} Section 727(1)(a) Companies Act 2006.

\textsuperscript{375} Section 727(1)(b) Companies Act 2006.

\textsuperscript{376} Section 729 Companies Act 2006.


\textsuperscript{378} Art. 3(86) Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, also known as the Capital Requirements Regulation Hereafter: “CRR”.


\textsuperscript{382} Art. 5(2) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

\textsuperscript{383} Art. 5(3) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
3. Exceptions to the excluded activities

The Vickers Report contains recommendations for ancillary activities, which can only be engaged in to the extent necessary to support non-prohibited services of the ring-fenced body. These activities are risk management, liquidity management and fund raising for the provision of non-prohibited services.\textsuperscript{384}

In the list of general exceptions we can indeed find that a ring-fenced body can hedge its own exposure or that of a subsidiary or conduit vehicle to certain factors, listed in the box below.\textsuperscript{385}

<table>
<thead>
<tr>
<th>Box 3: List of factors for which hedging is allowed - Art. 6(1) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Changes in interest rates, exchange rates or commodity prices;</td>
</tr>
<tr>
<td>b) changes in any index of retail prices or of residential or commercial property prices;</td>
</tr>
<tr>
<td>c) changes in any index of the price of shares;</td>
</tr>
<tr>
<td>d) default risk;</td>
</tr>
<tr>
<td>e) liquidity risk.\textsuperscript{386}</td>
</tr>
</tbody>
</table>

Further, transactions in liquid assets for liquidity management purposes are also allowed.\textsuperscript{387} Only those assets which can be used for the liquidity requirement in article 412 of the Capital Requirements Regulation are sufficiently liquid for this purpose.\textsuperscript{388} Ring-fenced bodies will also be permitted to buy and resell investments as collateral for the above transactions.\textsuperscript{389}

Closely related to liquidity management is the exception for transactions with a central bank.\textsuperscript{390} This exception gives ring-fenced bodies access to central bank liquidity.\textsuperscript{391}

For the purpose of fund raising, a ring-fenced body may deal in debentures issued by itself, its subsidiaries or its parent undertaking or in instruments giving right to shares or debentures of itself

\textsuperscript{384} Vickers Report, 62, n° 3.57.  
\textsuperscript{385} Art. 6(1) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.  
\textsuperscript{386} Art. 6(2)(a) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.  
\textsuperscript{387} Art. 6(3) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.  
\textsuperscript{389} Art. 6(3)(b) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.  
\textsuperscript{390} Art. 8 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.  
or its subsidiaries. Consequently, the ring-fenced body is also allowed to acquire debentures from another company in its group. This debenture has to relate to a loan given by the ring-fenced body to that group member.

Incidentally, to make it possible for the ring-fenced body to own subsidiaries, an exception was necessary to allow the acquisition of shares if, after that acquisition, that company would be a subsidiary or if the ring-fenced body would own a participating interest in that company. A participating interest is an interest held for a long term with the intention of asserting influence over the company.

Apart from the ancillary activities, a number of exceptions were also introduced to improve lending operations. For instance, a ring-fenced body is permitted to accept shares or debentures issued by the debtor or any of his group members as compensation for releasing him from his debt. This was first mentioned in the Vickers Report itself, albeit only as a side note and was subsequently taken up in the draft secondary legislation under the heading debt-equity swaps, with the intention of not limiting the ring-fenced body’s options in case of a debt restructuring of one of its debtors. Naturally, once acquired, the ring-fenced body must be allowed to resell this equity. A further exception was created to provide this possibility.

In the same spirit, ring-fenced bodies may also accept or grant a security interest over an investment or transfer them under a collateral agreement. This was not there in the draft, nor is it mentioned in previous documents, but it seems like a logical extension because it facilitates loans. The downside is that this might increase the exposure of ring-fenced bodies to the financial markets, because the debt-equity swap exclusion is only applicable in the specific situation of a distressed

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395 Section 421A FSMA.  
397 Vickers Report, 57.  
398 HM TREASURY, Banking reform: draft secondary legislation, 2013,  
company, whereas this exclusion is not.

The last exclusion, apart from the derivatives, is that ring-fenced bodies will retain the possibility to set up a structured finance vehicle and transact with it. Based on a statement in the Vickers Report, the draft secondary legislation clarifies that this vehicle may only contain assets previously owned by the ring-fenced body.

4. Derivatives

The issue of derivatives is a complex one. The intention of the ICB was to prohibit ring-fenced bodies from transacting in them. Nevertheless, the UK Government believes that some derivatives could under some circumstances be used without infringing the principles set out in the Vickers Report. By giving the ring-fenced body the possibility to use those instruments in small amounts, they aim to make hedging services available to individuals and SME customers, without the frictional costs which transacting with a separate entity might lead to. An additional argument given by the Government is the development at EU level in regulating derivatives, which makes them less volatile and easier to manage.

There are two types of restrictions to the derivatives exception: First, only certain types of products are permitted and secondly there are limits on the risk and amount of derivatives ring-fenced bodies can hold.

403 HM Treasury, Banking reform: draft secondary legislation, 2013,
405 HM Treasury, Banking reform: delivering stability and supporting a sustainable economy, 2012,
406 HM Treasury, Banking reform: delivering stability and supporting a sustainable economy, 2012,
407 HM Treasury, Banking reform: delivering stability and supporting a sustainable economy, 2012,
408 HM Treasury, Banking reform: draft secondary legislation, 2013,
The draft secondary legislation limited the product types to derivatives related to currencies, interest rates and commodities, which the Government considered sufficient to make the hedging of the most frequent business risks possible. It would have allowed only forwards, futures and certain swaps. In response to comments from to this proposal, the Order now also permits certain options and swaptions. Therefore the Order permits currency swaps, interest rate swaps, forwards relating to currencies or commodities and options which either relate to currencies or commodities and capped or very specific interest rate swaps. An extra requirement concerning the type of product is that all of the above have to constitute a level 1 or level 2 input according to IFRS 13, which are products of which the price is easily observable in the market. The intention is to restrict the use of illiquid and not commonly traded instruments.

The first limit is on market risks, which is what the Vickers Report wanted to eliminate. The net market risk has to be lower than 0,5% of the ring-fenced body's own funds. The small margin forces ring-fenced bodies to hedge almost all their market risk, but allows some flexibility for

412 Art. 10(1)(a), (b) and (c) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
413 Art. 11(1), (2) and (3) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

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Two absolute limits were established, in which hedging is not taken into account, to curtail the risk a large hedged portfolio might still contain. The exact calculation is very technical, so they will only briefly be touched upon. The basis for both limits is the capital requirement against risk arising from its derivatives position, called the position risk requirement, because a metric that included the credit risks arising from loans would encourage the ring-fenced body to take more risky loans. In the first limit, this is set against the total credit risk capital requirement, which, in accordance with the Capital Requirements Regulation, does not take into account risks outside of the trading book, meaning it is unaffected by the loans. The sum of the position risk requirements must at any time be lower than 25% of the credit risk capital requirement. The second absolute limit sets the maximum for options at 20% of the position risk requirement.

B. Prohibitions

The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 contains prohibitions relating to financial institution exposures and non-EEA branches and subsidiaries, which will both be treated in the next part on relationships with other entities. Therefore this sub-chapter will only be concerned with the limitation on the use of inter-bank payment systems. Vickers Report had already acknowledged that these activities had to be permitted, but strictly regulated, because they are extremely useful in the provision of liquidity throughout the financial system, but could lead to counterparty risks.


This prohibition only applies to inter-bank payment systems of which the operator is not a recognised clearing house or an operator of a relevant system approved by the Bank of England under regulation 5 of the Uncertificated Securities Regulations 2001. These operators are deemed sufficiently secure as counterparty.

Correspondent banking, an arrangement in which one credit institution provides payment services to clients of another credit institution on behalf of that credit institution, and arrangements regarding the physical transfer of money between financial institutions are also expressly excluded from the prohibition.

In cases not covered in the previous two paragraphs, the ring-fenced body is not allowed to use services provided through the inter-bank payment system, unless it is a direct participant in the system or, if it not a direct participant, it meets at least one of the four following conditions:

- It is either active through another ring-fenced member that is both a group member of the and is a direct participant of the inter-bank payment system;
- under the rules of the inter-bank payment system it cannot become a direct participant itself;
- if the intermediary can no longer provide the required service, the ring-fenced body would still be able to make the payment through another intermediary or another inter-bank payment system or by other means; or
- the PRA has granted permission.

The permission by the PRA can only be granted in exceptional circumstances, to be defined in a statement by the PRA by 1 July 2019. In its current proposal, the PRA suggests to consider cases in which becoming a direct participant would result in a disproportionate level of cost, risk or other burden, as exceptional circumstances. Still, every inquiry will be judged on its individual merits

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and be weighed against the impact on the objectives of the ring-fence.\textsuperscript{435}

\footnotesize{435 Draft Supervisory Statement, 28, n° 9.8-9.9.}
C. Conclusion

In this conclusion, the main question will be whether the excluded activities and prohibitions, not related to group members and financial institution exposures, are a correct implementation of the Vickers Report. The above analysis contains various references to the Report and mentions where the Order deviates.

The first issue is allowing investments to be traded as security interest. While this seems to be in line with the intent of the ring-fencing proposal, it is an expansion of the possibilities of exposure. The risk is that when they are most needed, the investments might have become worthless because of the bad position of their issuer.

Another issue, which has not been mentioned before, is that the Vickers Report had foreseen backstop limits on the ring-fenced body's wholesale funding.\textsuperscript{436} This was explained by the development of liquidity regimes at an international level, which also aim to reduce reliance on short-term wholesale funding.\textsuperscript{437}

The main deviation is of course the permission to sell certain derivatives to customers. Even if the net market risk exposure is close to zero and despite the extra safeguards limiting its total volume, this increases ring-fenced bodies' potential exposure to elements which would otherwise have been moved to other entities.

\textsuperscript{436} Vickers Report, 62, n° 3.57.

III. Continental Europe

A. Liikanen Report

Once the threshold established in part II has been surpassed, the bank has to split up in a deposit bank and a trading entity. Not only the excess trading activities, but all trading activities should be transferred, with two exceptions. Hedging services to non-banking clients, subject to narrow risk limits in relation to own funds and underwriting and related activities will still be allowed. Market making and proprietary trading are explicitly mentioned as prohibited activities.

B. France

France follows the structure of the Liikanen Report. As established in part II, the threshold is exceeded if the financial assets at fair value through profit or loss surpass 7.5% of the total assets. However, there are more exceptions in the French statute than the two described above.

The first exception, which is providing investment services to customers, actually encompasses both exceptions from the Liikanen Report. Other activities on the list referred to, such as holding a customer's securities trading account and various forms of investment advice, are less likely to interfere with the prohibited activities. The activities have to respond to the needs of customers. Consequently the profits must be a result of the provision of this service and risks must be adequately hedged. The preparatory works explain that the risk management may not always be perfect, but that any remaining risk must be proportionate to the needs of the customer. The French regulatory authority is charged with monitoring the risk of the deposit bank.

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438 See p. 24 of this dissertation: Assets held for trading + assets available for sale exceed 15-25%.
440 See p. 25 of this dissertation.
444 L’autorité de contrôle prudentiel et de résolution (ACPR).
Contrary to the first, the other exceptions were not directly derived from the Liikanen Report.

The next exception deals with clearing activities, without further specifications in the statute.\textsuperscript{446} The preparatory works clarify that this is mostly a concern of clearing houses, but that members of this clearing house need to engage in certain activities from time to time for which this exception was necessary. Nevertheless, it also allows bilateral clearing for financial instruments for which no central counterparty exists.\textsuperscript{447}

Following this, is an exception for the hedging of the deposit bank's own risks or the risk of its group members, apart from the trading entity.\textsuperscript{448} The hedging instruments must have an economic relationship to the market or credit risks of the deposit bank.\textsuperscript{449} The examples given in the preparatory works contain derivatives, which under IAS 39 would be classified as hedging instruments, if the criteria for an effective hedge were met, and were therefore not prohibited in the first place.\textsuperscript{450} Nevertheless the French government chose not to refer to an accounting standard, because not all criteria from those standards are necessary to be an efficient hedging instrument.\textsuperscript{451}

The final exception not related the relationship with financial institutions is market making\textsuperscript{452}, which the statute defines as transacting in certain financial instruments as an intermediary by either simultaneously quoting competitive buying and selling prices in comparable volumes on a regular basis, leading to more liquidity in the market, or executing orders in the market for customers or responding to orders for customers.\textsuperscript{453}

The French government chose not to follow the Liikanen Report's prohibition of market making because the distinction between market making and underwriting was considered difficult to

\textsuperscript{446} Art. L511-47, I, 1°, b) Code monétaire et financier.
\textsuperscript{447} ASSEMBL\^{E}E NATIONALE, Rapport fait au nom de la commission des finances, de l'économie générale et du contrôle budgétaire sur le projet de loi de séparation et de régulation des activités bancaires, 7 February 2013, \url{http://www.assemblee-nationale.fr/14/pdf/rapports/r0707.pdf}, 62.
\textsuperscript{448} Art. L511-47, I, 1°, c) Code monétaire et financier.
\textsuperscript{449} Art. L511-47, IV Code monétaire et financier.
\textsuperscript{450} IAS 39(9).
\textsuperscript{451} ASSEMBL\^{E}E NATIONALE, Project de loi de séparation et de régulation des activités bancaires, étude d'impact, 19 December 2012, \url{http://www.assemblee-nationale.fr/14/pdf/projets/pl0566.pdf}, 14.
\textsuperscript{452} Art. L511-47, I, 1°, d) Code monétaire et financier.
\textsuperscript{453} Art. L511-47, V Code monétaire et financier.
Meanwhile the implementation of the Volcker Rule in the US had already distinguished market making from proprietary trading, so it could act as an example to do the same in France. However, in the Final Rule in the US, underwriting and market making are also treated separately. Moreover, the exact reason for the Liikanen Report to exclude market making was the difficulty in defining it in relation to proprietary trading. A second and possibly better argument is that market making is seen as an essential activity for the functioning of the financial markets, which is best left to banks because of their size. If the distinction was truly difficult to make, a safer solution might have been to require both market making and underwriting to be transferred to the trading entity as in the UK. This path was not followed, out of fear that because of the regulatory requirements set out in Basel III, smaller entities would not be able to take over market making activities and that banking groups would not want to supply enough funds to their trading entity to allow them to carry out those activities. An interesting point made by the French Banking Federation is that the underwriting possibility would be meaningless without at least some options to be active on the secondary market in order to address the needs of issuers and investors.

Monitoring by the French regulatory authority is foreseen to assure compliance with the conditions of market making, checked through indicators such as presence on the market and bid ask spreads. Naturally, these indicators will be adapted to the type of instruments. Certain of those indicators will have to be sent to the French prudential control authority once or thrice a year for every unit involved in market making. Internal risk management will also be subject to control. The French minister responsible for economy may also impose a cap on the market making exception.

455 Liikanen Report, 102.
460 Art. 6 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

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though at the moment there is no such cap in place. For all exceptions, the deposit bank has to assign the task to specific units, similar to the trading desks in the US, which have to comply with a written mandate.463

Apart from the exceptions, the French rule also contains certain trading activities which even the trading entity is no longer permitted to perform. This effectively ensures that those activities are banned from groups containing a deposit bank. Envisaged are high frequency trading and trading in instruments of which the underlying element is related to agriculture464, which are considered harmful to the good functioning of the market.465

C. Germany

The German statute lists the prohibited activities separately from those used to determine the threshold. Both Eigenhandel, which, in this case, means high frequency trading, as well as Eigengeschäft, which is broadly described as buying and selling financial instrument for one's own account, apart from high frequency trading466, are proscribed, subject to the following exceptions.467

Hedging of the bank's transactions with customers is permitted.468 The deposit bank is also allowed to manage its exposure to interest rates risk, foreign exchange risk, liquidity risk or default risk.469 Furthermore, the German statute also explicitly excludes long-term investments and activities which are not made to make a profit from short-term price movements.470 In this case, the second and third exclusion are necessary, because of the broad terms used to initially describe the prohibited activities. The proposal also contains an indicative list of other activities which are allowed. Noteworthy are activities entered into on request of customers, including hedging services, acting as

463 Art. 1 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires. The exact content of these mandates for each of the exceptions is determined in articles 2 to 5.
466 Kreditwesengesetz, §1 Absatz 1A, Satz 3. Hereafter: “KWG”.
467 KWG, §3 Absatz 2, Satz 2.
468 KWG, §3 Absatz 2, Satz 3, 1.
469 KWG, §3 Absatz 2, Satz 3, 2.
470 KWG, §3 Absatz 2, Satz 3, 3.
a central counterparty on an exchange and underwriting activities.\textsuperscript{471}

Surprisingly, market making is again excluded, contrary to the intentions of the Liikanen Report.\textsuperscript{472} They use the definition of Regulation 236/2012, which is the same as the definition from the French statute.\textsuperscript{473} The German minister of financial matters, Mr Wolfgang Schäuble, explained that the idea is to let banks prove that market making is done primarily for the benefit of customers and not to conceal proprietary trading.\textsuperscript{474} If they cannot do this, the responsible federal agency can impose additional prohibitions on an individual level.\textsuperscript{475} In this way, the prohibited activities may be fine-tuned along the way and the risk of overshooting the mark is limited.\textsuperscript{476} The agency will only be able to exercise this option after 1 July 2016.\textsuperscript{477}

D. Belgium

The Belgian statute did not contain a \textit{de minimis} exemption for the application of the rule\textsuperscript{478}, so it cannot fall back on previously determined concepts. Prohibited are all trading book positions\textsuperscript{479}, in accordance with the Capital Requirements Regulation\textsuperscript{480}. Briefly summarised, this encompasses all positions in financial instruments or commodities held with short-term trading intent, including positions arising from client servicing, as well as positions held to hedge the aforementioned positions.\textsuperscript{481}

\textsuperscript{472} KWG, §3 Absatz 2, Satz 2, 3.
\textsuperscript{473} Art. 2(1)(k) Regulation 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.
\textsuperscript{475} KWG, §3 Absatz 4.
\textsuperscript{477} http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2013/fa_bj_2013_07_trennbankengesetz_en.html?nn=3698804#doc4056834bodyText3 (consulted 6 April 2016).
\textsuperscript{478} See p. 31 of this dissertation.
\textsuperscript{479} Art. 119 Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen. Hereafter: “Belgian Banking Act”.
\textsuperscript{480} Art. 118, § 1, 1\textdegree Belgian Banking Act.
\textsuperscript{481} Art. 4(1)(86) CRR.
Similar to the German legislation, after a broad prohibition, there are exceptions for servicing customers\footnote{For this exception, services to professional customers with significant trading activities are limited. Significant trading activities means either trading activities exceeding €50 million or market making activities, regardless of the amount. (art. 4, § 1, section 2 and art. 1, § 2, 4 NBB Regulation 1 April 2014).}, hedging the deposit bank's own risks and long-term investments.\footnote{Art. 121, § 1, 1°, 3° and 5° Belgian Banking Act.} It does, however, not exempt activities which are not intended to make profits from short-term price movements in a general fashion. On the other hand, there is an express exclusion for liquidity management.\footnote{Art. 121, § 1, 4° Belgian Banking Act.} The proposal indicates that the long-term investment exclusion was only added for clarity's sake, because those investments can never be part of the trading book.\footnote{KAMER, parl. stukken, n° 3406/001, 26 Febraury, 2014, \url{http://www.dekamer.be/FLWB/pdf/53/3406/53K3406001.pdf}, 117.} Note that the list of permitted financial services includes underwriting.\footnote{Art. 46, 1°, 1 Wet van 6 april 1995 inzake het statuut van en het toezicht op de beleggingsondernemingen.}

More detailed rules concerning the exclusions are set out in a regulation from the National Bank of Belgium, which is strongly based on the Volcker Rule and its Regulation.\footnote{KAMER, parl. stukken, n° 3406/001, 26 Febraury, 2014, \url{http://www.dekamer.be/FLWB/pdf/53/3406/53K3406001.pdf}, 117.} For instance, there is a rebuttable presumption that the instruments are held with trading intent if the deposit bank does not intend to hold them for at least six months.\footnote{Art. 2, § 2 Reglement van 1 april 2014 van de Nationale Bank van België betreffende de handelsactiviteiten voor eigen rekening. Hereafter: “NBB Regulation 1 April 2014”.} This regulation also requires a liquidity management plan.\footnote{Art. 3, § 3 NBB Regulation 1 April 2014.} Liquidity management must always be done in other departments than those responsible for the permitted trading activities.\footnote{Art. 3, § 3, section 2 NBB Regulation 1 April 2014.} A third similarity are the conditions for hedging activities, which must follow the internal guidelines and procedures, relate to identifiable risks (which may be pooled together) and effectively mitigate those risks and finally cannot create new significant risks, unless these are immediately hedged as well.\footnote{Art. 7, § 3 and 4 NBB Regulation 1 April 2014.}

The regulation of the National Bank further determines that some activities will not be seen as trading for one's own account. These activities are buying and selling financial instruments related to comply with clearing and settlement requirements, transactions for the account of customers in
which the deposit bank does not take on any risk and holding and selling financial instruments held as security interest.\textsuperscript{492}

In line with the German and French legislation, Belgium also does not follow the Liikanen Report with respect to market making, although differently than the aforementioned countries, it limits the exclusion to market making on regulated markets and MTFs and requires the deposit bank to be registered as market maker on the relevant markets.\textsuperscript{493} A clear explanation for this difference or for the acceptance of market making in general cannot be found in the preparatory works, which only observe that these activities are necessary for the intermediary role of banks in service of their customers.\textsuperscript{494} The statute goes on to require that banks show that their market making activities, as well as their hedging and customer service activities, are carried on in the interest of this role as an intermediary and are necessary for its fulfilment.\textsuperscript{495} Again no further clarification is provided.

Another idea, copied from the Volcker Rule, is the prohibition to use the exclusions to gain high-risk assets or for high-risk trading strategies.\textsuperscript{496} Asset-backed securities of which the underlying assets are not limited to loans and debt instruments are expressly labelled high-risk in this context.\textsuperscript{497} For the future, the National Bank of Belgium will keep an eye out for complex products and derivative strategies which could lead to excessive margin calls.\textsuperscript{498}

Because the Belgian statute does not contain a \textit{de minimis} exemption, other activities than those excluded are strictly prohibited. This will be the case for all proprietary trading which does not serve customers. Moreover the activities which are excluded, are only allowed beneath certain limits. This ensures that even the permitted activities cannot interfere with the intention of the legislation to make banks safer.\textsuperscript{499} Apart from the internally established risk limits, which have to

\begin{itemize}
\item[] 492 Art. 4, § 4 NBB Regulation 1 April 2014.
\item[] 493 Art. 121, § 1, 2° Belgian Banking Act.
\item[] 495 Art. 121, § 2, 2° Belgian Banking Act.
\item[] 496 Art. 8, § 1 NBB Regulation 1 April 2014.
\item[] 497 Art. 8, § 3, iii NBB Regulation 1 April 2014.
\item[] 498 Art. 8, § 4 NBB Regulation 1 April 2014.
\end{itemize}
include stop-loss limits\textsuperscript{500}, the regulation of the National Bank imposes two limits:

\textsuperscript{500} Art. 12, § 1-3 NBB Regulation 1 April 2014.
• The total trading assets may not exceed 15% of the total assets; and
• the capital requirements for market risk\(^{501}\) may not exceed 10% of the total capital requirements.\(^{502}\)

Derivatives and government obligations from EU member states can be excluded from the calculation of this threshold if they are used to hedge non-trading positions or if the deposit bank makes a market in those government obligations.\(^{503}\) Extra capital requirements will ensure that banks are not tempted to purposely exceed the aforementioned limits.\(^{504}\)

There is an additional buffer to this limit for activities beyond the two limits from the regulation and other activities which only partly comply with the regulation. The total amount of those activities may not create a capital requirement for market risk of more than one percent of the legal capital of the deposit bank. The buffer can only be used with permission from and up to the limit determined by the National Bank of Belgium.\(^{505}\) Above this limit, these activities are prohibited.\(^{506}\) This additional margin was created for activities which were intended to fall within the scope of a permitted activity, but after closer inspection did not conform with the requirements. It must not be used to engage in trading activities on a permanent basis outside the requirements or limits set by the National Bank.\(^{507}\)

Finally, it is worth noting that, although it is not treated here, the regulation of the National Bank contains extensive rules on the implementation of a compliance programme.\(^{508}\)

\(^{501}\) Calculated in accordance with the CRR.

\(^{502}\) Art. 12, § 4, section 2 NBB Regulation 1 April 2014.

\(^{503}\) Art. 12, § 4, section 6 NBB Regulation 1 April 2014.

\(^{504}\) Art. 12, § 4, section 4 NBB Regulation 1 April 2014.

\(^{505}\) Art. 13, § 6 NBB Regulation 1 April 2014.

\(^{506}\) Art. 13 NBB Regulation 1 April 2014 and art. 123 Belgian Banking Act.

\(^{507}\) KAMER, parl. stukken, n° 3406/001, 26 February, 2014,


\(^{508}\) Section 4 NBB Regulation 1 April 2014.
E. Conclusion

All three countries have decided not to follow the Liikanen Report with regard to the prohibition of market making within the deposit bank. As a consequence, the trading activities which have to be separated closely resemble the prohibited proprietary trading activities under the Volcker Rule. Therefore it makes more sense to compare these rules in combination with the Volcker Rule, which will be done in the chapter IV Comparison and conclusions, hereafter.
IV. Comparison and conclusions

A. General remarks

As we have seen above and what will be confirmed in the analyses below is that, in a lot of cases the outcome is the same in at least four of the five analysed countries. Nevertheless there is a significant difference in the structure of the rules and the chosen concepts. For instance, in France the accounting standards are also used for the initial qualification as trading activities, while in the US, the use of accounting standards for this purpose was avoided, because those standards might change without regard for the implication which this has for other legislation such as the Volcker Rule.\textsuperscript{509} As another example, the Vickers Report rejected only using the IAS/IFRS or the EU trading book definition\textsuperscript{510}, which is used in Belgium, for the same reason as the Volcker Rule and because the qualification in these definitions is based upon the intentions of the bank.\textsuperscript{511}

These differences also arise due to the difference in legal culture. The prime example is the US' preference for detailed rules over general principles. Mr. Dodd, one of the people after whom the Act implementing the Volcker Rule was named, was in favour of a principle-based approach, but his view did not prevail.\textsuperscript{512} On the other hand, the German and French legislation is much more generally framed and trying to define speculative activities \textit{ex ante} was even seen as too complex and too difficult to keep up to date.\textsuperscript{513} Of course the detailed rules in one country can be a source of inspiration for the interpretation of the rule in more principle-based countries. For instance in Belgium, the general rules in the statute were supplemented by a regulation of the National Bank, which was clearly inspired by the Volcker Rule and its Regulation.

In the remainder of this comparison, the rules will first be compared as they are enacted before looking at their relationship to the underlying reports and purposes. This comparison is naturally limited to the most important aspects, because not all countries have used the same amount of detail. This means that the actual differences could be higher than is apparent from the analyses below.

\textsuperscript{509} Regulation, 5561.

\textsuperscript{510} They did refer to trading book assets as one of the elements to determine if an activity should be prohibited. (Vickers Report, 52, n° 3.39 and p. 64 of this dissertation).

\textsuperscript{511} Vickers Report, 56.

\textsuperscript{512} Hearing, 45-46.

B. Comparison of the prohibited activities

Looking at the starting point of the various prohibitions, we can establish that in all jurisdictions a rather wide description was chosen, rather than attempting to single out the exact proscribed activities immediately. However, not all starting points are the same and even if they are similar, the wording is often completely different. In all cases buying and selling financial instruments with trading intent as a principal is prohibited. In the UK, as well as in Belgium, buying or selling commodities as a principal is added to this. At this stage, the inclusion of commodities in those two countries is the only real difference. Although even this difference might be smaller than it seems, because contracts for the future delivery of commodities are derivatives, which are financial instruments, which makes speculation nearly impossible. Note that the excluded commodities, which are financial instruments in the US, would not be considered commodities in the European definition, so they do not alter this observation. Because of the broad definitions, positions resulting from permitted customer related activities will have to be allowed again at a later stage.

In the UK, long-term investments are included in the prohibition and not subsequently exempted, such as in Germany, which results in a broader starting position. There is an exception, however, for acquiring shares from a company to gain control or at least a serious influence in the target company.

The US, and to a lesser extent Belgium, make a distinction between activities which are exempted and activities which are not considered prohibited activities, despite potentially meeting the definition. These activities are not subject to additional requirements in order to be allowed. The US list contains activities using the financial instruments as security interest or collateral, including certain transactions such as repo’s, liquidity management, all sorts of clearing related activities and activities in which the banking entity only acts as a broker and does not incur any risk. The Belgian list contains the same four elements, although the clearing exception is much more narrow. How would those same activities be treated in the other countries? The brokerage activities would probably not be forbidden anywhere, even if they are not mentioned. In the UK, exclusions to the prohibitions are provided for liquidity management and for using financial instruments as securities or acquiring them through debt-equity swaps. Connections with central counterparties are also still permitted, which means that the ring-fenced body will carry on some clearing related activities. In the UK the term ‘investments’ is used, which also includes qualifying contracts of insurance. Apart from a minor restriction in the UK on the use of some interbank payment systems. Central counterparties and recognised clearing houses are explicitly excluded from the list of relevant financial
The PRA will further regulate these activities before the ring-fencing requirement comes into force.\textsuperscript{517} In France, there is a provision allowing clearing activities, but liquidity management and security interests as such are not mentioned. Nevertheless, since liquidity risk is amongst those risks which the deposit bank is allowed to mitigate and it is hard to see why France would consider taking financial instruments as collateral as proprietary trading. In Germany neither of the above is named explicitly in the legislation itself, but as mentioned above they have a more general clause allowing activities which are entered into for another purpose than gaining benefits from short-term price movements. The permissibility of the activities can also be deduced from the list in the preparatory works. So from the four categories of activities, derived from the US list of excluded activities, it seems like all countries permit them to some extent.

Next are the activities which, despite being trading activities, are nevertheless permitted. The most common are underwriting, market making, hedging and trading activities provided as a service to customers.

Underwriting is permitted in all jurisdictions, except the UK. In the US, it is a separate exemption, with its own conditions, while in France and Belgium it is part of the permitted customer related investment services. In Germany, an express reference to underwriting can be found in the preparatory works. In the UK, an exclusion was inserted in the secondary legislation to allow a ring-fenced body to trade in its own debentures or in those of its parent company. In this way, the constraint on its underwriting activities will not negatively impact the ring-fenced body's access to funds.

Also market making is permitted in all countries, except the UK. In Belgium, market making is restricted to banks registered as market makers on a regulated market or MTF. It is interesting to note that this is contrary to the situation in the US where, even though it is strictly speaking allowed to be a market maker on an exchange, the focus of the Regulation is on OTC instruments.\textsuperscript{518} To avoid evasion attempts, large banks, in most circumstances, will not be considered customers for the market making exemption in the US.

\footnotesize{institutions, which means the prohibition discussed in part IV will not apply to them.}


\textsuperscript{518} R. LEDIG \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis}, s.l., Thomson Reuters, 2014, 121.
Hedging or risk-mitigating is to some extent allowed in all of the analysed countries. Some countries only provide measures to assure that this exemption is not abused to engage in speculation, such as the US, France and Belgium. The UK and Germany, on the contrary, list the risks for which risk-mitigation is permitted. Those lists are rather extensive in scope and serve the purpose of making sure that the exemption is only used to hedge specific risks, instead of for speculative purposes. A similar requirement that the risk which is being mitigated can be identified, can also be found in the other countries. Therefore hedging against general market risk is no longer possible.

In France and Germany, the hedging exemption, allows hedging for the entire group, although France explicitly excludes the trading entity from the group. In Belgium and the UK, the exemption is only extended towards risks of the subsidiaries\textsuperscript{519} of the deposit bank/ring-fenced body and not from the parent undertaking or the entire group. In the US, only the banking entity is mentioned, but hedging takes place on the level of the trading desk, which can consist of members of separate legal entities. Moreover, hedging risks from another trading desk is allowed as long as these risks are identifiable. Therefore situations where risks are hedged by a trading desk in a different legal entity within the same group will probably arise.

Finally, sometimes customer related activities demand that the deposit bank enters into trading activities. Since it is not the purpose of most countries to capture those activities, some of them have explicitly excluded them from the prohibition. In both Belgium and France reference is made to a list which is the implementation of annex I of Directive 2004/39/EC.\textsuperscript{520} For clarity's sake, Belgium has excluded point 3 (dealing for own account) of this list, while France has not chosen to do so. Contrary to France, Belgium also limits the services which can be provided to professional customers with significant trading activities. In Germany, there is no explicit provision, but the preparatory works clarify that these activities fall under the activities with another purpose than short-term profit. In the US trading on behalf of customers is only allowed if it is done in a fiduciary capacity and the bank retains no beneficiary ownership or if it is effected in such a way that the banking entity does not incur any risk during the transaction. Considering the purpose of the ring-

\textsuperscript{519} In the UK conduit vehicles are also explicitly mentioned, apart from subsidiaries.

fencing rule, it should not come as a surprise that the UK does not have any similar exclusion. However, under strict conditions, the ring-fenced body can provide hedging services to customers through certain simple derivatives.

In the US, there is one extra exemption, which is transactions in government obligations. In the other countries those are only permitted if they meet the conditions of one of the exemptions or exclusions above.

All countries require extensive reporting compliance programmes and procedures and internal risk limits. Apart from that, both the US and Belgium have general requirements which the exempted activities have to meet. In the US, these requirements are not leading to excessive risk and absence of any material conflict of interest. In Belgium transactions with a high risk are prohibited and all permitted trading activities must remain within certain limits.

On an organisational level, the requirement to install trading desks can be found in the US, France and Belgium. Germany is more flexible and requires an adequate organisational structure. In the UK there is no need for such a recommendation, because only a very limited number of trading activities are permitted.

C. **Comparison to the Reports and purpose**

When comparing the Volcker Rule to the Liikanen Report, it seems that while the former only wanted to prohibit proprietary trading, the latter also wanted market making to be proscribed, although it did allow underwriting activities and hedging services to non-financial institutions. The Liikanen Report wanted to avoid unnecessary difficulties in its implementation and separating market making from proprietary trading was seen as too complex.\(^{521}\) As should be clear by now, the countries which based their separation requirement on the Liikanen Report have all permitted market making, thereby reducing the difference with the activities permitted under the Volcker Rule. Whether or not market making should be allowed, is a policy question that cannot easily be answered. Those in favour stress its role in providing liquidity to the markets, while opponents point to its risk and similarity to trading activities. In the logic of the Volcker Rule, the question is whether or not this activity is beneficial to society and should be protected, but in the thinking of the Liikanen Report, the right question is if market making can lead to excessive risks. There are definitely arguments to answer the second question affirmatively. Especially keeping in mind that

\(^{521}\) Liikanen Report, 102-103.
the Report proposed narrow risk limits for the activities that it exempted from the prohibition. Only Belgium seems to have followed this recommendation, while Germany and France both only require internal risk limits and have an open norm allowing the competent authority to interfere as safeguard. If market making was prohibited, an exemption of certain simple derivatives for hedging services comparable to the current legislation in the UK, might have been more in line with the intentions of the Liikanen Report.

The Vickers Report considered the Volcker Rule's prohibition of proprietary trading as a starting point, but not sufficient to avoid the risk of bail-outs for the continuation of essential financial services. 522 This is the crucial difference in ambition of the various rules. The objective of the Vickers Report is that the authorities will not have to bail-out banks in the next crisis on the financial markets, because the ring-fenced bodies, which perform the essential services, will simply not be involved. The Volcker Rule only avoids that, when banking entities have to be bailed out, taxpayers' money is used for activities which do not benefit the economy. Finally, the Liikanen Report aims at limiting the times banks have to be bailed out, because deposit banks will take on less risk and even if one bank fails, it will be less connected to the rest of the system so there is less risk of a chain-reaction. This is another argument in favour of a more strict implementation, prohibiting market making and providing statutory risk limits.

PART IV CONNECTIONS WITH ENTITIES CARRYING ON PROHIBITED ACTIVITIES
In this second main part, the focus is on relationships with other entities that can still carry on prohibited activities. This falls apart in two categories: third parties and group members. In the US certain relationships with covered funds are prohibited. In the Liikanen Report, hedge funds and private equity funds are mentioned. Meanwhile in the UK, exposures to financial institutions are forbidden.

Intra-group exposures are regulated in the UK and in the continental European countries. In the US, prohibited activities cannot take place within the group so there is no need to provide distinct rules for links between group members of a group containing a banking entity.

I. United States

If the statute only prohibited banking entities from engaging in proprietary trading activities, then it would not be very effective. In order to curtail evasion, it must also regulate the relationship between the banking entity and the entities which carry on prohibited proprietary trading activities. These entities are referred to as covered funds in the Regulation.

As seen in part II, if an entity is a subsidiary or an affiliate of the banking entity, it will itself become a banking entity, unless it qualifies as a covered fund. As a result, proprietary trading is prohibited in the entire group and there is no need to regulate intra-group relationships.

This chapter will first establish what a covered fund is, then it will look at which relationships with covered funds are prohibited and which are permitted.

A. Covered funds

1. Definition of a covered fund

Even though the proposal had a very broad definition of covered fund, this was significantly revised in the Final Rule. The intent is to capture private equity funds and hedge funds, which are funds created for trading in securities or derivatives and are only offered to institutional investors and high net-worth individuals. By avoiding public offering, the funds are not required to register as investment funds and are therefore not subject to all securities law protection, allowing them to take more risks.

523 R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 169.
524 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds
Keeping this intention in mind, the first of the three types of entities that are covered funds, is an issuer which would have been an investment company, but is not because all its securities are owned by qualified investors or are beneficially owned by less than one hundred people. If the entity can also rely on any other exclusion than those two in order not to be qualified as an investment company, then it is not a covered fund for the present legislation.

While the first type was the statutory definition of private equity funds and hedge funds, the Agencies added two extra types of funds which are similar to the first and should therefore also be labelled covered funds. Commodity pools, which are entities trading in commodity interests, are also covered funds if they are exempted under 17 CFR 4.7. To fall under this exemption, the commodity pool only sells its participations to qualified individuals. Commodity pools which are not technically exempted, but which are very similar to the exempted pools are also covered funds. If this was not the case, an easy way to escape the prohibition to transact with banking entities would be not to apply for the exemption.

Third type of covered funds are certain foreign entities. Under the proposal, every foreign issuer that would have been a covered fund under US law was a covered fund. The intention is to curtail evasion attempts and ensure that foreign entities can not pose a threat to US banking entities. Therefore, in the Final Rule, foreign funds are only covered funds in relation to US banking entities. If the foreign funds would have been able to rely on an exemption from the Investment Company Act of 1940, other than its securities being owned by qualified investors or are beneficially owned by less than one hundred people, then it will also not be deemed to be a covered

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525 “Issuer means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.” (Section 2(a)(22) of the Investment Company Act of 1940).
526 Regulation, §_.10(b)(1)(i).
527 Regulation, §_.10(b)(2).
528 Regulation, 5670-5671.
529 Regulation, §_.10(b)(1)(ii)(A).
530 Regulation, 5674.
531 Regulation, §_.10(b)(1)(ii)(B) + Regulation, 5674.
532 Regulation, 5674.
533 Regulation, §_.10(b)(1)(iii).
534 Regulation, 5671.
535 Regulation, 5672.
2. Exclusions

There are no less than thirteen exclusions to the definition of covered funds. Moreover, the competent agencies may also jointly exclude other entities than those already listed. Following is a short overview of the exclusions.

The first is foreign public funds. These are funds which would have been investment companies if they were subject to US law. Its main characteristics are that its participations are publicly offered and that retail investors are eligible to participate. To avoid the possibility that a US investment company is ever considered a covered fund, in spite of the definition, they are also explicitly excluded in the twelfth exclusion.

Secondly, wholly-owned subsidiaries are excluded. Maximum 0.5% of the shares may be held by a third party, or maximum 5%, minus the 0.5% if applicable, by employees or directors. The reason for its exclusion is that wholly-owned subsidiaries are often established for organisational purposes and do not pose the same threats to the banking entity as private equity funds or hedge funds. The small amount held by third parties was permitted because this is necessary in some jurisdictions to establish a corporate separateness. Finally, the Agencies warn that the wholly-owned subsidiary will itself be a banking entity and will have to comply with the Volcker Rule.

The third exempted category are joint ventures comprised of less than ten co-venturers, which do not invest in securities for resale. Commenters had expressed that these joint ventures are often

536 Regulation, §_.10(b)(2).
537 Regulation, §_.10(c)(14).
538 Regulation, §_.10(c)(1).
539 Regulation, 5677-5678.
540 Regulation, §_.10(c)(1)(A) and (B).
541 Regulation, §_.10(c)(12).
542 Regulation, §_.10(c)(2).
543 Regulation, 5679.
544 Regulation, 5680.
545 Regulation, 5680.
546 Regulation, §_.10(c)(3).
used for permitted activities, e.g. to share risks from loans or credit cards.\textsuperscript{547}

Fourthly, acquisition vehicles, which only exists to facilitate a merger or acquisition transaction are also permitted.\textsuperscript{548}

The next exclusion relates to foreign pension or retirement funds.\textsuperscript{549} This exclusion is analogous to the exclusion of US pension funds from the definition of investment companies in the Investment Company Act of 1940.\textsuperscript{550}

Separate accounts of insurance companies are also excluded.\textsuperscript{551} The reason is that it is the policyholder and not the insurance company that is the main beneficiary of the investments held in the separate account.\textsuperscript{552} Similarly, a separate account used only for a bank owned life insurance is also permitted.\textsuperscript{553} These BOLI separate accounts are often used to cover the costs of providing pension plans to key employees.\textsuperscript{554}

The most complex group of exclusions are numbers eight to ten. Starting of is the exclusion of loan securitisations.\textsuperscript{555} In this context, loans include other secured or unsecured receivables which are not securities or derivatives.\textsuperscript{556} A limited number of securities and derivatives are permitted in the issuing entity. Permitted are interest rate or foreign exchange derivatives which effectively reduce the risk.\textsuperscript{557} Securities which were received as collateral are also permissible as well as cash equivalents held to ensure a timely distribution of the profits to the holders.\textsuperscript{558} Finally the issuing entity may also hold special units of beneficial interest (SUBI) or collateral certificates issued by an SPV that complies with this exclusion.\textsuperscript{559} These are constructions which are often used, in which an

\begin{footnotesize}
\begin{enumerate}
\item Regulation, 5681.
\item Regulation, §.10(c)(4).
\item Regulation, §.10(c)(5).
\item Regulation, 5682.
\item Regulation, §.10(c)(6).
\item Regulation, 5683.
\item Regulation, §.10(c)(7).
\item Regulation, 5684.
\item Regulation, §.10(c)(8).
\item Regulation, §.2(s).
\item Regulation, §.10(c)(8)(iv).
\item Regulation, §.10(c)(8)(iii).
\item Regulation, §.10(c)(8)(v).
\end{enumerate}
\end{footnotesize}
intermediary is placed between the issuer and the securitised assets. The Agencies note that these are the only asset-backed securities which are allowed. Because other securities than those mentioned above are still proscribed, the loan securitisation vehicle will not be allowed to hold any participation in another loan securitisation vehicle.

Closely related is the exclusion of qualifying asset-backed commercial paper conduits, which is similar to the loan securitisation exclusion above but in this case asset-backed securities of which the underlying assets are loans are also permitted. Typical of ABCP conduits is that the liabilities are short-term and are regularly “rolled”. A regulated liquidity provider must provide a liquidity coverage of 100%, in case that the conduit cannot repay its matured securities.

The last of the three exclusions relating to securitisation of loans is the exclusion of qualifying covered bonds. These are debt obligations related to a pool of assets comprised only of assets permitted in the loan securitisation exclusion. In some foreign countries these asset pools may contain mortgage-backed securities and other non-loan assets, as a result of which they would not comply. The envisaged SPV constructions could fall under the definition of covered funds despite being similar in some respects to the previous two exclusions. They are often used in Europe, especially in the UK. In order to be excluded the covered bonds must be fully and unconditionally guaranteed by the foreign bank holding the asset pool.

The eleventh exclusion is formed by Small Business Investment Companies (SBICs) and public welfare investment funds. The first type are registered companies which provide financing to

560 Regulation, 5692.
561 Regulation, 5692.
562 R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 194.
563 Regulation, §.10(c)(9).
564 Regulation, 5693.
565 Defined as a depository institution, bank holding company, saving and loans association, foreign bank or a sovereign nation. (Regulation, §.10(c)(9)(ii)).
566 Regulation, 5695.
567 Regulation, §.10(c)(10).
568 R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 200.
569 Regulation, 5696.
570 Regulation, §.10(c)(10).
571 Regulation, §.10(c)(11).
small business in order to stimulate the US economy.\textsuperscript{572} The Regulation allows transactions with these entities, because they are considered beneficial to society. The Agencies also hope that the banking entities will provide valuable expertise to these entities.\textsuperscript{573}

Since the twelfth exclusion was mentioned together with the second, only the thirteenth exclusion is left. This exclusion relates to entities established by the FDIC in its capacity as conservator and receiver of an insured depository institution.\textsuperscript{574}

\section*{B. Permitted and prohibited relations with covered funds}

1. Ownership interest in or sponsoring a covered fund

Prohibited is acquiring or retaining an ownership interest in or sponsoring a covered fund as a principal, in any other case than those permitted by the Regulation.\textsuperscript{575} The definition of ownership interest in this context is much broader than might otherwise be the case.\textsuperscript{576} It includes being able to take part in the election of managers and directors, most types of economic exposure to the profits and losses of the covered fund and even synthetic exposures to the same.\textsuperscript{577} An example given by the Agencies is that even loans of which the interest is calculated based on the profits of the covered funds are included.\textsuperscript{578} Compensating the banking entity for its services through restricted profit interest, will remain permitted under strict conditions, ensuring that the banking entity will not be exposed to the losses of the covered fund, apart from a possible “clawback” covenant.\textsuperscript{580} The banking entity will be allowed to invest a small amount in the fund, which is necessary to receive a beneficial tax treatment as investment manager or investment advisor receiving this restricted profit interest.\textsuperscript{581}

Sponsoring is acting as a managing member, general partner or trustee of a covered fund or being able to elect or control its management, trustees or directors. This includes the case where the

\textsuperscript{572} Section 102 of the Small Business Investment Act of 1958.
\textsuperscript{573} Regulation, 5698.
\textsuperscript{574} Regulation, §.10(c)(13).
\textsuperscript{575} Regulation, §.10(a)(1).
\textsuperscript{576} Regulation, 5707.
\textsuperscript{577} Regulation, §.10(d)(6)(i).
\textsuperscript{578} Regulation, 5707.
\textsuperscript{579} Regulation, §.10(d)(6)(ii).
\textsuperscript{580} Regulation, 5708-5709.
\textsuperscript{581} Regulation, §.10(d)(6)(ii)(C) and Regulation, 5709.
banking entity's employees or directors constitute the majority of the board, trustees or managers of the covered fund. Additionally, sharing a name with the covered fund is also considered to be sponsoring.\textsuperscript{582}

The Regulation specifies that activities conducted as broker, agent or in a fiduciary capacity are not prohibited, as long as the banking entity does not retain any beneficiary ownership.\textsuperscript{583} Likewise, pension plans for the benefit of employees are allowed.\textsuperscript{584} The banking entity can also still collect an ownership interest if its counterparty fails to repay its debt.\textsuperscript{585}

Following the prohibition are a number permitted covered fund activities. As opposed to the activities listed in the previous paragraph and the exclusions to the definition of covered funds, those activities will still lead to the banking entity having an ownership interest in or sponsoring a covered funds. As a result, they are only permitted within certain limits and under the conditions established by the Regulation.

2. \textit{Permitted investments in covered funds}

Banking entities will still be allowed to organise and offer covered funds in a limited number of circumstances. The first case in which this is permitted is the provision of trust or fiduciary services or investment or commodity trading advice to customers.\textsuperscript{586} This is only important if the banking entity wishes to retain an ownership interest in or sponsor the covered fund, because simply providing the aforementioned services would not qualify as a prohibited relationship with a covered fund.\textsuperscript{587} Nevertheless, this permission is often necessary to keep providing the services in an efficient matter.\textsuperscript{588}

Secondly, the banking entity will also still be able to offer and organise an issuing entity of asset-backed securities, which, in this case, means acting as the securitiser.\textsuperscript{589} As was mentioned above, an entity is not a covered fund if the only underlying assets are loans. If the entity owns other assets,

\begin{itemize}
\item \textsuperscript{582} Regulation, §_.10(d)(9).
\item \textsuperscript{583} Regulation, §_.10(a)(2)(i) and (iv).
\item \textsuperscript{584} Regulation, §_.10(a)(2)(ii).
\item \textsuperscript{585} Regulation, §_.10(a)(2)(iii).
\item \textsuperscript{586} Regulation, §_.11(a)(1) and (2).
\item \textsuperscript{587} Regulation, 5715.
\item \textsuperscript{588} R. LEDIG \textit{et al.}, \textit{The Volcker Rule: Commentary and Analysis}, s.l., Thomson Reuters, 2014, 230.
\item \textsuperscript{589} Regulation, §_.11(b).
\end{itemize}
this permission will have to apply in order for the banking entity to be allowed to hold an ownership interest in or sponsor the asset-backed securities fund. The motive for permitting asset-backed securities funds was that section 15G of the Securities Exchange Act of 1934 requires the securitiser of the fund to retain a minimum amount of risk. If this issue was not resolved, this could lead to a loss of liquidity and less possibilities to spread risks in the market, ultimately leading to less or more costly funding for businesses.

In those two cases, the banking entity will be able to provide sufficient equity to establish the fund and attract independent investors. After this initial period, its participation must be reduced to a de minimis investment of 3% of the total ownership interests or, in case of an asset-backed securities fund, 3% of the fair market value of the ownership interests, unless a higher percentage is required by section 15G of the Securities Exchange Act of 1934. These percentages include ownership interests held by affiliates of the banking entity. The seeding period is generally limited to one year, in which the banking entity must actively seek to sell its participation, but an application to Board of Governors of the Federal Reserve System (FRB) to extend this period is possible.

Most importantly, because the permitted investments in covered funds can still pose some risks, the aggregate value of the banking entity's and affiliates' investments in covered funds may never exceed 3% of the tier 1 capital of the banking entity. This absolute risk limit was directly taken over from the statute itself. The invested amounts must also be deducted from the tier 1 capital to calculate compliance with the capital requirement rules. As a result, the banking entity will have to hold 100% of the value of those investments in tier 1 capital, dissuading them from overusing this permission because of its cost.

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590 R. LEDIG et al., The Volcker Rule: Commentary and Analysis, s.l., Thomson Reuters, 2014, 236.
591 Regulation, 5721.
592 Regulation, 5721.
593 Regulation, §_.12(a)(1)(i).
594 Regulation, §_.12(a)(1)(i) and (2)(ii).
595 Regulation, §_.12(b)(1)(i).
596 Regulation, §_.12(a)(2)(i).
597 Regulation, §_.12(e).
598 Regulation, §_.12(a)(2)(iii).
599 Section 13(d)(4) of the Bank Holding Company Act of 1956.
600 Regulation, §_.12(d).
Some additional measures are in place to avoid evasion attempts. For instance only employees or directors who are directly involved in providing the aforementioned services to the covered fund may own any ownership interest in the fund. While the Agencies are cautious about the possibility of evading the rule through employees or directors, they do see the benefit of aligning the interest of the management of the fund and its customers. However, the same risk led them to include the ownership interests held by those employees or directors if those investments are directly or indirectly financed by the banking entity.

To avoid additional exposure, the banking entity is also prohibited from guaranteeing the obligations of the covered funds. There is also separate mandatory legislation in place to ensure this. Moreover, customers have to be made aware that any losses will be borne by the investors and that the covered funds are not FDIC insured.

The last condition, which is aimed at reducing incentives to bail out distressed covered funds, is that the covered fund may not carry the same name as the banking entity, nor may its name contain the word “bank”. Ironically, in some European countries, such as the UK and Germany, funds have to bear the name of its advisor to increase transparency. Many commenters were opposed to this requirement, because another rule that forbids bailing out funds is already in place.

3. Permitted market making and underwriting

A banking entity will be allowed to engage in underwriting and market making activities in relation to covered funds, under the same conditions as in the market making and underwriting exemptions to the prohibited activities. However, those activities will be included in the calculation of the
aggregate risk limit of 3% of the tier 1 capital and, if applicable to the type of covered fund, in the per-funds limits described above.\textsuperscript{613} The flexibility during the seeding period of the covered fund will also apply here.\textsuperscript{614}

4. **Other permitted covered funds activities**

Section 13 contains three shorter permitted activities, one of which is related to activities solely outside the US.\textsuperscript{615} Since this relates to the international application of the Volcker Rule, it is outside the scope of this dissertation. Another permitted is the acquisition of ownership interests by a regulated insurance company solely for its general account or one of its separate accounts.\textsuperscript{616}

The last of the other permitted activities in this section is hedging, though, in this case, it is only allowed in connection with the compensation arrangement of an employee that provides services to the covered funds, such as investment advice.\textsuperscript{617} The conditions with which the banking entity has to comply are similar to those of the hedging exemption from the prohibited activities.\textsuperscript{618}

5. **Limits on covered funds relationships**

To address the danger of evasion posed by these links, the Regulation expands the prohibited activities in relation to covered funds which the banking entity sponsors or in which the banking entity holds an ownership interest, in accordance with the rules explained above, or for which the banking entity acts as an investment manager, investment advisor or commodity trading advisor, even without having an ownership interest.\textsuperscript{619}

Prohibited in this case are all covered transactions under the Federal Reserve Act, i.e. the extension of credit, the acceptance of securities or of any kind of debt instrument giving rise to credit risk exposure, including providing guarantees and even accepting securities or debt obligations of the covered fund as collateral for credit provided to another person.\textsuperscript{620} As a result,
contrary to unrelated hedge funds and private equity funds, the banking entity cannot provide simple loans to these covered funds with which it has a relationship of the kind specified above.

Naturally, this restriction does not affect the permissions described in numbers 2 to 4 above\textsuperscript{622}, since this would deprive those permissions of any use.\textsuperscript{623} If the covered fund described above invests in another covered fund, the banking entity will be allowed to provide a limited number of services, called prime brokerage transactions to the latter covered fund.\textsuperscript{624} Prime brokerage transactions are covered transactions under the Federal Reserve Act, connected to custody, clearing and settlement, trade execution or similar services.\textsuperscript{625} This limited permission came directly from the statute.\textsuperscript{626} The reason for its adoption was that those funds are unaffiliated, but because of the indirect link do provide a risk. Therefore some services are acceptable, while others are not.\textsuperscript{627} Put simply, it allows the borrowing of securities and cash.\textsuperscript{628} This permission may not be abused to create two-levelled structures to evade the prohibition. Accordingly, the second-tier funds should be independent from the banking entity for it to apply.\textsuperscript{629}

All transactions, including prime brokerage transactions, with the covered funds subject to these extended rules, must be conducted on market terms or more favourable terms for the banking entity.\textsuperscript{630}

C. Investment companies

Before concluding this chapter, it is useful to have a short look at some of the rules governing investment companies in order to understand why relationships with them are not restricted.

\textsuperscript{622} Regulation, § 14(a)(2)(i).
\textsuperscript{623} Regulation, 5746.
\textsuperscript{624} Regulation, § 14(a)(1)(ii).
\textsuperscript{625} Regulation, § 10(d)(7).
\textsuperscript{626} Section 13(f)(3) of the Bank Holding Company Act of 1956.
\textsuperscript{630} Regulation, § 14(b) and (c) and Regulation, 5744.
Investment companies are regulated by the Investment Company Act of 1940. This act's objectives can be summarised as follows: It aims to eliminate some forms of abuses in sale practices and advisory fees.631 Further it wants to separate management from bankers, brokers, commercial bankers, principal underwriters, which are persons who buy securities from the company for redistribution or act as an agent for the company632 and from other similar investors whose vision might be biased.633 In the same spirit, the Act aims to increase the investors' power in electing the management, requiring that at least two thirds of the board is elected by the security holders.634 These measures are certainly useful in the context of the Volcker Rule for eliminating certain evasion attempts. Completely opposite is the situation in hedge funds, where the investors often do not have any say in the composition of the management.635

When further comparing investment funds to hedge funds, those differences in transparency and possibilities to take on risk are even more pronounced. For instance investment funds are forbidden from margin trading or selling short. They are also required to obtain permission from their security holders to for investments in certain assets such as real estate or commodities.636 Looking at transparency, hedge fund do often not even disclose information about their investments to their investors.637

D. Conclusion

Just like in the previous chapter, the implementation of the Volcker Rule has led to a difficult balancing exercise. Keeping in mind the purpose of the Rule, the question is always whether an activity is useful for the economy or only for the person conducting it. Even more complex is the task of defining the permitted activities, without introducing evasion opportunities.

The Volcker Rule, as enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act, focuses on hedge funds and private equity funds. The last section of this chapter explained some of

632 Section 2(a)(29) of the Investment Company Act of 1940.
the key differences between those funds and regulated investment funds, especially with regard to
their risk-taking possibilities, transparency and independence. Looking at those differences, it is
clear why the former are considered highly risky, while the latter are not.

Moving on to the funds excluded from the definition of covered fund. This list is comprised of
funds which do not present the same risks as hedge funds and private equity funds and activities
which are beneficial to the economy and should not be restricted, most importantly loan
securitisations. In all cases, there are good arguments for its exclusion, although one could always
argue that an exclusion is too broad or too narrow.

The prohibition in this part relates to ownership interests in or sponsoring a covered fund. Its main
intention is to avoid exposure to the profits and losses of the covered fund. Nevertheless in cases
where the banking entity and covered fund already have a certain relationship, there are additional
limitations in place, to further limit the possibilities to engage in risky activities through those
covered funds. Activities which are still permitted, will have to be conducted at market terms.

Escaping the prohibition, are investments in funds that provide certain customer services and asset-
backed securities funds. After the seeding period, only a de minimis investment will be allowed. The
statute also provided an absolute maximum for permitted covered fund investments of 3% of the
tier 1 capital. The reason for these permissions is again not to disrupt the provision of useful
services, while the limits prevent overly exposing the banking entity to risk.

Just like in the case of the prohibition of proprietary trading, underwriting activities and market
making are also permissible, on more or less similar terms. On the contrary, hedging activities with
covered funds are severely restricted.

A final important safeguard is that banking entities will have to hold tier 1 capital for all the money
invested in permitted covered fund activities.

These permitted investments in covered funds are thus aimed at ensuring the efficient provision of
services and the continuation of the possibility to provide liquidity through asset-backed securities
funds, the risks of which are then spread to interested investors.
II. United Kingdom

To ensure the effectiveness of the prohibition for the ring-fenced body to carry on excluded activities, the Vickers Report introduced a prohibition of any service which results in an exposure to non-ring-fenced financial organisations.\(^{638}\) If such a prohibition were not in place, the ring-fenced body would simply lend the money to another entity that could then invest it in the financial system, indirectly exposing the ring-fenced body to the financial markets.\(^{639}\) However, exposures resulting from payment services should be allowed, within limits determined by the regulator.\(^{640}\)

Contrary to the Volcker Rule, the Vicker Report allows the excluded activities to be conducted within another entity in the same group.\(^{641}\) The rules concerning intra-group relationships will be treated after those relating to all financial organisations.

The ring-fenced body is also prohibited from having a branch or subsidiary outside the EEA.\(^{642}\) Since this rule relates to the international aspects, it is outside the scope of the present dissertation.

A. Financial institution exposures

The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 prohibits financial institution exposures.\(^{643}\) Exposures are defined by referring to the Capital Requirements Regulation. Every element that is taken into account for determining credit risk is considered an exposure, without taking into account the risk weights from the regulation.\(^{644}\) This includes the off-balance sheet risks from Annex I to the regulation, such as documentary credits, undrawn credit facilities, guarantees, etc. The draft secondary legislation used a different definition of exposure, which was similar in scope, but did not refer to any other legislation. It defined exposure as all losses which may result from the other party not meeting its obligations or realising its assets.\(^{645}\)


\(^{639}\) Vickers Report, 50, n° 3.38.


\(^{641}\) Vickers report, 62-77.


Only exposures to relevant financial institutions are prohibited. When discussing which deposits are not core deposits, those financial institutions were already mentioned. To recap, these are credit institutions, investment firms, various types of investment funds, systemically important insurers and structured finance vehicles.646

There are exceptions for other ring-fenced bodies, building societies, credit unions and other institutions that only carry on activities permitted within the ring-fence, including investment firms without authorisation to deal in investments as a principal or agent and credit institutions which cannot carry on prohibited activities. Recognised clearing houses and central counterparties are also not included and neither are certain international organisations such as the EU and the IMF.647

In the draft, there was some discussion about creating an exclusion for small banks which, because they meet the de minimis exemption, are not required to ring-fence their deposits. Although not allowing transactions with small banks could make it more difficult for them to obtain credit, protecting the core services provided by ring-fenced bodies was considered more important.648

Not all financial institution exposures are prohibited. Parallel to the hedging exemption to the excluded activities, the ring-fenced body is also allowed to incur financial institution exposure if the sole purpose is to mitigate certain risks.649

Also in line with an exclusion from part III are securisations of the ring-fenced body's own assets.650 An additional exclusion was necessary here, to allow the ring-fenced body to retain an interest in its own structured finance vehicle.651 Sometimes it is the customer who sets up the vehicle for the loan.

646 Art. 2 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014. The complete list of relevant financial institutions is: “(a) credit institutions; (b) investment firms; (c) structured finance vehicles; (d) global systemically important insurers; (e) UCITS (wherever established) and alternative investment funds; (f) management companies or alternative investment fund managers; and (g) financial holding companies and mixed financial holding companies.” The European definitions, discussed in Part II, apply.


Those so called conduit vehicles hold the assets as a security. Because these types of loans are similar to securitisations, the Treasury decided to permit them as well.\textsuperscript{652} Article 17 of the Order therefore provides that conduit lending is permitted, as long as the entity holding the conduit is not a relevant financial institution and all the assets of the conduit are used as a security for the financing provided by the ring-fenced body.\textsuperscript{653}

Another exclusion is related to liquidity management. As part of the liquidity management, to show that the assets kept as buffer are sufficiently liquid, banks are required to regularly turn over these assets. Instead of buying and selling assets, this can also be done through repo transactions.\textsuperscript{654} Article 18 of the Order therefore allows exposures arising from repo and reverse repo transactions for this purpose.\textsuperscript{655} This permission should not be confused with the permission to use repo transactions for funding purposes, as was seen in part III.\textsuperscript{656}

Partly related to an exclusion from the prohibitions is the fact that a ring-fenced body is allowed to incur payment exposure under certain conditions, yet to be determined by the FCA and PRA.\textsuperscript{657} Payment exposure can arise during the settlement of transactions, when providing payment services to customers or when taking part in an inter-bank payment system.\textsuperscript{658} It is those payment systems which were explicitly accepted by the Vickers Report in this context.\textsuperscript{659} The PRA is in the process of determining how the use of financial market infrastructures by ring-fenced bodies would best be organised.\textsuperscript{660}

\textsuperscript{652} HM Treasury, Banking reform: draft secondary legislation, 2013,  

\textsuperscript{653} Art. 17 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

\textsuperscript{654} HM Treasury, Banking reform: draft secondary legislation, 2013,  

\textsuperscript{655} Art. 18 Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

\textsuperscript{656} HM Treasury, Banking reform: draft secondary legislation, 2013,  


\textsuperscript{659} Vickers Report, 52, n° 3.39.

\textsuperscript{660} Prudential Regulatory Authority, Consulation paper CP37/15. The implementation of ring-fencing:
The Vickers Report permits trade financing within the ring-fenced body.\(^{661}\) This could lead to financial institution exposure, for instance when accepting a letter of credit from a non-ring-fenced bank.\(^{662}\) Therefore the proposal contained an exclusion for issuing or confirming letters of credit or guarantees\(^{663}\), which was replaced in the final version with a general exclusion for financial exposures resulting from trade finance.\(^{664}\) The permitted transaction must finance, make payment or guarantee payment for services or goods provided by an entity which is not a relevant financial institution.\(^{665}\) The agreement with the ring-fenced body must refer to this underlying transaction.\(^{666}\) The maximum amount which the ring-fenced body could be liable for will also have to be established in the agreement.\(^{667}\) For commodities reference may be made to the average index over a specified period.\(^{668}\)

When engaging in some permitted activities, financial institution exposures can arise. Therefore the order allows ancillary exposures when providing payment services to customers\(^{669}\), when participating in syndicated loans\(^{670}\) and when purchasing insurance from a globally systemically important insurer for the benefit of directors or employees.\(^{671}\) Exposure can also arise if the financial institution breaches a duty owed to the ring-fenced body in connection with a permitted transaction.\(^{672}\)

\(^{661}\) Vickers Report, 54.

\(^{662}\) HM TREASURY, Banking reform: draft secondary legislation, 2013,

\(^{663}\) HM TREASURY, Banking reform: draft secondary legislation, 2013,


B. Intra-group relationships with financial institutions

The Independent Commission on Banking believes that, if the ring-fenced body is sufficiently independent from the rest of the group, in some cases common ownership can protect it against failure.\textsuperscript{673} In addition, it also saves costs and makes live easier for customers, because they can still rely on one banking group for their banking services.\textsuperscript{674} The independence of the ring-fenced body is determined by looking at the legal and operational links and the economic links.\textsuperscript{675}

The Report requires the ring-fenced body to be a separate legal entity. The group structure must ensure that the ring-fenced body has access to all the infrastructure necessary to continue its activities, even in case of problems in the rest of the group.\textsuperscript{676} The Report suggested that the common infrastructure could be placed in a bankruptcy-remote subsidiary or included in the ring-fence.\textsuperscript{677} Another precaution is that any entity owned by the ring-fenced body should also refrain from engaging in prohibited activities.\textsuperscript{678} On the contrary, the parent is allowed to be an operational company itself. The Report does not require the use of a holding company structure.\textsuperscript{679}

As for economic links, ring-fenced bodies and other group members should interact on third party basis. This should also be reflected in the governance of the ring-fenced body, e.g. by having an independent board of directors, meeting the regulatory requirements on its own and by deciding separately about the payment of dividends.\textsuperscript{680}

The Report gives a list of some elements that should be taken into account when making regulations. First of all, the rules limiting large third-party exposures should also apply to relationships between the ring-fenced body and other group members. Additionally, separate limits should be placed on secured exposures, because collateralised exposures are not taken into account for determining large third-party exposures. Another element which should be taken into account for third-party exposure are guarantees or similar activities.

\textsuperscript{673} Vickers Report, 64, n° 3.64.
\textsuperscript{674} Vickers Report, 64-65, n° 3.65-3.66.
\textsuperscript{675} Vickers Report, 66-76, n° 3.71-3.94.
\textsuperscript{676} Vickers Report, 67, n° 3.74.
\textsuperscript{677} Vickers Report, 67, footnote 65.
\textsuperscript{678} Vickers Report, 67, n° 3.74.
\textsuperscript{679} Vickers Report, 72, n° 3.86.
\textsuperscript{680} Vickers Report, 71-72, n° 3.85.
The implementation of these technical rules is mostly left to the PRA, with article 14(4) of the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 only stating that the exposure should be the result of an arm’s length transaction and comply with the rules made by those entities.\textsuperscript{681} The PRA is still in the process of developing these rules. The following will be based on the consultation paper of October 2015 and the draft rules and supervisory statement attached to it.\textsuperscript{682} Since these are only drafts, changes could occur between now and 1\textsuperscript{st} January 2019, when the ring-fencing rules come into effect.

1. Group structure

Some recommendations will apply on a sub-consolidated level, which simply means that part of the group will be treated as a separate group for the application of those rules.\textsuperscript{683} The sub-group is usually formed by the ring-fenced body and its subsidiaries, although in some cases a parent company with multiple ring-fenced bodies could be seen as one sub-group.\textsuperscript{684}

A ring-fenced body nor a member of the sub-group should own any entity that carries on excluded activities or that owns securities in an entity carrying excluded activities,\textsuperscript{685} nor should such an entity own a ring-fenced body or a member of the sub-group.\textsuperscript{686} Consequently, the entity carrying on excluded activities will never be part of the sub-group and the ring-fenced body and its sub-group will be easily separable from the rest of the group.

Members of the sub-group are obligated to comply with some of the rules as if it were a ring-fenced body.\textsuperscript{687}

\begin{itemize}
\item \textsuperscript{681} Art. 14(4) Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
\item \textsuperscript{683} PRUDENTIAL REGULATORY AUTHORITY, Consulation paper CP37/15. The implementation of ring-fencing: prudential requirements, intra-group arrangements and use of financial market infrastructures, October 2015, http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp3715.pdf, Appendix 2, 7, n° 3.1. Appendix 2 will hereafter be referred to as “Draft Supervisory Statement”.
\item \textsuperscript{684} Draft Supervisory Statement, 9, 3.14.
\item \textsuperscript{685} Draft Supervisory Statement, 4, n° 2.3.
\item \textsuperscript{686} Draft Supervisory Statement, 5, n° 2.7.
\item \textsuperscript{687} PRUDENTIAL REGULATORY AUTHORITY, Consulation paper CP37/15. The implementation of ring-fencing: prudential requirements, intra-group arrangements and use of financial market infrastructures, October 2015, http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp3715.pdf, Appendix 1, 8, n° 2.2.
\end{itemize}
The group structure must also ensure that in case of financial difficulties within the group, the ring-fenced body can continue to use the facilities and services it obtained from within the group. Therefore those facilities or services must be provided by an entity within the sub-group or by an entity that only provides those services or facilities.\(^688\) Other members of the sub-group should also only be serviced by those permitted suppliers.\(^689\) As an additional safeguard, the ring-fenced body must make sure that the provision of these services or facilities cannot be ended or altered by a third party as a result of anything that happened to another entity of the group.\(^690\)

2. **Prudential requirements**

Although a detailed discussion of the prudential requirements is not within the scope of this dissertation, it is worth mentioning that the ring-fenced body will have to comply with some prudential requirements on the level of the sub-group. This does not affect existing requirements which have to be met on an individual or consolidated level.\(^691\) The list of the requirements on sub-group level includes capital adequacy, liquidity adequacy and capital buffers.\(^692\)

Sometimes intra-group prudential arrangements are available. For instance some intra-group concessions make it possible to only meet the prudential requirements on a consolidated basis instead of on an individual and a consolidated basis. For members of the sub-group, these concessions should only be available within the sub-group to avoid exposures to the ring-fenced body from other parts of the group.\(^693\)

Similarly, the PRA is allowed under the capital requirements regulation to permit groups not to take intra-group relations in account for the limitation on large exposures. The PRA has decided it will not grant these permissions for relationships between sub-group members and other group

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\(^688\) Draft Ring-fenced Bodies Rules, 13, n° 9.1.

\(^689\) Draft Ring-fenced Bodies Rules, 8, n° 2.1(2) and 2.2(1).

\(^690\) Draft Ring-fenced Bodies Rules, 13, n° 9.2.


\(^692\) The complete list can be found in the Draft Ring-fenced Bodies Rules, 20, n° 18.1.

members. The same also applies to intra-group liquidity concessions.

As a final point, for the calculation of capital to held against credit risk under the capital requirements regulation, ring-fenced bodies and other sub-group members will have to include transactions with non-sub-group members, even though the regulation normally allows not taking into account intra-group transactions. The same also applies on sub-consolidated level.

3. Transactions and exposures

The rules concerning transactions are aimed at assuring that the ring-fenced body does not become dependent on other entities within the group or becomes too exposed to them.

Ring-fenced bodies will only be allowed to enter into transactions with group members, including members of the sub-group, at arm's length conditions. Other members of the sub-group will also have to meet this requirement for transactions with a group member from outside the sub-group, but it can transact freely with other sub-group members.

The ring-fenced body or other member of the sub-group has to manage its transactions with and exposures to other group members as if they were third parties. For secured transactions, this means that the collateral will have to be examined to ensure that it is sufficiently liquid and that its

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696 Draft Ring-fenced Bodies Rules, 13, n° 10.1.


698 Draft Ring-fenced Bodies Rules, 13, n° 10.2.


700 Draft Ring-fenced Bodies Rules, 14, n° 12.1 and 12.2.

701 Draft Ring-fenced Bodies Rules, 8, n° 2.1(3) and 2.2(1).

702 Draft Ring-fenced Bodies Rules, 9, n° 3.5.
value is not related to that of the debtor.\textsuperscript{703}

Three special cases of exposures are explicitly treated in the consultation paper and the drafts. Firstly, the ring-fenced body should avoid becoming income dependent on transactions with group entities outside the sub-group or on transactions with customers that depend on services provided outside the sub-group.\textsuperscript{704} Next, netting agreements with third parties should not be allowed to offset debts of group entities outside the sub-group against claims from within it.\textsuperscript{705} If not, the ring-fenced body would possibly be exposed to third-party exposures from elsewhere in the group.\textsuperscript{706} Thirdly, the ring-fenced body or sub-group member will have to make sure that collateral cannot become unavailable because of anything that passes in a group entity outside the sub-group.\textsuperscript{707} If possible, joint claims on collateral between group entities from within and from out the sub-group should therefore be avoided.\textsuperscript{708}

4. Distributions

The ability of the ring-fenced body to pay dividends has been described as a concession of the PRA or as a victory for the banks in some media.\textsuperscript{709} However, it was never the intention of the ICB to block all dividends. The first half of the relevant paragraph of the Vickers Report says that:

\begin{quote}
“It is to be expected that a ring-fenced bank would pay dividends to its parent company. These should not be constrained in normal times since, as well as investors in the holding company needing access to profits of the ring-fenced bank, the ability to move excess capital
\end{quote}

\textsuperscript{703} Draft Supervisory Statement, 22-23, n° 7.5.
\textsuperscript{704} Draft Ring-fenced Bodies Rules, 15, n° 13.1.
\textsuperscript{705} Draft Ring-fenced Bodies Rules, 15, n° 14.1.
\textsuperscript{707} Draft Ring-fenced Bodies Rules, 16, n° 15.1.
\textsuperscript{708} Draft Supervisory Statement, 24, n° 7.11-7.12.
around a banking group is the main way in which a bank holding company can retain diversification benefits from owning both retail and wholesale/investment banks. However, in times of stress it is also a potential way in which the ring-fenced bank could be weakened by the rest of the group. The ring-fenced bank must not pay dividends where doing so could threaten its own viability. This should be ensured both through regulation and through governance.”

So to retain the benefits of allowing both types of entities in the same group, dividends should be permitted. The real question is if there are adequate rules in place to ensure that the ring-fenced bodies are not drained to benefit the rest of the group.

The Draft Ring-fenced bodies Rule requires ring-fenced bodies and other members of the sub-group to inform the PRA of intended distributions.\(^\text{711}\) The notice must include information about the impact on the capital ratio of the individual entity and of the sub-group.\(^\text{712}\) If the PRA does not agree with the distribution, the Financial Services and Markets Act 2000 itself gives them a number of options to impose it.\(^\text{713}\)

5. Corporate governance

To ensure the independence of the ring-fenced body, the draft rules contain some corporate governance requirements, which have to be met by the ring-fenced body on an individual level. Contrary to the previous rules, these requirements are not applicable to other sub-group members.\(^\text{714}\) In an older policy statement, the PRA has emphasised that independent decision making does not mean that group policies are impossible, but it does mean that the directors and managers will be able to ascertain if the policy is in the interest of the ring-fenced body.\(^\text{715}\)

\(^{710}\) Vickers Report, 75, n° 3.92.

\(^{711}\) Draft Ring-fenced Bodies Rules, 14, n° 11.1, also applicable to other sub-group members through Draft ring-fenced Bodies, 8, n° 2.1(4) and 2.2(1).

\(^{712}\) Draft Ring-fenced Bodies Rules, 14, n° 11.2-11.3.


\(^{715}\) PRUDENTIAL REGULATORY AUTHORITY, Policy statement PS10/15. The implementation of ring-fencing: legal
At least half of the board of directors have to be independent non-executive directors.\textsuperscript{716} This does not include the chairman\textsuperscript{717}, who should be an independent non-executive director as well.\textsuperscript{718} Moreover, the chairman may not be part of the board of any other group member outside the sub-group.\textsuperscript{719} Of the other board members of the ring-fenced body, not more than one-third may be an employee or director of another group member outside the sub-group.\textsuperscript{720}

No executive director may simultaneously be a member of the board of any group entity outside the sub-group, except for the UK parent company of the ring-fenced body.\textsuperscript{721}

The ring-fenced body must establish four committees in its board of directors: the risk committee, audit committee, nomination committee and remuneration committee.\textsuperscript{722} The chairman of all these committees may not perform the same function in any group member outside the sub-group.\textsuperscript{723}

Special care should be taken to ensure that the risk and audit committees have adequate resources.\textsuperscript{724}

An additional requirement for the remuneration committee is that its members can only be non-executive directors.\textsuperscript{725}

The remuneration policies should not encourage excessive risk taking, but enforce the business strategy and long-term goals of the ring-fenced body.\textsuperscript{726} The human resources policy should not rely on employees who might be unavailable in case of problems in another member of the group.\textsuperscript{727}

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\textsuperscript{716} Draft Ring-fenced Bodies Rules, 10, no 4.1.
\textsuperscript{717} Draft Ring-fenced Bodies Rules, 10, no 4.2(1).
\textsuperscript{718} Draft Ring-fenced Bodies Rules, 10, no 4.3(1).
\textsuperscript{719} Draft Ring-fenced Bodies Rules, 10, no 4.3(2).
\textsuperscript{720} Draft Ring-fenced Bodies Rules, 10, no 4.4.
\textsuperscript{721} Draft Ring-fenced Bodies Rules, 10, no 4.7.
\textsuperscript{722} Draft Ring-fenced Bodies Rules, 11-12, no 5.1-8.5.
\textsuperscript{723} Draft Ring-fenced Bodies Rules, 11-12, no 5.2, 6.2, 7.2 and 8.3.
\textsuperscript{724} Draft Ring-fenced Bodies Rules, 11, no 5.3(1) and 6.3(1).
\textsuperscript{725} Draft Ring-fenced Bodies Rules, 12, no 8.1.
\textsuperscript{726} Draft Ring-fenced Bodies Rules, 12, no 8.4(3).
\textsuperscript{727} Draft Ring-fenced Bodies Rules, 12, no 7.3.
Finally, the draft rules also mention in a general way that the ring-fenced body must identify and manage conflicts of interest with its directors and managers\textsuperscript{728} or with other members of the group.\textsuperscript{729}

\textbf{C. Conclusion}

The rules governing financial institution exposures are in line with the excluded and prohibited activities. They avoid that the ring-fenced body becomes exposed to those activities through another company. Most exceptions relate to activities which are also excluded from the excluded and prohibited activities, such as hedging, securitisation and liquidity management. Payment exposures are permitted to allow the ring-fenced body to be member of an inter-bank payment system and access the services of a central counterparty. Finally trade and project finance will also remain permissible. The counterparty in a trade finance agreement may not be a relevant financial institution.

The intra-group relationships are also consistent with the recommendations from the Vickers Report and are often even stricter.

The group structure has to ensure that the ring-fenced body can at all times be separated and continue its core activities. In this respect, the PRA rules do not only to require the ring-fenced body to be a separate legal entity, as was done in the Vickers Report, but they also created a sub-group, to which many of the rules also apply. Another element of the group structure is the requirement to put all joint services used by the ring-fenced body in a separate legal entity with no other purpose than providing these services and facilities, unless they are owned by an entity within the sub-group. The third element is that sub-group members and entities carrying on excluded activities can not own shares in each other. This again goes further than the Vickers Report, which only prohibited ring-fenced bodies from owning shares in entities carrying on excluded activities, but not the other way around.

This group structure has its effects on prudential requirements. As intended by the Vickers Report, the ring-fenced body will have to meet these requirements on its own, but in addition to that, the prudential requirements will also have to be complied with on the level of the sub-group. This addresses the concerns about large exposures and secured intra-group exposures. The PRA has

\textsuperscript{728} Draft Ring-fenced Bodies Rules, 9, no 3.2.
\textsuperscript{729} Draft Ring-fenced Bodies Rules, 9, no 3.3.
made clear that it does not intend to grant concessions to intra-group exposures between members of the sub-group and other group members.

Independence is also enforced through governance requirements. The board of directors and its committees will have to be sufficiently independent from the rest of the group. These requirements are only imposed on ring-fenced bodies and not on other sub-group members.

Despite its independence, dividend payments are still permitted, as was intended by the Vickers Report. Again the rules are slightly stricter than the Report, because apart from approval from the board and compliance with the capital requirements, the draft rules also dictate that the PRA has to be informed.

The last group of rules require the ring-fenced body's intra-group transactions, including those with other sub-group members, to be at arm's length. Moreover, transactions between sub-group members and group members outside the sub-group will also have to be at arm's length. This is an additional protection for the ring-fenced body, because it may rely on certain services or facilities provided from within the sub-group.

Arrangement in which the ring-fenced body or other sub-group member could indirectly become jointly liable with any other group member, should be avoided. This can be deducted from a couple of rules prohibiting acts or financial problems of other group members to adversely effect agreements with ring-fenced bodies. This is compatible with the Report, which prohibits unlimited guarantees and requires limited guarantees or joint liabilities to be included in the third party exposure limits.

One element which cannot be found in the rules, but is foreseen in the Report is backstop limits on the total exposure to financial institutions. The large exposure limits will serve the function of limiting these total exposures.

730 Requirements mentioned in Vickers Report, 72, n° 3.85.
III. Continental Europe

A. Liikanen Report

Similarly to the Volcker Rule, the Liikanen Report limits relationships with hedge funds. The Report requires “loans, loan commitments or unsecured credit exposures” to hedge funds, private equity funds and similar entities to be transferred to the trading entity.\(^{733}\) Some elements from the list of activities which are permitted within the deposit bank can help clarify the scope of this rule. Permitted are, amongst others, trade finance, interbank lending, project finance, plain vanilla securitisation and exposures to money market (UCITS) funds.\(^{734}\)

The Liikanen Report is fairly succinct about the relationship between deposit banks and trading entities within a group. Once there is a separation, the deposit bank can only transfer funds to the trading entity on market-based terms and the normal large exposure rules apply. Prudential requirements will also apply separately to both entities. Only if the capital requirements are fulfilled, can dividends be paid. The Report expressly allows the same marketing organisation, the so called “one-stop shop”, to be used to service customers.\(^{735}\)

B. France

1. Exposures to hedge funds

The French statute prohibits unsecured\(^{736}\) activities with hedge funds and similar funds. Collective investment funds that invest more than 40%\(^{737}\) of their assets in hedge funds or similar funds will be assimilated with those funds.\(^{738}\)

For the application of this rule, hedge funds are investment funds that use leverage on a substantial


\(^{734}\) Liikanen report, 101.

\(^{735}\) Liikanen report, 102.

\(^{736}\) Activities are only counted as secured activities if the collateral meets certain requirements, determined by reference to the capital requirements regulation (Art. 7, II, alinéa 3 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires).

\(^{737}\) Art. 7, II, alinéa 2 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

Relations with funds that do not present such a high risk as hedge funds, such as UCITS, general purpose investment funds, employees savings plans and regulated investment funds are not included in the prohibition.

Some unsecured activities with prohibited hedge funds are still permitted. First of all, investments by insurance companies are subject to their own rules and thus not prohibited here. Secondly, clearing activities, hedging and operating loans or overdrafts provided in attendance of the payment of executed transactions are permitted. Lastly, the deposit bank will also be able to set up a hedge fund, as long as its participation is reduced to obligated minimum participation after a period of maximum one year. In exceptional circumstances, this period can be extended with one additional year by the Prudential Control Authority.

2. Intra-group relationships

Two types of permitted trading activities were not mentioned when discussing the prohibition of trading activities in France, because they relate to intra-group relationships. The non-trading entities of the group can still be responsible for the centralised treasury management of the group. According to the government, other rules are in place to ensure that this is done in a safe and

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740 Art. 111(1) Commission Delegated Regulation 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision. The calculation of the exposure is done using the commitment method from article 8 of this delegated regulation. It also takes into account the exposures of derivatives, netting arrangements, reinvestments and hedging arrangements.

741 Funds which are to a large extent similar to UCITS, according to the French Financial Market Authority (http://www.amf-france.org/Acteurs-et-produits/Produits-et-SICAV/FIA/Fonds-a-vocation-generale.html).


743 Art. 7, II, alinéa 1, 1° Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

744 Art. 7, II, alinéa 1, 2°-3° Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

745 Art. 7, II, alinéa 1, 4° Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

prudent way. The other permitted activity is long-term investments. The reason this is mentioned here, is because the statute expressly includes the purchase and sale of securities issued by other group members in the definition of this activity.

The French statute requires all prohibited activities, including the relations with hedge funds to be transferred to a separate entity, but there are only a limited amount of rules to separate this entity from the rest of the group.

The trading entity and the rest of the group must each meet the prudential requirements, such as capital and liquidity requirements on a separate basis. This does not affect the potential obligation to comply with certain requirements on a consolidated basis.

For the application of the large exposure limits, the trading entity is to be considered a separate entity by the rest of the group. Conversely, the trading entity must take exposures to the rest of the group into account as if it were one distinct entity. The total exposure limits for the rest of the group to the trading entity is limited to 10% of the rest of the group's eligible capital. In addition to these rules, the mother company of the trading entity must obtain permission from the prudential control authority to obtain new shares in a capital increase by the trading entity.

People who effectively manage the trading company, cannot be responsible for the management of any non-trading company of the group.

Finally, to avoid any confusion, the trading entity must bear a different name than the rest of the group.

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751 Art. 8, alinéa 1 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.
752 Eligible capital consists of tier 1 capital and tier 2 capital up to 1/3 of the value of tier 1 capital. (art.4(1)(71) CRR).
753 Art. 8, alinéa 2 Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.
C. Germany

1. Exposures to hedge funds

Providing credits to or guarantees for the benefit of hedge funds or funds that invest in hedge funds, called *Dach-Hedgefonds*, are amongst those activities that need to be separated within the banking group. Apart from funds that use leverage on a substantial basis, the German legislation also considers funds that engage in short selling as hedge funds.

2. Intra-group relationships

The German law requires the trading entity to be economically, legally and organisationally independent from the rest of the group. Amongst other things, this has to ensure that trading risks cannot affect the deposit banks within the group. However, as long as this does not entail any risk for the deposit bank, the trading entity will still be allowed to use the infrastructure and services from other group members.

It also has to meet the prudential requirements on its own. The preparatory works also clarify that, because the trading entity is a financial institution, it will have to meet all applicable requirements of the *Kreditwesengesetz*. The trading entity is also responsible for its own refinancing and transactions with it must be treated as third party transactions by other group members. The combination of those two rules primarily focuses on capital increases. The group must always ensure that participations in the trading entity

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757 Kreditwesengesetz, §3 Absatz 2, Satz 2, Nummer 2. Hereafter: “KWG”.
758 Kapitalanlagegesetzubuch, § 283.
759 KWG, § 25f Absatz 1.
762 KWG, § 25f Absatz 2.
764 KWG, § 25f Absatz 3.
do not endanger deposit banks.\textsuperscript{765}

The preparatory works are also concerned about reputational risks, although there is no separate name requirement such as in France. To avoid doubt about the independence of the trading entity, the banks will be obligated to disclose this information to non-professional customers.\textsuperscript{766}

The focus on the result of the separation instead of the practical aspects has led to some criticism. It is still not entirely clear how separate the group members must function.\textsuperscript{767} For instance, nothing is said about the independence of the directors or senior managers.

D. Belgium

1. Exposures to hedge funds

In the Belgian law, unsecured transactions with hedge funds are also considered prohibited proprietary trading.\textsuperscript{768} The same European definition used in the French rule applies, i.e. investment funds that use leverage on a substantial basis.\textsuperscript{769} Unsecured transactions with another investment fund invests more than 10\% in hedge funds will be treated the same as unsecured transactions with hedge funds.\textsuperscript{770} Transactions with either of the two types of funds described above without adequate securities, will be labelled high-risk transactions, which are prohibited.\textsuperscript{771}


\textsuperscript{767} MAYER BROWN, Impact of Volcker, the EU Proposal and Trennbankengesetz on German Banks, 13 February 2014, https://www.mayerbrown.com/files/Event/6de9e941-6ac1-4226-833a-9a3ba3741d3e/Presentation/EventAttachment/405445b1-b027-4e28-9e33-c02d34957e1a/140213-Presentation.pdf, 75-76.

\textsuperscript{768} Art. 120 Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen. Hereafter: “Belgian Banking Act”.

\textsuperscript{769} Art. 120 Belgian Banking Act refers to the FSMA (Financial Services and Markets Authority) that uses this definition, in accordance with European law. Cfr. FSMA, De rapporteringsverplichtingen van de beheerders van alternatieve instellingen voor collectieve belegging ten aanzien van de FSMA, September 2014, http://www.fsma.be/nl/Supervision/finprod/icb/circmedprak/AIFM.aspx, 6.

\textsuperscript{770} Art. 120 Belgian Banking Act and Art. 8, § 3, ii Reglement van 1 april 2014 van de Nationale Bank van België betreffende de handelsactiviteiten voor eigen rekening. Hereafter: “NBB Regulation 1 April 2014”.

\textsuperscript{771} Art. 8, § 3 NBB Regulation 1 April 2014.
Apart from unsecured transactions with hedge funds, asset-backed securities of which the underlying assets are not limited to loans and debt instruments are also considered high-risk assets.\textsuperscript{772}

2. \textit{Intra-group relationships}

All trading activities of the group have to be transferred to a trading entity that cannot be a subsidiary of the deposit bank.\textsuperscript{773} The deposit bank will need prior approval from the regulator to hold a participation of more than 10\% in a trading entity. The participation of more than 10\% has to be covered entirely by tier 1 capital.\textsuperscript{774}

The trading entity will have to comply with all prudential requirements individually.\textsuperscript{775} For the calculation of large exposures, the deposit entity will have to treat exposures to trading entities within the group as third party exposures.\textsuperscript{776} The limit of 25\% can be lowered by the National Bank of Belgium, although it has not chosen to do so at the moment.\textsuperscript{777}

Last are the corporate governance requirements: At least half of the non-executive directors of the trading entity do not have any function in another entity within the group.\textsuperscript{778} The board must also contain at least one independent director.\textsuperscript{779} Executive directors and senior managers of the trading entity, are proscribed from having any function in another group entity.\textsuperscript{780}

E. \textbf{Conclusion}

Before moving on to the comparison and conclusions for part IV, it might be useful to have a quick look at the differences between France, Germany and Belgium in the implementation of the Liikanen Report.

\textsuperscript{772} Art. 8, § 3, iii NBB Regulation 1 April 2014.  
\textsuperscript{773} Art. 119 Belgian Banking Act.  
\textsuperscript{774} Art. 130 Belgian Banking Act.  
\textsuperscript{775} Art. 128 Belgian Banking Act.  
\textsuperscript{776} Art. 129, § 1 Belgian Banking Act.  
\textsuperscript{777} Art. 129, § 2 Belgian Banking Act.  
\textsuperscript{778} Art. 131, § 2, section 2 Belgian Banking Act.  
\textsuperscript{779} Art. 131, § 2, section 1 Belgian Banking Act.  
\textsuperscript{780} Art. 131, § 1 Belgian Banking Act.
1. **Exposures to hedge funds**

The Liikanen Report literally requires “loans, loan commitments or unsecured credit exposures” to hedge fund to be transferred to the trading entity. In Belgium and France, this was implemented as a prohibition on unsecured transactions with hedge funds, while Germany chose to proscribe all loans to and guarantees for hedge funds. The French rule also contains Volcker style exemptions, which will be considered when comparing these rules to the US regulation.

The three countries have defined hedge funds as investment funds that use leverage on a substantial basis, in accordance with EU law. In Germany, funds that engage in short selling are also added to this definition. Exposures to investment funds that invest in hedge funds are also included in the prohibition. In France, investment funds are captured by this rule if they invest at least 40% of their assets in hedge funds. In Belgium this percentage is 10% while in Germany no percentage is given.

2. **Intra-group relationships**

Various measures have been taken to ensure that the separation meets its aim of avoiding that risks spread from the trading entity to the rest of the group.

First of all, France, Germany and Belgium have adopted the requirement from the Liikanen Report that the trading entity must meet the prudential requirement on an individual basis. Similarly, in the three countries exposures between trading entities and other group members have to be treated as third-party exposures for the calculation of the large exposure requirements. In France exposures to the trading entity are even reduced to 10% of the eligible capital, instead of the regular 25%.

Participation interests in the trading entity are another way in which risk could be passed on to the rest of the group. Therefore, in Belgium, the trading entity may not be a subsidiary of a deposit bank nor can a deposit bank hold more than 10% in a trading entity without permission from the authority and without subtracting this participation from its tier 1 capital. In France, permission by the authority is required every time a parent company of the trading entity would like to participate in a capital increase by the trading entity. Lastly, in Germany the trading entity is responsible for its own refinancing, including through a capital increase. The rest of the group can only participate at arm's length terms and if this would not endanger their own well-being. Even though France and Germany allow the trading entity to be a subsidiary of a deposit bank, the size of this trading entity will be limited because of the large exposure limits.
While the German law requires transactions with the trading entity to be at arm's length, the Belgian and French rules rely upon corporate governance requirements to ensure a sufficient level of independence in the decision making to engage in transactions. In France executive directors and senior management of the trading entity cannot simultaneously have any executive position in another group entity. In Belgium, executive management of the deposit bank is not allowed to have any function a trading entity. Moreover, the same applies to at least half of the non-executive directors. An additional safeguard is that at least one director must be an independent director.

The Liikanen Report mentions using the same facilities, as one of the advantages of having the two types of entities within one group. Germany requires the shared facilities to be located in the deposit bank or in a non-trading entity within the group to ensure that an organisational separation remains possible. The French and Belgium legislation do not mention nor proscribe this option.

To avoid confusion about the separate nature, the French law requires that the trading entity has a separate name. The German legislation only requires that non-professional customers are informed. In Belgium, there are no such rules.
IV. Comparison and conclusions

A. Exposures to certain entities

1. Relationships with entities that carry on prohibited activities

The rules relating to exposures to other entities are there to make certain that the protected entity cannot be exposed to risks from prohibited activities indirectly through another entity that is permitted to engage in those activities. Therefore the scope of these rules should aim to capture the same activities. Seeing that the US, France, Germany and Belgium proscribe more or less the same activities, one would expect similar rules here as well. Nevertheless there are some significant differences between the US and the continental European countries as well as between the continental European countries themselves.

All four countries aim to capture exposures to private equity funds. In the European countries, a definition was derived from the rules governing alternative investment funds. This definition focuses on the amount of leverage an investment fund can use, because this increases the volatility and the risk. In Germany, short selling was added to this. All three countries also include funds that invest in hedge funds, although the tolerated level of these investments differs. In the US, the focus is not on the effective use, but on the possibility to use risky investment strategies, such as high levels of leverage and short selling, which regulated investment companies are not allowed to employ. Consequently, in the US, hedge funds are funds which are excluded from registering as an investment company because all their securities are owned by qualified investors or are beneficially owned by less than one hundred people. Exempted commodity pools were added to this, because apart from the assets they invest in, these type of funds are similar to the former category. The downside of this broader definition, is that no less than thirteen exclusions were needed. On the other hand, this definition is likely more accurate than the European definition for the purpose of these rules.

The Volcker Rule limits ownership interests in or sponsoring of a covered fund. Meant are activities which could lead to an economic exposure to the profits and losses of the hedge fund or activities which result in the banking entity having any say in the management of the hedge fund. In normal circumstances simple loans remain unrestricted. In France and Belgium, all unsecured transactions with or positions in hedge funds are prohibited. In Germany, on the contrary, the prohibition focuses on loans to or guarantees for hedge funds. The result is that as a general rule in the US the banking entity is only allowed to have debt exposures to hedge funds, while Germany only permits equity
positions.

The Volcker Rule does allow a limited amount of investments in covered funds, the total of which may never exceed 3% of the tier 1 capital of the banking entity. Moreover the amount has to be deducted from the tier 1 capital when calculating compliance with the capital requirements. Investments in connection with certain services are permissible, as are investments in asset-backed securities funds. The reason for the former permission is that these investments are often necessary in connection with the related services. Investments in the latter type of funds are allowed so securitisations which include other assets than loans would not be entirely impossible. After a seeding period of one year these investments have to be reduced to a maximum of 3% of the outstanding securities in the fund. Other permitted activities in relation to covered funds are market making and underwriting. Hedging is only allowed in well defined circumstances.

The banking entity cannot guarantee the investments in those covered funds by customers. To avoid any chance of confusion, these funds must also have a different name than the banking entity. If the banking entity provides services to a covered fund, it is not allowed to provide loans to that fund. As a result, if a banking entity is allowed to invest in a covered fund, it will most likely not be able to provide loans to or guarantees relating to the covered fund at the same time. Moreover, the treatment of covered funds investment for the purpose of capital requirements, makes them expensive to hold.

The French rule permits unsecured transactions with hedge funds for the purpose of hedging, to participate in clearing activities or to provide operating loans or overdrafts in attendance of the payment of executed transactions. Just like under the Volcker Rule the deposit bank will also be able to set up a hedge fund, as long as its participation is reduced to the obligated minimum participation after a period of maximum one year.

On the contrary, in Belgium all transactions with hedge funds that are not sufficiently secured, will be deemed high-risk transactions and are thus prohibited. Apart from hedge funds, this is also true for asset-backed securities of which the underlying assets are not limited to loans and debt instruments.

In Germany, because of the way the statute is drafted, all exceptions to the prohibition on proprietary trading activities, apart from market making, are applicable here as well. Even so,
because only credits and guarantees to hedge funds are forbidden, they will often not be very useful.

A simplified schematic overview might help to keep track of the different rules.

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>France</th>
<th>Germany</th>
<th>Belgium</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hedge funds</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Able to use risky strategies</td>
<td></td>
<td>High leverage</td>
<td>High leverage + short selling</td>
<td>High leverage</td>
</tr>
<tr>
<td><strong>Other prohibited investment funds</strong></td>
<td></td>
<td>&gt; 40% in hedge fund</td>
<td>Investment in hedge fund (Dach hedgefonds)</td>
<td>&gt; 10% in hedge fund; ABS of which the underlying assets are not only loans and debt instruments</td>
</tr>
<tr>
<td><strong>Prohibited relationship</strong></td>
<td></td>
<td>Unsecured transactions or positions (debt or equity)</td>
<td>Loans and guarantees (debt)</td>
<td>Unsecured positions (debt or equity)</td>
</tr>
<tr>
<td>Influence in management or economic exposure (equity)</td>
<td></td>
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<tr>
<td><strong>Exemptions</strong></td>
<td></td>
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<tr>
<td>Limited investments to set up fund + <em>de minimis</em> investment; Market making; underwriting</td>
<td></td>
<td>Hedging; clearing activities; operating loans and overdrafts; set up funds + <em>de minimis</em> investment</td>
<td>All exemptions from the prohibited activities, except market making.</td>
<td>There are no exemptions.</td>
</tr>
<tr>
<td><strong>Extra information</strong></td>
<td></td>
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</tr>
<tr>
<td>In most cases no loans or guarantees in relation to a fund in which the banking entity has invested.</td>
<td></td>
<td>There is no absolute limit like in the US rule to the permitted activities.</td>
<td>Since only debt is prohibited, most of the permissions will not serve any purpose here.</td>
<td>What the NBB regulation of 1 April 2014 prohibits are direct or indirect exposures to high-risk assets, including for long-term investments.</td>
</tr>
</tbody>
</table>
In the UK, the situation is entirely different. Any exposure to a financial institution is prohibited, with the following exclusions. Exposures to financial institutions resulting from trade finance or syndicated loans to non-financial institutions will remain permitted. Transactions with financial institutions to hedge other activities are also still permitted. Certain activities related to liquidity management could also still give rise to some exposures. Lastly, securitisation and conduit lending are still allowed, although strictly speaking the structured finance or conduit vehicle is also a financial institution.

2. Comparison to the Reports and purpose

Both the UK and US rules are in line with the intentions on which they are based. In the case of the UK, exposures to excluded activities through financial institutions are avoided and only some incidental exposures remain permitted to provide necessary banking services to the economy. In the US, the rule aims to prohibit risks resulting from activities which only serve the person engaging in them. Investment companies serve a purpose by allowing risk to be spread across the market to other investors who are willing to bear it. This in turn allows more, and consequently cheaper, credit to be available which is beneficial to the economy as a whole. On the contrary, hedge funds take huge risks, are not governed transparently and their activities can sometimes pose a threat to the economy. By not allowing the banking entity to expose itself to the profits and losses of hedge funds, the risk of huge losses cannot spread to insured deposits. Loans of which the interest is not dependent on the profit of the hedge fund are still allowed. Because the fund will not be owned by the banking entity or be a member of the banking group, the banking entity has no incentive to provide these loans on more favourable terms.

Differently, in the Liikanen Report the focus is on debt exposures, to avoid that a banking entity grants a loan to a hedge fund that subsequently uses it for prohibited activities. In France and Belgium, unsecured transactions arising from both debt and equity are prohibited. This of course avoids any exposure, as long as the security is adequate, which could be a problem during a time of crisis. In Germany, only credit exposures and guarantees are prohibited. Safeguards against equity exposures will have to come from the intra-group exposure rules. Practice will have to show, if these rules are sufficient to shield the deposit banks from trading risks.

The definition used to determine which funds are prohibited in the EU has also been criticised for being to formalistic and therefore inaccurate for capturing high risk activities.781

781 MAYER BROWN, Impact of Volcker, the EU Proposal and Trennbankengesetz on German Banks, 13 February 2014,
Finally, the French exemptions could also be criticised. For one, the hedging exemption was considered too risky by the US Agencies implementing the Volcker Rule. Nevertheless, this was later permitted in France. The second part of the criticism relates to the possibility to set up hedge funds. Using the European definition, it hardly seems necessary to allow a deposit bank to set up a fund which uses high leverage. In contrast, because of the broader prohibition in the US this exemption makes sense to limit the adverse effect on the economy.

B. Intra-group exposures

1. Full separation v. ring-fencing

Apart from the US, all countries allow the trading activities to take place within the group through another group member. In the US, all group members of the deposit bank will become a banking entity themselves and are thus subject to the Volcker Rule.

Mr. Volcker does not believe that ring-fencing is sufficient, because all activities remain in one group and there is always a risk of links between the activities if they are not fully separated. He also considers it very difficult to define the permitted relationships between the two types of activities. On the other hand, the Vickers Report states that:

“In general, it is not clear that ring-fencing rules need be much more complex than those for full separation. In either case, for separation truly to limit contagion, rules need to consider the relationship between retail banks and the rest of the financial system, and the division between mandated and prohibited services needs to be defined.”

Keeping in mind the complex rules about covered fund relationships, there is certainly some truth to that statement. Having both activities within one group also reduces some costs and could even save the deposit bank in certain circumstances. One major benefit that full separation has over ring-fencing is that it avoids conflicts of interest. However, this is not the main concern of the Vickers Report or the Liikanen Report. Nevertheless, it is true that to limit contagion, detailed rules on intra-
group exposures will be necessary.

2. Comparison of intra-group relationships

The countries that allow prohibited activities to be conducted through another entity within the same group have enacted or proposed a whole range of rules to ensure that the trading entity or the ring-fenced body are sufficiently independent from the rest of the group. This overview will use the same five elements used to analyse the UK Draft Ring-fenced Bodies Rules.

The first element is the group structure. In the UK, most risks are not only separated from the ring-fenced body, but from the entire sub-group of the ring-fenced body. Mostly this sub-group is formed by the ring-fenced body and all its subsidiaries, but it could be larger. The sub-group members and entities within the group that carry on excluded activities may not have ownership rights of each other. In Belgium, a trading entity cannot be a subsidiary of the deposit bank, but a participation up to 10% is possible without permission from the authorities. In France and Germany, the only rules are related to a capital increase, for which a French parent of the trading entity must obtain permission. In Germany, the only limit is that the participation in the capital increase may not pose a threat to the well-being of the other group members. These rules only aim to ensure that when the trading entity runs into problems that it is not saved at the cost of the deposit bank.

Another structural rule is that in the UK, facilities or services used by both sub-group members and entities carrying on excluded activities must be located within the sub-group or in an entity that is only responsible for these facilities or services. This rule is only copied by Germany.

The second element is prudential requirements. All countries provide that those have to be met by both the deposit bank and the trading entity on a separate basis. In the UK, the requirements have to be met on a sub-consolidated basis as well. In all countries, the relationships between the trading entities and deposit banks, or for the UK the ring-fence sub-group, have to be treated as third-party exposures for the calculation of the large exposure limits. Only France has implemented a stricter large exposure limit for banking groups to the trading entity, i.e. 10% instead of 25%.

The third element is that transactions with trading entities have to be conducted at arm's length terms. Apart from the UK, only Germany mentions this. The Liikanen Report requires the transfer of funds to be at arm's length. The major concern is that the capital buffers of the deposit bank must remain adequate after the transfer. Therefore the main focus of the German rule is on capital
increases by the trading entity. On the contrary, in the UK this rule must always be observed by the ring-fenced body towards all other group members and by the sub-group members in transactions with non-sub-group members.

Directly tied in with this is the fourth element, dividends, which is another way of transferring funds. The Liikanen Report only mentions that after the payment of dividends, the capital must still be sufficient to meet all capital requirements. As a result, none of the continental European countries have imposed any rules concerning dividends. In the UK, the PRA must be informed of the intention of any sub-group member to pay dividends, so they can check compliance with the capital requirements and oppose the decision if they think this is necessary.

The last element are extra governance requirements. In both the UK and Belgium there are extensive requirements, so the decision making within the ring-fenced body will be independent from the rest of the group. In the UK, the PRA has emphasised that this does not mean that group strategies are altogether impossible, only that the ring-fenced body is able to decide independently if this does not negatively affect them. By comparison, the extra corporate governance requirements in France are much more limited. Only the people who are effectively in charge of management, generally executive directors and senior management, cannot have a similar function in and outside the trading entity.

3. **Comparison to the Reports and purpose**

The biggest difference between the Vickers Report and the Liikanen Report is that the former tries to isolate the core activities, while the latter means to separate the trading activities. In the implementation, one immediately notices that the UK rules are much more detailed and strict than the French, German or Belgian rules. This can be explained on the one hand by the more detailed requirements in the Report and on the other hand by the intentions and ambitions of the Reports.

In the Liikanen Report, the intention was to remove trading risk exposures from deposit banks. This can be achieved by placing those activities which may give rise to those risks in a trading entity and limiting the economic exposure of the rest of the group to this entity. The aim of the Vickers Report is to remove all risks from the ring-fenced body which are not related to the provision of core services. To be effective, this sometimes requires additional safeguards. Placing a second ring in the form of a sub-group around the ring-fenced body is a good solution to ensure that risks do not sneak
in through close group members.

The continental European countries have mostly implemented the limited number of requirements from the Liikanen Report. Even considering the aforementioned explanation, the question could be asked if a further separation might not have been more beneficial. Especially, when taking into account that the Report only gives principles and not clear cut rules. Nevertheless, all rules aim to avoid that money is passed on from the deposit entity to the trading entity without at least some safeguards, be it prudential requirements, large exposure rules, permission by a regulator or corporate governance requirements which ensure that independent decisions are taken.

There is one final point that also explains the difference between the implementation of Liikanen and Vickers, which is related to the fundamental difference in ambition between those Reports. The Vickers Report hopes to be able to split off the core services and let the trading part of the group go bankrupt in case of financial difficulties. This requires far reaching rules to keep the ring-fenced body from being in any way dependent on the survival of the trading part of the group. The main purpose of the Liikanen Report, on the other hand, is to limit the risk deposit banks can take. In the European landscape of which it is part, being able to separate the deposits and core banking activities from other activities is also enabled through the bank recovery and resolution plans.\textsuperscript{784}

CONCLUSION
I. Final comparison

In this type of regulations, the saying that the devil is in the details is especially applicable. Therefore every conclusion runs the risk of oversimplifying things and presenting an incomplete picture. So, while this final comparison will emphasise the most important conclusions from the previous parts, one should realise that it can never be entirely complete.

Essential for the analysis is the difference in ambition of the various rules. Naturally, these rules are not meant to be applied in a vacuum and other proposals, some of which from within the Vickers and Liikanen Reports themselves, further enhance the safety of the financial system. However, to gain a better understanding of these rules, it is best only to look at what the intention of that particular rule is in the entire scheme of new financial regulations. This was the subject of part I. We have established that the objective of the Vickers Report is that the authorities will not have to bail-out banks in the next crisis on the financial markets, because the ring-fenced bodies, which perform the essential services, will simply not be involved; the Volcker Rule only avoids that, when banking entities have to be bailed out, taxpayers' money is used for activities which do not benefit the economy; and finally, the Liikanen Report aims at limiting the times banks have to be bailed out, because deposit banks will take on less risk and even if one bank fails, it will be less connected to the rest of the system so there is less risk of a chain-reaction.  

Part II looked at the scope of the rules. Since one of the major reasons for these rules is the protection of insured deposits, it is no surprise that the scope of application was centred around this. However, only Belgium and the US seem to have captured all deposits. In the UK ring-fencing is only compulsory if the core deposits reach £25 billion. Certain non-core deposits are insured deposits, but nevertheless excluded. Similarly, in France and Germany, the trading activities only need to be separated if they reach a certain level, 7,5% and 20% respectively. Although the German rule also has an absolute limit of €100 billion and an exemption for banks with total assets of €90 billion. This kind of de minimis exemption is only logical in the Liikanen type of thinking, where the aim is to reduce systemic risks and avoid excessive risk taking. Especially in the UK, all deposit banks should have been included and some of the deposits should not have been excluded from being core deposits.

The analysis in part III agrees with the general opinion that the separated activities in France,  

785 Although this exact wording is taken from the comparison in part III, the idea was developed in part I.  
786 Part II has shown that the two countries do not use exactly the same assets to calculate this threshold.
Germany and Belgium are essentially similar to the Volcker Rule. Belgium, again, is somewhat stricter than the other two countries, because it follows the UK in proscribing trading in commodities\(^{787}\) and there are limits on the amount of exempted trading activities. The huge debate here is whether or not market making should have been prohibited in these countries. On the one hand the vision of the creators about what was feasible on a legal level also played a role. However, despite the argument that distinguishing market making from trading is impossible and the counter-argument claiming the same for market making and underwriting, both distinctions have been made in the US. On the other hand this discussion again depends on the intention of the rule. This time the distinction is between avoiding risks, such as in the Liikanen Report, or not bailing out activities that do not benefit the economy.

In the UK all trading activities and investments in financial instruments and commodities are prohibited within the ring-fenced body, except in limited circumstances. Contrary to the other systems it does not allow underwriting, market making or proprietary trading positions incurred in relation to services provided to customers. Instead, the ring-fenced body can trade in its own debentures and in those of certain group members and it can offer a limited amount of derivatives to customers. Only the hedging exemption applies to ring-fenced bodies in the same way as in the other countries.

Part IV dealt with the relationships with hedge funds and private equity funds or financial institutions in the UK and with group members. For the former type of relationships, the UK prohibits all exposures to financial institutions capable of engaging in excluded activities.\(^{788}\) The other countries only prohibit certain relationships with hedge funds and private equity funds, because these contain more risks than relationships with regulated investment funds. The schedule on page 125 shows the differences between the rules in these four countries. The first interesting element is the definition of hedge funds. In the EU a quantifiable method is preferred, while in the US, the type of funds that can take on the risks are identified, followed by an attempt to carve out funds which were unintentionally covered by that definition. While this is harder to do, it also gives more certainty that the funds which were meant to be captured, are effectively included. A second noteworthy difference is the focus of the Volcker Rule on equity exposures to covered funds, while the Liikanen Report mainly aims to limit debt exposures. The former aims to ensure that funds of the banking entity are not exposed to profits and losses from trading activities, while the purpose of

\(^{787}\) There are some other minor differences, which the reader can find in the conclusion to part III.

\(^{788}\) Which is the UK terminology for activities which the ring-fenced body cannot carry on.
the latter is to avoid that money is easily transferred to hedge funds to take risks. Essential here is that the Liikanen Report allows trading activities to remain within the group and equity exposures to hedge funds will in most cases be limited by the intra-group exposure rules. Note however that both France and Belgium limit unsecured transactions with as well as unsecured positions in hedge funds. The last element worth mentioning is that the French rule has Volcker style exclusions from this prohibition. Because of what has been said above, these exclusions seem superfluous and only increase the possible risk exposures of the deposit bank. Belgium, on the contrary, deems all unsecured exposures to hedge funds prohibited high-risk activities.

For the intra-group exposures, the UK rules are much more extensive than the French, German and Belgian rules. Again the intentions of the Reports provide an explanation. The Liikanen Report only addresses economical exposures so risks will not pass from the trading entity to the deposit bank, while the Vickers Report requires the ring-fenced body to be operated as a separate business so it can carry on if the rest of the group runs into trouble. Owing to Mr. Volcker's distrust of incomplete separations, such as 'Chinese walls', the US does not allow proprietary trading to remain within the group. This is brought into effect by bringing all group members, except for the permitted covered funds, under the definition of a banking entity. This has the added benefit of addressing conflicts of interest between the bank and its customers.

The main question this dissertation tried to answer was: How were the separation requirements from the Volcker Rule, the Vickers Report and Liikanen Report implemented in the US, the UK, France, Germany and Belgium? What are the main differences and how can they be explained by the different underlying visions?

While the conclusion above gives a good answer for the Volcker Rule and the Vickers Report, the situation for the Liikanen Report is slightly more complicated, because the continental European countries have not adopted all its recommendations. Therefore the conclusion with regards to the Liikanen Report seems to be that it has not been properly implemented in any of the three countries, although elements of it have been combined with elements from the Volcker Rule, creating a sort of light version of the two. The same activities are prohibited as in the Volcker Rule, but only above a certain threshold\textsuperscript{789} and they are allowed to stay within the group. This allows significantly more risk than the Liikanen Report intended. Apart from the avoiding conflicts of interest, separation within the group could still achieve the purpose of the Volcker Rule, depending on how well the

\textsuperscript{789} In France and Germany.
separation of the trading entity holds up. However, the de minimis threshold is more problematic, because the potential bankruptcy of a lot of small banks, could put considerable pressure on the deposit guarantee scheme and force the government to bail out banks carrying on proprietary trading once again.

This shows that the continental European approach is not consistent with either Report. If the countries were truly concerned about the difficulty of distinguishing between underwriting and market making, a more consistent approach would have been to require the separation of both.

II. The struggle ahead

Since the rules are new and sometimes still not even fully implemented yet, there is still a lot that will only become clear over time. How strict will the rules be applied? Will they be effective? What problems will arise and how will they be solved? Therefore, as the end of the dissertation approaches, I would like to shortly point out three obstacles that will have to be overcome.

One important element is politics. As mentioned in the introduction, politics are the reason that a EU regulation is unlikely to be enacted any time soon, if at all. Also, as pointed out in the podcast from the the University of Pennsylvania, there is still a long way to go in the implementation of the Vickers Report in the UK. Even though the PRA seems to be continuing on its path now, despite the change of government, it is not guaranteed that they will keep standing up to the pressure until 2019. As the crisis is left further behind, it is unsure if future governments will leave the rules untouched or if major exemptions will be allowed or if the legislation will even be entirely repealed. For example, the Republican party in the US, would like to repeal large parts of the Dodd-Frank Wall Street Reform and Consumer Protection Act and have at the moment introduced a bill to repeal title II of that Act.

Secondly, even if the rules remain in force, there is still uncertainty about their application. As mentioned before, the authorities aim to collect information through the compliance programmes

_790 Because the separation is mainly on an economic basis, the effectiveness of the separation will also depend on the success of other reforms such as the RRPs and the increased capital requirements.


and reporting requirements and use their powers to adapt or clarify the rules where necessary. Moreover, clarification will also be necessary in countries with a more principle-based approach, such as Germany. Only time will tell how this will work out.

Meanwhile, players on the market have already started looking for ways to circumvent the rules, especially in the US where the banks are already in the process of reforming. One bank in particular, Goldman Sachs, has been very active in searching for loopholes. Matt Levine wrote a very interesting article about the tricks Goldman Sachs employs to escape the Volcker Rule.\textsuperscript{793} For instance, the joint venture exclusion can be used to set up private equity like structures and they have started enormous investments in apartments in Spain, which they resell after more than 60 days. At the same time, for the first time in history, Goldman Sachs has started accepting deposits from regular households\textsuperscript{794}, thus increasing the amount of deposits exposed to their trading activities. Naturally these investments are against the spirit of the law and combating this kind of evasion attempts will have to be high on the list of priorities of the regulators if these rules are to succeed.


\textsuperscript{794} B. McLANNAHAN, “Goldman Sachs opens to the masses”, Financial Times, 24 April 2016, \url{https://next.ft.com/content/c49f9004-08d0-11e6-a623-b84d06a39ec2}. 

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ANNEX: List of services and activities and financial instruments


Section A Investment services and activities

1. Reception and transmission of orders in relation to one or more financial instruments.
2. Execution of orders on behalf of clients.
3. Dealing on own account.
4. Portfolio management.
5. Investment advice.
6. Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.
7. Placing of financial instruments without a firm commitment basis

Section B Ancillary services

1. Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management;
2. Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction;
3. Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings;
4. Foreign exchange services where these are connected to the provision of investment services;
5. Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments;
6. Services related to underwriting.
7. Investment services and activities as well as ancillary services of the type included under Section A or B of Annex 1 related to the underlying of the derivatives included under
Section C – 5, 6, 7 and 10 - where these are connected to the provision of investment or ancillary services.

Section C Financial Instruments

1. Transferable securities;
2. Money-market instruments;
3. Units in collective investment undertakings;
4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
5. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
6. Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
7. Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
8. Derivative instruments for the transfer of credit risk;
10. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.
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United States

Legislation

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Federal Reserve Act of 1913.

Securities Act 1933.


Investment Company Act of 1940

Federal Deposit Insurance Act of 1950.

Bank Holding Company Act of 1956.


Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5535-6076. Referred to as: the “Final Rule” or the “Regulation”.

Preparatory works

Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies:


**Miscellaneous**


Website of the FDIC, bankfind application: [https://research.fdic.gov/bankfind/](https://research.fdic.gov/bankfind/)


**United Kingdom**

**Legislation**

Financial Services and Markets Act 2000. Referred to as “FSMA”.


Companies Act 2006.
Preparatory works


The appendices of this document were referred to as
Appendix 1: “Draft Ring-fenced Bodies Rules”;
Appendix 2: “Draft Supervisory Statement”.

Miscellaneous


European Union

Directives


Guarantee Schemes. Referred to as: “Deposit Guarantee Directive”.


**Regulations**


**Commission Delegated Regulation**


**Website**


**France**

**Legislation**

Code de Commerce.

Code monétaire et financier.

Arrêté du 9 septembre 2014 portant application du titre Ier de la loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

Ordonnance n° 2014-158 du 20 février 2014 portant diverses dispositions d'adaptation de la législation au droit de l'Union européenne en matière financière.
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Miscellaneous


Germany

Legislation

Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen vom 7 August 2013. Referred to as: “Trennbankengesetz”.

Kapitalanlagegesetzbuch

Kreditwesengesetz. Referred to as: “KWG”.

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MAYER BROWN, Impact of Volcker, the EU Proposal and Trennkengesetz on German Banks, 13 February 2014, https://www.mayerbrown.com/files/Event/6de9e941-6ac1-4226-833a-9a3ba3741d3e/Presentation/EventAttachment/405445b1-b027-4e28-9e33-c02d34957e1a/140213-Presentation.pdf, 82 p.

Belgium

Legislation

Wet van 25 april 2014 op het statuut van en het toezicht op kredietinstellingen. Referred to as: “Belgian Banking Act”.

Wet van 6 april 1995 inzake het statuut van en het toezicht op de beleggingsondernemingen.

Reglement van 1 april 2014 van de Nationale Bank van België betreffende de handelsactiviteiten voor eigen rekening. Referred to as: NBB Regulation 1 April 2014.


Report


Preparatory works


International

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Short forms of sources

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Capital Requirements Directive: cfr. CRD IV.

Capital Requirements Regulation: Cfr. CRR.


Draft supervisory statement: Appendix 2 of the same document.

Final Rule: cfr. Regulation.


KWG: Kreditwezengesetz.


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