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OCC'S INTERIM VOLCKER RULE EXAMINATION PROCEDURES PROVIDE MUCH-NEEDED GUIDANCE TO BANKS SEEKING TO COMPLY

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THIS ARTICLE SUMMARIZES THE KEY OBJECTIVES OF THE INTERIM PROCEDURES ISSUED BY THE OFFICE OF THE COMPTROLLER OF THE CURRENCY FOR BANKS TO USE IN ASSESSING THEIR PROGRESS IN COMPLYING WITH THE REQUIREMENTS OF THE VOLCKER RULE.

On June 12, 2014, the Office of the Comptroller of the Currency (OCC) issued interim procedures for examiners to assess banks' progress in developing a framework to comply with the requirements of what is commonly known as the "Volcker Rule."[1] The interim procedures would apply to examinations of national banks (other than certain limited-purpose trust banks), federal savings associations, and federal branches and agencies of foreign banks (collectively, "Banks").[2] Although the OCC's interim procedures are addressed to examiners rather than banks, they shed some (long awaited) light on the OCC's focus and priorities with regard to the implementation of the Volcker Rule.[3]

The Volcker Rule prohibits banking entities from engaging in short-term proprietary trading of financial instruments ("Proprietary Trading") and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds ("Covered Funds"). Unless the Board of Governors of the Federal Reserve System ("Federal Reserve") extends the conformance period again, Banks must conform their activities and investments to the regulations' requirements by July 2015. However, as stated in the OCC's interim procedures, Banks that do not have ownership interest in, sponsor, or have certain relationships with Covered Funds ("Cover Fund Activities") and limit their Proprietary Trading to domestic government obligations are not required to adopt compliance programs or report metrics, and OCC examiners are not required to conduct additional procedures.

The interim procedures are divided into four categories: General Procedures, Proprietary Trading, Covered Funds, and Conclusions. Below we summarize the key objectives of each category; however, for banks seeking to comply, we recommend a review of the entire set of interim examination procedures.

GENERAL PROCEDURES

The General Procedures direct examiners to assess a Bank's progress toward identifying its activities that are subject to the

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regulations. In particular, an examiner shall assess a Bank's progress in identifying (i) its banking entities that are engaged in Proprietary Trading and Covered Fund Activities, and then (ii) the respective Proprietary Trading and Covered Fund Activities. Among other requirements that the examiners must assess, the interim procedures indicate that a Bank must identify:

- Purchases and sales of financial instruments for specified short term purposes;
- Trading desks responsible for short-term trading, and exemptions on which each desk intends to rely for such activities; and
- Ownership interests in covered funds, covered funds that the Bank sponsors or advises, and entities that the Bank expects to be exempt from the definition of Covered Funds.

The General Procedures also require examiners to assess a Bank's:

1. Progress toward establishing a compliance program.

   Among other requirements, the procedures indicate that Banks are required to determine what kind of compliance program is required (e.g., None, Simplified, Standard, Enhanced), and to document why each fund that the Bank sponsors will be exempt from the definition of Covered Fund.

THE GENERAL PROCEDURES DIRECT EXAMINERS TO ASSESS A BANK'S PROGRESS TOWARD IDENTIFYING ITS ACTIVITIES THAT ARE SUBJECT TO THE REGULATIONS.

2. Plan for avoiding material conflicts of interest and material exposures to high-risk assets and high-risk trading strategies.

   The interim procedures indicate that, among other requirements, a Bank must develop criteria for identifying material conflicts of interest, high-risk assets, and high-risk trading strategies, and take into account exposure to seven types of assets (set forth in Appendix B.II.A, Other Compliance Matters).

PROPRIETARY TRADING

With regard to a Bank's Proprietary Trading, an examiner is expected to assess the following:

1. A Bank's progress toward computing and reporting metrics as and when required.

   A Bank must determine whether it is subject to metrics reporting and, if so, when reporting begins. The interim procedures provide a convenient

[1] The Volcker Rule is section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, together with implementing regulations.

[2] The OCC's press release accompanying the interim procedures is available here.

[3] The OCC cautions that the interim procedures present a simplified version of the regulations and directs examiners to consult 12 C.F.R. Part 44 for more details.

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reminder that the largest banks – those with trading assets and liabilities of at least $50 billion, need to start collecting metrics on July 1, 2014, and reporting them monthly starting on September 2. The procedures require examiners to assess the bank's progress toward identifying the trading desks that will compute and report metrics, strongly suggesting that banks are required to do so. As part of identifying the trading desks that will compute and report metrics, banks must determine how many trading desks will report metrics (and whether the number of trading desks is reasonable). Relevant factors for identifying trading desks include "whether the trading desk is managed and operated as an individual unit and whether the profit and loss of employees engaged in a particular activity is attributed at that level."

The interim procedures indicate at least one potentially evasive practice that examiners should look out for: if a Bank combines previously delineated trading desks into a single trading desk, whether it is acceptable depends on whether the desks have similar strategies, the combination has a legitimate business purpose, and the combination allows the bank to more accurately reflect the positions and fluctuations of its proprietary trading. Multiple units with disparate trading strategies being combined into a single desk "could suggest a Bank's attempt to dilute the ability of the metrics to monitor" Proprietary Trading.

2. A Bank's ability to calculate the required metrics.

For the **customer-facing trade ratio**, the procedures expect a Bank to "tag" each trade as customer-facing or not, in order to enable a Bank to determine how it will identify whether a counterparty is a client, customer, or counterparty.

For the **inventory turnover ratio** and **inventory aging**, the Bank's systems must compute delta-adjusted notional value and 10-year bond equivalent values. For options, value means delta-adjusted notional value; for other interest rate derivatives, value means 10-year bond equivalent value.

For **comprehensive profit and loss** (P&L) **attribution**, the procedures expect that a Bank's systems are able to segregate P&L into three categories:

- P&L associated with the trading desk's existing positions (i.e., those held at the end of the prior day) and reflecting changes in value on the day. P&L must be further attributed as applicable to changes in market risk factors and any other applicable elements—such as cash flows, carry, changes in reserves, or trade amendments, cancellation, or exercise.
- P&L associated with new positions (i.e., executed during the day) including commissions, fee income and expenses, and market gains or losses. P&L from new positions may be reported in aggregate and does not need to be further attributed.
- Residual P&L that cannot be explained by existing and new positions.

Banks must compute **value-at risk** (VAR) and **stress VAR** metrics for each trading desk. The procedures expect risk sensitivities to be reported on a sufficiently granular basis to account for a preponderance of the expected price variation in the trading desk's holdings. In addition, the procedures require metrics reported across all trading desks to capture all of the Bank's trading risk from underwriting, market making-related activities, risk-mitigating hedging, and trading in domestic government obligations or foreign government obligations.

AN EXAMINER'S ASSESSMENT WITH REGARD TO COVERED FUND ACTIVITIES WILL FOCUS ON A BANK'S PLAN FOR CONFORMING ASSET MANAGEMENT AND SPONSORSHIP ACTIVITIES.

3. A Bank's progress toward using the metrics to monitor for impermissible Proprietary Trading.

The interim procedures indicate that the Bank must ensure that its metrics reports are meaningful, and that it has established a policy and practice for reviewing, and escalating to its governing body and the OCC, for further review, measurement results that indicate a heightened risk of impermissible Proprietary Trading, along with analysis and explanation.

4. A Bank's progress toward identifying its market making-related activities, market-maker inventory, and reasonably expected near-term demand.

The interim procedures expect Banks to develop systems to separately measure and manage each desk's market-maker inventory and overall financial exposure. Banks must also document, for each market-making desk, the securities, derivatives, and futures in which the desk makes a market, in addition to ownership interests in covered funds in which the desk makes a market, if relevant.

In addition to other requirements, the procedures indicate that Banks must be capable of separately

identifying, monitoring, and managing each market-making desk's (1) market-maker inventory; (2) financial exposure; (3) reasonably expected near-term demand; and (4) financial instruments that contribute to its financial exposure, but are not included in the market-maker inventory.

5. A Bank's progress toward establishing a compliance program for its permitted market making-related activities.

   According to the exam procedures, the compliance program specific to market-making activities should have detailed desk mandates and limits for each desk's inventory and financial exposure, based on risk appetite and reasonably expected near-term demand. The procedures discuss policies and procedures, internal controls, analysis, independent testing, and other features of an internal compliance program reasonably designed to ensure compliance with the requirements of the regulations governing market-making activities.

6. A Bank's progress toward establishing a compliance program for its underwriting activity.

   The compliance program specific to underwriting requires detailed desk mandates and limits for each desk's underwriting position, based on the nature and amount of the desk's underwriting activities and reasonably expected near-term demand. The procedures discuss policies and procedures, internal controls, analysis, independent testing, and other features of an internal compliance program reasonably designed to ensure compliance with the requirements of the regulations governing underwriting activities.

7. A Bank's progress toward establishing a compliance program for its risk-mitigating hedging activity and satisfying the regulations' documentation requirements.

   The interim procedures discuss the requirements for complying with the regulation's compliance program for risk-mitigating hedging activity, including documentation requirements under certain circumstances. The interim procedures clarify that not all hedges rely on the risk-mitigating hedging permitted activity; for example, hedging that occurs as part of market making-related activity is covered by that activity. The procedures indicate that trades that rely on the risk-mitigating hedging permitted activity are likely to be short-term derivatives that involve multiple trading desks or legal entities.

COVERED FUNDS

An examiner's assessment with regard to Covered Fund Activities will focus on a Bank's plan for conforming asset management and sponsorship activities.

Subject to conditions, a Bank may acquire or retain an ownership interest in, sponsor, or organize and offer a Covered Fund as part of its trust, fiduciary, or investment advisory business. The interim procedures expect a Bank to identify, and create a written plan outlining how it intends to offer, Covered Funds that the Bank organizes and offers to investors as part of such business. A Bank must also identify and plan to change the names of such Covered Funds that share the same name or a variation of the same name with the Bank or an affiliate, or have "bank" included in the name of such funds.

> THE INTERIM PROCEDURES REQUIRE EXAMINERS TO IDENTIFY POTENTIALLY SIGNIFICANT GAPS IN THE BANK'S EFFORTS TO CONFORM ITS ACTIVITIES AND INVESTMENTS TO THE REGULATIONS.

Among other conditions, a Bank that serves as the investment manager, investment adviser, or sponsor to a Covered Fund, or that organizes and offers a covered fund, generally may not enter into a covered transaction (as defined in section 23A of the Federal Reserve Act) with the fund. A Bank must also engage in all transactions with a Covered Fund on market terms in accordance with section 23B of the Federal Reserve Act. The procedures briefly discuss such restrictions and note that, in certain cases, a Bank may enter into prime brokerage transactions with a Covered Fund that the Bank indirectly owns through a Covered Fund that the Bank manages, sponsors, or advises.

The interim procedures address other requirements relating to such asset management and sponsorship activities, including written disclosures to investors.

The interim procedures further require that an examination should assess a Bank's plans for:

1. Conforming *securitization activities* involving a securitization vehicle that is a Covered Fund.

   Banks may organize and offer securitizations on the same terms as they may permissibly offer Covered Funds to their trust, fiduciary, and investment advi-

sory clients, except that securitizations need not be part of the Bank's trust, fiduciary, or investment advisory services. The procedures indicate that a Bank must identify securitizations in which the securitization vehicle is a Covered Fund and (i) for which the bank was the securitizer under the risk retention rule (when it is finalized) or (ii) in which the bank acquired or retained an ownership interest as the risk retention rule requires. A Bank must also identify and plan to change the names of such securitizations that share the same name or a variation of the same name with the Bank or an affiliate, or have "bank" included in their names.

The interim procedures address other requirements relating to such securitization activities, including written disclosures to investors.

2. Conforming *underwriting and market-making activities* in Covered Funds.

   A Bank may hold an ownership interest in a Covered Fund as part of its underwriting activities or market making-related activities. Among other requirements, the procedures expect Banks to identify the underwriting and market making-related activities involving Covered Funds, and develop a plan to ensure compliance with the requirements of the regulations.

3. Conforming *hedging activities* using Covered Funds.

   Covered Funds used for hedging is only permitted for hedging compensation obligations toward an employee who provides investment advisory or other services to a Covered Fund. The procedures indicate that, subject to conditions, a bank may invest in a covered fund as a hedge for compensation obligations to the fund manager based on the value of the fund. The procedures address the documentation, policies, procedures, internal controls, and ongoing monitoring that the regulations require for hedging using Covered Funds.

4. Divesting *nonconforming investments* in Covered Funds.

   Unless the Federal Reserve extends the conformance period, banks must conform their investments in covered funds by July 2015. Among other requirements, the procedures indicate that a Bank must identify any illiquid investments for which it plans to seek a special five-year conformance period extension, and to plan for conforming investments in Covered Funds. The procedures also indicate that a Bank may need to engage its accountants to advise on the accounting consequences of different divestiture options.

Examiners looking at the Covered Fund Activities of Banks also must assess the Bank's progress in ensuring compliance with the *de minimis* ownership limits on investments in Covered Funds relevant to permitted asset management, securitization, underwriting, and market-making activities. The interim procedures indicate that Banks must test for compliance with the three percent limits quarterly, and maintain records that are sufficient to test for compliance.

CONCLUSIONS

An examiner will have to assess a Bank's overall progress in taking the necessary actions to meet the requirements of the regulations within the conformance period.

The interim procedures require examiners to identify potentially significant gaps in the Bank's efforts to conform its activities and investments to the regulations. If there are any gaps, examiners must take appropriate remedial action, considering the significance of the gap, the remaining conformance period, the Bank's efforts, and other relevant factors.

The interim procedures also contain a glossary which sets forth definitions of key terms in the regulations. While the glossary may be helpful, the OCC recommends that examiners consult the regulations for additional detail, and we recommend that banks do the same; a close review of the regulations, including the commentary in its adopting release, is crucial to ensure compliance with the Volcker Rule during the conformance period and thereafter. Here is one example: the glossary's definition of "Covered Fund" with respect to "funds not offered or sold in the United States" omits the regulation's qualification that such funds are Covered Funds only if they are controlled directly or indirectly by a banking entity located in or organized under the laws of the United States.[4]

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[4] 12 C.F.R. 44.10(b)(1)(iii). *See also* 79 Fed. Reg. 5672 ("A foreign fund therefore may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.").

EMIR REPORTING – FURTHER REPORTING OBLIGATIONS APPLY IN AUGUST 2014

JOHN YOUNG with contributions from LEIGH FRASER and MICHELLE MORAN

THIS ARTICLE PROVIDES AN OVERVIEW OF THE ADDITIONAL REPORTING OBLIGATIONS SOON TO BE IN EFFECT UNDER THE EUROPEAN MARKET INFRASTRUCTURE REGULATION, AND GIVES GUIDANCE ON HOW TO ADDRESS THE VARIOUS REPORTING FIELDS.

Derivative counterparties are already subject to the requirement in the European Regulation on Derivative Transactions, Central Counterparties and Trade Repositories (known as the European Market Infrastructure Regulation ("EMIR")) that all European Union ("EU") counterparties to over-the-counter ("OTC") and exchange-traded derivatives report details of their derivatives transactions to a trade repository.[1] From August 11, 2014, EU established financial counterparties[2] ("FCs") and non-financial counterparties that exceed the clearing threshold[3] ("NFC+s") must report the mark-to-market (or mark-to-model) value of any OTC or exchange-traded derivative, whether a trade is collateralized, and the value of the collateral posted. This information must be reported following execution of a trade and, thereafter, following any changes to the previously reported values. Thus, if the value of a trade changes daily, this information must be reported daily. FCs, NFC+s and non-financial counterparties that do not exceed the clearing threshold ("NFC-s") must continue to report basic details of their derivatives trades.

This article gives an overview of the additional reporting obligation and gives guidance on how to address the various reporting fields. ESMA published on June 24, 2014 an updated version of its EMIR Questions & Answers, providing answers to many outstanding questions on the additional reporting obligation.

WHICH ENTITIES ARE SUBJECT TO THE REPORTING OBLIGATION?

The reporting obligation applies to the entity which is the counterparty to the trade. Only EU established counterparties (for instance, a UCITS fund or pension fund) are subject to the reporting obligation. In practice, many counterparties rely on their investment manager to report on their behalf. Note that, unlike the approach under Dodd-Frank, both counterparties (if established in the EU) are responsible for making a report to a trade repository.

WHAT TYPES OF DERIVATIVES TRADES ARE SUBJECT TO THE ADDITIONAL REPORTING OBLIGATION?

The EMIR reporting obligation applies to both OTC and exchange-traded derivatives (e.g. futures and listed options), meaning that valuation and collateral details will need to be reported for both types of trades. This is not in line with the reporting obligations under Dodd-Frank. Also, unlike under Dodd-Frank, the EMIR reporting obligation applies to all product types (other than, prospectively, some types of FX forwards – see below).

Whether or not valuation and collateral information must be reported for these trades as of August 11, 2014 depends on when the trade was entered into:

- For trades entered into on or after August 16, 2012 that are outstanding on August 11, 2014, valuation and collateral information must be reported by August 12, 2014.
- For trades entered into before August 16, 2012 that are outstanding on August 11, 2014, valuation and collateral information must be reported within 90 days after August 11, 2014.
- For (i) trades entered into before August 16, 2012 that were outstanding on August 16, 2012 and are not outstanding on August 11, 2014 and (ii) trades entered into on or after August 16, 2012 that are not outstanding on August 11, 2014, valuation and collateral information must be reported within three years after August 11, 2014.

WHAT IS THE ACTUAL START DATE FOR THESE EXPANDED REPORTING OBLIGATIONS?

ESMA has confirmed that the date the reporting obligation arises is August 11, 2014, meaning that an FC or NFC+'s first report will be due no later than close of business on the following day, August 12, 2014.

IS THE DATA IN THESE FIELDS SUBJECT TO "MATCHING" WITH THE COUNTERPARTY BEFORE IT IS REPORTED?

No. EMIR envisages that only the "Common Data" in the report is agreed between both parties to the trade before

[1] This obligation started on February 12, 2014.

[2] Financial counterparties include banks, brokers, pension funds, UCITS funds and investment funds managed by EU managers.

[3] Non-financial counterparties are EU undertakings other than financial counterparties. An NFC will exceed the clearing threshold if it executes uncleared OTC derivatives (other than hedging derivatives) above a threshold.

it is reported. As these additional fields are part of the "Counterparty Data," there is no requirement to match the data with the counterparty before it is reported.

WHAT IS THE TREATMENT OF FX FORWARDS?

EMIR draws in a much broader range of FX trading than certain provisions of Dodd-Frank, and currently includes (subject to the position outlined by the FCA, CSSF and CBI) FX forward trades which are used purely for settlement, not investment, purposes. The European Commission has consulted on the treatment of FX forwards under EMIR and the indication is that the Commission will exclude FX forwards with a short settlement date (at least those settling within T+2) and all "security conversion" transactions from the scope of EMIR. Until the position is clarified at European level, counterparties must follow the approach set by their local regulator. In this regard, the FCA and the Luxembourg CSSF have excluded all FX forwards settling within T+7 from the scope of EMIR, whilst the Irish CBI has stated that all FX forwards settling beyond T+3 are within the scope of EMIR.

CAN VALUATION AND COLLATERAL REPORTING BE DELEGATED TO DEALERS?

A party may delegate some or all of its reporting obligations to another party, including the other counterparty, the exchange or clearing house (if the trade is executed on exchange or cleared) or a third party service provider such as a fund administrator. As noted above, both counterparties are responsible for making a report. For this reason, a counterparty that delegates reporting obligations will still be legally responsible for the reporting obligation and will be expected to agree to the contents of any report with the entity that makes the report on its behalf.

ESMA HAS CONFIRMED THAT THE DATE THE REPORTING OBLIGATION ARISES IS AUGUST 11, 2014, MEANING THAT AN FC OR NFC+'S FIRST REPORT WILL BE DUE NO LATER THAN CLOSE OF BUSINESS ON THE FOLLOWING DAY, AUGUST 12, 2014.

A counterparty that has delegated its reporting obligations to its dealer counterparty may want to ask its dealer to report the valuation information on the basis of the dealer's own valuations, rather than the counterparty's valuations. This may leave a counterparty in the position of using its own (or its administrator's) valuations to satisfy the requirement in EMIR to perform daily mark-to-market valuations and relying on a dealer's valuations (which may produce a different valuation on the basis of a different model, or even may be subject to dispute between the counterparty and the dealer) to satisfy the reporting requirement. The industry view appears to be that this is acceptable at least in the short term and to the extent that the respective valuations are reconciled and there are no material discrepancies between them, but managers may wish to consider consistency between their own valuations and the reported valuations in the longer term. ESMA has recently published advice on delegation of reporting of valuations, commenting that "when counterparties delegate reporting, including valuations, they retain responsibility for ensuring that reports submitted on their behalf are accurate and for periodically ensuring that they are in agreement with the values submitted on their behalf."

HOW OFTEN WILL THESE ADDITIONAL REPORTS NEED TO BE MADE?

EMIR requires, as part of the separate risk mitigation obligations, that each FC and NFC+ performs a daily mark-to-market valuation of its outstanding contracts. Any changes in the valuation will need to be reported as a "modification to the report" in field 58 of the "Common Data" section of the form. Changes in the mark-to-market value may adjust the amount of collateral that is posted, and any such changes also need to be reported.

HOW SHOULD VALUATIONS BE REPORTED FOR TRADES EXECUTED ON EXCHANGES OR CLEARING HOUSES?

For OTC trades that are cleared by a clearing house, EMIR requires that counterparties report the mark-to-market valuations provided by the clearing house. It follows that the values for exchange-traded trades should also be reported at the exchange value. Some clearing houses and exchanges will agree to report this data on behalf of counterparties in respect of the trades cleared on the clearing house or exchange. Otherwise, counterparties (or their reporting agents) will need to obtain this data from clearing houses and report it to the trade repository.

WHAT MEANS CAN ASSET MANAGERS USE TO REPORT TRADES?

For cleared or on-exchange trades, managers can delegate the reporting obligation to the clearing house or exchange (although this requires the clearing house or

exchange to look to the intermediary dealer to receive various pieces of "counterparty data" relating to the counterparty to complete the report). Other possible providers are the fund's clearing member or broker, its administrator or service providers such as affirmation vendors. For OTC trades, managers will typically look to their dealer counterparty or fund administrator.

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LEIGH FRASER, co-leader of the firm's hedge funds group, focuses her practice on issues related to hedge funds and derivatives. She advises a variety of financial institutions, including hedge funds, investment advisors, mutual funds, and endowments, on derivatives and arrangements with brokers and custodians. Leigh also has significant experience forming onshore and offshore private funds, and advising these entities and their sponsors on an ongoing basis with respect to regulatory matters and structuring new investment products.

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VOLCKER RULE: AGENCIES RELEASE LIMITED VOLCKER RULE GUIDANCE

WHITNEY A. CHATTERJEE, C. ANDREW GERLACH, CAMILLE L. ORME and ROBERT W. REEDER III

THIS ARTICLE DISCUSSES THE VIRTUALLY IDENTICAL FREQUENTLY ASKED QUESTIONS ISSUED BY SEVERAL AGENCIES ADDRESSING SIX TOPICS REGARDING THE IMPLEMENTATION OF SECTION 13 OF THE VOLCKER RULE.

On June 10, 2014, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (collectively, the "Banking Agencies") and the Securities and Exchange Commission (the "SEC") released substantially identical Frequently Asked Questions ("FAQs") addressing six topics regarding the implementation of section 13 of the Bank Holding Company Act of 1956, as amended, commonly known as the "Volcker Rule."

The Volcker Rule imposes broad prohibitions on proprietary trading and investing in and sponsoring private equity funds, hedge funds and certain other investment vehicles ("covered funds") by banking entities (as that term is defined under the Volcker Rule) and their affiliates. These prohibitions are subject to several exemptions for permitted activities. The final rule implementing the Volcker Rule, issued by the Banking Agencies, the SEC and the Commodity Futures Trading Commission (collectively, the "Agencies") on December 10, 2013 (the "Final Rule"), raised a number of interpretive issues with respect to the structure and conduct of many business activities of both U.S. and non-U.S. banking entities, which have prompted numerous requests by banking and other organizations for interpretive guidance from the Agencies. One of the first definitive pronouncements, the FAQs provide very limited guidance on six topics out of the many issues that have been raised and do not attempt yet to address a significant number of issues viewed as critical by the industry.

ONE OF THE FIRST DEFINITIVE PRONOUNCEMENTS, THE FAQS PROVIDE VERY LIMITED GUIDANCE ON SIX TOPICS OUT OF THE MANY ISSUES THAT HAVE BEEN RAISED AND DO NOT ATTEMPT YET TO ADDRESS A SIGNIFICANT NUMBER OF ISSUES VIEWED AS CRITICAL BY THE INDUSTRY.

Specifically, the FAQs clarify the following, which generally confirm pre-existing industry expectations with respect to the application of the Final Rule:

- for those banking entities subject to reporting of quantitative trading metrics, the initial metrics collecting

and reporting dates (including the time periods for which metrics must be collected during the initial reporting periods) and the treatment of weekend and holiday reporting deadlines;

- the treatment of trading desks that span multiple affiliated banking entities, including that metrics for such trading desks "should be calculated at the level of the entire desk" and "should be reported to each Agency that has authority under section 13 of the BHC Act over any of the affiliated entities that compose the trading desk so that the Agency may understand the context of the trading activity and discharge its responsibility for the legal entity that the Agency supervises or regulates"[1];
- that a banking entity is not required to deduct investments in covered funds from its tier 1 capital prior to the end of the conformance period (currently July 21, 2015);
- that permitted "servicing assets" under the loan securitization exception to the covered fund restrictions[2] are generally limited to cash equivalents (high quality, highly liquid short term investments) that are expected to meet the funding obligations of the loan securitization vehicle;
- that a seeding vehicle formed and operated pursuant to a written plan to become a qualifying foreign public fund[3] will not be treated as a covered fund during the seeding period, provided that certain conditions are met that mirror those applicable to registered investment companies or business development companies (including that the plan provides that the entity will be converted into a foreign public fund within one year from the date of establishment); and
- that a covered fund would generally be considered to share the same name or a variation of the same name with a banking entity for purposes of the prohibitions on name sharing if the name of the fund features the same root word, the same initials or a logo, trademark or other corporate symbol that is also used by, or that clearly references a connection with, the banking entity, including any affiliate of the banking entity.

The FAQs issued by each Banking Agency note that the Agencies have been working together on the FAQs, and that while the FAQs issued by each Agency apply to banking entities for which that Agency has jurisdiction under the Volcker Rule, the FAQs "have been developed by staffs of the Agencies and substantively identical versions will appear on the public websites of each Agency."[4] The text of the FAQs issued by the Federal Reserve follows.

VOLCKER RULE

Frequently Asked Questions

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the Bank Holding Company Act of 1956 ("BHC Act"), commonly referred to as the Volcker rule, that generally prohibits insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions.

A BANKING ENTITY WITH TRADING ASSETS AND LIABILITIES OF AT LEAST $50 BILLION, AS CALCULATED UNDER § 248.20(D)(1), MUST BEGIN TO MEASURE AND RECORD THE REQUIRED METRICS ON A DAILY BASIS STARTING JULY 1, 2014.

The Federal Reserve Board ("Board") is working closely with the other agencies charged with implementing the requirements of section 13, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (each an "Agency" and collectively with the Board "the Agencies"). While these frequently asked questions ("FAQs") apply to banking entities for which the Board has jurisdiction under section 13 of the BHC Act, they have been developed by staffs of the Agencies and substantively identical versions will appear on the public websites of each Agency.

1. To comply with the requirement to record and report quantitative measurements in § 248.20(d) and Appendix A, when must a banking entity with $50 billion or greater in trading assets and liabilities begin to measure and record the required metrics? When

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[1] *See* Federal Reserve, Volcker Rule, Frequently Asked Questions (June 10, 2014) available at http://federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

[2] *See* 12 C.F.R. § 248.10(c)(8).

[3] See 12 C.F.R. § 248.10(c)(1).

[4] *See* Federal Reserve, Volcker Rule, Frequently Asked Questions (June 10, 2014) available at http://federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

must the banking entity begin to report metrics data to the Board?

2. May a trading desk span multiple affiliated banking entities? If a trading desk spans multiple affiliated banking entities, to which Agency(ies) should a banking entity report metrics?
3. How do the requirements of section 13 of the BHC Act and the final rule apply to a banking entity during the conformance period? For instance, must a banking entity deduct its investment in a covered fund from its tier 1 capital prior to the end of the conformance period?
4. Are the "rights or other assets" described in § 248.10(c)(8)(i)(B) ("servicing assets") limited to "permitted securities," or can other assets be servicing assets for purposes of the loan securitization exclusion?
5. The final rule excludes from the definition of covered fund a registered investment company and business development company, including an entity that is formed and operated pursuant to a written plan to become one of these entities. Would an entity that is formed and operated pursuant to a written plan to become a foreign public fund receive the same treatment?
6. Section 248.11 of the final rule provides that a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers, subject to a number of conditions. Among other things, these conditions require that the covered fund, for corporate, marketing, promotional or other purposes does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof). What does it mean for a covered fund to share the same name or a variation of the same name with a banking entity?

Metrics Reporting Date

1. To comply with the requirement to record and report quantitative measurements in § 248.20(d) and Appendix A, when must a banking entity with $50 billion or greater in trading assets and liabilities begin to measure and record the required metrics? When must the banking entity begin to report metrics data to the Board?

Posted: 6/10/2014

A banking entity with trading assets and liabilities of at least $50 billion, as calculated under § 248.20(d)(1), must begin to measure and record the required metrics on a daily basis starting July 1, 2014. As explained below, this banking entity must report its daily metrics recorded during the month of July to the Board by September 2, 2014.

Section 248.20(d)(2) provides that the threshold for reporting quantitative measurements under § 248.20(d)(1) is $50 billion beginning on June 30, 2014. This means that the first day for which daily metrics must be measured and recorded by a banking entity at the $50 billion threshold is July 1, 2014.

The final rule requires a banking entity at or above the $50 billion threshold to report metrics data for each calendar month within 30 days of the end of the month unless the Board notifies the banking entity in writing that it must report on a different basis. However, if the reporting deadline occurs on a Saturday, Sunday, or federal holiday, then a banking entity may report the data on the next business day following the reporting deadline. Thus, the relevant banking entity must collect metrics data for the month of July and report that data by September 2, 2014. This banking entity has until September 2, 2014 to report metrics data under these circumstances because August 30, 2014 (which is 30 days after July 31, 2014) is a Saturday, and the following Monday on September 1, 2014 is a federal holiday. Beginning with information for the month of January 2015, the final rule requires this banking entity to report metrics data within 10 days of the end of each calendar month, unless the Board notifies the banking entity in writing that it must report on a different basis.

THE FINAL RULE DEFINES TRADING DESK TO MEAN THE SMALLEST DISCRETE UNIT OF ORGANIZATION OF A BANKING ENTITY THAT PURCHASES OR SELLS FINANCIAL INSTRUMENTS FOR THE TRADING ACCOUNT OF THE BANKING ENTITY OR AN AFFILIATE THEREOF.

Certain of the required metrics have a calculation period of 30 days, 60 days, and 90 days. For these measurements, the initial metrics report for the month of July may provide data for only a 30-day calculation period. Likewise, the metrics report due by September 30, 2014 may provide data for only a 30-day and 60-day calculation period. Beginning with the report due October 30, 2014, metrics reports must include data for all required calculation periods.

Trading Desk

2. May a trading desk span multiple affiliated banking entities? If a trading desk spans multiple affiliated banking entities, to which Agency(ies) should a banking entity report metrics?

UNDER THE FINAL RULE, SERVICING ASSETS MAY BE ANY TYPE OF ASSET. HOWEVER, ANY SERVICING ASSET THAT IS A SECURITY MUST BE A PERMITTED SECURITY UNDER § 248.10(C)(8)(III).

Posted: 6/10/2014

The final rule defines trading desk to mean the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof. As discussed in the preamble to the final rule, the Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of the traders is attributed. This approach allows more effective management of risks of trading activity by requiring the establishment of limits, management oversight, and accountability at the level where the trading activity occurs. It also allows banking entities to tailor the limits and procedures to the type of instruments traded and markets served by each trading desk.

The definition of "trading desk" specifically recognizes that the desk may buy or sell financial instruments "for the trading account of a banking entity or an affiliate thereof." The preamble to the final rule explains that a trading desk may span more than one legal entity and thus employees may be working on behalf of multiple affiliated legal entities. Additionally, trades and positions managed by the desk may be booked in different affiliated entities. The rules require that if a single trading desk books positions in different affiliated legal entities, it must have records that identify all positions included in the trading desk' s financial exposure and the legal entities where such positions are held.

Appendix A to the final rule provides that a banking entity with significant trading assets and liabilities must furnish periodic reports to the Agencies regarding a variety of quantitative measurements of their covered trading activities. If a trading desk spans multiple legal entities, it must report quantitative measurements to each of the agencies with jurisdiction under section 13 of the BHC Act over any of the entities. For a trading desk that spans multiple affiliated banking entities, the quantitative measurements of Appendix A should be calculated at the level of the entire desk; calculations do not need to be performed separately for each subset of positions booked at the various banking entities that compose the trading desk. As indicated above, this same set of desk-wide measurements should be reported to each Agency that has authority under section 13 of the BHC Act over any of the affiliated entities that compose the trading desk so that the Agency may understand the context of the trading activity and discharge its responsibility for the legal entity that the Agency supervises or regulates.

Conformance Period

3. How do the requirements of section 13 of the BHC Act and the final rule apply to a banking entity during the conformance period? For instance, must a banking entity deduct its investment in a covered fund from its tier 1 capital prior to the end of the conformance period?

Posted: 6/10/2014

The Board extended the statute's conformance period until July 21, 2015 ("Board Conformance Order").[1] The Board also has issued a statement of policy in which the Board clarified the activities and investments that are permissible during the conformance period.[2]

As explained in the Board Conformance Order, a banking entity must conform all of its proprietary trading activities and covered fund activities and investments to the prohibitions and requirements of section 13 and the final rule by no later than the end of the conformance period. During the conformance period, a banking entity is expected to engage in good-faith efforts, appropriate for its activities and investments that will result in the conformance of all of its activities and investments to the requirements of section 13 and the final rule no later than the end of the conformance period. Good-faith efforts include evaluating the extent to which the banking entity is engaged in activities and investments that are covered by section 13 and the final rule, as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period. In addition, under the Board Conformance Order, banking entities that have stand-alone

[1] See Board Order Approving Extension of Conformance Period (PDF).

[2] See Statement of Policy Regarding the Conformance Period for Entities Engaged in Proprietary Trading or Private Equity Fund and Hedge Fund Activities, 77 Fed. Reg. 33,949 (June 8, 2012).

proprietary trading operations are expected to promptly terminate or divest those operations. Moreover, banking entities should not expand activities and make investments during the conformance period with the expectation that additional time to conform those activities or investments will be granted.

A COVERED FUND THAT IS ORGANIZED AND OFFERED BY "BANKING ENTITY A" MAY NOT SHARE THE SAME NAME OR A VARIATION OF THE SAME NAME AS "BANKING ENTITY A," NOR MAY IT SHARE THE SAME NAME OR A VARIATION OF THE SAME NAME AS ANY AFFILIATE OF "BANKING ENTITY A."

As an example of how the conformance period works in practice, section 13(d)(4) of the BHC Act and § 248.12(d) of the final rule require a banking entity to deduct from the banking entity' s tier 1 capital, as determined under § 248.12(c)(2) of the final rule, its permitted investments in all covered funds. A banking entity would not be required to make this deduction until the end of the conformance period, which is currently July 21, 2015. As noted above, a banking entity is expected to engage in good faith efforts during the conformance period so that it can comply with this requirement no later than the end of the conformance period. Notably, as specified in the final rule, certain metrics reporting requirements will be in place before the end of the conformance period for banking entities with $50 billion or greater in trading assets and liabilities.

Loan Securitization Servicing Assets

4. Are the "rights or other assets" described in § 248.10(c)(8)(i)(B) ("servicing assets") limited to "permitted securities," or can other assets be servicing assets for purposes of the loan securitization exclusion?

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The exclusion from the definition of covered fund for loan securitizations provides that, in addition to loans, a loan securitization may hold rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset meets the requirements of § 248.10(c)(8)(iii) of the final rule.

Under the final rule, servicing assets may be any type of asset. However, any servicing asset that is a security must be a permitted security under § 248.10(c)(8)(iii). Permitted securities under this section include cash equivalents and securities received in lieu of debts previously contracted as set forth in § 248.10(c)(8)(iii). The preamble to the final rule provides additional detail on the meaning of cash equivalents, noting that the Agencies interpret "cash equivalents" to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization' s expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities.

Foreign Public Fund Seeding Vehicles

5. The final rule excludes from the definition of covered fund a registered investment company and business development company, including an entity that is formed and operated pursuant to a written plan to become one of these entities. Would an entity that is formed and operated pursuant to a written plan to become a foreign public fund receive the same treatment?

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Section 248.10(c)(12) of the final rule explicitly excludes an issuer that is registered as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), or that is formed and operated pursuant to a written plan to become a registered investment company ("RIC") in accordance with the banking entity's compliance program as described in § 248.20(e)(3), and that complies with the requirements of section 18 of the Investment Company Act (15 U.S.C. 80a-18).[3] Section 248.10(c)(1) of the final rule also excludes from the definition of covered fund a foreign public fund that is an issuer that is organized or established outside of the United States; is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and sells ownership interests predominantly through one or more public offerings outside of the United States Foreign public funds that meet these qualifications are therefore treated the same as RICs for purposes of the definition of "covered fund" under the final rule. Although the final rule excludes from the definition of covered fund certain seeding vehicles that will become RICs, as discussed above, the final rule

[3] The final rule also explicitly excludes an issuer that has elected to be regulated as a business development company ("BDC") pursuant to section 54(a) of that Act (15 U.S.C. 80a-53) and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a BDC as described in § 248.20(e)(3) and that complies with the requirements of section 61 of the Investment Company Act of 1940 (15 U.S.C. 80a-60).

does not address a seeding vehicle that will become a foreign public fund.

Staffs of the Agencies believe that, with respect to determining whether an entity is a covered fund, it would be appropriate that an issuer that will become an excluded foreign public fund be treated during its seeding period the same as an issuer that will become an excluded RIC. Accordingly, staffs of the Agencies do not intend to advise the Agencies to treat as a covered fund under the final rule an issuer that is formed and operated pursuant to a written plan to become a qualifying foreign public fund. Any written plan would be expected to document the banking entity's determination that the seeding vehicle will become a foreign public fund, the period of time during which the vehicle will operate as a seeding vehicle, the banking entity's plan to market the vehicle to third-party investors and convert it into a foreign public fund within the time period specified in § 248.12(a)(2)(i)(B) of subpart C, and the banking entity's plan to operate the seeding vehicle in a manner consistent with the investment strategy, including leverage, of the issuer upon becoming a foreign public fund. For purposes of the definition of covered fund, this would treat an issuer that becomes a qualifying foreign public fund the same as an issuer that becomes a RIC during the seeding period for the fund.

Namesharing Prohibition

6. Section 248.11 of the final rule provides that a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers, subject to a number of conditions. Among other things, these conditions require that the covered fund, for corporate, marketing, promotional or other purposes does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof). What does it mean for a covered fund to share the same name or a variation of the same name with a banking entity?

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A covered fund that is organized and offered by "banking entity A" may not share the same name or a variation of the same name as "banking entity A," nor may it share the same name or a variation of the same name as any affiliate of "banking entity A." Additionally, the final rule prohibits a covered fund from using the word "bank" in its name.

Similar restrictions on a fund sharing the same name, or variation of the same name, with an insured depository institution or company that controls an insured depository institution or having the word "bank" in its name, have been used previously in order to prevent customer confusion regarding the relationship between such companies and a fund.[4] In order to comply with § 248.11(a)(6) of the final rule and not be considered to share the same name or variation of the same name with a banking entity, the name of a covered fund must be sufficiently distinct from the name of the banking entity that the covered fund' s use of the name would not likely lead to customer confusion regarding the relationship between the banking entity and the covered fund. For instance, a covered fund would generally be considered to share the same name or a variation of the same name with a banking entity if the name of the fund features the same root word, initials or a logo, trademark, or other corporate symbol that is also used by, or that clearly references a connection with, the banking entity, including any affiliate of the banking entity. Additionally, materials used to market, promote, or offer the fund may not contain any statements that would mislead an investor into thinking that the banking entity or any of its affiliates, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or any covered fund in which such covered fund invests.

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[4] See, e.g., 12 CFR 225.125(f); Bank of Ireland, 82 Fed. Res. Bull. 1129, 1132 (1996).

MIFID II: THE EXPANSION OF THE EU'S FRAMEWORK FOR THE REGULATION OF FINANCIAL MARKETS AND SECURITIES

CHRISTOPHER LEONARD and CHRIS POON

THIS ARTICLE DISCUSSES THREE CATEGORIES OF ENTITY THAT WILL BE BROUGHT INTO SCOPE OF MIFID REGULATION FOR THE FIRST TIME: FIRMS SPECIALIZING IN TRADING COMMODITIES AND COMMODITY DERIVATIVES; FIRMS WHO ENGAGE IN HIGH FREQUENCY ALGORITHMIC TRADING; AND THIRD COUNTY FIRMS.

On June 12, 2014 the final texts of MiFID II and MiFIR[1] were published in the Official Journal of the European Union, comprising the package of reforms and amendments to the Markets in Financial Instruments Directive[2] which establishes the framework for the regulation of financial markets and securities across the European Union.

[1] The new Markets in Financial Instruments Regulation ("**MiFIR**").

[2] Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments ("**MiFID**").

Member States are required to transpose MiFID II and MiFIR into their national legislation by July 3, 2016, with such national rules required to come into effect by January 3, 2017. Although that may seem a long way off, firms operating in the financial services sector need to be mindful of the changes that will be brought about by the new legislation and start acting now to ensure they are ready for those changes and they do not fall behind their competitors.

This article focuses on three categories of entity that will be brought into scope of MiFID regulation for the first time: firms specializing in trading commodities and commodity derivatives; firms who engage in high frequency algorithmic trading; and third country firms (including the possibility that third country firms will, for the first time, be able to apply for a "passport" to provide investment services throughout the EU).

COMMODITY AND COMMODITY DERIVATIVE DEALERS

Under MiFID, firms dealing in commodity derivatives are able to rely on the Article 2(1)(k) exemption for persons whose main business is dealing on own account in commodities and/or commodity derivatives. Excessive commodity price volatility has been a hot topic at the G20 summits in recent years, however, and the G20 summit in Cannes on November 4, 2011 endorsed the International Organization of Securities Commission's *Principles for the Regulation and Supervision of Commodity Derivatives Markets*[3] and called for market regulators to have formal position management powers, including the power to set *ex ante* position limits as appropriate. As a direct result, the Article 2(1)(k) exemption has been removed from MiFID II, bringing specialist commodity and commodity derivative dealers into scope for the first time.

The only commodity derivative dealers who will not be caught by the directive will be those falling within MiFID II Article 2(1)(j), which exempts firms who, ancillary to their main business, deal on their own account in commodity derivatives or provide other investment services to the customers or suppliers of their main business (provided the main business is not the provision of investment services or acting as a market-maker in relation to commodity derivatives). This is subject to the new conditions that they (i) do not deal on own account for the purpose of executing client orders; (ii) do not employ a high frequency algorithmic trading technique; and (iii) notify the home regulator annually that they make use of this exemption and can justify to them why such investment activities are ancillary to their main business.

All other firms dealing in commodities or commodity derivatives will fall within the scope of MiFID II and will be subject to the relevant authorization, supervision, capital and conduct of business requirements, including new rules on position limits and position reporting. These new rules will be discussed in more detail in a subsequent article.

HIGH FREQUENCY ALGORITHMIC TRADING TECHNIQUE USERS

Regulators have also expressed a desire to gain greater control over the users of trading algorithms which often submit and/or execute trade orders with little or no human interaction, and particularly those who use *high frequency* algorithmic trading techniques.[4] The perception is that such algorithms are capable of exacerbating the rate of decline in a downward market, are a tool by which a market may be manipulated (e.g. used for "layering" or "spoofing") and could, potentially, lead to the mass execution of erroneous trades.

REGULATORS HAVE ALSO EXPRESSED A DESIRE TO GAIN GREATER CONTROL OVER THE USERS OF TRADING ALGORITHMS WHICH OFTEN SUBMIT AND/OR EXECUTE TRADE ORDERS WITH LITTLE OR NO HUMAN INTERACTION, AND PARTICULARLY THOSE WHO USE *HIGH FREQUENCY* ALGORITHMIC TRADING TECHNIQUES.

Accordingly, under MiFID II, firms which conduct high frequency algorithmic trading will no longer be able to rely on the current exemption in MiFID Article 2(1)(d) for firms which only provide the investment service of "dealing in financial instruments on own account," or the exemption in MiFID Article 2(1)(j) outlined above. This means that they will be required to be authorized by their home state regulator if they are not already so authorized and if they are not able to rely on any other exemption. They will also be subject to the new rules on algorithmic trading, pursuant to Article 17 of MiFID II.

[3] *Published in September 2011.*

[4] *"High frequency algorithmic trading technique"* is defined in Article 4(1)(40) of MiFID II as *"any algorithmic trading technique characterized by: (a) infrastructure intended to minimize network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high speed direct electronic access; (b) system determination of order initiation, generating, routing or execution without human intervention for individual trades or orders; and high message intraday rates which constitute orders, quotes or cancellations."*

TABLE 1: SETTING OUT AT A GLANCE THE NEW CATEGORIES OF ENTITY BROUGHT INTO SCOPE OF MIFID REGULATION

TYPE OF FIRM	WILL MIFID APPLY?	IMPACT?
Commodity or commodity derivatives trader	Yes, unless, ancillary to its main business, the firm deals on its own account in commodity derivatives or provides other investment services to the customers or suppliers of its main business (provided the main business is not the provision of investment services or acting as a market-maker in relation to commodity derivatives), and it: 1. does not deal on own account for the purpose of executing client orders; 2. does not employ a high frequency algorithmic trading technique; and 3. notifies the home regulator annually that it makes use of this exemption and can justify why such investment activities are ancillary to their main business.	The firm will be required to be authorised by its home state regulator and will then be subject to capital and conduct of business requirements (among others) under MiFID II, including rules on position limits and position reporting.
Algorithmic trading technique user	Yes	The firm may be able to rely on an exemption and not therefore require authorisation under MiFID II. However, it will still be subject to the rules on algorithmic trading pursuant to Article 17 of MiFID II.
High frequency algorithmic trading technique user	Yes	The firm may be able to rely on an exemption (with the exception of Article 2(1)(d) and Article 2(1)(j)) and not therefore require authorisation under MiFID II. However, it will still be subject to the rules on algorithmic trading pursuant to Article 17 of MiFID II.
Third country firm providing investment services to retail clients from within the EU	Yes, provided the relevant EU member state has adopted the MiFID II provisions requiring the third country firm to establish a local branch.	The firm will be: • required to open a branch in the relevant jurisdiction(s); and • subject to local authorisation and supervision requirements; unless it provides services at the exclusive initiative of the client.
Third country firm providing investment services to professional clients from within the EU	Yes, provided the relevant EU member state has adopted the MiFID II provisions requiring the third country firm to establish a local branch.	The firm will be: • required to open a branch in the relevant jurisdiction(s); and • subject to local authorization and supervision requirements; unless it provides services at the exclusive initiative of the client.
Third country firm providing investment services to professional clients in the EU on a cross-border basis	Yes, provided they are first registered with ESMA.	The firm will be able to provide cross-border investment services or investment-activities.
Third country firm providing investment services to eligible counterparties in the EU on a cross-border basis	Yes, provided they are first registered with ESMA.	The firm will be able to provide cross-border investment services or investment-activities.

Such rules will be explored in detail in a subsequent Bingham article but they will include rules pertaining to systems and controls, reporting and record-keeping requirements.

It should be noted that the rules in Article 17 of MiFID II will apply to all investment firms engaging in algorithmic trading, not just those applying high frequency algorithmic trading techniques, including those members or participants of regulated markets and Multi-Lateral Trading Facilities who are not required to be authorized under MiFID II by virtue of: (i) the MiFID II Article 2(1)(j) exemption; or (ii) the MiFID Article 2(1)(a) exemption for insurance undertakings; or (iii) the MiFID Article 2(1)(i) exemption for investment undertakings, pension funds and the depositaries and managers of such undertakings.[5]

NEW THIRD COUNTRY FIRM REGIME

EU Branch Requirement

Whereas MiFID did not address the provision of investment services into the EU by third country firms, and therefore it was for each member state to adopt its own rules and requirements, MiFID II expressly allows a member state, should it so choose, to require a third country firm which intends to provide investment services to retail and/or professional clients within its jurisdiction to establish a local branch.

Should a member state decide to adopt this branch requirement, the third country firm branch would be subject to authorization and supervision in that member state by the relevant regulator. The relevant regulator will only be able to grant such authorization where: (i) the third country firm is already appropriately authorized and supervised in its home jurisdiction; (ii) certain co-operation agreements are already in place relating to the exchange of information as between the home regulator of the third country firm and the relevant European regulator; (iii) the branch has sufficient initial capital; (iv) one or more persons are appointed to be responsible for the management of the branch (who must comply with the governance and management body arrangements set out in CRD IV[6]); (v) the home jurisdiction of the third country firm has entered into certain tax agreements with the relevant member state; and (vi) the firm belongs to an investor-compensation scheme authorized or recognized in the EU.[7]

Member states will not be able to impose requirements for a branch over and above those prescribed by MiFID II and will not be permitted to treat any third country firm branch more favorably than EU authorized firms.[8] Further, member states will not be permitted to impose the branch requirement on third country firms which provide investment services at the "exclusive initiative of the client."[9]

Should the UK decide to adopt the branch requirement for third country investment firms, the current UK financial services exemption for "overseas persons"[10] would likely no longer be available.

EU Cross-Border Services Passport

MiFIR allows third country firms to provide investment services on a cross-border basis to eligible counterparties and professional clients throughout the whole of the EU provided they are first registered with ESMA,[11] thus effectively allowing such firms to benefit from an EU "passport" for the first time.

WHERE THEY HAVE NOT ALREADY DONE SO, FINANCIAL SERVICES FIRMS NEED TO START ENGAGING WITH MIFID II NOW. FIRMS SHOULD CONSIDER WHETHER AND HOW THE CHANGES TO THE SCOPE OF MIFID WILL IMPACT ON THEM AND THEIR BUSINESSES AND PLAN HOW THEY ARE GOING TO DEAL WITH THOSE CHANGES.

Registration with ESMA will only be possible, however, once: (i) the European Commission has published an "equivalence decision" which shall only be granted if the European Commission has determined that the legal and supervisory arrangements of the home jurisdiction of the third country firm impose prudential and business conduct requirements which are equivalent to those imposed by MiFID and the European capital adequacy rules; (ii) the third country firm is appropriately supervised in its home jurisdiction for the purpose of ensuring full compliance with such rules; and (iii) the relevant home regulator of the third country firm has

[5] MiFID II Article 1(5).

[6] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC ("CRD IV").

[7] MiFID II Article 41.

[8] MiFID II Article 41(2).

[9] MiFID II Article 42.

[10] See art.72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

[11] MiFIR Article 46(1).

entered into appropriate co-operation agreements with ESMA.[12]

Where a third country firm is registered with ESMA, member states are not permitted to impose additional requirements in relation to the provision of investment services into their respective jurisdictions, and are equally not permitted to treat registered third country firms more favorably than EU authorized firms.[13]

NEXT STEPS

Where they have not already done so, financial services firms need to start engaging with MiFID II now. Firms should consider whether and how the changes to the scope of MiFID will impact on them and their businesses and plan how they are going to deal with those changes.

In the meantime, we will be publishing a series of articles on the following topics: corporate governance arrangements; trading issues, including new venues and pre- and post-sale transparency requirements; position limits and reporting; the European Market Infrastructure Regulation and how it will operate alongside MiFID II; and algorithmic trading requirements. We do not expect further details regarding the treatment of third country firms to be available for some time; however we will follow these developments closely and will publish further articles on this issue in due course.

CHRISTOPHER LEONARD is a partner and CHRIS POON is an associate in the London office of Bingham McCutchen LLP. Copyright 2014 Bingham McCutchen LLP. All rights reserved.

[12] MiFIR Article 46(2).

[13] MiFIR Article 46(3).

PCAOB AUDITING STANDARDS

SULLIVAN & CROMWELL LLP

THIS ARTICLE EXAMINES THE NEW AUDITING STANDARD ADOPTED BY THE PCAOB FOR RELATED PARTY TRANSACTIONS AND AMENDMENTS REGARDING TRANSACTIONS AND RELATIONSHIPS WITH EXECUTIVE OFFICERS AND SIGNIFICANT UNUSUAL TRANSACTIONS.

The Public Company Accounting Oversight Board (PCAOB or the "Board") has adopted Auditing Standard No. 18*, Related Parties,* addressing audit procedures used to evaluate transactions and relationships between a company and its related parties. Under the new standard, the auditors must (i) perform specific procedures to obtain an understanding of a company's relationships and transactions with related parties, (ii) perform more in-depth procedures in response to risks of material misstatement associated with these relationships and transactions, (iii) communicate with the audit committee or its chair to obtain information specifically regarding related party transactions during the auditor's risk assessment, and (iv) communicate to the audit committee or its chair the auditor's evaluation of the company's identification of, accounting for, and disclosure of related party relationships and transactions.

The Board also adopted amendments that prescribe specific audit procedures intended to improve the auditor's identification and evaluation of significant unusual transactions and the auditor's review of financial relationships and transactions with executive officers.

Although the new standard and amendments are directed at auditors, not issuers, SEC-reporting companies should consider the extent to which their audit committee agendas should be updated to take into account the new required communications with the auditor. In addition, companies should note that the auditor will be required to inquire of the chair of the compensation committee or its equivalent and any compensation consultants engaged by either the committee or the company regarding the structuring of the company's compensation for executive officers.

Auditing Standard No. 18 and related amendments are subject to SEC approval. Subject to that approval, the PCAOB anticipates that the new standard will be effective for audits and quarterly reviews for fiscal years beginning on or after December 15, 2014.

THE ADOPTED STANDARD

Auditing Standard No. 18, *Related Parties*, is intended to strengthen auditor performance requirements for identifying, assessing, and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties.[1] The procedures required by the new standard expand the risk assessment procedures performed under Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.* In performing procedures to obtain an understanding of internal control over financial report-

[1] The adopted standard instructs the auditor to look to the requirements of the U.S. Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to the company, including the definition of the term "related parties" and the financial statement disclosure requirements with respect to related parties.

ing, under the new standard, the auditor must also (i) obtain an understanding of the company's process for identifying related parties and relationships and transactions with related parties, including obtaining an understanding of the nature of the relationships and of the terms and business purposes (or lack thereof) of transactions involving related parties, (ii) evaluate whether the company has properly identified its related parties and relationships and transactions with its related parties, (iii) perform specific procedures if the auditor determines that there exists a related party or relationship or transaction with a related party previously undisclosed to the auditor, (iv) perform specific procedures regarding each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk, and (v) communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties, and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

THE PROCEDURES REQUIRED BY THE NEW STANDARD EXPAND THE RISK ASSESSMENT PROCEDURES PERFORMED UNDER AUDITING STANDARD NO. 12, *IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT.*

The most significant changes from the current standard include:

- **Adding Basic Requirements**—While the existing standard, AU sec. 334, suggests procedures but does not require them in every audit, the new standard requires basic procedures in response to identified risks of material misstatement associated with related party transactions. These procedures are required for related party transactions and relationships that (i) require disclosure in the financial statements or (ii) are determined to be a significant risk. The more in-depth procedures required by the standard are designed to be scalable and commensurate with the company's facts and circumstances. These required procedures include:
  - reading the underlying documentation and evaluating whether the terms and other information about a transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
  - determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures regarding related party transactions;
  - determining whether any exceptions to the company's established policies or procedures were granted;
  - evaluating the financial capability of the related parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
  - performing other procedures as necessary to address the identified and assessed risks of material misstatement.
- **Adding Audit Committee Communications**—While AU sec. 334 does not specifically mention communications with the audit committee regarding related party transactions, the new standard requires the auditor to communicate with the audit committee or its chair to obtain information during the auditor's risk assessment. The new standard also requires the auditor to communicate the auditor's evaluation of the company's identification of, accounting for, and disclosure of related party relationships and transactions to the audit committee.
- **Emphasizing a Complementary Audit Approach**—The new standard specifically references complementary standards, including those relating to significant unusual transactions, and requires the auditor to take into account information gathered during the audit when evaluating a company's identification of its related parties.
- **Enhancing Procedures to Obtain an Understanding of the Company's Relationships and Transactions with Its Related Parties**—The new standard requires the performance of specific procedures in this area that go beyond the limited direction given in AU sec. 334, including obtaining an understanding of the terms and business purposes (or lack thereof) of related party transactions.[2]
- **Aligning with the Risk Assessment Standards**—The new procedures are intended to be performed in con-

[2] The adopting release specifically criticizes the statement in AU sec. 334 that in the absence of evidence to the contrary, related party transactions should not be assumed to be out of the ordinary course of business, opining that this statement "could be misunderstood to create a 'presumption of validity' for the business purpose of related party transactions in situations where experience suggests a need for heightened scrutiny."

junction with the procedures performed as part of the auditor's risk assessment.

- **Improving the Auditor's Focus on Accounting**—While AU sec. 334 emphasizes the adequacy of disclosure, the new standard requires that the auditor evaluate both the accounting for, and disclosure of, related party transactions.

The new standard recognizes that the company is responsible for the identification of related parties and transactions and relationships with related parties in the first instance, and that the auditor begins the audit with information obtained from the company.[3] However, the standard also provides that the auditor's procedures used to evaluate that company's financial statements in this regard must extend beyond mere inquiry of management. Specifically, the standard requires inquiries not only of management and others within the company likely to have knowledge of related parties or relationships, but also inquiries of the audit committee regarding the committee's understanding of the company's relationships and transactions with related parties and "whether any member of the audit committee has concerns regarding those relationships or transactions." The auditor must perform procedures to test the accuracy and completeness of the identifications made by the company. An appendix to the standard contains examples of information and sources of information that may be gathered by the auditor during the audit that could indicate undisclosed related parties, relationships and transactions:

- buying or selling goods or services at prices that differ significantly from prevailing market prices;
- sales transactions with unusual terms, including unusual rights of return or extended payment terms generally not offered;
- "bill and hold" type transactions;
- borrowing or lending on an interest-free basis or with no fixed repayment terms;
- occupying premises or receiving other assets or rendering or receiving management services when no consideration is exchanged;
- sales without economic substance (e.g., funding the other party to the transaction to facilitate collection of the sales price, or entering into a transaction shortly prior to period end and unwinding that transaction shortly after period end); and
- loans to parties that, at the time of the loan transaction, do not have the ability to repay and possess insufficient or no collateral.

After performing audit procedures, the auditor must evaluate whether the company has properly identified, accounted for, and disclosed related party relationships and transactions. The auditor may be required to design and implement audit processes that address identified and assessed risks of material misstatement associated with related parties and relationships and transactions with related parties. In addition, if the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor will be required to perform significant additional procedures.

THE NEW STANDARD RECOGNIZES THAT THE COMPANY IS RESPONSIBLE FOR THE IDENTIFICATION OF RELATED PARTIES AND TRANSACTIONS AND RELATIONSHIPS WITH RELATED PARTIES IN THE FIRST INSTANCE, AND THAT THE AUDITOR BEGINS THE AUDIT WITH INFORMATION OBTAINED FROM THE COMPANY.

The new standard works in conjunction with Auditing Standard No. 16, which addresses communications to the audit committee, but specifically requires the auditor to communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor must also communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties, such as the identification of:

- related parties or relationships or transactions with related parties that were previously undisclosed to the auditor;
- significant related party transactions that have not been authorized or approved in accordance with the company's established policies or procedures;
- significant related party transactions for which exceptions to the company's established procedures were granted;
- statements in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's length trans-

[3] See Auditing Standard No. 18—Related Parties, Paragraph 14, PCAOB Rel. No. 2014-002 (June 10, 2014), available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

action and the evidence obtained by the auditor to support or contradict such an assertion; and

- significant related party transactions that appear to the auditor to lack a business purpose.

THE AMENDMENTS

Relationships and Transactions with Executive Officers

The amendments regarding financial relationships and transactions with executive officers are intended to provide for improved audit procedures in complementary areas, including requiring that the auditor perform procedures, as part of the auditor's risk assessment, to obtain an understanding of the company's financial relationships and transactions with its executive officers. These new procedures are intended to heighten the auditor's attention to possible incentives or pressures for the company to achieve a particular financial position or operating result.[4] The amendments reflect a recognition that a company's executive officers, because of their position, can exert influence over the company's accounting and financial statement presentation. The PCAOB noted in its adopting release that after considering comments received, it had revised its proposed amendments to explicitly provide that the auditor's work relating to a company's financial relationships and transactions with its executive officers does not include an assessment of the appropriateness or reasonableness of executive compensation arrangements.

The most significant changes from the current standards include:

- **Adding a Definition of "Executive Officer"**—Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, is revised to add a definition of "executive officer,"[5] a category distinct from "senior management," the term currently used in Auditing Standard No. 12.
- **Specifying Additional Required Procedures**—Auditing Standard No. 12 is revised to specify procedures required to obtain an understanding of the company's financial relationships and transactions with its executive officers, including procedures designed to identify risks of material misstatement. These procedures should include, but not be limited to:
  - reading the employment and compensation contracts between the company and its executive officers;
  - reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers;
  - inquiring of the chair of the compensation committee, or the compensation committee's equivalent, and any compensation consultants engaged by either the compensation committee or the company regarding the structuring of the company's compensation for executive officers; and
  - obtaining an understanding of established policies and procedures regarding the authorization and approval of executive officer expense reimbursements.

Significant Unusual Transactions

The amendments regarding significant unusual transactions revise AU sec. 316 and Auditing Standards No. 12, *Identifying and Assessing Risks of Material Misstatement*, and No. 13, *Auditor's Reponses to Risks of Material Misstatement*, to strengthen the requirements relating to identification and evaluation of significant unusual transactions.

THESE NEW PROCEDURES ARE INTENDED TO HEIGHTEN THE AUDITOR'S ATTENTION TO POSSIBLE INCENTIVES OR PRESSURES FOR THE COMPANY TO ACHIEVE A PARTICULAR FINANCIAL POSITION OR OPERATING RESULT.

The most significant changes from the current standards include:

- **Definition of Significant Unusual Transactions**—Auditing Standard No. 12 and AU sec. 316 are amended to define "significant unusual transactions" as "significant transactions that are outside the normal course of business for the company or that oth-

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[4] The PCAOB references a study examining SEC Accounting & Auditing Enforcement Releases from 1998 to 2007 which noted that the most commonly cited motivations for fraud included the need to: (i) meet external earnings expectations of analysts and others; (ii) meet internally set financial targets or make the company look better; (iii) conceal the company's deteriorating financial condition; (iv) increase the stock price; (v) bolster financial position for pending equity or debt financing; (vi) increase management compensation through achievement of bonus targets and through enhanced stock appreciation; and (vii) cover up assets misappropriated for personal gain. PCAOB Rel. No. 2014-002 (June 10, 2014), available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket038.aspx.

[5] "Executive officer"—For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policymaking functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policymaking functions for the company (See Rule 3b-7 under the Exchange Act); for brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions.

erwise appear to be unusual due to their timing, size, or nature."

- **Improving Requirements for Identifying Significant Unusual Transactions**—Auditing Standards No. 12 and No. 13 are amended to require the auditor to:
  - inquire of management and internal audit personnel (if any) as to whether the company has entered into any significant unusual transactions, and, if so, the nature, terms and business purpose (or lack thereof) of those transactions and whether such transactions involved related parties; and
  - inquire of others within the company—including employees involved in initiating, recording, or processing complex or unusual transactions—about their views regarding fraud risk.
- **Improving the Auditor's Evaluation of Significant Unusual Transactions**—The amendments require the auditor to specifically obtain an understanding of the controls management has established to identify, authorize and approve, and account for and disclose significant unusual transactions in the financial statements (if the auditor does not already do so in obtaining an understanding of internal control under the existing standard). The basic procedures include:
  - reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;
  - determining whether the transaction has been authorized and approved in accordance with the company's established policies and procedures;
  - evaluating the financial capability (based on information that may include audited financials, reports of regulatory agencies, financial publications, and income tax returns) of the other parties with respect to significant uncollected balances, loan commitments, supply arrangements, guarantees, and other obligations, if any; and
  - performing other procedures as necessary, depending on the identified and assessed risks of material misstatement.
- **Enhancing Attention to the Business Purpose (or lack thereof) of Significant Unusual Transactions**—Under the amendments, the auditor must also respond to fraud risks with procedures specifically designed to address the risk of management override of internal controls. These procedures require the auditor to evaluate whether a significant unusual transaction may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
  - In AU sec. 316, the amendments add to the list of risk factors for misstatements arising from fraudulent financial reporting a new potential internal control deficiency: "contractual arrangements lacking a business purpose."

THE ADOPTED STANDARD AND AMENDMENTS WILL NOT APPLY TO THE AUDITS OF "EMERGING GROWTH COMPANIES" UNLESS THE SEC DETERMINES THAT IT IS NECESSARY OR APPROPRIATE TO APPLY THE ADOPTED STANDARD AND AMENDMENTS TO SUCH AUDITS.

- **Emphasizing a Complementary Audit Approach**—Amendments to AU sec. 316 require the auditor to take into account other work performed during the audit when identifying a company's significant unusual transactions by specifically cross-referencing a variety of other auditing standards.
- **Emphasizing Accounting and Disclosure**—The amendments to AU sec. 316 emphasize that the auditor must evaluate whether the financial statements contain the information regarding significant unusual transactions necessary for a fair presentation in conformity with the applicable financial reporting framework.

EMERGING GROWTH COMPANIES

Section 104 of the Jumpstart Our Business Startups Act (the "JOBS Act") provides that any rules adopted by the PCAOB after April 5, 2012 do not apply to the audits of "emerging growth companies" unless the SEC determines such application to be "necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[6] Accordingly, the adopted standard and amendments will not apply to the audits of "emerging growth companies" unless the SEC determines that it is necessary or appropriate to apply the adopted standard and amendments to such audits. The

[6] See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002, as added by Section 104 of the JOBS Act. An "emerging growth company" generally means any issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year, other than a company that completed its initial public offering on or before December 8, 2011. For a discussion of the JOBS Act, see Sullivan & Cromwell's publication, dated March 27, 2012, entitled "Congress Passes the 'Jumpstart Our Business Startups Act.'"

PCAOB states in the release that it intends to request that the adopted standard and amendments be made applicable to emerging growth companies.

IMPLICATIONS FOR ISSUER MANAGEMENT AND AUDIT COMMITTEES

This new standard and the related amendments prescribe specific, mandatory procedures in place of the discretionary guidance and examples in the existing standards. For many public companies, this more targeted audit approach may not be a substantial departure from existing audit practices and procedures, but will instead enhance and expand them. Company management teams should be aware of these developments as they may affect audit firm practices and procedures relating to the preparation of financial statements, internal controls and risk management. The audit and compensation committees of a public company may wish to consider these developments in preparing meeting agendas to ensure proper attention is given to the auditor's expanded inquiry, communication and other requirements. Management may find taking the following actions helpful in light of these developments:

- review the company's internal controls and procedures on an ongoing basis to ensure that the company is adequately identifying, accounting for and disclosing transactions and relationships with related parties and significant unusual transactions;
- ensure that related party transactions and significant unusual transactions have been authorized or approved in accordance with the company's established policies and procedures and that adequate substantiation exists for departures from these procedures;
- prepare adequate evidence to support any statements in the financial statements that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction;
- ensure that adequate documentation and other evidence is available to substantiate the business purpose(s) for entering into related party transactions or significant unusual transactions;
- prepare and retain appropriate documentation for significant unusual transactions;
- prepare and document an evaluation of the financial capability of each counterparty to a significant unusual transaction to determine whether the counterparty can support the transaction without assistance from the company;
- ensure that the financial statements contain the information regarding related party transactions or significant unusual transactions necessary for fair presentation under the applicable reporting framework; and
- monitor employment and compensation contracts, structure, and policies and procedures to identify incentives or pressures to engage in fraudulent financial reporting and ensure internal controls addressing these risks are properly designed and operated.

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IN RECENT NEWS

IRS ISSUES LONG-AWAITED INSTRUCTIONS FOR FATCA FORM FOR ENTITIES, FORM W-8BEN-E

IRS ISSUES LONG-AWAITED INSTRUCTIONS FOR FATCA FORM FOR ENTITIES, FORM W-8BEN-E

IRS has released the long-awaited Instructions to Form W-8BEN-E (June 2014), Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities). This form is used exclusively by entities to document their status both as a payee under chapter 4 and a beneficial owner under chapter 3 of the Code, and to establish their status for withholding or reporting purposes under certain other Code sections.

Background. Chapter 3 of the Code (Code Sec. 1441 through Code Sec. 1464) deals with information reporting and withholding on foreign persons. It contains reporting and withholding rules relating to payments of certain U.S. source income (e.g., dividends on stock of U.S. companies) to non-U.S. persons. These payments are payments from sources within the U.S. that constitute (a) fixed or determinable annual or periodical (FDAP) income—such as interest, dividends, rents, and annuities; (b) certain gains from the disposal of timber, coal, or domestic iron ore with a retained economic interest; (c) gains relating to contingent payments received from the sale or exchange of patents, copyrights, and

similar intangible property; and (d) distributions of effectively connected income by a publicly traded partnership.

THE IGAS REPRESENT AN ALTERNATE MEANS TO IMPLEMENT FATCA IN A WAY THAT IS DESIGNED TO INCREASE REPORTING COMPLIANCE BY FFIS WHILE ADDRESSING DIFFICULTIES WITH IMPLEMENTATION UNDER FATCA PARTNER LOCAL LAW.

On Mar. 18, 2010, the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147) added chapter 4 (Code Sec. 1471 through Code Sec. 1474, the "Foreign Account Tax Compliance Act" or FATCA) to the Code. Chapter 4 requires withholding agents to withhold 30% of certain payments to a foreign financial institution (FFI) unless the FFI has entered into a "FFI agreement" with IRS to, among other things, report certain information with respect to U.S. accounts. (The withholding rules are essentially a mechanism to enforce new reporting requirements.) FFIs that have entered into FFI agreements are referred to as "participating FFIs." Chapter 4 also imposes withholding, documentation, and reporting requirements on withholding agents with respect to certain payments made to certain non-financial foreign entities. The statutory provisions are generally effective for payments made after Dec. 31, 2012, but their implementation has been delayed and phased in over several years.

IRS issued final FATCA regs on Jan. 17, 2013 that, among other things, provided for a phased implementation of the FATCA requirements over the period beginning on Jan. 1, 2014 and continuing through 2017. Subsequently, in Notice 2013-43, 2013-31 IRB 113, Treasury and IRS provided revised timelines for implementing various FATCA requirements with the goal of a more orderly implementation of FATCA.

Under the final regs, an FFI agreement generally includes a qualified intermediary (QI) agreement, withholding foreign partnership (WP) agreement, or withholding foreign trust (WT) agreement that is entered into by an FFI and that has an effective date or renewal date on or after Dec. 31, 2013. QIs, WPs and WTs are parties that have entered into agreements to withhold tax under Chapter 3 of the Code, i.e., the portion of the Code under which tax is withheld on nonresident aliens and foreign corporations.

To ease the burdens of FATCA implementation and compliance, the U.S. also issued two model intergovernmental agreements (IGAs) to be implemented between the U.S. and other countries (FATCA partners). The IGAs represent an alternate means to implement FATCA in a way that is designed to increase reporting compliance by FFIs while addressing difficulties with implementation under FATCA partner local law. In general, under the Model 1 agreements, FFIs would satisfy their chapter 4 requirements by reporting information about U.S. accounts to their respective tax authorities, which in turn would exchange that information on a government-to-government basis with the U.S.. Under Model 2 agreements, FFIs would provide specified information directly to IRS, supplemented by government-to-government exchange of information on request.

Newly released instructions. The Instructions for Form W-8BEN-E provide that a foreign entity must give Form W-8BEN-E to a withholding agent or payer if it is receiving a withholdable payment from the withholding agent, receiving a payment subject to chapter 3 withholding, or maintaining an account with an FFI requesting the form. A withholding agent or payer of income may rely on a properly completed Form W-8BEN-E to treat a payment as a payment to a foreign person who beneficially owns the amounts paid. If applicable, the withholding agent may rely on the Form W-8BEN-E to apply a reduced withholding rate or exemption from withholding. Those who receive certain types of income must provide Form W-8BEN-E to: (i) claim that they are the beneficial owner of the income or a partner in a partnership subject to Code Sec. 1446 (which requires a partnership conducting a trade or business in the U.S. to withhold tax on a foreign partner's distributive share of the partnership's effectively connected taxable income); and (ii) if applicable, claim a reduced withholding rate or exemption from withholding as a resident of a foreign country with which the U.S. has an income tax treaty that is eligible for treaty benefits.

Form W-8BEN-E should be provided to the withholding agent or payer before income is paid or credited. Failure to provide a Form W-8BEN-E when requested may lead to 30% withholding (foreign-person withholding rate) or the backup withholding rate. Form W-8BEN-E may be used to identify income from a notional principal contract that isn't effectively connected with the conduct of a trade or business in the U.S.

to establish the exception to reporting such income on Form 1042-S. Form W-8BEN-E may be required to claim an exception from domestic information reporting on Form 1099 and backup withholding (at the backup withholding rate under Code Sec. 3406) for certain types of income, including: broker proceeds, short-term (183 days or less) original issue discount (short-term OID), bank deposit interest, and foreign source interest, dividends, rents, or royalties.

In addition to the requirements of chapter 3, chapter 4 requires withholding agents to identify the chapter 4 status of entities that are payees receiving withholdable payments. A withholding agent may request this Form W-8BEN-E to establish a taxpayer's chapter 4 status and avoid 30% withholding (the chapter 4 rate) on the payments. Chapter 4 also requires participating FFIs and certain registered deemed-compliant FFIs to document their entity account holders in order to determine their chapter 4 status, regardless of whether withholding applies to any payments made to the entities. An entity maintaining an account with an FFI should provide Form W-8BEN-E when requested by the FFI in order to document its chapter 4 status.

Form W-8BEN-E isn't provided to IRS. It is given to the person who is requesting it from the taxpayer. Generally, this will be the person from whom the taxpayer receives the payment, who credits the taxpayer's account, or a partnership that allocates income to the taxpayer. An FFI may also request this form from the taxpayer to document the status of the taxpayer's account.

The Instructions also specify those who should not file Form W-8BEN-E. A partial list includes:

- U.S. persons (including U.S. citizens, resident aliens, and entities treated as U.S. persons, such as a corporation organized under the law of a state). Instead, use Form W-9, Request for Taxpayer Identification Number and Certification;
- foreign insurance companies that have made an Code Sec. 593(d) elections to be treated as a U.S. person. Instead, use Form W-9;
- nonresident alien individuals. Instead, use Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals);
- disregarded entities (not a hybrid entity claiming treaty benefits) with a single owner that is a U.S. person. Instead, the single owner should provide Form W-9; and
- foreign branches of a U.S. financial institution that is an FFI (other than a qualified intermediary branch) under an applicable Model 1 IGA. Instead, submit Form W-9 to certify to U.S. status for purposes of identifying self to withholding agents.