> Final Volcker Rule Regulations: Restrictions on Proprietary Trading

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On December 10, 2013, the U.S. federal banking agencies,[1] the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission (the "CFTC," and, together with the federal banking agencies and the SEC, the "Agencies") jointly adopted regulations (the "Final Regulations") to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule.[2] The Final Regulations were adopted more than two years after proposed regulations to implement the Volcker Rule (the "Proposed Regulations") were first published.[3]

The Volcker Rule prohibits any "banking entity" from (i) engaging in proprietary trading and (ii) acquiring and retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds and certain other private funds ("covered funds"), subject to certain exemptions.

In this Alert, we discuss the Volcker Rule's prohibition on proprietary trading, as those prohibitions implemented by the Final Regulations.[4]

Summary of Volcker Rule's Prohibition on Proprietary Trading

Under the Final Regulations, the proprietary trading restrictions do not apply to trading activity such as clearing, liquidity management, transactions in satisfaction of debts previously contracted, and other types of transactions that, in the view of the Agencies, do not involve an

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[1] The U.S. federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "FRB"), and the Federal Deposit Insurance Corporation (the "FDIC").

[2] The Final Regulations and accompanying statements, fact sheets, and related documents can be found on the websites of the Agencies. For example, they are available on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

[3] For a summary of the Proposed Regulations, *see* Proposed Volcker Rule Regulations: A Summary (Oct. 18, 2011). The Proposed Regulations can be found in the Federal Register at 76 FR 68846 (Nov. 7, 2011) and on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

[4] For a summary of some of the key highlights of the Final Regulations, *see* Regulators Adopt Final Volcker Rule Regulations (Dec. 11, 2013). For a summary of the Final Regulations' restrictions on covered fund activities, *see* Final Volcker Rule Regulations: Restrictions on Covered Fund Activities and Investments (Jan. 6, 2014). For a summary of the Final Regulations application to securitizations and other structured transactions, *see* Final Volcker Rule Regulations: Securitizations and Other Structured Transactions (Updated Jan. 16, 2014).

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intent by the banking entity to resell in order to profit from short-term price movements. These activities are excluded from the definition of proprietary trading.

With respect to the permitted proprietary trading activities:

- The Final Regulations clarify the parameters for permitted underwriting and related activities of trading desks in connection with the distribution of securities. Compliance programs specific to underwriting and related trading desk activities are required, and must include written policies and procedures, internal controls, analysis and testing, among other things, that address the trading desk activities and risks arising from the underwriting and related activities.

- The Final Regulations clarify parameters for permitted marking making. They do not require that market making-related activities be designed to generate revenues primarily from fees. Banking entities with significant trading activity must report data regarding patterns of revenue generation by market making desks. A banking entity may engage in market-making in different types of asset classes and market making-related activity may vary based on the liquidity, maturity and depth of the market for the particular financial instrument. Under the Final Regulations, dealers in securities, derivatives and other financial instruments may continue to act as principal when making markets.

- The Final Regulations permit hedging of specific and aggregate positions. However, any permitted hedging activity, at the inception of the hedge, must be designed to demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks to the banking entity in connection with, and related to, positions, contracts or other holdings of the banking entity.

- The exemption for proprietary trading by regulated insurance companies includes both trading through general accounts and separate accounts. Under the Proposed Regulations, separate account trading would have been permitted under the exemption for trading on behalf of customers.

- The exemption for trading by foreign banking entities has been changed from a transaction-based to risk-based approach. As under the Proposed Regulations, this exemption is not available to U.S. firms and their subsidiaries (including foreign subsidiaries). Under this new approach, a foreign banking entity may rely on the exemption only if:

    - the foreign banking entity acts as principal in the purchase or sale outside the U.S.,

    - the banking entity (including relevant personnel) that makes the decision to purchase or sell is not located in the U.S.,

    - the purchase or sale, including any related hedging transactions, is not accounted for as principal in the U.S.,

    - no financing for the banking entity's purchase or sale is provided by a U.S. affiliate of the foreign banking entity, and

  - the purchase or sale is not conducted with or through any U.S. entity, other than on an anonymous basis on a U.S. exchange or through an unaffiliated intermediary in a transaction cleared through a U.S. central counterparty, or in a transaction with the foreign operations of a U.S. entity.

- The Final Regulations provide a new exemption for certain trading in foreign government obligations by certain banking entities. Specifically, the Final Regulations permit:

  - trading by the U.S. operations of a foreign banking entity, other than an insured depository institution, in obligations of the home chartering authority of the foreign banking entity (including obligations of any agency or political subdivision thereof), and

  - trading by a foreign bank or foreign securities broker-dealer owned by a U.S. banking entity in obligations of the foreign sovereign that charters the foreign bank or foreign broker-dealer (including obligations of any agency or political subdivision thereof).

I. Banking Entity

The prohibitions of the Volcker Rule apply to "banking entities." The Final Regulations track the statutory definition (and the definition in the Proposed Regulations) closely in broadly defining a "banking entity" as any of the following:

- Any insured depository institution (other than certain limited purpose trust institutions);

- Any company that controls an insured depository institution;

- Any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (12 U.S.C. § 3106); and

- Any affiliate or subsidiary of any of the foregoing (as defined in the Bank Holding Company Act of 1956 (the "BHC Act").[5]

The Final Regulations provide exclusions from the definition of banking entity for:

- A covered fund that is not itself a banking entity under the first three bullets above (accordingly, a covered fund will not be a banking entity solely because it is a subsidiary or affiliate of a banking entity);

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[5] Final Regulations § __.2(c)(1). "Affiliate" and "subsidiary" are defined by reference to the definitions of those terms in Sections 2(k) and 2(d) of the BHC Act, respectively. 12 U.S.C. §§1841(k) and (d). A company is a "subsidiary" of a banking entity (and therefore a banking entity itself, except as excluded in the Final Regulations (see above)) if the banking entity owns, controls, or has the power to vote 25% or more of the voting shares of the company, has control over the election of a majority of the company's directors, or otherwise has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the company. 12 U.S.C. § 1841(d). A company is an affiliate of a banking entity (and therefore a banking entity itself, except as excluded in the Final Regulations (see above)) if the company controls, is controlled by, or is under common control with the banking entity. 12 U.S.C. § 1841(k).

- A portfolio company held under merchant banking authority or insurance company investment authority of the BHC Act, or a portfolio concern controlled by a small business investment company ("SBIC"), so long as the portfolio company or portfolio concern is not a banking entity under the first three bullets above; or
- The FDIC acting in its corporate capacity as conservator or receiver.[6]

II. Proprietary Trading, Generally

The Volcker Rule prohibition on proprietary trading is, on its face, quite simple: it bans a banking entity from engaging as principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, a security, derivative, contract of sale of a commodity for future delivery, or other financial instrument that the Agencies include by rule.[7]

This ban, however, combined with the sweeping definition of banking entity, requires that financial institutions and their affiliates around the world evaluate current activities ,and potentially revisit contemplated activities, in order to ensure compliance upon the effective date of the Final Regulations. Furthermore, the seemingly straightforward principles embodied in the ban on proprietary trading create a complex web of potential and actual issues, which the Final Regulations and the preamble to the Final Regulations ("Preamble") try to address. Together, the text in the Final Regulations and the discussion in the Preamble on Proprietary Trading come to over 450 pages, and still there are innumerable mysteries to be solved in assessing (1) whether an activity is caught in the ban, and (2) whether a seemingly excluded (i.e., permitted) activity actually is prohibited.

Although some commenters requested a bright-line rule for greater certainty, the Agencies deemed that a Final Regulation capturing only "bright-line, speculative proprietary trading" would be inconsistent with Congressional intent because it would not give effect to the limitations on permitted activities that were enacted as part of the Dodd-Frank Act.[8]

The Agencies addressed commenters' concerns about the likely reduction in available liquidity resulting from the prohibition on proprietary trading.[9] While the Agencies acknowledged that the termination of prohibited proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes, they also expressed the view that these liquidity reductions might be temporary.[10] The Agencies suggested that non-banking entity market

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[6] Final Regulations § ___.2(c)(2). These are broader exclusions than were provided in the Proposed Regulations, which would have excluded only an affiliate or subsidiary of a banking entity if the affiliate or subsidiary is a covered fund that is organized, offered and held by a banking entity pursuant to the exemption for organizing and offering a covered fund. *See* Final Volcker Rule Regulations: Restrictions on Covered Fund Activities and Investments (Jan. 6, 2014).

[7] *See* 12 U.S.C. 1851(h)(4). *See* Appendix A for the definition of "contract of sale of a commodity for future delivery."

[8] Preamble at 29-30.

[9] *Id.*

[10] *Id.* at 30-31.

participants likely would, over time, provide much of the lost liquidity, and thus mitigate anticipated increased trading costs, higher costs of capital, and greater market volatility resulting from the loss of liquidity.[11] In addition, the Agencies speculated that the exemptions in the Final Regulations that permit banking entities to continue to provide beneficial market-making and underwriting services to customers should also reduce the anticipated loss of liquidity forecast by commenters.[12]

The Agencies acknowledged the challenges for banking entities attempting to navigate the complexities of the ban on proprietary trading. In response to comments, as discussed in more detail below, the Agencies, among other things:

- Expressly excluded from the definition of proprietary trading certain kinds of transactions, such as, but not limited to, those arising under certain repurchase and reverse repurchase agreements, certain securities lending agreements, certain bona fide liquidity management transactions, and purchases and sales of one or more financial instruments in connection with clearing financial instruments by a clearing agency or derivatives clearing organization;
- Acknowledged that the rule likely would result, over time, in a shift among in liquidity providers to entities not subject to the prohibition;
- Significantly reduced, though by no means eliminated, the impact of the ban on certain non-U.S. banking entities; and
- Addressed questions about how "trading accounts" should be administered to assess for permitted and prohibited activities.

III. Proprietary Trading in a Trading Account

(A) "Trading Account."

The Final Regulations specify that a banking entity may not trade financial instruments as principal for a trading account. "A "trading account" is defined as "any account that is used by a banking entity" to engage in one or more of three enumerated types of activities:

- Purchase[s or sales of] one or more financial instruments principally for the purpose of . . . short-term resale;. . . [b]enefitting from actual or expected short-term price movements; . . . [r]ealizing short-term arbitrage profits; or . . . [h]edging one or more positions resulting from the purchases or sales of [certain] financial instruments . . . .;
- Purchase[s or sales of] one or more financial instruments that are both market risk capital rule covered positions and trading positions[13] (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured

[11] *Id.*

[12] *Id.*

[13] *See* Appendix A for the definition of "market risk capital rule covered position and trading position."

depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule;[14] ***or***

- Purchase[s or sales of] one or more financial instruments for any purpose, if the banking entity . . . [i]s licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or . . .[i]s engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[15]

The definition of "trading account" also includes a rebuttable presumption that purchases and sales of financial instruments by a banking entity shall be deemed for the banking entity's trading account if certain conditions are met.[16]

(1) Short-term trading in a trading account.

"Short-term trading" is defined in the Final Regulations as a banking entity trading financial instruments as principal in a trading account for the purpose of:

- Short-term resale;
- Benefitting from actual or expected short-term price movements;
- Realizing short-term arbitrage profits; or
- Hedging one or more positions resulting from the purchases or sales of financial instruments that falls within any of the above.[17]

While Congress's concerns, reflected in the Dodd-Frank Act, generally focused on short-term trading, the Final Regulations reflect the Agencies' determination that an analysis of the economics of a banking entity's trading activity will help the banking entity determine whether it is engaged in proprietary trading.[18] The Agencies also noted that they included within the prohibition provisions regarding price movements and arbitrage - the economic equivalent of "transactions that are principally for the purpose of selling in the near term or with the intent to resell to profit from short-term price movements" - in order to prevent evasion of the statute and Final Regulations. One result of this determination is that the Final Regulations prohibit transactions in intended to benefit from short-term price movements or to benefit from differences in multiple

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[14] *See* Appendix A for the definition of "market risk capital rule."

[15] Final Regulations § __.3(b)(1).

[16] Final Regulations § __.3(b)(2). The Final Regulations also include numerous defined terms. Some of these terms are used specifically with regard to permitted market making and underwriting, and other terms are used throughout the Final Regulations and the Preamble's discussion of proprietary trading. We have included the definitions in Appendix A to this Alert.

[17] Final Regulations § __.3(a) and (b). *See also* Preamble at 32.

[18] Preamble at 37-38.

market prices, including where price movement is not necessary to realize the intended profit.[19] Moreover, because the Agencies assumed that a banking entity generally intends to hold a hedging position in a trading account for only so long as the underlying position is held, short-term trading also includes hedging one or more positions captured by the short-term trading prong of the prohibition.[20]

(2) Market risk capital rule trading by certain entities.

The second category of trading account activity involves purchases and sales of one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity:

- Is an insured depository institution, bank holding company, or savings and loan holding company; and
- Calculates risk-based capital ratios under the market risk capital rule ("Market Risk Capital Rule").[21]

The Agencies believe that this category (along with the third "dealer" category discussed below) is not duplicative of the short-term trading category, but is "mutually reinforcing, strengthen[s] the [Final Regulations'] effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the [banking entity's] trading account."[22] The Agencies noted that this "reinforces the consistency between governance of the types of positions that banking entities identify as "trading" for purposes of the market risk capital rules and those that are "trading" for purposes of the [Final Regulations and] . . . reduces the compliance burden on banking entities with substantial trading activities by establishing a clear, bright-line rule for determining that a trade is [, or is not,] within the trading account."[23]

(3) Trading by a dealer.

The third category of trading account activity involves the purchase or sale of one or more financial instruments *for any purpose* if the banking entity [i]s:

- Licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

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[19] *Id.* at 39. For example, a banking entity could realize a profit due to price differences across markets, without any price movements on such markets. *Id.*

[20] *Id.*

[21] Final Regulations § __.3(b)(1)(ii).

[22] Preamble at 39-40.

[23] *Id.* at 40-41.

- Engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the U.S., to the extent the instrument is purchased or sold in connection with the activities of such business.[24]

The Agencies noted that they "believe the scope of the dealer [category] is appropriate because . . . positions held by a registered dealer in connection with its dealing activity are generally held for sale to customers upon request or otherwise [to] support the firm's trading activities, . . . which is indicative of short-term intent."[25] The Agencies also stated that it is "appropriate" to extend the dealer category to non-U.S. dealers due to concerns about regulatory arbitrage.[26]

The Agencies noted that the "broad scope of the dealer trading account is balanced by the exemptions that are designed to permit dealer entities to continue to engage in customer-oriented trading activities," described in greater detail below.[27] The Agencies acknowledged that a possible burden resulting from the dealer category is that banking entities that do not currently analyze whether a particular activity would require dealer registration will now have to engage in this analysis.[28]

(B) Rebuttable Presumption of Proprietary Trading.

The Final Regulations include a "rebuttable presumption" that a banking entity is engaged in short-term trading if it "holds [a] financial instrument for *fewer than sixty days* or substantially transfers the risk of the financial instrument within sixty days of purchase (or sale)."[29] To rebut the presumption, a banking entity must "demonstrate, based on all relevant facts and circumstances, that [it] did not purchase (or sell) the financial instrument principally for the purpose of" prohibited short-term trading (described above).[30]

The "purpose of the rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the trading account," and should ensure consistency in interpretation and create a level playing field for all banking entities."[31] The Agencies believe that facts and circumstances might rebut the presumption when, for instance, "an unexpected increase in [a] financial instrument's volatility or a need to liquidate the instrument to meet unexpected liquidity demands," results in a banking entity disposing of a financial instrument intended as a long-term investment within 60 days of its purchase.[32] The Agencies also noted that

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[24] Final Regulations § __.3(b)(1)(iii).
[25] Preamble at 41.
[26] Preamble at 43.
[27] *Id.*
[28] *Id.* at 42.
[29] Final Regulations § __.3(b)(2) (emphasis added).
[30] *Id.*
[31] Preamble at 46.
[32] *Id.* at 47.

"[t]o reduce the costs and burdens of rebutting the presumption, . . .a banking entity [may] rebut the presumption for a group of related positions."[33]

IV. "Financial Instrument"

As noted above, banking entities are prohibited from engaging in proprietary trading in "financial instruments." The definition of "financial instrument" in the Final Regulations is:

- A security, including an option on a security;
- A derivative, including an option on a derivative; or
- A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[34]

The Final Regulations specify, however, that "financial instrument" does not include:

- A loan;[35]
- A commodity that is not:
  - an excluded commodity (other than foreign exchange or currency);[36]
  - a derivative;
  - a contract of sale of a commodity for future delivery; or
  - an option on a contract of sale of a commodity for future delivery; or
- Foreign exchange or currency.[37]

The definition of "financial instrument" is intentionally comprehensive, in an effort to encompass all the financial instruments that the statutory "proprietary trading prohibition . . . was designed to

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[33] *Id.*

[34] Final Regulations § __.3(c)(1).

[35] A "loan" is defined in the Final Regulations as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative." Final Regulations § __.2(s). In the Preamble, "the Agencies note that the parties' characterization of an instrument as a loan is not dispositive of its treatment under the federal securities laws or federal laws applicable to derivatives. . . . [Rather, t]he determination of whether a loan is a security or a derivative [and therefore a "financial instrument"] for purposes of the loan definition is based on the federal securities laws and the Commodity Exchange Act. . . . . Whether a loan is a "note" or "evidence of indebtedness" and therefore a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan." *See* Preamble at 529-530.

[36] An excluded commodity is defined to have the same meaning as in section 1a(19) of the Commodity Exchange Act. *See* Preamble at 53.

[37] Final Regulations § __.3(c)(2).

cover."[38] The Agencies also noted that the express exclusion from the definition of "financial instrument" of certain types of instruments is intended to provide clarity that "the purchase and sale of loans, commodities, and foreign exchange or currency . . . are outside the scope of transactions to which the proprietary trading restrictions apply."[39] The Agencies noted as an example that "the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion."[40]

V. Exclusions to Proprietary Trading

The Final Regulations include express exclusions from "proprietary trading" for activities that the Agencies do not believe are proprietary trading as defined by the statute or Final Regulations and therefore are not prohibited activities under the Volcker Rule.[41]

(A) Certain Repurchase and Reverse Repurchase Agreements and Securities Lending Agreements.

A banking entity may engage in any "purchase or sale of one or more financial instruments . . . that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty."[42] A banking entity may also engage in any purchase or sale of one or more financial instruments . . . that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties."[43] The Agencies noted that such transactions are not normally considered proprietary trading, however, they warned that they will continue to monitor such activities to ensure that they are not being used to circumvent the rule.[44] The Agencies also clarified that the exclusion will not apply to any collateral or positions being financed by the repurchase or reverse repurchase agreement, rather it will only apply to the actual

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[38] Preamble at 53.

[39] *Id.* at 54

[40] *Id.* The Agencies noted that "[w]hile some commenters requested that certain instruments such as foreign exchange swaps and forwards be excluded from the definition of derivative or financial instrument, . . . the Agencies believe that these instruments appear to be, or operate in economic substance as, derivatives. . . . If these instruments were not included within the definition of financial instrument, banking entities could use them to engage in proprietary trading, that is inconsistent with the purpose and design of section 13 of the BHC Act." *See id.*

[41] Preamble at 55-56. The Agencies also noted that they believe the "exclusions for . . . non-proprietary activities will likely promote more cost-effective financial intermediation and robust capital formation." *Id.*

[42] Final Regulations § __.3(d)(1).

[43] Final Regulations § __.3(d)(2).

[44] Preamble at 59.

"transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement."[45]

(B) *Bona Fide* Liquidity Management Purposes.

A banking entity may engage in any purchase or sale of a security for the purpose of liquidity management in accordance with a documented liquidity management plan that meets the following requirements:

- Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of the securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used;
- Requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;
- Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;
- Limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan;
- Includes written policies and procedures, internal controls, analysis and independent testing to ensure that the purchase and sale of securities that are not permitted under § __.6(a) or (b) of the Final Regulations are for the purpose of liquidity management and in accordance with the liquidity management plan described [herein]; and
- Is consistent with the [appropriate agency's] supervisory requirements, guidance and expectations regarding liquidity management.[46]

The Agencies recognize that liquidity management activity "serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act and in rules and guidance of the

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[45] *Id.* at 59-60. If a banking entity has any short positions as a result of securities lending agreements, they also will not be excluded from prohibited proprietary trading.

[46] *See* Final Regulations § __.3(d)(3).

Agencies, of ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs."[47]

While the Agencies remarked that banking entities that engage in bona fide liquidity management activities generally do not purchase or sell financial instruments for the purpose of short-term resale or to benefit from actual or expected short-term price movements,[48] the Agencies did not expand the provision to allow for asset-liability management, earnings management, or scenario hedging. The Agencies noted that such activities would need to qualify for another exemption in order to be permissible.[49]

(C) Certain Clearing Agencies, Derivatives Clearing Organizations in Connection with Clearing Activities.

A banking entity may purchase or sell one or more financial instruments in connection with clearing financial instruments if it is a derivatives clearing organization or a clearing agency.[50] In order to promote one of the goals of the Dodd-Frank Act - promotion of central clearing of financial transactions - the Agencies excluded clearance and settlement transactions and also acknowledged that banking entities provide clearing services for third parties, not for their own short-term resale or to obtain short-term price movements.[51] The exclusion, however, is narrowly tailored.[52] In addition to SEC and CFTC registered clearing and derivatives clearing agencies, respectively, certain foreign clearing agencies and foreign derivatives clearing organizations may also rely on the exclusion.[53]

(D) Members of a Clearing Agency, Derivatives Clearing Organization, or Designated Financial Market Utility Engaged in Excluded Clearing-Related Activities.

A banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility may engage in any excluded clearing activities.[54] The Agencies stated that "certain core clearing-related activities conducted by a clearing member, often as required by regulation or the rules and procedures of a clearing agency, derivatives clearing organization, or designated financial market utility, represent proprietary trading as contemplated by the statute."[55] The exclusion ensures that the covered organizations can engage in clearing-related transactions that provide important benefits to the

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[47] Preamble at 63.

[48] *See id.* at 66.

[49] *Id.*

[50] Final Regulations § __.3(d)(4). *See* Appendix A for the definitions of "clearing agency" and "derivatives clearing organization."

[51] Preamble at 67-69.

[52] *Id.* at 69.

[53] *Id.* at 68.

[54] Final Regulations § __.3(d)(5). *See* Appendix A for the definitions of "designated financial market utility" and "excluded clearing activities."

[55] Preamble at 71.

financial system such as reducing counterparty risk.[56] The Agencies noted that although they are specifying certain permissible activities, they may, in the future provide additional guidance or relief, if necessary.[57]

(E) Satisfaction of Existing Delivery Obligations/Satisfaction of an Obligation of the Banking Entity in Connection with a Judicial, Administrative, Self-Regulatory Organization, or Arbitration Proceeding.

A banking entity may purchase or sell one or more financial instruments, so long as the "purchase (or sale) satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity *or* the purchase (or sale) satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding."[58] These limited exclusions are intended to address a situation where a banking entity is "subject to conflicting or inconsistent regulatory requirements" or a judicial or regulatory body orders a banking entity to purchase or sell financial instruments.[59]

(F) Acting Solely as Broker, Agent, or Custodian.

A banking entity may purchase or sell one or more financial instruments if it is acting solely as agent, broker, or custodian.[60] Although the Proposed Regulations clarified that acting as agent, broker, or custodian does not constitute trading as "principal," the Agencies expressly excluded acting as agent, broker, or custodian from the definition of proprietary trading and also included certain affiliates within the exclusion.[61] The Agencies warned, however, that if a banking entity acts as both principal and agent on a transaction, only the portion of the transaction on which it acted as agent would qualify for the exclusion and it would need to rely on another exemption or exclusion for the principal portion of the transaction to be permissible.[62]

(G) Purchases or Sales Through a Deferred Compensation or Similar Plan.

A banking entity may purchase or sell "one or more financial instruments . . . through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are (or were) employees of the banking entity."[63] The Agencies stated that "purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do

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[56] *Id.* at 71-72.
[57] *Id.* at 73.
[58] Final Regulations § __.3(d)(6) (emphasis added).
[59] Preamble at 74-76.
[60] Final Regulations § __.3(d)(7).
[61] Preamble at 76-77.
[62] *Id.* at 77.
[63] Final Regulations § __.3(d)(8).

not constitute the type of principal trading that is covered by the statute."[64] The Agencies also noted that a banking entity would not be engaged in impermissible proprietary trading if it engaged in trading activity for an unaffiliated pension or similar deferred compensation plan, as long as the banking entity was acting solely as agent, broker or custodian.[65]

(H) Satisfaction of a Debt Previously Contracted.

A banking entity may purchase or sell "one or more financial instruments . . . in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and in no event . . . retain[s] such instrument for longer than [the] period permitted by the Agency."[66] This exclusion permits banking entities to continue to extend margin loans, take possession of collateral, if necessary, take, hold and exchange margin collateral as counterparty to certain swaps and comply with certain regulatory requirements.[67]

VI. Market Making-Related Activities.

Section 4(b) of the Final Regulations provides that the prohibition on proprietary trading will not apply to market making-related activities that a banking entity undertakes in order to provide important intermediation and liquidity services to its clients, customers, and counterparties.[68] The Final Regulations support a flexible approach to this exemption because, as stated by the Agencies, market-maker activities will vary based on differences across markets and asset classes.[69] In order for trading activity to fall within this exemption, all of the following criteria must be satisfied.[70]

(A) Criteria for Market-Making Exemption.

(1) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell.[71]

The requirements of the provisions permitting certain market-making activities apply to the "trading desk that establishes and manages the financial exposure."[72] A "trading desk" is the "smallest discrete unit" of the banking entity that purchases or sells financial instruments for the account of that entity and/or an affiliate.[73] Significantly, the Agencies concluded that "a trading

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[64] Preamble at 78.
[65] *Id.*
[66] Final Regulations § __.3(d)(9).
[67] Preamble at 79.
[68] Final Regulations § __.4(b)(1).
[69] Preamble at 140.
[70] Final Regulations § __.4(b)(2).
[71] *Id.* at § __.4(b)(2)(i).
[72] Preamble at 192.
[73] Final Regulations § __.3(e)(13). *See* Preamble at 193. *See also* Appendix A for the definition of "trading desk."

desk need not be constrained to a single legal entity." Rather, as discussed below, even if members of a trading desk are not located in a single office or affiliate of a banking entity, their activities are managed and operated as an individual unit for which profit and loss is attributed.[74]

Underpinning the exemption for certain market making-related activities from the prohibition on proprietary trading are the key concepts of: 1) market-maker inventory, and 2) financial exposure that results from the trading activity of a particular trading desk. These concepts are defined in the Final Regulations as follows:

- *[M]arket-maker inventory* means all of the positions in the financial instruments for which the trading desk stands ready to make a market . . . that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[75]
- *[F]inancial exposure* means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.[76]

Simply put, a trading desk's market-maker inventory is the position(s) in financial instruments that the trading desk stands ready to buy and sell (or otherwise transact in), and the financial exposure of a trading desk is the risk from that inventory, as well as the risk from the positions acquired to manage that risk (and the risk of positions acquired incidentally while doing so).[77]

This reflects the Agencies' focus in the Final Regulations on analysis of the overall financial exposure of the banking entity and its affiliates through a trading desk. This focus is a result of significant criticism of the Proposed Regulations' approach of transaction-by-transaction analysis.[78]

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[74] Preamble at 103.

[75] Final Regulations § __.4(b)(5).

[76] *Id.* at § __.4(b)(4).

[77] The Agencies stated that: "The market-maker inventory of a trading desk includes the positions in financial instruments, including derivatives, in which the trading desk acts as a market maker. The financial exposure of the trading desk includes the aggregate risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk acts as a market maker, but in which the trading desk does not itself make a market, as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker." Preamble at 195-96. Furthermore, "[T]he term 'aggregate' does not imply that a long exposure in one instrument can be combined with a short exposure in a similar or related instrument to yield a total exposure of zero. Instead, such a combination may reduce a trading desk's economic exposure to certain risk factors that are common to both instruments, but it would still retain any basis risk between those financial instruments or potentially generate a new risk exposure in the case of purposeful hedging." *Id.* at 201.

[78] Preamble at 145-47, 157, 167-68.

To qualify as engaged in market making, a trading desk must have inventory and risk limits, as well as escalation procedures for when limits may be or are exceeded, on its financial exposure.[79] A trading desk's financial exposure may include positions booked in the different legal entities that contribute to the trading desk.[80] For instance, a trading desk may direct another organizational unit of the banking entity to execute a risk-managing transaction on its behalf; if so, that other unit may rely on the market-making exemption if it acts in accordance with the trading desk's risk management policies and procedures and the resulting position is attributed to the trading desk's financial exposure.[81]

To fall within the market-making exemption, a trading desk must routinely stand ready to transact in financial instruments related to its financial exposure.[82] Standing ready includes being willing and available to quote, buy and sell (or otherwise enter into long and short positions in) the financial instruments in commercially reasonable amounts and throughout market cycles.[83] It is not sufficient for a trading desk to provide wide quotations or be only willing to trade on an irregular, intermittent basis.[84]

The Final Regulations' standard of "routinely" standing ready is a refinement of the Proposed Regulations' proposed standard to hold oneself out as being willing to transact "on a regular or continuous basis."[85] Responding to several commenters who believed the proposal requirement was impractical in less liquid markets and would have a chilling effect on market-making, the agencies modified the Final Regulations and its guidance to clarify that "routinely" standing ready must be interpreted to account for differences across markets and asset classes.[86] Thus, the requirement to routinely stand ready to transact will differ based on the "liquidity, maturity, and depth of the market" for a given financial instrument.[87] At one extreme, a market maker in liquid equity securities is expected to engage in very regular or continuous quoting and trading activity on both sides of the market; whereas, at the other extreme, a market maker in a highly illiquid market may trade only intermittently or by request from particular customers.[88] Regardless of differences across markets and asset classes, a trading desk should have a pattern of quoting and trading on both sides of the market.[89]

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[79] *Id.* at 199-200.

[80] *Id.* at 203.

[81] *Id.* at 203-04.

[82] *Id.* at 186.

[83] *Id.*

[84] *Id.* Wide quotations are quotations that are wide "on one or both sides of the market relative to prevailing market conditions." *Id.*

[85] *Id.* at 186-87.

[86] *Id.* at 187.

[87] *Id.* at 207-08.

[88] *Id.* at 208-09.

[89] *Id.* at 210.

Standing ready to transact in "commercially reasonable amounts" requires a trading desk generally to quote and trade in sizes requested by other market participants.[90] A trading desk must make a market through "market cycles" and not just when it is most favorable to do so.[91]

The availability of the market making exemption is not limited to financial instruments on certain trading platforms or financial instruments that meet certain liquidity requirements.[92]

(2) The amount, types, and risks of the financial instruments in the market-maker inventory are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[93]

An analysis of a trading desk's market-maker inventory is required to determine whether this inventory is "related to the reasonably expected near term demands of clients, customers, or counterparties."[94] The market-maker inventory is analyzed, rather than the financial exposure of a trading desk, because positions in the desk's money-market inventory are more directly related to customer demand than risk-managing positions in the financial exposure of that desk.[95] Based on this analysis, a banking entity must establish risk and inventory limits for each trading desk designed to prevent trading activity unrelated to market-making or managing the risk of specific market-making.[96] The near term customer demand requirement directly applies only to the market-maker inventory; however, limits based on the near term customer demand requirement must be set for not only the market-maker inventory but for the "products, instruments, and exposures" the desk may use for risk management purposes, and the aggregate financial exposure.[97]

Two factors are specified for assessing whether the "amount, types, and risks of the financial instruments" in the market-maker inventory are designed not to exceed near term customer demand.[98]

- For each financial instrument, the "liquidity, maturity, and depth of the market" must be considered.[99]

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[90] *Id.* at 210-11.

[91] *Id.* at 212.

[92] *Id.* at 213.

[93] Final Regulations § __.4(b)(2)(ii).

[94] Preamble at 198-99.

[95] *Id.* at 239.

[96] *Id.* at 239-40.

[97] *Id.*

[98] *Id.* at 240.

[99] Final Regulations § __.4(b)(2)(ii)(A); Preamble at 240. Very generally, in more liquid markets, customer demand is likely to be more frequent and market-makers should have higher rates of inventory turnover and less aged inventory. Preamble at 253-54. When considering a less mature market, for which it will be more difficult to predict customer demand due to a lack of historical analysis, banking entities are encouraged to consider their experience with similar products. *Id.*

- There must be a demonstrable analysis (generally based on trading desk records and market information) of the following: "historical customer demand," "current inventory of financial instruments," and market and other factors regarding the risks associated with the financial instruments in which the trading desk makes a market, including through block trades.[100] The demonstrable analysis should also account for how the "liquidity, maturity, and depth of the market" may impact the inventory that the trading desk may need in order to meet the reasonably expected near term demands of clients, customers or counterparties.[101]

"Clients, customers, or counterparties" that create this customer demand are broadly defined as "market participants that make use of the banking entity's market making-related services."[102] The trading desk of a large banking entity ($50 billion or more in total trading assets and liabilities), is *not* a "client, customer or counterparty," unless the market-maker can document why this other banking entity should be treated as a customer.[103]

The Preamble provides guidance for interpreting the near term customer demand requirement in three specific situations: acting as a primary dealer for a sovereign government;[104] acting as an Authorized Participant (or simply a market-maker) in an exchange-traded fund;[105] and engaging in interdealer trading.[106] However, the Agencies have determined that a fourth specific situation, where a trading desk is wholly or principally engaged in arbitrage trading not driven by customer, client or counterparty demand, will not qualify for the market-making exemption.[107] A trading desk may be able to use the market-making exemption to acquire the risk associated with complex structured products if that trading desk has evidence of customer demand for each of the associated significant risks, based on prior express interest.[108]

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[100] Final Regulations § __.4(b)(2)(ii)(B); Preamble at 240-41. This analysis need not be done on an instrument-by-instrument basis. Preamble at 261. This analysis is necessary to ensure that determinations of customer near term demand and associated inventory levels comply with the standards articulated in the Final Regulations. *Id.* at 255-56. An appropriate analysis will not be static, but rather both backward- and forward-looking by taking into account historical trends and events expected to occur in the near future. *Id.* at 256-57.

[101] *Id.* at 258. Other potential factors that could be assessed include "recent trading volumes and customer trends," "trading patterns of specific customers," "analysis of the banking entity's . . . ability to win new customer business," "schedule of maturities in customers' existing portfolios," and "expected market events, such an index rebalancing." *Id.*

[102] *See* Appendix A for the definition of "clients, customers, or counterparties," found in Section 4(b) of the Final Regulations.

[103] Preamble at 245.

[104] *Id.* at 247-48.

[105] *Id.* at 248-50.

[106] *Id.* at 252-53.

[107] *Id.* at 251.

[108] *Id.* at 258-59.

(3) The banking entity implements, maintains, and enforces an internal compliance program that is reasonably designed to ensure its compliance with the market-making exception.[109]

Certain banking entities will be subject to enhanced compliance reporting and requirements, depending on their size.[110] The compliance program must satisfy the requirements of subpart D of the Final Regulations and include "reasonably designed written policies and procedures, internal controls, analysis, and independent testing,"[111] which must identify and address five specific topics.[112] These are:

- Products, instruments, and exposures the trading desk stands ready to purchase or sell as market maker or for risk management purposes.[113]
- Actions the trading desk will take to "demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the required limits." For each trading desk, this includes the "policies, instruments, and exposures" it may use for risk management purposes, as well as the "techniques and strategies" it may use to "manage the risks of its market making-related activities and inventory." The program also must identify the "process, strategies, and personnel responsible for ensuring" that risk-mitigating actions taken by the trading desk are and continue to be effective. [114]
- Limits for each trading desk that address the factors prescribed by the near term customer demand requirement. These will be "based on the nature and amount of the trading desk's

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[109] Final Regulations § __.4(b)(2)(iii).

[110] Final Regulations, Subpart D.

[111] The Preamble notes that the independent testing standard is described in further detail in Subpart D of the Final Regulation and Part IV.C of the Preamble, which discuss the compliance program requirement. Preamble at 265 n.951.

[112] *Id.* at 264-65.

[113] *Id.* at 267; Final Regulations § __.4(b)(2)(iii)(A). This identification will prevent an individual trader from "establishing positions in instruments that are unrelated to the desk's market-making function." Preamble at 267. This identification of instruments also helps "form the basis for the specific type of inventory and risk limits that the banking entity must establish." *Id.* S*ee* Final Regulations § __.4(b)(2)(iii)(C). It is also relevant to considerations "regarding the liquidity, depth, and maturity of the market for the relevant financial instrument." Preamble at 267. *See, e.g.,* Final Regulations § __.4(b)(2)(iii)(A).

[114] Final Regulation at § __.4(b)(2)(iii)(B). "The risk management techniques developed and used by a trading desk must be independently tested or verified by management separate from the trading desk." Preamble at 274. The Agencies stated in the Preamble that a banking entity should be able to demonstrate the relationship between the market-making instruments and the instruments used to manage the risk in the market-making instruments, and show why the latter instruments "appropriately and effectively mitigate risk . . . without generating an entirely new set of risks that outweigh the risks that are being hedged." *Id.* at 267-68. Written policies and procedures also must describe "how and under what timeframe a trading desk must remove hedge positions once the underlying exposure is unwound." *Id.* at 273.

market making-related activities."[115] Limits must be specifically set for each trading desk regarding:

- The amount, types, and risks of its market maker inventory;[116]
- The amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes;[117]
- Level of exposures to relevant risk factors arising from its financial exposure;[118] and
- Period of time a financial instrument may be held.[119]

- "Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its required limits."[120]
- "Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s)." [121]

The compliance program also must provide the "process and personnel responsible" for ensuring that the risk-managing activities of the market-making trading desk "are and continue to be effective."[122] If these monitoring procedures show that the trading desk's risk management procedures are ineffective, "such deficiencies must be promptly escalated and remedied" in accordance with established escalation procedures.[123]

The written policies and procedures must also "set forth the process for determining the circumstances under which a trading desk's risk management strategies may be modified" on a temporary or permanent basis.[124] This should include "potential scenarios" when a trading desk's limits should be raised or lowered.[125] There must also be escalation procedures that require "review and approval of any trade that would exceed one or more of a trading desk's limits."[126] Also required is a demonstrable analysis that the basis for any increase is consistent with the near

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[115] Final Regulations § __.4(b)(2)(iii)(C).
[116] *Id.* at § __.4(b)(2)(iii)(C)(1).
[117] *Id.* at § __.4(b)(2)(iii)(C)(2).
[118] *Id.* at § __.4(b)(2)(iii)(C)(3).
[119] *Id.* at § __.4(b)(2)(iii)(C)(4).
[120] *Id.* at § __.4(b)(2)(iii)(D).
[121] The procedures must include "demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of" the reasonably expected near term demands of clients, customers, or counterparties. Independent review of this demonstrable analysis is also required, and this must be conducted by "risk managers and compliance officers at the appropriate level independent of the trading desk." *Id.* at § __.4(b)(2)(iii)(E).
[122] Preamble at 273.
[123] *Id.* at 273-74.
[124] *Id.* at 274, 277-78.
[125] *Id.* at 277-78.
[126] *Id.* at 278.

term customer demand requirement, with an independent review and procedures for approval of the increase and its analysis.[127]

Many of the compliance requirements for the market-making exemption were originally included in the proposed compliance requirements of Appendix C of the Proposed Regulations. The Agencies moved these requirements into the body of the market-making exemption in the Final Regulations "to ensure that critical components are made part of the compliance program for market making-related activities" and to "emphasize the important role they play in overall compliance with the exemption."[128]

One other significant difference from the Proposed Regulations is that the Final Regulations do not require that risk managing activities for the market-making exemption separately comply with the requirements found in the hedging exemption.[129] The Agencies recognize that some banking entities may manage the risk of a market-making desk at a different level than the trading desk; for such entities, the risk management activity may not be permitted under the market-making exemption, but it may be permitted under the hedging exemption if the requirements of that section are met.[130]

(4) The trading desk takes action to return to compliance as promptly as possible after a limit is exceeded.[131]

Each limit, as required by Section 4(b)(iii)(3)(c) of the Final Regulations, is independent of each other limit.[132] "A trading desk must maintain its aggregated market-making position within each of these limits."[133] If a limit is exceeded, the trading desk must take action to return to compliance within the limits as quickly as possible.[134]

(5) The compensation arrangements of persons performing market making-related activities are designed not to incentivize prohibited proprietary trading.[135]

The market-making exemption requires that persons conducting the banking entity's market making-related activities are not rewarded or incentivized for prohibited proprietary trading.[136] The Agencies do not intend to prevent such an employee from being compensated for successful market making, which is acknowledged to involve some risk-taking.[137] A compensation

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[127] *Id.*
[128] *Id.* at 266-67.
[129] *Id.* at 282-83.
[130] *Id.* at 284.
[131] Final Regulations § __.4(b)(2)(iv).
[132] Preamble at 274-75.
[133] *Id.* at 275.
[134] *Id.*
[135] Final Regulations § __.4(b)(2)(v).
[136] Preamble at 288-89.
[137] *Id.* at 289.

arrangement may not, however, reward "speculation in, and appreciation of, the market value of a position held in inventory."[138]

A compensation arrangement may reward use of the market-maker inventory to "successfully provide effective and timely intermediation and liquidity services to customers."[139] A banking entity may take into account "revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk."[140] Ultimately, a banking entity relying on the market-making exemption should design compensation arrangements that "primarily reward customer revenues and effective customer service."[141]

(6) The banking entity is licensed or registered to engage in market making-related activities in accordance with applicable law.[142]

Generally, a U.S. banking entity that wishes to rely on the market-making exemption for trading in securities would be expected to be an SEC-registered dealer, and a U.S. banking entity that wishes to rely on the market-making exemption for trading in swaps would be expected to be a CFTC-registered swap dealer, and so forth.[143] This provision is not intended to expand the scope of licensing or registration requirements applicable to a banking entity engaged in market-making activity, however.[144]

This requirement is narrower in the Final Regulations than in the Proposed Regulations in response to comments. The Proposed Regulations would have required an entity to be a registered dealer in a foreign jurisdiction to the extent required by applicable law. The Final Regulations recognize that an entity must be subject to "substantive regulation of their dealing business in the relevant foreign jurisdiction." Thus, a banking entity's ability to engage in permitted market-making activities will not be impeded in a foreign jurisdiction that does not substantively regulate its dealers.[145]

(B) The Final Regulations Do Not Include a Source of Revenue Requirement.[146]

The Proposed Regulations would have required that market-making activities be designed to "generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of financial instrument positions it holds in trading accounts or the hedging of such positions."[147] This source of revenue requirement was one of the

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[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Final Regulations § __.4(b)(2)(vi).

[143] *Id.*

[144] Preamble at 293.

[145] *Id.* at 295.

[146] *Id.* at 304-07.

[147] *Id.* at 295.

most commented-upon provisions of the proposed market-making exemption.[148] In response to the comments, the Agencies decided to modify the focus from particular revenue sources to when the trading desk generates revenue from its positions.[149] Therefore, the Final Regulations have a Comprehensive Profit and Loss Attribution metrics data reporting requirement.[150] Over time, this metric can be evaluated to see if patterns of revenue generation by market-making trading desks indicate further review of the desk's activities is warranted.[151]

VII. Permitted Underwriting Activities

The prohibition on proprietary trading in the Final Regulations also does not apply to a banking entity's underwriting activities, as long as certain requirements are met.[152] The Volcker Rule specifically permits banking entities to continue providing beneficial underwriting services to clients, customers, and counterparties.[153] In adopting the Final Regulations, the Agencies emphasized the importance of underwriters[154] in facilitating issuers' access to funding, and as a result, their importance in the capital formation process and in economic growth.

The Agencies stated in the Preamble that:

> An underwriter can help reduce [an issuer's] costs [of obtaining financing] by mitigating the information asymmetry between an issuer and its potential investors. The underwriter does this based in part on its familiarity with the issuer and other similar issuers as well as by collecting information about the issuer. This allows investors to look to the reputation and experience of the underwriter as well as its ability to provide information about the issuer and the underwriting. For these and other reasons, most U.S. issuers rely on the services of an underwriter when raising funds through public offerings.[155]

The Agencies, however, have imposed conditions on permitted underwriting activities that are designed to reduce the potential for evasion of the general prohibition on proprietary trading. Generally, to engage in permitted underwriting activity, trading desks must satisfy certain requirements with regard to their activities, must make reasonable efforts to sell or otherwise reduce underwritten positions and must be subject to robust risk limit structures.[156]

(A) The Banking Entity Must Be an Underwriter.

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[148] *Id.* at 304.
[149] *Id.* at 305.
[150] Final Regulations § __.Appx. A, IV(A)(4); *see* Preamble at 304-07.
[151] Preamble at 306-07.
[152] *See* Final Regulations § __.4(a)(1).
[153] *See* Preamble at 81 (citing 12 U.S.C. § 1851(d)(1)(B)).
[154] *See* Appendix A for the definition of "underwriter."
[155] Preamble at 88-89.
[156] *Id.* at 87-88.

The exemption for underwriting activities applies to a banking entity acting as an underwriter for a distribution of securities and the related trading desk's underwriting position, provided that the conditions articulated in the Final Regulations are satisfied.[157]

The Final Regulations with regard to permitted underwriting activity were modified from the Proposed Regulations to address comments the Agencies received.[158] First, the Final Regulations refer to the trading desk's "underwriting position," rather than "purchase or sale."[159] The Final Regulations focus on the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or its affiliates is acting as an underwriter rather than taking a "transaction-by-transaction" approach.[160] This distribution-by-distribution approach addresses the relatively distinct nature of underwriting activities for a single distribution on behalf of an issuer or seller security holder."[161] However, the Agencies also do not allow a banking entity to aggregate positions from multiple distributions for which it is acting as an underwriter. A distribution-by-distribution approach should facilitate review by internal compliance personnel and Agency examiners of the trading desk's positions to assess a trading desk's compliance with this exception to the prohibition on proprietary trading.[162]

Second, to balance this aggregated position-based approach, the Final Regulations specify, as discussed earlier in this Alert, that for permitted underwriting, as well as market-making activities, the trading desk is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed.[163]

In addition, the Agencies modified the definitions of several terms used in relation to permitted underwriting, in response to comments on the Proposed Regulations. As described in greater detail in Appendix A of this Alert, the definition of "distribution" was amended to better capture the various types of private and registered offerings a banking entity may be asked to underwrite by an issuer or selling security holder.[164] The definition of "underwriter" was refined to clarify that both members of the underwriting syndicate and selling group members may qualify as underwriters for purposes of this exemption.[165] Finally, the word "solely" was removed to clarify that a broader scope of activities conducted in connection with underwriting (e.g., stabilization activities) are permitted under this exemption."[166]

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[157] Final Regulations § __.4(a)(2). *See* Appendix A for the definitions of "distribution" and "underwriting position."

[158] Preamble at 100.

[159] *Id.*

[160] *Id.* at 101.

[161] *Id.* at 102. *See* Appendix A for the definition of "security holder."

[162] Preamble at 102.

[163] *Id.* at 100.

[164] *Id.*

[165] *Id.*

[166] *Id.*

(B) The Amount and Type of Securities in a Trading Desk's Underwriting Position are Designed Not to Exceed Reasonably Expected Near Term Demands of Clients, Customers or Counterparties.

The underwriting activities of a banking entity are permitted if the amount and type of the securities in the trading desk's[167] underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[168]

The Agencies did not differentiate between liquid and less liquid securities because a banking entity is already required to have a reasonable expectation of purchaser demand for the securities and must make reasonable efforts to sell or otherwise reduce its underwriting position in a reasonable period.[169]

(C) The Banking Entity Engaged in Permitted Underwriting has Established an Internal Compliance Program.

Consistent with the other parts of the Final Regulations, a banking entity can engage in permitted underwriting activities only if it has established, and implements, maintains, and enforces, an internal compliance program reasonably designed to ensure compliance with the conditions of Final Regulations. The Agencies believe that a compliance program with requirements similar to those required for a banking entity to engage in permitted market-making should help to minimize duplication and thereby reduce some of the burdens associated with building and maintaining the required programs. The compliance program for permitted underwriting should include reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

- The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities to facilitate monitoring and oversight;
- Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the amount, types, and risk of its underwriting position, the level of exposures to relevant risk factors arising from its underwriting position, and the period of time a security may be held;
- Internal controls, which may include management and exception reports, and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature and extent that the trading desk exceeds its limits; and

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[167] *See* Appendix A for the definition of "trading desk."

[168] Final Regulations § __.4(a)(2).

[169] Preamble at 87. We note that the Agencies did not include in the Final Regulations a "source of revenue" requirement, as proposed in the Proposed Regulation. *Id.* at 136-137.

- Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval.[170]

(D) Compensation for Banking Entity Personnel Engaged in Permitted Underwriting and Related Trading Desk Activities Does Not Incentivize or Reward Prohibited Proprietary Trading.

The compensation arrangements of persons at a banking entity engaged in underwriting activity cannot reward or incentivize prohibited proprietary trading.[171] Rather, a banking entity should provide compensation incentives that primarily reward client revenues and effective client services.[172]

When determining compensation, a banking entity may take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk.[173] However, activities for which a banking entity "has established a compensation incentive structure that rewards speculation in, and appreciation of the market value of[,] securities underwritten by the banking entity are inconsistent with the underwriting exemption."[174] The Agencies noted in the Preamble that, for example, "a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the underwriting exemption."[175]

(E) The Banking Entity is Licensed or Registered to Engage in Permitted Underwriting, or if Licensing and/or Registration are not Required, is Compliant with Local Regulations Applicable to the Underwriting Activities.

A banking entity must be appropriately licensed or registered to engage in permitted underwriting activity.[176] This provision of the Final Regulations specifically requires a "U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities – other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills – unless the banking entity is exempt from registration or excluded from regulation as a dealer."[177]

A banking entity that underwrites a distribution of municipal securities or government securities may, as required by applicable law, have to be registered or licensed as a municipal securities

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[170] Final Regulations § __.4(a)(2); Preamble at 129-130.
[171] Final Regulations § __.4(a)(2).
[172] Preamble at 132-33.
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] Final Regulations § __.4(a)(2).
[177] Preamble at 135.

dealer or government securities dealer.[178] However, this provision of the Final Regulations, like the parallel provision related to banking entities engaged in permitted market-making activity, does not require a banking entity to register in order to qualify for the underwriting exemption if the banking entity is not otherwise required to register by applicable law.[179] The Agencies also recognized that certain foreign jurisdictions may not provide for substantive regulation of dealing businesses.[180] Therefore, for purposes of the underwriting exemption, a banking entity outside the U.S. is subject to licensing or registration provisions only if required under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities).[181]

VIII. Permitted Risk-Mitigating Hedging Activities

The Final Regulations provide that the prohibition on proprietary trading will not apply to risk-mitigating hedging activities that a banking entity undertakes in order to reduce specific, identifiable risks associated with that entity's (individual or aggregate) positions, contracts, or other holdings.[182] In order for trading activity to fall within this exemption, all of the following criteria must be satisfied.[183]

(A) The Banking Entity Must Have a Compliance Program in Place with Written Policies that Dictate each Trading Desk's Permissible Hedging Activities.[184]

The banking entity is required to implement, maintain, and enforce a compliance program that is reasonably designed to ensure compliance with the Final Regulations' restrictions on hedging activities.[185] The compliance program must have written policies and procedures regarding the positions, techniques, and strategies that may be used for hedging. These written policies should include specific guidelines for each trading desk on what positions, contracts, or other holdings that desk is allowed to use for its hedging activities, and should lay down position and aging limits for those positions, contracts, and other holdings.[186]

As part of its compliance program, the banking entity must conduct independent testing and analysis – including correlation analysis – in order to verify that the permissible hedging positions and strategies can be reasonably expected to demonstrably reduce the specific, identifiable risks being hedged.[187] Although it is not explicit in the text of the Final Regulations, the Preamble states that the "correlation [must] be analyzed as part of the compliance program before a hedging

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[178] *Id.*
[179] Id.
[180] *Id.* at 135-36.
[181] *Id.*
[182] Final Regulation § __.5(a).
[183] *Id.* at § __.5(b).
[184] *Id.* at § __(b)(1).
[185] *Id.*
[186] *Id.* at § __.5(b)(1)(i).
[187] *Id.* at § __.5(b)(1)(iii).

activity is undertaken."[188] The Preamble also acknowledges that "some effective hedging activities, such as deep out-of-the-money puts and calls, may not exhibit a strong linear correlation to the risks being hedged."[189] However, "[i]f correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation."[190]

The banking entity must also implement internal controls and monitoring procedures to ensure that the requirements imposed by the compliance program are being followed. The banking entity must also put in place escalation procedures, for when an issue needs to be brought to the attention of senior management.[191]

(B) The Trading Activity Must be Conducted in Accordance with the Banking Entity's Own Compliance Program.[192]

The Final Regulations explicitly provide that proprietary trading activity will not fall within the hedging activity exemption unless it complies with the entity's own compliance program.[193] No exception is made for trading activity that would otherwise be considered proper.

(C) The Trading Activity Must, at the Time it is Entered Into, be Tied to One or More Specific, Identifiable Risks and Must Demonstrably Reduce Those Risks.[194]

In order to be permissible hedging, the trading activity must be designed to reduce or significantly mitigate one or more specific and identifiable risks from its inception, and it must demonstrably reduce those risks.[195] Both requirements must be met; it is not enough for a banking entity to show that a trade was well-intentioned but did not demonstrably reduce any risk, nor may a bank justify a trade after-the-fact by showing that it has resulted in risk mitigation.

The kinds of risks that can be hedged "includ[e] market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity."[196] The risks to be mitigated can be based on aggregate positions as well as

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[188] Preamble at 332 (emphasis added).

[189] *Id.*

[190] *Id.*

[191] Final Regulations § __.5(b)(1)(ii).

[192] *Id.* at § __.5(b)(2)(i).

[193] *Id.*

[194] *Id.* at § __.5(b)(2)(ii).

[195] *Id.*

[196] *Id.*

individual exposures,[197] but the trading activity still has to mitigate specific and identifiable risks arising from those aggregate positions.[198]

The Agencies noted in the Preamble that banking entities do not have to show they engaged in the "best hedge" to mitigate a risk so long as the trading activity is designed to reduce a specific and identifiable risk. The Agencies specifically stated that banking entities should be free to choose their own hedging strategy without being second-guessed by regulators.[199]

(D) The Trading Activity Must not, at the Time it is Entered Into, Give Rise to any Significant New and Additional Risks Unless They are Contemporaneously Hedged.[200]

Banking entities are not permitted to expose themselves to "significant" new risks through hedging activity, unless at the time the trade is entered into a contemporaneous trade is made to reduce the newly incurred risk.[201] The Agencies explained in the Preamble that this provision was necessary because the purpose of the hedging exemption would be thwarted if it opened the door to trades that actually increased a banking entity's overall risk exposure.[202] This requirement could preclude, for example, an uncollateralized swap transaction designed to hedge an existing position, because the swap transaction might be viewed as exposing the banking entity to the credit risk of the swap counterparty.

(E) Any Trading Activity that was Entered Into for the Purpose of Hedging Must be Subject to Ongoing Monitoring and, Where Necessary, Recalibration in Order to Ensure that it Never Adds to the Banking Entity's Risk Exposure.[203]

The Final Regulations require ongoing recalibration of hedging activity in order to make sure that a position, contract, or holding that was entered into for the purpose of hedging does not later become a source of risk exposure.[204] As clarified in the Preamble, "[i]f an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, . . . the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce the risk associated with that position as soon as reasonably practicable after it is determined that the anticipated risk will not materialize. This requirement focuses on the purpose of the hedge as a trade designed to reduce anticipated risk and not for other purposes."[205]

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[197] Preamble at 344.
[198] *Id.* at 346.
[199] *Id.* at 337-38.
[200] Final Regulations § __.5(b)(2)(iii).
[201] *Id.*
[202] Preamble at 338.
[203] Final Regulations § __.5(b)(2)(iv)(C).
[204] *Id.*
[205] Preamble at 354-55.

(F) The Compensation Arrangements of People Engaged in Hedging Activities Cannot be Designed to Reward or Incentivize Proprietary Trading.[206]

Trading activity that is ostensibly for the purpose of hedging will constitute impermissible propriety trading if the banking entity compensates its staff in a way that incentivizes them to accomplish anything other than risk mitigation. For example, the Agencies stated that "an incentive compensation plan that rewards an employee engaged in activities under the hedging exemption based primarily on whether that employee's positions appreciate in value instead of whether such positions reduce or mitigate risk would appear to be designed to reward prohibited proprietary trading . . . ."[207]

(G) If the Hedging Activity Involves Multiple Trading Desks or is Undertaken by a Trading Desk not Explicitly Permitted to Engage in that Kind of Trading, the Banking Entity Must Document the Hedging Activity.[208]

The Final Regulations impose documentation requirements on any hedging activity where one or more of the following is true:

- The hedging transaction is being made by one trading desk in order to mitigate a risk for which another trading desk is responsible;
- The trading desk that is going to effect the hedge will do so using a financial instrument or strategy that the desk is not explicitly authorized to use under either the banking entity's own compliance policies or Section 4(b)(2)(iii)(B) of the Final Regulations; or
- The hedging transaction is intended to mitigate the risk of an aggregated position spread across two or more trading desks.[209]

For any transaction that falls into the categories above, the banking entity must, at a minimum, document: (i) the specific, identifiable risk the trade is designed to reduce; (ii) the specific risk-mitigation strategy by which this trade will reduce that risk; and (iii) the trading desk that is responsible for the hedging transaction.[210] Any such documentation must be retained by the banking entity for at least five years, in a form that can be promptly turned over to a regulatory agency upon request.[211]

IX. Other Permitted Trading Activities

The Final Regulations also permit the following categories of trading activity.

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[206] Final Regulations § __.5(b)(3).
[207] Preamble at 357.
[208] Final Regulations § __.5(c).
[209] *Id.* at § __.5(c)(1)(i)-(iii).
[210] *Id.* at § __.5(c)(2)(i)-(iii).
[211] *Id.* at § __.5(c)(3).

(A) Proprietary Trading in Obligations of the U.S. Government, States and Other Political Entities is Permitted.[212]

This exemption applies to obligations issued or guaranteed by (i) the U.S.; (ii) any federal agency; (iii) any State or political subdivision of a State (including municipal securities); (iv) the FDIC or an entity formed by the FDIC for the purpose of disposing of assets; (v) the Government National Mortgage Association, (vi) the Federal National Mortgage Association, (vii) the Federal Home Loan Mortgage Corporation, (viii) a Federal Home Loan Bank, (ix) the Federal Agricultural Mortgage Corporation; or (x) a Farm Credit System institution.[213]

The Agencies noted that the term "municipal securities" has been defined elsewhere to include obligations that are issued or guaranteed by agencies of State and local governments, as well as the State and local governments themselves.[214] The Agencies also clarified that this exemption does not apply to trading in derivatives based on government obligations, but that those derivatives may fall under one of the other permissible exemptions, such as market making or risk-mitigating hedging.[215]

(B) Proprietary Trading in Foreign Government Obligations is Permitted for Banking Entities with Ties to Those Foreign Nations.[216]

As a result of extensive advocacy by foreign governments and non-U.S. financial institutions that are "banking entities" as defined in the Volcker Rule, the Final Regulations permit certain banking entities to engage in proprietary trading of foreign government obligations, subject to the conditions described below.

(1) U.S. affiliates of foreign banking entities.[217]

A U.S. banking entity that is not an insured depository institution, and that is directly or indirectly controlled by a banking entity organized under the laws of a foreign sovereign, may engage in proprietary trading of obligations issued or guaranteed by (i) that specific foreign sovereign, (ii) a political subdivision of that sovereign; (iii) an agency of that sovereign; or (iv) a central/multinational bank to which that foreign sovereign is a member.[218]

This exemption will not apply if the foreign entity that controls the U.S. banking entity is itself ultimately controlled by another U.S. banking entity.[219]

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[212] *Id.* at § __.6(a).
[213] *Id.* at § __.6(a)(1)-(4).
[214] Preamble at 386-8; *see also* Section 3(e)(12).
[215] Preamble at 365.
[216] Final Regulations § __.6(b).
[217] *Id.* at § __.6(b)(1).
[218] *Id.* at § __.6(b)(1)(i)-(ii).
[219] *Id.* at § __.6(b)(1)(iii).

(2) Foreign affiliates of U.S. banking entities.[220]

A foreign entity that is owned or controlled by a U.S. banking entity, and that is either recognized as a foreign bank by the FDIC or is regulated as a securities dealer in its home country,[221] may engage in proprietary trading of obligations issued or guaranteed by (i) the foreign sovereign of the country in which it is organized, (ii) a political subdivision of that sovereign; (iii) an agency of that sovereign; or (iv) a central/multinational bank to which that foreign sovereign is a member.[222]

This exemption will only apply if the government obligation in question is owned by the foreign entity – not the U.S. affiliate – and the U.S. affiliate is not financing the transaction.[223]

(C) Proprietary Trading Undertaken on Behalf of a Customer is Permitted.[224]

(1) Fiduciary transactions.[225]

A banking entity may engage in proprietary trading when it is acting on behalf of a customer (e.g., as a trustee).[226] To rely on this exemption, a banking entity must not retain any beneficial ownership interest in any of the financial instruments traded.[227]

(2) Riskless principal transactions.[228]

A banking entity may, after receiving an order to purchase (or sell) a financial instrument from a customer, purchase (or sell) the financial instrument for its own account to offset the contemporaneous purchase from (or sale to) the customer. The Preamble emphasizes that this exemption only allows the banking entity to engage in this kind of transaction after it has received an order from the customer, and therefore the banking entity cannot be the party that initiates the transaction.[229]

(D) Proprietary Trading by an Insurance Company, or an Affiliate Acting on its Behalf, is Permitted.[230]

A banking entity that is an insurance company or an affiliate of an insurance company may engage in proprietary trading so long as the trading activity is solely for the benefit of the insurance

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[220] *Id.* at § __.6(b)(2).
[221] *Id.* at § __.6(b)(2)(i).
[222] *Id.* at § __.6(b)(2)(ii).
[223] *Id.* at § __.6(b)(2)(iii).
[224] *Id.* at § __.6(c).
[225] *Id.* at § __.6(c)(1).
[226] *Id.* at § __.6(c)(1)(i).
[227] *Id.* at § __.6(c)(1)(ii).
[228] *Id.* at § __.6(c)(2).
[229] Preamble at 397.
[230] Final Regulations § __.6(d).

company.[231] The exemption applies to trading done both for the insurance company's general account and for any separate account.[232] Such trading must otherwise be in compliance with all applicable laws and regulations governing investments by insurance companies.[233]

This exemption is subject to the caveat that it will cease to have effect if "appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and relevant insurance commissioners of the States and foreign jurisdictions," determine that one or more of the existing laws regulating investments by insurance companies "is insufficient to protect the safety and soundness of the covered banking entity, or the financial stability of the United States."[234]

(E) Foreign Banking Entities that Perform Most of Their Banking Activities Overseas are Permitted to Engage in Proprietary Trading, but the Trading Must Occur Outside of the U.S. and be Conducted Exclusively Between Foreign Entities.[235]

While the Volcker Rule would have allowed proprietary trading outside the U.S., as construed in the Proposed Regulations this statutory permission would not have been available to non-U.S. banking entities with U.S. banking entity affiliates. The Final Regulations reflect the Agencies' shift to a risk-based approach to offshore activities, which commenters explained would minimize the potential transfer of risk of the activities to the U.S..[236] If a banking entity is not organized under the laws of the U.S. (or any individual State), and is not directly or indirectly controlled by a U.S. entity, the banking entity may be entitled to engage in proprietary trading outside of the U.S., so long as the following criteria are satisfied.

(1) The foreign banking entity must be engaged primarily in banking activities outside of the U.S.[237]

The banking entity in question must be a qualified foreign banking organization (a "QFBO") under the Federal Reserve Board's Regulation K,[238] or it must satisfy at least two of the following requirements: (i) its total foreign assets exceed its total U.S. assets; (ii) its total foreign revenues exceed its total U.S. revenues; or (iii) its total net foreign income exceeds its total net U.S. income.[239]

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[231] *Id.* at § __.6(d)(1).
[232] *Id.*
[233] *Id.* at § __.6(d)(2).
[234] *Id.* at § __.6(d)(3).
[235] *Id.* at § __.6(e).
[236] Preamble at 419.
[237] Final Regulation at § __.6(e)(2)(ii)(A); *see also* 12 C.F.R.211.23.
[238] Final Regulations § __.6(e)(2)(ii)(A).
[239] *Id.* at § __.6(e)(2)(ii)(B).

(2) The proprietary trading must be conducted exclusively between foreign entities, and must take place outside of the U.S.[240]

For proprietary trading activities to be permissible under this exemption, all of the following criteria must be satisfied:

- The entity that acts as the principal in the transaction must not be located in the U.S. or organized under U.S. law;[241]
- The entity that decides whether to enter the transaction must not be located in the U.S. or organized under U.S. law;[242]
- The transaction must not be accounted for as a principal transaction – either directly or on a consolidated basis – by any branch or affiliate that is located in the U.S. or organized under U.S. law;[243]
- No financing for the transaction may be provided – either directly or indirectly – by any branch or affiliate that is located in the U.S. or organized under U.S. law;[244] and
- The transaction must not be conducted with or through any U.S. entity, unless the transaction falls into one of the following categories:[245]
    - The purchase or sale of a U.S. entity's foreign operations, where none of the representatives for the U.S. entity who are involved in the transaction are actually located in the U.S.;[246]
    - A transaction where an unaffiliated market intermediary (i.e., a registered broker, dealer, or futures commission merchant) is acting as principal, and where the transaction is promptly cleared and settled via a clearing agency acting as a central counterparty;[247] or
    - An anonymous transaction on an exchange or similar facility via an unaffiliated market intermediary (i.e., a registered broker, dealer, or futures commission merchant).[248]

For the purposes of this subsection of the Final Regulations, a foreign banking entity that has branches, agents, or subsidiaries in the U.S. is not considered a U.S. entity. However, a foreign

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[240] *Id.* at § __.6(e)(3).
[241] *Id.* at § __.6(e)(3)(i).
[242] *Id.* at § __.6(e)(3)(ii).
[243] *Id.* at § __.6(e)(3)(iii).
[244] *Id.* at § __.6(e)(3)(iv).
[245] *Id.* at § __.6(e)(3)(v).
[246] *Id.* at § __.6(e)(3)(v)(A).
[247] *Id.* at § __.6(e)(3)(v)(B).
[248] *Id.* at § __.6(e)(3)(v)(C).

entity that is controlled by or acting on behalf of a U.S. entity will be treated as a U.S. entity for the purposes of this analysis.[249]

X. Limitations on Permitted Proprietary Trading Activities

Section 7 of the Final Regulations provides that no proprietary trading activity is permitted under Sections 4, 5, or 6 of the Final Regulations if any of the following is true.[250]

(A) The Trading Activity Would Involve a Material Conflict of Interest Between the Banking Entity and a Client, Customer, or Counterparty.[251]

A material conflict of interest exists when a banking entity engages in a transaction or activity that would involve the banking entity's interests being materially adverse to those of a client, customer, or counterparty.[252] However, a material conflict of interest will not exist if the banking entity undertakes either of the following two precautions:[253]

1. The banking entity makes a timely and effective disclosure of the conflict, such that the affected party has the opportunity to negate or substantially mitigate any adverse effect it might suffer as a result of the conflict,[254] or

2. There is no material conflict of interest where the banking entity has appropriate information barriers in place that are reasonably designed to prevent the conflict of interest from having a materially adverse effect on the client, customer, or counterparty affected by it.

In order to fall under this exemption, the banking entity must have written policies and procedures regarding information barriers that are being maintained and enforced.[255] Those procedures should be appropriately tailored to the "nature of the banking entity's business."[256] The Preamble includes a non-exhaustive list of the kinds of policies that a banking entity might implement under this subsection, including "restrictions on information sharing, limits on types of trading, and

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[249] *Id.* at § __.6(b)(5).
[250] *Id.* at § __.7(a).
[251] *Id.* at § __.7(a)(1).
[252] *Id.*
[253] *Id.* at § __.7(b)(1).
[254] *Id.* at § __.7(b)(2)(i)(A)-(B). The Final Regulations do not define when a disclosure is "timely" or "effective," but the Agencies state in the Preamble that a disclosure is insufficient if it is so generic or made so far in advance of a particular transaction that the affected party is unlikely to take it into account when evaluating the transaction. Preamble at 452. Furthermore, simply obtaining the affected party's consent to the conflict will be insufficient unless that party is also offered the opportunity to negate or substantially mitigate any possible adverse effect of the conflict. *Id.* at 452.
[255] Final Regulations § __.7(b)(2)(ii).
[256] *Id.*

greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees."[257]

This exception will not apply if the banking entity knows – or should reasonably know – that there is a specific conflict of interest which, notwithstanding the information barriers, may have a materially adverse effect on a client, customer, or counterparty. [258]

(B) The Trading Activity Would Result, Directly or Indirectly, in the Banking Entity Being Materially Exposed to a High-Risk asset or a High-Risk Trading Strategy.[259]

"High-risk" assets and strategies are defined in the Final Regulations as those that would "significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States."[260] The Agencies stated that they "believe that it is appropriate to include a broad definition of these terms that accoun[t] for different facts and circumstances that may impact whether a particular asset or trading strategy is high-risk with respect to a banking entity. . . . [T]his framework is effective and flexible enough to be utilized by the Agencies in a variety of contexts."[261]

Factors identified in the Preamble that an Agency could use to determine whether an asset or strategy is "high-risk" are "the amount of capital at risk in a transaction, whether or not the transaction can be hedged, the amount of leverage present in the transaction, and the general financial condition of the banking entity engaging in the transaction."[262]

(C) The Trading Activity Would Involve a Material Conflict of Interest Between the Banking Entity and a Client, Customer, or Counterparty.[263]

The Final Regulations do not provide additional clarity on how this language should be interpreted. The Preamble simply notes that this subsection mirrors language in the Dodd-Frank Act, and that when it was first proposed the drafters of the Final Regulations received no objections from members of the public.[264]

XI. Compliance Program Requirements

As discussed earlier in this alert, banking entities that engage in permitted proprietary trading and/or covered fund activities must implement internal controls and compliance programs reasonably designed to ensure and monitor compliance with the Final Regulations, and to comply

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[257] Preamble at 439.
[258] Final Regulations § __.7(b)(2)(ii).
[259] *Id.* at § __.7(a)(2).
[260] *Id.* at § __. 7(c)(1)-(2).
[261] Preamble at 461.
[262] *Id.*
[263] Final Regulations § __.7(a)(3).
[264] Preamble at 462.

with reporting and recordkeeping requirements.[265] The internal controls and compliance program must be appropriate for the size, scope and complexity of the activities and business structure of the banking entity.[266] A banking entity must establish the required internal controls and compliance program as soon as practicable and in no event later than the end of conformance period, which is July 21, 2015.[267]

Enhanced internal control and compliance program standards apply to a banking entity that has significant proprietary trading activities or that has total consolidated assets of $50 billion or more (or, in the case of a foreign banking entity, total U.S. assets of $50 billion or more).[268] The Proposed Regulations would have imposed the enhanced internal control and compliance program requirements on a banking entity if it has significant covered fund activities, but that threshold was replaced by the total consolidated assets threshold in the Final Regulations. One important addition to the enhanced internal control and compliance program standards in the Final Regulations is a requirement that the CEO of the banking entity attest in writing to the appropriate Agency that the banking entity has a compliance program reasonably designed to comply with the Volcker Rule and the Final Regulations.[269]

XII. Conformance Period

By statute, a banking entity must bring its activities and investments into compliance with the Volcker Rule and the Final Regulations no later than two years after the statutory effective date, which was July 21, 2012, unless extended by the FRB. Thus, absent extension, compliance would have been required by July 21, 2014. The FRB may grant up to three one-year extensions of the compliance transition period if the extension would be consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. For certain "illiquid funds," an additional extension of up to five years may be available to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.[270]

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[265] Final Regulations § __.20(a).

[266] *Id.*

[267] Some banking entities will be required to report and record quantitative measurements regarding certain proprietary trading activities beginning as of June 30, 2014.

[268] Final Regulations §§ __.20(c)(1) and (2) and (d). A banking entity also will be subject to the enhanced compliance program requirements if the appropriate Agency notifies the banking entity that it must comply with those requirements. Final Regulations § __.20(c)(3).

[269] Final Regulations, App. B, § III.

[270] The FRB issued final regulations regarding the conformance period and extended transition period authorities for the Volcker Rule on February 11, 2011 (the "Conformance Period Regulations"). As part of the Proposed Regulations, the Agencies proposed to relocate the Conformance Period Regulations from §§ 225.180-182 of the FRB's Regulation Y to Subpart E of the Volcker Rule regulations. Although Subpart E was not included in the Final Regulations published by the Agencies, the Conformance Period Regulations remain effective as adopted by the FRB.

Concurrently with its adoption of the Final Regulations, the FRB issued an order (the "Order") that granted a one-year extension of the conformance period until July 21, 2015.[271] The Order explains that, during the conformance period, each banking entity will be 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 the Volcker Rule and the Final Regulations by 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 the Volcker Rule and the Final Regulations, 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. Banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted.[272] Furthermore, banking entities "with stand-alone proprietary trading operations are expected to promptly terminate or divest these operations,"[273] suggesting that as Agencies begin to examine banking entities for compliance with the Volcker Rule and the Final Regulations, the banking entities should be able to demonstrate bona fide efforts to change their activities to eliminate prohibited proprietary trading, even before the extended conformance period ends.

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Please direct questions to the authors or a member of our Volcker Rule team or the Bingham lawyer with whom you ordinarily work.

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[271] *See* FRB, Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[272] Order, at 3.

[273] *Id.*

APPENDIX A

DEFINITIONS

Section 3 of the Final Regulations provides an extensive list of defined terms related to proprietary trading generally.[274] They are:

(1) *Anonymous* means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale.

(2) *Clearing agency* has the same meaning as in section 3(a)(23) of the Exchange Act (15 U.S.C. 78c(a)(23)).

(3) *Commodity* has the same meaning as in section 1a(9) of the Commodity Exchange Act (7 U.S.C. 1a(9)), except that a commodity does not include any security;

(4) *Contract of sale of a commodity for future delivery* means a contract of sale (as that term is defined in section 1a(13) of the Commodity Exchange Act (7 U.S.C. 1a(13)) for future delivery (as that term is defined in section 1a(27) of the Commodity Exchange Act (7 U.S.C. 1a(27))).

(5) *Derivatives clearing organization* means:

(i) A derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1);

(ii) A derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1); or

(iii) A foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

(6) *Exchange*, unless the context otherwise requires, means any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, or, for purposes of securities or security-based swaps, an exchange, as defined under section 3(a)(1) of the Exchange Act (15 U.S.C. 78c(a)(1)), or security-based swap execution facility, as defined under section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)).

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[274] Final Regulations § __.3(e).

(7) *Excluded clearing activities* means:

(i) With respect to customer transactions cleared on a derivatives clearing organization, a clearing agency, or a designated financial market utility, any purchase or sale necessary to correct trading errors made by or on behalf of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(ii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(iii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(iv) Any purchase or sale in connection with and related to the management of the default or threatened default of a clearing agency, a derivatives clearing organization, or a designated financial market utility; and

(v) Any purchase or sale that is required by the rules or procedures of a clearing agency, a derivatives clearing organization, or a designated financial market utility to mitigate the risk to the clearing agency, derivatives clearing organization, or designated financial market utility that would result from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

(8) *Designated financial market utility* has the same meaning as in section 803(4) of the Dodd-Frank Act (12 U.S.C. 5462(4)).

(9) *Issuer* has the same meaning as in section 2(a)(4) of the Securities Act of 1933 (15 U.S.C. 77b(a)(4)).

(10) *Market risk capital rule covered position and trading position* means a financial instrument that is both a covered position and a trading position, as those terms are respectively defined:

(i) In the case of a banking entity that is a bank holding company, savings and loan holding company, or insured depository institution, under the market risk capital rule that is applicable to the banking entity; and

(ii) In the case of a banking entity that is affiliated with a bank holding company or savings and loan holding company, other than a banking entity to which a market risk capital rule is applicable, under the market risk capital rule that is applicable to the affiliated bank holding company or savings and loan holding company.

(11) *Market risk capital rule* means the market risk capital rule that is contained in subpart F of 12 CFR 3, 12 CFR 208 and 225, or 12 CFR 324, as applicable.

(12) *Municipal security* means a security that is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.

(13) *Trading desk* means 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."[275]

Section 4(a) of the Final Regulations includes defined terms for permitted underwriting activity.[276] They are:

(1) *Distribution* is defined as:

(i) an offering of securities, whether or not subject to registration under the Securities Act of 1933 ("Securities Act"), that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) an offering of securities made pursuant to an effective registration statement under the Securities Act.

The Agencies explained that a definition of "distribution" requiring special selling efforts and selling methods was sufficient to distinguish between permissible securities offerings and

[275] *Id.* As discussed in this alert, the term trading account and the term trading desk each is used in relation to proprietary trading, and the express exemptions from proprietary trading for market-making and underwriting activities.

[276] Final Regulations § __.4(a).

prohibited proprietary trading. As a result, the additional magnitude factor from the Proposed Rule was omitted from the Final Regulations.[277]

As reflected above, the Final Regulations also define "distribution" to include an offering of securities pursuant to an effective registration statement under the Securities Act to ensure that a registered offering of securities can be conducted under the underwriting activity exemption, even absent other special selling efforts and selling methods or a determination of whether such efforts and methods are being conducted.[278] The Agencies believe this should reduce potential administrative burdens by providing a bright-line test for what constitutes a distribution.[279]

(2) *Underwriter* is defined as:

(i) a person who has agreed with an issuer or selling security holder to:

(A) purchase securities from the issuer or selling security holder for distribution;

(B) engage in a distribution of securities for or on behalf of the issuer or selling security holder; or

(C) manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

(3) *Security holder* is defined as any person, other than an issuer, on whose behalf a distribution is made.

(4) *Underwriting Position* is defined as the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, across relevant entities, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter.

(5) *Client, customer, and counterparty*, on a collective or individual basis, refers to market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.[280]

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[277] Preamble at 104. The Proposed Regulations defined "distribution" as "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." *Id.* at n. 379.

[278] *Id.* at 105.

[279] *Id.*

[280] Final Regulations § __.4(a).

Section 4(b) of the Final Regulations provides defined terms for permitted market making activity.[281] They are:

(1) *Client, customer, and counterparty*, on a collective or individual basis, refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that:

(i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § __.20(d)(1) of subpart D, unless:

(A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of [Final Regulations § __.4(b)(2)]; or

(B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

(2) *Financial exposure* means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.

(3) *Market-Maker Inventory* means all of the positions in the financial instruments for which the trading desk stands ready to make a market in accordance with [Final Regulations § __.4(b)(2)(i)], that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[282]

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[281] *Id.* at § __.4(b).

[282] *Id.*

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