

**Davis Polk**

**Volcker Rule Materials  
Proprietary Trading**

October 7, 2011

**DPW Proposed Rule Memo**

## Summary of Leaked Volcker Release — Proprietary Trading

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Based on staff draft of Sept. 30, 2011 leaked to the *American Banker* on Oct. 5, 2011

- **Draft may have changed since leak.** The leaked draft includes the rulemaking release only, not the proposed rule text, the metrics, or the compliance appendices.
- **Comment Period.** Deadline for comments bracketed as Dec. 16, 2011. Hundreds of questions throughout draft suggest disagreement among agencies.
- **Effective Date.** July 21, 2012. Compliance programs and record-keeping must also be in place and effective on this date.

### Core Definitions for Proprietary Trading.

General definition remains overbroad, but includes carveouts.

- **Proprietary Trading.** Defined as in the statute and includes engaging as principal for the trading account of a banking entity in any transaction to purchase or sell certain types of financial positions.
  - The theory is that if short-term principal trading is not excluded from the scope and is not a permitted activity, it is prohibited.
- **Covered Financial Position.** Any position whether long, short, synthetic or otherwise, in a security, derivative or future, and any option thereon.
  - Swaps, security-based swaps, FX forwards, FX swaps and a number of other instruments are classified as derivatives and therefore are covered financial positions.
- **Trading Account.** There are three independent ways to fall within the definition of trading account:
  - **Purpose:** The account is used to acquire or take covered positions principally for the purpose of short-term resale, price movements, arbitrage or hedging another trading account position. Resale is not required: taking the position is sufficient. Includes derivatives that are closed out or for which variation margin is exchanged.
    - **Rebuttable presumption** that if a position is held for 60 days or less, it is a trading account. This rebuttable presumption does not apply to the status test and the market risk capital test below.
  - **Status:** Regardless of purpose, the account is an account of a registered securities dealer, municipal securities dealer, government securities dealer, or a swap or security-based swap dealer and is used to take covered financial positions in connection with their registered activities.
  - **Market Risk Capital Rule:** The banking entity, or any affiliate bank holding company, calculates risk-based capital under the Market Risk Capital Rule and takes covered financial positions that are also covered positions under the Market Risk Capital Rule, other than certain FX and commodities positions. Proposed rule contemplates the proposed but pending changes in the Market Risk Capital Rule. Keyed to Call Reports.
- **Exclusions.**

- Accounts used solely for positions arising under repos/reverse repos because they are the economic equivalent of a secured loan.
- Loans, spot commodities, or spot FX, but not derivatives on the same.
- Accounts used solely for positions held under a securities lending arrangement because such arrangement operates, in economic substance and function, as a means to facilitate settlement of securities transactions and is not based on expected or anticipated movements in asset prices.
- Accounts used solely for *bona fide* liquidity management to meet short-term liquidity needs in accordance with a documented liquidity plan that meets five criteria:
  - specifically contemplates and authorizes any particular instrument used;
  - principally for the purpose of liquidity management;
  - limited to highly liquid positions and financial instruments that are not expected to move in value;
  - limitations on amounts to what is consistent with short-term funding needs; and
  - consistent with agencies' to-be-issued guidance on liquidity.

## Permitted Market-Making Related Activity

- **Bona Fide Market-Making.** The particular unit must hold itself out as willing to buy **and** sell positions in, or otherwise enter into long/short positions in, the particular covered financial position for its own account on a regular or continuous basis. Similar to the Exchange Act definition of "market-maker."
  - Criteria in the case of liquid positions include:
    - making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
    - a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;
    - making continuous quotations that are at or near the market on both sides; and
    - providing widely accessible and broadly disseminated quotes.
  - Criteria in the case of *less* liquid markets, such as over-the-counter markets for debt, equity securities and derivatives, include:
    - holding oneself out as willing and available to provide liquidity by providing quotes on a regular but not necessarily continuous basis;
    - with respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers or counterparties in the secondary market; and
    - transaction volumes and risk proportionate to historical customer liquidity and investment needs.
- **Near-Term Client, Customer and Counterparty Demand.** Activities must be designed not to exceed reasonably expected near-term demands of clients, customers and counterparties. Should be based on more than a simple expectation of future price appreciation and the generic increase in marketplace demand that such price appreciation reflects — instead should generally

be based on the unique customer base and the near-term demands of those customers based on particular factors beyond a general expectation of price appreciation.

- **Organized Trading Facility or Exchange.** If the market-making is in a security executed on an organized trading facility or exchange, reasonably expected near-term customer demand includes passively providing liquidity by submitting resting orders that interact with other orders in a non-directional or market-neutral trading strategy, and the market-maker is registered if the facility or exchange does registration. Primarily taking liquidity does not qualify, even if by a registered market-maker.
- **Anticipatory/Inventory Activity and Block Positioning.** Contemplates some anticipatory/inventory activity as long as it is reasonable and related to clear, demonstrable trading interest of clients, customers or counterparties and block positioning for the purpose of intermediating customer demand is contemplated.
- **Revenue.** The activities of the trading unit must be designed to generate revenues primarily from sources including fees, commissions and bid/ask spreads, not attributable to changes in value, or hedging, of covered financial positions.
- **Registration.** A banking entity must be registered, or excluded or exempt from registration, as a securities dealer, municipal securities dealer, government securities dealer, or swap or SBS dealer, or, if engaged in business as a dealer outside the United States, subject to substantive regulation offshore, to qualify for the market-making exemption in certain asset classes.
- **Internal Compliance; Compliance with Regulatory Commentary.** Activity must be conducted in accordance with “reasonably designed written policies and procedures” and controls. It must be subject to independent testing. It must also be consistent with market-making principles contained in regulatory commentary, which may include the following concepts.
  - Market-making related activities of a banking entity acting as principal, generally involve either:
    - for a security executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker, or
    - in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy.
  - Trading is generally considered to be proprietary trading rather than permitted market-marking related activity if:
    - unit retains risk in excess of the size and type required to provide intermediation services to customers;
    - unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;
    - activity generates only very small or very large amounts of revenue per unit of risk taken, does not demonstrate consistent profitability, or demonstrates high earnings volatility;
    - unit either does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making unit to

provide liquidity services, or holds principal positions in excess of reasonably expected near-term customer demands;

- unit routinely pays rather than earns fees, commissions, or spreads; and
- unit uses compensation incentives for employees that primarily reward proprietary risk-taking.
  - Does not include, but asks about the possibility of, using numerical thresholds.
- **Compensation Design.** Compensation arrangements for market-making personnel must be designed not to encourage or reward proprietary risk-taking.
- **Quantitative Metrics.** See below.
- **Market-Making Related Hedging.** Hedging of positions acquired pursuant to market-making related activity is also permitted, but hedging requirements apply. The purchase or sale must be conducted in order to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exceptions. Must also meet the criteria specified in the general exemption for risk-mitigating hedging activity discussed below.

## Permitted Hedging Activity

- **Specific Risks.** The hedging transaction must be made in connection with, and relate to, existing individual or aggregated positions, contracts or other holdings and be designed to reduce the specific risks in connection therewith. Portfolio, or dynamic, hedging is contemplated.
  - Anticipatory hedging is permitted if consistent with risk management practices, otherwise meets the terms of the hedging exemption and does not involve the potential for speculative profit.
- **Correlation.** Hedges must be reasonably correlated to the targeted risk, and at inception must not give rise to new and significant unhedged exposures.
- **Continuing Review.** Ongoing review of the hedge must ensure that a reasonable level of correlation is maintained and that any significant exposure after inception of the hedge is also mitigated.
- **Internal Compliance.** See above market-making section. Compliance regime must include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader to ensure that the decision of when and how to put on a hedge is consistent with such policies and mandates, and not fully left to a trader's discretion.
- **Compensation Design.** Compensation arrangements for market-making personnel must be designed not to encourage or reward proprietary risk-taking.
- **Hedging by Different Entities or Levels of Organization.** If separate legal entities or levels of an organization establish, or are responsible for, positions or contracts and the corresponding hedges, the banking entity must document the risk-mitigating purpose of the hedging transaction and identify the risks of the individual or aggregated positions and contracts that the transaction is designed to reduce, at the time the transaction is executed.

## Permitted Underwriting Activity

- Available solely for purchases and sales of securities in connection with a distribution of securities for which the banking entity acts as an underwriter.

- Seven criteria must be met to qualify as underwriting:
  - internal compliance program and reporting of quantitative measurements;
  - exemption is only available for purchases and sales of securities;
  - transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter. Generally tracks Regulation M definitions of distribution, securities, and underwriter, although the definition of underwriter is broader and includes a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder;
  - if the transaction involves securities for which a person must be a registered securities dealer to underwrite, the banking entity must have the appropriate dealer registration or otherwise be exempt, or, if engaged in business as a dealer outside the United States, subject to substantive regulation offshore;
  - the underwriting activities of the banking entity must be designed not to exceed the reasonably expected near-term demands of clients, customers and counterparties;
  - the underwriting activities of the banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, and not from appreciation in the value of covered financial positions it holds related to such activities or the hedging of such covered financial position; and
  - compensation arrangements for market-making personnel must be designed not to encourage or reward proprietary risk-taking.

## Permitted Activity Outside the US by Foreign Banks

- **Purchase or Sale Occurs Solely Outside the US.** Restrictions include the following:
  - the banking entity must not be organized under US law;
  - no party may be a US resident (similar to but slightly narrower than Regulation S);
  - no banking entity personnel directly involved in the trade may be physically located in the US; and
    - personnel performing purely administrative, clerical, or ministerial functions may be in the US.
  - the trade must be executed wholly outside the US; risk management and booking outside the US is insufficient.

## Selected Other Permitted Activities

- **Government Obligations.** Includes U.S. and municipal general, limited and pass-through obligations and forward trading. Does not include foreign governments, multilateral organizations derivatives on government obligations or obligations guaranteed by a government issuer, but questions are asked about whether each of the above should be included.
- **On Behalf of Customers.** Limited to three types of transactions, probably:
  - fiduciary activity as an investment adviser, commodity trading advisor, trustee or in a similar fiduciary capacity *and* involves solely positions in which the customer is the beneficial owner;
  - activity as a riskless principal; and

- trading by an insurance company for the separate account of insurance policyholders.

## Backstop Provisions

- **Material Conflicts of Interest.** Two disclosure requirements for any transaction where a “material” conflict of interest might arise.
  - Disclosure must be explicit, effective and provided close in time to the transaction. Cannot be generic.
  - Only applies if the conflict is “material,” a term that is not clear from the preamble.
  - Information barriers could affect this element but not if the firm knows or should have known that the conflict may involve or result in a material adverse effect for the client, customer, or counterparty. The SEC’s recent asset-backed security rule is similar.
- **High Risk Asset or High Risk Trading Strategy.**
  - Defined but not explained in the preamble.

## Quantitative Metrics

- Each trading unit engaged in certain permitted activities must report additional metrics. “Trading unit” is broad and includes both individual desks and other organizational units used to structure and control aggregate risk-taking activities, as well as the entire firm.
  - Metrics are taken from five categories:
    - risk-management measurements (including VaR, SVaR and VaR exceedance);
    - source-of-revenue measurements (including several P&L metrics);
    - revenue-relative-to-risk measurement (including P&L volatility and related statistical analyses);
    - customer-facing activity measurements (including inventory aging and risk turnover, and a ratio of customer to noncustomer trades); and
    - payment of fees, commissions and spreads measurement (spreads/fees earned vs. paid).
- **Deadlines and Reporting.** Metrics would be calculated each trading day and reported on a monthly basis.
- **Less Complex Metrics for Smaller Institutions.** See compliance policies and procedures below.

## Compliance Policies and Procedures

- **Basic Requirement.** All banking entities engaging in Volcker covered activity must establish a compliance program including internal policies and procedures, internal controls, responsibility/accountability for compliance, independent testing, training and recordkeeping. The standard is “reasonably designed” to ensure and monitor compliance.
- **Trading Unit—Specific Requirement.** Compliance program must meet additional requirements applicable at the trading unit level.
  - **Internal policies and procedures:** Specify how trading accounts are identified, descriptions of missions and strategies, including authorized instruments/products, hedging procedures and holding periods; trader mandates; descriptions of risks and risk

management policies; explanations of compliance, including identification of permitted activities; and remediation of violations.

- **Internal controls:** Authorized risks, instruments and products; risk limits; analysis and quantitative measurement of activities, including metrics reported to regulators; heightened review based on measurements, including internal escalation and regulator notification upon a reasonable likelihood of violation; firm-specific metrics as necessary. Timely notification to the relevant agency of any investigation and remedial action is required.
- **Senior management responsibility and accountability for compliance:** Board of Directors and CEO review and approval of the program, responsibility for culture of compliance and identification of responsible business line managers. The possibility of CEO attestation is asked in a question.
- **Independent testing of program effectiveness:** Question asks whether it should be at least once every 12 months and may be internal or external. Remedial action must be taken.
- **Training:** Must be provided to trading personnel, managers and others as appropriate.
- **Recordkeeping:** Must be sufficient to demonstrate compliance and be promptly produced to regulators upon request, with a five-year requirement.
- **Less Complex for Smaller Institutions.**
  - **Reporting and Recordkeeping.** A banking entity does not need to comply with certain reporting and recordkeeping requirements if it has, together with its affiliates and subsidiaries, trading assets and liabilities less than \$1 billion measured as a gross sum on a worldwide-consolidated basis on the last day of each of the four prior calendar quarters.
  - **Metrics.** If trading assets and liabilities are less than \$1 billion, no metrics are required. If trading assets and liabilities are between \$1 billion but less than \$5 billion, smaller set of quantitative metrics required than if the amount is greater than \$5 billion.
  - **Minimum Compliance Standards.** Compliance program does not need to meet heightened minimum standards *unless* the institution either:
    - engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities (as measured above)
      - equal to or greater than \$1 billion, or
      - equal to ten percent or more of its total assets; *or*
    - invests in, or has relationships with, a covered fund and the covered banking entity
      - has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion, or
      - sponsors and advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than \$1 billion.



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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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