CLIENT UPDATE

THE VOLCKER RULE: AN IN-DEPTH Q&A ABOUT THE PROPRIETARY TRADING PROVISIONS

NEW YORK
Paul L. Lee
pllee@debevoise.com

Byungkwon Lim
blim@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

Lee A. Schneider
lschneid@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Samuel E. Proctor
seproctor@debevoise.com

Chen Xu
cxu@debevoise.com

WASHINGTON, D.C.
Satish M. Kini
smkini@debevoise.com

Robert T. Dura
rdura@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

Introduction

More than two years after they were originally proposed, on December 10, 2013, the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission adopted final regulations (the "Final Rule") to implement Section 13 of the Bank Holding Company Act (commonly known as the "Volcker Rule").

In a prior Client Update, we provided our initial analysis of this highly complex new regulation. This Update presents a more in-depth analysis of the proprietary trading aspects of the Final Rule and their implications for affected institutions. For the benefit of clients and friends seeking a way to understand the new regulatory framework and the principal features of the proprietary trading restrictions, we present in question-and-answer format a discussion of the most prominent components relating to the proprietary trading aspects of the Final Rule.

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1. *Scope and compliance deadlines*

1.1 What "banking entities" are subject to the Volcker Rule?

Consistent with the proposed rule, the Final Rule defines a "banking entity" as (i) an FDIC-insured depository institution (i.e., a bank, thrift or industrial loan company); (ii) a company that controls an insured depository institution; (iii) a company that is treated as a bank holding company under the International Banking Act of 1978 (generally, a foreign bank with a U.S. banking presence); and (iv) any affiliate or subsidiary of the above.[1] In short, any entity that owns an FDIC-insured depository institution is subject to the Final Rule on a consolidated basis (subject to the Final Rule's exceptions).[2]

The following entities were excluded from the definition of "banking entity" for technical reasons or to be consistent with Section 13 of the BHCA: "covered funds" that are not themselves banking entities; certain portfolio companies, including merchant banking portfolio companies; certain FDIC-insured depository institutions that only engage in certain trust and fiduciary activities; and the FDIC acting in its corporate capacity or as conservator or receiver.[3] The agencies did not exclude any other classes of entities, such as industrial companies with FDIC-insured depository institution subsidiaries.

The agencies also did not address how or whether the Volcker Rule will be applied to nonbank systemically important financial institutions ("Nonbank SIFIs") not affiliated with an insured depository institution, although Section 13 of the BHCA permits the agencies to adopt capital requirements and quantitative limits for Nonbank SIFIs.[4]

1.2 What is the deadline for compliance?

In a release accompanying the Final Rule, the Federal Reserve exercised its statutory authority under Section 13 of the BHCA to extend by one year – to July 21, 2015 – the date by which banking entities must come into full conformance with the Volcker Rule's restrictions.[5] The Federal Reserve retains statutory authority to grant additional

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1 Final Rule § __.2(c)(1). The Final Rule incorporates the definition of the term "affiliate" from Section 2(k) of the Bank Holding Company Act (the "BHCA").

2 Final Rule § __.2(c)(1).

3 Final Rule § __.2(c)(2).

4 Preamble 1.

5 Board of Governors of the Federal Reserve, Order Approving Extension of Conformance Period (December 10, 2013).

extensions, and previously adopted regulations explain how requests for extensions should be made and will be processed.[6] Because of this extension, however, the Federal Reserve now only has authority to provide two additional one-year extensions (as it has now used one of the three extensions authorized by Section 13 of the BHCA).

Notwithstanding the extension of the conformance period, certain requirements to collect and report quantitative metrics related to proprietary trading activity become effective on June 30, 2014 for banking entities that have, on a consolidated basis, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $50 billion.[7] The effective date for reporting these metrics for banking entities with less than $50 billion in trading assets and liabilities is discussed in question 8.1. For foreign banking entities, this threshold applies only to the trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located, or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States).[8] Thus, while U.S. banking entities must apply the threshold based on global operations, a foreign banking entity must apply the threshold to only its U.S. operations.

2. *Definition of proprietary trading*

2.1 What types of "proprietary trading" are prohibited?

The Final Rule prohibits a banking entity from trading any "financial instrument" as principal for its "trading account."[9] The definition of "trading account" was adopted substantially as proposed to include three categories of trading: (i) short-term trading; (ii) trading in market-risk capital rule covered positions and trading positions; and (iii) trading as a securities dealer, swap dealer, or security-based swap dealer.[10] The final rule maintains, with certain revisions, the rebuttable presumption that a financial position is

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6 Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011).

7 Final Rule § __.20(d)(1)(i), (d)(2).

8 Final Rule § __.20(d)(1)(ii).

9 Final Rule § __.3(a).

10 Final Rule § __.3(b)(1); Preamble 32-33.

presumed to be a short-term position if the position was held for a period of fewer than 60 days, or the risk of such position was substantially transferred within 60 days of the purchase or sale.[11] The agencies declined to adopt a "reverse presumption" for positions held for 60 days or more.[12] The definition of "financial instrument" was also adopted substantially as proposed to include three categories of instruments: (i) securities, including options on securities; (ii) derivatives, including options on derivatives; and (iii) futures, including options on futures.[13] Consistent with the proposed rule, and despite industry comments, foreign exchange swaps and forwards, which are excluded from the definition of "swap," are included in the definition of "financial instrument."[14] Instruments excluded from the definition include loans, spot foreign currencies and physical commodities.[15]

2.2 What activities or transactions are excluded from the definition of "proprietary trading"?

Noting that "[o]verly narrow exclusions for [proprietary trading] would potentially increase the cost of core banking services," the Final Rule broadens the exclusions from the definition of "proprietary trading" compared to the proposed rule.[16] The following categories of transactions are excluded: (i) repos and reverse repos; (ii) securities lending; (iii) bona fide liquidity management using securities and subject to certain conditions, including that liquidity management activities be conducted in accordance with a documented liquidity management plan; (iv) clearing activities; (v) covering short sales and similar existing delivery obligations; (vi) satisfying judicial or similar proceedings; (vii) acting solely as broker, agent or custodian (including on behalf of affiliates); (viii) purchases or sales of financial instruments through deferred compensation or similar plans; and (ix) satisfaction of debts previously contracted.[17]

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11 Final Rule § __.3(b)(2).

12 Preamble 46-47.

13 Final Rule § __.3(c)(1).

14 Final Rule § __.3(c)(1)(ii); Preamble 53-54.

15 Final Rule § __.3(c)(2).

16 Preamble 56.

17 Final Rule § __3(d); Preamble 77-78.

2.3 What is a "trading desk"?

The proprietary trading restrictions in the Final Rule focus on and apply compliance requirements to the "trading desk" level of a banking entity, defined as 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."[18] The agencies selected this definition to focus on the "functionality of the desk rather than its legal status" and would apply requirements "at the trading desk level of the organization within a banking entity or across two or more affiliates."[19]

2.4 How are primary dealer activities treated?

Under the Final Rule, banking entities that act as primary dealers (or the functional equivalent) for a sovereign government may rely on the market-making exemption (discussed below) to the prohibition on proprietary trading to the extent that the banking entity's primary dealing activities do not otherwise qualify for the underwriting exemption (also discussed below).[20] Specifically, the agencies clarified that a sovereign government and its central bank each would be considered a "client, customer, or counterparty" for purposes of the market-making exception as well as the underwriting exception, and therefore the banking entity may engage permissibly in primary dealing activities with these entities.[21]

3. ***Underwriting exemption***

The Volcker Rule exempts underwriting activities from the proprietary trading prohibition. The Final Rule adopts the underwriting exemption substantially as proposed, but clarifies that a relatively broader range of activities qualify for the exemption, as described below.[22]

3.1 What are the requirements for the exemption?

A banking entity's underwriting activities are permitted if the: (i) banking entity is acting as an "underwriter" for a "distribution" of securities, and the trading desk's "underwriting position" is related to that distribution; (ii) amount and type of securities in the trading

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18 Final Rule § __.3(e)(13).

19 Preamble 84.

20 Final Rule § __.(4)(b)(3); Preamble 248.

21 Preamble 247-248.

22 Preamble 80.

desk's underwriting position are designed to not 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; (iii) banking entity has implemented an internal compliance program to monitor such activities, including risk and other limits; (iv) compensation arrangements for personnel performing the activities are not designed to reward or incentivize prohibited proprietary trading; and (v) banking entity is licensed or registered to engage in underwriting activities.[23]

3.2 What activities are considered a "distribution"?

The Final rule defines a "distribution" as an offering of securities (i) 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) made pursuant to an effective registration statement under the Securities Act.[24] The preamble clarifies that a "distribution" includes small private placements, and that the agencies will rely on the same factors considered under Securities and Exchange Commission Regulation M to analyze the presence of special selling efforts and selling methods, including delivering sale documents, conducting road shows and receiving compensation that is greater than that for secondary trades but consistent with underwriting compensation.[25]

3.3 What activities are indicative of underwriting?

The preamble notes that the following activities are indicative of underwriting, although "the precise activities performed by an underwriter will vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted":

- Assisting an issuer in capital raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;

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23 Final Rule § __.4(a)(2).

24 Final Rule § __.4(a)(3).

25 Preamble 104-105; 12 C.F.R. Part 242.

- Purchasing securities from an issuer, a selling security holder or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[26]

3.4 Are stabilization efforts permitted?

Yes. Rather than requiring that a purchase or sale be "effected solely in connection with" an underwriting distribution (as set forth in the proposed rule), the Final Rule removes the word "solely" and requires that the underwriting position be held "in connection with" an underwriting distribution.[27] The agencies clarify that this change is intended to permit banking entities to engage in a broader range of activities, including stabilization activities, under the exemption.[28]

3.5 Can a banking entity relying on the exemption retain unsold allotments?

Yes. The agencies clarify that banking entities will be allowed to rely on the underwriting exemption to retain unsold allotments "when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution," but they will be required to "make reasonable efforts to sell or otherwise reduce the underwriting position."[29]

3.6 Are activities related to short selling permitted?

Yes. The preamble also notes that syndicate shorting and aftermarket short covering also may be permitted under the underwriting exemption.[30]

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26 Preamble 109-110.

27 Final Rule § __.4(a)(6); Preamble 112.

28 Preamble 100.

29 Preamble 112.

30 Preamble 112.

3.7 Can co-managers rely on the exemption?

Yes. Co-managers and others who have agreed to participate or are participating in a securities underwriting for or on behalf of the issuer or a selling security holder may rely on the underwriting exemption as "underwriters."[31] The agencies further clarify that members of an underwriting syndicate or lead underwriter need not be in privity of contract with the issuer or selling security holder in order to qualify for the exemption.[32]

4. ***Market-making exemption***

The Agencies faced significant challenges in distinguishing market making from prohibited proprietary trading, as market making inherently involves proprietary risk-taking. The Final Rule moves away from the proposal's "trade-by-trade" approach to analyzing market-making activities and appears to provide banking entities with greater flexibility to perform this critical function and manage associated risks.

4.1 What are the requirements for the exemption?

A banking entity may engage in market-making activities only if the: (i) trading desk that establishes and manages the "financial exposure"[33] routinely stands ready to purchase and sell financial instruments related to its financial exposure and is willing and available to quote, purchase and sell or otherwise enter into positions in those types of financial instruments for its own account in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market for the relevant types of financial instruments; (ii) amount, types and risks of the financial instruments in the trading desk's "market-maker inventory"[34] are designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers or counterparties based on the liquidity, maturity, and depth of the market and demonstrable analysis of historical customer demand for the relevant types of financial instruments,

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31 Final Rule § __.4(a)(4)(ii); Preamble 108.

32 Preamble 108.

33 "Financial exposure" is defined as 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 affiliates and managed by a particular trading desk as part of the trading desk's market-making-related activities. Final Rule § __.4(b)(4).

34 "Market-maker inventory" is defined as all of the positions in 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. Final Rule § __.4(b)(5).

among other factors; (iii) banking entity establishes an internal compliance program, including risk and other limits; (iv) compensation arrangements of persons performing market-making activities are not designed to reward or incentivize prohibited proprietary trading; and (vi) banking entity is licensed or registered to act as a market-maker.[35]

The Final Rule does not require a "trade-by-trade" analysis of whether a particular position is a market-making position, and instead allows market makers to maintain and monitor the overall "financial exposure" and "market-maker inventory" held by each trading desk.[36]

4.2 Is a banking entity permitted to hedge risk of its market-making desks on an aggregated basis?

Yes. While the agencies recognized that banking entities may manage risks at a higher aggregate level than individual trading desks, they noted that "this risk management activity is not permitted under the market-making exemption" though it may be permitted under the risk-mitigating hedging exemption, provided that the requirements of the risk-mitigating hedging exemption are met.[37] At the same time, the agencies note that a market-making desk may engage in a risk-mitigating transaction with a second trading desk of the same banking entity or an affiliate that is engaged in permissible market-making.[38] In such a case, both trading desks would be able to rely on the market-making exemption.

4.3 How would a market-making desk show historical customer demand for new products or asset classes?

The agencies acknowledge that a market maker in a new asset class or market may look to reasonably expected future developments on the basis of a trading desk's customer relationships and experience with similar products, as well as other factors such as expected evolution of demand and market events.[39] While the Final Rule acknowledges that banking entities may examine such forward-looking factors, it is not yet clear exactly how the agencies might apply heightened scrutiny to determinations based exclusively on forward-looking, as opposed to backward-looking, factors. Along these lines, the agencies

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35 Final Rule § __.4(b).

36 Final Rule § __.4(b)(2)(ii); Preamble 194-195.

37 Preamble 283-284.

38 Preamble 204.

39 Preamble 254, 258.

note that an approach that does not provide for any consideration of historical trends could result in a heightened risk of evasion.[40]

4.4 Is a market-making trading desk required to hedge ***all*** of its risk?

Generally, yes. While the Final Rule does not explicitly require a market-making trading desk to hedge all risks arising from its market-making activities, the market-making trading desk is required to "demonstrably reduce or otherwise significantly mitigate … the risks of its financial exposure" associated with market-making activities.[41]

4.5 Does market-making related hedging need to comply with the risk-mitigating hedging exemption?

No. Market-making related hedging need not separately comply with the risk-mitigating hedging exemption so long as such hedging is conducted or directed by the trading desk conducting the market-making activity.[42]

4.6 Is "trading by appointment" permitted?

Yes. Market makers in highly illiquid markets may engage in trading by appointment to the extent there is demand for liquidity in the relevant products.[43]

4.7 Is a market-making trading desk permitted to engage in interdealer trading?

Yes. The agencies recognize that interdealer trading provides certain market benefits and clarify that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of inventory management activities.[44] However, in determining the reasonably expected near-term demands of clients, customers or counterparties, a trading desk generally may not account for the trading interests of a trading desk or other organizational unit of another banking entity with aggregate trading assets and liabilities of $50 billion or greater, unless (i) the trading desk documents how and why a particular desk or unit should be considered a customer; or (ii) the purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading

40 Preamble 257 n. 933.

41 Final Rule § __.4(b)(2)(iii)(B); Preamble 268.

42 Preamble 282.

43 Preamble 209.

44 Preamble 252.

facility that permits trading on behalf of a broad range of market participants.[45] The agencies note that interdealer trading will "bear some scrutiny."[46]

4.8 Is a banking entity permitted to act as an "authorized participant" for exchange traded funds?

Yes. The Final Rule permits banking entities to act as "authorized participants" for exchange traded funds ("ETF") via the inclusion, for purposes of the market-making exemption, of both market participants seeking to purchase ETF shares and the ETF itself within the definition of clients, customers and counterparties.[47] Thus, inventories of ETF shares or underlying instruments held by an authorized participant may be evaluated under the criteria of the market-making exemption, including whether holdings relate to reasonably expected near-term customer demand.[48]

4.9 Is arbitrage trading permitted?

Generally no. The agencies note that a trading desk would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading that is not in response to, or driven by, the demands of clients, customers or counterparties.[49] However, trading activity used by a market maker to maintain a price relationship expected and relied upon by clients, customers and counterparties is permitted as it is related to the demands of clients, customers and counterparties because the relevant instrument has the capability of being exchanged, converted or exercised for or into another instrument.[50]

5. ***Risk-mitigating hedging exemption***

The risk-mitigating hedging exemption was the subject of considerable debate during the rulemaking process, and the agencies responded by including new requirements that appear to limit ability of banking entities to hedge generalized risks (such as "portfolio hedging") in reliance on the exemption. Consistent with the statutory Volcker Rule, however, the Final Rule continues to permit banking entities to hedge "aggregated" positions.

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45 Final Rule § __.4(b)(3)(i); Preamble 252.

46 Preamble 253.

47 Preamble 249.

48 Preamble 249.

49 Preamble 251.

50 Preamble 251.

5.1 What are the requirements of the exemption?

In order to qualify for the risk-mitigating hedging exemption, hedging activity must: (i) be conducted in accordance with a banking entity's written policies and procedures reasonably designed to ensure that the banking entity limit its hedging activity to risk-mitigating hedging; and (ii) at its inception (and at any subsequent adjustment) be designed to reduce or otherwise significantly mitigate, and demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks (including 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 individual or aggregate positions, contracts or other holdings of the banking entity.[51] The agencies note that the banking entity must ensure that hedging activities do not give rise to any significant new or additional risk that is not itself hedged contemporaneously in accordance with the exemption.[52]

5.2 What is portfolio hedging (generally)?

The Final Rule does not use the term "portfolio hedging." However, a banking entity is permitted to engage in risk-mitigating hedging with respect to its aggregated positions that relate to one or more identifiable risks arising from and related to identified positions, contracts or other holdings of the banking entity.[53]

The agencies state that a banking entity is not permitted to rely on the risk-mitigating hedging exemption with respect to hedging risks associated with the banking entity's assets and/or liabilities generally; hedging general market movements or broad economic conditions; hedging profit in the case of a general economic downturn; counterbalancing revenue declines generally; or otherwise arbitraging market imbalances unrelated to the risks resulting from positions lawfully held.[54]

5.3 Is dynamic hedging permitted?

Yes. In recognition of the fact that risks associated with a permissible position or aggregated positions may change or emerge over time, the Final Rule permits dynamic hedging, i.e., adjusting hedging positions as risk profiles change.[55] However, a banking

51 Final Rule § __.5(b)(2).

52 Finale Rule § __.5(b)(2)(iii).

53 Final Rule § __.5(a).

54 Preamble 327, 345-346.

55 Preamble 351.

entity is required to support decisions regarding appropriate hedging positions, strategies and techniques for ongoing hedging activity in the same manner as for initial hedging activities.[56]

5.4 Is anticipatory hedging permitted?

Yes. The Final Rule permits anticipatory hedging[57] and removed proposed requirements that would have required anticipatory hedges to satisfy various criteria, including that the hedge be established "slightly" before the banking entity became exposed to the underlying risk.[58] A banking entity's policies and procedures should address specifically when anticipatory hedging is appropriate and what policies and procedures apply to anticipatory hedging.[59] If 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.[60]

5.5 Is cross-affiliate hedging permitted?

Yes. The Final Rule permits hedging across affiliates under the risk-mitigating hedging exemption,[61] subject to additional documentation requirements.[62]

6. ***Foreign banks and foreign government obligations***

In general, the Final Rule provides foreign banking entities more flexibility with respect to trading activities outside the United States, in contrast to the application of the Final Rule to U.S. banking entities.

6.1 Are foreign banks subject to a global prohibition on proprietary trading?

No (outside of the United States). The prohibition against proprietary trading does not extend to the purchase or sale of financial instruments by a banking entity if the: (i)

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56 Preamble 351.

57 Preamble 354.

58 Preamble 353-54.

59 Preamble 354.

60 Preamble 355.

61 Preamble 333, 360.

62 Final Rule § __.5(c)(1)(iii).

banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States; (ii) purchase or sale is made pursuant to section 4(c)(9) or 4(c)(13) of the BHCA (essentially, requiring that the banking entity's business be centered outside of the United States); and (iii) purchase or sale meets the following conditions:

- The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States;
- The banking entity (including relevant personnel) that makes the trading decision is not located in the United States or organized under the laws of the United States;
- The purchase or sale, including any related hedging, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States;
- No financing for the banking entity's purchases or sales is provided directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States; and
- The purchase or sale is not conducted with or through any U.S. entity (which is any entity that is, is controlled by, or is acting on behalf of or at the direction of any other entity that is located in the United States or organized under the laws of the United States) other than: (A) the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale; (B) a purchase or sale with an unaffiliated market intermediary acting as principal, provided the transaction is centrally cleared; or (C) a purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly centrally cleared.[63]

6.2 Can a foreign bank trade in home country securities?

Yes. In addition to the general exemption discussed in the response to the previous question, a foreign banking entity may use its U.S. operations to engage in otherwise prohibited proprietary trading in the United States in "home country" obligations and obligations of any multinational central bank of which the home country is a member, so

[63] Final Rule § __.6(e).

long as the purchase or sale is not made by an FDIC-insured depository institution.[64] This exemption also applies to trading in obligations of agencies and political subdivisions of the home country, but does not extend to derivatives of foreign sovereign obligations.[65]

6.3 Can a foreign subsidiary of a U.S. bank trade in the government obligations of the subsidiary's home country?

A foreign bank or broker-dealer controlled by a U.S. banking entity is permitted to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized, including obligations of an agency or political subdivision of that sovereign.[66] This exception does not apply to branches,[67] and a U.S. affiliate may not finance the transaction.[68] Proprietary trading in foreign sovereign debt by U.S. banking entities is generally prohibited,[69] and derivatives on foreign government obligations are not included in the exemption.[70]

7. ***Other exemptions***

7.1 Are insurance company activities subject to the prohibition on proprietary trading?

No. The Final Rule exempts the purchase or sale of financial instruments by an insurance company or an affiliate solely for the general account or separate accounts of the insurance company, provided such activity is conducted in compliance with and subject to insurance investment law and regulation applicable to the insurance company. The agencies have revised the definitions of "general account" and "separate account" to remove any gaps in the definitions, thereby ensuring that all insurance company assets will be covered by the exemption.[71]

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64 Final Rule § __.6(b)(1)(iii).

65 Final Rule § __.6(b)(1)(iii); Preamble 381.

66 Final Rule § __.6(b)(2).

67 Final Rule § __.6(b)(2)(i).

68 Final Rule § __.6(b)(2)(iii).

69 Preamble 378.

70 Preamble 381.

71 Final Rule § __.6(d); Preamble 406.

7.2 Is asset-liability management exempt from the prohibition?

No. The Final Rule does not broadly permit asset-liability management, earnings management or scenario hedging.[72] These activities would need to independently qualify for an exemption.[73]

7.3 Can FX swaps and forwards be used to hedge interest rate, duration and other risks?

Yes. Consistent with the proposed rule, the Final Rule includes foreign exchange swaps and forwards in the definition of "financial instrument," making them subject to the proprietary trading prohibition.[74] Nevertheless, such instruments may be used to hedge interest rate, duration and other risks in reliance on an exemption, and the preamble provides examples of such permitted trading.[75]

7.4 Are municipal obligations subject to the prohibition?

No. The Final Rule exempts trading in obligations of U.S. States and their political subdivisions from the prohibition, and expands the exception to include trading in obligations of agencies and instrumentalities of States and their subdivisions by using a definition based on the Securities Act definition of "municipal securities."[76] Trading in derivatives on municipal securities, however, is generally prohibited.[77]

7.5 Is trading on behalf of customers exempt from the prohibition?

Yes. The Final Rule exempts both fiduciary transactions, where the transaction is conducted for account of, or on behalf of, a customer, so long as the banking entity does not have or retain beneficial ownership of the financial instruments, as well as "riskless principal" transactions, in which a banking entity offsets orders to purchase (or sell) by purchasing (or selling) for its own account in order to offset the contemporaneous sale to (or purchase from) such customer.[78] Consistent with other precedents, the riskless

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73 Preamble 66.

73 Preamble 66.

74 Final Rule § __.2(h)(1)(iii); § __.3(c)(1)(ii); Preamble 53-54.

75 Preamble 55.

76 Final Rule § __.3(e)(12); § __.6(a)(3).

77 Preamble 388.

78 Final Rule § __.6(c); Preamble 395.

principal exemption does not permit a banking entity to purchase or sell a financial instrument without a customer order for the instrument.[79]

8. *Recordkeeping and reporting requirements*

The recordkeeping and reporting requirements of the Final Rule have been streamlined, but are the first aspect of the Final Rule to become effective (on June 30, 2014).

8.1 Which banking entities are required to collect and report quantitative metrics about trading activities and when do they need to start reporting?

Reporting begins June 30, 2014: for banking entities with $50 billion or more in consolidated trading assets and liabilities.[80]

Reporting begins April 30, 2016: for banking entities with $25 billion or more in consolidated trading assets and liabilities.[81]

Reporting begins December 31, 2016: for banking entities with $10 billion or more in consolidated trading assets and liabilities.[82]

8.2 What are "trading assets and liabilities" for purposes of these thresholds?

The thresholds referred to in the previous question apply to the worldwide trading assets and liabilities of a U.S. banking entity and the trading assets and liabilities of a foreign banking entity's U.S. operations (including branches and agencies).[83]

8.3 What metrics must be reported?

Banking entities that meet the thresholds set out above are required to record and report seven quantitative metrics, a smaller number than the number listed in the proposed rule.[84] These metrics, which are to be calculated for each trading day, are: (i) Risk and Position Limits and Usage; (ii) Risk Factor Sensitivities; (iii) Value-at-Risk ("**VaR**") and Stress VaR; (iv) Comprehensive Profit and Loss Attribution; (v) Inventory Turnover; (vi) Inventory

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79 Final Rule § __.6(c)(2); Preamble 397.

80 Final Rule § __.20(d)(2).

81 Final Rule § __.20(d)(2).

82 Final Rule § __.20(d)(2).

83 Final Rule § __.20(d)(1).

84 Final Rule § __.20(d); Final Rule Appendix A, Section III.

Aging; and (vii) Customer-Facing Trade Ratio.[85] Reporting would occur for banking entities that meet the $50 billion threshold each calendar month within 30 days of the end of the relevant calendar month, but beginning with the information for the month of January 2015, the information shall be reported within 10 days of the end of each calendar month.[86] All other banking entities required to report are required to report at the end of each calendar quarter within 30 days of the end of that calendar quarter.[87]

The Final Rule includes details on how to calculate the metrics.[88]

9. ***Compliance policies and procedures***

Now that the Final Rule has been adopted, affected banking entities will need to begin to adapt and implement the specific compliance programs that are required by the Final Rule, which increase in stringency with the size and trading activities of a banking entity.

9.1 What policies and procedures are required?

The Final Rule adopts a "tiered" approach to compliance requirements, as described below.

Banking entities that do not engage in proprietary trading activities or covered fund activities and investments are not required to establish a compliance program prior to engaging in such activities and investments.[89]

Banking entities with total consolidated assets of $10 billion or less that engage in covered trading or covered fund activities or investments may satisfy the compliance requirements by updating existing compliance policies and procedures to reference the Final Rule and Section 13 of the BHCA.[90]

Banking entities with total consolidated assets greater than $10 billion that engage in covered trading or covered fund activities must establish a new compliance program.[91]

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85 Final Rule Appendix A, Section III, IV.

86 Final Rule § __.20(d)(3).

87 Final Rule § __.20(d)(3).

88 Final Rule Appendix A, Section IV.

89 Final Rule § __.20(f)(1).

90 Final Rule § __.20(f)(2).

91 Final Rule § .20(a)-(b); Preamble 772-774.

Banking entities with 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, including branches and agencies) or that are required to comply with the quantitative metric reporting requirements (based on the trading asset and liability thresholds described above) are subject to heightened compliance requirements, including a CEO attestation.[92]

9.2 Are the same compliance policies and procedures required for all banking entities?

No. Banking entities are permitted to tailor compliance policies and procedures to the size, scope and complexity of their activities.[93] For example, if a banking entity's activities involved only proprietary trading, policies and procedures would need to address those activities but would not need to address the covered fund prohibitions.[94]

9.3 Can compliance policies and procedures be applied on an enterprise-wide basis?

Yes. A banking entity is permitted to employ common policies and procedures that are established on an enterprise-wide basis or business-unit level to the extent that such policies and procedures are appropriately applicable to more than one trading desk or activity and as long as all the otherwise applicable compliance program requirements are satisfied.[95]

9.4 What are the limits on employee compensation?

As noted above, the underwriting, market-making and risk-mitigating hedging exemptions include requirements that the compensation arrangements of persons performing the exempt activities not be designed to reward or incentivize proprietary trading.[96]

The Final Rule also requires banking entities subject to the heightened compliance program requirements to include in required policies and procedures details regarding the compensation arrangements, including incentive arrangements, for employees associated with each relevant trading desk.[97]

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92 Final Rule § __.20(c).

93 Final Rule § __.20(a).

94 Preamble 791.

95 Preamble 801.

96 Final Rule § __.4(a)(2)(iv), __.4(b)(2)(v), __.(5)(b)(3).

97 Final Rule Appendix B, Section II, Paragraph A.

9.5 Does the CEO attestation requirement apply to all banking entities?

No. Only banking entities subject to the heightened compliance requirements (see Question 9.1 above for the relevant thresholds) are subject to the CEO attestation requirement.[98]

9.6 What must the attestation address?

The CEO of the banking entity must annually attest in writing to the relevant agency that the banking entity has in place a program reasonably designed to achieve compliance with section 13 of the BHCA and the Final Rule.[99]

In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations who is located in the United States.[100]

The Final Rule does not contain any explicit exception to the CEO attestation requirement for an industrial company with an insured depository institution subsidiary.

10. ***Statutory backstops***

10.1 Are there any additional restrictions on proprietary trading?

Yes. The Final Rule includes, with certain revisions from the proposal, provisions to implement the statutory "backstops" that prohibit proprietary trading that would involve or result in a material conflict of interest, would result in a material exposure to high-risk assets or high-risk trading activities, or would pose a threat to the safety and soundness of the banking entity or the United States.[101] A material conflict of interest exists under the rule if the banking entity engages in any activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer or counterparty with respect to such activity.[102] Subject to certain limits, these conflicts may be mitigated through the use of disclosure or the establishment of information barriers.[103]

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98 Final Rule Appendix B, Section III.

99 Final Rule Appendix B, Section III; Preamble 802-803.

100 Final Rule Appendix B, Section III.

101 Final Rule § __.7(a); Preamble 434; 457.

102 Final Rule § __.7(b)(1).

103 Final Rule § __.7(b)(2); Preamble 447.

10.2 Are there additional restrictions relating to high-risk activities and strategies?

Yes. As discussed above, another statutory backstop involves material exposures to high-risk assets and high-risk trading strategies. High-risk assets and trading strategies, if held or engaged in by a banking entity, 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.[104] The Final Rule does not provide much gloss on what assets or activities might fall within these definitions, but the agencies state that "the expansive scope of section 13 of the BHC Act supports … [an] inclusive approach focusing on the facts and circumstances of each potential conflict or high-risk activity."[105] Thus, it is not yet clear under what circumstances the agencies will enforce these provisions.

11. ***Interpretive guidance and penalties for violations***

11.1 Is there a standard process for requesting interpretive relief or guidance from the agencies?

No. The Final Rule does not include a provision for requesting interpretive relief or guidance from the agencies. Rather, Section 13(e)(2) of the BHCA mandates that each agency enforce compliance with respect to a banking entity under the respective agency's jurisdiction. The agencies recognize that banking entities may be subject to jurisdiction by more than one agency, but "plan to coordinate their examination and enforcement proceedings under section 13, to the extent possible and practicable, so as to limit duplicative actions and undue costs and burdens for banking entities."[106]

Thus, it remains to be seen the extent to which the agencies will coordinate on interpretive, supervisory and enforcement matters, or whether the agencies will develop a predetermined process or protocol for coordination.

Certain provisions of the Final Rule contemplate "joint determinations," but it is not clear how any such joint determinations would be made (i.e., the applicable legal authority or administrative process, including an opportunity for public comment).[107]

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104 Final Rule § __.7(c).

105 Preamble 434.

106 Preamble 861.

107 See, e.g., Final Rule § __.10(c)(14)(i).

11.2 What are the consequences of noncompliance?

Any banking entity that engages in an activity or makes an investment in violation of the Final Rule or acts in a manner that functions as an evasion of the Final Rule shall, upon discovery, promptly terminate such activity and, as relevant, dispose of the investment.[108]

The Final Rule provides the agencies authority to take any action permitted by law to enforce compliance with the Final Rule, "including directing the banking entity to restrict, limit or terminate any or all activities [under the Final Rule] … and dispose of any investment."[109] Notably, this "termination" provision was revised from the proposed rule to remove an opportunity for a "hearing" and to apply to "any and all activities" under the Final Rule, as opposed to "the activity" that is the subject of a violation (as was the case in the proposed rule).[110]

The agencies note in the preamble that they may rely on their inherent authorities under otherwise applicable provisions of banking, securities and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law.[111]

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Please do not hesitate to contact us with any questions.

January 6, 2014

[108] Final Rule § __.21(a).

[109] Final Rule § __.21(b).

[110] Preamble 855-856.

[111] Preamble 858.