

ADVISORY | Dodd-Frank Act

October 11, 2011

VOLCKER RULE: PROPOSED REGULATIONS – PROPRIETARY TRADING PROVISIONS

On October 11, 2011, the Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation issued proposed regulations implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the “Volcker Rule.”¹ The Volcker Rule consists of two key restrictions. First, banking entities are prohibited from engaging in proprietary trading (“Proprietary Trading Provisions”). Second, banking entities are prohibited from sponsoring or investing in private equity or hedge funds, or extending credit to or engaging in other covered transactions with affiliated private equity or hedge funds (“Covered Fund Provisions”).² The Proprietary Trading Provisions are covered in Subpart B of the proposed regulations, and the Covered Fund Provisions are covered in Subpart C of the proposed regulations. This client alert outlines the Proprietary Trading Provisions.

The agencies are requesting comment on the proposed regulations on or before January 13, 2012. The Volcker Rule provisions in Dodd-Frank become effective 12 months after issuance of final rules by the agencies, or July 21, 2012, whichever is earlier.

PROHIBITION ON PROPRIETARY TRADING

What activities are prohibited?

- The proposed regulations prohibit “covered banking entities” from engaging in “proprietary trading.”
 - “Covered banking entities” include (1) insured depository institutions, (2) companies that control insured depository institutions, (3) companies that are treated as bank holding companies for purposes of section 8 of the International Banking Act of 1978, and (4) any affiliate or subsidiary of an entity described in (1) through (3), except certain qualifying investment funds and their subsidiaries.
 - The term “proprietary trading” means “engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions.” The term does not include acting solely as agent, broker, or custodian for an unaffiliated third-party.
 - A “covered financial position” is any position, including any long, short, synthetic or other position in (i) a security, including an option on a security, (ii) a derivative, including an option on a derivative, or (iii) a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery. The term does not include any position that is a loan, commodity, or foreign exchange or currency.

¹ For an overview of the Volcker Rule, please see our previous client alerts: “Final Volcker Rule Provisions” (July 21, 2010) and “Volcker Rule Study by the Financial Stability Oversight Council” (January 31, 2011).

² For an overview of the Covered Fund Provisions, please see the client advisory, “Volcker Rule: Proposed Regulations – Covered Fund Provisions” (Oct. 11, 2011).

- A “trading account” is any account that is used by a covered banking entity to (1) acquire or take one or more covered financial positions principally for the purpose of short-term resale, benefiting from actual or expected short-term pricing movements, realizing short-term arbitrage profits, or hedging one of these positions; (2) acquire or take one or more covered financial positions (other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery) that are market risk capital rule covered positions, provided the banking entity or its holding company calculates risk-based capital ratios under the market risk capital rule; or (3) acquire or take one or more covered financial positions for any purpose, if the covered banking entity is an SEC-registered dealer or municipal securities dealer, registered government securities dealer, SEC-registered security-based swap dealer, CFTC-registered swap dealer, or otherwise engaged in the business of a dealer, security-based swap dealer, or swap dealer, provided that the covered financial position(s) is acquired or taken in connection with the activities of such business.
 - Presumption – An account is presumed to be a “trading account” if it is used to acquire or take a covered financial position that the covered banking entity holds for a period of 60 days or less, unless the entity can demonstrate that the covered financial position was not acquired or taken principally for short-term resale, benefiting from actual or expected short-term pricing movements, realizing short-term arbitrage profits, or hedging one of these positions.
 - Exclusions – An account is not deemed a “trading account” to the extent the account is used to acquire or take a position in one or more covered financial positions (1) that arise under a repurchase or reverse repurchase agreement pursuant to which the covered 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; (2) that arise under a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement satisfying certain criteria; (3) for the bona fide purpose of liquidity management and in accordance with a documented liquidity management plan that satisfies various criteria; or (4) that are acquired or taken by a covered banking entity that is a registered derivatives clearing organization.

What exemptions apply to the prohibition on proprietary trading?

- The proposed regulations contain exemptions from the prohibition on proprietary trading for permitted underwriting activities, market making-related activities, risk-mitigating hedging activities, and certain other trading activities.
 - *Underwriting activities* – The prohibition does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity’s underwriting activities. A purchase or sale is deemed to be made in connection with a covered banking entity’s underwriting activities if:
 1. The entity has established an internal compliance program designed to ensure compliance with the regulations (see discussion, below);
 2. The covered financial position is a security;

3. The purchase or sale is effected solely in connection with a distribution³ of securities for which the entity is acting as underwriter⁴ ;
 4. The covered banking entity is, with respect to a purchase or sale effected in connection with a distribution of securities, an SEC-registered dealer or engaged in the business of a dealer outside the United States, with respect to a purchase or sale effected as part of a distribution of one or more municipal securities, a registered municipal securities dealer, or, with respect to a purchase or sale effected as part of a distribution of one or more government securities, a registered government securities dealer;
 5. The underwriting activities are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties;
 6. The underwriting activities are designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to appreciation in the value of the covered financial positions or hedging of covered financial positions; and
 7. The compensation arrangements of persons performing underwriting activities are designed not to reward proprietary risk-taking.
- *Market making-related activities* – The prohibition does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity’s market making-related activities. A purchase or sale is deemed to be made in connection with a covered banking entity’s underwriting activities if:
1. The entity has established an internal compliance program designed to ensure compliance with the regulations (see discussion, below);
 2. The trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in the covered financial position for its own account on a regular or continuous basis;
 3. The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;
 4. The covered banking entity is, with respect to a purchase or sale effected in connection with a distribution of securities, an SEC-registered dealer or engaged in the business of a dealer outside the United States, with respect to a purchase or sale effected as part of a distribution of one or more municipal securities, a registered municipal securities dealer, or, with respect to a purchase or sale

³ The term “distribution” means an offering of securities, whether or not subject to registration, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

⁴ The term “underwriter” means (a) a person who has agreed with an issuer of securities or selling security holder to purchase securities for distribution, to engage in a distribution of securities for or on behalf of such issuer or selling security holders, or to manage a distribution of securities for or on behalf of such issuer or selling security holder, and (b) a person who has an agreement with such a person to engage in distribution of such securities for or on behalf of the issuer or selling security holder.

effected as part of a distribution of one or more government securities, a registered government securities dealer;

5. The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to appreciation in the value of the covered financial positions or hedging of covered financial positions;
 6. The market making-related activities are consistent with the proposed regulations' commentary; and
 7. The compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.
- A purchase or sale of a covered financial position also shall be deemed to be made in connection with market making-related activities if the covered financial position is purchased or sold to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings and the purchase or sale satisfies the requirements in the proposed regulations for risk-mitigating hedging activities.
 - *Risk-mitigating hedging activities* – The prohibition does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity and is designed to reduce the specific risks to the entity in connection with and related to such positions, contracts, or other holdings. Such a purchase or sale is deemed to be made in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity and is designed to reduce the specific risks to the entity in connection with and related to such positions, contracts, or other holdings if:
 1. The entity has established an internal compliance program designed to ensure compliance with the regulations (see discussion, below);
 2. The purchase or sale (a) is made in accordance with the entity's written policies, procedures, and internal controls, (b) hedges or otherwise mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity, (c) is reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate, (d) does not give rise at the inception of the hedge to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings of the entity and that are not hedged contemporaneously, (e) is subject to continuing review, monitoring, and management by the covered banking entity, and (f) the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.

- Other trading activities –
 - *Government Obligations.* The prohibition does not apply to the purchase or sale by a covered banking entity of a covered financial position that is an obligation of the United States or an agency thereof; an obligation, participation, or other instrument issued by the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; or an obligation of any state or political subdivision thereof.
 - *On Behalf of Customers.* The prohibition does not apply to the purchase or sale of a covered financial position by a covered banking entity on behalf of customers. Such a purchase or sale is on behalf of customers if (i) the purchase or sale is conducted by a covered banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for a customer, is conducted for the account of the customer, and involves solely covered financial positions of which the customer is beneficial owner; (ii) the covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase or sell a covered financial position from a customer, purchases or sells the covered financial position for its own account to offset a contemporaneous sale to or purchase from the customer; or (iii) the covered banking entity is an insurance company that purchases or sells a covered financial position for a separate account, and the insurance company and purchase or sale satisfy certain criteria.
 - *Regulated Insurance Companies.* The prohibition does not apply to the purchase or sale of a covered financial position by an insurance company or any affiliate of an insurance company if (i) the insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator, (ii) the insurance company or its affiliate purchases or sells the covered financial position solely for the general account of the insurance company, (iii) the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the state or jurisdiction in which the insurance company is domiciled, and (iv) the appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant state insurance commissioners, have not jointly determined after notice and comment that a particular law, regulation, or written guidance is insufficient to protect the safety and soundness of the covered banking entity.
 - *Trading Outside the United States.* The prohibition does not apply to the purchase or sale of a covered financial position by a covered banking entity if (i) the covered banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states, (ii) the purchase or sale is conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act, and (iii) the purchase or sale occurs solely outside of the United States.
 - A purchase or sale is deemed to be conducted pursuant to paragraph (9) or (13) if (a) with respect to a covered banking entity that is a foreign banking organization, the banking entity is a qualifying foreign banking organization and conducting the purchase or sale in compliance with subpart of Federal Reserve Regulation K or (b) with respect to a covered banking entity that is not a foreign banking organization, the entity meets at least two of the three requirements: (1) total assets of the entity held outside of the U.S. exceed total assets of the entity held in the U.S., (2) total revenues derived from the business of the entity outside of the U.S. exceed total revenues derived from

the business of the entity in the U.S., and (3) total net income derived from the business of the covered banking entity outside of the U.S. exceed total net income derived from the business of the entity in the U.S.

- A purchase or sale is deemed to have occurred solely outside of the United States if (1) the covered banking entity conducting the purchase or sale is not organized under the laws of the United States or one or more states, (2) no party to the purchase or sale is a resident of the United States, (3) no personnel of the covered banking entity who is directly involved in the purchase or sale is physically located in the United States, and (4) the purchase or sale is executed wholly outside of the United States.

Do any requirements or limitations apply to the exemptions outlined above?

- The proposed regulations impose recordkeeping and reporting requirements and conflicts of interest limitations in connection with the exemptions.
 - *Reporting and Recordkeeping* – A covered banking entity engaged in any proprietary trading activity exempted in the proposed regulations is required to comply with the reporting and recordkeeping requirements in the proposed regulations, if the covered banking entity, together with affiliates and subsidiaries, has traded assets and liabilities the average gross sum 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, as well as other requirements imposed by the appropriate federal agency.
 - *Material Conflicts of Interest* – No transaction is permissible if the transaction would (1) involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties, (2) result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy, or (3) pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.
 - A “material conflict of interest” exists if the covered banking entity engages in any transaction, class of transactions, or activity that would involve or result in the covered banking entity’s interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, unless the covered banking entity makes a timely and effective disclosure of the conflict and provides the client, customer, or counterparty the opportunity to negate the conflict or the covered banking entity establishes information barriers to prevent the conflict from involving or resulting in a materially adverse effect on a client, customer, or counterparty.
 - A “high-risk asset” means an asset or group of related assets that would, if held by the covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail. A “high-risk trading strategy” is a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or fail.

Are covered banking entities required to develop compliance programs to ensure and monitor compliance with the prohibition on proprietary trading?

- Yes. Each covered banking entity is required to develop a program reasonably designed to ensure and monitor compliance with the prohibitions on proprietary trading, and such program

must be appropriate for the size, scope, and complexity of activities and business structure of the entity.

- *Minimum Requirements* – The minimum requirements for the program include (1) internal written policies and procedures reasonably designed to document, describe, and monitor trading activities subject to the proposed regulations and to ensure that such activities comply with section 619 of Dodd-Frank and the proposed regulations, (2) a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 619 of Dodd-Frank and the proposed regulations and to prevent the occurrence of activities that are prohibited by section 619 and the proposed regulations, (3) a management framework that clearly delineates responsibility and accountability for compliance, (4) independent testing of the effectiveness of the compliance program conducted by qualified personnel of the entity or by a qualified outside party, (5) training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program, and (6) making and keeping records sufficient to demonstrate compliance with section 619 of Dodd-Frank and the proposed regulations, which the entity must promptly provide to the appropriate federal agency upon request and retain for a period of at least five years.
- *Additional Requirements* – Certain covered banking entities are subject to enhanced program requirements relating to reporting and recordkeeping for trading desks' purchases and sales of covered financial positions. These covered banking entities generally include entities that (1) have trading assets and liabilities equal to or greater than \$1 billion or equal to or greater than 10 percent of total assets or (2) invest in or have relationships with or sponsors or advises a covered investment fund and the entity's investments in such funds is equal to or greater than \$1 billion.
- *No Required Program*. If a covered banking entity does not engage in proprietary trading, the entity satisfies the requirements if its existing compliance policies and procedures include measures that are designed to prevent the covered banking entity from becoming engaged in such activities and require the entity to develop a compliance program consistent with the minimum requirements if the entity engages in proprietary trading activities.

If you would like to discuss the proposed regulations and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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